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REFORMING THE IMF

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A. Introduction

2.01 Although the overall objective of the International Monetary Fund (the 'Fund')—the promotion of international monetary and financial stability—has remained constant over the past 60 years, the role it has played to achieve that objective has evolved considerably in light of changes in the global economy.[1]

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[1] The purposes of the Fund enumerated in the Articles of Agreement are, in fact, more specific:

> The purposes of the International Monetary Fund are:
> (i) To promote international monetary cooperation through a permanent institution which provides the machinery for consultation and collaboration on international monetary problems.
> (ii) To facilitate the expansion and balanced growth of international trade, and to contribute thereby to the promotion and maintenance of high levels of employment and real income and to the development of the productive resources of all members as primary objectives of economic policy.
> (iii) To promote exchange stability, to maintain orderly exchange arrangements among members, and to avoid competitive exchange depreciation.

A somewhat stylized overview:

- When it was established, the Fund performed primarily a regulatory function. Under the original Articles of Agreement, each member maintained the value of its currencies relative to the currencies of other members, and the Fund was charged with overseeing the performance of these obligations. While the Fund also had financial powers, these powers could be seen as supporting this regulatory function: by making its resources available to meet balance of payments problems—problems which would put pressure on a member's exchange rate—the Fund helped members adhere to their obligations.
- Following the collapse of the par value system in the early 1970s, the Fund relied increasingly on its financial powers. The steady growth of private capital flows to emerging market economies, while generally beneficial, generated periods of instability when these economies borrowed—sometimes with the encouragement of their creditors—more than they could repay. By providing financial support for members' economic adjustment programmes during these periods, the Fund facilitated the normalization of relations between sovereign creditors and their creditors, a process which sometimes necessitated the restructuring of unsustainable debt.
- The Fund also exercised its financial powers in other contexts. Following the collapse of the former Soviet Union, Fund-supported adjustment programs played a critical role in the integration of Central and East European countries into the global economy. Separately, since the mid-1970s, the Fund has provided concessional financing to address the specific types of balance of payments problems experienced by low-income countries.[2]

During the period of 2004–8, the Fund took advantage of the relatively benign conditions **2.02**
in the global financial markets to reflect on whether, given the evolution of the global economy, it is adequately prepared to address future challenge.[3] During this unusual period

> (iv) To assist in the establishment of a multilateral system of payments in respect of current transactions between members and in the elimination of foreign exchange restrictions which hamper the growth of world trade.
> (v) To give confidence to members by making the general resources of the Fund temporarily available to them under adequate safeguards, thus providing them with opportunity to correct maladjustments in their balance of payments without resorting to measures destructive of national or international prosperity.
> (vi) In accordance with the above, to shorten the duration and lessen the degree of disequilibrium in the international balances of payments of members.
>
> The Fund shall be guided in all its policies and decisions by the purposes set forth in this Article.
> (Articles of Agreement, Article I.)

[2] Such concessional financing is currently provided under a framework where the Fund administers, as trustee, resources contributed by donors to low-income members; see Instrument to Establish the Poverty Reduction and Growth Facility and Exogenous Shocks Facility Trust in *Selected Decisions and Selected Documents of the International Monetary Fund*, Thirty-Second Issue, Washington, DC, 31 December 2007 (hereinafter *Selected Decisions*), 143–74.

[3] This process was initiated by the Managing Director's Medium-Term Strategy which is set forth in the Managing Director's Report on Implementing the Fund's Medium-Term Strategy (5 April 2006). The Managing Director's Report On The Fund's Medium-Term Strategy (15 September 2005) available at: <http://www.imf.org/external/np/omd/2005/eng/091505.pdf>; The Managing Director's Report on Implementing the Fund's Medium-Term Strategy (5 April 2006) available at: <http://www.imf.org/external/np/pp/eng/2006/040506.pdf> and Statement by the Managing Director on Strategic Directions in the Medium-Term Budget (12 April 2007) available at: <http://www.imf.org/external/np/pp/eng/2008/041208.pdf>.

of introspection, a consensus emerged around several themes. First, the Fund needed to update the role it performed in overseeing members' exchange rate policies, referred to as its 'surveillance function'. Second, if it wished to continue to remain relevant to its emerging market members, it also needed to modify the design of its financial facilities. Third, the system the Fund relied upon to finance its administrative expenditures would require reform in order to place its own finances on a sustainable footing. Finally, and as with other international organizations established in the wake of the Second World War, the Fund's governance structure needed to be updated to reflect the enhanced role of emerging markets in the world economy.

2.03 A considerable amount of progress has been made with respect to these issues. Shortly before the 2008 spring meetings of the International Monetary and Finance Committee, the Fund approved two separate amendments to the Articles of Agreement that would modernize both its income and governance structure. In addition, in the summer of 2007, the Fund overhauled the legal framework it relies upon to assess members' exchange rate policies.

2.04 The financial crisis that swept through the global economy in the autumn of 2008 further accelerated the reform process. In the lending area, a key breakthrough has been the establishment of the Flexible Credit Line, which has enabled the Fund to commit large amounts of financing to members on a precautionary basis. In other areas, however, the crisis has only served to underline the need for further reform. Perhaps most importantly, recent events demonstrate that the Fund's capacity to fashion and implement global responses to global problems is likely to require further reforms in its governance structure, with a view to giving emerging markets a greater voice in the decision-making process.

2.05 This chapter discusses the reforms that have taken place to date and their implications for the Fund and its membership going forward.

B. Revising the Legal Framework for Surveillance

(1) Background

2.06 Article IV of the Articles sets forth obligations of members regarding both their exchange rate policies and those domestic policies that have an impact on their exchange rates.

Article IV. Obligations Regarding Exchange Arrangements

Section 1. General obligations of members

Recognizing that the essential purpose of the international monetary system is to provide a framework that facilitates the exchange of goods, services, and capital among countries, and that sustains sound economic growth, and that a principal objective is the continuing development of the orderly underlying conditions that are necessary for financial and economic stability, each member undertakes to collaborate with the Fund and other members to assure orderly exchange arrangements and to promote a stable system of exchange rates. In particular, each member shall:

(i) endeavor to direct its economic and financial policies toward the objective of fostering orderly economic growth with reasonable price stability, with due regard to its circumstances;

(ii) seek to promote stability by fostering orderly underlying economic and financial conditions and a monetary system that does not tend to produce erratic disruptions;

(iii) avoid manipulating exchange rates or the international monetary system in order to prevent effective balance of payments adjustment or to gain an unfair competitive advantage over other members; and

(iv) follow exchange policies compatible with the undertakings under this Section.

2.07 The current text of Article IV was incorporated into the Articles by the Second Amendment of the Articles of Agreement in 1978 (the 'Second Amendment').[4] Prior to the Second Amendment, a member had to express the value of its currency in terms of gold, either directly or through the US dollar. A member who changed the value of its currency beyond a certain limit without the concurrence of the Fund would become ineligible to use the Fund's resources. Under the Articles, the Fund could concur only if it was satisfied that the change was necessary to correct a 'fundamental disequilibrium'.[5]

2.08 With the adoption of the Second Amendment, members were given flexibility with respect to their choice of exchange arrangement, which could include, for example, a floating exchange rate. However, it did not abandon the principle that exchange rates are a matter of international concern. In this respect, the present text of Article IV represents a delicate political compromise among the Fund's members and, as is sometimes the case with language that is the product of negotiation, a number of terms are vague and obscure.

2.09 In 2006, and as a means of facilitating a review that led to the adoption of the 2007 Decision (discussed below), the Fund's Legal Department prepared a paper that analysed the legislative history of Article IV (hereinafter 'The Legal Department Paper').[6] This analysis identified several principles that guided the drafters of Article IV, which may be summarized as follows:

2.10 First, Fund members should no longer resist an adjustment in their exchange rates if such an adjustment is necessary in light of underlying economic and financial conditions. There was a concern that the fixed exchange rate system had been excessively rigid, with members failing to adjust even in circumstances of fundamental disequilibrium. This rigidity was perceived as having undermined the sustainability of the overall system. Accordingly, by allowing exchange rates to move in response to underlying conditions, the Second Amendment was designed to enhance the long-term stability of the system of exchange rates.

2.11 Second, the Second Amendment recognized the important relationship between domestic policies and exchange rates. The view was taken that the overall stability of the exchange rate system would be enhanced by the pursuit of appropriate domestic policies; eg by 'fostering orderly underlying conditions for economic and financial stability'.

[4] For the consolidated text of the Second Amendment and a commentary on its provisions, see 'Proposed Second Amendment to the Articles of Agreement, a Report by the Executive Directors to the Board of Governors', IMF (1976).

[5] Art IV, Section 5(a) of the original Articles of Agreement.

[6] 'Article IV of the Fund's Articles of Agreement—An Overview of the Fund's Legal Framework' (28 June 2006), available at: <http://www.imf.org/external/np/pp/eng/2006/062806.pdf>.

Accordingly—and unlike the text of the original Articles—the Second Amendment introduced obligations with respect to members' domestic policies. However, as can be seen in para 2.06 above, these obligations (set forth in Article IV, Section 1(i) and (ii)) are of a particularly 'soft' nature, taking into account that the priniple that members should not have to give up a significant degree of sovereignty with respect to policies that, while they may have an international impact, are of a domestic nature.

2.12 Finally, members should avoid pursuing exchange rate policies that pose particular problems for other members or the system more generally. Accordingly, a specific obligation under Article IV, Section 1 is the requirement that members 'avoid manipulating exchange rates or the international monetary system in order to prevent effective balance of payments adjustment or to gain an unfair competitive advantage'.[7] Unlike the obligations with respect to domestic policies, members' exchange rate obligations are of a 'hard' nature, which was considered appropriate given their direct international impact. As will be discussed below, the potential applicability of the obligation to avoid manipulation is constrained by the need to determine intent.[8]

2.13 As noted in the Legal Department Paper, the present Article IV also sets forth obligations for the Fund. Specifically, under Article IV, Section 3(a), the Fund is required to oversee the international monetary system to ensure its effective operation and to oversee the compliance of each member with its obligations under Article IV.[9] Given the relative importance of exchange rate obligations under Article IV, Section 1, the Articles specifically direct the Fund to exercise firm surveillance over the exchange rate policies of members and to adopt specific principles for the guidance of members with respect to those policies.[10] To meet this obligation, the Fund conducts consultations with members, normally on an annual basis, which are generally referred to as 'Article IV Consultations'.[11]

(2) The 2007 Decision

2.14 The surveillance decision adopted in 2007 (the '2007 Decision') establishes a comprehensive and unified legal framework designed to guide the Fund in the performance of its surveillance responsibilities under Article IV.[12] It replaces the decision adopted by the Executive Board in 1977, which was generally recognized as being incomplete and outdated. The 2007 Decision may be described as comprising three elements. First, it provides further clarity regarding the meaning of members' obligations under Article IV to avoid exchange rate manipulation. Second, it updates the principles that are designed to provide guidance to members' other obligations regarding exchange rate policies. Finally, it identifies the domestic policies of members that the Fund will assess for purposes of conducting surveillance. Each of these elements will be discussed in turn. This section also briefly discusses the application of the decision to members that form part of a currency union.

[7] Articles of Agreement, Art IV, Section 1(iii).
[8] Legal Department Paper, 1–2.
[9] Articles of Agreement, Art IV, Section 3(a).
[10] Articles of Agreement, Art IV, Section 3(b).
[11] The procedures for Art IV Consultations are set forth in *Selected Decisions*, 50–2.
[12] See *Selected Decisions*, 24–33.

(a) Exchange rate manipulation

2.15 A key achievement of the 2007 Decision is that it provides guidance as to the meaning of the relatively complex and obscure text of Article IV, Section 1(iii), which requires members to 'avoid manipulating exchange rates or the international monetary system in order to prevent effective balance of payments adjustment or to gain an unfair competitive advantage over other members'. While it was not possible to provide clarity with respect to all elements of this provision (for example what constitutes manipulation of the 'international monetary system'?), agreement was reached on a sufficient number of concepts to make the provision operational for the first time since its adoption in 1978.[13] Specifically:

1. First, 'manipulation' of the exchange rate is only carried out through policies that both target and affect the level of an exchange rate. Policies that have an effect on the exchange rate but are not directed at it cannot give rise to manipulation. However, it is recognized that manipulation can be carried out in a number of different ways. For example, it could occur through excessive intervention in the exchange markets or through the imposition of capital controls. Importantly, there is agreement that manipulation would not necessarily require movement of the exchange rate. It may also be designed to prevent movement in the rate.
2. Second, even if it is demonstrated that a member is 'manipulating' its exchange rate, the member would only be acting inconsistently with Article IV, Section 1(iii) if the Fund were to determine that such manipulation was being undertaken for the purpose of either (a) preventing effective balance of payments adjustment or (b) gaining an unfair competitive advantage over other members. It was agreed that a member could only be considered to be manipulating its exchange 'to gain an unfair competitive advantage' if two elements were found to be present. First, it would need to be determined that the member was pursuing these exchange rate policies for purposes of securing fundamental exchange rate misalignment in the form of an undervalued exchange rate; the concept of 'fundamental exchange rate misalignment' corresponding to a situation where a member's underlying current account (which comprises trade and services) differs from its equilibrium rate.[14] Second, it would also need to be demonstrated that the member was seeking to secure such misalignment for the purpose of increasing net exports.[15]
3. Third, as is evident from the above analysis—and indeed from the text of Article IV, Section 1(iii) itself—it is necessary for the Fund to determine intent, which makes the provision more difficult to apply. It was agreed, however, that this did not mean that

[13] The guidance provided the Executive Board regarding the meaning of Art IV, Section 1(iii) is set forth in the Annex to the 2007 Decision; see *Selected Decisions*, 33, 34.
[14] This analysis was set forth in a staff paper that was endorsed by the Executive Board at the time of the adoption of the 2007 Decision: 'Review of the 1977 Decision—Proposal for a New Decision—Companion Paper' (22 May 2007) (hereinafter 'The Companion Paper'), available at: <http://www.imf.org/external/np/pp/2007/eng/nd.pdf>.
[15] Importantly, the 2007 Decision does not attempt to provide guidance with respect to the alternative basis for a violation of Art IV, Section 1(iii), namely, where a member manipulates its exchange rate 'in order to prevent effective balance of payments adjustment'.

the Fund would be required simply to accept the representation made by the member regarding the purpose for its actions. Rather, while such a representation would be given the benefit of any reasonable doubt, the Fund would take into account all other available evidence regarding members' policies; that is, the Fund would make its own independent and objective assessment of intent.[16]

(b) Principles on exchange rate policies

2.16 As is discussed above, in the context of its exercise of surveillance over the exchange rate policies of members, the Articles require the Fund to adopt specific principles for the guidance of members with respect to those policies. Although an important component of the 2007 Decision is an update of these principles, progress on this question required the resolution of a number of legal questions. In particular, since it was recognized that the principles had to take into account the scope of members' obligations in this area, the question arose as to what obligations—other than the obligation relating to manipulation, discussed above—were applicable to exchange rate policies. Moreover, to the extent that other obligations existed, what implications would the non-observance of a principle have on a member's adherence to these obligations? The advice provided in the Legal Department Paper may be summarized as follows:

1. With respect to the specific obligations that are enumerated in Article IV, Section 1(i)–(iv), the injunction against exchange rate manipulation is the only obligation that specifically applies to 'exchange rate policies', which the Fund has always understood as being limited to policies that are imposed for balance of payments reasons. As is evident from both the text of the provision and its legislative history, the obligations set forth in Article IV, Section 1(i) and (ii), all apply to domestic policies. Regarding Article IV, Section 1(iv), which requires members to 'follow exchange policies compatible with the undertakings' of Article IV, Section 1, the meaning of this provision is relatively obscure and the legislative history provides very little illumination. Consistent with general principles of interpretation, it may be argued that the term 'exchange policies' should be understood as meaning something other than the term 'exchange rate policies', perhaps policies regarding the use of exchange controls.
2. Notwithstanding the above, the general obligation to collaborate under Article IV provides a basis for the Fund to specify exchange rate policy obligations that are additional to those specifically identified in Article IV, Section 1(i)–(iv). This conclusion takes into account the text of the relevant provision. As can be seen from para 2.06, the sentence that links the general collaboration obligation to the specific obligation reads 'In particular, each member shall'. Based on the use of the term 'in particular' in this sentence, it is reasonable to conclude that the specific obligations which follow, although they represent particularly important ways in which the general collaboration obligation may be fulfilled, are not the *only* measures needed to meet this general obligation; that is, the general obligation is broader in scope than the sum total of the four

[16] As noted by the Legal Department Paper, this approach is consistent with the term 'a balance of payments purposes has been interpreted in the context of Fund arrangements'. See Legal Department Paper, below, at para 2.16.

specific obligations. A contrary interpretation—one which would conclude that the specific obligations exhaust the general obligation—would render the general obligation redundant, contrary to general principles of statutory construction. Moreover, the concept of using the general obligation of collaboration to require members to take more specific actions was relied upon by the Fund after the breakdown of the par value system but prior to the adoption of the Second Amendment.

3. In light of the above, it would be legally feasible for the Fund to rely upon the general collaboration obligation set forth in Article IV, Section 1 as a basis for requiring that members take—or refrain from taking—those actions that, while not included in the specific obligations listed in Article IV, Section 1, are considered by the Fund to be necessary, in light of changing circumstances—to assure orderly exchange arrangements and promote a stable system of exchange rates. It was recognized, however, that the Fund could—relying again on the practice followed prior to the Second Amendment—stop short of identifying such actions as an obligation but, instead, give them the status of a non-binding 'recommendation'.[17]

2.17 Taking into account the above analysis, the Executive Board established a new principle which would have the legal status of a non-binding recommendation. This principle provides that 'a member should avoid exchange rate policies that result in external instability'. The concept of 'external stability' merits some discussion since it is critical not only to the new principle but also to the 2007 Decision more generally. The central thesis of the 2007 Decision is that members satisfy their obligations under Article IV to collaborate in the promotion of a 'stable system of exchange rates' by promoting their own 'external stability', which is defined as 'a balance of payments that does not and is not likely to give rise to disruptive exchange rate movements'. This definition seeks to capture the concept that the Fund is concerned not only with the stability of the member in question but also the effect of the member's external position on the stability of other members.

2.18 In light of the definition of 'external stability' described above, the new principle introduced by the 2007 Decision covers a broader range of situations than 'exchange rate manipulation' in a number of respects. First, there is no requirement that the Fund demonstrate intent: if the exchange rate policies—whatever their intent—result in external instability, there is a problem. Second, the concept of 'external instability' is broader than the concept of 'fundamental misalignment in the form of an undervalued exchange rate' (which, as noted above, is an important component of the definition of exchange rate manipulation). Specifically, an unstable balance of payments position—unlike fundamental misalignment—may arise from either the current or capital account. Moreover, it may manifest itself as either an overvalued or undervalued exchange rate. In one respect, however, the activity precluded by the new principle is more limited than exchange rate manipulation. While, in the latter case, it is not necessary to demonstrate that fundamental

[17] As noted by the Legal Department Paper, this approach was followed after the collapse of the par value system but prior to the Second Amendment, relying on Art IV, Section 4(a) of the original Articles of Agreement, which required members to 'collaborate with the Fund to promote exchange stability'; see Legal Department Paper, 10–11.

misalignment actually exists (only that it is intended), non-observance of the new principle will occur only if external instability exists.

2.19 When the Fund's Executive Board approved the adoption of the above principle, a number of Executive Directors sought—and received—assurances regarding the implications of a determination by the Fund that a member had not observed this principle. It was generally recognized that, upon such a determination, the member may need considerable latitude in terms of when and how it brings itself into conformity with the principle. To that end, the 2007 Decision specifically provides '[i]n circumstances where the Fund has determined that a member is implementing policies that are not consistent with these Principles and is informing the member as to what policy adjustments should be made to address this situation, the Fund will take into consideration the disruptive impact that excessively rapid adjustment would have on the member's economy.' Separately, and in light of the recognition that the Fund could transform the new exchange rate principle from a recommendation to an obligation, Executive Directors sought some assurance that such a step would not be taken without adequate procedural safeguards. To that end, the 2007 Decision provides that a determination by the Fund that a member is not following one of these recommendations 'would not create a presumption that member is in breach of its obligations under Article IV, Section 1'. Moreover, the relevant staff paper pointed out that the Fund would need to take several steps before a member that was not following a recommendation could be found in breach of the general obligation of collaboration.[18] First, the Fund would need to adopt a policy of general applicability—that is, not specific to a particular member—which provided that the conduct identified in the recommendation was an obligation under the Articles. This decision would need to be general in application in light of the principle of uniformity of treatment of members: the Fund would be precluded from requiring certain conduct from one country and only recommending it to another. Once such a decision was adopted, members would need to be given adequate time to bring their policies into conformity with the new obligation before the Fund determined the member to be in breach of its obligations.

(c) Domestic policies

2.20 The original 1977 Decision did not provide guidance to members with respect to domestic policies, notwithstanding the fact that, as noted earlier, Article IV makes it clear that such policies are a matter of legitimate interest to the Fund. While, as a matter of practice, Article IV consultations with individual members typically include an analysis of domestic policies, a key objective of the 2007 Decision was to articulate explicit guidance to the entire membership in a manner that ensured both (a) adequate focus (there had been criticism that Fund coverage of domestic policies had, on occasion, been excessively broad) and (b) uniformity of treatment among members. Several aspects of the 2007 Decision's treatment of domestic policies should be highlighted. First, in terms of the appropriate objectives of such policies, the 2007 Decision states that 'a member promotes external stability when it pursues policies that promote domestic stability'. Accordingly, provided that a member's domestic polices are promoting domestic stability, the Fund could not

[18] See Review of the 1977 Decision on Surveillance over Exchange Rate Policies—Further Considerations, 22–3.

require the member to change these domestic policies in the interest of external stability. Second, consistent with the text of Article IV, Section 1(i) and (ii), the concept of 'domestic stability' recognizes the imperative of achieving an appropriate balance between economic growth and price stability. Finally, with respect to the range of domestic policies that will generally be assessed by the Fund, the 2007 Decision provides that while monetary, fiscal, and financial sector policies will always be the subject of Fund surveillance, other policies will be examined 'only to the extent that they significantly influence present or prospective external stability'. This last feature was designed to encourage greater focus during the Article IV Consultation process.

(d) Currency unions

2.21 During the discussions that led to the adoption of the 2007 Decision, the question arose as to how the conceptual framework set forth in the decision would be applied to members that form part of a currency union. From a legal perspective, the issue is relatively straightforward. The obligations of Fund members under the Articles of Agreement are not modified when they become members of currency unions. Accordingly, while certain policies that are relevant to the performance of a member's obligations under Article IV may be delegated by the members to union-level institutions, individual members remain accountable to the Fund for those policies and fulfil their individual obligations by ensuring that union-level institutions act consistently with these obligations. When conducting surveillance under Article IV, the Fund considers the policies of the union-level institutions as being conducted on behalf of the currency union's members.

2.22 From an economic perspective, however, it became clear during the discussion of the 2007 Decision that application of the framework to currency unions presented some challenges. First, it was necessary to distinguish between those policies relevant to Article IV that are carried out at the union level and those that are carried out at the individual member level. Although the allocation may differ depending on the union in question, it was recognized that exchange rate and monetary policies will generally be carried out at the union level, while other financial and fiscal policies may be carried out at the level of the individual members. Accordingly, the content of Fund discussions with individual members and union institutions would be shaped by this allocation. Second, the 2007 Decision specifically recognizes that, given the definition of external stability—'a balance of payments position that does not, and is not likely to, give rise to disruptive exchange rate movements'—this concept must be understood as relating to the balance of payments of the union, as it is only at this level that disruptive adjustments in exchange rates can arise. Accordingly, when union-level institutions implement policies that promote the external stability of the union, such policies would be consistent with the obligations of individual members under Article IV. When evaluating the domestic policies implemented by the individual union members, the Fund would assess whether these policies promote the domestic stability of the individual member concerned. If so, these policies would be considered to be promoting the external stability of the union.[19]

[19] For further analysis of the implications of the 2007 Decision for currency unions, see Companion Paper, 10–11.

C. Governance Reform

2.23 Although discussion of the merits of changes in the Fund's governance structure is hardly new, over the past year calls for reform in this area have grown in urgency.[20] There has been a concern that failure by the Fund to take meaningful action to address perceived inequities and inefficiencies in the decision-making process could undermine its legitimacy and effectiveness. It is possible to identify several different strands of criticism.

2.24 First, there is concern that the Fund has failed fully to adhere to the key principle that guides the determination of a member's voting power in the Fund; namely that of relative economic weight. Emerging-market economies have been particularly vocal in their criticism that the size of 'quotas'—which determine both the size of their voting power and the level of access to Fund resources—no longer reflects their relative size in the global economy. After a series of financial crises in Asia and Latin America where Fund decisions played a major role in guiding the economic policies of these countries, there is a growing perception that, unless steps were taken to increase the influence of the countries in the Fund's decision-making process, they would rely, instead, on their own regional arrangements.

2.25 Second, a separate, but related, issue pertains to perceived problems with the size and composition of the Executive Board, which makes most key strategic and operational decisions and, accordingly, is the primary organ through which a member's voting power is expressed. While any steps taken to increase the voting power of emerging-market economies will eventually address concerns that they are inadequately represented on the 24-member body, there is also the view that, separately, the representation of European members should be consolidated into a single chair, appropriately reflecting European integration in the monetary, financial, and economic areas.[21] Such a consolidation would also address concerns that the Executive Board has grown to be too large to be an effective decision-making body.

2.26 Finally, a specific problem exists regarding the representation of low-income members in the Fund. Although, unlike emerging-market economies, their economic weight does not provide the basis for an increase in voting power, there is a recognition that, given the number of Fund-supported programmes with these members, their voice in the Fund needs to be enhanced. At a minimum, increases in quotas for emerging-market members should not excessively dilute this voting power.[22]

[20] For a discussion of reform proposals that recently have been, see eg Edwin Truman 'Rearranging IMF Chairs and Shares: *The Sine Qua Non* of IMF Reform' in 'Reforming the IMF for the 21st Century', *Institute for International Economics Special Report No 19, April 2006*; see also Ngaira Woods and Dominico Lombardy. 'Uneven Patterns of Governance: How Developing Countries are Represented in the IMF', *Review of International Political Economy* 13:3 August 2006, 480–515.

[21] See Lorenzo Bini Smaghi, 'IMF Governance and the Political Economy of a Consolidated European Seat' in 'Reforming the IMF for the 21st Century', *Institute for International Economics Special Report* No 19. April 2006.

[22] See 'Reform of Quota and Voice in the International Monetary Fund—Report of the Executive Board to the Board of Governors', International Monetary Fund, 28 March 2008, (hereinafter 'Report on Quota and Voice'), available at: <http://www.imf.org/external/np/pp/eng/2008/032108.pdf>, pp 5–7 and 'Proposed Amendment of the Articles of Agreement Regarding Basic Votes—Preliminary Considerations'.

2.27 Set forth below is a brief overview of the progress that the Fund has made over the past two years on the above issues. As will be seen, while important steps have been taken, the reform process will be protracted and, given the political sensitivities, rather complex.

(1) Quota Adjustments

2.28 When a country becomes a member of the Fund, it receives a quota, which has a number of important implications in its relationship with the Fund. First, it determines the size of its financial subscription to the Fund.[23] (Unlike the World Bank, the resources the Fund makes available to members in credit operations consist of the proceeds of member subscriptions rather than the proceeds of capital market borrowing.) Second, it generally determines the amount of financial assistance it may receive from the Fund in the event of balance of payments difficulties.[24] Finally, a member's quota determines a member's voting power in the Fund (along with the relatively small number of 'basic votes' it receives, discussed below).[25] While the Fund has the power to increase or decrease a member's quota, such a decision requires both support of 85 per cent of the total voting power and the consent of the member concerned.[26]

2.29 The primary basis for determining a member's quota is the 'quota formula', which has appropriately been made up of variables that are relevant to the role of quotas, as described above. Accordingly, a member's GDP and reserve level have been included as indicators of a member's capacity to finance Fund operations. A member's current payments and receipts (its openness) and the variability of these payments and receipts were also included since they provided indications of the extent to which a member may need balance of payments assistance from the Fund.[27] The quota formula has never been applied mechanistically. Rather, it always provided a basis for discussion. Other factors are also taken into account, including how the economy of the new member compared with that of other members with similar characteristics. Moreover, members' quotas have been regularly increased across the board periodically in order to satisfy the Fund's need for liquidity, irrespective of whether this increase was consistent with the application of the quota formula.[28] For these reasons, a member's actual quota does not always conform to the quota that corresponds to the direct application of the quota formula.

22 December 2006 (hereinafter 'Report on Basic Votes') available at: <http://www.imf.org/external/np/pp/eng/2006/122206a.pdf>.

[23] Articles of Agreement, Art III, Section 1.

[24] More specifically, a member's quota is used to determine a member's annual and cumulative access limits. The current annual and cumulative access limits are 100% of quota and 300% of quota, respectively; see *Selected Decisions*, 353–4.

[25] Articles of Agreement, Art XII, Section 5(a).

[26] Articles of Agreement, Art II, Section 2(a) and (c).

[27] For a more detailed discussion of the quota formula see 'Quotas—Updated Calculations and Data Adjustments', Appendix III: available at: <http://www.imf.org/external/np/pp/2007/eng/071107.pdf>. For a comprehensive discussion of recent quota reform proposals, see also Truman, 'Rearranging IMF Chairs and Shares: The Sine Qua Non of IMF Reform,' above n 20 at 210–30.

[28] The Articles require that the Fund undertake a 'General Review' of quotas at least every five years: Articles of Agreement, Art III, Section 2(a). The most recent general review that resulted in an increase in quotas was the Eleventh General Review, completed in 1997.

2.30 A key element of reform was the modification of the quota formula. There was a broad consensus that the quota formula was excessively complicated and needed to be made more transparent: the formula actually consisted of a combination of five formulae, all of which used the variables described above, but with different weights. Views differed, however, regarding the extent to which the variables themselves should be modified and the amount of weight that should be accorded to each of them. A number of Executive Directors were of the view that overall economic size was the most relevant variable and, accordingly, GDP should be given greater weight. Perhaps most importantly, there was a strong view held by some that GDP should be measured by purchasing power parity rather than by market exchange rates. Reliance on purchasing power parity, which would benefit large emerging-market economies, was considered by these Executive Directors to be the best—and most dynamic—way of measuring the relative volume of goods and services produced by economies.[29]

2.31 It was recognized at the outset that the agreement on a new quota formula would be sensitive and, accordingly, time-consuming. Accordingly, the reform was structured in two stages. The first stage involved increasing the quotas of those members who—even on the basis of the traditional quota formula—were the most under-represented. This stage was completed during the 2006 Annual Meetings when the Fund's Board of Governors approved an increase in the quotas of China, Korea, Turkey, and Mexico, which were increased by 27 per cent, 79 per cent, 24 per cent, and 22 per cent, respectively.[30] The second stage was completed in April 2008, when the Executive Board approved a new quota formula and, on the basis of this new formula, the Board of Governors approved an increase in the quotas of 54 members, many of them being emerging-market members.[31] Importantly, the new quota formula increases the weight of GDP to 50 per cent (making it the most significant of the four variables) and GDP is calculated using a blend of market exchange rates and purchasing power parity (60 per cent and 40 per cent, respectively).[32]

2.32 By one standard, the outcome of the reform is very modest: the overall size of Fund quotas increased by 11.5 per cent, with the aggregate shift in relative quota shares to those that received quota increases being 4.9 per cent.[33] This shift would only result in a net increase in the voting share of emerging-market and developing economies of 2.7 per cent. Perhaps more important, however, are the commitments that have been made to continue the quotas adjustment process. Specifically, the relevant Board of Governors Resolution provides that, as a means of ensuring 'that members' quota shares continue to reflect their relative positions in the world economy, the Executive Board is requested to recommend further

[29] See Report on Quota and Voice, 2. For a discussion of the benefits of Purchasing Power Parity, see also Truman, above, n 20, 12.

[30] The new quotas offered China, Korea, Turkey, and Mexico were 27%, 79%, 24%, and 22%, respectively; see Singapore Board of Governors Resolution No 61-5, available at: <http://www.imf.org/external/np/pp/eng/2006/083106.pdf>, pp 6–8.

[31] Board of Governors Resolution No 63-2, April 2008, available at: <http://www.imf.org/external/np/pp/eng/2008/032108.pdf>, pp 19–23.

[32] Report on Quotas and Voice, 2–3.

[33] Report on Quotas and Voice, 4–6.

realignments of members' quota shares in the context of future general quota reviews'.[34] Under the Fund's Articles, while such general reviews are required to take place every five years, they have typically only resulted in quota increases when the Fund's overall liquidity position requires replenishment. The above-quoted text indicates that adjustments will be made in the context of these general reviews, irrespective of overall liquidity needs, if such adjustments are judged to be needed to realign members' relative quota shares in the Fund.

2.33 The financial crisis that erupted in 2008 has given fresh momentum to further shifts in voting power. As the Fund's financing function has emerged as a critical element of the effort to contain the crisis (to be discussed further below), emerging markets have pressed for a further transfer of voting power in their direction, emphasizing that, given the far-reaching implications of the Fund's decisions in this—and other—areas, emerging markets needed to have a greater say in the decision-making process. In October 2009, the Fund's International Monetary and Financial Committee issued a communiqué indicating its support for 'a shift in quota share to dynamic emerging market and developing countries of at least five percent from over-represented countries to under-represented countries using the current quota formula as the basis to work from'. Although the communiqué is non-binding—and the relevant language somewhat obscure—it signals considerable political support for a further shift in voting power.

(2) Addressing the Needs of Low-Income Members

2.34 The treatment of low-income members within the governance reform framework presented the Fund with a particular challenge. On the one hand, it was abundantly clear that, by any metric, the weight of these countries in the world economy is still relatively small and, accordingly, there was no likelihood that their quotas would be increased in any significant way under the reforms discussed above. On the other hand, as an operational matter, the Fund was more actively engaged with this group of members than perhaps any other. With the decline of lending to emerging-market members, most of the Fund's financial assistance over the past several years has been provided to low-income countries through the Fund's concessional lending facility. Moreover, the Fund provides a considerable amount of technical assistance and advice to these members in areas that are relevant to the Fund's work (for example monetary and fiscal policy, legal and regulatory frameworks to support the financial sector). For this reason, there was a consensus that steps needed to be taken to enhance the voice of these members in the Fund.

2.35 It should be noted that the measures taken by the Fund to address this issue take into account the fact that the Fund is not, in fact, a development institution. Accordingly, while the measures taken are of particular benefit to low-income members, they are of broader applicability. As discussed below, they involve two components: (a) an increase in 'basic votes' and (b) the appointment of a second Alternate Executive Director. Both require an amendment of the Fund's Articles.

[34] Board of Governors Resolution No 63-2, April 2008, Section B, above.

(a) Increasing basic votes

2.36 Article XII, Section 5(a) provides that a member's voting rights consist of two components. The first component is made up of what are generally referred to as 'basic' votes, which are allocated to each member in an equal amount, set at 250 votes. The second component is allocated to members in proportion to the size of their quotas and, accordingly, varies among members.[35] As is evident from the legislative history of the Articles of Agreement, Article XII, Section 5(a) was adopted at the Bretton Woods Conference in 1944 as a balance between two alternative bases for determining voting power. On the one hand, given the Fund's role as a financial institution, it was recognized during the Bretton Woods negotiations that a member's voting power in the Fund should reflect the size of the member's financial contribution to the Fund. On the other hand, as an intergovernmental organization constituted through a multilateral treaty, it was considered necessary to pay due regard to the equality of states under international law.[36] The voting structure in the Articles, which sought to balance these considerations, is similar to those in place in other international financial institutions.[37]

2.37 The effect of basic votes, in comparison with a voting system based exclusively on quotas, is to increase the relative voting power of members with small quotas, many—but not all—of whom are low-income members.[38] More specifically, basic votes enhance the relative voting power of those members whose quotas are below the average quota of the Fund's membership as a whole. The share of Fund total voting power represented by basic votes has decreased over time. This reflects the fact that Article XII, Section 5(a), which fixes the number of basic votes at 250, has never been amended to provide for an increase in such votes, while quotas have expanded significantly over the decades. The 250 basic votes held by each of the Fund's current members amount to 46,000 basic votes in the aggregate which, in turn, represents 2.1 per cent of the current total voting power in the Fund. In comparison, the participants in the Bretton Woods Conference at which the Articles were adopted would have had aggregate basic votes of 11,250, representing 11.3 per cent of the anticipated total voting power in the Fund at that time.

2.38 To address this decline in the relative importance of basic votes, the Fund has approved a proposed amendment of the Articles of Agreement that would both (a) triple the number

[35] Art 12, Section 5(a) provides that '[e]ach member shall have two hundred fifty votes plus one additional vote for each part of its quota equivalent to one hundred thousand special drawing rights'.

[36] See eg *Participation of the Developing Countries in the Decision-Making of the Fund*, SM/80/192 (7/31/80) at 4; and *Eleventh General Review of Quotas—Issues Relating to the Size of Basic Votes*, EB/CQuota/96/3 (2/13/96), 7. See also *Informal Minutes, Committee 3 of Commission I, United Nations Monetary and Financial Conference at Bretton Woods* (5 July 1944), (inter alia, statement by US representative that what the voting power provision in the Articles 'attempts to do is to equate, bring together and balance the rights of each country as a country and its investment in the Fund, so that both factors are represented in the votes of a particular country', 26).

[37] Specifically, the charter documents of various international financial organizations (including the IBRD, IFC, IDA, MIGA, IDB, AfDB, and AsDB) provide for a similar dual voting structure under which total voting power is the sum of members' 'proportional' votes (which are generally determined as a function of members' financial contribution) and 'basic' votes (which are allocated to each member in the same amount).

[38] For a detailed discussion of basic votes and their effect on relative voting power, see Report on Basic Votes, above.

of basic votes possessed by each member and (b) and ensure that the ratio of the sum of basic votes of all members to the sum of members' total voting power remains constant following this tripling, in the event of any subsequent changes in the total voting power of members.[39] Accordingly, in the event that there are future quota increases, this will automatically result in an increase in basic votes for all members, without the need for a further amendment of the Articles or, indeed, any decision by the Fund. While each member will be always be allocated a number of basic votes that is identical to the number allocated to other members (reflecting the principle of equality of states) the introduction of a mechanism to avoid the future erosion of basic votes as a ratio of total voting power will—as noted above—be of particular benefit to members with small quotas, including low-income members.

(b) Appointing a second alternate executive director

2.39 The Fund's Executive Board currently consists of 24 Executive Directors. As mandated by the Articles, five of these Executive Directors are appointed by the members with the largest quotas (currently France, Germany, Japan, the UK, and the USA).[40] The remaining 19 Executive Directors are elected every two years through a process where, subject to certain election rules, members are free to form member constituencies for election purposes. Because the voting power of African members is relatively small, there are only two Executive Directors elected by African members, one of these Executive Directors being elected by a constituency made up of 19 African members and the other being elected by a constituency of 24 African members.[41]

2.40 For African members seeking greater representation on the Executive Board, the optimum reform measure would have been to expand the size of the Executive Board to allow for the election of a third Executive Director from Africa. There was no appetite among the larger members of the Fund to expand the Executive Board, at least at this stage of the reform process. There was a recognition, however, that the size of the African constituencies placed a considerable strain on the ability of the relevant Executive Directors to represent their members effectively. This problem is exacerbated by the fact that members within these constituencies have traditionally had, as noted earlier, a disproportionately large number of

[39] Under the proposed amendment, Art XII, Section 5(a) would be amended to read as follows:

(a) The total votes of each member shall be equal to the sum of its basic votes and its quota-based votes.
(i) The basic votes of each member shall be the number of votes that results from the equal distribution among all the members of 5.502 percent of the aggregate sum of the total voting power of all the members, provided that there shall be no fractional basic votes.
(ii) The quota-based votes of each member shall be the number of votes that results from the allocation of one vote for each part of its quota equivalent to one hundred thousand special drawing rights.

The operation of the mechanism set forth in the amendment may, in some circumstances, also result in a decline in the number of basic votes possessed by each member. Specifically, because each member is to be allocated the same number of basic votes, the aggregate number of basic votes that corresponds to the percentage set forth in the proposed amendment will be divided by the number of Fund members to arrive at the number of basic votes to be allocated to each member. Applying this mechanism, the number of basic votes possessed by each member could decline, eg as a result of the admission of a new member whose quota is smaller than the average of Fund quotas. See Report on Basic Votes, above, at 7–8.

[40] Articles of Agreement, Art XII, Section 3(b)(i).

[41] See IMF Directory, available at: <http://www.imf.org/external/np/sec/memdir/members.htm>.

Fund-supported programmes. In that context, it should be noted that when the Fund was established there were 38 members, the largest constituency consisted of 9 members, with the average constituency consisting of 5 members. Although the Executive Board has expanded since then (from 12 to 24) this expansion has not kept up with the growth in membership (currently 185) and, accordingly, the average constituency consists of 9 members, with the 2 African constituencies, as noted above, being the largest.

2.41 To address the above concerns, the second feature of the amendment of the Articles of Agreement approved by the Fund's Board of Governors was to allow for the Executive Director elected from a large constituency to appoint two Alternate Executive Directors. Under the existing Articles, each Executive Director is entitled—and required—to appoint a single Alternate with full power to act for him or her when he or she is not present.[42] The existence of an Alternate Executive Director is designed to balance the need for a resident Executive Board at Fund headquarters, on the one hand, and the need for Executive Directors to travel to—and maintain close contact with—the members opposing or electing them. Allowing Executive Directors elected from large constituencies to appoint a second Alternate was generally regarded as providing meaningful support to these Executive Directors, given the workload, including travel, involved.

2.42 Two specific aspects of this element of the amendment merit attention. First, to provide for flexibility, the text of the amendment does not specify how large a constituency must be before it is entitled to appoint a second Alternate Executive Director. Rather, the text empowers the Board of Governors to adopt rules that enable large constituencies (as defined by the Board of Governors from time to time, taking into account changing circumstances) to appoint a second Alternate.[43] When the Board of Governors approved the proposed amendment, it also adopted the initial constituency threshold at 19 members, thereby allowing both of the Executive Directors elected by African members to appoint a second Alternate.[44] Second, in order to avoid potential conflicts, the text of the amendment requires Executive Directors appointing two Alternates to designate the Alternate who shall act for them when they are not present and both of the Alternates are present.[45]

2.43 Finally, it should be emphasized that both of these reform measures—an increase in basic votes and the appointment of a second Alternate—are not yet complete. Although the

[42] Articles of Agreement, Art XII, Section 3(e).

[43] More specifically, the text of the proposed Amendment to Art XII, Section 3(e) provides as follows (with changes from the existing text indicated):

(e) Each Executive Director shall appoint an Alternate with full power to act for him when he is not present, *provided that the Board of Governors may adopt rules enabling an Executive Director elected by more than a specified number of members to appoint two Alternates. Such rules, if adopted, may only be modified in the context of the regular election of Executive Directors and shall require an Executive Director appointing two Alternates to designate: (i) the Alternate who shall act for the Executive Director when he is not present and both Alternates are present and (ii) the Alternate who shall exercise the powers of the Executive Director under (f) below.* When the Executive Directors appointing them are present, Alternates may participate in meetings but may not vote.

[44] See Board of Governors Resolution No 63-2, April 2008, Attachment II.

[45] See Board of Governors Resolution No 63-2, April 2008, Section D.

[46] For a more detailed discussion of the proposed Amendment, see Report on Quotas and Voice, 9–11.

text of the amendment containing both these elements has been approved by the Board of Governors, the amendment will not enter into force until it has been accepted by three-fifths of the members, having 85 per cent of the total voting power.[46] For most members, acceptance of an amendment of the Articles—an international treaty—requires approval by the domestic legislature. Importantly, the relevant Board of Governors Resolution provides that the increases in quotas, discussed above, will not become effective until the amendment becomes effective.[47]

(3) The Size and Composition of the Executive Board

2.44 Although decisions have not yet been taken to modify the size and composition of the Executive Board, there is increasing momentum for reform in this area. In some respects, changes in the composition of the Executive Board will flow from the shifts in voting power that will occur if—and when—the ongoing quota adjustment process described above is fully implemented. For example, if China's quota becomes one of the five largest, it will be able to appoint its own Executive Director. More generally, as the quotas of emerging-market economies increase, some of them will obtain a sufficiently dominant position within their constituencies to ensure that one of their nationals will be elected as Executive Director. However, beyond these longer-term implications of shifting voting power, there are other forces that may lead to reform in this area. The first relates to a concern with the Board's size: with 24 Executive Directors there is a perception that the Board is too large to operate efficiently as an executive decision-making body. The second concern relates to the number of European Executive Directors. The countries of the European Union currently provide 6 of the 24 Executive Directors, 3 of whom are appointed (nationals of France, Germany, and the UK) and 3 of whom are elected from constituencies (nationals of Belgium, Italy, and the Netherlands). With European economic and financial integration, there have been growing calls for European 'consolidation' into a smaller number of seats at the Executive Board.[48] Although originating from elsewhere, these calls can now be heard from within Europe itself. More specifically, a member of the Executive Board at the European Central Bank argues forcefully that consolidation resulting in a single EU Executive Director would actually enhance the voice and influence of the EU within the Fund.[49] Since, when voting on a proposed decision, Fund Executive Directors are not permitted to split the votes of the constituents who have elected them, consolidation would force EU countries to take a single position—and vote in a single, powerful block—on issues of relevance to the Fund. Given the breadth of the Fund's mandate, however, it is not clear that the policies of individual EU members have, in fact, converged sufficiently to enable them to be represented by a single Executive Director. For example, while France has traditionally urged greater Fund involvement in low-income countries, Germany has stressed that the Fund is a monetary institution—not a development agency.

[46] Articles of Agreement, Art XXVIII.

[47] Board of Governors Resolution No 63-2, April 2008, Section A(5).

[48] See Truman, above, n 20 at 203–10.

[49] See Bini Smaghi, above, n 21 at 233–57.

2.45 If a single Executive Director were to represent all of the EU members, such a step would require an amendment of the Articles of Agreement. This is because the Articles *require* each of the members with largest five quotas to appoint their own Executive Director. Accordingly, as long as an EU member's quota is among the five largest, the member concerned could not participate in such a consolidation.[50] Perhaps because of this fact, there have also been calls recently for the election of *all* Executive Directors, most notably from the USA, a step which would facilitate future EU consolidation.[51]

D. Reforming the Fund's Lending Instruments

2.46 Until October 2008—when the financial crisis began to affect the balance of payments positions of emerging markets—members' demand for the Fund's general resources had declined significantly. As of 31 July 2008, outstanding credit was SDR 7.8 billion, as compared with SDR 70 billion in 30 September 2003.[52] While this decline in the use of Fund credit was explained, in part, by the prolonged period of global liquidity, there was concern within the Fund that the decline in demand also reflected a general reluctance for emerging-market economies to turn to the Fund in times of distress. The fact that members were taking contingency measures to address potential crises that did not involve the Fund—whether it be the build-up of their own reserves or the pooling of reserves though regional arrangements—served to underline the perceived problem. Instead of catalysing market confidence, there appeared to be a perception that approaching the Fund would create market panic by signalling that the situation is worse than thought. Separately, Fund conditionality may create domestic political difficulties by creating the impression that the government has surrendered sovereignty with respect to the conduct of its economic policies.

2.47 Taking into account the above concerns, the Fund decided to launch a comprehensive review of its lending policies in September 2008. However, shortly after the initiation of the review, the global financial crisis that had originated in the USA began to exact its toll on a number of emerging markets. During the one-year period beginning October 2008, the Fund approved stand-by arrangements for a number of emerging-market economies, primarily in Central and Eastern Europe. While the problems experienced by these members were somewhat similar to those experienced during the Asian crisis, it became clear that the broader de-leveraging process was beginning also to affect members whose overall economic policies continued to be appropriate. To address the special needs of these countries—and in order to avoid further contagion—the Fund established the Flexible Credit Line, which represents an important breakthrough in the Fund's overall financing role.[53]

[50] Articles of Agreement, Art XII, Section 3(b) provides, in part, that, of the Executive Directors, 'five *shall* be appointed by the five members having the largest quotas' (emphasis added).

[51] See 'Remarks by Treasury Under Secretary for International Affairs', David H McCormick at the Peter G Peterson Institute for International Economics, IMF Reform: Meeting the Challenges of Today's Global Economy at: <http://www.ustreas.gov/press/releases/hp838.htm>.

[52] See IMF Finances, available at: <http://www.imf.org/external/fin.htm>.

[53] See FCL Decision at: <http://www.imf.org/external/pp/longres.aspx?id=4321>.

To understand the basis and implications of this development, it is important to provide an overview of the legal and operational framework for Fund financing.

(1) The Existing Framework for Fund Financing

2.48 One of the purposes of the Fund, as set forth in the Articles of Agreement, is as follows:

> To give confidence to members by making the general resources of the Fund temporarily available to them under adequate safeguards, thus providing them with opportunity to correct maladjustments in their balance of payments without resorting to measures destructive of national or international prosperity.[54]

> Consistent with the above mandate, when the Fund makes its financial resources available to members, it has taken measures designed to satisfy itself that two conditions have been met. First, since its resources are to be used to help countries resolve their balance of payments problems, it is important that the country be implementing policies that will address—rather than simply delay the resolution of—its balance of payments problems. Second, the Fund must ensure that 'adequate safeguards' are in place to ensure that the member will be in a position to repay the Fund within the relatively short timeframe mandated under the Articles.[55] 'Conditionality' refers to the mechanism that the Fund uses to ensure that Fund financial assistance is made conditional upon the effective implementation of a credible adjustment programme thereby ensuring, in turn, that the above two conditions are in place.[56] The adoption of appropriate adjustment policies is designed not only to give the Fund some assurance that the member's balance of payments problems will be corrected but is also designed to provide the Fund with an adequate basis to conclude that the member will have sufficient foreign exchange to repay once the adjustment programme has been successfully implemented.

2.49 The stand-by arrangement is the principal instrument relied upon by the Fund to make conditionality operational. It constitutes a decision of the Executive Board to make an overall amount of resources available in support of an adjustment programme as described in a letter of intent prepared by the member. Under the terms of the stand-by arrangement, tranches of the committed resources are disbursed on the basis of the member's observance of targets ('performance criteria') and reviews that have been identified in the letter of intent and specified by the Fund's Executive Board. It should be emphasized that the amount of financing provided by the Fund has traditionally been relatively modest in comparison with a member's needs. However, the fact that the Fund has made a judgement that the member's adjustment programme merits financial support is intended to 'catalyse' financial assistance from other sources. The catalytic function not only serves to limit the amount of Fund exposure to a single member (thereby contributing to the 'safeguards' required under the Articles), it is also designed to provide a means by which a member can regain access to capital markets, thereby contributing to a lasting resolution of its external difficulties.

[54] Articles of Agreement, Art I(v).

[55] More specifically, Art V, Section 3(a) requires the Fund to adopt policies 'on the use of its general resources . . . that will assist members to solve their balance of payments problems in a manner consistent with the provisions of this Agreement and that will establish adequate safeguards'.

[56] Consistent with the requirement set forth in Art V, Section 3(a) the Fund has adopted a general policy regarding the design and implementation of its conditionality, which is reviewed periodically: see Guidelines on Conditionality, Selected Decisions.

(2) The Flexible Credit Line

2.50 Although this chapter does not try to identify the causes of—or distil the lessons from—the global financial crisis that erupted in September 2008, it is clear that its impact on emerging markets was both swift and significant. The disruption in short-term funding in mature markets, the de-leveraging and contraction of the balance sheets of financial institutions, and the overall loss of confidence are all factors that resulted in a sharp reduction of capital flows to emerging-market countries. For some of these countries, this significant reduction revealed and exacerbated important vulnerabilities in their policies, and, accordingly, an economic adjustment programme supported by a Fund arrangement has been relied upon to address these vulnerabilities, buttress confidence, and facilitate a return to market financing.

2.51 However, the sharp reduction in capital flows has also given rise to emerging pressures in countries whose policies have been very strong and where there are no concerns about the sustainability of the member's indebtedness; that is, where the member is facing liquidity pressures caused by external development and where no adjustment policies are required. While the Fund has stood ready to provide assistance to these members, they have been resistant to seek Fund financing, largely because of the stigma associated with the traditional lending instruments of the Fund and the conditionality associated with these instruments.

2.52 To address this perceived gap in the Fund's toolkit, the Fund established the Flexible Credit Line (FCL) in March 2009. The key distinguishing features of the FCL are that (a) it makes available the full amount of financing upfront without the need for traditional conditionality (that is, phasing and performance criteria) that are associated with the traditional stand-by arrangements and (b) it may be approved on a precautionary basis; that is, in the absence of an actual balance of payments need. Clearly, the design of the FCL takes into account the concerns, noted above, regarding the problems associated with traditional Fund conditionality. Moreover, the fact that the FCL may be used on a precautionary instrument is designed to enhance the Fund's capacity not only to resolve financial crises, but also to prevent them.

Several features of the FCL merit elaboration.

(a) Qualification

2.53 As noted above, 'conditionality' is required under the Articles; that is, the Fund must satisfy itself that the policies being taken by the member are adequate to ensure both the resolution of the balance of payments problems and, relatedly, repayment to the Fund. Under the FCL, this is achieved through the application of strict qualification criteria rather than through the phasing and other conditions that are found in stand-by arrangements; that is, under the FCL, the Fund relies on *ex ante* rather than *ex post* conditionality. Not surprisingly, the qualification criteria identified in the decision are those that are designed to give the Fund the assurance that, given the strong policy stance of the member and strong track record of policy performance, the member is already in a position to address its balance of payments pressures—or, if the FCL arrangement is approved on a precautionary basis, will be in such a position in the event the pressures emerge. In addition to a very

positive assessment of the member's policies in the context of the most recent Article IV Consultation, the decision establishing the FCL decision provides that the relevant criteria for the purposes of assessing qualification for an FCL arrangement shall include: (a) a sustainable external position; (b) a capital account dominated by private flows; (c) a track record of steady sovereign access to capital markets at favourable terms; (d) a reserve position that is relatively comfortable, when the FCL is approved on a precautionary basis; (e) sound public finances, including a sustainable public debt position; (f) low and stable inflation, in the context of a sound monetary and exchange rate policy framework; (g) the absence of bank solvency problems that pose an immediate threat of a systemic banking crisis; (h) effective financial sector supervision; and (i) data transparency and integrity.

(b) Amount of financing

2.54 Importantly, the decision establishing the FCL did impose strict limits on the financing that could be made available under an FCL arrangement.[57] This reflects an underlying assumption behind the FCL: large amounts of financing would need to be available if the FCL was to fulfil the key objective of preventing crisis in relatively large emerging-market economies. More specifically, the FCL would only succeed in calming nervous markets if the markets had the assurance that large amounts of financing had been committed on an upfront basis. Of course, consistent with the Fund's catalytic function, it is envisaged that markets would also take comfort from the judgement made by the Fund that the member's policies were adequate to address any pressures should they emerge; that is, the satisfaction of the relevant qualification criteria are designed, in part, to enhance the crisis prevention objective.

(c) Commitment period

2.55 A key issue that arose in the design of the FCL was the maximum length of the arrangement; that is, the length of the period during which the financing would be unconditionally available to the member. There were two competing considerations. On the one hand, there was a recognition that the period had to be sufficiently long to serve the key objective of providing comfort to both the member and the markets. On the other hand, there was a concern that an excessively long commitment period would pose risks for the Fund's resources: as time passed, there was a risk that the Executive Board's positive assessment of the member's policies *vis-à-vis* the established qualification criteria would become somewhat stale as a result of developments with respect to either the member's policies or the external environment. As a means of balancing these consideration, it was agreed that an FCL arrangement could be approved for either a 6-month or a 12-month duration. In the event that an FCL was approved for a 12-month period, the availability of financing beyond the initial 6-month period would be subject to completion of a positive assessment by the Executive Board to the effect that the member continued to meet the relevant qualification criteria.

[57] While the Summing Up of the Executive Board that was adopted an the time of the FCL decision indicates that the Executive Board 'welcomed staff's expectation that access would not normally exceed 1,000 percent of quota', this did not give rise to a binding limit of 1,000% of quota.

2.56 Since its establishment, an FCL arrangement has (as at December 2009) been approved for Mexico (SDR 31.258 billion), Colombia (SDR 6.966 billion), and Poland (SDR 13.69 billion). In all cases, the arrangements were approved on a precautionary basis and, since their approval, none of them have been drawn upon. The fact that members have not had to draw suggests that the crisis-prevention objective has been achieved. More generally, it may be argued that the mere addition of the FCL to the Fund's lending toolkit has fostered broader confidence in the market also for the benefit of members who, although they may not have actually requested an FCL arrangement, are generally perceived to satisfy the qualification criteria.

E. Developing a New Income Model

2.57 A critical element of the Fund's reform programme has been the development of a new means of financing the administrative expenditures of the Fund. The process was launched in May 2006, when the Managing Director established a Committee of Eminent Persons to Study Sustainable and Long-term Financing of IMF Running Costs (the 'Committee').[58] The Committee, chaired by Andrew Crockett, the former general manager of the Bank for International Settlements, delivered its recommendations in January 2007.[59] Taking into account these recommendations, the Managing Director and the Executive Board developed specific proposals which, because some of them entailed amendments to the Fund Articles, required approval by the Fund's Board of Governors, which was received in April 2008.[60] The process is not yet complete, however, since—as with the case of the governance amendment discussed earlier—the income amendment will not become effective until it is formally accepted by the requisite threshold of the membership.

2.58 At one level, the need to develop a new income model can be seen as simply an inevitable consequence of the decline of Fund lending. Since its establishment, the Fund has financed its administrative expenditures primarily from the interest income derived from such lending; that is, through the difference between (a) the rate of interest it charges to members utilizing its general resources (the 'rate of charge') and (b) the rate of interest it pays to those members whose currencies are used in these credit operations (the 'rate of remuneration'). As noted earlier, Fund credit involving its general resources had declined significantly and, although it is difficult to project the future demand for Fund credit, Fund staff had projected the low credit environment would persist over the medium term.[61]

[58] Press Release No 06/100, available at: <http://www.imf.org/external/np/sec/pr/2006/pr06100.htm>. The other remaining members of the Committee were Mohamed El-Erian, Alan Geenspan, Tito Mboweni, Guillermo Ortiz, Hamad Al-Sayari, and Jean Claude Trichet.

[59] 'Committee to Study Sustainable Long-Term Financing of the IMF—Final Report' (the 'Final Report of the Committee') available at: <http://www.imf.org/external/np/oth/2007/013107.pdf>.

[60] Board of Governors Resolution No 63-3. The report of the Executive Board to the Board of Governors provides a description of key aspects of the proposal; see Report of the Executive Board on the Proposed Amendment of the Articles of Agreement of the International Monetary Fund To Expand the Investment Authority of the International Monetary Fund.

[61] Final Report of the Committee, above n 59, at 4 and Appendix 4.

2.59 Even though, as discussed above, Fund lending has recently increased, there is a growing recognition that there are other problems with the Fund's traditional income model. The existing model is flawed because it relied on this credit function to finance a range of activities that was much broader than the provision of credit. These activities included not only the Fund's surveillance function, which involves annual consultation with each Fund member, but also the provision of a substantial amount of technical assistance.[62] Indeed, of the total US$930.3 billion incurred in administrative expenditure in financial year 2006, only US$220.6 million were incurred in credit intermediation activities.[63] It was recognized that it was neither equitable nor sustainable for the cost of all these activities to be financed by those members receiving financing from the Fund's general resources, particularly in an environment where such financing is expected to be somewhat concentrated within the membership. More generally, and as was noted by the Committee, the existing income model 'has the curious feature that the Fund's financial well-being depends on it being unsuccessful in its primary mission, which is to prevent financial crises'.[64]

2.60 Viewed from a purely financial perspective, the problem was not particularly urgent. As a result of the significant amount of credit extended over the previous ten years, particularly during the Asian crisis, the Fund had accumulated reserves of SDR 5.9 billion, which could have technically been used to finance the Fund's anticipated income shortfall for a number of years to come.[65] But for an institution whose mandate includes advising member countries on principles of fiscal rectitude, it was recognized that it would be somewhat hypocritical for the Fund to use reserves—which should be used primarily to mitigate the effects of future credit losses—to finance a structural income shortfall. Moreover, unless this problem was fixed, the nature of the Fund's dialogue with members could be clouded by perceptions of a conflict of interest: was the Fund's recommendation to seek a Fund finance programme motivated primarily by an interest in the well-being of the member's economy or a desire to finance the Fund's operational expenses?

2.61 As is evidenced by its report, the Committee reviewed a wide range of options, a number of which were rejected on the ground that they would risk undermining the Fund's effectiveness. In particular, the idea of introducing annual levies that would be required to be paid by each member in order to finance the Fund's operations was considered problematic since the annual appropriation process that would be involved in each member for this purpose could risk undermining the independence of the Fund's regulatory assessments policy and policy advice.[66]

2.62 The underlying principle that formed the basis for the Committee's recommendations was that, since the Fund was undertaking distinct activities—some of which benefited the entire membership and others benefited only a group of members—it was both logical and fair that these activities should have different funding sources. Accordingly, since

[62] The nature of the Fund's technical assistance is described further, below at para 2.70ff.

[63] Final Report of the Committee, Appendix 5, 3. Moreover, of this US$220.6 million, only 130.7 were expenditures related to GRA financing; ibid.

[64] Final Report of the Committee, 5.

[65] Ibid, 5.

[66] Ibid, 8.

surveillance is a 'public good' that is provided to the membership at large, the Committee concluded it appropriate that, for these activities, all members should contribute to the necessary financing. Regarding the cost of the Fund's credit intermediation activities, the cost of these activities should be borne out of the intermediation margin and should take into account the broader credit environment. Finally, members that receive technical assistance from the Fund should be charged for this assistance.[67]

2.63 The Fund supported the overall approach taken by the Committee and decided to implement many of its recommendations. However, a consensus could not form around a key recommendation of the Committee: that the Fund generate income by investing the quota subscriptions of its members.[68] Regarding those recommendations that were accepted and developed by the Fund's staff and Executive Board, set forth below is a summary of their key operational and legal features.

(1) The Sale of Gold

2.64 The Fund currently holds approximately 3,217 metric tons of gold, which are derived from two distinct sources.[69] Most of the gold represents the proceeds of a portion of the quota subscriptions made by Fund members prior to the Second Amendment, when the par value system was still in existence and gold played a central role in the international monetary system.[70] As required under the Articles, this gold is carried on the Fund's balance sheet at the historical price of SDR 35 per ounce (the price of gold at the time of the Second Amendment).[71] The remaining amount of gold held by the Fund (about 400 tons) was acquired when it accepted credit repayments from members in the form of gold during the period 1999–2000.[72] This gold was acquired at the average price of SDR 207 per ounce and is carried on the Fund's balance sheet at the value at the time of acquisition.

2.65 The Committee recommended that the Fund exercise its authority under the Articles and sell a limited portion of its gold, the profits being invested pursuant to an expanded investment authority (discussed further below) and the income of such investments being used to finance the Fund's administrative budget.[73] Since the Fund's gold holdings are 'in a broad sense the joint property of the membership' it would be equitable that these resources be used to finance the Fund's public goods, particularly the Fund's surveillance activities.[74] The recommendation on gold sales was qualified in two important respects. First, the amount of gold to be sold should be limited in amount and conducted in coordination

[67] Ibid, 6.
[68] See Report of the Executive Board on the Proposed Amendment of the Articles of Agreement of the International Monetary Fund To Expand the Investment Authority of the International Monetary Fund at 4.
[69] For a discussion of the Fund's holdings of gold and the relevant legal and accounting frameworks that apply to such holdings, see Final Report of the Committee, Appendix 6.
[70] Ibid.
[71] This corresponds to the value identified in Art V, Section 12(e), namely 'one special drawing right per 0.888 671gram of fine gold'.
[72] Final Report of the Committee, Appendix 6.
[73] Ibid, 11–13.
[74] Ibid, 12.

with existing central bank gold sales agreements so as not to add to the announced volume of gold sales from official sources. The objective was to limit strictly the market impact of such sales. For this reason, the Committee recommended that the gold sold be limited to the 400 tons that the Fund acquired during the period of 1999–2000, the distinct nature of this gold providing a useful means of 'ring fencing' the amount that would be expected to be sold.[75] Second, in recognition that the gold held by the Fund 'provides fundamental strength to the Fund's balance sheet', the Committee recommended that the investment policy have a prescribed pay-out ratio that preserves the real value of the profits of the sale over time; that is, that portion of the annual investment income that compensates for inflation should be retained.[76]

2.66 Consistent with the Committee's recommendations, on 18 September 2009, the Executive Board adopted a decision to sell 12,965,649 fine troy ounces of gold (approximately 400 tons) that have been acquired by the Fund since the date of the Second Amendment. While the actual sale transactions will be negotiated and concluded by the Managing Director on the basis of market prices, the Executive Board decision provides some direction on how these sales are to be carried out. In particular, the decisions established a framework that allows for sales to be made both directly to official holders and on the market. Consistent with the recommendations of the Committee, however, any gold sales on the market must be phased over time and conducted in a manner that ensures that such sales can be accommodated within the limit on official gold sales set forth in the Central Bank Gold Agreement dated 7 August 2009.

(2) Expansion of Investment Authority

2.67 The objective of generating income from the investment of the proceeds of the sale of the Fund's gold required the amendment of a number of provisions in the Fund's Articles that restricted the Fund's investment authority.[77] These restrictions included: (a) the requirement that resources held in the Fund's Investment Account be invested only in the obligations of a member or an international organization; (b) the need to obtain the concurrence of the member whose currency is being used to make the investment; and (c) the requirement to invest exclusively in obligations denominated in Special Drawing Rights or in the currency used for investment.[78]

2.68 Under the amendment approved by the Board of Governors, these restrictions are eliminated and the Fund is given the authority to 'use a member's currency held in the Investment Account as it may determine, in accordance with rules and regulations adopted

[75] Ibid.
[76] Ibid, 12, 13.
[77] When the Board of Governors approved the proposed amendment, it did so in the context of gold price assumptions that were lower than the actual market prices prevailing when the Executive Board adopted the decision to sell the gold in question. In recognition of this development, the Executive Board has approved a strategy whereby a portion of the resources needed for financing of the Fund's concessional lending would be financed by an amount equal to the 'windfall' generated by any gold sales undertaken at prices in excess of a specified amount.
[78] Article of Agreement, Art XII, Section 6(f)(iii).

by the Fund by a seventy percent majority of the total voting power'.[79] This text was signed to strike a balance between two different considerations. On the one hand, there was a desire to provide for the broadest possible grant of investment authority in the Articles themselves so as to avoid the need for a further amendment in the future. On the other hand, the requirement that the investments be made pursuant to policies adopted by a significant majority of voting power (no investments could be made until such rules and regulations were in place) ensured that any investments would not be made on an ad hoc basis but, rather, in accordance with a broader investment strategy that had wide support within the membership.

2.69 Although the above-referenced investment rules and regulations will not be adopted until the amendment enters into force, there is a consensus within the Executive Board (reflected in the relevant Executive Board report to the Board of Governors) that the design of these rules and regulations should be guided by several principles. First, given the Executive Board's responsibilities to conduct the business of the Fund, it is understood that the Executive Board would play a central role in both designing the investment strategy and monitoring its implementation. Second, the Fund's investment policies would take into account a range of factors, including the Fund's mandate and its income needs. Thus, for example, the assessment of the level of risk to be tolerated would take into account the public nature of the resources being invested. Moreover, the 'endowment' investment policy pursuant to which the profits of gold sales would be invested would be designed to generate income for the Fund's administrative expenditures while, at the same time, preserving the real value of the profits being invested. Finally, it was recognized that the rules and regulations would need to ensure that the Fund's expanded investment authority did not give rise to perceived or actual conflicts of interest. This was considered to be of particular importance given the fact that the Fund, in the conduct of its other responsibilities (surveillance and the provision of financial and technical assistance), regularly receives non-public information from its members.[80]

(3) Charging for Technical Assistance

2.70 In addition to its surveillance and financial assistance responsibilities, the Articles authorize the Fund to perform, upon request, 'financial and technical services'.[81] Unlike its other functions, these financial and technical services are discretionary, in as much as the Fund is not required to honour a request by a member to perform such services. In exercising this discretion the Fund may decide to perform the financial or technical service and absorb the administrative cost incurred in its performance or it may decide to perform the service on

[79] *Report of the Executive Board to the Board of Governors on the Proposed Amendment of the Articles of Agreement of the International Monetary Fund to Expand the Investment Authority of the Intentional Monetary Fund* (hereinafter 'Report on Expansion of Investment Authority'), at 11 (unpublished).
[80] Report on the Expansion of Investment Authority, 5–6.
[81] Art V, Section 2(b) provides as follows:
If requested, the Fund may decide to perform financial and technical services, including the administration of resources contributed by members, that are consistent with the purposes of the Fund. Operations involved in the performance of such financial services shall not be on the account of the Fund. Services under this subsection shall not impose any obligation on a member without its consent.

the condition that it be reimbursed in full or in part for this cost—either from the member or from a third-party donor.

2.71 Over the years, the Fund's provision of technical services—including training—has grown considerably and, for the large part, such services have been provided free of cost. These services are performed in the Fund's core area of expertise (for example monetary, fiscal, and financial sector policies, including the design and implementation of the legal and regulatory frameworks that support these policies) and, in some cases, provide input into both the Fund's surveillance work and the programmes of the members that are supported by the Fund's financial resources. While the Committee, in its report, recognized that the bilateral technical services represent a 'fundamental contribution of the Fund to the well-being of many of its member countries',[82] it expressed the view that charging members for such services had 'positive aspects', including providing an incentive for members to take a disciplined approach to their costs and benefits and enhancing Fund transparency and accountability.[83]

2.72 Building on this recommendation, the Fund's Managing Director, following consultation with the Executive Board, has introduced a new country contribution policy for Fund technical assistance.[84] The stated objective is not to raise revenue—indeed, it is recognized that the budgetary implications of a charging policy are likely to be small—but, rather, to ensure that the assistance is consistent with the priorities and objectives of the recipients.[85] As noted in the new policy, it creates a 'market test' for Fund technical assistance: namely, 'recipients' willingness to pay provides a signal of their interest and the value they attach to the Fund's capacity-building services. This signal serves as an important input into the Fund's prioritization and efficient allocation of limited resources . . . An alternative market test is the willingness of donors to finance the Fund's capacity-building services.'[86] The newly established country contribution policy incorporates a 'means-testing element': members are divided into different GNI per capita categories, with those in the higher category having to pay for the full cost of such services while those in the lowest category have to pay only 10 per cent.[87] Importantly, the policy includes exemptions for those technical assistances that are judged to provide important inputs into the Fund's other—non-discretionary—function and, using the Committee's lexicons, are judged to be 'public goods'. In particular, the Fund's assessment of members under the Financial Sector Assessment Program and the programme entitled 'Reports on Standards and Codes', while a form of technical assistance, are judged to provide important inputs into the Fund's surveillance responsibilities and are exempt from charging.[88] A similar exemption applies to technical assistance that helps members implement a programme that is supported by

[82] Final Report of the Committee, 13.
[83] Ibid.
[84] Policy for Country Contribution for Capacity Building (unpublished), Attachment I.
[85] Ibid, 10.
[86] Ibid.
[87] Ibid, 10, 11.
[88] Ibid, 12.

the Fund's financial resources.[89] The rationale is that such assistance is also of benefit to the Fund, as it helps to ensure that the member will have the capacity to repay the Fund.

F. Conclusion

2.73 Although, at a certain level of abstraction, all international organizations may be described as having the objective of enhancing human welfare, their charters direct them to make their own distinct contribution to that objective. In the case of the IMF, the 'public good' it seeks to deliver is international monetary and financial stability. The assumption in 1944—when the Articles of Agreement were signed by its original members—was that such stability was a necessary precondition for the enhancement of economic welfare. Particularly in light of the financial crisis that swept through the global economy in 2008 and 2009, there can be little question that, 65 years later, this assumption still holds. Indeed, one of the distinguishing features of the existing financial turmoil is its global reach. Although it originated in the mature economies, the crisis was transmitted not only to emerging markets but also to a number of low-income countries. Given the economic and financial integration of the world economy, the need for an institution that can organize cooperation effectively among members to achieve international financial stability has never been greater. Accordingly, the issue is not whether the IMF is needed but whether it is currently equipped both to maximize the benefits of this integration and to minimize its costs. As discussed, a process has been under way that is designed to update both the Fund's regulatory and financial powers to take into account the changes in the global economy and, by extension, the needs of its members. Looking forward, perhaps the key outstanding challenge relates to governance reform. The willingness of countries to rely on the Fund to address the challenges that have been exposed by the recent crisis may depend on whether they feel that they are adequately represented in the decision-making process.

[89] Ibid.

3

CRISIS PREVENTION: LESSONS FROM EMERGING MARKETS FOR ADVANCED ECONOMIES

*Jonathan T Fried and James A Haley**

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A. Introduction

3.01 Slightly more than a decade ago, a wave of financial crises swept across Asia, plunging the region into economic and social upheaval before engulfing Brazil, Russia, Turkey, and other emerging-market economies.[1] These crises affected economies that had been growing rapidly and which, for the most part, had hitherto been widely regarded as models for economic and social development. Although some economists had presciently warned of potential problems, the speed with which the crisis spread took most by surprise. In their wake, however, the official sector responded quickly, and a series of exceptionally

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Helpful comments from Randall Bartlett, Lee Bucheit, Michael Francis, Sean Hagan, Paul Jenkins, Mark Jewett, Cynthia Lichtenstein, Tiff Macklem, John Murray, and Doug Nevison are gratefully acknowledged. The views expressed are those of the authors and should not be attributed to the Government of Canada.

[1] The onset of the Asian financial crisis is generally attributed to the devaluation of the Thai baht on 2 July 1997. Although serious problems were evident well before that date, growing losses of foreign exchange reserves prompted the authorities to devalue the currency by 15% in an attempt to stem the outflow. But rather than stabilize the situation, the devaluation triggered even greater speculation that quickly spread throughout the region.