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# The Politics of IMF Lending

Michael Breen



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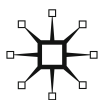
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# The Politics of IMF Lending

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# Contents

<i>List of Figures and Tables</i>	vi
<i>Acknowledgments</i>	viii
<i>List of Abbreviations</i>	ix
1 Introduction	1
<b>Part I Theory</b>	
2 Who Controls the IMF?	13
3 Domestic Interests and IMF Programs	27
4 The Impact of the Shareholders on IMF Programs	43
<b>Part II Evidence</b>	
5 Testing the Argument	71
6 IMF Lending	85
7 IMF Lending and the Crisis in Europe	105
8 IMF Conditionality	123
9 IMF Conditionality and the Asian Crisis	141
<b>Part III Implications</b>	
10 Theory, Evidence, and Reform	161
<i>Appendix</i>	170
<i>Notes</i>	189
<i>Bibliography</i>	197
<i>Index</i>	214

# List of Figures and Tables

## Figures

3.1	IMF's lending and bureaucratic capacity	38
5.1	IMF loans approved (billions of SDRs)	74
5.2	Distributional plots of conditionality variables	78
5.3	Histograms of independent and dependent variables	79
6.1	IMF programs	86
6.2	Concessional and non-concessional programs	86
6.3	IMF programs and financial crises	89
6.4	Probability of program approval	94
6.5	Probability of program approval and G5 bank exposure	94
6.6	Probability of program approval and GDP growth	95
7.1	G5 bank exposure to Iceland, 2005–2012	107
7.2	G5 bank exposure to Greece, 2005–2012	112
7.3	G5 bank exposure to Ireland, 2005–2012	117
8.1	Conditionality by program review	126
8.2	Predicted rate of binding conditions	135
8.3	Predicted rate of performance criteria	135
8.4	Predicted rate of non-binding conditions and waivers	136
9.1	G5 bank exposure to Asian crisis economies	143
9.2	Scope of conditionality during the Asian crisis	147

## Tables

4.1	Distribution of voting power at the IMF (2009)	46
4.2	Voting shares of the IMF's 10 largest members	50
4.3	Extracts from Articles of Agreement of the IMF	57
5.1	IMF conditionality	75
5.2	IMF dataset summary statistics	83

5.3	IMF conditionality dataset summary statistics	84
6.1	IMF program approval	91
6.2	Substantive effects from logistic regression	92
6.3	Program intervals	97
6.4	IMF loan size	100
6.5	Substantive effects	102
8.1	Binding conditions	128
8.2	Quantitative performance criteria	129
8.3	Structural performance criteria	130
8.4	Non-binding conditions	131
8.5	Waivers	132
8.6	Substantive effects	134
9.1	Conditionality and the Asian crisis	145
A.1	IMF program approval and G10 bank exposure	176
A.2	IMF program approval and G10 bank exposure	177
A.3	IMF program approval robustness checks	178
A.4	IMF loan size and program approval robustness checks	180
A.5	IMF loan size and G10 bank exposure	184
A.6	IMF loan size and individual G10 exposure	185
A.7	IMF binding conditions robustness checks	186
A.8	Data sources	188



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# List of Abbreviations

EC	European Commission
ECB	European Central Bank
ECOFIN	Economic and Financial Affairs Council
ED	IMF Executive Director
EEA	European Economic Area
EFF	Extended Fund Facility
EFSF	European Financial Stability Fund
EMU	Economic and Monetary Union
ESAF	Extended Structural Adjustment Facility
ESM	European Stability Mechanism
EU	European Union
G5	Group of Five
G7	Group of Seven
G10	Group of Ten
G20	Group of Twenty
GATT	General Agreement on Tariffs and Trade
GDP	Gross Domestic Product
IEO	Independent Evaluation Office
IFI	International Financial Institution
IMF	International Monetary Fund
IMFC	International Monetary and Finance Committee
IO	International Organization
IPE	International Political Economy
IR	International Relations
LOI	Letter of Intent
MD	IMF Managing Director
PA	Prior Action or Principal-Agent Approach
PC	Performance Criteria

PDR	Policy, Development and Review Department
PRGF	Poverty Reduction and Growth Facility
PRM	Poisson Regression Model
QPC	Quantitative Performance Criteria
SAF	Structural Adjustment Fund
SB	Structural Benchmark
SBA	Stand-By Arrangement
SDR	Special Drawing Rights
SPC	Structural Performance Criteria
SPR	Strategy, Policy and Review Department
UK	United Kingdom
UN	United Nations
US	United States
WTO	World Trade Organization

# 1

## Introduction

International organizations have come to play a prominent role in an increasingly interdependent world. The International Monetary Fund (IMF), in particular, is one of the most important international organizations in modern times. Every year for the last decade, more than one billion people have lived in countries under IMF supervision. Only a handful of developing countries have not participated in an IMF program, and this list grows smaller every year. As a result, the extent of its involvement in the societies of developing countries is remarkable. When taken together with the depth of its involvement in national policy-making, via conditionality, its role is unique in contemporary international relations (IR). Few international organizations can claim to have such a broad reach while still retaining the ability to make and enforce decisions that affect the core functions of sovereign states.

In return for an IMF loan a country must agree to implement a list of policy conditions. The Fund's ability to set and enforce conditions has been a source of great controversy, with criticism coming from across the political spectrum over whether it, or any other international organization, should have the power to dictate economic policy to sovereign states. On the one hand, critics argue that it has used its powers recklessly, contributing to a series of financial crises all over Asia and Latin America in the late 1990s. Supporters on the other hand argue that while there is always room to improve the IMF, financial crises like those which occurred in Latin America and Asia were really nothing new.

Despite being the subject of considerable research, scholars of IR disagree over how politics matters when it comes to IMF behavior. The consensus is that the United States has considerable influence over IMF decision-making. However, some argue that US influence is not unique and that a larger group of powerful states also matter. The European

sovereign debt crisis is a reminder that the United States does not exercise a monopoly on political control, as it has ceded this region as a sphere of German and French influence.

In this book, I develop and test a theory that explains variation in IMF policies, based upon the domestic interests of its largest shareholders – the United States, the United Kingdom, France, Germany, and Japan. I contend that some of the IMF's most important policies vary because of the economic exposure of powerful domestic interests in the large shareholders, including (a) the decision on whether to approve an IMF program for a troubled country, (b) the decision on how much to lend, and (c) the terms and conditions attached to the loan.

Apart from helping to fill a gap in IR, analyzing IMF decisions is important for a number of reasons. First, the IMF is the custodian of a large pool of financial assets. One of its primary tasks is to redistribute these according to the needs of its membership. As of late 2012, it has committed \$243 billion to help both rich and poor countries on five continents. With so much at stake, it is important to scrutinize how the IMF makes decisions about loans and conditionality.

Second, the IMF's far-reaching and deep involvement in the societies of its member-states affects the lives of millions of people. As a consequence, scholars from across the social sciences have been engaged in explaining the effect of IMF programs on a diverse range of outcomes, including human rights (Abouharb and Cingranelli 2009), human health (Stuckler *et al.* 2008), government spending (Nooruddin and Simmons 2006), the global spread of financial liberalization (Mukherjee and Singer 2010) and privatization (Brune *et al.* 2004; Doyle 2011; Breen and Doyle 2013), foreign direct investment (Jensen 2004; Jensen 2006; Biglaiser and DeRouen 2010; Bauer *et al.* 2012), poverty (Joyce and Hajro 2003), civil war onset (Hartzell *et al.* 2010), inflation (Stone 2002), income inequality (Vreeland 2003a), debt crises (Jorra 2012), government crises (Dreher and Gassebner 2012), economic reform (Biglaiser and DeRouen 2006), and economic growth.<sup>1</sup> Anyone seeking to understand the Fund's effect on social outcomes must understand also, by necessity, how the organization functions and reaches decisions. By elucidating the determinants of IMF behavior, the argument and findings presented in this book can help to illustrate the logic underlying IMF policies.

Third, the consequences of the global financial crisis have sparked a debate on the appropriate international architecture required to ensure global financial stability. Recently, the G20 group of industrialized and emerging economies agreed to treble the IMF's lending capacity to \$750 billion at their summit in 2009. Since the onset of the global crisis,

there has also been a record-breaking surge in IMF lending activity. Loans far exceeding normal limits were recently agreed with Greece (23 billion and 26 billion Special Drawing Rights; SDRs), Portugal (23 billion SDRs), Ireland (19 billion SDRs), Poland (19 billion SDRs), and Romania (11 billion SDRs). As the future of global financial stability rests on political choices, understanding how states reach collective decisions through international financial institutions can help us to understand how states cooperate to address financial crises. While previous research has analyzed national policy responses to international economic crises (Gourevitch 1986), this book seeks to explain how states and societies generate international policy responses through international institutions.

Finally, it is clear that the IMF is a unique international organization because of the depth and breadth of its involvement in the societies of its members. According to Randall Stone (2002) it has been, since the end of the Cold War, the most powerful international institution in history. As such, it provides us with one of the most important laboratories for investigating the use of power in international organizations, allowing this book to contribute to a broader literature on the nature of that power (Bachrach and Baratz 1962; Abbott and Snidal 1998; Barnett and Finnemore 1999; Keohane and Nye 2003; Barnett and Duvall 2005).

## The IMF's role in the world economy

Since the collapse of the Bretton Woods system of fixed exchange rates, the Fund's primary role has been to prevent and manage the consequences of financial crises in developing and emerging markets.<sup>2</sup> By doing so it is fulfilling the mission set out in its "Articles of Agreement," which charge it with maintaining an open and stable world economy by helping governments to resolve international monetary problems. While much of its work to achieve this outcome involves macroeconomic surveillance and technical assistance, it is also unique in several respects. First, the IMF's Articles of Agreement stipulate that it should be a permanent venue from which member-states can cooperate to resolve international monetary problems. As such, it is one of the most important sites of international cooperation and global governance.

Second, it holds the unique position of *de facto* lender of last resort for scores of middle- and low-income countries (Fischer 1999). Over the last few decades it has exercised this function through short- and long-term conditional lending arrangements. Transitional and emerging markets generally enter short-term arrangements such as the Stand-By

Arrangement or Extended Fund Facility. Such arrangements are intended to provide a country with breathing room to address its balance of payments problems. While many countries have entered short-term programs, the IMF also introduced long-term programs in the 1980s with the Structural Adjustment Facility (SAF).<sup>3</sup> Under this facility it offers loans with lower interest rates and longer repayment periods. In 2009, 78 low-income countries were eligible for concessional assistance based on a cutoff point of \$1095 (per capita income, 2007) (IMF 2009a). As well as providing bridging loans of this nature, the Fund is also deeply involved in the economic policies of its member governments through its application of binding conditions to every loan. These conditions stipulate the precise way in which the Fund expects a government to adjust its economic policies in order to be able to continue to receive assistance.

Although the Fund's policies on loans and conditionality are the subject of intense scrutiny and debate, important questions remain as to how the Fund actually makes decisions on how to treat its borrowers. A look back at some recent cases reveals considerable variation. For example, Ireland (19 billion SDRs in 2010) and Greece (23 billion in 2010 and 26 billion SDRs in 2012) received generous loans with relatively few conditions, while others like Thailand (2.9 billion SDRs in 1997) received smaller loans with many conditions. The difference in treatment has serious consequences for the countries involved. A lot hinges on the Fund's decision over how to treat a borrower. For one, a larger loan can provide a government with much more breathing room to implement an adjustment program, sheltering it from some of the immediate pressures of domestic politics in hard times. Furthermore, a loan with too many binding conditions can create panic among creditors; if a country fails to implement even one of these conditions it cannot continue to draw on IMF resources. Indeed, both Mauritania in 2000 and Gabon in 2001 were given so many binding conditions in their IMF agreements that both failed to meet several, and were subsequently granted waivers so that they could continue with their IMF programs.

What explains the difference in treatment? The conventional explanation is that IMF decisions are responsive to both political and economic pressures. More specifically, many scholars stress that IMF policies consistently reflect US interests and are not merely technocratic decisions (Kahler 1990; Thacker 1999; Stone 2002; Oatley and Yackee 2004; Andersen *et al.* 2006; Woods 2006; Dreher and Jensen 2007; Stone 2008). By contrast, other scholars emphasize the independent role of the IMF's bureaucracy (Vaubel 1996; Dreher and Vaubel 2004; Willett 2000; Barnett

and Finnemore 2004; Chwieroth 2008). While most studies have converged on one of these two positions, there is still an ongoing debate over whether the other large shareholders matter. According to Stone (2011), US influence at the IMF far exceeds G5 influence, with the exception of French and British influence over the application of conditionality in Africa. Kang (2007) and Copelovitch (2010a), on the other hand, argue that a larger group – the G5 shareholders – affect the IMF’s lending and conditionality.

## **The big shareholders and IMF decision-making**

In this book, I reconsider the role of the large shareholders in IMF decision-making. While there is no shortage of anecdotes about the effect of powerful states on IMF policies, the European sovereign debt crisis is a reminder that France, Germany, and the United Kingdom also have substantial influence. One of the reasons why the “others” matter is that IMF programs can have significant distributive consequences in all of the Fund’s shareholders – not only the United States and the countries that use IMF resources. From this, it is my contention that the IMF will tend to offer governments bigger loans with fewer conditions when interest groups in the G5 (the United States, the United Kingdom, France, Germany, and Japan) pressure their governments into achieving this outcome. But why do domestic actors want these sorts of policies? What do they do to get their desired policies enacted? Why are G5 governments in a position to deliver favorable policies? And how do G5 governments share the gains from international cooperation over IMF policies?

To answer the first question, bigger IMF loans benefit domestic actors when some of the loan is diverted back to them in the form of debt service or other payment. As well as benefitting from bigger loans, some domestic actors also benefit from less stringent conditionality, reducing the risk that a borrowing country will be cut off from IMF assistance. Interest groups should be aware that failure to comply with even one binding condition can lead to a situation where a borrowing country is forced to exit its program, possibly triggering losses among creditors. Apart from this motivation, reducing conditionality frees up the capacity of the borrowing country to service its creditors, providing another incentive for them to seek less conditionality.

To answer the second question one must realize that while many domestic actors in the G5 stand to benefit from generous IMF loans to developing countries, few are actually in a strong position to pressure



their governments into achieving this outcome. Indeed, governments will not always slavishly capitulate to pressure from societal groups. Governments must strike a balance between protecting their investment in the Fund and supporting special interests at home. In this book, I argue that due to collective action problems concentrated interests in the G5 – banks and exporters with significant levels of exposure in developing and emerging markets – are capable of shaping government preferences over IMF lending and conditionality.

While domestic political processes drive G5 governments' policies in relation to the IMF, these governments must also bargain and cooperate with one another on the international stage to secure gains for domestic actors. Their success or failure in influencing IMF policy depends on the strength of their position in the organization. Without being correctly positioned to affect the IMF's decision-making process, a government will not be able to deliver any benefits to special interest groups.

This brings me to the third and fourth questions posed in this section: why only G5 governments? And how do these governments share the gains from international cooperation over IMF policies? In this book, I advance the argument that the G5 are in a commanding position to influence IMF policies. Their position is reflected in the institution's rules and design, which give them extensive control over Fund policy. First, unlike the other 19 members of the Executive Board, their representatives are automatically appointed without having to stand for election.<sup>4</sup> This advantage means they do not need to cater to the interests of other countries in advance of elections, allowing their representatives to advance their country's national interests more effectively. Second, apart from this advantage, the G5 possess around 40 per cent of the Fund's votes, giving them the ability to easily form a coalition of 50 per cent to pass any decision over lending or conditionality. Third, without the need to form a coalition, the G5 have enough votes to veto any major "program decision" that would change the way in which the organization is governed by its membership, thus preserving the status quo. As such, the group's power is enshrined in the organization's rules and design. However, it is rarely invoked or formally exercised. Instead, it prefers informal decision-making procedures, leading to the appearance of consensus. That the organization proceeds by consensus gives the other member-states an incentive to participate, as long as they do not form coalitions to block programs that are favorable to G5 interests.

Finally, how does the G5 actually cooperate as a group? Does it act as a single unit in all lending cases, or are there one or more dominant countries, like the United States? Copelovitch (2010a) is particularly

interesting in the context of this question. He argues that the variance of G5 exposure determines whether they will cooperate. When some members of the group have a weak interest in a bailout and others have a strong interest, we should expect them to disagree strongly over the generosity of the bailout. Stone (2011), on the other hand, argues that the United States clearly dominates the other shareholders. I argue that neither perspective captures fully the political pressures on IMF lending. Rather, I contend that the G5 has significant incentives to cooperate, even in cases where it appears that some have a very weak interest and others have a strong interest. If one shareholder is highly exposed, the threat of contagion should push the group to cooperate. A former US Secretary of the Treasury, Robert E. Rubin, put this in simple terms:

Say, for instance, that Japanese banks were heavily exposed to South Korea. And say that U.S. commercial and investment banks had heavy exposure to Japanese banks. South Korea's troubles could feed back in unexpected ways to U.S. banks that had not considered themselves unduly exposed to South Korea. (Rubin and Weisberg 2003: 231)

As a consequence, I argue that the G5 should cooperate through simple favor-trading where each member of the group supports the most exposed shareholder in the knowledge that the others will reciprocate when their turn comes. This is the most plausible way in which these countries could cooperate, given the rules and design of the IMF. Moreover, too much conflict over lending cases among the group's members would eventually undermine the informal consensus-based decision-making system at the IMF, which allows the G5 to continue to benefit while also pacifying the other members of the Fund's 24-member Executive Board.

To summarize, my theory supposes the following steps: First, an economic shock leads interest groups in the G5 to seek favorable IMF treatment for the affected country. Second, G5 governments decide whether to capitulate to the demands of the relevant interest group depending on the degree to which it is exposed. Third, G5 governments engage in international bargaining over IMF treatment for the affected country. And finally, their position at the IMF influences staff behavior, leading to more favorable treatment for a country affected by an economic shock.

## **The structure of the book**

This book proceeds as follows. In Chapter 2, I outline the existing approaches to the study of IMF behavior, finding two very broad

approaches to explaining variation in its behavior. The first focuses on the internal drivers of policy change, specifically the IMF's bureaucracy, and the second stresses the importance of the external drivers of change, most notably powerful states and private actors. Building on this blueprint to explain IMF behavior, Chapter 3 sets out my theory in greater detail, extending our understanding of the domestic and international determinants of IMF policies. Overall, it stresses that economic linkages between the IMF's most powerful shareholders and its borrowers drive Fund behavior. As such, the economic exposure of the G5 is given a central explanatory role in this chapter.

Although many scholars agree that the Fund's largest shareholders have substantial input into its policy decisions, it is difficult actually to observe political interventions in specific lending cases. To overcome this impasse, most scholars abstract from the decision-making process and instead present statistical associations to illustrate the influence of states over IMF behavior. Chapter 4 takes a closer look inside the "black box" in order to identify the methods by which states make policies and influence decisions in the IMF's institutional environment. Examining the Fund's internal governance and how member-states exercise political control through both formal and informal channels of influence fills an important gap in our knowledge of decision-making inside powerful international organizations. By exploring the Fund's inner workings, it also illustrates the extent to which the organization's rules and design affect and constrain state behavior. Chapter 4 concludes by offering a simple theory that explains how the IMF's shareholders cooperate to influence decisions through a system of favor-trading as well as a number of testable hypotheses on the relationship between G5 exposure and IMF policies.

Chapter 5 sets out the research design, laying the foundation on which my argument is tested in a quantitative analysis of IMF policies. In this chapter I focus on issues such as measurement and conceptual clarity, specifying the variables that were selected to test my theory of IMF behavior and discussing the reasons why they were chosen over alternative measurements. The subsequent chapters – six, seven, eight, and nine – put all of this to work by subjecting my theory to evaluation in a quantitative and qualitative analysis of the IMF's two most important policy decisions: lending and conditionality. Chapters 6 and 7 focus on lending. The former provides a quantitative analysis of IMF lending to 159 countries from 1983 to 2006 and the latter examines the politics of IMF lending to Iceland, Greece, and Ireland. Chapters 8 and 9 focus on conditionality. The former provides a quantitative analysis of

641 conditionality agreements from 1997 to 2006 and the latter examines the application of conditionality during the Asian financial crisis.

Chapter 10 reviews the findings from across the empirical chapters, examining the similarities and differences and evaluating how my theory stands in light of these findings. Finally, I discuss the reform of the organization after the global financial crisis, the rise of China to the G5, and some of the broader implications of my argument and findings for our understanding of international cooperation in “hard times.”

# **Part I**

## **Theory**

# 2

## Who Controls the IMF?

There is now a broad consensus among scholars that IMF policies are responsive to both political and economic pressures and are not merely technocratic decisions. Despite this consensus, there is still much disagreement over exactly how politics matters when it comes to the IMF and other IOs. At the most general level, there are two broad approaches to explaining how politics affects IMF policies. The first approach emphasizes the external drivers of policy change, most notably states and private actors in the world economy. The second approach stresses the internal drivers, specifically the Fund's bureaucracy. Within each of these broad approaches, there are many variations. For example, among scholars who focus on the Fund's bureaucracy, some view it as a benign technocracy, while others argue that the integrity of its programs has been undermined by staff rent-seeking.

In a formal sense, power and authority rest with the IMF's 188 member-states, each of which appoints a representative to the Board of Governors, which is the organization's highest decision-making body. Although all formal powers are vested in it, the Board of Governors meets only twice a year to decide on issues such as the election and appointment of executive directors (ED), the admittance of new members, the expulsion of existing members, increases in quotas, and amendments to the Articles of Agreement (IMF 2007a: 4). All its powers over day-to-day operations such as program approval, lending, conditionality, surveillance, and technical assistance have been delegated to the Executive Board. This is essentially the Fund's governing body, which meets daily to discuss programs and policies. It is comprised of five directors appointed by the United States, United Kingdom, France, Germany, and Japan. The remaining 19 seats on the 24-member council are filled by election. Many scholars argue accordingly that IMF

policies are driven by the powerful states that oversee and guide policy, intervening when necessary to align policy with their preferences. In particular, many scholars have stressed that the United States uses its position as the Fund's largest shareholder to achieve its foreign policy objectives. As a result, a substantial volume of literature argues and presents evidence to support the claim that IMF decisions faithfully reflect US interests.

Another common view is that the Fund's member-states have, for the most part, surrendered their power to its bureaucracy. Proponents of this view argue that specific attributes of the bureaucracy give it a lot of independence from its political masters. First, the bureaucracy has "agenda-setting" power, which allows it to devise policy independently before presenting it to the Executive Board for approval. Second, the bureaucracy is comprised of some of the world's most skilled economists, making the organization a source of knowledge and expertise. Finally, they argue that staff is largely insulated from most forms of lobbying and political pressure.

While advocates of the bureaucratic politics approach all agree that the Fund has autonomy, they disagree over how the staff use their freedom. On the one hand, governments may have delegated autonomy to the Fund in the knowledge that it is comprised of responsible technocrats who will act mostly in the public interest. On the other hand, the Fund's bureaucracy may have escaped their control, engaging in rent-seeking behavior and "mission creep." As a result, those who focus on the internal drivers of IMF policy differ on the nature of the organization and the forces that drive its behavior.

This chapter is structured as follows. First, I discuss the three most common views of the nature of the Fund's bureaucracy. Two of these views are agent-centred – the first assuming that the Fund is mostly comprised of responsible technocrats and the second finding that there is a lot of potential for rent-seeking among the staff. The third view argues that bureaucracy's unique organizational culture dominates both member-states and bureaucratic agents. In the later part of this chapter, following my review of the literature on the Fund's bureaucracy, I review the substantial and growing literature on the external drivers of IMF policy-making. The "lion's share" of these studies highlights the commanding role of the United States in IMF policy, with a minority considering the influence of the other shareholders and private actors in the world economy. To conclude this chapter, I summarize some of the strengths and weaknesses and place my argument in the context of the wider literature on IMF behavior.

## Internal: the bureaucracy

For many years, IR theorists had little to say about how international bureaucracies affect world politics. For the most part, bureaucracies were treated as entities with no independence from their creators. In recent times, scholars have argued that we need to turn our attention to understanding how IOs actually work, what they do after they are created, and whether their behavior conforms to expectations (Barnett and Finnemore 1999, 2004).

As a result, there are now several studies of the IMF that stress the internal logic of its behavior. The first approach, originating mainly from economics, views the Fund as a benign technocracy that tries but often fails to provide global public goods. Another approach, also first articulated among economists, contends that bureaucrats, particularly of the international variety, have incentives toward rent-seeking behavior (Frey 1984; Vaubel and Willett 1991; Frey 1997). Coming broadly under the label of *public choice*, supporters of this approach expect principal-agent relationships to determine the behavior and activities of the IMF. Finally, the *organizational culture* approach rejects the notion that bureaucracies are driven only by agents acting according to their interests and preferences. Rather, this approach turns its attention to the IMF's organizational culture, stressing the importance of norms, shared beliefs, and socialization processes. Scholars adopting this approach argue that the Fund's unique organizational culture is responsible for major changes in IMF policy over the last few decades.

## Technocrats

Many economists have long viewed the IMF as a technocracy, where experts use their control of decision-making to design and implement optimal policies. Sometimes referred to as the "optimal policy approach" (Willett 2002), this view of the IMF's behavior rests on several assumptions. First, it assumes that the Fund is largely free from political interference and that it uses this freedom to provide global public goods. Second, the approach assumes that the staff and political representatives who design and oversee the organization's policies are mostly interested in translating the latest insights from economic theory into good policies which in turn lead to good outcomes like economic growth. Whenever the Fund fails to deliver optimal policies, so this story goes, this is due to market failures or a lack of information.

A sizeable body of literature applies this view of the organization to explain the effects of IMF programs on borrowing countries. In particular,



many recent studies examine the effect of IMF programs on economic growth, generally finding that programs either reduce growth or have no effect (Conway 1994; Bagci and Perraudin 1997; Bordo and Schwartz 2000; Dicks-Mireaux *et al.* 2000; Hutchison and Noy 2003; Butkiewicz and Yanikkaya 2005; Easterly 2005; Atoyan and Conway 2006).

The analysts who have adopted this approach have developed and applied a set of rigorous and sophisticated tools for estimating the IMF's effect on some very important outcomes. However, this approach is fundamentally flawed in explaining both the causes and consequences of IMF policies. An emerging body of empirical research in political science, reviewed in the rest of this chapter, finds that IMF policies are not free of political pressures, with only one study finding evidence to the contrary (Sturm *et al.* 2005). In addition, it seems unrealistic that an organization that exists only because of political decisions will not in some way, or on particular occasions, better reflect the interests of certain members over others. Finally, this approach has become increasingly unpopular in recent years: a number of leading economists now agree that the IMF should be remodeled as a bureaucratic and political organization for the purposes of empirical analysis (Barro and Lee 2005; Bird and Rowlands 2003).

While this approach to understanding the IMF's behavior is essentially oblivious of politics, it closely reflects the organization's mandate, which is enshrined in its constitution. The Articles of Agreement of the IMF stress that the Fund should take economic considerations into account only when making decisions, and in doing so uphold a "doctrine of economic neutrality" whereby decisions are made on neutral economic grounds free from political interference (Swedberg 1986). The Fund therefore should use its mandate to engage in the monitoring and surveillance of its members' macroeconomic conditions. When these conditions deteriorate and one of its members requires an IMF program, its eligibility for program-based assistance, a loan, or conditionality, should reflect changes in key macroeconomic variables, such as the country's current account and international reserves position. The importance of these particular variables is confirmed by what we know from existing quantitative studies on the IMF (Steinwand and Stone 2007) and from the Fund's own Articles of Agreement, which state that it will monitor its members' balance of payments and reserves position (IMF 2010a: Articles V and XIX). Likewise, the conditions that the Fund asks borrowing countries to implement should be the result of IMF financial programming models which are designed to produce optimal outcomes. Because IMF conditionality models are linked to

country-level economic variables, conditionality should be free from political interference.<sup>1</sup> Finally, apart from the logic of the Fund's mandate to address specific country-level imbalances, it might sometimes act preemptively to stop "contagion" or the spread of a financial crisis from one country to others (Hausken and Plümper 2002).

### Rent-seeking bureaucrats

Often referred to as the *public choice* approach, this view of the IMF's staff assumes that international bureaucrats have incentives toward rent-seeking and will try to enact policies that increase their power, resources, and autonomy. How might this view explain changes in the IMF's output and behavior? According to Vaubel, in years where the Fund's budget is reviewed by the Board of Governors (quota review years), the staff should "hurry-up lending" (Vaubel 1983, 1991, 1996). By depleting resources in the year of a quota review, the bureaucracy is sending a strong signal to the shareholders that its current budget allocation is stretched to capacity and should be increased. This sort of behavior is standard practice in bureaucracies with budget cycles; both spending and lending should increase at the end of the cycle.

In what other ways might the organization's behavior be affected by rent-seeking? According to Aldenhoff (2007), IMF economic forecasts are systematically biased toward optimism in countries with more IMF credit. Dreher (2004) also finds that IMF conditionality follows a similar logic where rent-seeking bureaucrats use it as an instrument to increase their power and prestige. However, the argument that IMF bureaucrats are free to engage in such behavior is not without its critics. According to Willett (2002, 2000), "hard-core" versions of the public choice view of the IMF as a strictly budget-maximizing institution are unrealistic. Instead, he argues that rent-seeking among bureaucrats coexists and interacts with formal political oversight by the Fund's membership.

In recent times, the principal-agent framework, first deployed in economics, has come to reflect this relationship (Moe 1984). Having already been applied to the study of the European Union (EU) (Pollack 1997; Kassim and Menon 2003) and to the political control of bureaucracies in domestic politics (Weingast *et al.* 1999), this approach is being used increasingly to explain the behavior of IOs (Nielson and Tierney 2003; Vaubel 2006; Hawkins *et al.* 2006a; Dreher *et al.* 2007; Lyne *et al.* 2009), including the IMF (Gould 2006a; Martin 2006; Copelovitch 2010b).

According to the principal-agent framework, a "principal" (the IMF's 185 member-states) delegates conditional authority to an agent, who then performs various tasks on its behalf. The act of delegation leads to

a well-defined contractual relationship that should produce predictable behavior under certain conditions. To apply this framework, it is necessary first to assume the interests of both principal and agent, then to infer what their preferences are over different policy outcomes such as lending and conditionality. Typically, the agent's characteristics are defined according to the rent-seeking logic; in some situations, bureaucrats have incentives to deviate from principal preferences to increase their utility. In the literature, "agency slack" is the term used to describe independent action against the wishes of the principal. "Shirking" occurs when an agent puts in only minimal effort on its principals' behalf and "slippage" results when an agent shifts policy away from its principal's preferred outcome and toward its own preferences (Hawkins *et al.* 2006: 7).

How do these actions manifest themselves in the IMF? According to Vaubel (2006), we should expect to see more agency slack, shirking, and slippage in IOs like the IMF because the chain of delegation is longer. Dreher *et al.* (2007: 275) tested this argument, using staff growth to measure autonomy. They presented evidence of slack in the growth of the IMF's professional staff. It has had an annual average growth of 3.2 per cent that does not reflect the annual average growth in membership of 2.5 per cent since 1950. The principal-agent approach has been refined even further by re-conceptualizing the role of the "principal," not as a single entity but as a collective or multiple principal comprised of different member governments, each with sometimes conflicting preferences over policy outcomes (Bernheim and Whinston 1986; Dixit *et al.* 1997).

## Culture

Proponents of the *organizational culture* approach stress the importance of norms, ideas, shared beliefs, and socialization processes in explaining IMF behavior. According to Chwioroth (2010, 2008), a major change in policy – the Fund's support of capital account liberalization in the 1990s – resulted from shared ideas and beliefs about the utility of this policy. These beliefs were engendered in Fund staff through their professional training and other socialization processes. Furthermore, a selective recruitment practice has sustained the organization's culture, ensuring that shared values and belief systems are reproduced over time (Momani 2007).

In a more sweeping account of IMF policy change, Barnett and Finnemore (2004) examined the interrelationship between interests, preferences, and the Fund's organizational culture. They found that the IMF has expanded beyond its original mandate of addressing short-term balance of payments crises to invasive micro-conditionality (Barnett and

Finnemore 2004). Bureaucratic processes such as rationalization, homogenization, and the normalization of deviant practices led to this outcome which, according to the authors, was desired neither by the IMF's staff nor by their political masters (Barnett and Finnemore 1999). In other words, the authors argue that bureaucracies, particularly the IMF's, can take on a life of their own, becoming uncontrollable in some respects.

This view of the Fund is unrealistic, as it tends to portray the organization as hostage to culture, rather than as made up of agents capable of change. It seems unlikely that policies and procedures, with sometimes enormous material and distributional implications, arise from random processes, to the discomfort of all bureaucratic and political actors. Although IMF staffers have occasionally voiced their opposition to micro-conditionality, and even the US government has suggested that it should be reduced, it is clearly in the interests of some actors, some of the time, to ask for micro-conditions. Why else would the United States have pushed for the inclusion of structural benchmarks in Indonesia's and Korea's IMF programs during the Asian financial crisis? (Goldstein 2001: 70). The static portrait of the IMF's bureaucracy has been criticized by others who stress the importance of organizational culture. For example, Chwieroth argues that the bureaucracy's culture is more dynamic and that major changes in its behavior result from endogenous processes. In particular, the battle of ideas over capital account liberalization in the developing world was fought and won inside the Fund's bureaucracy.

### **External: states and private actors**

For too long, IR theorists had little to say about how states wield power and influence through IOs. Rather, most viewed IOs only in the context of broader international regimes comprising of rules, norms, principles, and procedures. They argued that regimes facilitate cooperation by reducing transaction costs, market failures, and moral hazard, and by mitigating uncertainty through the provision of information (Keohane 1984: 85–96). By providing their creators with these benefits, international regimes held the potential to transform the very nature of politics, turning international relations from an arena of conflict and state competition toward one of cooperation. Even though international regimes held this great promise, their supporters recognized that this potential would not always be unlocked – sometimes international regimes would not be effective or even good in principle (Keohane 1984: 73).

Despite regime theorists providing a strong rationale for the existence and maintenance of international institutions, many realist scholars

remained unconvinced of their potential to transform the nature of international politics. As a consequence, the next stage in the direction the literature took was a lengthy debate over whether international institutions mattered in the first place. On one side of the debate, realists argued that international institutions are simply products of states' behavior and have no independent effect on state behavior (Grieco 1988; Mearsheimer 1994). On the other side, scholars argued that realists' assumptions about state preferences hold only under a limited number of circumstances (Powell 1991). In recent years, this debate has moved on, with the advances in the study of international regimes being incorporated into a new body of research on the role of IOs in world politics. In particular, the regime theorists' explanation for the creation and maintenance of international institutions is enduring. It provides a good rationale to explain why states would want to create IOs and the types of activities that they should engage in (Abbott and Snidal 1998). This was a necessary starting point before going on to explain the effect of IOs on state behavior or their effectiveness as independent actors in world politics (Martin and Simmons 1998: 738).

Only in the last few years have theorists started to address this gap in the literature, with a steady stream of studies on international economic institutions, including the General Agreement on Tariffs and Trade (GATT) and World Trade Organization (WTO) (Steinberg 2002; Mansfield and Reinhardt 2003; Goldstein *et al.* 2007) and World Bank (Nielson and Tierney 2003; Abouharb and Cingranelli 2006; Kilby 2009; Knack *et al.* 2012). There are now two very broad approaches to explaining why states created IOs and how they go on to use IOs to achieve their objectives: *functionalism and structuralism* (Steinwand and Stone 2007; Stone 2008). These approaches come with a different view of the interests that IOs serve. For example, scholars who adopt the functionalist approach, which largely draws on the previous literature on international regimes, find that IOs facilitate cooperation by providing information, reducing transaction costs, and facilitating reciprocity in an otherwise anarchic international environment (Keohane 1984; Fang 2008; Fang and Stone 2012). A further benefit is IOs' ability to facilitate reform in domestic politics by monitoring compliance with international agreements and strengthening the constituencies that support "good" policies (Dai 2007). When all these are taken together, the functionalist approach provides a strong rationale for the existence of IOs and how they can serve their members.

Despite these benefits, the functionalist approach tends to neglect power relations among the members of IOs. By contrast, advocates of structuralism argue that variation in the policies of IOs can be explained

by looking at the distribution of power in the international system. A key weakness of this view is that it can overlook the importance of IOs' institutional design. By taking the use of force "off the table," some IOs might restrain and limit the influence of great powers, creating a more cooperative environment where great powers tend to follow the rules more than they otherwise would in its absence (Ikenberry 2001).

In recent years, there has been a behavioral/institutionalist turn in the literature on IOs. The focus of this new strand of scholarship is on the informal norms and hidden "rules of the game," which structure and guide the behavior of IOs in world politics. Recent work in this tradition has argued that weaker states grant powerful states "informal influence," and in return, weaker states are allowed more input through formal channels. This argument has been applied to the European Union (Kleine 2012), World Bank (Kilby 2009), Asian Development Bank (Kilby 2011), WTO (Stone 2011), US control of the IMF (Stone 2011), and the role of the IMF's staff (Chwieroth 2013).

### **United States**

Scholars of international relations have long argued that the United States has a privileged and commanding position at the IMF (Krasner 1968). Its influence has been a source of great controversy, with many arguing that it is substantial and above that of any other member-state (Kahler 1990; Woods 2003; Woods and Lombardi 2006; Henning 2009). Anecdotal evidence of US interventions abound. Calomiris (2000), for example, commenting on an IMF loan to Ecuador, noted that it was viewed by many as a side payment to the Ecuadoran government in return for the continuing use of military bases to monitor drug traffic. Similarly, Calomiris speculated that Pakistan's access to an IMF loan may have been conditional on its willingness to sign a nuclear non-proliferation treaty. Going beyond mere anecdotes, systematic qualitative research has already illustrated the importance of the United States in selected lending cases; according to Momani (2004), the United States intervened in 1987 and 1991 to secure lenient IMF treatment for Egypt in order to preserve the political stability of the pro-Western Egyptian regime during that period.

Are these once-off interventions or does the United States regularly use and abuse the IMF? In the first quantitative study of US influence at the IMF, Thacker (1999) examined the relationship between voting patterns at the United Nations (UN) and the probability that a country would receive a loan from the IMF and found that countries which moved toward the US position on key issues were more likely to get a loan.

Similarly, countries that move away from the United States are less likely to do so. Since Thacker's original study, several other studies have confirmed his findings (Barro and Lee 2005; Andersen *et al.* 2006), although others have found no evidence of a link (Eichengreen *et al.* 2006a).

One problem with these studies, and others that examine voting patterns in the UN, is the significant clustering of G7 votes in the General Assembly; closer voting with the United States might simply be movement toward any of the other members of the group too (Volgy *et al.* 2003). More promising are the empirical studies of the relationship between IMF programs and a country's membership of the UN Security Council (Dreher *et al.* 2006; Dreher and Vreeland 2007; Dreher *et al.* 2009). While G7 voting at the General Assembly is highly correlated and difficult to disentangle, shifting the focus to the Security Council provides a more objective way of observing the link between states' interests and outcomes.

Besides participation in IMF programs, researchers have found evidence of US influence over conditionality. Dreher and Jensen (2007), for example, found that closer allies of the US – again measured by voting affinity in the UN – have to meet fewer conditions. The authors also extended their analysis to the entire G7 and found that this relationship holds there too. Similarly, Stone (2007) found that the United States does intervene strategically to reduce the scope of conditionality for favored borrowing countries (Stone 2008).

Another important policy decision concerns when to re-admit a country to an IMF program following its failure to implement the conditions of its previous program. In two separate studies on Africa and Eastern Europe, Stone (2004, 2002) found that countries with strategic links to the United States, the United Kingdom, and France received shorter program suspensions or “punishment intervals” before being allowed to continue to draw on Fund resources. Oatley and Yackee (2004) also argued that US interests decisively shape IMF short-term lending programs. In a study of the period from 1986 to 1998, the authors found that the size of IMF loans is dependent on the extent of US banking and foreign policy interests in the borrowing countries. On the other hand, Moser and Sturm (2011) found little evidence of shareholder influence in a large sample from 1990 to 2009. Finally, in a study of conditionality agreements from 1990 to 2002, Stone (2008) has found even more evidence of US influence in reducing the severity of conditionality in strategically important countries.

While several authors have presented evidence of US influence over IMF policy, Broz and Hawes (2006) have provided detailed evidence

of the determinants of US policy toward the IMF, in an examination of US Congressional voting on IMF quota reviews aimed at increasing the organization's resources. The authors found that domestic interests affect the way representatives cast their votes, with the pro-globalization composition of constituencies and the amount of campaign financing from money-center banks determining their preferences (Broz and Hawes 2006). Following their analysis of the domestic determinants of US Congressional voting over IMF resources, the authors find evidence that US commercial bank exposure increases the likelihood of IMF assistance for a country experiencing a financial crisis.

These studies provide an impressive array of evidence on the importance of US interests across several prominent IMF policies (e.g., lending, conditionality, program approval, and punishment intervals). Nevertheless, few writers have examined the role of other powerful governments in the Fund. This is a puzzling omission considering the United States has only one representative, holding 16.4 per cent of the votes, on the organization's 24-member Executive Board. Do other governments similarly influence IMF policies? If so, what do they want from IMF policies and how do they bargain and cooperate to get what they want? A number of authors argue that we should take the rules of IOs seriously and also consider the possibility that coalitions of states can cooperate (or not) to affect outcomes (Nielson and Tierney 2003; Lyne *et al.* 2006).

### Powerful states

With few exceptions, most studies are silent on the Fund's other large shareholders, choosing instead to emphasize the importance of US and bureaucratic influence over IMF policy. This is a puzzling omission, considering that there is not much of a gap in voting power between the United States and the Fund's other large shareholders. While most empirical studies of IMF behavior omit the role of the other shareholders there is also, at the same time, a commonly held view among leading international economists and policymakers that the Fund's largest shareholders have substantial input into the IMF's broader goals and mission (Boughton 2001; Rieffel 2003; Fratianni and Pattison 2004; Roubini and Setser 2004).

The study of the intergovernmental aspect of the IMF has not been entirely neglected, however. A substantial body of literature has emerged on how IMF voting rights should be re-allocated to (a) strengthen the Fund's legitimacy in the eyes of its members and the wider public and (b) make it operate more efficiently (Martin and Woods 2005; Bradlow 2006; De-Rato 2006; Woods and Lombardi 2006; Rapkin and Strand 2006; Eichengreen 2007; Meltzer 2007; Truman 2009).



Is there also empirical evidence of government influence over day-to-day policies? One notable exception that explores the role of other shareholders is Randall Stone's (2004) analysis of IMF lending in Africa, which finds that both British and French influence exists over the duration of "punishment intervals" or length of time during which a country is punished for failing to fulfill the terms of its program before finally being allowed to continue to draw on Fund resources. Kang (2007) goes further, arguing that the Fund's five largest shareholders – the G5 – intervene to relax conditionality where their strategic and financial interests are at stake. Again, Kang found a statistical relationship between the number of conditions in IMF agreements and the political and economic characteristics of borrowing countries. Dreher and Jensen (2007) have also established a statistical relationship between G7 voting at the UN General Assembly and IMF conditionality. Similarly, Presbitero *et al.* (2012) found that during the global financial crisis from 2007 to 2010, the IMF tended to allocate more toward countries where G7 multinationals and financial systems were exposed.

Taken together, this is an impressive array of evidence on the importance of the G5. However, the way in which the G5 share the gains from cooperation is unclear in many of these studies. Copelovitch (2010a, 2010b) has gone further by exploring the issue of cooperation among the shareholders. He argues that variation in key IMF policies is dependent on the intensity and heterogeneity of G5 interests in each specific case that comes before the Executive Board. Hence, when some members of the G5 have a weak interest in IMF lending and others have a strong interest, we should expect conflict among the shareholders and relatively more input from the IMF's staff. However, given the potential for "contagion" to spread from one G5 member to the others, it is likely that even in some of these cases the G5 should cooperate. For example, German instability in the wake of a Greek default or exit from the euro currency would have quickly spread to others. In 2010, Greece received an exceptional level of IMF financial support, even though there was substantial variation in the economic exposure of the shareholders to Greece.

So far I have focused on the powerful shareholders; however, an alternative view is that borrowing countries themselves have some input into IMF programs. On the one hand, proponents of this view find that IMF programs are a major event in the domestic political landscape of borrowing countries that decisively shape political outcomes for years to come. According to Vreeland, IMF arrangements provide political cover for governments that would otherwise be unable to implement

any necessary adjustment (Vreeland 2003b, 2005). Another view is that IMF programs are ultimately the outcome of negotiation between the IMF staff and officials from the borrowing country, suggesting that the partisan interests of the politicians and parties drive government policy, and therefore need to be considered when trying to explain variation in IMF behavior (Pop-Eleches 2008: 5). Indeed, Caraway *et al.* (2012) found that democratic countries with stronger domestic labor receive less intrusive labor-related conditionality.

### Private actors

A novel argument in the current literature is that private financiers drive variation in IMF policies. According to this view, private financiers hold a key advantage over the IMF: they have the ability to supplement IMF loans and can threaten to withdraw supplementary financing if the terms of an IMF program are not to their liking (Gould 2003; 2006b: 19). At the same time, the IMF can walk away from a deal with the banks if they do not provide reasonable terms. Gould (2006b, 2003) has tested this argument by examining the composition of IMF conditionality arrangements, finding that some are more likely to include “bank friendly” conditions when private financial institutions provide majority financing to a country under an IMF program.

While this is a novel explanation of variation in IMF policies, it is not quite satisfactory. First, there is a clear hierarchy among the IMF’s creditors. Governments, in particular, have the power to choose whether to offer majority financing when their interests are threatened, and if they wish, can exclude other sources of finance. While government financing alone is not always sufficient to fund a program, it allows states to exercise a measure of control over IMF policies. Second, the argument assumes that private financiers can easily lobby or signal their intentions to the IMF’s staff. However, international bureaucrats are largely insulated from lobbying by private interests, so it is not clear if this is possible. Rather, it seems more likely that private actors would approach the staff’s political masters to orchestrate financing. Third, even if private financial institutions can influence the terms of IMF programs, lobbying the staff is useless if they do not have enough control to act in the interest of banks and exporters, assuming they would even do so in the first place. Finally, private actors are more likely to finance or not finance a borrowing country in response to an IMF program and not in advance of one.<sup>2</sup> As a result, it seems that the most likely channel of influence available to private financiers is indirect and through domestic political channels.

## Conclusions

This chapter provided a detailed review of the main approaches to the study of IMF behavior as well as a broader overview of some of the main developments in the study of IOs. It argued that advocates of the internal drivers of IMF behavior all tend to view the Fund as autonomous (within limits) from its political masters but differ over whether the bureaucracy uses its freedom to pursue its own selfish interests or protect its member-states from economic catastrophes. On the external drivers of IMF behavior, it showed that the literature tends to be "US centric" but that this is beginning to change as scholars have started to incorporate the role of the other shareholders into their explanations of IMF behavior.

I build on these approaches in Chapters 3 and 4. First, in Chapter 3, I set out a theory of the external drivers of IMF behavior, providing an explanation of IMF behavior that incorporates the role of the Fund's largest shareholders. Doing so opens the "black box" to show how these governments cooperate to influence IMF policies and how their interests and preferences are predicated on the behavior of private actors. As a result, I address a substantive point made by Martin and Simmons (1998: 749), who argued that International Political Economy (IPE) scholars should devote more attention to developments in domestic politics, arguing that sometimes even minority groups can influence matters at the international level. This point is expanded on by Martin and Frieden (2003: 119), who argued that one of the most daunting challenges for scholars of IPE is to show how domestic and international factors interact and subsequently affect outcomes. This means that scholars need well-specified theories of the domestic sources of foreign policy; to date only Broz and Hawes' (2006) study achieves this much, and then only in the United States. Extending their approach to the other powerful members of the IMF can help to illustrate the relationship between domestic and international politics, showing how states engage in cooperation and conflict over the gains from IMF policies, and how the policies of IOs like the IMF are predicated on the domestic politics of, and strategic interaction among, the IMF's large shareholders.

In Chapter 4, I extend this further by examining the Fund's internal governance and commenting on the extensive range of mechanisms that the G5 can deploy to control staff behavior, including screening and selection procedures, monitoring, and selecting agents with similar preferences. As a result, I highlight some of the weaknesses in the literature which focuses only on the internal drivers of IMF behavior, by showing how unlikely it is that the organization would be allowed to trample without consequences on the interests of its main shareholders.

# 3

## Domestic Interests and IMF Programs

One of the most important developments over the last few decades has been the rapid increase in international economic exchange. The explosion in cross-border transactions has already had a profound effect on domestic politics within countries. Increasingly, in the words of Milner and Keohane (1996: 3), “we can no longer understand politics within countries – what we still conventionally call ‘domestic politics’ – without comprehending the nature of the linkages between national economies”.

In this chapter, I set out an explanation of how the changing economic linkages between the IMF’s most powerful members (the United States, the United Kingdom, France, Germany, and Japan) and its borrowers drives variation in some of the organization’s most important policies. According to my argument, the exposure of G5 domestic interests to risk and loss in developing and emerging markets is a crucial determinant of IMF behavior.

My contention is that G5 governments will try to secure generous IMF programs for countries where their domestic interests are exposed. Their aim in so doing is to protect their domestic interest groups from the harmful consequences of banking, debt, and currency crises. The losses following some of these economic crises can be substantial, leading groups across the world to suffer. In this chapter, I outline the domestic sources of governments’ preferences over IMF policies and discuss the ways in which domestic actors might lobby governments to secure generous IMF programs.

The structure of this chapter is as follows. Section “Interest groups and IMF programs” introduces the basic premise of my argument, which is that an economic shock in a developing or emerging market can trigger domestic political conflict in other countries, leading interest groups to

use their resources to lobby governments in order to provide IMF financing. This section both uncovers the domestic sources of governments' preferences over IMF programs and also demonstrates why they are so desirable for domestic actors that might otherwise lose substantially from an economic shock. Section "Lobbying strategies to influence IMF programs" builds on this argument by outlining the channels through which interest groups can use their resources to lobby politicians and governments. Section "Governments' preferences and IMF programs" explains why governments should respond positively to lobbying by domestic interest groups. It also explores the factors that limit and constrain governments from freely exercising influence over IMF policies. The resulting argument is that pressure from organized groups in society should often tip the balance of interests away from policies that are in the best interests of all at a global level. IMF financing is often the most desirable mechanism for responding to groups that are dislocated by an economic shock. Governments possess few other mechanisms for compensating domestic actors which are nearly as effective or risk-free. I conclude this chapter by discussing strategic interests and IMF programs.

## **Interest groups and IMF programs**

IMF programs can have substantial distributive consequences. In today's more integrated global economy, these consequences are less confined to a single country or region than before. As a result, a range of actors, both in and out of the affected country, stand to gain from IMF financing. First, all the creditors of the affected country are in a position to benefit. A country's creditors include other governments, commercial banks, bond investors, and suppliers. Second, to the extent that IMF loans keep borrowing countries open for business, any government, firm, or individual with significant economic links to a borrowing country can potentially benefit. One of the many strategies these societal groups should consider is to lobby for IMF finance in the expectation that some of it will be diverted back to them.

Although many actors have a potential stake in IMF programs, most will find it difficult to act on their interests in the political arena. In order to be able to influence one of the powerful governments which can shape IMF policy, an interest group must be part of one of the IMF's largest shareholders and stand to gain significantly from IMF financing. Furthermore, it must possess the resources to exert political pressure in domestic politics. As a result, concentrated interests in the G5 that have

the ability to employ significant resources to influence their governments' preferences are more likely to influence IMF policies.

The other societal groups that might benefit from IMF financing will find it difficult to gain access to the "IMF strategy." Individual investors, for example, face many difficulties recouping their losses from sovereign defaults. Being too numerous and diverse, they face many obstacles which prevent them from acting collectively and limit their ability to lobby governments. Individual investors are also by their nature more short-term and less visible in international politics than banks or firms.<sup>1</sup> One visible outcome of their failure to act collectively is that they possess few formal institutions through which they can coordinate their actions as a group or engage in negotiations with debtors. One only needs to consider the history of bond financing, which is littered with failed attempts to form institutions to recoup losses to see that this class of actor has achieved little success in mobilizing for political action (Sturzenegger and Zettelmeyer 2007: Chapter 1). Much of the same can also be said for taxpayers. Each taxpayer stands to gain in a very small way from additional IMF financing but will find organizing for collective action even more challenging than an investor.

For some large firms, the story is different. Banks are in a better position to seize the opportunity provided by IMF financing because they are fewer in number than individual investors. Their smaller numbers make it easier for them to exercise political influence.<sup>2</sup> Banks benefit from IMF financing when a recipient government redirects it to them. For example, the terms of Ghana's 1983 IMF program stipulated that Ghana's loan would be deposited in the Bank of England from where it would be directly transferred to Standard Chartered Bank to repay a short-term loan (Gould 2006b: 156). There is also evidence that markets expect IMF financing to be redirected as the stock market capitalization of financial institutions tends to increase following IMF quota increases (Demirguc-Kunt and Huizinga 1991).

Exporters are the other relevant interest group that would usually prefer more IMF financing to offset their losses. Economic shocks hurt exporters by reducing the demand for foreign imports in an afflicted country and also when they increase the competitiveness of an afflicted country's exports. A generous IMF program can help to take some of the pain associated with an economic shock. In particular, an IMF program can support the public sector in a developing or emerging market, many of which import a lot of foreign goods and services. Therefore, exporters that supply governments will be the first to benefit from additional IMF financing because it allows governments to continue to purchase goods

and reduces the likelihood of governments defaulting on payments for goods and services already supplied. That exporters lobby their governments to offset losses is already well established in the political economy of trade (Dür 2010). It is also reasonable to expect that exporters would seek IMF financing where they face both a loss of their market share and a loss of profits due to a reduced demand for goods and services and/or government default on the payment for goods or services already supplied.

Both banks and exporters ideally should want to influence several aspects of IMF financing. First, they should like to see their chosen country participate in an IMF program so that they can benefit from the IMF financing in the first place. Second, they will tend to prefer bigger IMF loans. Additional financing, beyond what a struggling government would have otherwise received, means that it can continue to service its obligations to creditors. Finally, interest groups would normally want to influence the terms attached to the loan, otherwise known as “conditionality.” They will tend to favor easier conditionality because they fear a scenario where a borrowing country fails to implement a binding condition and is subsequently cut-off from IMF financing, plunging it into a sovereign default. The domestic interest groups that are exposed to this sort of risk will prefer more relaxed conditionality and will pressure G5 governments into delivering this outcome.

Apart from IMF financing, the other options available to both banks and exporters include reducing their exposure to a troubled country and bilateral or multilateral negotiations to recover outstanding debt. Indeed, reducing exposure is a popular strategy; capital flight and financial crises are highly correlated. The same is also true of trade which predictably collapses in the years following a Paris Club agreement to reschedule or restructure sovereign debt (Rose 2005). While reducing exposure is a popular strategy, it is much easier to do under the cover of an IMF program. Furthermore, negotiation with the debtor is much less desirable. This is because private cooperation to reschedule debt is complicated by the number of actors involved, the diversity of financial assets, and the variation in exposure of the actors involved (Lipson 1985: 203). Although collective action to recover debt is difficult, bilateral or multilateral talks with the debtor are possible if a country has unmanageable debt that it must restructure. Private creditors (whether banks or exporters) can offer to postpone principal payments, inject new capital to keep interest payments current, or offer to reschedule debt. Although rarely successful, private creditors can also use the threat of commercial sanctions (particularly trade sanctions) to limit their losses (Tomz 2007: 195).

Private cooperation is even more difficult when governments enter the formal debt restructuring process through the Paris Club and Heavily

Indebted Poor Countries Initiative. In a formal restructuring arrangement, private actors are at the bottom of the creditor hierarchy in terms of their ability to recover debt.<sup>3</sup> Their lack of seniority means they can become crowded out in the process. By contrast, the IMF and other multilateral development banks are at the top of the creditor hierarchy. International institutions like these are almost risk-free lenders that borrowers must repay. Next in line are bilateral lending agencies – mostly export credit agencies financed by their governments – whose debts are easier to recover because they are publicly guaranteed by debtor governments.<sup>4</sup> After the public creditors represented by the Paris Club seize the opportunity to recover their debts, the commercial banks represented by the London Club<sup>5</sup> or Bank Advisory Committee are the next in line to receive treatment. Finally, bond investors and suppliers are the last to receive treatment in the process. Suppliers, including exporters, are the least likely to receive anything from a default or restructuring but sometimes their goods and services are insured against sovereign default through export credits. Before doing business with a developing or emerging market, exporters have to choose one of three options: demand payment in advance, extend credit without a guarantee, or acquire third party insurance. Exporters balance the risks involved against the potential gains before making a decision. Governments also decide whether to subsidize or insure exports to countries or regions. As a result, the economic exposure of exporters will vary – some will be highly exposed to risk and loss in a developing country following an economic shock whereas others will be fully secured in advance.

In summary, banks, bondholders, and exporters are all lower down in the creditor hierarchy and must negotiate through different mechanisms to recover debt. Debt recovery is a difficult process taking years and often yielding nothing. International cooperation among debtors and creditors is difficult to achieve and the formal debt restructuring is not ideal for banks or bondholders as they are not priority creditors. With the odds stacked against them, interest groups in the G5 that have lost, or expect to lose from an economic shock, are left with little other option but to look toward their own government for assistance. Through lobbying, they can pressure their government into extending additional IMF finance to a troubled country, some of which can then be diverted back to them.

### **Lobbying strategies to influence IMF programs**

So far I have outlined how an economic shock in a foreign country can hurt domestic interest groups in other countries, potentially causing them to lobby through political channels to limit their actual or



potential losses. My argument is that interest groups should organize primarily to lobby governments over IMF programs and should use their resources to shape government preferences according to their aggregate exposure to a shock. To achieve this, interest groups can draw on different types of resources including money, legitimacy, political support, knowledge, expertise, and information (Dür 2008: 1214). In this section, I turn to the specific channels through which banks and exporters can use their resources to lobby politicians and governments. Exporters and banks are both strong societal groups which can mobilize significant resources to lobby politicians, governments, and the IMF's professional staff. Although there are many potential pathways to influence, it is still possible to identify two main strategies. The first involves lobbying in domestic politics to influence government policy and the second strategy is direct lobbying of the IMF through international political channels.

### **Domestic lobbying**

In 2006, approximately 8 per cent of US exports went to Mexico. With so many of their exports going to this one country, many US firms and businesses would suffer from any economic deterioration in Mexico that leads to a reduced demand for their goods and services. In such a scenario, it would be in the interests of some US export-oriented firms to lobby for IMF assistance for Mexico. One would expect that political representatives from states like Texas would take an active part in the lobbying process, as Mexico was the destination of 36 per cent of its exports in 2006.<sup>6</sup> With so much of the states' income coming from this economic linkage, members of the US Congress from Texas should demand that US international economic policy is favorably disposed toward a generous IMF program. This would lead to significant gains for business interests in their district with links to Mexico. On the whole, a Mexican bailout would be much more beneficial for a state like Texas than other states, so representatives from this state should try to influence US international economic policy in this direction. The other members of Congress from areas that are similarly exposed can also influence IMF decisions through the committees that oversee and direct US international economic policy. Members of Congress that aren't on one of these committees can logroll, vote-swap, or horse-trade with other members who have access. The particular committees in the United States that can influence US policy toward the IMF are *the Committee on Appropriations (the Subcommittee on Foreign Operations, Export Financing and Related Programs)*, *the Committee on International Economics Policy and Trade*, *the Subcommittee on Africa*, *the Subcommittee*

*on Asian and Pacific Affairs, and the Subcommittee on Europe and the Middle East* (Laovakul 2004: 24).

To summarize, in a hypothetical case like this, interest groups should lobby politicians directly on the basis of their exposure to risk and loss. We should also see politicians working within the constraints of their political system to shape US policy toward the IMF. But how exactly will interest groups lobby politicians? Much of the political science literature finds that campaign financing and political donations are popular strategies for buying influence (Becker 1983; Denzau and Munger 1986; Austen-Smith 1987). Recent contributions to the IMF literature also support this conclusion. Broz and Hawes (2006: 375) found that campaign contributions from “money-center” banks increase the likelihood that a member of the US Congress will vote in favor of increasing the contribution of the United States to the IMF. Therefore, the authors demonstrated a clear link between banks, campaign contributions, and IMF resources. Furthermore, Lavelle (2011) has demonstrated conclusively that societal groups with stakes in the International Financial Institution (IFI) such as banks, global corporations, protectionist interests, and even environmental and social policy NGOs actively engage in lobbying to have an impact on US policy toward the IMF.

While I have illustrated how the various political processes can unfold in the US political system, domestic political institutions differ considerably across the G5. In the United States, for example, the legislative branch has relatively more influence over US policy toward the IMF than the United Kingdom’s House of Commons. In contrast, in the UK political system, this power is concentrated in the executive branch (particularly the office of the Prime Minister and the UK’s economics and finance ministry). Why should interest groups have similar levels of access to politicians and bureaucrats across each of these countries? If a powerful financial institution or exporter lobbies the German government to approach the IMF for a bigger loan for Greece, should we also expect that they will have the same level of access and influence over policymakers? How do the distributional implications of economic shocks play out in other members of the G5 and how do political processes unfold in France, Germany, Britain, and Japan?

Lobbying strategies will differ in each of the IMF’s major shareholders. In some, political contributions are strictly limited and there is a tendency toward public funding of political actors. In others, ordinary legislators might have little influence over their countries’ international economic policy. Regardless of the variation across countries, at the

aggregate level it is reasonable to expect that governments will respond, and in later sections, I take up this point in more detail.

In summary, banks and exporters possess significant resources, along with knowledge, expertise, and information. Because of the significant distributional implications of some economic shocks, it makes sense that they should lobby to offset their losses.

### **International lobbying**

In recent years, commentators have speculated on the existence of a Wall Street–Treasury–IMF complex, where constant social interaction among elite investment bankers, highly-placed government officials, and IMF officials leads to shared preferences (Bhagwati 2004: 206). However, few scholars have gone as far as saying that it leads international banks to lobby directly IMF officials for special treatment. Nevertheless, this perspective leads to the argument that an elite group of actors has similar policy preferences. Is there any evidence to suggest that international lobbying channels exist or are socialization processes enough to embed shared preferences? Can large international banks lobby the IMF directly?

The IMF's managing director (MD) and professional staff have held talks on occasions with commercial bank representatives. According to De Vries (1986: 936), borrowing countries also negotiate concurrently with the IMF and private banks occasionally. The result is a potential conflict of interest for IMF staff. On the one hand, commercial banks would like to obtain information from them on the status of the debtor country so that they can better evaluate the risks involved in lending money to it. On the other, commercial banks hold information relevant to the IMF on how much debt relief they can extend to troubled countries. An exchange of information, however, could potentially disrupt markets and cause an international incident. De Vries argues that the relationship between private banks and the IMF was always very sensitive. IMF staff members are acutely aware of the privacy issues involved in the disclosure of information. In some instances, officials from borrowing countries were concerned that the Fund might give banks too much information, whereas officials from the more powerful shareholders were afraid that too much information could lead to bailouts and moral hazard (De Vries 1986: 937). Instead, it is Fund policy not to discuss economic developments in member countries with private actors but to make statistical data available on selected topics.

The relationship between private actors and the IMF is, however, always changing. In 2000, a consultative group was established to facilitate the exchange of views between IMF management and representatives of the financial industry. The IMF also has a capital markets department to

monitor developments in this sector. On the side of commercial banks, the Institute of International Finance coordinates the representatives from the financial sector. According to Reiffel (2003: 236), the G7 and officials in the public sector in general are very reluctant to cooperate with the financial sector for fear of the negative implications. Overall, I find that historical accounts of the IMF lend little support to the argument concerning a "Wall Street–Treasury–IMF Complex" (Horsefield 1969; De Vries 1976, 1986; Boughton 2001). Moreover, international bureaucrats should have very strong incentives not to release information to private actors. If IMF staff divulge information to a private bank, or agree to act in its interest, this could result in retaliation from an affected member-state. Not only would this cause a diplomatic incident but it also could threaten the stability of the institution and financial markets. These sorts of risks are too much for bureaucrats to assume; therefore, I find little support for a systematic relationship between private actors and the IMF's staff. Although the Fund has increasingly engaged with private interests – and private actors are now better coordinated at the international level – this particular channel of influence is not likely to work very well.

In summary, interest groups have several key strategies at their disposal and must evaluate the relative usefulness of pursuing each option. Adopting any strategy to recover debt requires investing resources in acquiring information, knowledge, lobbying, and more. Private financial institutions and some firms have advanced models of risk management and should be rational actors in this regard, selecting the most efficient method of recovering debt, reducing exposure, and lobbying governments. Beyond the key strategies that I have outlined, interest groups also have other ways of wielding power. According to Dür (2008: 1215), other methods include supporting an incumbent or challenger in an electoral contest, conferring legitimacy on political actors, facilitating decision-makers through the provision of information, and shaping public actors' beliefs and preferences. Overall, it is possible to conclude that domestic political channels are likely to be much more effective for private creditors such as banks and exporters compared with international channels.

## **Governments' preferences and IMF programs**

So far I have outlined how a deteriorating economy in a foreign country can hurt domestic interest groups, encouraging them to employ lobbying to limit their actual or potential losses. My argument is that interest groups should often organize to lobby governments over IMF programs and should use their resources to shape government preferences in line

with their aggregate exposure in a foreign country. But will the exposure of domestic interests ultimately lead to government action?

At an international level, governments have few other avenues to turn to other than the IMF. The other possible strategy involves the use of taxpayers' money. In some situations governments will subsidize banks and exporters directly. In others, government will orchestrate a bilateral or multilateral loan to "bail out" a country that is on the verge of default or experiencing some form of economic crisis. From the vantage point of a government, however, these options are less desirable. IMF financing involves no direct transfer of money from taxpayers, making it the most attractive option for governments that possess the means and motivation to align the organization's policy with their preferences. Many experts see this as an inherent flaw in the international financial architecture. For example, former First Deputy Managing Director of the IMF, Anne Krueger, commented that:

We lack incentives to help countries with unsustainable debts resolve them promptly and in an orderly way. At present the only available mechanism requires the international community to bail out the private creditors. (Krueger 2001)

Although many expert analysts understand the nature of this problem and have suggested possible solutions, there are few systematic explanations of the political consequences that follow from its existence.<sup>7</sup> My argument is that interest groups are aware of this gap in the international financial architecture and will use their resources in order to exploit it. Governments will often respond favorably to lobbying because banks and exporters have structural importance, constraining the extent to which governments and politicians can act against their interests. The structural importance argument is based on the insight that the state is structurally dependent on capital; governments tend to dislike policies that hurt business interests because they are dependent on the private sector to provide revenue for the state (Wallerstein and Przeworski 1988).

Governments must also evaluate the effectiveness of the different strategies at their disposal. As a group, they benefit collectively from good IMF policies that stabilize economies, prevent the disruption of trade and capital flows, and reduce the risk of "contagion" where a financial crisis in one country spreads to others. In return for the provision of international public goods, governments contribute to the IMF's resources. The primary cost that arises for governments is the "opportunity cost"

of membership: to continue as a member a government must not withdraw its IMF quota and divert it to some other use. Added to the opportunity cost of membership is the possibility that the organization will not always deliver the goods; capture by powerful countries or special interests may well prevent the organization from delivering. Politicians that represent citizens who benefit disproportionately from international economic integration should accept these potential costs in return for the potential benefits.<sup>8</sup>

Considering both the costs and benefits associated with the IMF, does it follow that governments will always support socially optimal IMF programs? In many instances, governments lack the incentive to do so because a socially optimal program might benefit its constituents only marginally. Because voters are uninformed or apathetic about international financial rescues, they do not always hold governments accountable for their success or failure to support good IMF policies. Information asymmetries also make it difficult for governments to be informed about every international financial rescue. This is one of the reasons why the task was delegated to the IMF's staff in the first place. By contrast, governments will often support a policy that is sub-optimal at the global level in order to cater to a narrow segment of society because it benefits disproportionately from IMF financing.

Nevertheless, there are still limits to how far a government can influence IMF policy, even when one wants to stray as far from the socially optimal outcome as possible. First, the organization's budget acts as a considerable constraint. Its budget is comprised of members' subscriptions, reserve holdings, and its ability to issue SDRs. This gives it a potential budget greater than its members' quota subscriptions alone, but strict rules prevent it from unlocking this potential. Since the end of the Bretton Woods system of fixed exchange rates, member-states have reduced the organization's funding base, and its capacity to issue international currency has remained dormant. In recent times, the Fund's resources have been increased to meet the challenges of the global financial crisis. Figure 3.1 illustrates the changes in the IMF's lending capacity over previous quota reviews (the trebling of the IMF's lending capacity after the G20's annual summit in 2009 is not included in the figure).

Second, if the Fund were to lend too freely without concern for the risks involved, it would damage its reputation, increase moral hazard, and deplete its limited resources. To avoid these outcomes, the IMF's member governments must strike a balance between the provision of liquidity and the prevention of moral hazard (Copelovitch 2010b: 53). Providing liquidity allows debtors to continue to service their loans.

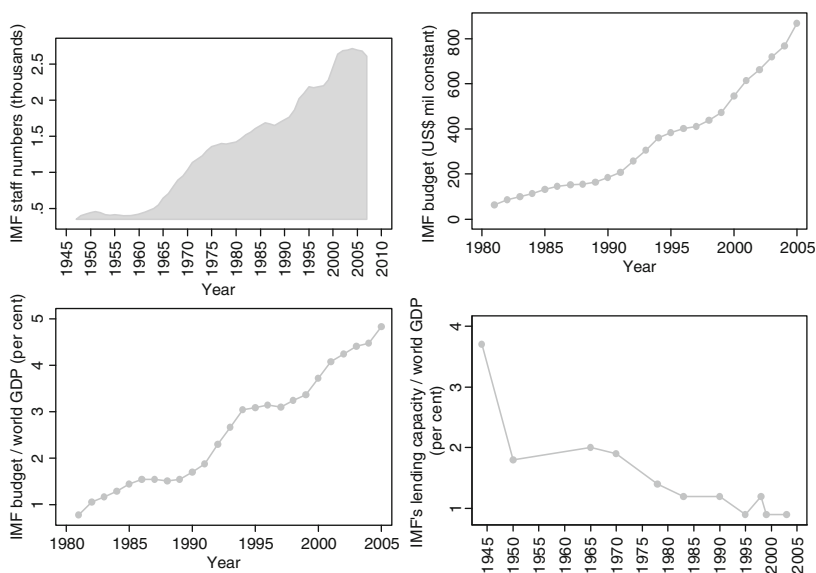


Figure 3.1 IMF's lending and bureaucratic capacity

Source: International Monetary Fund and Brown (2009).

Keeping debtors liquid also has a pacifying effect on the international financial system by preventing the spread of a financial crisis to other countries. If IMF resources are used recklessly, however, this will create “moral hazard” where both private investors and recipient governments might act recklessly without sufficient concern for risk. IMF insurance alters their expectations, as they do not have to suffer all of the consequences of their actions, leading to the possibility that IMF financing could increase the likelihood of a financial crisis occurring in the first place.

Third, if the G5 were to continuously exercise power with no restraint, this might upset the IMF's current membership. According to Hirschman (1970), actors have a number of key strategies at their disposal when an organization deteriorates: an actor can withdraw from the organization, remain loyal to the status quo, or attempt to repair the organization through communication. Perceived misuse of the IMF by a small group of states would eventually lead to a political response by the other members. In the next chapter, I take up this issue in more detail, commenting on why excluded governments continue to tolerate *de facto* G5 governance of the Fund.

Finally, a strong consensus exists among many social actors that IOs like the IMF should be democratic, accountable, legitimate, and transparent. When the IMF acts in ways that are inconsistent with these norms, it risks alienating a range of social actors. As an institution, it should try to avoid this if it can. According to Seabrooke (2007), the IMF suffers from an international legitimacy crisis, its design and the way in which it represents powerful countries already break important social norms, meaning that it is already sacrificing some of its potential to work well. Thirkell-White (2005) made a similar argument, adding that one of the consequences of the Asian crisis was an increase of skepticism about whether the organization should be allowed to exist and function in its current form.

A crisis of legitimacy could lead to political challenges from inside and (or) outside the institution: if many political actors, NGOs, and civil society groups believe that the organization is not tenable in its current form, its existence might be threatened. At the very least, a legitimacy-deficit makes it more difficult to do business and persuade others to adopt certain policies. In order to address this problem, key political decision-makers must try to strike a balance between maintaining their political influence at the organization and allowing it to remain both efficient and legitimate. This is not an easy trade-off. Making the organization more democratic might make it less efficient and making it more efficient might lead to less political control over decisions.

Therefore, subject to all of these constraints, governments must make the trade-off between hurting special interest groups and damaging the IMF's legitimacy, reducing the effectiveness of IMF policies, and increasing moral hazard. The balance will often tip toward policies that fail to deliver socially optimal IMF programs when the costs of doing so outweigh the benefits. Governments will tend to support banks and exporters when the cost of not doing so exceeds the gains from their investment in the IMF, both in terms of their holding of SDRs in the common pool of resources and also in terms of the gains made from the international public goods which the institution provides.

## **Strategic interests**

In this chapter, I have argued that G5 preferences over IMF programs are shaped primarily by each member's domestic economic exposure in developing and emerging markets. However, many authors stress that the strategic interests of the United States should have a central explanatory role in any study of IMF behavior. How important are strategic as



opposed to economic interests? First, there is a good case to make that bilateral economic links are actually a good proxy for strategic interests. The strategic and economic importance of developing and emerging countries often goes hand-in-hand. However, on the margins, a member of the G5 might have little economic exposure in a borrowing country, yet still seek a generous IMF assistance for this country because of its strategic importance. Such a country would have to “compensate” a member of the G5 for incurring the cost of its “bailout.” Another way of framing this point is that such a country would have to possess something of enough value that a member of the G5 would offer additional IMF financing to obtain it.

The product or concession will have certain characteristics that make it of unique strategic importance. First, it cannot be easily convertible into another good: its value will often be context specific and it might expire or become worthless at some point in the future. The decision to exchange an item of strategic value in return for IMF financing is a complex two-level game, determined by domestic politics in the provider and the recipient as well as international negotiations. To put it more simply, a country must be willing to supply it to another country where there is sufficient demand for it.

Goods of strategic importance, according to my definition, fit into two broad categories. First, they could involve a political concession like a vote at the UN Security Council. Indeed, evidence suggests that temporary membership of the Security Council influences IMF decisions in favor of the temporary member (Dreher *et al.* 2006). Second, they could involve the use of a country’s public goods, such as permission to establish a military base, use a shipping lane, or build an oil pipeline. Authors and researchers who have studied foreign aid support the argument that aid is often given for “policy concessions” such as these (Bueno de Mesquita and Smith 2009).

A once-off exchange of political concessions and public goods for IMF financing explains only part of the political story. It is more likely that long-term alliances exist where goods of strategic importance are exchanged in return for financial support of various kinds, including military assistance, foreign aid and, if necessary, IMF financing and World Bank project assistance. Where a country gives a member of the G5 long-term use of its public goods or political support, it can threaten to withdraw this and continue to charge a premium for its continued support.

To summarize, although G5 economic and trade exposure are good proxies for the strategic importance of a borrowing country, in some

cases the G5 might have little in the way of economic exposure yet still want to provide such a country with a generous IMF loan. Although unlikely, it is possible that both strategic and economic interests could clash to the extent where strategic interests might change government preferences toward denying IMF financing to a country. Such occasions would be very rare. If they occur, I would surmise that economic exposure is the baseline from which strategic interests are formed. Where economic exposure is high, a government will have to weigh the costs and benefits of denying its strategic rival IMF financing and thereby hurting its own special interest groups. If a strategic rival were granted IMF assistance and it continued to service the debt owed foreign banks and foreign exporters, a member of the G5 will often prefer this outcome. This is because granting a strategic rival IMF assistance can make sense financially. Otherwise, the government seeking to deny its rival a loan would have to consider directly compensating their special interest groups for their losses.

While powerful states have strategic interests which determine their behavior in many venues, it is important to place these in the context of what the IMF actually does and how it might be used to achieve strategic objectives. With regard to this point, my argument is twofold. First, strategic and economic interests are mostly aligned. Where the two are not aligned, the latter should trump because of the distributive effects of IMF programs, which can create fear among creditors, driving governments to respond. Strategic interests in borrowing countries do not have the same effect on domestic politics in the G5. No pressure will emerge from domestic interest groups lobbying on behalf of a borrowing country. There is an argument that a "military-industrial complex" or foreign policy elite might fill the shoes of private banks and exporters in lobbying to grant or deny IMF assistance to a particular country but the causal mechanisms remain unclear. Indeed, explaining the domestic sources of governments' strategic preferences from sub-national units such as individuals, groups, and firms has proven difficult for scholars of international political economy (Frieden 1999). If these sorts of processes matter for systematically influencing IMF agreements, they will matter more so in the United States. Indeed, the United States stands out when one looks at just one crude measure of a country's aggregate strategic interests – military spending as a percentage of GDP (gross domestic product) – which clearly dwarfs all other IMF shareholders. As a result, it is necessary to control for its role in any empirical analysis because its influence has both theoretical and empirical support in the literature.

## Conclusions

With the rapid increase in international economic exchange, many states are more interdependent than ever before. Following an economic shock that threatens and disrupts the linkages between states, governments and IOs must make hard choices over how to respond. With the possibility of many actors standing to lose significantly from an economic shock, governments can come under severe pressure to do what they can to reduce losses, even if this means supporting policies that go against the best interests of everyone on a global level.

In this chapter, I have argued that the IMF is a venue where these sorts of difficult trade-offs and hard choices are made, affecting the prosperity and development of many countries. I gave a central explanatory role to domestic political processes in the G5, showing how these aggregate into government responses to address economic shocks at the international level. I took a linear approach, first by deriving the interests and preferences of domestic actors over IMF policies and then showing how governments respond to these depending on the strength of the interest group in question, and their position in the international economy.

Overall, this theory of IMF behavior incorporates both the domestic and international determinants of its most important policy output, showing that more governments than just the United States matter when it comes to explaining variation in its decisions. Furthermore, it illustrates how the changing economic linkages between societies can incite political competition to influence the policies of IOs. Therefore, this theory adds to international political economy, which has focused on the societal determinants of trade and monetary policy, with less examination or analysis of how similar forces can shape the behavior of the IOs that govern the world economy.

# 4

## The Impact of the Shareholders on IMF Programs

The previous chapter set out the conditions under which domestic interests in the G5 influence government policy toward the IMF. Recognizing that domestic political processes drive government behavior, this chapter outlines the international political processes by which governments reach collective decisions over high-level IMF policies. To achieve this, it presents several critical insights into international politics at the IMF including (a) the strength of the G5 relative to the other member-states represented at the Executive Board, (b) the process by which G5 governments cooperate among themselves to influence decisions, (c) the officials appointed by the G5 that act on its behalf at the Executive Board, and finally (d) the power of the G5 relative to the IMF's professional staff.

This chapter is divided into four sections where I scrutinize each of these points in more detail. First, I discuss G5 governance of the Fund, commenting on why this group of states is in such a pivotal position to influence policies and why other members of the organization continue to tolerate this arrangement. My argument is that G5 governance of the Fund rests on its ability to make "program decisions" to alter the IMF's mission and purpose. A further strength is its ability to shape policy decisions before they reach the Executive Board for approval. As this chapter illustrates, their input into the decision-making process is substantial and occurs without the need continually to invoke the formal voting procedures. The group's authority is embedded in the organization's rules and formal decision-making processes. These rules condition the behavior of other actors, who make decisions under the threat of the G5's ability to veto decisions that require a 70 per cent or 85 per cent special majority and its ability to collapse the current system of representation at the Executive Board. The other members of the organization continue to

tolerate this arrangement because it is not without advantages: the organization clearly functions, allowing input, access, and voices from both the Fund's staff and membership in areas that do not go against G5 interests.

Second, I describe how the governments which comprise the Board reach collective decisions and how the institution's rules and design limit and constrain their behavior. I argue that the most plausible way in which G5 governments cooperate to influence events is through a system of logrolling. An informal process of bargaining such as this works alongside the group's ability to threaten to invoke their formal powers. This allows other governments to participate whenever their interests do not go against the G5. Therefore, my explanation gives an important role to the Fund's institutional design, by showing how it aggregates the interests and preferences of 188 states and illustrating the most plausible way in which governments cooperate to make decisions at this level.

Third, I analyze the role of the political representatives appointed to govern the organization via the Executive Board. According to my theory, as I set out in the previous chapter, these actors are good proxies for states' interests and should faithfully reflect the positions of the governments that appointed them.

Fourth, my theory of IMF behavior also rests on the assumption that the G5 has the ability to exercise significant control over the organization's output via its professional staff. To explore this facet of their power over decision-making, I draw on principal-agent theory to analyze the mechanisms by which governments can constrain the IMF's staff from taking independent action against their interests. Principal-agent theory specifies several mechanisms by which governments can structure bureaucrats' incentives to limit rogue behavior. To begin with, governments design an initial contract specifying the range of independent action that bureaucrats are authorized to take. Throughout the life of an IO, governments can amend the contract, as both parties learn to adapt to the relationship. Governments can also use a variety of monitoring and reporting requirements, screening and selection procedures, institutional checks and balances and sanctions, to rein in, and prevent, slack or rogue behavior. Many of these mechanisms of control are costly and imperfect, however, and governments that use them know that they must invest time and effort. Therefore, we should not expect IOs to follow slavishly their political masters but instead to possess different levels of autonomy across policy areas.

The resulting argument in this section is that the G5 has significant influence over policy through its input into, and control of, the recruitment of key officials, career advancement, salaries, and job security.

This input comes from their ability to control the organization's program or contract, and to veto decisions if Fund behavior strays too far from government preferences. The institution's checks and balances are also extensive. Its organizational structure includes bureaus with opposing mandates, a strict hierarchy and methods of controlling autonomy during crisis negotiations with borrowing countries. G5 governments can also use various sanctions to control slack, such as quota reviews and reviews of staff compensation and benefits.

### **G5 governance of IMF: formal or informal?**

According to the argument I set out in the previous chapter, the position of the G5 is a crucial determinant of variation in some of the Fund's most important policies. First, the G5 are the only representatives that are automatically appointed to the Executive Board, rather than having to stand for election like the rest of the membership. Second, their command of a large share of the Fund's votes – around 38 per cent – gives them widespread influence and the ability to veto any decision requiring a 70 per cent special majority (see Table 4.1). Decisions requiring special majorities are described in the IMF's Articles of Agreement. The most important decisions pertain to voting rights and issues of representation at the Executive Board. These require an 85 per cent majority at the Fund's Board of Governors. In addition, 40 decisions require special majorities at the Executive Board, 16 of which require 85 per cent of the votes (Houtven 2002). G5 voting power is optimal for preventing any group of governments from organizing to change the IMF's constitution or major institutional rules. As a group, it holds enough voting power to block any decision requiring a 70 per cent majority. The United States alone has the ability to veto decisions requiring an 85 per cent majority, giving it the privilege of deciding whether or not to maintain some of the institution's core rules and design, thus preserving the status quo.

More importantly, lending decisions require only a 50 per cent majority. This means that the G5 is almost a minimum winning coalition in that it needs only the support of the directors that request the loan and one to three other directors to pass a lending decision, if one is formally challenged.<sup>1</sup> Of course, lending decisions hardly ever come to a formal vote. However, the G5's ability to form a winning coalition quickly gives it the ability to prevent other governments from voting down IMF programs.

By contrast, other governments are not able to influence program approval, lending, and conditionality to the benefit of domestic interest groups located in their respective jurisdictions. Both the distribution

*Table 4.1* Distribution of voting power at the IMF (2009)

Country with ED	Countries in group	ED's home country size in group (per cent)	Size of group in IMF (per cent)
United States	Appointed	–	16.79
Germany	Appointed	–	5.88
France	Appointed	–	4.86
Japan	Appointed	–	6.02
United Kingdom	Appointed	–	4.86
China	1	–	3.66
Russia	1	–	2.7
Saudi Arabia	1	–	3.17
Belgium	10	40.6	5.15
Netherlands	12	49.2	4.76
Italy	7	77.8	4.11
Finland	8	16.8	3.44
Switzerland	8	56.3	2.79
Australia	14	38	3.85
Canada	12	79.2	3.64
Venezuela	8	27.2	4.45
Egypt	13	13.6	3.2
Indonesia	12	30.4	3.12
Iran	7	28.3	2.42
Brazil	9	57	2.42
India	4	80.2	2.35
Peru	6	15.2	1.96
Kenya	19	4.5	2.94
Rwanda	24	3.4	1.39

*Source:* IMF (2009d) and author's calculations.

of power in terms of voting rights and the institution's rules put other countries in a weaker bargaining position.<sup>2</sup> This is not to say that governments outside this privileged group have no influence over Fund policy; it is just that they cannot form a voting bloc with enough power to shift some of the most important policies – program approval, lending, or conditionality – in favor of their constituents.

Many other authors have identified the importance of the G7 (which includes Italy and Canada) as a commanding influence at the IMF and in the international financial system more generally (Rieffel 2003; Fratianni and Pattison 2004; Roubini and Setser 2004). We also have many accounts of their cooperation in international finance and their ability to set the agenda of the IOs that operate in this area (James 1996; Boughton 2001; IEO 2008).

The political power of the United States and the United Kingdom in the organization is derived from their legacy as its creators. The position of the United States and the United Kingdom at the Bretton Woods conference – largely unopposed – gave them the opportunity to do this. Since it was established, realist conceptions of state power based on military strength do not provide a good explanation for the ability of states to wield authority at the IMF. Rather, authority and power are more closely related to states' economic size than military strength. This was embedded in the organization from its very beginning through its quota system, which does not privilege military strength. Advanced industrial economies with little military power are very well represented, above and beyond those with larger armed forces. However, economic strength alone does not provide a perfect explanation of a governments' position at the Fund. For example, China was underrepresented for many years until 2010, even though it had a larger GDP than the United Kingdom, France, and Germany. Rather, the G5 countries have a privileged position because they are at the core of the international financial system in several respects. First, their currencies – the euro, dollar, and yen – are the world's reserve currencies in which most foreign transactions are conducted. Although the dollar has been the cornerstone of the international financial system since before Bretton Woods, the other members of the G5 also constitute and maintain the financial system, clearly setting these governments apart from others at the Board. Even the IMF's unit of accounting – the SDR – is derived from a weighted basket of G5 currencies. In summary, these countries are the most important in the international financial system, and this is reflected in their share of votes in the Fund.

Although their power and privilege are embedded in the rules of the organization, it is not officially recognized and rarely invoked through formal processes like voting over decisions. Instead, their governance of the organization is informal, starting with the group's ability to set "program decisions." Program decisions set the norms and rules that direct the behavior of IOs, as opposed to the operational decisions which are the focus of the empirical chapters contained in this book (Rittberger and Zangl 2006: 92). Program decisions are made in informal high-level committees that oversee the IMF's mission and functions. First, G7 finance ministers and central bank governors (the G8 excluding Russia) meet twice annually to monitor major developments in the world economy. Each member of the group is in constant contact with IMF officials. Second, these states are a controlling force on another high-level committee: the International Monetary and Finance



Committee, which is charged with advising the IMF on the direction of its work (IMF 2010e). Such fora allow members to renegotiate, rewrite, or change major program decisions or the direction of the IMF's mission. If the Fund's staff do not act in accordance with the preferences of these higher level committees, members can adjust the organization's role and responsibilities through negotiation in these fora. Annual summits and other regular meetings provide the opportunity to initiate program changes. Apart from major program level changes to the IMF's mission, these fora allow states to coordinate their actions, share information, and reach consensus on issues such as controlling agency slack. These sorts of committees also help the group to avoid conflict over every case that presents itself for approval in a formal decision-making arena like the IMF's Executive Board. It is not an accident that voting rarely occurs in individual lending cases in fora like this, as states engineer ways to avoid constant conflict.<sup>3</sup>

Besides summits and official meetings, the G7 group of finance ministers is a crucial interface between the Executive Board and the IMF's professional staff. According to Rieffel (2003), it holds a constant dialogue with the IMF staff, allowing politicians to signal their preferences over the design of loans, programs, and conditions to the staff. Rieffel argued that decisions flow from the top-down through the G7 finance ministers to the International Monetary and Finance Committee and then Executive Board (Fratianni and Pattison 2004). It is important that this group act cohesively and that private disagreement over the Fund's policies is not made public, as this could destabilize markets and attract unwanted public scrutiny, making it difficult for the group to coordinate future policies. One example of disagreement at the G7 level comes from Blustein's account of the Argentinean financial crisis, where the British "took the unusual step of sending a private letter to the US Treasury and other G7 finance ministers advancing the argument that the chances of failure for a conventional IMF program in Argentina were very high" (Blustein 2005: 101). In this way, the United Kingdom made their strong opposition to the proposal clear. At the IMF's Executive Board, however, they did not block the program, which is in line with my expectations regarding logrolling over loan size and program approval.

Accepting that the G5 have a privileged and commanding position at the Fund, what of the other governments with representation on the Executive Board? Because G5 control is largely informal and "behind-the-scenes," the Fund's entire membership can continue to play a part, even if not a commanding role, in the formal decision-making process. First, in the case of developing countries, many lack the capacity to

exercise authority at the Fund because they lack access to the same level of resources, officials, and policy advice. Furthermore, they find it even more difficult to act in individual lending cases because directors from developing countries often represent very large constituencies and groups of states that constantly require IMF assistance (See Table 4.1 for the size of directors' constituencies). This burdens the small number of directors from developing countries with the task of always having to support requests for assistance, leaving them with little time or resource to affect other matters. Rwanda's director, for example, represented 24 countries in 2010 and would have expended much of their effort requesting IMF assistance and reviewing current programs. Furthermore, ED elected by the membership are appointed to two-year renewable positions, whereas there are no term limits for any of the directors appointed by the G5 (Martinez-Diaz 2008: 24).

Although the difficult position of directors from developing countries is clear, many small- and medium-sized European countries have seats on the Executive Board and do not suffer similar constraints. There is a clear division, nevertheless, among the small and larger European members of the IMF's Executive Board. The latter prefer to maintain their coalition with the United States and Japan. So far, there has been no move toward greater European cooperation at the IMF or a single seat for all European members. If the EU reorganized into a single seat at the Fund, it would hold over 30 per cent of the votes. However, in its review, the EU Council of Ministers did not suggest consolidation implying that, for the moment, EU members prefer representation at the national level (Smaghi 2004: 230). A reorganization of European members into a single seat would go against the interests of the United Kingdom, France, and Germany. They would lose significant influence over decisions by cooperating with smaller European countries through a single directorate. It would also discommodate the United States which in turn could result in retaliation.

Finally, the Fund's current representative structure is preserved by the United States, on the basis that it can exercise an "Armageddon option" that will cause all groups and constituencies to crash. This is because the IMF's Articles of Agreement allow for only 20 EDs; the current number of 24 directors is a temporary solution that the United States has continually approved since 1980.<sup>4</sup> Therefore, the United States alone can threaten to shrink the organization by exercising their power to reorganize the constituencies. Thus, EDs have strong incentives not to challenge the status quo. They would have to evaluate the costs of forming a coalition to bring down the organization's representative structure and weigh

this against the status quo. The potential gains in terms of increased representation would be tiny relative to the costs, which include the risk of failure and punishment. Reorganization could potentially lead to their losing representation on the Board. Members of the Board want to avoid this outcome. They want to avoid it because they want to preserve their seat on the Board, which was won through negotiation and election by other member-states. EDs (and alternative directors) want to remain in office and like most elected representatives fear losing their position to an official from another country.

In December 2010, the IMF announced a series of important reforms as part of its Fourteenth General Review of Quotas. The reforms were at the behest of the United States, who threatened to exercise the “Armageddon option” in the absence of support from the other shareholders. The most important reform was the transfer of votes to China, making it the third largest member of the organization. Furthermore, in July 2011, it was announced that a Chinese citizen would be appointed to an additional Deputy Directorship. Table 4.2 illustrates the changes to distribution of power. It shows that four dynamic emerging economies – Brazil, Russia, India, and China – are now among the IMF’s top ten shareholders. This reorganization has the potential to change the old G5’s

*Table 4.2* Voting shares of the IMF’s 10 largest members

Country/group of countries	Voting shares		
	2009	2012*	Change
United States	17.02	16.47	–3.2
Japan	6.11	6.14	0.4
China	2.93	6.07	107.2
Germany	5.97	5.31	–11.1
France	4.93	4.02	–18.4
United Kingdom	4.93	4.02	–18.4
Italy	3.24	3.02	–7.0
India	1.92	2.63	37.1
Russia	2.73	2.59	–5.4
Brazil	1.4	2.22	58.1
Total	51.18	52.47	2.5
Advanced economies	60.6	55.2	–8.9
Emerging market and developing countries	39.4	44.8	13.7
G20 countries	64	64.7	1.1
EU	32.5	29.4	–9.5

*Source:* Deutsche Bundesbank (2012).

\*Outcome of quota increase adopted in 2010.

control of the organization. On the one hand, China's new position may reduce the IMF's European bias. On the other hand, the old G5 – the primary focus of this book – are still in roughly the same position as before; they will be able to continue to form coalitions with enough voting power to defend their interests and spheres of influence in the global economy.

### **How do the G5 agree (or not) over IMF policy?**

Another step in developing my theory is to describe the decision-making process whereby the big shareholders bargain and cooperate with one another on the international stage to influence the IMF's policy output. Governments do so officially through the IMF's Executive Board, which sits in a continuous session, overseeing and influencing the direction of Fund policy. At first glance, it appears that governments are not in control of this process: the IMF's Executive Board rarely rejects a proposal from the staff, giving the impression that the staff are firmly in control of policy-making. This is unlikely, however, as the repeated nature of their interaction means that voting is not necessary for governments to wield influence. Instead, it is more likely that governments and their officials exert influence through informal channels. By threatening to reject a policy or taking punitive action in another policy area, governments can limit staff autonomy.

Although it is clear that governments wield influence over IMF policy, there is still much debate in the literature over how shareholders cooperate. On the one hand, Stone (2011) has argued that the United States is the dominant shareholder; the others yield to it in critical cases because of its unrivalled power. On the other hand, Copelovitch (2010) argued that the entire G5 matter but that the variance of their bank exposure will determine whether they agree or disagree over IMF lending and conditionality.<sup>5</sup> Like Copelovitch (2010), I argue that the entire G5 should be considered when we analyze government control of the IMF. The recent European sovereign debt crisis, where Germany has taken a leading role in organizing financial support, is a reminder that the other shareholders are important. However, I argue that the G5 have significant incentives to cooperate, even in cases where it appears that some have a very weak interest and others have a strong interest. It is primarily the threat of contagion that should push them to cooperate. As a consequence, the intensity of the group's exposure, rather than the heterogeneity of its exposure, is the most important means of identifying G5 preferences over IMF lending.

In this section, I argue that the most plausible way in which G5 governments cooperate is through a system of logrolling rather than confrontation and conflict over each case that presents itself before the IMF's Executive Board for approval. This explanation is based on the group's voting power and the IMF's constitution and institutional design, which are clearly biased in their favor. Logrolling in this context means that a member of the G5 will support a generous IMF loan for a country where their domestic interests are exposed to risk and loss. To gain support for their position, they will also support generous loans for other members of the G5 if they are the most exposed. In this way, a member of the group with little economic exposure will still support a large loan for another member in the expectation that the favor will be returned. In the long-run, this favor-trading process should skew IMF lending and program approval decisions to the benefit of the G5. As the exposure of the most exposed member of the group increases so should the size of the loan and the likelihood of program approval. In Ireland's 2010 program it was Germany, in Indonesia's 1998 program it was Japan, in Mexico's 1994 program it was the United States, and so on. By yielding to the most exposed shareholder, the group can avoid conflict over every case that presents itself before the IMF's Executive Board and ensure that the benefits accruing from IMF lending are oversupplied in the cases where a G5 group member's economic exposure is greater.

Logrolling processes like the one I describe occur frequently in domestic politics. As far back as the 1950s, scholars recognized that they were more or less likely depending on the strategic and institutional setting that legislators inhabit (Tullock 1959). Despite many advances in the study of legislative behavior in the intervening years, there are still large gaps in our knowledge of how these sorts of processes play out in international settings like the IMF's Executive Board. A reasonable assumption is that international legislators should act similarly to their domestic counterparts when they are subject to the same constraints and incentives. But when applying this logic to the IMF's Executive Board, what specific aspects of its constitution and institutional design support logrolling among the G5? According to Carrubba and Volden (2000: 265), it is easier to maintain cooperative coalitions for logrolls where: *the number of legislators is small, the bills are much more beneficial than costly, the future is highly valued, the probability of re-election is high, coalitions can be formed quickly and easily, and voting rules are less inclusive.*

All of these points fit the constitution and institutional design of the IMF very closely. There are only 24 EDs. Bills (or IMF programs in this context) are much more beneficial than costly. Although there are risks,

IMF loans are much more secure than typical bank or even bilateral loans from another government. The future is also highly valued: no G5 government can know the time, location, or magnitude of the next financial crisis or the extent to which their domestic constituents could benefit from a more generous IMF loan. Re-election is also guaranteed: only G5 representatives are appointed without election. Added to this, the voting rules are not inclusive; 161 of the IMF's 188 members delegate their voting power to an official from another member-state. All else being equal, the bargaining dynamic in this environment clearly tends toward logrolling: members of the G5 allow loans that are more generous where a G5 government has a strong interest in a particular case. In return, other G5 governments can expect the same treatment if they have a strong interest in the future.

So far I have provided a rationale for why the G5 has a commanding position at the Fund. My argument is that their control over the organization is informal in nature but is predicated on formal rules that are rarely invoked. Nevertheless, the Fund has formal decision-making procedures that must be followed. The theoretical framework that I set out in the previous chapter rests on a number of assumptions about these processes. It rests in particular on the idea that EDs will not act in ways that are contrary to the interests of the governments that appointed or elected them. It is important to question this assertion – are EDs autonomous from the states that appointed them?

According to Martin (2006), EDs were autonomous in the early days of the Fund. They were frequently involved in program design and had a more “hands on” role in developing policy. This practice declined, however, as states began to take a more active interest. What followed was both formal and informal interchange among member-states, EDs, the managing director, and the Fund's staff over individual cases that came before the Board (Horsefield 1969: 13). Martin argues that the staff was finally given more autonomy over operational policy as the organization developed, and that this was a rational decision on the part of the states who wanted to take advantage of specialized knowledge (Martin 2006).

In the Fund's current institutional framework, national governments exercise control through both formal and informal channels of influence. Governments act, for the most part, through their finance ministry or treasury department to influence a decision at the IMF. EDs must act according to the instructions of their country's finance minister who in turn is accountable to other actors in domestic politics. In other words, a G5 director cannot act against the wishes of the state that appointed him or her. As a result, when G5 directors bargain and cooperate with

each other, it is safe to assume that they are representing their national interests. Many EDs were former officials in the finance ministry and can probably expect to return to a post there after a number of years service. US Executive Director, Meg Lundsager, was formerly Deputy Assistant Secretary for International Trade and Investment Policy at the US Treasury. British Executive Director, Alex Gibbs, was also a former official: the Head of the Globalization, Trade and Institutions Team in the UK Treasury (House of Commons Treasury Committee 1999). In interview, the US Director discussed her role at the IMF:

On the surface, it looks like my job is to cast the vote for the United States on policies and programs that come before the IMF. In reality, a lot of what I do is behind the scenes coordinating and consulting. I try to keep up to date on events in many countries. As programs are being developed, I'm aware of what the issues are, and can make suggestions before the program is finalized during official negotiations. (IMF 2007c)

A former British IMF Executive Director, Stephen Pickford, outlined the role of an ED:

essentially the role of an Executive Director, especially a single country Executive Director like myself, is that I am appointed by the governor of the institution and in this case the UK Governor is the Chancellor of the Exchequer – the alternate governor is the Governor of the Bank of England. He appoints me and he can de-appoint me, if he wants to. My role in that regard at the institution is to support the policies of the UK Government. On major decisions, even medium level decisions, I would take instructions from the UK, from the Treasury and from the Chancellor, as to how the UK Government wanted me to vote. (House of Commons Treasury Committee 1999)

Importantly, he makes the point that even medium level decisions, in the British case, are referred to the Chancellor of the Exchequer. It is likely that this applies to all of the major EDs at the Fund. It is still possible that some EDs have more autonomy from their governments, particularly those with fewer votes, or those who represent many countries. On voting procedures at the Executive Board, Pickford goes on to say that:

The IMF is an organization that tries to proceed where it can by consensus. Certainly the IMF Board tries very hard to avoid situations

where you have a big divide between one side and the other, and in most cases programs and policies will be decided by unanimity, by consensus. So there are relatively few cases where we actually do formally vote. I think most countries do not publish the way their executive director votes. I am sure the Chancellor would want to consider the overall ramifications before taking a step like this. (House of Commons Treasury Committee 1999)

If a government wants to influence a decision, at some point in the decision-making process, it must instruct its ED on how to behave, and whether formally or informally to communicate with the staff or the managing director.

Borrowing countries cannot negotiate directly with the IMF's Executive Board. Instead, they can take part in informal discussions with the managing director and staff who will signal if the Board is likely to approve their application for assistance (Horsefield 1969: 198; Boughton 2001). A similar process continues after a country enters into a program. It will not directly lobby the Executive Board for changes to the program but instead can request changes through its director, who will communicate their wishes to staff and management.

## **Mechanisms of control**

The IMF's member-states have delegated authority to its professional staff of economists, granting them the power to act independently within their remit. By delegating authority, member-states and the Fund's bureaucracy are locked in a classic principal-agent relationship (Moe 1984). By entering this relationship, members want to incur benefits such as increased efficiency, legitimacy, and credibility. In the final section of this chapter, I examine this relationship in more detail in order to arrive at a judgment about the ability of the G5 to exercise control over the organization's policy output.

A significant body of research now exists on the principal-agent relationship and how it applies to IOs (Pollack 1997; Nielson and Tierney 2003; Hawkins *et al.* 2006a; Vaubel 2006). An enduring question in this literature is centered on the extent to which IOs like the IMF engage in behavior that runs contrary to the interests of those that granted them the authority to act independently. Agency slack, for example, describes independent action against the wishes of the principal; "shirking" occurs when an agent puts in only minimal effort on its principals behalf; "slippage" occurs when an agent shifts policy away from its



principal's preferred outcome and toward its own preferences (Hawkins *et al.* 2006a: 7).

What do member-states do to limit this behavior or dissuade the IMF's bureaucracy from acting in these ways? According to Hawkins *et al.* (2006a: 26), states use various mechanisms to structure agents' incentives so that they act according to principal preferences. First, the principal designs an initial contract specifying the range of independent action that the agent is authorized to take. Throughout the life of an IO, the principal can amend the contract as they and the agent learn to adapt to the relationship. Principals can also use a variety of monitoring and reporting requirements, screening and selection procedures, institutional checks and balances and sanctions to rein in agency slack and prevent rogue behavior. These mechanisms often structure staff incentives *ex ante* so that it is in their interest to carry out functions on their principals behalf.

In this section, I describe how principals use these mechanisms to influence staff behavior. All staff are closely monitored by the Executive Board and their actions are also reviewed by the Independent Evaluation Office (IEO). Screening and selection procedures at the Fund are more stringent than in other IOs, creating an organization with a unique and distinctive culture. Principals have input into the recruitment of key officials, career advancement, salaries, and job security. This input comes from their ability to control the organization's program or contract and to veto decisions if Fund behavior strays too far from their preferences. The institution's checks and balances are also extensive. Its organizational structure includes bureaus with opposing mandates, a strict hierarchy and methods of controlling autonomy during crisis negotiations with borrowing countries. Governments can also use various sanctions to control agency slack, such as quota reviews and reviews of staff compensation and benefits.

### **Rules versus discretion**

The principal-agent approach tells us that where an organization's contract is biased toward rules rather than discretion, a principal should expect to gain less from the agent's expertise and specialization. By writing a very detailed contract, the principal will expend time and effort learning the task and gaining the same level of expertise and specialization as the agent. If the circumstances under which the agent carries out its task change, the principal must expend even more effort and repeat this task so that the organization's rules do not become ineffective with age. In this section, I briefly examine the balance between rules and discretion.

The IMF's Articles of Agreement constitute the official contract between principal and agent. Amended only three times (1969, 1978, and 1992), the document specifies the organization's mission, goals, and the extent of its discretionary powers (see Table 4.3). The initial negotiations at the Bretton Woods conference over the balance between rules and discretion were two-sided. On the one side, John Maynard Keynes, representing the United Kingdom, had a vision of a rules-based organization where loans designed to correct imbalances were disbursed automatically. On the other side, the US preferred a Fund with significant discretionary powers. It is not surprising that this division existed between the two main powers following the Second World War. From its pre-eminent position in the international system, the United States preferred discretion because it had more power than other governments to influence operations (James 1996; Boughton 2002).

The Fund that eventually emerged from Bretton Woods was indeed quite different from Keynes's vision; it was much more flexible and had far more room for the use of discretion. However, historians and political scientists have found that the nature of this flexibility and discretion has varied over time and across the IMF's different operations, which include surveillance, monitoring, standard setting, lending, and conditionality.<sup>6</sup>

The articles on organization and management emphasize the importance of efficiency, technical competence, and freedom from political influence.<sup>7</sup> The official rules and guidelines for the design of conditionality suggest that IMF policies should be dependent primarily on the

Table 4.3 Extracts from Articles of Agreement of the IMF

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**Article I (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.*

**Article I (vi)** *In accordance with the above, to shorten the duration and lessen the degree of disequilibrium in the international balances of payments of members.*

**Article XII (c)** *The Managing Director and the staff of the Fund, in the discharge of their functions, shall owe their duty entirely to the Fund and to no other authority. Each member of the Fund shall respect the international character of this duty and shall refrain from all attempts to influence any of the staff in the discharge of these functions.*

**Article XII (d)** *In appointing the staff the Managing Director shall, subject to the paramount importance of securing the highest standards of efficiency and of technical competence, pay due regard to the importance of recruiting personnel on as wide a geographical basis as possible.*

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Source: IMF (2010a).

economic condition of the countries that seek its assistance. However, the rules of conditionality also specify that IMF officials and bureaucrats can exercise discretion if they require. Where individuals can exercise discretion, the rules specify that they should do so only with the best interests of the borrowing country in mind. The rules are important; the Fund must address problems in a country's balance of payments by translating the latest in economic theory into policies and these in turn frame the conditions for borrowing. There have been numerous exceptions to the guidelines and they should only be exceeded in order to improve a member's standing.

Although the IMF's Articles of Agreement have been amended only three times, there are a complex set of guidelines, which are not part of the agreement but structure the Fund's operations. These guidelines are subject to constant review and are regularly changed. New sets of guidelines are often introduced to address a new and salient problem where it arises, or where the Executive Board wants the Fund to address a new problem or policy area. For example, a focus on good governance was discussed at the Executive Board in 1997 and a set of in/formal guidelines was introduced subsequently. Since then non-binding good governance conditions have been included in hundreds of IMF programs.<sup>8</sup>

In summary, the balance between rules and discretion means that the Fund is very much open to political influence over decisions. This stands in sharp contrast to Keynes's vision of a rules-based organization. Furthermore, its constitution has not seen a radical overhaul since 1978, although new guidelines are continuously being developed and introduced, revising practices and procedures.

### **Monitoring and reporting requirements**

Monitoring and reporting requirements reveal information about an agent's actions to its principal. According to Hawkins *et al.* (2006b: 28), we should expect "police patrols," which involve the direct monitoring of the agent by the principal, and "fire alarms," which are activated by "affected parties outside the agency relationship." In the case of the IMF, the Executive Board partially fulfills the role of a police patrol. Sitting in continuous session, it reviews programs and policies and comments on surveillance of individual countries and the state of the world economy. Directors receive documentation (staff reports, draft letters of intent (LOI), and so on) a few days before the Board meets and nothing can become official policy without their approval. The Board's role in this regard is not just to accept or reject a proposal from the staff but also to approve both the theory and methodology used to formulate IMF policy.

Until recently, there was no “fire alarm” or body outside the agency relationship to monitor its actions. Many civil society groups and NGOs criticized the Fund for being unaccountable in this regard. In 2001, the Board established the IEO to address these concerns amid the heightened criticism of the Fund following the financial crises of the late 1990s. The IEO evaluates staff activities and Fund policies and is independent of the management, staff, and board. Other standing committees along with the Strategy, Policy and Review Department (SPR) also fill the role of “police patrols,” but are not outside the agency relationship. The Fund has largely embraced the idea of transparency and now releases many documents voluntarily. However, when it comes to the monitoring of operations, the trend is still toward strong “police patrols” and weaker “fire alarms.”

### **Screening and selection procedures**

The Fund’s creators struck a deal at the Bretton Woods conference that has largely remained in place for over sixty years; the IMF’s MD would always be a European and in return, the World Bank’s president and IMF deputy managing director would always be an American. This is one of several powerful screening and selection procedures at management level that give the Fund’s most influential members significant input into day-to-day operations. It is also in line with the principal-agent approach, which expects that principals should seek to reduce agency slack by selecting agents with preferences similar to their own (Hawkins *et al.* 2006a: 28–29). If a member-state wants to influence the operational decisions of the IMF, going through the office of the managing or deputy managing director is the clearest and most direct channel. IMF members can ask the MD to change a draft program or policy, and the director can then instruct the staff to implement the requested changes. Requesting changes in this way is more effective than debating the merits of a program or policy at the Executive Board as there are few options at this stage but to accept or reject a proposal.

MDs and their deputies have extensive powers. On the Executive Board, the director has control of what items appear on the agenda or are excluded. If there are strong disagreements among EDs over a particular item, it is the responsibility of the MD to reconcile these differences before the item is placed on the agenda for discussion (Horsefield 1969: 15; Boughton 2001). The MD can also specify which items are to be passed automatically and without discussion if sufficient time has elapsed without any objection.

A few days before the Board meets EDs must inform their constituency of staff proposals and ask for instructions on how to proceed at the formal meeting, namely whether they should offer support, say nothing, or be critical. Before the formal meeting commences, EDs and the MD and his senior staff (heads of the various area and functional departments) are in constant contact (Horsefield 1969: 986; Boughton 2001). EDs can discuss potential programs with the MD, the likelihood of their success, approval, and the conditions a borrower might be expected to be given.

The formal meeting is highly choreographed, as there are usually many items to consider across several countries. The first to speak is the ED appointed or elected by the country under discussion, presenting his or her views of the staff's analysis or proposal. Other directors are then requested to speak and their comments can range from supportive to critical. There is room for flexibility. Further comments are solicited by the MD at the end of meeting. At this point, EDs can voice concern, ask for minor changes, or disagree outright with the staff's analysis. Very occasionally, there is a formal vote (from 1972 to 1978, there were only three formal votes, all on staff salaries, and from 1946 to 1978, there were only 34 formal votes, apart from those required by the Articles of Agreement (De Vries 1986: 51)).

As the meeting nears its end, the MD must sum up the "general sentiment of the meeting." This is a function that requires much diplomacy and tact; the MD must aggregate the sentiments of all present and convert them into a short summary, which then becomes the Fund's official position. Once this position is reached, all staff and EDs must support it, regardless of how much they might have protested at the meeting.

To summarize, there are many channels through which bargaining and cooperation are facilitated among member-states, the IMF management, and others. Formal interaction is highly choreographed but major decisions are discussed informally. Directors can contact the MD and senior staff informally to discuss items in confidence before the Board meets to debate them.

Using these channels to try and influence operational decisions does not guarantee success. The MD and deputy MD must take into consideration the interests of both the Fund's major shareholders and the organization, as their reputation depends on successful programs. However, they must also be sensitive to the needs of the governments that appointed them and can remove them if necessary or certainly block further career advancement.

Detailed screening and selection procedures also apply at ordinary staff level. Before an economist joins the staff, he or she must have

a PhD level of training in macroeconomics. Members of staff are not direct political appointees, and like many international civil servants, they must remain independent of politics (see Table 4.3). Independence is not to be equated with ignorance here, however, and the Fund's professional staff must be aware of the political interests of the different actors they deal with, both those of their political masters and borrowing countries. Some argue that the selection procedures at agency level are very narrow with a strong technical focus and subsequent training which entrenches them even further (Momani 2005b).

Screening procedures continue to be applied after an individual joins the Fund. Career advancement and job security are powerful mechanisms for reining in rogue agents, perhaps even more than the initial screening and selection of staff prior to their joining the organization. Staff members do not have the same level of job security or tenure which many national civil servants enjoy. First, new economists must participate in a three-year program before they receive a permanent position. Although this program has very high retention rates, candidates still must perform well in order to be placed in one of the better permanent positions, from which they are likely to be promoted further (Momani 2005b). Even those members of staff with permanent contracts are aware that this does not give them total job security. According to Boughton, these individuals face even more difficulties:

Staff are totally dependent on the institution not only for their livelihood but also for their continued right to live in the United States. Many of them have come from countries where the political environment might have changed sharply since they left making a resumption of their earlier occupations impossible. Many have made their careers at the institution, their spouses may be prohibited by US law from seeking employment in the country, and their children may have grown up with no home other than Washington. Moreover, their employer is immune from prosecution, and labor disputes are not subject to negotiation or arbitration. (Boughton 2001: 1050)

### **Institutional checks and balances**

In this section, I review the institutional checks and balances that limit autonomous behavior by the staff. There is evidence of opposing bureau mandates, internal policing, and intra-departmental politics. A lot of private competition between agents is not revealed to outsiders. Furthermore, there are much stronger checks on autonomy during negotiations with borrowing countries. Autonomy and discretion are

far more likely to be applied at managerial level which is rendering it therefore more open to G5 influence.

The Fund is organized into several functional and area/regional departments. When a country seeks its assistance, some functional departments are more involved, depending on the particular needs of the country in question. There is one notable exception, however. The SPR<sup>9</sup> aims to bring coherence and uniformity to IMF programs and policies. All Fund documents (staff reports, surveillance exercises, and so on) must be cleared through this department before going to the MD who then distributes them to the Executive Board. Very few international bureaucracies have such a mechanism for reducing agency slack between management and staff. It is unique to the IMF because of its relatively small size and clearly defined functions and operations. Such a mechanism is more likely to be found in domestic politics but even then "internal policing" of this sort is rarely as effective.

Those employed in the SPR, informally known among staff as the "thought police," are quick to identify staff who have become too close to one particular country or mission and censor any proposals that go against general Fund policy.<sup>10</sup> The SPR ensure that policies on conditions, loans, and tranches follow the guidelines approved by the Executive Board and will amend any proposal in which they detect too much leniency. Typical IMF missions to borrowing countries include an official from SPR as well as staff from other functional and area departments. Unlike the other members of the mission, the loyalties of the SPR official are divided. They report to the head of the mission but their purpose is also to ensure that the mission complies with the organization's policy. This has led to tension and competition among staff on some missions as the SPR staff member can report independently to the deputy MD or MD if any problems should arise. The member of staff from SPR is there to ensure that the other individuals on the mission implement the instructions agreed by senior managers across the various departments.

Apart from reviewing all policy output, an official from SPR is also present on the Executive Board for all matters under discussion. As a department, it has an input into nearly all of the substantive decisions whereas other departments are merely called upon as required. That one department should have so much influence relative to the others could render the organization one-sided, stifle innovation and internal dissension, and force policies to conform to a rigid template.<sup>11</sup> However, competition and disagreement exist at draft stage where staff can offer different solutions to the problems faced by borrowing countries. According to

Blustein (2005: 41–42), staff engage in intense debate over policy toward individual countries but this is kept strictly confidential. During the economic crisis in Argentina, for example, there was intense disagreement between the various departments, particularly the Research Department headed by Michael Mussa who was a critic of the currency board arrangement that others supported. In situations where disagreement persists and the departments cannot agree on different proposals or solutions for a problem, the deputy MD or MD acts as the final arbiter.

One of the strongest features of the IMF's organizational culture is that staff members rarely disclose internal differences to anyone outside the Fund. A member of staff who fiercely disagreed with a policy at the draft stage must fully support and endorse it if it should become part of the final country-agreement. Furthermore, once the Executive Board approves a policy, all directors must also support it.<sup>12</sup> In this way, the staff's position, and by proxy the IMF's policy, often appears clear and sends a very strong signal to market participants and borrowing countries. If the Fund were to reveal internal disagreements, it would send mixed signals to financial markets, leading to confusion and negative consequences.

According to Woods (2006), the organization also suffers (by design) from a very high turnover of staff across departments with the result that it cannot build any meaningful local and country-specific knowledge. The organization is not completely devoid of ideas and creativity, however. Although policies and ideas do not originate so much from the grassroots, there is frequently vibrant discussion and an interchange of ideas among the organization's management, EDs, and high-level staff.

Some of the Fund's most important work includes missions to negotiate new programs with the governments and officials of its members. As one would expect with the principal-agent approach, institutional checks and balances exist to prevent rogue agent behavior during these difficult times. To exemplify this, missions are dispatched only after the terms and conditions of a program have already been drafted and circulated among the departments. The process of drafting a program begins when a country first approaches the Fund informally. At this point, staff members prepare an informal briefing document and circulate it for discussion. Debate and some internal dissension over the content of the draft program are deemed acceptable and normal at this stage, as the various functional departments, regional departments, and management make their various contributions to the draft program document. Once a draft program has been agreed, the organization's procedure then involves dispatching a mission to the country in question. It is very rare for internal disagreement to persist beyond this stage as by the



time the mission arrives in the member-state, the terms of the program have been agreed.<sup>13</sup> IMF missions are composed of a senior official in-charge of affairs, officials from area and functional departments, and an official from Policy, Development and Review (PDR) who is there to oversee their activities. Occasionally an ED accompanies them simply to observe but not to take part in the negotiations.<sup>14</sup> The mission's ability to negotiate is strictly limited as senior managers agree the terms before traveling to the troubled country. Staff must stick closely to their instructions, leaving little room for autonomy and negotiation (Blustein 2005: 41–42). The result of a mission is a staff report, written in the field if necessary. Upon its return, the mission reports within forty-eight hours to the MD (Horsefield 1969: 14). The report is then checked by a reviewing committee and can make its way to the Executive Board in as little as two weeks.<sup>15</sup> On an individual level, autonomy is strictly limited and decision-making is concentrated within the managerial sphere. Initially the heads of the various departments have the authority to make a program easier or stricter and then finally the MD and deputy MD can alter the course of the program. Borrowing countries have very little bargaining power during this process; they cannot go against the Fund and G5 preferences but can help to adapt the program to local circumstances and add content where no conflict exists.

In summary, staff autonomy is strictly limited at all times. Where discretion exists, it can only be exercised at the management level. Internal competition exists among the various departments, but SPR acts to ensure that staff members act closely in line with management. Missions that travel to troubled countries adhere rigidly to their negotiating instructions which are set out in advance and cases where internal differences are revealed to outsiders are rare. Finally, hierarchy is very important as it is clearly in the interest of G5.

## **Sanctions**

One of the most powerful sanctions available to G5 governments is their ability to change the Fund's budget during a quota review. A typical quota review should calculate the IMF's funding base by looking at changes in the world economy, changes in the needs of individual members and changes in the needs of borrowing countries (IMF 2007b). In reality, a quota review is equivalent to a sanction; G5 governments can punish the IMF for its failures or reward it for its successes through a budget expansion or retraction. Public choice theory tells us that organizations like the IMF will want to maximize their "power, prestige, and amenities by increasing their budget, staff, and resources (Vaubel 1983,

1991, 1996). However, quota reviews are rather infrequent, occurring only 14 times since 1959 and only twice has no increase been recommended (Woods 2006: 30).

EDs can sanction staff behavior more frequently by reviewing staff salaries, performance, and compensation. When it comes to these issues, the remit of the Executive Board for discussion and decision-making is not as restricted as it is in the case of policies which affect member-states. While directors can sometimes be vocal in their criticism of a policy that affects another member-state, they will rarely, if ever, formally block such a proposal (Chelsky 2008). Directors are cautious when officially discussing requests for the use of Fund resources and are neither willing nor permitted to criticize other governments. Instead of directly attacking a request for a loan, or the conditions attached to that loan, most governments will prefer to exercise influence through informal channels to avoid damaging relations with other member-states. While directors are cautious and measured in their interaction with other political representatives, they are not nearly as restricted when they come to consider changes to general Fund policy or staffing. Therefore, if members of staff bring proposals to the Executive Board that are not aligned with the preferences of G5 governments in sensitive areas of policy, they can expect retaliation in other areas of policy. EDs are constitutionally bound to vote on matters related to staff salaries, performance, and compensation. If staff continuously acts against their interests, members of the Board can sanction them in these areas through formal voting.

Another sanction of sorts is the ability of the G5 to delegate authority to other IOs or shift functions from one organization to another. In many IMF programs, other organizations are involved as partners. In this way, the G5 can create competition and limit the independence of each organization. If the policy and advice offered by one contradicts or is inconsistent with the advice coming from the other, the G5 can then decide which organization is right.

The need to delegate authority to an IO often occurs in response to a crisis. The oil crisis of the 1970s, the debt crisis of the 1980s, the collapse of the Soviet Union, and the financial crises of the 1990s have all led to changes in the authority delegated to IOs; states have altered and redesigned international financial institutions and in some cases have shifted authority from one institution to another. The G5 often selects the IMF as their body of choice to address a salient problem or act as a fire-fighter. The current global financial crisis is a good example of this as the IMF's lending capacity trebled and its role and responsibilities strengthened as the crisis was developing around the world. This

power could well have been conferred on another organization, or on a newly-created organization, or even through an alternative process. In the current international financial system, a myriad of international financial institutions both complement and compete with each other for influence, resources, and authority. However, it is the Fund's most powerful shareholders who have the definitive say on which organization is delegated authority to act in any given situation.

The possibility that the IMF might lose some of its functions to other institutions, such as the Bank for International Settlements, the World Bank, or other multilateral agencies should be of utmost concern to the Fund's bureaucracy. In order to avoid such an outcome, all IOs have to innovate, maintain their relevance, and adapt to changing circumstances. However, if an organization expands too quickly, it could be accused of "mission creep," a concept that has often been associated with the IMF and World Bank. If it does not expand strategically in order to address better the concerns of member governments, it risks becoming redundant. Although the IMF is far from redundant, it has been far more conservative in its expansion than other IOs. Those who claim it is a case of "mission creep" claim too much when examples of "mission creep" can be far better applied to its sister institution, the World Bank.

## **Observable implications of theory**

To summarize, I have outlined the domestic political processes that lead G5 governments to respond to the economic exposure of domestic interest groups. I have also outlined how these governments cooperate through a system of logrolling to distribute the benefits of IMF financing. Taking both into consideration, and considering the constraints that limit extreme behavior, leads us to the following testable hypotheses, which should hold even after controlling for alternative explanations:

Following an economic shock in a developing or emerging market, the higher the economic exposure of the most exposed G5 member:

- (a) The more likely that the IMF will approve a program
- (b) The higher the IMF loan
- (c) The less restrictive the conditionality

## **Conclusions**

This chapter examined G5 governance of the IMF, discussing the group's privileged position relative to other members, their control of

policymaking at the Executive Board, and their ability to exercise influence over the Fund's staff. The essence of my argument is that G5 governance of both the Fund's mission and its day-to-day operations is informal in its nature. Although the Fund's rules and design do guide the policy-making process, the rules are rarely invoked. Instead G5 preferences are most likely to be communicated to the Fund's management before being put to the Executive Board for approval.

One of the implications of my argument is that we should expect to find similar mechanisms of control in IOs that wield real rather than symbolic, power, and authority. As IMF policies can have significant distributional implications across the world, governments take an active rather than a passive role in the policy-making process. Nevertheless, control mechanisms are costly and imperfect, meaning that governments cannot always control bureaucracies without devoting time and effort to the task (Hawkins *et al.* 2006a: 31). Therefore, in some instances, and across policy areas (lending, conditionality, monitoring, surveillance, standard setting), the agent may possess different levels of autonomy.

Another implication of my argument is that the distinct organizational culture which exists in the IMF is a product of a system of delegation designed by the member-states and who continue to employ the various mechanisms of control that I discuss here in order to reduce agency slack and influence decisions. This stands in sharp contrast to the argument of many scholars who contend that major changes in the Fund's mission and its policies are a result of its unique organizational culture often resulting in dysfunctional behavior (Barnett and Finnemore 2004).

## **Part II**

# **Evidence**

# 5

## Testing the Argument

Before proceeding to the empirical analysis, this chapter outlines the steps taken to operationalize and test my argument. It begins with a discussion of the data that were collected for this book and continues with a discussion of the main dependent variables – program approval, lending, and conditionality. Much of the discussion about the dependent variables focuses on conditionality, which is a complex and multifaceted policy instrument. In the case of a concept like conditionality, no single variable can easily capture all its dimensions. In order to close the gap between concept and indicator, I discuss my rationale for breaking conditionality into its leading indicators – binding conditions, non-binding conditions, and waivers. Third, I discuss the operationalization of the independent variable – G5 economic exposure in the recipient, or potential recipient, of IMF financing. Like conditionality, economic exposure is difficult to capture in a single variable. As a result, I have coded several measures to ensure that the explanatory power of my argument is robust. Following the discussion of both the dependent and independent variables, I describe how the control variables were selected and coded, including variables that control for the technocratic, bureaucratic, and strategic interest effects on IMF policies.

Finally, there are several important steps required to operationalize my theory which are worth mentioning here. The primary hurdle in any analysis of several policy outcomes is first to determine whether the outcomes of interest are actually independent of one another. Of the outcomes of interest in this book, both lending and conditionality are dependent on program approval. In other words, before a country can receive a loan of any size, or conditionality of any kind, it must first be granted a program. Similarly, the granting of a waiver for a missed condition is also dependent on program approval. As a consequence,

it is essential to model these dependencies correctly in any empirical analysis of IMF policy outcomes.

## Data

To test the hypotheses set out in this book, I have drawn data from several sources. First, I collected data on IMF program approval and lending which covers all developing and emerging economies (159 in total) from 1983 to 2006.<sup>1</sup> This work generated a dataset of 3816 country-years, 535 of which resulted in an IMF program and a loan. Both varieties of programs – concessional and non-concessional – are included in the sample, making the dataset one of the most comprehensive on IMF lending and program approval, covering more countries, years, and program types than previous studies.

With few exceptions, previous quantitative studies have focused only on one type of program. According to my argument, however, truncating the sample in this way is unwise. Even if the IMF lends at a concession, members of the G5 can still benefit because the loans will have distributive consequences. Omitting concessional loans risks introducing substantial bias, as hundreds of small loans would drop from the sample. Furthermore, all IMF programs are subject to the same decision-making process – there is no separate process at the IMF's Executive Board for approving concessional programs – and therefore no reason why the same political actors should behave differently.

Second, I compiled an original dataset on conditionality drawn from IMF LOI, covering 87 countries from 1997 and 2006.<sup>2</sup> LOIs outline the policies that countries intend to implement as part of their agreement with the IMF. I recorded the conditions in 641 of these documents, which comprised 161 “initial letters” that mark the beginning of an IMF program and 480 “review letters” that amend the terms of the previous LOI.<sup>3</sup>

An observation in the conditionality dataset is a *country – program review* or *conditionality agreement*. In other words, the data are cross-sectional, describing the characteristics of each country at each stage of the conditionality process from a country's first point of contact with the IMF to its final program review. The data are structured in this way because the IMF reviews the content of its program at regular intervals and these are known as *program reviews*. For many countries, few changes are made to their programs at these reviews. For the most part, the Fund adjusts the internal composition of performance criteria and sets new targets, ceilings, and floors on macroeconomic variables, and the program continues on its pre-determined path. For other borrowing

countries, however, new conditions are added and old ones are revised or dropped from the agreement altogether. Furthermore, the Fund often grants one or more waivers to countries that have failed to implement binding conditions.

## IMF policy

The dependent variables in this study are program approval, loan size, and conditionality. In this section, I set out how these important dimensions of IMF programs are measured and the alternative measures which were considered but rejected. While program approval and loan size are straightforward to measure, conditionality is a more contested concept. Nevertheless, I have proposed several methods of measuring it, which build and improve upon the existing literature.

IMF program approval is captured using a binary variable that takes the value of “1” in the year that a country enters an IMF program and “0” otherwise. The other ways in which participation in IMF programs have been measured include drawings on the IMF (Bird 1995), months per year under IMF management (Conway 1994), the fraction of months during a five-year period that a country operated under an IMF program, count data on the number of years spent under an IMF program (Bird *et al.* 2004), and the number of years between IMF programs (Evrensel and Kim 2006). The measurement I have selected is preferable because the study will examine the factors that trigger programs, not continuation or participation in general.<sup>4</sup>

To measure lending, I take the size of a country’s IMF loan in SDRs as a share of its IMF quota.<sup>5</sup> Figure 5.1 illustrates IMF lending approved in SDRs from 1983 to 2006, peaking in 2002 as a consequence of Brazil and Turkey’s mega loans. Weighting the dependent variable by a borrowing country’s quota takes account of the constraints that the quota system sets on IMF lending. In the early years of the IMF, there were strict limits on a country borrowing above its quota but these have since been removed (Bird and Rowlands: 158). There are now no formal limits on borrowing, but in the data collected for this paper, there were only 15 instances from a total of 535 where a country’s loan exceeded three times its quota.

At an operational level, the organization and its officials benchmark and compare loans in this way (IMF 2009d). When actors bargain over loan size, it is easier for them to do so using this measure than a more complicated one. In addition, its ease of use as a benchmark allows policymakers to compare loan size across countries. Therefore, measuring



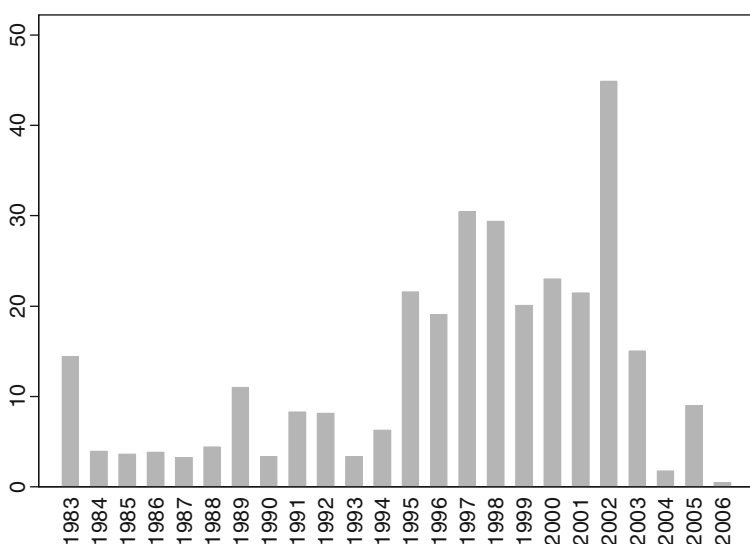


Figure 5.1 IMF loans approved (billions of SDRs)

a loan in proportion to a borrowing country's quota takes account of the constraints on IMF resources and the ability of the borrowing country to use influence (in the form of votes) to gain access to finance. Any alternative measure of IMF lending will not account for these important political economy dimensions.

The third dependent variable in this study is conditionality. A conditionality agreement consists of a detailed list of policies that a country must implement in order to draw on IMF resources. Previous empirical studies have considered two principal sources of variation in conditionality: binding and non-binding conditions (Dreher 2004; Dreher and Vaubel 2004; Dreher and Jensen 2007; Kang 2007; Copelovitch 2010b).<sup>6</sup> Binding conditions or performance criteria come in two varieties. The first are quantitative performance criteria (QPC) which set targets or limits on macroeconomic variables such as government debt and international reserves. Structural performance criteria (SPC) make up the other type of binding condition. These criteria are designed to take into account the individual and unique characteristics of borrowing countries and they first became part of conditionality agreements in the 1980s under the Fund's Structural Adjustment Facility.

The second source of variation that previous authors have considered is the number of non-binding conditions. It is important to distinguish

between both types of conditions in any empirical analysis. For one, failure to comply with a binding condition means that a borrowing country cannot continue to draw on Fund resources, while a borrowing country that ignores every structural benchmark in its agreement does not suffer this consequence. Furthermore, non-binding conditions are relatively new as they were first introduced under the Fund's Structural Adjustment Facility in the 1980s. As the Fund expanded increasingly into long-term programs such as this, the frequency of these conditions increased.

In what follows, I set out my rationale for considering both sources of variation in this book. More specifically, I justify my use of the number of binding conditions in an IMF conditionality agreement to measure the restrictiveness of conditionality and then proceed to discuss my use of the number of non-binding conditions as a proxy for the level of interest-group-friendly conditionality. Finally, I discuss my use of the number of waivers in an IMF agreement as a third source of variation that has not been examined in the existing literature.

### IMF conditionality

Finding a meaningful source of variation in conditionality is challenging because the concept spans many dimensions (Table 5.1). While the number of binding conditions in an IMF agreement is not a perfect measure of stringency, it is the most desirable for several reasons. First, governments that receive more of these conditions carry a greater burden: failure to adhere to even one condition results in the termination of their IMF loan unless a waiver is granted.<sup>7</sup> Some governments will have more difficulty implementing conditions than others. Even within a state, the capacity to implement reform is not evenly distributed across a government and its bureaucracy. More binding conditions increase the likelihood that a condition will be applied in those areas where the government or civil service are incompetent or simply lack the capacity to implement reform.

Second, more conditions restrict the ability of a government to act independently. By reducing domestic policy, autonomy governments

*Table 5.1* IMF conditionality

Variable	
1. Binding conditions	→ Quantitative performance criteria Structural performance criteria
2. Non-binding conditions	→ Structural benchmarks Prior actions
3. Waivers	

may find it more difficult to reduce the negative political consequences of fiscal adjustment. While entering an IMF program allows a government to shift some of the “blame” to the Fund, a government will benefit in this way regardless of the amount of autonomy the Fund allows. Less autonomy makes it more difficult for a government to respond to constituencies or interest groups that want to be shielded from the burden of economic adjustment. Therefore, even more conditions are politically difficult for a government, because it cannot distribute the burden of adjustment according to government preferences, which may differ considerably from the outcome which is socially optimal.

Third, the sum of binding conditions is a superior measure of stringency because it is difficult to compare the relative stringency of any single condition in a cross-national context. Because conditions are uniquely tailored to the circumstances of a borrowing country, any comparison would be subjective and subject to error. According to Conway, such errors often occur in the IMF's financial programming exercise to derive conditions (Mussa and Savastano 1999; Easterly 2006).

To calculate the number of binding conditions, I have added together the number of QPC and SPC. Similarly, to measure the number of non-binding conditions, I add the number of structural benchmarks to the number of prior actions in borrowing countries' conditionality agreements. Structural benchmarks are similar to SPCs in every regard except that failure to implement one does not lead to program suspension. Prior actions are also similar but are implemented before a program review takes place.

Finally, I have measured the number of waivers that each country was granted for missed conditions. If a borrowing country fails to observe a particular policy condition by a set deadline, it can request a waiver to allow it to continue to receive IMF assistance. The literature on conditionality occasionally refers to waivers, but apart from official IMF sources, there is no empirical research on their use or purpose (IMF 2005b).<sup>8</sup> Since so many countries go on to request waivers across a wide range of policy areas, it is important to consider their role in conditionality. For example, Rwanda was granted 12 waivers in its 2004 program review. If one were to examine solely the number of conditions they received, this would appear very strict, but in reality they were not penalized, even though they failed to implement 12 conditions.

Because the granting of waivers and the setting of conditions each follow different processes I have replicated all of the specifications with the number of waivers as a dependent variable. Since the number of waivers granted is partially dependent on the extent of conditionality a borrowing

country received in the first place, I also include the number of binding conditions as a control variable in these specifications. Unfortunately, it was not possible to determine cases where a country was denied a waiver for a missed condition and subsequently had to forfeit its IMF program.

In summary, for conditionality I use three indicators: binding conditions, non-binding conditions, and waivers. In terms of how this approach fits with the existing literature I have followed the “disaggregate” approach of Stone (2008) and Copelovitch (2010b), as opposed to the approach followed by Brown (2009) and Dreher (2007), where both binding and non-binding conditions are aggregated into a single indicator. The latter strategy is problematic because domestic interests in the G5 fear a situation where a borrowing country receives too many binding conditions and defaults on its debt. By contrast, domestic interests in the G5 should not fear non-binding conditions because they pose no such risk. On the contrary, domestic interests with economic links to a borrowing country should welcome non-binding structural conditions that increase or preserve their market access, or improve debt service arrangements. With such very different implications, aggregating these conditions into a single indicator is not appropriate.

Figure 5.2 illustrates the distribution of the conditionality variables. Each panel combines a box plot of the data with a density trace plotted symmetrically above and below it. The plots allow for easy interpretation of the distribution of each variable, as well as information on skewness and outliers. The white dots depict median values, the boxes show the interquartile range, and the thin lines connect the lower adjacent value to the upper adjacent value. From the panels, it is clear that structural benchmarks are prone to skew and outliers, while performance criteria are less so.

## Independent variables

### G5 economic exposure

As the economic exposure of domestic interests should determine the shareholders’ preferences over IMF policy decisions, I have coded separate measures of bank and trade exposure. The data on *bank exposure* is taken from the Bank for International Settlements. Commercial banks report the stock of assets they hold in developing and emerging markets to the central bank of the reporting country (McGuire and Wooldridge 2005: 74). The Bank for International Settlements (BIS) then collects these data and derives the flow from quarterly or semi-annual differences in the stocks, adjusting for exchange rates. Consequently, the data is a

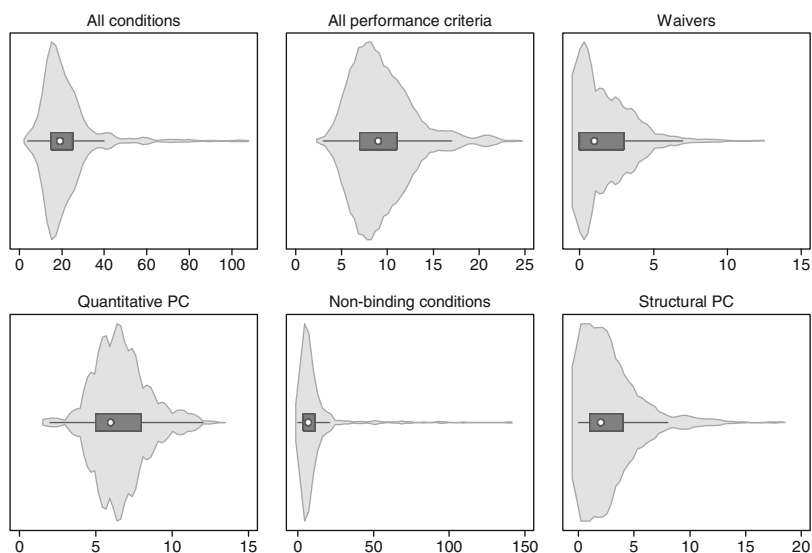


Figure 5.2 Distributional plots of conditionality variables

good proxy for the consolidated foreign claims of reporting banks (in millions of US dollars).

To measure *trade exposure*, I have collected data from the IMF's own Direction of Trade Statistics. These data capture exports from the main IMF shareholders to developing and emerging markets (also in millions of US dollars).

Each of the economic exposure variables measures the highest level of exposure from among the large shareholders (the G5) to reflect international cooperation to cover potential losses from a default or debt restructuring scenario (Figure 5.3). The absolute values in the exposure variables are weighted by the shareholder's total exposure to the world, whether the claims of commercial banks or the market share of exporters. In 1983, for example, Afghanistan showed no claims from banks in France, the United Kingdom, or Japan. It did show one million dollars of German claims and four million dollars of US claims. Using this example, four million would enter the index, as it is the highest value. By treating the data in this way, the empirical analysis is then grounded in my theory, which posits that the G5 engage in logrolling at the IMF.

Weighting the measures of trade and bank exposure in this way also controls for historical differences in bank lending and the financial sector

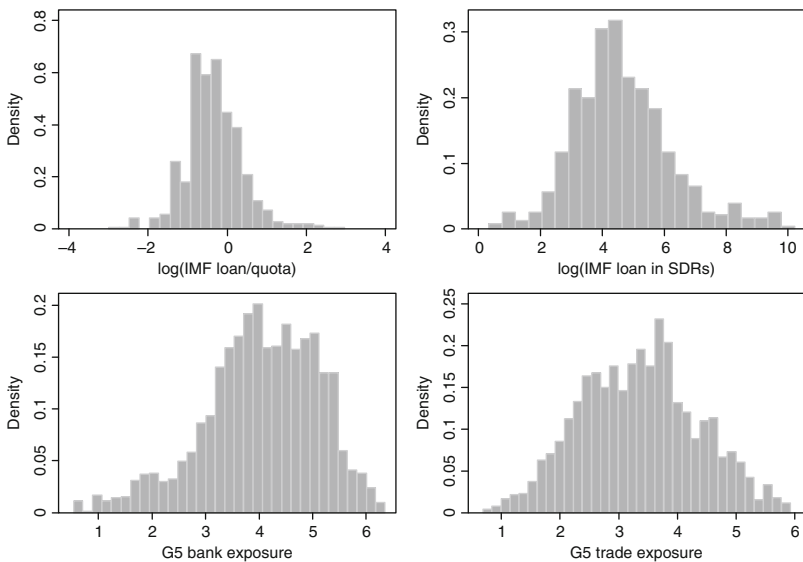


Figure 5.3 Histograms of independent and dependent variables

that might introduce further bias. While these are clearly the best data on the extent of banks' exposure in foreign countries, there are some weaknesses that should be acknowledged. First, 45.7 per cent of observations are missing because there is no data available on the exposure of at least one member of the G5. This is not an unusually high number of missing data points, however, when one considers that the data on foreign direct investment would produce hardly any observations. Second, data on exports are more comprehensive with very few missing values. Interestingly, the descriptive statistics show that no single large shareholder dominates in developing and emerging markets. Rather, there is significant variation in the identity of the most exposed large shareholder. The United States and France are the top lenders in the majority of cases, followed closely by Germany, the United Kingdom, and Japan.

In order to test for the possibility that IMF financing is not brokered through logrolling, I have coded dummy variables that take the value of "1" in cases where a member of the G5 is the most exposed and "0" otherwise. In this way, I test the following argument: borrowing countries are treated differently depending on the member of the G5 that is most exposed. Evidence that developing countries were treated differently on this basis would suggest that the way in which power and influence are channeled through the IMF is not explained adequately in my theory.

According to my argument, it should not matter which member of the G5 is the most exposed. Rather, what should matter is the level of exposure of the most exposed member of the group. As a result, these are good variables for testing the robustness of my argument.

Second, in order to test if the logrolling story is robust to alternative measurements of the independent variables, I have recoded both G5 trade and bank exposure variables as a percentage of the G5 members' GDP. While these alternative measures – presented in the Appendix – capture a different dimension of G5 economic exposure, they are not as satisfactory as the one I include in all of the specifications because they do not reflect the strength of domestic interest groups. Rather, these variables capture the strength of these groups relative to other groups in the G5 member's economy. Therefore, taking exposure as a percentage of GDP can underestimate the aggregate exposure of trade and banking interests in developing and emerging markets. By not directly measuring the potential group loss as a percentage of total interest group activity, these alternative measures have the potential to lose their explanatory power. Finally, a series of variables measuring the economic exposure of different groups of powerful states were coded. The findings using these alternative measures are presented in the Appendix.

## Control variables

In order to test the argument that the IMF is essentially blind to politics, I have included several sets of variables in the models. First, I have included a number of other domestic economic conditions in borrowing countries that appear time and time again in the literature as predictors of program approval, loan size, and conditionality (Knight and Santaella 1997; Bird and Rowlands 2008). In particular, I have selected variables that measure the size of a country's income, its rate of growth and level of indebtedness. All should influence positively the dependent variables with the exception of GDP per capita and GDP growth, which the literature has shown reduces the likelihood of participation in an IMF program as well as reducing loans and conditions (Steinwand and Stone 2007). To summarize, the following variables have been included to control for the economic logic of IMF programs: *international reserves measured in months of imports*, *current account balance as a percentage of GDP*, *external debt as a percentage of GDP*, *debt service as a percentage of GDP*, *the log of GDP per capita*, and *the GDP growth rate*. I also include an additional control variable – financial crisis – to take account of instances where the IMF is acting in its traditional role as lender of last resort. This choice of control variable is motivated by the literature on financial crises, which shows

that even countries with strong underlying fundamentals are sometimes vulnerable to speculative attacks (Leblang and Satyanath 2006: 247). Therefore, the policies of interest in this book may well be crisis-driven and not necessarily reflected in the macroeconomic “fundamentals.” This variable is coded “1” if a country experienced any combination of currency, banking, or debt crisis in the year of IMF program approval and “0” otherwise (Laeven and Valencia 2008). Finally, a variable is included in the conditionality chapter to account for the quality of a country’s existing economic policy, as this might bias program design toward fewer binding conditions. As a proxy for policy quality, I use Gwartney *et al.*’s (2008) index of economic freedom. It is important to acknowledge that this isn’t a perfect measure of policy quality by any means, but it is one that should resonate with the IMF. Overall, the variables included to control for the economic determinants of IMF behavior capture both domestic economic conditions in borrowing countries, which tell us about the extent to which the borrower matters for international financial stability and the general state of their key macroeconomic indicators.

In order to control for some of the potential bureaucratic biases in the design of IMF programs, I include a variable binary variable – IMF quota review – for years in which the organization’s budget was reviewed. The rationale underlying this decision is that the Fund may have an incentive to “hurry up lending” before its budget is reviewed (Vaubel 1983, 1996). By depleting its resources in the year of a quota review, the bureaucracy is demonstrating to the shareholders that its current budget allocation is stretched to capacity and should be increased. As a consequence, staff should hold incentives to reduce conditionality in advance of a quota review in order to increase lending.<sup>9</sup>

Several authors have also argued that the design and implementation of IMF programs are affected by the level of autonomy that the bureaucracy possesses from the shareholders (Vaubel 1996, 2006; Gould 2003, 2006b; Dreher 2006; Copelovitch 2010b). The argument is as follows: as bureaucratic autonomy increases, we should expect to see a more autonomous institution that pursues its own interests ahead of the shareholders. To control for this possible outcome, I include an index that captures the bureaucracy’s level of autonomy from political decision-makers in any given year. It was developed by Brown (2010) and captures several features of organizational independence including the IMF’s autonomy in the filling of staff posts, financial autonomy, management autonomy, size of budget, and staffing. One would expect that the variable is positively signed, as the bureaucracy should seek more conditionality in order to expand its mission and authority over borrowing countries. However, it should be noted that changes in the index from 1997 to 2006 are only driven by budget and



staff size, as there were no significant institutional design changes during this time; therefore, the results should be interpreted with caution.

To control for the argument that the United States uses its power and influence to favour its political allies, I include US military aid (measured in millions of dollars) in the all of the models. Foreign aid has also been used as a proxy for the economic and strategic interests of the IMF's most powerful shareholders (Stone 2011). I do not consider this measure, however, but instead argue that we should be cautious about using foreign aid donation as a proxy for US interests over IMF resources. A large body of literature on the determinants of foreign aid donation find that both strategic and economic factors matter when it comes to both the selection of recipients for aid and the decision on how much aid to donate to a government once it is selected (Schraeder *et al.* 1998; Stone 2006; Milner and Tingley 2010). As both strategic and economic interests are captured in this variable – potentially more so than military aid – I have not included it in the models.

Finally, I include a variable that takes account of the impact of the Cold War on IMF program approval. The G5 had minimal or reduced exposure in the Soviet bloc during the Cold War. With the collapse of the Soviet Union, IMF lending was geared toward facilitating the transition of these countries from planned to market economies. The systemic transformation facility was created to achieve this. Therefore, it is necessary to control for the impact of the transition on program approval only rather than lending or conditionality.

In order to control for the transition from communism, I create a binary variable that takes the value of “1” during the transition for former members of the USSR and satellite states. I define the transition narrowly, taking the years 1991–1993 only. After the transition, programs should be subject to the same political pressures as I outlined in the theory. In addition, before the transition I still argue that IMF lending was subject to the same political economy pressures in the limited number of Soviet bloc countries it dealt with. For example, Boughton confirms that Yugoslavia had significant commercial bank exposure and required IMF assistance at several stages when it found it difficult to meet its obligations (Boughton 2001).

## Conclusions

The remaining chapters in Part II of this book implement these methodological decisions. Chapter 6 examines the statistical record of IMF lending and program approval. Chapter 8 does the same for IMF conditionality. Although these chapters offer substantial evidence to

support the book's theory, they do not illustrate any of the mechanisms involved in the G5's impact on IMF policies; however, Chapters 7 and 9 complement the quantitative evidence with case studies of IMF lending to Greece, Iceland, and Ireland and the application of IMF conditionality in South Korea, Indonesia, and Thailand. The case studies shed light on the impact of domestic interests on the shareholders, the interactions among the shareholders, and impact of the shareholders on negotiations. Furthermore, they represent the dependent variable and independent variable at extreme values during two global financial crises (Tables 5.2 and 5.3).

Table 5.2 IMF dataset summary statistics

Variable	Mean	Standard deviation	Minimum	Maximum	N
IMF loan (millions SDR)	579.15	2108.12	1.4	27375.1	535
IMF loan/quota	1	1.4	0.05	19.38	535
IMF program approval	0.14	0.35	0	1	3816
G5 trade exposure (per cent)	0	0.01	0	0.12	2536
G5 bank exposure (per cent)	0.01	0.03	0	0.28	2079
Reserves (mts imports)	3.5	2.99	-0.09	32.13	2768
Current account/GDP	-4.15	10.7	-240.5	53.23	2817
External debt/GDP	0.79	0.91	0	17.77	2545
Debt service/GDP	5.52	5.33	0	107.37	2524
GDP growth (per cent)	1.46	6.66	-50.49	90.07	3292
GDP per capita (log)	7.11	1.29	4.03	10.47	3289
IMF quota review	0.22	0.41	0	1	3657
IMF delegation index	24.77	1.55	22.65	27.47	3657
Financial crisis	0.07	0.26	0	1	3816
US military aid (mil. USD)	15.13	130.17	0	5753.90	3233
Systemic transition	0.02	0.13	0	1	3816
<b>Robustness checks only</b>	<b>Mean</b>	<b>Standard deviation</b>	<b>Minimum</b>	<b>Maximum</b>	<b>N</b>
G5 bank exposure/GDP	0.002	0.008	0.000	0.14	2079
G5 trade exposure/GDP	0.000	0.001	0.000	0.018	2692
US-UN voting affinity	0.15	0.10	0	0.82	2882
IMF program history	0.61	0.88	0	4	3816
Veto players	2.35	1.61	1	18	3226
Elections	0.23	0.42	0	1	3337
POLITY	0.27	6.86	-10	10	3015

*Table 5.3* IMF conditionality dataset summary statistics

	<b>Mean</b>	<b>Median</b>	<b>Minimum</b>	<b>Maximum</b>	<b>Standard deviation</b>
All conditions	23.25	20	4	106	12.50
Performance criteria	9.40	9	3	24	3.46
Prior actions	2.70	1	0	39	4.24
Quantitative	6.65	6	2	13	1.82
performance criteria					
Structural	2.73	2	0	18	2.78
performance criteria					
Structural benchmarks	9.85	7	0	140	13.36
Quantitative indicators	1.71	2	0	11	1.69
Waivers	1.59	1	0	12	1.91

*Source:* 641 letters of intent, [www.imf.org](http://www.imf.org), 87 countries, 4/1997–2/2007.

# 6

## IMF Lending

The IMF is custodian of a large amount of its members' currencies. One of its main tasks is to act as a gatekeeper, by deciding who is allowed to draw on these assets. With so many developing and emerging economies under IMF programs at any given time, the question of what drives participation is of considerable interest to academics and policymakers. Without the initial decision to grant assistance in the form of a concessional or non-concessional loan, the other policies of interest in this book would never be realized. This makes the study of program approval a natural starting point in any empirical analysis of IMF behavior.

Many existing studies find that participation in IMF programs is determined primarily by the needs of countries in dire economic circumstances (Conway 1994; Bird 1995; Knight and Santaella 1997; Ghosh *et al.* 2008). Why else would a government surrender its ability to formulate economic policy and agree to implement conditions that are often deeply unpopular? Increasingly, analysts are also turning to the "supply-side" to explain the puzzle, arguing that as well as examining the economic imperatives that drive borrowing countries to seek IMF financing, we also need to consider the Fund's willingness to supply loans in the first place. A growing number of studies now place considerable emphasis on the interests and preferences of the Fund's most powerful shareholders as an important determinant of participation. Nevertheless, their influence on the important question of "Who gets chosen?" has received much less attention in comparison with the economic determinants of program approval.<sup>1</sup>

Besides its role as gatekeeper, the IMF must also decide on the appropriate amount to lend in each individual case. A lot can hinge on the outcome of this decision; a large IMF loan can significantly limit the losses of private creditors and also give the borrowing country enough

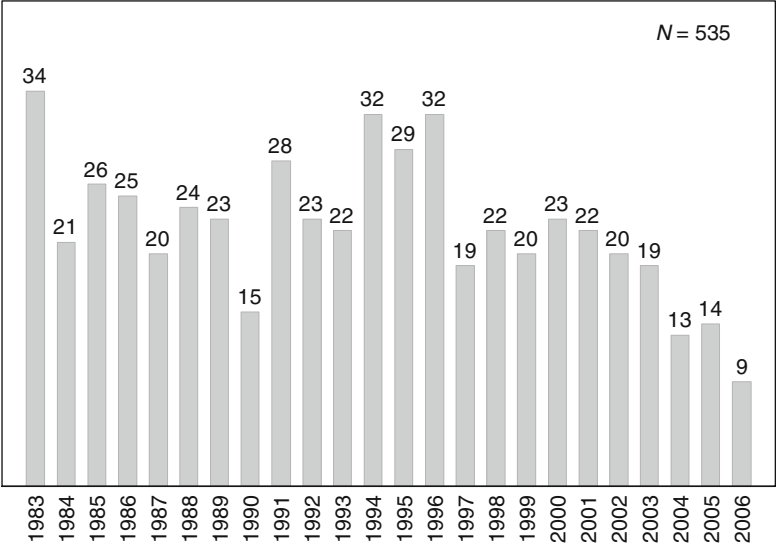


Figure 6.1 IMF programs

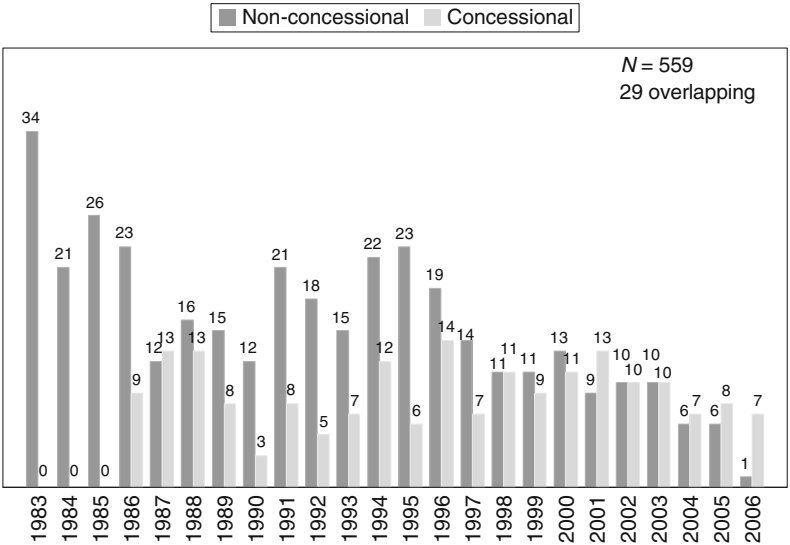


Figure 6.2 Concessional and non-concessional programs

breathing space to recover from an economic shock. A small loan, on the other hand, could leave some creditors with empty pockets and the borrowing country with little time to implement an adjustment program.

The outcome of the negotiations over the lending decision is eagerly awaited by creditors, sometimes with confusion reigning before a decision is finally made. Take Greece's IMF Stand-By Arrangement in 2010. It was widely reported in the financial media that the Fund was considering a loan in the region of 15 billion euro to allow Greece to meet its obligations to creditors for a period of two months (Bloomberg 2010). Within only a few weeks, however, the Fund agreed to a 30 billion euro loan, in addition to bilateral loans from other European governments (Thomas and Kulish 2010). Despite the importance of the "how much to lend" decision, only a handful of previous studies have examined variation in the size of IMF loans (Stone 2011; Oatley and Yackee 2004; Copelovitch 2010b).

In this chapter, I test quantitatively the argument that G5 economic exposure drives variation in these important outcomes. Before testing the argument in a quantitative analysis, I discuss the scope of IMF programs in developing and emerging markets, describing the range of IMF programs and the nature of the Fund's intervention. This basic overview of Fund operations establishes the need to consider a broad sample of program types in any empirical analysis. Following this overview of the program approval process, I discuss the results of a statistical analysis of (a) program approval, (b) the interval between programs, and (c) loan size in 159 countries from 1983 to 2006.<sup>2</sup> I conclude the chapter with a discussion of the relevance of these findings for my theory of IMF behavior.

## The scope of IMF programs

The extent of the IMF's involvement in developing and emerging markets is striking. Figure 6.1 clearly illustrates this, showing that programs are approved for nearly twenty countries every single year. Since 1983, there have been 535 lending programs in total, peaking at the start of the sample and reaching a low point before the global financial crisis in 2006. IMF programs come in two varieties: concessional and non-concessional. Middle-income economies generally enter into non-concessional arrangements and low-income countries are eligible for concessional assistance. The main differences between concessional and non-concessional programs are in the length of the program, the number of repayments, the number of program reviews, and the interest rate charged on the loan. Generally, concessional programs are longer, with more

program reviews and a lower rate of interest charged on the loan. Figure 6.2 illustrates the split between concessional and non-concessional programs. The general trend has been toward fewer non-concessional programs, particularly in quiet years before the global financial crisis.

With few exceptions, most previous research on the political economy of IMF behavior examines only non-concessional lending.<sup>3</sup> The argument often put forward by those that limit their focus to the IMF's short-term lending facilities is that concessional lending programs are offered for different purposes and require separate explanation. Oatley and Yackee (2004: 419), for example, excluded concessional loans because they were established in response to the debt crisis of the 1980s. According to them, including these programs would bias the sample in favor of positive results on bank exposure because concessional programs were established specifically to address commercial bank exposure. In light of my theory of IMF behavior, this is not a satisfactory reason to drop the 191 concessional programs from this study. Furthermore, my use of both trade and bank exposure adds to the robustness of the empirical analysis.

Copelovitch argued (2010b: 51) that we should exclude concessional IMF programs because the countries that use these facilities rely on the IMF for long-term access to external finance, which they would otherwise be unable to access. There are several reasons why this is a less than satisfactory reason for excluding such a large group of countries from the empirical chapters of this book. First, if a country is cut off from international capital markets, this should be reflected in some of its macroeconomic indicators, such as its external debt and debt service to GDP ratios. The variables included in this study to control for economic conditions in borrowing countries should capture debt problems.

Second, it is also important not to generalize excessively across the countries that are eligible for concessional programs. Some of these countries have borrowed from international capital markets and have experienced significant public and private capital inflows over the period which is the focus of this study from 1983 to 2006. The amount of capital flowing into low-income countries as a percentage of GDP is actually comparable with many other regions. However, it tends to be composed mostly of foreign direct investment (Ahlquist 2006: 683). Furthermore, the presence of a currency, debt, or banking crisis cuts across all income groups and IMF program types in this study.

Third, G5 banks and exporters can still benefit from the distributive consequences of an IMF loan regardless of whether it is concessional or not. Given that the exposure of G5 banks and exporters will not always

amount to much in many Least Developed Countries (LDCs), IMF loans to countries in concessional programs will often be smaller as a result. Truncating the sample so that it includes only non-concessional loans will not explain all of the variation in loan size and it could lead to biased estimates by excluding many smaller loans from the analysis.

Finally, all IMF programs follow a similar path and are subject to the same decision-making processes. There is no separate system of approving concessional programs and therefore no reason why the same political actors will act differently. All of the steps and decision-making processes described in the theoretical chapters apply equally to both concessional and non-concessional programs.<sup>4</sup>

Although the distinction between concessional and non-concessional lending is often discussed, one of the most important differences in the nature of IMF financing is between those cases where it acts in its role as lender of last resort and those where it does not. This is because the IMF's mission is primarily to act as a crisis lender. Nevertheless, a simple cross-tabulation of IMF programs and financial crises (Figure 6.3) shows that they were contemporaneous in only 79 of 535 programs from 1983 to 2006. This illustrates why we should be cautious about the use of statistical methods that do not correct for selection bias. Selection bias presents

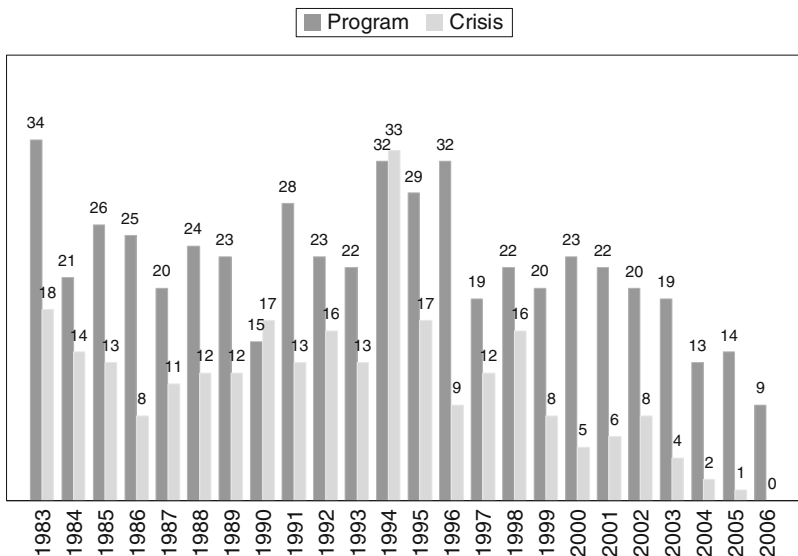


Figure 6.3 IMF programs and financial crises



a problem because countries should enter IMF programs only when in dire economic circumstances. There were, however, 189 financial crises in the sample without any IMF intervention in the year of the crisis.

## **Program approval**

The program approval decision is probably the IMF's most important policy decision. Nevertheless, the role that the Fund's most powerful shareholders play in shaping this decision has received less attention in comparison with the economic determinants of program approval. This omission is puzzling when one considers the power and influence of the G5 and also that G5 banks and exporters can benefit significantly from IMF programs in countries where they are exposed to risk.

The evidence from logistic regression, presented in Table 6.1, confirm the importance of the politics. In these models, the dependent variable takes the value of "1" in a year where a program was approved and "0" otherwise.<sup>5</sup> The specifications use robust standard errors and clustering by country.<sup>6</sup> The first column in Table 6.1 presents the base model with variables measuring domestic economic conditions in borrowing countries. The second column introduces the G5 index of bank exposure as an explanatory variable, and the columns that follow this add additional variables to control for alternative explanations. Columns five, six, and seven, substitute the G5 index of bank exposure with the index of G5 trade exposure.

The results confirm the theoretical predictions on the importance of the political determinants of program approval, both G5 bank and trade exposure are statistically significant at the " $p < 0.5$ " level in all specifications, supporting the argument that G5 economic exposure matters. By contrast, US military spending does not affect program approval, as do the variables to control for the most exposed banks or exporters in the G5.

Moving on to domestic economic conditions, GDP growth is statistically significant and negatively correlated with program approval in all specifications. The presence of a financial crisis is also statistically significant and positively correlated with program approval in all of the specifications in which it is included. The evidence in support of the other economic determinants of program approval is less compelling. International reserves are statistically significant and negatively correlated with program approval in models one to four. Reserves are not statistically significant in any of the models that use G5 trade exposure as opposed to bank exposure. The current account balance as a percentage of GDP is significant and negatively correlated with program

Table 6.1 IMF program approval

	(1)	(2)	(3)	(4)	(5)	(6)	(7)
G5 bank exposure		0.10** (0.04)	0.09** (0.05)	0.11** (0.04)			
G5 trade exposure					0.12** (0.05)	0.11** (0.06)	0.11** (0.05)
Reserves	-0.09** (0.03)	-0.14*** (0.05)	-0.14*** (0.05)	-0.14*** (0.05)	-0.07 (0.04)	-0.08 (0.04)	-0.07 (0.04)
Current account	0.01 (0.01)	-0.02** (0.01)	-0.02 (0.01)	-0.01 (0.01)	0.00 (0.01)	0.00 (0.01)	0.01 (0.01)
External debt	-0.04 (0.11)	-0.15 (0.16)	-0.05 (0.18)	-0.08 (0.18)	0.05 (0.12)	0.13 (0.12)	0.22 (0.12)
Debt service	0.04** (0.02)	0.01 (0.02)	0.01 (0.02)	0.01 (0.02)	0.00 (0.02)	-0.00 (0.02)	-0.00 (0.02)
GDP growth	-0.06*** (0.01)	-0.05*** (0.01)	-0.05*** (0.01)	-0.05*** (0.01)	-0.06*** (0.01)	-0.05*** (0.02)	-0.05*** (0.02)
GDP per capita	-0.13 (0.09)	-0.04 (0.11)	0.01 (0.12)	-0.06 (0.13)	-0.10 (0.11)	-0.02 (0.11)	-0.15 (0.13)
IMF quota review			0.21 (0.19)	0.21 (0.19)		0.37** (0.16)	0.36** (0.16)
IMF delegation index			-0.08 (0.07)	-0.10 (0.08)		-0.01 (0.06)	-0.07 (0.07)
Financial crisis			0.80*** (0.23)	0.77*** (0.23)		0.87*** (0.24)	0.77*** (0.26)
US military aid			-0.00 (0.00)	-0.00 (0.00)		0.00 (0.00)	-0.00 (0.00)
Systemic transition	1.53*** (0.26)	0.99*** (0.25)	0.85*** (0.29)	0.54 (0.38)	1.27*** (0.26)	1.26*** (0.31)	0.54 (0.41)
Banks and trade controls				Yes			Yes
Observations	2181	1301	1069	1069	1694	1358	1358
Countries	118	105	101	101	118	117	117
Log p. likelihood	-1010	-643	-537	-532	-745	-603	-584
r2_p	0.034	0.041	0.062	0.072	0.031	0.048	0.078

Note: Logistic regression. Robust standard errors in parentheses.

\*\*\* $p < 0.01$ , \*\* $p < 0.05$ .

approval in model two. Overall, this is rather weak evidence relating to the importance of the balance of payments.

Another finding is that the presence of an IMF quota review is positively correlated with program approval in models six and seven. This lends tentative support to the public choice argument that the IMF tends to “hurry up” lending in advance of a quota review. However, the extent to which bureaucratic inefficiency affects IMF operations is not uniformly present across the models and depends on the specification. Furthermore, the other measure of bureaucratic power, the delegation of authority from the shareholders to the staff, does not appear to influence the program approval decision.

Overall, the findings from the regression models are in accordance with the observable implications of my theory. They also support the claim that domestic economic conditions matter when it comes to IMF program approval, although the evidence is mixed for all but GDP growth and the presence of a financial crisis.

In order to provide a more intuitive understanding, I now proceed with my interpretation of the results using odds ratios and predicted probabilities. An odds ratio is derived by exponentiating the coefficients so that they can be interpreted as the ratio of the odds of program approval occurring to the odds of it not occurring. In this way, Table 6.2 presents several measures of the results from model four, including the odds ratio in terms of standardized predictor variables and the odds ratio in terms of a percentage change, and a percentage change for one standard deviation.

*Table 6.2* Substantive effects from logistic regression

	<i>b</i>	<i>z</i>	<i>P</i> > <i>z</i>	Odds ratio	$e^{bStdX^*}$	Standard deviation	Odds ratio (per cent)	Standard deviation (per cent)
Reserves	-0.09	-1.83	0.06	0.9	0.79	2.42	-9	-20.5
Current Account	-0.02	-2.03	<b>0.04</b>	<b>0.97</b>	<b>0.83</b>	<b>7.59</b>	<b>-2.4</b>	<b>-16.6</b>
Debt	-0.16	-0.88	0.37	0.84	0.9	0.61	-15.6	-9.8
Debt service	1.96	0.88	0.37	7.11	1.08	0.04	611	8.2
GDP growth	-0.05	-3.88	<b>0.00</b>	<b>0.94</b>	<b>0.76</b>	<b>5.02</b>	<b>-5.1</b>	<b>-23.3</b>
GDP per capita	-0.18	-1.44	0.15	0.83	0.82	1.06	-16.6	-17.6
Quota review	0.08	0.42	0.67	1.08	1.03	0.41	8.6	3.5
Financial Crisis	0.5	2.26	<b>0.02</b>	<b>1.65</b>	<b>1.16</b>	<b>0.3</b>	<b>65.1</b>	
US-UN	1.04	1.26	0.2	2.83	1.1	0.09	183	10.8
G5 bank	0.15	3.08	<b>0.00</b>	<b>1.17</b>	<b>1.42</b>	<b>2.2</b>	<b>17.3</b>	<b>42</b>

*Notes:* Findings from model four. \*Odds ratio in terms of standardized predictor variables.

The findings show that a one unit increase in the current account balance results in a 2.4 per cent decrease in the odds of a country being in the program approval category. Looking at this same relationship, a one standard deviation increase reduces the odds by 16.6 per cent. GDP growth has a similar impact on IMF program approval: a one unit change here leads to a 5.1 per cent decrease and one standard deviation leads to a 23.3 per cent decrease in the odds of program approval. Of all the macroeconomic variables, the presence of a financial crisis has the greatest impact, increasing the odds of IMF program approval by 65.1 per cent. Finally, G5 bank exposure significantly predicts program approval: a one unit change in bank exposure increases the odds of IMF program approval by 17.3 per cent, and a one standard deviation change increases the odds by 42 per cent. These are substantial increases, showing that countries that were relatively better connected with G5 domestic interests were more likely to enter IMF programs, holding other variables constant.

While G5 bank and trade exposure are correlated with program approval, even a country with a high level of domestic exposure to a member of the G5 and an extreme financial crisis is likely to have less than a 0.6 probability of entering an IMF program. Figure 6.4 illustrates this, showing the predicted probabilities for each observation in the data. By and large, these are concentrated between 0 and 0.6.

6.5 illustrates the probability of program approval at different values of G5 bank exposure, when all other variables are held at their mean value, and also plots the 95 per cent confidence interval. Similarly,

6.6 graphs the probability of program approval at different values of GDP growth. The figures are self-evident, showing that an increase in bank exposure leads to a much higher likelihood of program approval, but with the added advantage of illustrating how confident we can be of these predictors. An increase in GDP growth reduces the likelihood of program approval, although we can be less confident about this at very low levels of growth and much more confident at high levels, as the plots illustrate.

## Program intervals

Although the binary regression models have illustrated some of the drivers of the program approval decision, some countries consistently draw on IMF resources with very little time elapsing between programs. Indeed, the repeated involvement of the IMF in some developing and emerging economies since the collapse of the Bretton Woods system has

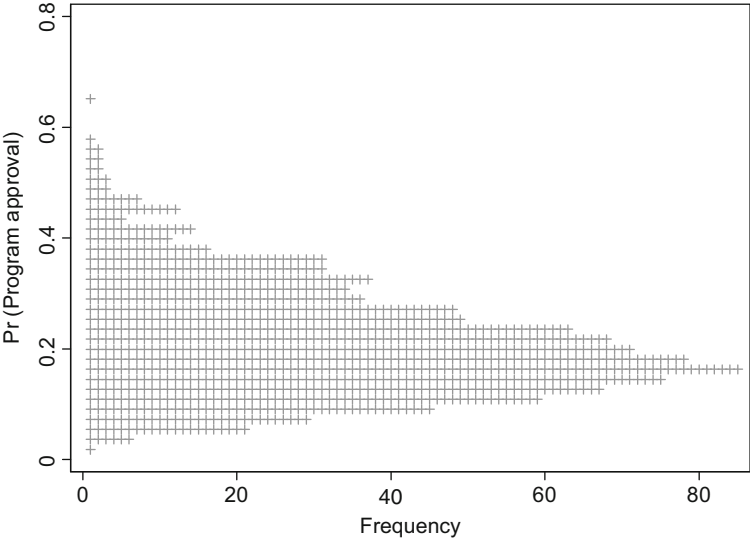


Figure 6.4 Probability of program approval

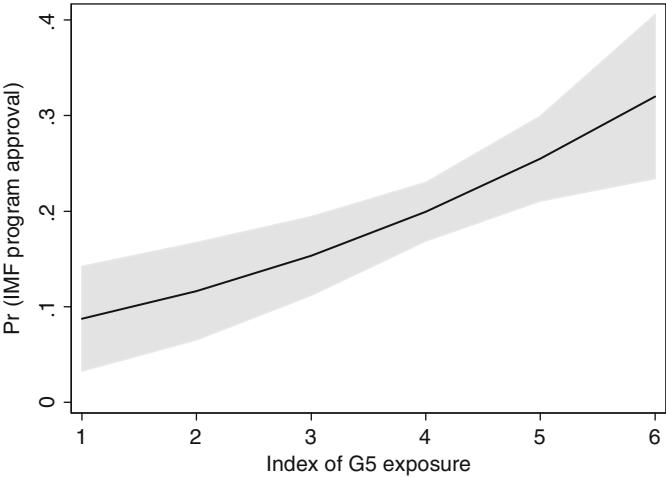


Figure 6.5 Probability of program approval and G5 bank exposure

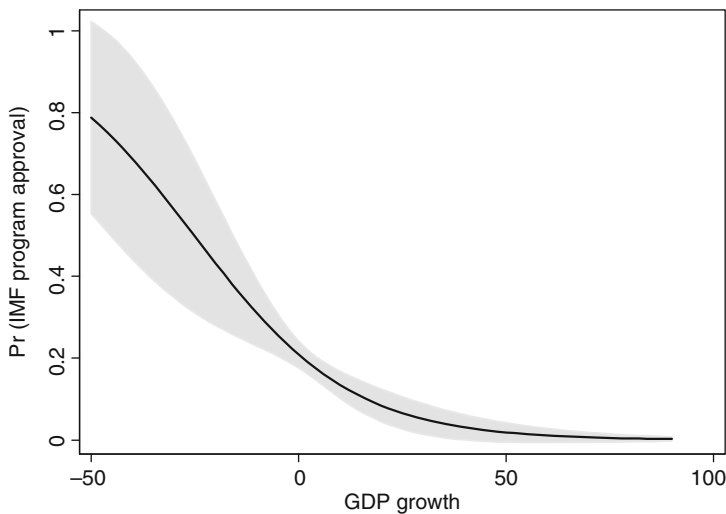


Figure 6.6 Probability of program approval and GDP growth

been the subject of much previous research (Hutchison and Noy 2003; Bird 2004; Bird *et al.* 2004; Joyce 2005; Conway 2007). If the Fund is locked in long-term or repeated relationships with some of its borrowers, examining the intervals between occasions of program approval is another useful way of testing the G5 economic interests' explanation of IMF behavior. In other words, does the economic exposure of the G5 lead to longer or shorter periods of time between approvals? Does it matter at all?

To answer these questions, I employ survival analysis where the dependent variable is the duration of time until a change in program approval status occurs. The first necessary step in implementing survival analysis is to specify the shape of the baseline hazard or the risk of program approval when all of the independent variables are equal to zero. According to Golub (2007: 162), researchers conducting survival analysis should select the parametric shape of the baseline hazard only on the basis of strong theory. Given what we know about IMF programs, the Weibull distribution, which assumes that the hazard of program approval increases over time, is the most sensible shape for the baseline hazard. This is because the IMF is reluctant to approve a second program without giving the first program time to succeed. As a result, in the early months and years following program approval, it is much less likely to

reoccur as it takes time for borrowing countries to implement the terms and conditions of their existing program. Nevertheless, there are individual cases where programs are canceled prematurely and reapproved shortly afterwards.<sup>7</sup> However, because these cases are rare, they should still fit the Weibull distribution. Although there is a good *a priori* reason to prefer the Weibull distribution, the models were tested with the log-logistic and exponential baseline hazards. The AIC (Akaike Information Criterion) score was lower for the Weibull models, providing further support for their use.<sup>8</sup>

Table 6.3 presents the results. The specifications are identical to the logit models in all cases.<sup>9</sup> In terms of the results, international reserves and GDP growth are all negatively correlated with non-program intervals; countries that maintain good levels of both can expect to stay away from the IMF for longer. However, financial crises and domestic economic exposure among the G5 are positively correlated, reducing the amount of time before a country eventually calls on the IMF for assistance. The findings on G5 economic exposure show that it is statistically significant in models one, two, three, and four. The level of IMF autonomy and IMF quota reviews are significant in models two and three. In these models, as the Fund's autonomy increases, countries survive for longer without entering a program. Overall, many of the same factors that influence the decision over program approval also determine the time between program approvals. As a result, the findings are roughly comparable with those from the logit models, with the exception that G5 economic exposure is not robust in all of the specifications.

## IMF loan size

In this section, I test the argument that G5 governments secure larger IMF loans for countries where their domestic banks and exporters are exposed to risk and loss. I expect, therefore, to find evidence of larger IMF loans as the economic exposure of G5 banks and exporters increases. Although this is not direct evidence that the G5 continuously intervene to protect domestic interest groups from the consequences of economic shocks in developing and emerging markets, a systematic relationship between loan size and G5 economic interests is one of the main observable implications of my theory of IMF behavior.

The factors that influence IMF loans are difficult to estimate, however, because the lending decision is not a separate or discrete one. A loan of any size is first conditional on program approval. As the findings on program approval have demonstrated, countries that participate in IMF

Table 6.3 Program intervals

	(1)	(2)	(3)	(4)	(5)	(6)	(7)
G5 bank exposure (log)		0.09*** (0.03)	0.07** (0.04)	0.09** (0.03)			
G5 trade exposure (log)					0.11** (0.05)	0.07 (0.05)	0.08 (0.04)
Reserves	-0.08** (0.03)	-0.12*** (0.04)	-0.11*** (0.04)	-0.11*** (0.04)	-0.06 (0.03)	-0.07** (0.03)	-0.06 (0.03)
Current account	0.01 (0.01)	-0.02** (0.01)	-0.02 (0.01)	-0.01 (0.01)	-0.00 (0.01)	0.00 (0.01)	0.01 (0.01)
External debt	-0.04 (0.09)	-0.16 (0.12)	-0.12 (0.13)	-0.14 (0.13)	0.04 (0.10)	0.17 (0.10)	0.24** (0.10)
Debt service	0.03*** (0.01)	0.01 (0.01)	0.01 (0.01)	0.01 (0.01)	0.00 (0.01)	-0.00 (0.01)	0.00 (0.01)
GDP growth	-0.04*** (0.01)	-0.04*** (0.01)	-0.04*** (0.01)	-0.03*** (0.01)	-0.05*** (0.01)	-0.05*** (0.01)	-0.04*** (0.01)
GDP per capita	-0.10 (0.07)	-0.06 (0.09)	-0.02 (0.09)	-0.08 (0.09)	-0.08 (0.09)	-0.00 (0.09)	-0.09 (0.11)
IMF quota review			0.24 (0.13)	0.24 (0.13)		-0.07 (0.12)	-0.05 (0.12)
Financial crisis			0.48*** (0.14)	0.45*** (0.15)		0.62*** (0.18)	0.56*** (0.19)
IMF delegation index			-0.32*** (0.07)	-0.34*** (0.07)		-1.93*** (0.15)	-1.88*** (0.16)
US military aid			-0.00 (0.00)	-0.00 (0.00)		0.00 (0.00)	0.00 (0.00)
Bank and trade controls				Yes			Yes
Observations	2181	1301	1069	1069	1694	1358	1358
No countries	118	105	101	101	118	117	117
Log p. likelihood	-180	-121	-80.9	-76.4	-28.0	26.5	38.4

Note: Weibull regression. Robust standard errors in parentheses.

\*\*\* $p < 0.01$ , \*\* $p < 0.05$ .



programs are systematically different from those that do not. They are more likely to suffer from deteriorating economic conditions and also more likely to be economically interdependent with the world's leading economies. The findings also confirm that we need to take politics seriously: if the exposure of domestic interests in the G5 affects program approval, it may also affect loan size.

IMF lending is best theorized as a two-stage process where the initial decision to approve a program dominates the subsequent decision over the size of a loan. In other words, the size of an IMF loan, which is the outcome of interest in this study, is not an independent decision. Fitting a statistical model to this reality calls for a two-stage model that takes account of the dominance of the first stage.<sup>10</sup> The Heckman selection model best fits this theoretical problem because it models a two-stage process starting with selection and continuing with a subsequent decision over a continuous outcome. It also controls for selection on observed and unobserved variables.<sup>11</sup>

Although the two-stage logic of the Heckman selection model is appropriate here, the model performs poorly without an exclusion restriction. An exclusion restriction is a variable that enters the selection equation but does not enter the outcome equation. Without one, the results are based only upon distributional assumptions about the residuals and not upon variation in the independent variables (Sartori 2003). Experts in international relations are often confronted with this problem when theory dictates that identical variables should enter both the selection and outcome equation. In the majority of cases where this issue has arisen, researchers have either dropped an explanatory variable from the outcome equation or included an additional variable in the selection equation. However, this course of action has been widely debated in social science and the consensus is that it is best avoided (Sartori 2003; Simmons and Hopkins 2005; Madden 2008).

In the statistical analysis, I include a variable in the selection equation that measures a systemic transition in the international system. This exclusion restriction controls for the transition from communism, where a large group of states moved from planned economies operating in a relatively autonomous economic system to market-based economies. The inclusion of this variable is justified on theoretical grounds and unlike many other applications of the Heckman selection model is not merely a practical measure to improve model fit. Variation in the IMF's program approval process should be partially explained by this transition, without it also affecting IMF lending. Whereas before the transition Soviet bloc members had little access to IMF financing

subsequently the IMF's Systemic Transformation Facility was created to assist their adjustment. Without the collapse of the Soviet Union, I assume that this group of states would have continued to have little access to IMF lending for some time. Therefore, a systemic change of this nature should influence program approval without influencing loan size, making this a naturally occurring process that can serve as a valid exclusion restriction. Controlling for this transition is also important at an empirical level. Without considering the transition, it would appear that many countries with similar economic systems all entered IMF programs within a very short period. This would introduce bias into the analysis, as it would inflate the importance of certain political economy variables. The variable is a binary variable taking the value of "1" where a state is transitioning from communism during the years 1991–1993 only.<sup>12</sup>

The results from the Heckman selection models are reported in Table 6.4 along with measures of model suitability and selection bias. The first column of Table 6.4 presents the base model including only domestic economic conditions and the exclusion restriction. The second column introduces one of the main quantities of interest in this paper: the G5 index of bank exposure. The third column builds on this by adding several variables to control for financial crises, IMF quota reviews, and US military spending. Column four presents the results from the full model, including control variables for the most exposed lender from among the G5. These were not statistically significant and were dropped from the table in order to improve the presentation of the results. Models five, six, and seven replicate models two, three, and four but substitute the G5 index of bank exposure with trade exposure, and in the place of the variables to control for bank exposure among the G5, it substitutes variables to control for trade exposure. Once again, the trade exposure dummies were not statistically significant and were dropped from the table to improve presentation.

The findings from the analysis are consistent with the hypothesis that IMF loans and program approval are responsive to an increase in the economic exposure of the most exposed member of the G5. All the coefficients run in the expected direction and the explanatory variables of importance for my theory are statistically significant in all models. The greater the economic exposure of the most exposed member of the G5, the more likely are program approval and a larger loan. Table 6.5 presents the substantive effects, showing that a change in the value of G5 bank exposure from a very low level (the 10th percentile of exposure) to a very high level (the 95th percentile) leads to a 38 per cent

Table 6.4 IMF loan size

Loan/quota	(1)	(2)	(3)	(4)	(5)	(6)	(7)
G5 bank exposure (log)		0.18*** (0.04)	0.17*** (0.05)	0.17*** (0.04)			
G5 trade exposure (log)					0.19*** (0.06)	0.15** (0.06)	0.15** (0.06)
Reserves	-0.08*** (0.03)	-0.08*** (0.03)	-0.08** (0.04)	0.01 (0.03)	-0.06* (0.03)	-0.05 (0.04)	-0.04 (0.04)
Current account	0.01 (0.01)	-0.02** (0.01)	-0.02 (0.01)	-0.01 (0.01)	-0.00 (0.01)	-0.00 (0.01)	0.00 (0.01)
External debt	0.09 (0.09)	0.01 (0.12)	0.04 (0.14)	0.07 (0.13)	0.21* (0.11)	0.25* (0.14)	0.34** (0.14)
Debt service	0.03** (0.01)	0.01 (0.01)	0.01 (0.01)	0.01 (0.01)	0.00 (0.01)	-0.01 (0.01)	-0.01 (0.01)
GDP growth	-0.04*** (0.01)	-0.03** (0.01)	-0.03** (0.01)	0.00 (0.01)	-0.05*** (0.01)	-0.05*** (0.02)	-0.05*** (0.01)
GDP per capita (log)	-0.01 (0.08)	-0.10 (0.08)	-0.09 (0.08)	-0.16** (0.07)	-0.08 (0.10)	-0.06 (0.10)	-0.17 (0.11)
Financial crisis			0.68*** (0.20)	0.34** (0.16)		0.77*** (0.23)	0.73*** (0.24)
IMF quota review			0.05 (0.15)	-0.09 (0.11)		0.16 (0.14)	0.19 (0.14)
IMF delegation index			0.01 (0.06)	0.07 (0.05)		-0.01 (0.06)	-0.03 (0.06)
US military aid			0.00 (0.00)	0.00 (0.00)		0.00* (0.00)	0.00 (0.00)
Observations	2181	1301	1069	1069	1694	1358	1358
Censored	1777	1026	826	826	1408	1118	1118
No. countries	118	105	101	101	118	117	117
Log p. likelihood	-1459	-936	-796	-790	-1081	-876	-854
<i>Rho</i>	0.89	0.92	0.91	-0.081	0.90	0.94	0.94
Wald	33.2	51.6	70.3	56.9	33.5	61.1	85.0
Wald indep.	33.9	48.3	23.0	0.23	31.7	64.9	66.8

Notes: Heckman selection model. Robust standard errors in parentheses (program approval not displayed).

\*\*\* $p < 0.01$ , \*\* $p < 0.05$ , \* $p < 0.1$ .

increase in loan size, holding other variables at mean values. Similarly, G5 trade exposure leads to a 40.2 per cent increase in loan size when moving from a very low level, to a very high level of trade exposure. This stands in sharp contrast to the many leading economic indicators such as external debt, debt service, GDP per capita, and current account position, none of which have any effect on IMF loan size.

The dummy variables that control for alternative explanations about the impact of individual G5 members on IMF lending and program approval are not statistically significant in any of the specifications, lending little support to the argument that it is the identity of the most exposed member of the G5 that matters, rather than the actual extent of their economic exposure. In other words, it makes no difference to the size of an IMF loan whether the most exposed country is the United States, the United Kingdom, Germany, Japan, or France.

Of the principal macroeconomic variables, the presence of a financial crisis is consistent across the specifications. A financial crisis in the potential recipient of IMF financing is significantly correlated with the likelihood of program approval. While this is an intuitive finding in line with the IMF's role as an international lender of last resort, it does not follow automatically that loan size increases too. As it happens, the models predict larger loans following a financial crisis – 12 per cent larger in model three and 14 per cent in model five.

Of the other macroeconomic variables, GDP growth is negatively correlated with both program approval and loan size. As economies grow faster, the likelihood of program approval diminishes as does the size of loans. Table 6.5 shows how a change from a very low to a very high level of economic growth leads to an 8.4 per cent reduction in loan size, holding other variables constant. An increase in international reserves is also statistically significant and negatively correlated with program approval and loan size in five of the seven models. A change from a very low level of reserves to a high level leads to a 17 per cent reduction in loan size. This is also an intuitive finding and supported elsewhere in the literature. Clearly, domestic economic conditions matter, but the evidence for the impact of the other macroeconomic variables appears mixed at best.

It is surprising that the current account balance is statistically significant in only one of each of the models on loan size and program approval. It is also surprising that neither debt service nor external debt consistently predicts program approval or loan size. The latter is significant only in models five, six, and seven on the size of IMF loans. The results support the view that the IMF does not completely disregard its

Table 6.5 Substantive effects

<b>Change in IMF loan size</b>		
<i>When variable x moves from 10th to 95th percentile, with all other variables at mean values</i>		
G5 bank exposure	+38.1 per cent	(Model 2)
G5 trade exposure	+40.2 per cent	(Model 5)
GDP growth	-8.4 per cent	(Model 1)
Reserves	-16.9 per cent	(Model 2)
<i>Change in IMF loan size during financial crisis, with other variables at mean values</i>	+12 per cent	(Model 3)
	+13.8 per cent	(Model 5)

intended purpose by acting only in the interests of its most powerful members. But the economic determinants of IMF agreements tell only part of the story, as the results clearly indicate.

US military aid is statistically significant in the program approval equation of model four and the loan size equation of model six. That it is significant and negatively correlated with program approval in model four runs contrary to what is expected. Similarly, the level of delegation from member-states to the IMF staff has little systematic impact on loan size and program approval. The evidence on the impact of an IMF quota review is also quite sparse, with the only exception being that a quota review is correlated with an increase in the likelihood of program approval in models six and seven. As expected *systemic transition* is positively and significantly correlated with program approval in all but model four, reflecting the impact that the movement of a large group of states from planned to market economies has had on the likelihood of program approval.

Although the results from this statistical analysis lend support to the theory and hypotheses set out in this book, it is not possible to reject some of the alternative explanations of IMF behavior, as domestic economic conditions in borrowing countries clearly matter and in some cases the likelihood of participation in, and the size of the IMF loan, were greater under IMF quota reviews.

Finally, the results strongly support the use of the Heckman selection model and the presence of selection effects in IMF lending. First, the Wald test is reported for each model at the bottom of Table 6.4. Based on the *p* values from the tests, it is possible to reject the null hypothesis that the parameters of interest in the models are equal to zero, confirming the suitability of the model with these data. Secondly, Wald chi-squared

tests of the independence of the selection and outcome equations are also reported for each model. These tests confirm that the errors in the first and second stage are correlated, indicating that Heckman's procedure is appropriate here. Failing this, the results would be no different from those of separate probit and linear regression models. Finally,  $\rho$  – the correlation coefficient between the unobserved factors that determine selection into an IMF program and the unobserved factors that determine the size of the IMF loan – is reported for all models at the bottom of Table 6.4. The findings here also confirm the presence of selection effects as  $\rho$  is significantly different from zero. It is difficult to interpret this value further, though, because the factors in the error should be impossible to measure and sensitive to model specification. In summary, these measures confirm the suitability of the Heckman selection model with these data and also confirm the presence of selection effects. This is an important finding because previous research on the factors that influence IMF loans find either no evidence of selection effects or do not correct for selection bias in the first place.

## Conclusions

This chapter explored a much-neglected determinant of IMF lending and program approval: the benefit that a program can bring to key domestic interest groups in the IMF's most powerful shareholders. Overall, the evidence given by several statistical models supports the argument that these societal groups matter. Indeed, the results speak to the idea that the distributive consequences of economic shocks in developing and emerging markets drive variation partially in the IMF's program approval decision.

While the evidence presented here supports the idea that IMF lending is not just a technocratic process, it is important to emphasize that some of the economic determinants of program approval are robust. That a financial crisis is such a strong predictor of approval is good news – it would be very disappointing if it were not – from the perspective of an IO charged with managing balance of payments crises. However, there was no systematic relationship between loan size and many leading economic indicators, including a country's current account position, external debt and debt service. By contrast, G5 economic exposure was a robust predictor of loan size. Loans are expected to increase by up to 40 per cent when G5 exposure moves from a very low level to a very high level. Although this is not direct evidence that the G5 continuously intervene to increase IMF loans when their exporters and banks are

exposed to risk and loss, the relationship between G5 economic interests and IMF loan size is unlikely to be merely coincidental.

The results also lend support to some of the alternative explanations of IMF decision-making, showing that some domestic economic conditions in the borrowing countries matter, up to a point: GDP per capita growth and the presence of a financial crisis had a predictable effect on IMF loan size, with the presence of a crisis leading to an increase of 12–14 per cent. This finding speaks broadly to the role of the IMF in responding to financial crises, showing that the organization's policy responses during a crisis are systematically different than those under other conditions.

The findings also suggest that selection bias should be of the upmost concern to scholars who study IMF policy. It is clear that countries entering IMF programs are systemically different from others – not only in terms of their economies and societies but also in the way in which they are integrated with the world's five largest economies. Social scientists who study the effect of IMF programs need to be cautious of any empirical analysis that does not control for political linkages.

# 7

## IMF Lending and the Crisis in Europe

In the aftermath of the global financial crisis, rich European economies were forced to borrow from the IMF for the first time since the United Kingdom's 1976 program. Many had assumed that these countries would never need IMF help; none had defaulted since the Second World War and all have been democracies since the mid-1970s. Iceland was the first rich European country to run into problems. It was forced to borrow 1.4 billion SDRs in November 2008. In 2009, the crisis spread to Greece, which borrowed 26.4 billion SDRs in May 2010 and another 23.7 in March 2012.<sup>1</sup> Loans far exceeding normal limits were also agreed with Ireland (19.4 billion SDRs) and Portugal (23.7 billion SDRs). In 2011, the European sovereign debt crisis entered a new phase when Spain and Italy were drawn into the conflagration. In July, the yield on ten-year Spanish bonds was 7.6 per cent and the yield on ten-year Italian bonds was 6.6 per cent. The European Central Bank (ECB) intervened aggressively in the bond market to prevent the collapse of the European banking system and euro currency.

From catering exclusively for developing and emerging markets, the majority of the IMF's current lending is now directed toward European economies. At the beginning of 2013, Iceland, Greece, Ireland, and Portugal account for approximately 60 per cent of all outstanding IMF credit to 87 countries. This has led Germany's central bank to criticize the IMF for taking on too much risk; for weakening its standards by easing terms and conditions and for making its lending facilitates too attractive to borrowers (Riecher 2012).

This chapter examines IMF lending to Iceland, Greece, and Ireland. The aim is to test the book's theory against the experience of these countries and assess the relevance of alternative theories of IMF behavior. For each case, I begin with an analysis of G5 economic exposure and



proceed to analyzing the role of the G5 in negotiations to resolve the crisis. I then consider the role of strategic interests, domestic politics, and the IMF's bureaucracy. The chapter concludes with a discussion of the book's theory in light of these three cases.

## **Iceland**

In September 2008, the bankruptcy of Lehman Brothers sent shockwaves throughout the international financial system. The freezing of global inter-bank markets wiped out Iceland's banks, which were highly leveraged and dependent on foreign financing to continue to operate. Since the banks accounted for approximately 85 per cent of the banking system, Iceland was plunged immediately into a severe financial crisis. In October 2008, an IMF mission team was dispatched to negotiate a program of financial support. In November 2008, the IMF's Executive Board approved a two-year \$2.1 billion SBA – the first for an advanced economy since the United Kingdom's SBA in 1976.<sup>2</sup> This shattered the illusion that rich democracies were somehow immune to severe financial crises and ineligible for IMF support.

### **G5 exposure to Iceland**

During the 2000s, Iceland's three largest banks – Glitnir, Kaupthing, and Landsbanki – transformed from small state-owned institutions into large private banks with substantial international operations. Their rapid expansion was facilitated by Iceland's status as a member of the European Economic Area (EEA), which granted its banks access to European markets on good terms. Figure 7.1 illustrates a tenfold increase in G5 exposure to Icelandic banks in just a few years from 2000 until 2008.<sup>3</sup> The scale of the transformation, and the subsequent rise in G5 claims, is remarkable when one considers that Iceland's population is only slightly above 300,000. The majority of the increase was concentrated among large European economies, with German banks recording by far the highest level of claims. In 2008, German exposure peaked at over \$22.3 billion, followed by the United Kingdom at \$4.7 billion and France at \$3.5 billion.

In the aftermath of the crisis, the government's funding requirement was approximately \$5 billion. In the LOI of November 15, it was envisaged that the IMF would provide approximately \$2.1 billion, equivalent to 1190 per cent of Iceland's quota in the IMF – one of the largest loans in IMF history.<sup>4</sup> To reduce the risk to the IMF, it envisaged that the remaining \$3 billion would come from a series of bilateral loans but the source of these funds had not been finalized at the program's outset.

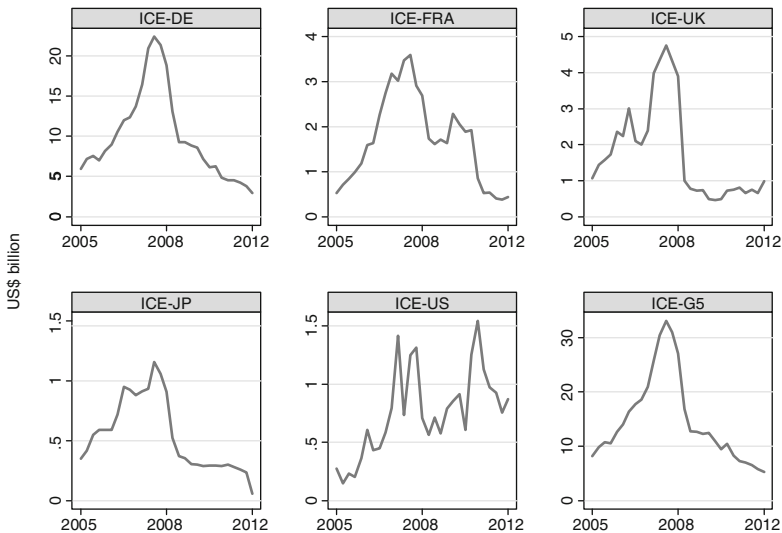


Figure 7.1 G5 bank exposure to Iceland, 2005–2012

Source: The Bank for International Settlements (2012).

In February 2009, negotiations to finance Iceland's program were still in progress with the Nordic countries, Russia, Poland, and the Faroe Islands. Together, these countries committed \$3.2 billion but there were delays (IMF 2009c). By October of 2009, Russia had withdrawn its support but the Nordic countries, Poland, and the Faroe Islands provided \$2.75 billion and Iceland's program was extended by six months until May 2011 to compensate for the delays in securing funding.

### The role of the G5 in negotiations

A dispute between Iceland on the one side and the United Kingdom and the Netherlands on the other side threatened to derail the program on several occasions. The dispute concerned Iceland's bust banks, which at approximately 85 per cent of its financial sector, were too big to save. In the restructuring process, the banks' domestic liabilities were transferred to a new institution. Most of their foreign liabilities remained with the old banks, ensuring that foreign creditors would suffer the majority of losses.

One of the banks – Landsbanki – had expanded its operations outside of Iceland in the immediate years before the crisis. When the bank was placed into receivership, it was estimated that 420,000 retail depositors

who had taken out “Icesave” accounts would suffer losses, including universities, hospitals, councils and London’s police force (Brogger and Einarsdottir 2008). The exposure of so many ordinary citizens placed considerable pressure on politicians in the United Kingdom and the Netherlands to refund directly. Both governments agreed immediately to cover losses. Other depositors, like UK local authorities and unguaranteed overseas depositors that were not covered by the United Kingdom or the Netherlands were not recompensed.

The United Kingdom and the Netherlands argued that they were entitled to compensation from Iceland for their bailout of Icesave depositors. They argued that Iceland had failed to implement the European deposit guarantee scheme – a scheme that was created under the treaty that established the EEA to reimburse depositors whose bank has failed up to a limit of €20,887 (Wade and Sigurgeirsdottir 2010: 23). Iceland’s government argued that it had not breached the treaty – it had established a compensation scheme in accordance with the guarantee scheme but it was too small to recompense depositors fully. In response, UK Chancellor, Alistair Darling, argued that Iceland was in breach of the treaty that established the EEA. Controversially, the UK Houses of Parliament voted to freeze Landsbanki UK domiciled assets under anti-terrorism legislation.

Although it was formally a separate issue from Iceland’s IMF program, the Icesave dispute had serious implications for Iceland’s interactions with the IMF because of the influence of the United Kingdom at the Executive Board. During negotiations, the IMF’s staff assumed the role of mediator in an effort to resolve the dispute, encouraging both sides to talk and providing specialist information on the legal and economic dimensions of the dispute. According to the IMF’s mission chief for Iceland, Mark Flanagan:

The fund has never had a formal condition on Icesave completion. Never. How Icesave affected the timing of the review was indirect and related to the broader financing for the program. Because other creditors of Iceland made it a condition, we had to wait until they were satisfied. The dispute between Iceland, Britain and the Netherlands concerning Icesave complicated efforts by Iceland to secure additional external financing for the program from other participating countries. (Northedge 2010)

According to Flanagan’s logic, IMF lending operations are sometimes a hostage to the actions of supplementary financiers. Wade and Sigurgeirsdottir (2010: 23) argued that the IMF backed the British and Dutch government’s

demands during the negotiations. Their interpretation of the IMF's position seems more sensible, given that it was widely reported that the United Kingdom and the Netherlands sought to delay disbursement of the IMF loan until the Icesave dispute was resolved. In response, Iceland asked the United States to stop Britain and the Netherlands from delaying the IMF's loan. Urou Gunnarsdottir, a spokesperson of the Icelandic Foreign Ministry, is reported to have stressed that Washington was not being asked to intervene directly in the depositor dispute but "to ensure that the IMF funds and the Icesave deal are separate" (Jolly 2010).

In the end, the United States did not side with the Icelandic authorities in the negotiations. Its lack of engagement suggests implicit support for the United Kingdom and Dutch position. Even more generally, there was little international support for Iceland's position among its European neighbors. According to Morgunbladid (quoted in Thorhallsson and Kirby 2012: 805), all of the member states of the EU, including the Nordic states, stood by Britain's action to delay IMF support.

Iceland's parliament eventually agreed to compensate the United Kingdom and the Netherlands. In an unexpected twist, however, the parliament was overruled by the president, who put the issue to a referendum on two separate occasions. On both occasions, compensation was rejected by the electorate and the dispute continues as of January 2013.

Iceland's financial crisis illustrates how domestic interests in the G5 can lobby their government to cover losses. Both the United Kingdom and the Netherlands immediately agreed to compensate domestic depositors while at the same time attempting to utilize the IMF to put pressure on Iceland to repay. The IMF was also inundated with enquires from private creditors about how they would be treated in Iceland's debt workout. The IMF took a hard line view, however, stating that creditors would receive fair treatment in line with the law but that "Iceland's public debt has already risen dramatically, leaving little scope for further socializing the losses of the banks that went under" (IMF, 2009e).

### **Security, bureaucracy, and domestic politics**

Despite Iceland's membership of the North Atlantic Treaty Organization (NATO), strategic interests didn't affect IMF lending. This is because Iceland's strategic importance declined after the Cold War and the withdrawal of US military personnel. In the 1970s, Iceland had used its strategic importance as a bargaining chip in its dispute with the United Kingdom over fishing rights in the North Atlantic when it threatened to close the NATO airbase at Keflavik. While the Icesave dispute evoked memories of this conflict, Iceland had no leverage on this occasion.

Iceland's crisis does, however, illustrate the importance of domestic politics to IMF lending. Iceland's parliament agreed to compensate the United Kingdom and the Netherlands who, in return, agreed to provide an official loan which Iceland's government would repay over a long period of time (IMF 2009b). Unexpectedly, the President of Iceland, Ólafur Ragnar Grímsson, rejected the parliament's decision. By refusing to sign the act of parliament, the president was able to force the act to go to a referendum where the entire electorate was asked to accept or reject the measure. The president's decision to reject the act was supported by 93 per cent of the electorate. Over one year later, in February 2011, the president again rejected the parliament's measure to compensate the United Kingdom and the Netherlands. The second referendum to reject the government's proposal was supported by nearly 60 per cent of the electorate.

While many policymakers expected that Iceland's executive had the authority to negotiate a resolution of the Icesave deal, it was not expected that their recommendation would be rejected by the president, a largely ceremonial figure until the financial crisis. This demonstrates that domestic politics, in the shape of additional veto players, had the potential to affect IMF lending. The president could have possibly derailed the IMF's loan if he had taken a similar action and it was approved in a referendum or if IMF lending and the Icesave deal were not separate issues.

## Greece

After the general election in 2009, Greece shocked financial markets. The new socialist government, led by George Papandreou (PASOK), admitted that the previous administration had concealed the true extent of Greek government debt, which was three times higher than previous estimates.<sup>5</sup> Many consider this event to mark the beginning of the European sovereign debt crisis.

With the stability of the euro currency in question, Greece's financial crisis had potentially lethal consequences for global financial stability. In December 2009, three leading credit rating agencies – Standard & Poor's, Moody's, and Fitch – downgraded Greek government debt. Financial markets feared that a Greek default was imminent because a large portion of the government's debt was due to mature in May 2010. At the beginning of 2010, financial markets began to predict a Greek default with certainty, mobilizing policy-makers to consider the practical implications of a bailout.

After a series of negotiations between Greece and its European partners, a bailout was agreed in principle. During the negotiations, it was reported

that a loan in the region of 15 billion euro was to be organized to allow Greece to meet its debt obligations for a period of two months (Bloomberg 2010). Within only a few weeks, it became apparent that Greece's requirements were much steeper. In May 2010, it was announced that Greece had reached an agreement with the IMF, European Commission (EC), and ECB on a program of financial support worth €110 billion (IMF 2010b). For its share, the IMF agreed to lend Greece €30 billion. A three-year SBA was announced on May 9 for 26.4 billion SDRs – a staggering 3212 per cent of Greece's IMF quota. A further loan facility agreement worth 80 billion euro was agreed by EU members; each member pledged to contribute in proportion to the size of their economy and it was agreed that the facility would be managed by the EC.

### **G5 exposure to Greece**

G5 banks and exporters were highly exposed to Greece. French banks were the most exposed. From 2005 to 2008, French exposure increased from approximately \$20 billion to \$80 billion. By contrast, German exposure – already high at \$45 billion – remained stable during these years. The other shareholders' banks also recorded substantial increases in their exposure to Greece. UK exposure doubled in the space of just three years from less than \$10 billion to almost \$20 billion. US and Japanese banks recorded similar increases in exposure. Taken together, G5 exposure was approximately \$75 billion in 2005 – increasing to over \$150 billion at the peak (Figure 7.2).

By the end of 2012, most of the shareholders had reduced substantially their exposure with the exception of French banks, which remain highly exposed. Together, they continue to shoulder 50 per cent of all European bank exposure to Greece. *Crédit Agricole* had one of the highest levels of exposure after it acquired a large share of *Emporiki Bank* in 2006. In total, *Emporiki Bank* cost *Crédit Agricole* €6 billion and its total loan book was €22.9 billion; *Société Générale*, another major French bank, had also purchased a large share in the operations of *Geniki Bank*. *BNP Paribas* is reported to have made a total loss of €3 billion due to Greece, mainly on the country's bonds (Daneshkhu 2012). With such high levels of exposure in some of the most prominent French banks, a Greek exit from the Eurozone would destabilize the entire French banking system, which in turn would undermine the global financial system.

### **The role of the G5 in negotiations**

On April 15, 2010, the IMF's MD, Dominique Strauss-Kahn, announced that the Greek authorities had requested financial support. The request

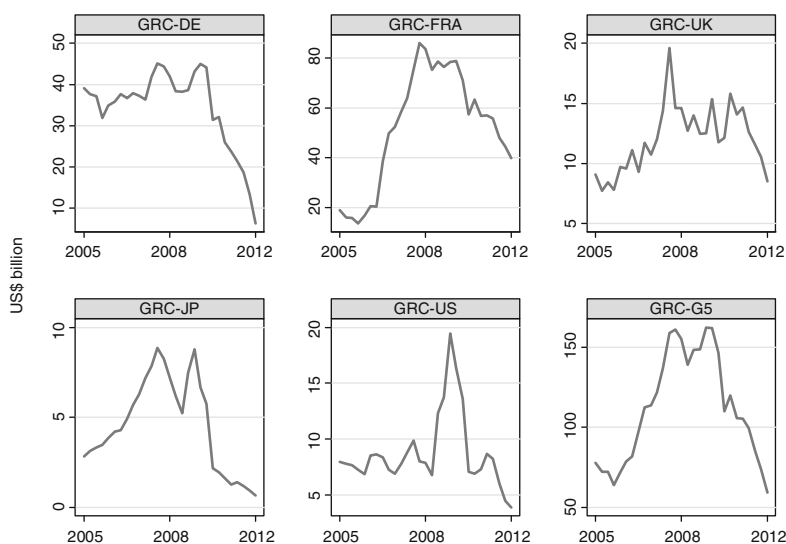


Figure 7.2 G5 bank exposure to Greece, 2005–2012

Source: The Bank for International Settlements (2012).

for support came just days after members of the euro area agreed that IMF engagement was appropriate. Soon after, an IMF team was dispatched to Athens to begin discussions over a multi-year program of financial support. It was agreed that the program would be financed jointly by the IMF and the European Union. While programs with supplementary financing are a common feature of IMF lending, the European Union's level of engagement with Greece's bailout was unprecedented.

In order to understand the role of the IMF's large shareholders in negotiations, it is essential also to consider the EU's response to the crisis. This is because Germany and the European Union took the lead in the negotiations. The other members of the G5 deferred to Germany and the EU, fearing that the crisis could spread to them.

But why did the European Union agree to IMF involvement? First, IMF involvement reduced substantially the amount of euro area financial support. Second, the EU's political and economic institutions were not designed to respond to such a severe financial crisis. The IMF's track record of crisis management made it the best institution to design, monitor, and enforce Greece's program of financial support, making it a more credible program in the eyes of international financial markets. Earlier proposals to establish a European Monetary Fund were shot down

as Germany insisted on IMF involvement as a condition of the bailout. Third, the large European shareholders have an exceptional level of access and ability to influence the IMF's decision-making process. As I have argued in previous chapters, it would be very difficult for the IMF to act contrary to the interests of its large European shareholders. Furthermore, the involvement of the IMF in Greece may have provided the EU with a convenient scapegoat.

Although the EU is not directly represented at the IMF, the substantial number of European executive directors gives the EU a strong voice at the Executive Board. European coordination in economic policy is highly institutionalized. Eurozone finance ministers meet informally to coordinate in the Euro Group before meeting in the Economic and Financial Affairs Council (ECOFIN).<sup>6</sup> European representatives to the IMF are often instructed to support policy agreed in ECOFIN. Furthermore, an informal committee of the IMF's EU representatives (EURIMF) meets at least once a week, in advance of IMF Executive Board meetings (Wouters and Kerckhoven 2012: 225).

While ECOFIN set the initial terms of Greece's bailout, the EC focused on implementing, monitoring, and administering the EU's response to the crisis. The EC established a "Task Force for Greece," to help reform public administration and support the EU/IMF adjustment program. The Task Force is based in Brussels with a support team in Athens. It reports directly to the European Commissioner for Economic and Monetary Affairs, Olli Rehn.

The ECB's role as the lender of last resort was essential in containing the crisis. If Greece refused to enter the EU/IMF program, the ECB could have threatened to withdraw funding from the Greek banking system, leaving the government little choice but to accept the terms of the program. The ECB was entitled to do this anyway under its risk control framework, which set out the list of eligible collateral that was required in return for ECB funding. The ECB changed the collateral rule in March 2010 to make allowances for Greece's low credit rating, which was eventually downgraded to "junk" status.

Europe's political leaders recognized that Greece's crisis was part of a larger European sovereign debt crisis. To contain the crisis, they moved to establish new institutional mechanisms. The European Financial Stability Fund (EFSF) – a special purpose vehicle with a lending capacity of €440 billion – was agreed in May 2010. The EFSF was a temporary solution to convince markets that funding would be available in the short to medium term in the event of any further financial crises. The European Stability Mechanism – an IO with a maximum lending



capacity of €500 billion – was established in September 2012 as a more permanent solution. These mechanisms rival the IMF in lending capacity and can be deployed more easily than Greece's individual loan facility agreement.

Greece's SBA set out an overly-ambitious adjustment program that had no chance of placing the economy on a sustainable debt path. Even if the terms of the program were implemented fully, Greece would emerge in 2014 with public debt at 153 as a percentage of GDP (Alogoskoufis 2012: 36–37). As a consequence, many commentators criticized the IMF and the EU for failing to set out a more credible program. For example, Nouriel Roubini argued that Greece was effectively insolvent and that the orderly restructuring of Greece's public debt should not be delayed (Roubini 2010). Despite these criticisms, many of the key figures in the negotiations emphasized that debt restructuring was off the table. German Finance Minister, Wolfgang Schäuble, argued that it would weaken market confidence (Davis 2010b). The IMF's Deputy Managing Director, John Lipsky, argued that a Greek default "would be a recipe for significant disorder" (Davis 2010a). The IMF's mission chief, Poul Thomsen, said that during the negotiations it was never on the table (Forelle *et al.* 2010).

One argument is that the architects of Greece's program were attempting to "buy time" to contain the immediate threat to the Euro currency from a possible Greek exit. Another is that Germany and France were protecting their own banking systems – which would have suffered from a Greek exit or default. As a consequence, if the IMF were to have demanded debt restructuring for Greece, it is highly likely that Eurozone finance ministers would have excluded it from participating in the bailout.

### **Security, bureaucracy, and domestic politics**

As a member of NATO and host of a US military base, Greece is strategically important. The protracted conflict in Cyprus has the potential to spark a direct confrontation between Greece and Turkey. Because of the conflict's potential to undermine peace and security in Europe, the EU has taken a leading role in efforts to resolve the conflict (Agnantopoulos *et al.* 2012). Reflecting the importance of security issues, Greece maintains a high level of military spending for a European democracy. Between 2005 and 2011, there was \$5.3 billion in major arms trade between Greece and the G5 economies. Germany was the largest supplier, transferring over \$2 billion during this time including hundreds of tanks, submarines, and surface-to-air missile systems. The United States was the second largest supplier, transferring \$1.45 billion, followed

closely by France at \$1 billion.<sup>7</sup> On the balance of evidence, however, the threat to the economic and financial interests of the G5 outweighed their immediate concerns about conflict and stability in the region.

Although Greek domestic politics is unlikely to have had an impact on IMF lending, domestic politics in the shareholders may have led to significant delays in the negotiations. According to Featherstone (2011: 201), German Chancellor Angela Merkel faced a difficult election in North-Rhine Westphalia on May 9, 2010, possibly encouraging her to delay any bailout. In the end, Chancellor Merkel faced down strong domestic opposition to Greece's bailout, allowing the establishment of the EFSF.

## **Ireland**

When Greece secured financial support in 2010, the focus of international markets and the IMF turned immediately to Ireland, which was engulfed in the worst financial crisis it had experienced since the foundation of the state. In September 2008, the government had taken the unorthodox step of issuing a two-year blanket guarantee of the liabilities of Irish-controlled banks. The blanket guarantee stands out as unnecessarily ambitious in scope when compared with other measures used to contain systemic financial crises.<sup>8</sup> Nevertheless, it initially had a positive effect on market behavior: deposits returned to Irish banks, sparking outrage among some officials in other governments. Despite its initial success, it soon became clear that the losses in Irish banks were much worse than anticipated and that the government could not possibly meet the terms of its own guarantee without bankrupting its own citizens. From that point forward, Ireland required external assistance if it were to avoid a messy sovereign default.

By the late summer of 2010, the government still had access to international funding but Ireland's position began to deteriorate sharply at the end of September. As the news about Ireland's banks became worse, it became clear that markets would not roll over previous loans. This was compounded by ECB council members who spooked depositors by signaling the institution's reluctance to maintain open-ended support for the Irish banking system. During September, depositors withdrew €18 billion from domestic banks and €13 billion from non-domestic banks. Overall, deposits had declined by roughly €125 billion from a peak of €600 billion in late 2008 (O'Callaghan 2011: 9). As the bank run accelerated, the ECB's commitment to support the banking system was no longer enough to contain the crisis: a program of financial support

was necessary to draw a line under the loss of confidence in the government's guarantee of the banking system's liabilities.

Although the Irish authorities' discussions with the IMF had been ongoing, the administration was reluctant to acknowledge their existence. In early October 2010, the Minister for Finance, Brian Lenihan, traveled to Washington, D.C., to meet with the IMF. This marked a crucial turning point for the Irish administration – by the end of the meeting, there was a general view that some form of external help would be required. The spread – or difference between the yield on Irish and German government bonds – had reached such high levels that by November 4, 2010, the Governor of the Central Bank, Patrick Honohan, had formed the view that Ireland had passed a critical threshold – a point of no return – and that discussions with the IMF should commence over the possibility of financial assistance. While senior officials in the Irish administration were now aware of the necessity of IMF support, this view was not necessarily shared by senior politicians. Presumably acting with the consent of the Taoiseach, the Department of Finance adopted a strategy of denial in the hope that the ECB/EC would provide a package of financial support that would allow the administration to “save face” domestically.<sup>9</sup>

The government most likely wanted a flexible line of credit rather than a traditional IMF SBA or EFF program so that it would not have to endure the humiliation of signing a formal IMF agreement and could go on to frame the promise of financial support as merely a precautionary measure. However, the ECB Governing Council and members of the Euro Group had resolved to take action regardless of the delaying tactics or preferences of the Irish administration. It is alleged that just two days before a deal was agreed, a letter was sent from the President of the ECB, Jean-Claude Trichet, to the Minister for Finance, Brian Lenihan, threatening the withdrawal of emergency liquidity assistance if Ireland did not accept a bailout (Raleigh 2012). In the end, it was the Governor of the Central Bank, Patrick Honohan, who took the unprecedented step of bypassing the government and making a public announcement on a morning radio program that financial assistance was imminent.

### **G5 exposure to Ireland**

Ireland was one of the fastest growing economies in the world from the mid-1990s to 2008. Economic growth was so impressive that Ireland became known as the “Celtic Tiger.” But low interest rates and Economic and Monetary Union (EMU) membership over-stimulated construction activity and the political system failed to prevent the growth of a massive property bubble. Huge capital flows inflated the bubble. According

to Honohan, most of these transfers were sucked in by locally controlled banks and amounted to more than 50 per cent of GDP from 2003 to 2007 (Honohan 2009a). At the same time, many foreign-owned banks – headquartered in the United Kingdom, the United States, and Europe – commenced operations in Ireland. The collapse of Ireland's financial system had serious consequences for some of these banks. For example, the German government had to nationalize Hypo Real Estate bank. Its Irish subsidiary DePfa bank had contributed substantially to the bank's overall losses. Similarly, when the UK government was forced to recapitalize the Royal Bank of Scotland and Lloyds Banking Group, it had to provide substantial amounts to cover the losses of their Irish subsidiaries, Ulster Bank, and "Bank of Scotland (Ireland)." Figure 7.3 illustrates G5 bank exposure to Ireland from 1999 until 2012. It shows that German banks were the most exposed at nearly \$250 billion with UK banks taking second place at approximately \$225 billion in 2008. Together, G5 exposure exceeded \$600 billion in 2008, declining sharply by approximately 50 per cent by 2012.

An Irish sovereign default – a possibility because of the government's blanket guarantee – would have had potentially lethal consequences for the European banking system and the euro currency. To contain the crisis, the government was forced to agree to an €85 billion joint EU–IMF

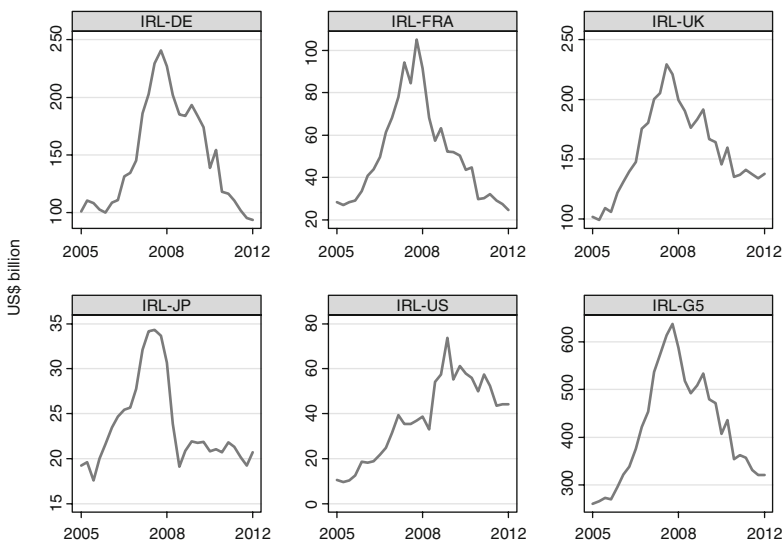


Figure 7.3 G5 bank exposure to Ireland, 2005–2012

Source: The Bank for International Settlements (2012).

program. The loan comprised €22.5 billion from the IMF. Further contributions included €12.5 billion from Ireland's National Pension Reserve Fund, €5 billion in Irish cash reserves, €22.5 billion from the European Financial Stability Mechanism (EFSM), €17.5 billion from the EFSE, and bilateral loans from the United Kingdom, Denmark, and Sweden to the sum of €5 billion.

### **The role of the G5 in negotiations**

Although Ireland's EU/IMF program is only one of hundreds of similar bailouts over the last few decades, it ranks as one of the largest in history. Collectively, the world's largest economies had no choice but to orchestrate a series of bilateral and multilateral loans. The crisis was of such magnitude that Ireland was the first item on the agenda of the G20 summit, the fifth meeting of the G20 heads of government, which took place in South Korea in mid-November 2010.<sup>10</sup> Officials from the US Treasury feared possible contagion from the crisis in Ireland and made it clear they were prepared to intervene if necessary.<sup>11</sup>

As negotiations continued over the form of financial support, a clear division emerged between the European shareholders and the IMF's staff. The Minister for Finance, Brian Lenihan, had discussed the possibility of imposing losses on the senior bondholders of Irish banks with the IMF's MD, Dominique Stauss-Kahn, and the President of the ECB, Jean-Claude Trichet. During the negotiations, the IMF mission team, led by AJ Chopra, Deputy Director of the European Department, was in agreement with the Irish authorities that some form of haircut should be imposed on the senior bondholders of Irish banks who were not covered by the extensive government guarantee. This position was shot down by the European Central Bank and the other large IMF shareholders.<sup>12</sup> They made it clear that they would not support a program unless Ireland agreed to cover the losses of all senior bondholders, even those not covered by the Irish government's guarantee. In all likelihood, the key shareholders – France and Germany – feared that a comprehensive debt restructuring deal for Irish banks would expose the weaknesses in their banks, which were highly exposed to Ireland and the rest of the European periphery. A further consequence of granting Ireland better terms would be the necessity of revisiting Greece's deal and possibly hastening negotiations with other failing economies. Furthermore, for their generosity, governments may have suffered a worse electoral backlash for being seen to use taxpayers' funds to help the European periphery.

For the most part, the main shareholders adopted a unified position during the negotiations. The ECB/EC and the French and German

governments were united in their preference that even unguaranteed senior bondholders would not have to suffer losses. While the other IMF shareholders could have blocked the deal they eventually supported the European position. At a conference call with the G7 finance ministers, the US Secretary of the Treasury, Timothy Geithner, was of the view that bank bondholders should not shoulder losses. When details of Geithner's intervention in the Irish case were leaked to the media, an unnamed senior US government official responded that: "The ECB and EC were both dead opposed and they are decisive. The US is not a decision-maker on European issues" (Brennan 2011).

With the EU authorities providing the lion's share of the bailout funds, any intervention by the US to block the deal could have seriously disrupted international relations among the world's major economic powers. It would have implied that the United States was attempting to become a decision-maker on European issues. Moreover, it would probably have yielded little as the EU authorities could have walked away from the negotiations and offered funding without IMF involvement. While the Irish case is a clear cut example of the IMF's staff yielding to their political masters, it is also a case where the IMF would have found it difficult to act independently without the additional financing provided by the EFSF and EFSM. At 22.5 billion euro, the IMF's portion of the bailout was already a historically large loan as a percentage of Ireland's undersized IMF quota, yet it was only a fraction of the 85 billion euro package of financial support.

### **Security, bureaucracy, and domestic politics**

The G5 had few security-related reasons for providing Ireland with better terms. A possible exception to this argument is the United Kingdom which is perhaps why it was the only dissenting voice during the negotiations. According to Kelly, George Osborne, the Chancellor of the Exchequer, was the only one among the G5 finance ministers to speak up for Irish interests (Kelly 2011). The UK's dissension among the shareholders needs to be put into perspective however. Both states share close historical, social, and economic ties and maintain a joint interest in the stability of Northern Ireland. Both governments also have a long record of political cooperation enshrined in several international treaties. For these reasons, it should have been expected that the United Kingdom would adopt a more critical tone than other shareholders. Ultimately, however, the United Kingdom did not move to block the program until better terms could be agreed, as it had done during Iceland's financial crisis.

Arguments that focus on the importance of bureaucratic politics also lack explanatory power in the Irish case. The IMF negotiators were forced to go against good practice and agree to a program that clearly had no chance of putting Ireland on a sustainable debt path without further external support, thereby removing a central pillar of any international rescue. On the one hand, this could be taken as evidence of the failure of the IMF to live up to its reputation as a technocracy. On the other hand, it could be viewed as a necessary compromise within the given political constraints imposed on the architects of Ireland's program. There is a reasonable argument that it was the best deal on offer and the only way to "buy time" in anticipation of further European support.

Finally, arguments from the IMF literature that focus on the importance of domestic politics during negotiations are not satisfactory when applied to Ireland's bailout. There is little evidence that the G5, EU, or IMF's position in the negotiations was affected by Irish politics. Unsurprisingly, most politicians were not aware of the negotiations, which were a closely guarded secret because of their potential to disrupt financial markets. But in the Irish case, even senior members of government were not briefed. This led to a series of embarrassing communication blunders that were amateurish by the standards of a modern democracy as senior cabinet ministers strongly denied the existence of negotiations just days before the financial package was announced. At the same time, the Department of Finance attempted to delay the decision to accept financial support in order to negotiate better terms. Their delaying tactics were overtaken by external events at the G5 and Eurogroup level. Essentially, their miscalculation was a belief that the government could dictate the pace of negotiations because it still possessed enough cash reserves to continue for several months without external support. This view assumed that outside parties affected by the crisis would not take swift action to prevent it from spilling over into a general run on the European banking system. In the end, the Governor of the Central Bank had to force senior politicians to acknowledge the existence of negotiations by announcing the inevitability of a deal on *Raidió Teilifís Éireann* (RTE) morning radio. After the bailout negotiations were made public, Ireland's coalition government immediately began to fracture. Fianna Fáil's junior coalition partner, the Green party, indicated that it would pull out of government after the December budget in 2010 and the EU/IMF funding program had been secured.<sup>13</sup> There is little evidence that this political realignment or the remarkable general election that the bailout precipitated in 2011 had an impact on the major terms of Ireland's program, namely the pace of fiscal adjustment and the issue of debt restructuring.

## Conclusions

The IMF literature has demonstrated that the world's most powerful economies do not support unconditional bailouts and that the terms of such bailouts rarely go against their strategic and economic interests. In all of the cases examined, G5 interests had an impact during negotiations.

In Iceland's case, the depth of the losses in Iceland's main banks meant that their liabilities could not be guaranteed by the state, reducing substantially the amount of assets that could be recovered by the banks of the shareholders. Nevertheless, Iceland's bailout demonstrates that the shareholders will use their leverage at the IMF to recoup losses.

Greece received a larger IMF loan as a percentage of its quota than any other country in history. But its program lacked credibility, both domestically and internationally, because it had little chance of placing Greece on a sustainable debt path without further European support. Greece's crisis was part of a broader European sovereign debt crisis which presented a stark choice for the IMF's large shareholders. They would have to fund the largest bailout in history or allow the meltdown of the European banking system. One can only conclude that the architects of Greece's program were less concerned about the program's immediate credibility and more concerned about providing the EU with the breathing space to address the crisis.

Nevertheless, adherents of the *public choice* view of IOs would argue that as a self-interested bureaucracy the IMF holds incentives to yield to the shareholders in difficult cases like Ireland's and Greece's, even at the expense of a sustainable program. If it were to refuse to cooperate, it would risk being forced to sit on the sidelines as the EU proceeded with a unilateral bailout. In other words, if the IMF were to refuse to cooperate with its political masters, it would be relegated to the status of an international institution of little importance.

In accordance with the theoretical framework, the non-European shareholders supported an exceptional level of access to IMF resources for Greece. The threat to the European shareholders was so great that they would have financed a bilateral bailout of Greece but the enormous contribution of the IMF to the bailout suggests strong multilateral support and no distributional conflict, even though there was substantial heterogeneity in the exposure of the G5 to Greece.

In Ireland, the role of the large shareholders explains why a more comprehensive debt restructuring was not achieved during the negotiations. The IMF's staff, who shared the Irish government's preference for debt restructuring, were unable to act contrary to the interests of



Germany. In all cases, the IMF's negotiators were unable to act contrary to the interests of Germany, France, the ECB/EC, and the other large G5 shareholders. The quantitative evidence on IMF lending demonstrated that support for shareholders' interests is a common feature of other international bailouts. Responsible technocrats are ultimately subject to political constraints when negotiating under pressure. There is less convincing evidence to support some of the other arguments from the literature, namely, those that focus on the role of bureaucrats, domestic politics in the recipient, and the strategic interests of the shareholders.

The European sovereign debt crisis has provoked serious debate and disagreement among the staff of the IMF, and uncharacteristically for the IMF, this has even leaked into the public domain as one economist wrote in his resignation letter, voicing his shame at the institution's failure to address its analytical risk aversion, bilateral priority, and European bias, which had contributed to a failure to deal with the global financial crisis and the European sovereign debt crisis (Doyle 2012).

# 8

## IMF Conditionality

IMF programs are part “carrot” and part “stick.” My theory posits that the Fund’s largest shareholders have incentives to relax the punitive element of conditionality where their banks and exporters are exposed to risk and loss in developing and emerging markets. By using their influence at the IMF to relax conditionality, the Fund’s major shareholders can take the pain out of an adjustment program by reducing the number of binding conditions that a borrowing country must implement. By making it easier for a borrowing country to implement the terms of its IMF program, the G5 can maximize the amount of resources that can be diverted back to their domestic interests.

Private creditors have good reasons to fear binding conditions. Because IMF loans are disbursed in tranches, each tranche is dependent on the implementation of binding conditions. If a borrowing country fails to implement even one binding condition, it cannot continue to draw on IMF assistance. As a result, the IMF lending process is designed to reduce moral hazard and maximize the implementation of binding conditions. Creditors should want the lending process to proceed as smoothly as possible so that the borrowing country can continue to service its external debt without defaulting or entering into a debt-restructuring process. Above all, creditors will want to avoid a worst case scenario where a borrowing country fails to implement a binding condition and is forced to default on its obligations. This is a very real threat, as 85 countries on 405 occasions have entered into formal debt-restructuring processes since the 1950s.<sup>1</sup>

With so much to lose, G5 preferences should be strongly skewed toward fewer binding conditions when their domestic interests are exposed to risk and loss. Furthermore, by reducing the number of binding conditions, the G5 can allow a borrowing country more “breathing

space" to distribute the burden of fiscal adjustment according to the borrowing government's preferences, rather than to potentially stricter criteria. Private creditors, like banks and exporters, can also benefit from this outcome as it gives them more time to reduce their economic exposure to a borrowing country's economy – in other words, an easy IMF program can help "smart money" to "get out."

The G5 could furthermore favor creditors by inserting binding conditions that cater directly to their domestic interests. While this might sometimes be a viable strategy, it must rank second-best to reducing the overall number of binding conditions. This is because pro-creditor binding conditions are useful only if they are implemented by the borrowing country and implementation is tied to the overall strictness of the country's agreement with the IMF. As such, creditors are not against the insertion of favorable conditions into IMF agreements, as long as the overall severity of the agreement is reduced to ensure the payment of the IMF loan.

While I have set out a new argument on the determinants of binding conditions in IMF agreements, conditionality is a more complex instrument. In recent years, the proliferation of non-binding conditions has also received much attention; even IMF staffers have voiced their discomfort and concern at setting non-binding structural benchmarks that they feel are beyond their expertise in macroeconomics (Barnett and Finnemore 2004; IMF 2005a; Gould 2006b). What explains the non-binding aspects of IMF agreements? Does the G5 also stand to benefit from this aspect of conditionality? I argue that under certain circumstances, the IMF's most powerful shareholders have incentives to increase, rather than reduce, non-binding conditions.<sup>2</sup> First, they pose no threat to a borrowing country's IMF loan. Without any consequences for failure to comply with these conditions, creditors in the G5 are unlikely to fear their inclusion or proliferation. Rather, they present a useful opportunity to initiate economic reforms that favor interest groups in the G5, generally liberalizing trade and finance. According to Goldstein, there is anecdotal evidence of this having occurred, as structural benchmarks were added to Indonesia's and Korea's IMF programs during the Asian crisis as a result of strong pressure from the Fund's largest shareholders (Goldstein 2001: 70).

However, shareholder intervention to increase the number of non-binding conditions is more likely when economic exposure is highly concentrated among key domestic interest groups. Since IMF conditionality is often in accordance with preferences of these groups in the first place, many of them will have less incentive to lobby unless they are highly exposed. Therefore, the politics of G5 intervention in conditionality should have two purposes: the first is to minimize the risks associated

with too many binding conditions and the second is to intervene when domestic interest groups are highly exposed, by including additional pro-creditor non-binding conditions that do not threaten payment of the loan or the continuance of the program.

Recent studies on conditionality have uncovered much evidence that the shareholders matter. Dreher and Jensen (2007), for example, found that closer allies of the United States – measured by voting affinity in the United Nations – have to meet fewer conditions. Similarly, Stone (2008) found that the US intervenes strategically to reduce the scope of conditionality for favored borrowing countries. Here, the scope of conditionality is defined as the number of dimensions along which IMF programs are designed including monetary, fiscal, debt, exchange-rate, and structural reforms.<sup>3</sup>

While these authors provide significant evidence that the United States intervenes to reduce conditionality, this is a complex policy instrument that must be decomposed into its constituents. It is important to clearly differentiate among binding and non-binding conditions. For example, in countries like Ireland and Greece, where the IMF's shareholders are exposed to massive losses from a potential debt restructuring, the shareholders should prefer fewer binding conditions to reduce the risk that Ireland will exit its IMF program for failing to comply with conditionality. By contrast, the shareholders should be less inclined to support fewer conditions for countries where their exposure is minimal.

However, the existing literature on conditionality has yielded mixed results on the determinants of binding conditions. Dreher and Vaubel (2004) and Dreher and Jensen (2007) found that neither political nor economic variables explain variation in the number of binding conditions in IMF arrangements. Copelovitch (2010b) found that the level of external debt matters, but that politics doesn't influence the number of binding conditions. On the other hand, Kang (2007) argued, and presented evidence to support the claim, that the G5 relax the number of binding conditions in IMF arrangements in order to advance their interests in borrowing countries.

The chapter proceeds as follows. First, I discuss the program review process. My aim is to improve upon previous studies of conditionality, which have tended to omit program reviews and focus only on the initial conditions in IMF LOI. Next, I set out the chapter's empirical strategy by discussing the statistical models that were employed, along with model specification decisions. The discussion of the results is split into five sections, each covering a different aspect of conditionality, including binding conditions, quantitative performance criteria, structural performance criteria, non-binding conditions, and waivers.

## The scope of IMF conditionality

The IMF's staff and Executive Board conduct program reviews, at regular intervals, to track the progress of all borrowing countries' IMF arrangements.<sup>4</sup> At each review, the Board decides whether to modify, terminate, or make no change to the terms of the program. Although each review is an important stage in the conditionality process, several previous studies have examined only the conditions set down in the initial agreement with the IMF (Gould 2006b; Kang 2007; Copelovitch 2010b). This is problematic. At each stage in the conditionality review process, the IMF's Executive Board can make substantial changes, including the granting of a waiver or the termination of a program. Because conditionality varies by program review, rather than simply from year to year, it is important to organize the data in this format and not to exclude program reviews.

In the sample, the minimum number of program reviews was one, the maximum was 13, and on average countries experienced three reviews with a standard deviation of two. The trend in Figure 8.1 shows that as the number of program reviews increases, the number of conditions tends to decrease, until about the seventh program review, after which the direction of the conditionality index is difficult to predict with any confidence.

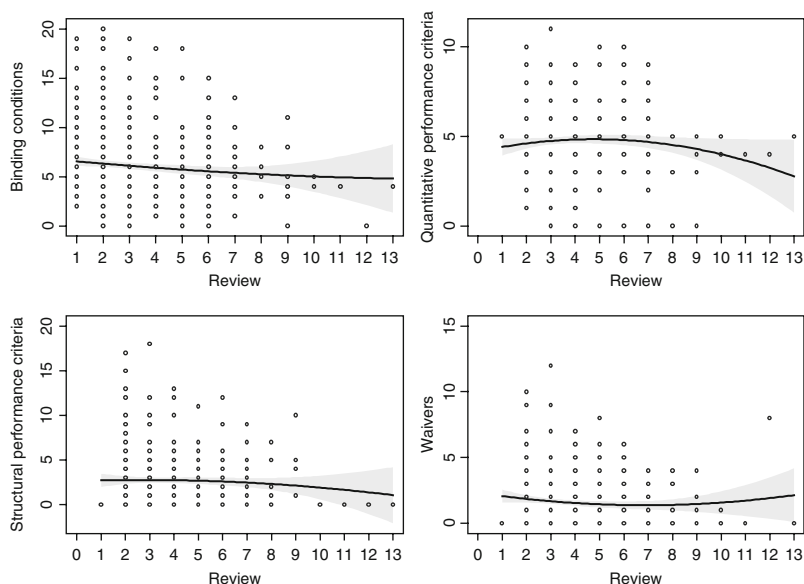


Figure 8.1 Conditionality by program review

When we disaggregate the index and look at the trend separately for quantitative performance criteria, structural performance criteria, and waivers, it appears that the IMF tends to set fewer quantitative performance criteria in the later stages of a program, although the correlation between program reviews and quantitative performance criteria is not strong. The trend for structural performance criteria and waivers is not as clear, as these categories of condition are stable only until later program reviews.

## Model specification and findings

All the dependent variables measure the number of conditions or waivers that a borrowing country received as part of its IMF agreement. As a consequence, a model designed for count outcomes is appropriate with these data, as each condition is equivalent to an event. More specifically, the Poisson regression model (PRM) is the standard model for count outcomes. One problem with this model, however, is that it is not suitable in the presence of overdispersion, where the model's variance is greater than the mean. The likelihood ratio tests to check for this problem indicated that this model is not suitable for most of the dependent variables used in this study. For cases where the PRM is not suitable, I employ negative binomial regression which addresses the issue of overdispersion by adding an additional parameter to the model in order to control for unobserved heterogeneity among observations. Furthermore, to control for potential selection bias, I have included an additional variable in all regression equations – the probability of IMF program approval. This probability was generated by the logit model in the previous empirical chapter on IMF program approval. It is not a perfect method of correcting selection bias but controls for the possibility that countries are either very likely or not very likely to enter IMF programs will receive different treatment on this basis.

The tables below present the results on five dependent variables: performance criteria (Table 8.1), quantitative performance criteria (Table 8.2), structural performance criteria (Table 8.3), non-binding conditions (Table 8.4), and waivers (Table 8.5). Six models are specified for each dependent variable. For each, the first model includes only the basic economic indicators and the G5 index of bank exposure. Model two builds on this specification by adding variables to control for financial crises, quota reviews, politicians delegating to the Fund's bureaucracy, and the amount of US military aid a borrowing country received. Model three includes five variables to control for cases where a member of the G5 had the most exposed banks during a program review. Models four,

Table 8.1 Binding conditions

Variable	(1)	(2)	(3)	(4)	(5)	(6)
G5 bank exposure	-0.09*** (0.03)	-0.09*** (0.03)	-0.08** (0.04)			
G5 trade exposure				-0.06*** (0.02)	-0.06** (0.03)	-0.05** (0.03)
Reserves	-0.02 (0.04)	-0.02 (0.06)	-0.01 (0.07)	-0.01 (0.03)	-0.02 (0.04)	-0.03 (0.04)
Current account	0.01** (0.01)	0.01 (0.01)	0.01 (0.01)	0.01*** (0.00)	0.01** (0.01)	0.01*** (0.01)
External debt	0.04 (0.10)	0.03 (0.14)	0.04 (0.11)	0.03 (0.09)	0.03 (0.09)	0.06 (0.09)
Debt service	0.02 (0.02)	0.02 (0.02)	0.02 (0.02)	0.01 (0.01)	0.01 (0.01)	0.01 (0.01)
GDP growth	0.03 (0.03)	0.03 (0.05)	0.02 (0.05)	0.02 (0.02)	0.01 (0.02)	0.00 (0.02)
GDP per capita	-0.04 (0.05)	-0.03 (0.07)	-0.05 (0.09)	-0.04 (0.04)	-0.06 (0.04)	-0.07* (0.04)
Pr (IMF Approval)	2.21 (3.03)	1.81 (5.01)	2.01 (5.45)	1.28 (1.92)	0.30 (2.46)	-0.13 (2.61)
IMF quota review		0.03 (0.06)	0.03 (0.06)		0.06 (0.04)	0.06 (0.04)
Financial crisis		-0.06 (0.12)	-0.08 (0.12)		-0.14 (0.11)	-0.14 (0.12)
US military aid		-0.00*** (0.00)	-0.00*** (0.00)		-0.00** (0.00)	-0.00*** (0.00)
IMF delegation index		0.06 (0.10)	0.06 (0.11)		0.03 (0.06)	0.03 (0.06)
Bank/trade controls			Yes			Yes
Observations	208	180	180	457	380	380
Log p.likelihood	-506	-437	-433	-1115	-925	-920
Chi2	93.9	220	294	37.7	95.7	109

Note: Negative binomial regression. Robust standard errors in parentheses.

\*\*\* $p < 0.01$ , \*\* $p < 0.05$ , \* $p < 0.1$ .

five, and six repeat these specifications but substitute all G5 bank exposure variables and control variables with G5 trade exposure.

Before reviewing the results for each one of these dependent variables, several notable trends in all of the statistical analyses are worth discussing. First, it is interesting how poorly the economic variables

Table 8.2 Quantitative performance criteria

Variable	(1)	(2)	(3)	(4)	(5)	(6)
G5 bank exposure	-0.02 (0.02)	-0.02 (0.02)	-0.02 (0.02)			
G5 trade exposure				-0.06** (0.02)	-0.05** (0.03)	-0.05* (0.03)
Reserves	-0.05 (0.04)	-0.02 (0.05)	-0.01 (0.05)	-0.00 (0.02)	0.00 (0.02)	0.00 (0.03)
Current account	0.01 (0.01)	0.00 (0.01)	-0.00 (0.01)	0.00 (0.00)	0.00 (0.00)	0.00 (0.00)
External debt	-0.01 (0.11)	-0.07 (0.11)	-0.04 (0.10)	-0.01 (0.09)	-0.04 (0.09)	-0.02 (0.09)
Debt service	0.02 (0.02)	0.01 (0.02)	0.02 (0.02)	0.01 (0.01)	0.01 (0.01)	0.01 (0.01)
GDP growth	-0.00 (0.02)	0.00 (0.03)	0.00 (0.03)	0.01 (0.01)	0.01 (0.01)	0.01 (0.01)
GDP per capita	-0.09** (0.05)	-0.09 (0.06)	-0.11* (0.06)	-0.05 (0.04)	-0.08** (0.04)	-0.09** (0.04)
Pr(IMF Approval)	-1.23 (2.32)	0.17 (3.21)	-0.17 (3.21)	0.52 (1.39)	0.62 (1.59)	0.47 (1.67)
IMF quota review		0.03 (0.05)	0.03 (0.05)		0.05 (0.03)	0.05 (0.03)
IMF delegation index		0.06 (0.06)	0.04 (0.06)		0.05 (0.04)	0.05 (0.04)
Financial crisis		-0.02 (0.11)	-0.02 (0.12)		0.05 (0.08)	0.05 (0.08)
US military aid		-0.00** (0.00)	-0.00 (0.00)		-0.00** (0.00)	-0.00** (0.00)
Bank/trade controls			Yes			Yes
Observations	221	192	192	478	398	398
Log p.likelihood	-414	-360	-356	-925	-765	-763
Chi2	20.2	34.0	98.5	32.7	49.1	75.9

Note: Poisson regression. Robust standard errors in parentheses.

\*\*\* $p < 0.01$ , \*\* $p < 0.05$ , \* $p < 0.1$ .

predict variation in conditionality. International reserves, external debt, debt service, and GDP growth are not statistically significant in any of the models. Without even considering the political determinants of IMF behavior, the poor performance of the economic variables implies



Table 8.3 Structural performance criteria

Variable	(1)	(2)	(3)	(4)	(5)	(6)
G5 bank exposure	-0.25*** (0.07)	-0.27*** (0.08)	-0.27*** (0.08)			
G5 trade exposure				-0.05 (0.06)	-0.06 (0.07)	-0.06 (0.07)
Reserves	-0.04 (0.11)	-0.14 (0.19)	-0.14 (0.19)	-0.05 (0.08)	-0.12 (0.10)	-0.12 (0.10)
Current account	0.04 (0.02)	0.06 (0.04)	0.06 (0.04)	0.03** (0.01)	0.03** (0.02)	0.03** (0.02)
External debt	0.23 (0.31)	0.38 (0.41)	0.38 (0.41)	0.08 (0.21)	0.14 (0.24)	0.14 (0.24)
Debt service	0.04 (0.04)	0.05 (0.06)	0.05 (0.06)	0.01 (0.03)	0.03 (0.03)	0.03 (0.03)
GDP growth	0.08 (0.07)	0.03 (0.11)	0.03 (0.11)	0.02 (0.04)	-0.02 (0.05)	-0.02 (0.05)
GDP per capita	-0.01 (0.13)	-0.04 (0.18)	-0.04 (0.18)	-0.10 (0.11)	-0.12 (0.12)	-0.12 (0.12)
Pr(IMF Approval)	5.41 (6.92)	-1.67 (11.52)	-1.67 (11.52)	1.65 (4.81)	-2.99 (6.16)	-2.99 (6.16)
IMF quota review		0.07 (0.14)	0.07 (0.14)		0.12 (0.09)	0.12 (0.09)
IMF delegation index		0.06 (0.22)	0.06 (0.22)		0.00 (0.15)	0.00 (0.15)
Financial crisis		-0.02 (0.29)	-0.02 (0.29)		-0.56** (0.25)	-0.56** (0.25)
US military aid		-0.00 (0.00)	-0.00 (0.00)		-0.00 (0.00)	-0.00 (0.00)
Bank/trade controls			Yes			Yes
Observations	215	186	186	466	388	388
Log p.likelihood	-420	-354	-354	-949	-784	-784
Chi2	36.9	63.6	63.6	13.9	34.1	34.1

Note: Negative binomial regression. Robust standard errors in parentheses.

\*\*\* $p < 0.01$ , \*\* $p < 0.05$ .

that IMF financial programming tends to be an *ad hoc* process. Second, the variable that controls for selection bias in all of the models – the likelihood of program approval – is not statistically significant. Another notable trend in the models was that the IMF quota reviews in 1998 and 2002 appear to have had little impact on conditionality (although the

Table 8.4 Non-binding conditions

Variable	(1)	(2)	(3)	(4)	(5)	(6)
G5 bank exposure	0.15*** (0.06)	0.04 (0.04)	0.02 (0.04)			
G5 trade exposure				0.19*** (0.05)	0.13*** (0.04)	0.11*** (0.03)
Reserves	-0.18* (0.10)	-0.03 (0.14)	-0.07 (0.13)	0.01 (0.07)	0.04 (0.07)	0.01 (0.07)
Current account	-0.01 (0.01)	0.01 (0.02)	0.01 (0.01)	-0.02* (0.01)	-0.01 (0.01)	-0.00 (0.01)
External debt	-0.18 (0.29)	0.06 (0.23)	0.02 (0.21)	-0.23 (0.16)	-0.18 (0.15)	0.00 (0.15)
Debt service	0.09*** (0.03)	0.02 (0.04)	0.02 (0.04)	0.03 (0.03)	0.00 (0.03)	-0.01 (0.03)
GDP growth	-0.03 (0.05)	0.06 (0.08)	0.01 (0.08)	0.02 (0.04)	0.03 (0.04)	0.01 (0.03)
GDP per capita	-0.23** (0.11)	-0.07 (0.11)	-0.15 (0.11)	-0.08 (0.10)	0.01 (0.08)	0.04 (0.07)
IMF quota review		-0.12 (0.11)	-0.15 (0.11)		-0.05 (0.09)	-0.03 (0.08)
IMF delegation index		-0.42*** (0.11)	-0.37*** (0.12)		-0.27*** (0.08)	-0.25*** (0.08)
Financial crisis		0.45* (0.24)	0.26 (0.29)		0.41 (0.30)	0.29 (0.31)
US military aid		-0.00** (0.00)	-0.00 (0.00)		-0.00 (0.00)	-0.00*** (0.00)
Pr(IMF approval)	-3.76 (7.04)	3.18 (9.30)	-0.56 (8.30)	3.14 (4.25)	3.28 (4.33)	1.76 (3.80)
Bank/trade controls			Yes			Yes
Observations	218	178	178	469	380	380
Log p.likelihood	-778	-624	-620	-1575	-1267	-1255
Chi2	70.1	174	376	46.8	101	147

Notes: Negative binomial regression. Robust standard errors in parentheses.

\*\*\* $p < 0.01$ , \*\* $p < 0.05$ , \* $p < 0.1$ .

quota review variable is statistically significant in the models where the number of waivers received by a borrowing country is the dependent variable). Similarly, the presence of a financial crisis is a significant predictor of structural performance criteria only in models five and six. While a crisis had a prominent effect on program approval and lending it

Table 8.5 Waivers

Variable	(1)	(2)	(3)	(4)	(5)	(6)
G5 bank exposure	-0.01 (0.07)	0.09 (0.08)	0.08 (0.07)			
G5 trade exposure				-0.00 (0.05)	0.02 (0.05)	0.02 (0.05)
Reserves	-0.19 (0.13)	-0.19 (0.12)	-0.14 (0.13)	-0.13* (0.07)	-0.16** (0.08)	-0.14* (0.08)
Current account	0.01 (0.02)	-0.05* (0.03)	-0.04 (0.03)	0.00 (0.01)	-0.01 (0.02)	-0.02 (0.02)
External debt	-0.23 (0.30)	-0.98** (0.41)	-0.91** (0.42)	-0.04 (0.21)	-0.33 (0.24)	-0.50* (0.26)
Debt service	0.07 (0.06)	0.14*** (0.05)	0.14*** (0.05)	0.03 (0.03)	0.05 (0.03)	0.06** (0.03)
GDP growth	-0.02 (0.10)	-0.03 (0.08)	0.02 (0.10)	-0.05 (0.04)	-0.06 (0.04)	-0.04 (0.04)
GDP per capita	-0.16 (0.18)	-0.31 (0.19)	-0.35 (0.24)	-0.05 (0.11)	-0.19 (0.12)	-0.21 (0.14)
IMF quota review		0.52** (0.22)	0.45** (0.20)		0.37** (0.14)	0.36** (0.14)
Financial crisis		-0.58 (0.52)	-0.37 (0.55)		0.11 (0.32)	0.13 (0.31)
US military aid		0.00 (0.00)	0.00 (0.00)		0.00 (0.00)	0.00 (0.00)
IMF delegation index		0.66*** (0.19)	0.52*** (0.20)		0.51*** (0.15)	0.50*** (0.15)
Performance criteria t-1	0.05*** (0.02)	0.03 (0.03)	0.03 (0.03)	0.08*** (0.02)	0.07*** (0.02)	0.07*** (0.02)
Pr(IMF Approval)	-9.30 (10.15)	-6.96 (9.14)	-3.37 (10.67)	-6.73 (4.90)	-6.56 (5.35)	-5.01 (5.76)
Bank/trade controls			Yes			Yes
Observations	174	140	140	364	295	295
Log p.likelihood	-298	-223	-222	-635	-504	-502
Chi2	21.2	56.1	166	19.6	43.1	65.2

Note: Negative binomial regression. Robust standard errors in parentheses.

\*\*\* $p < 0.01$ , \*\* $p < 0.05$ , \* $p < 0.1$ .

appears not to matter when it comes to conditionality, even though 136 out of 641 program reviews in this sample took place during a financial crisis. Finally, the bank and trade controls were not significant and were subsequently dropped from the tables in order to improve presentation.

### Binding conditionality

The economic exposure of the G5 is a significant predictor of variation in the number of binding conditions in all models, regardless of whether it is measured as the exposure of banks or exporters. Accordingly, an increase in the economic exposure of the G5 leads us to observe and predict fewer binding performance criteria, all else being equal. We can also draw the same conclusion regarding US military aid: as this variable increases, we observe and predict fewer binding conditions. The results also support the notion that the current account as a percentage of GDP matters, as it is positively signed and statistically significant in models four, five, and six. This result is surprising, however, as it indicates that improved economic conditions in borrowing countries lead to stricter conditionality.

While we can reach the general conclusion that performance criteria are responsive to the interests of the IMF's major shareholders, interpreting the value of the coefficients of event count models like the one presented here is not a straightforward exercise. In these models, coefficients represent the expected change in the number of performance criteria, based on a one unit change in the independent variable. Change is defined as the difference in the log of the expected count, holding all independent variables constant.

Rather than interpreting the values of the coefficients in this way, I proceed with an interpretation of the effect of the explanatory variables using a more intuitive approach: predicted probabilities in terms of percentage change. Table 8.6 shows some variables that are statistically significant predictors of variation in the number of binding conditions. The results from model one suggest that where we observe a unit increase in the current account to GDP ratio, conditionality is predicted to increase by 2.5 per cent, holding other variables constant. A standard deviation increase, on the other hand, leads to the prediction that conditionality increases by 18.8 per cent, holding other variables constant. Similarly, in model five, a unit increase in the current account as a ratio of GDP predicts an increase of 1.6 per cent, and a standard deviation predicts an increase of 11.6 per cent. Model one, turning to the effect of the key political variables, shows that a unit increase in G5 bank exposure leads to a 5.9 per cent reduction in conditionality, and a standard deviation increase in bank exposure reduces conditionality by 12.4 per cent. Model five, which substitutes G5 bank with trade exposure, predicts a 4.2 per cent reduction in conditionality from a one unit change and a 7.8 per cent reduction from a one standard deviation increase in trade exposure.

I have included a number of figures below to illustrate the trends in some of the key variables when all other variables are held at their mean

Table 8.6 Substantive effects

<b>Binding Conditions (model 1)</b>						
	<i>b</i>	<i>z</i>	<i>P&gt;z</i>	Per cent	%StdX	SDofX
Current account/GDP	0.02	3.5	0.000	2.5	18.8	6.84
G5 bank exposure	-0.06	-2.6	0.008	-5.9	-12.4	2.16
<b>Binding conditions (model 5)</b>						
	<i>b</i>	<i>z</i>	<i>P&gt;z</i>	Per cent	%StdX	SDofX
Current account/GDP	0.015	3.60	0.000	1.6	11.6	7.06
GDP per capita	0.026	2.08	0.038	2.7	13.8	4.79
G5 trade exposure	-0.042	-2.56	0.010	-4.2	-7.8	1.88
<b>Quantitative performance criteria (model 6)</b>						
	<i>b</i>	<i>z</i>	<i>P&gt;z</i>	Per cent	%StdX	SDofX
GDP per capita	-0.062	-2.15	0.031	-6.0	-6.8	1.12
GDP growth	0.015	1.38	0.168	1.6	8.0	4.79
G5 trade exposure	-0.045	-2.99	0.003	-4.4	-8.2	1.88
<b>Structural performance criteria (model 2)</b>						
	<i>b</i>	<i>z</i>	<i>P&gt;z</i>	Per cent	%StdX	SDofX
Current account/GDP	0.060	3.55	0.000	6.2	47.7	6.49
G5 bank exposure	-0.214	-4.25	0.000	-19.3	-37.0	2.15

Note: *b* is the raw coefficient.

*z* is the *z*-score for the test of *b*=0.

*P > z* is the *p*-value.

"Per cent" is a change in the expect count for a unit increase in the independent variable.

"%StdX" gives the expected count for a standard deviation increase in the independent variable.

"SDofX" gives the standard deviation of the independent variable.

(Figures 8.2 and 8.3). The Y-axis on these plots represents the predicted rate of change in the dependent variable (in this case the number of performance criteria). The plots on bank and trade exposure indicate that the models predict fewer performance criteria at higher levels of bank and trade exposure, but with less confidence at very low levels of trade and bank exposure. The plots illustrating the relationship between the current account and performance criteria show that countries with strong current account deficits tend to have more performance criteria in their agreements with the IMF, but there exists a lot less confidence in this prediction for countries with large current account deficits. Finally, Figure 8.4

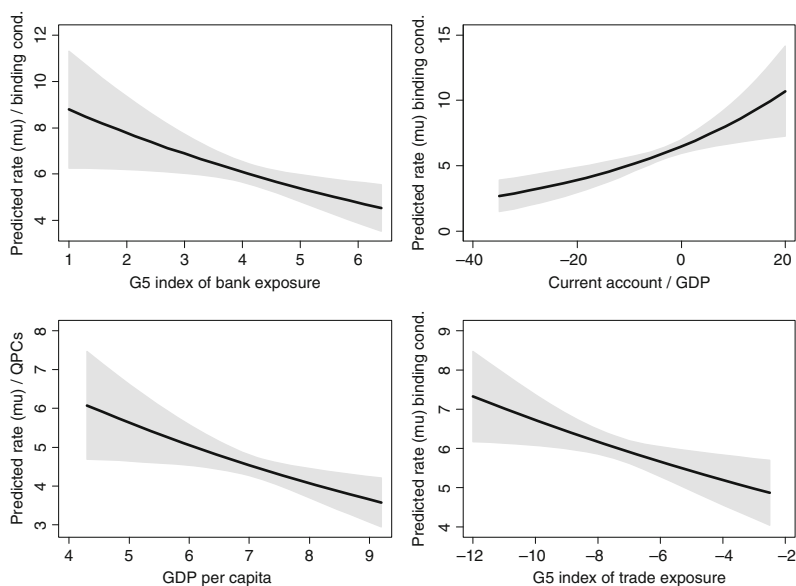


Figure 8.2 Predicted rate of binding conditions

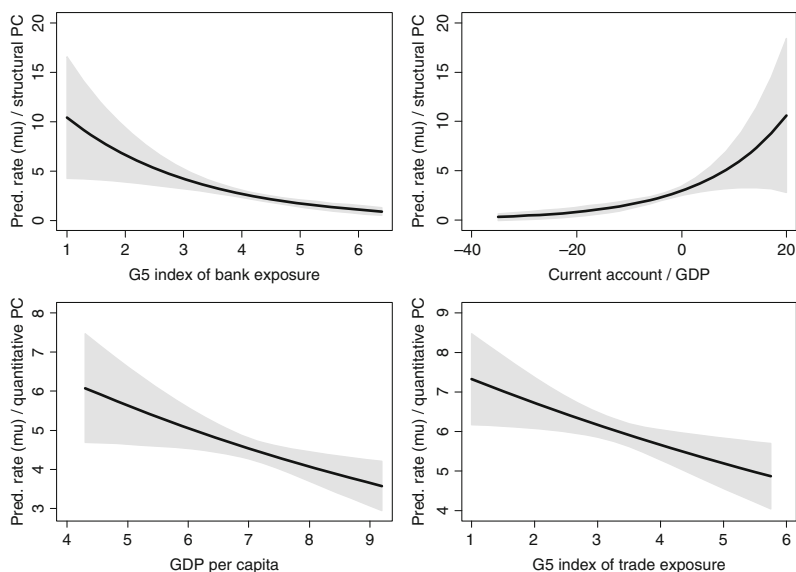


Figure 8.3 Predicted rate of performance criteria

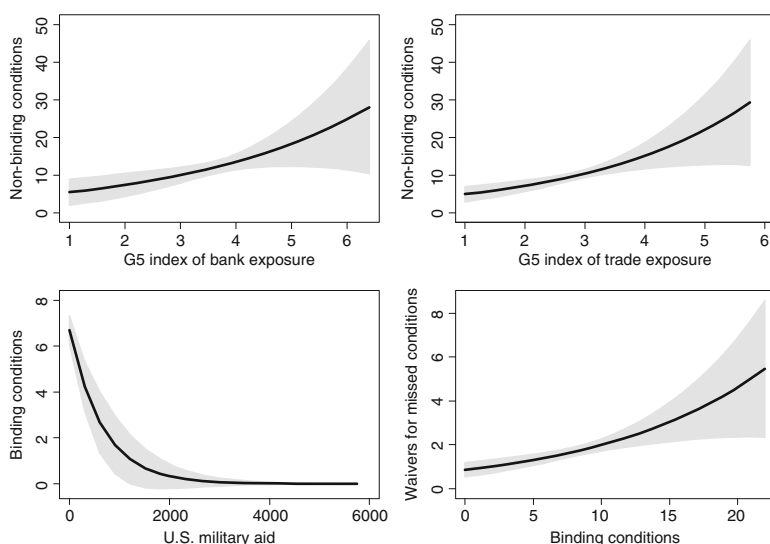


Figure 8.4 Predicted rate of non-binding conditions and waivers

includes a panel showing the relationship between US military spending and binding conditions. It shows a strong negative relationship where an increase in military aid leads to a reduction in binding conditions.

### Quantitative performance criteria

QPC are the only type of condition that must be part of every IMF agreement. My objective in replicating the statistical analysis with disaggregated measures of binding conditions is both to add depth and to serve as a robustness check. The table below presents the results for the models that include the number of QPCs as the dependent variable. The results on the determinants of QPCs are patchy. First of all, G5 trade exposure is statistically significant in models four and five. Second, GDP per capita is significant in models one, five, and six. Finally, US military aid is a significant predictor of the number of QPCs in models three and five. Otherwise, no variable consistently predicts variation in the number of QPCs across the various specifications. On the balance of evidence, it appears that political variables more consistently predict the number of QPCs than do economic variables.

Table 8.6 interprets the results from selected variables across the models in terms of per cent change. It shows that a one unit increase in the G5 index of trade exposure predicts a 4.4 per cent decrease in quantitative

performance criteria, holding other variables constant. Likewise, a standard deviation increase in trade exposure predicts an 8.2 per cent reduction in quantitative performance criteria. Table 8.6 also shows that as an economy's GDP grows by an additional per cent, model six predicts that we should observe a 1.6 per cent increase in QPC, holding other variables constant. This result is in line with the impact of the current account on the number of PCs, suggesting that we are more likely to observe restrictive conditionality for better performing economies.

### Structural performance criteria

Turning now to the factors that influence structural performance criteria, we see that the current account as a percentage of GDP is correlated with more structural conditions in models four, five, and six. Again this is roughly in line with the findings from the other models where countries with better current account positions are penalized for this with more binding conditions. Besides the current account, there is no evidence that any of the other macroeconomic variables have an impact on the number of structural conditions included in an IMF agreement.

Evidence on the impact of political variables is also patchy here. On the one hand, G5 bank exposure is negatively signed and statistically significant at the " $p < 0.01$ " level. In the models where G5 bank exposure is included, it is the only statistically significant variable. This result stands in sharp contrast to the results on quantitative performance criteria where only G5 trade exposure is statistically significant.

The predicted probabilities for structural performance criteria illustrate some important trends. First, the impact of the current account is much greater in these models. A unit increase in the current account to GDP ratio predicts much higher conditionality – at 6.2 per cent higher. A standard deviation increase predicts a 47.7 per cent increase in SPCs, holding other variables constant. Second, the predicted probabilities for model two show that a one unit increase in bank exposure predicts a large 19.3 per cent reduction in SPCs, holding other variables constant. A standard deviation increase in exposure, on the other hand, predicts a 37 per cent reduction in structural conditionality.

The plots (Figure 8.2, Figure 8.3, and Figure 8.4) illustrate these relationships: notably, the confidence intervals are much wider at lower levels of G5 bank exposure, with better predictions at high levels of bank exposure. The opposite relationship exists for the current account to GDP ratio: for this indicator, the plot shows that the model has little success in predicting structural performance criteria for countries whose current account balance is much larger as a portion of their GDP.



### **Non-binding conditionality**

The non-binding conditions that form part of the IMF's policy toolkit have proliferated in recent years. These conditions present a challenge because at first glance there are few consequences if a borrowing country fails to implement one of them. Nevertheless, when one looks at a series of conditionality documents, it is clear that these conditions are often implemented anyway. With little in the way of material consequences for failing to implement these conditions, actors will have different preferences over their inclusion (or not). First, G5 governments should favor more of these conditions if they generally open up and liberalize the host economy. These conditions are a potential channel through which liberal economic ideas are diffused through the international economy. A significant body of literature exists on how the Fund has used its programs in developing countries to coerce and persuade countries to adopt liberalizing measures (Simmons and Elkins 2004; Mukherjee and Singer 2010). While the G5 should generally favor non-binding structural conditions, they should also prefer specific conditions that favor their domestic interests in trade and banking.

As my theory predicts, with so few material consequences associated with the failure to implement non-binding conditions, the G5 will tend on average to favor their inclusion. While this is not conclusive evidence that the G5 actually inserts extra conditions into IMF agreements, it goes some of the way toward showing that creditors and their governments can have multiple preferences when it comes to conditionality agreements. First, they should want to minimize their losses and reduce the risk that a borrowing country will fail to meet the IMF's demands. And second, when this much is achieved, governments should tend to favor conditionality that opens markets and protects the existing market share of their domestic interests.

By contrast, none of the economic variables are statistically significant, with the exception of debt service in model one. The models also show some clear trends on the political variables: a change in the IMF's delegation index is associated with fewer non-binding conditions, and US military aid is associated with fewer non-binding conditions – models two and six.

### **Waivers**

The final IMF policy I examined is the number of waivers granted for missed conditions. At every program review, the Executive Board must approve a waiver if a borrowing country fails to meet a binding condition. The models are specified in the same manner as the other conditionality

models in this chapter, with one exception: I have included a variable measuring the number of performance criteria that a borrowing country received at its last program review to control for the stringency of conditionality. According to my argument, countries with more conditions should find it more difficult to implement them and are thus more likely to request a waiver for a missed condition. Indeed, the results bear this out as the number of performance criteria borrowing countries received at their last program review turns out to be a statistically significant predictor of the number of waivers (in models one, four, five, and six). This finding also supports my earlier claim that the number of performance criteria is a reliable measure of the stringency of conditionality.

While the other findings from the models do not support my explanation of IMF behavior, neither do they cast serious doubt on my argument. First, due to data limitations, it was not possible to determine which country was denied a waiver, so the results illustrate only the determinants of an increase in waivers for countries that already receive them. As a result, it is difficult to say whether G5 governments have already reduced the number of binding conditions for some countries, implying that they require fewer waivers to start with.

Nonetheless, the results show that waivers are politically driven to some extent and do not respond to domestic economic conditions in the borrowing countries. In particular, a change in the IMF's delegation index is a strong predictor of an increase in the number of waivers. As the Fund is given more autonomy from its political masters, the model predicts more waivers for missed conditions. All else being equal, the IMF's bureaucracy also grants more waivers in the year of a quota review. Taken together, this suggests that the Fund's bureaucracy has more autonomy and control over this aspect of conditionality and that it uses its influence to be generous rather than strict.

## **Conclusions**

This chapter tested the argument that the G5 intervenes in the IMF's policy-making process to reduce the number of binding conditions where their domestic banks and exporters are exposed. The evidence from the statistical analysis supports this argument, showing that G5 trade and bank exposure are both correlated with a significant reduction in binding conditions. As a result, conditionality is subject to change when strong societal groups in powerful countries stand to lose from strict conditionality in developing or emerging markets. This is a new finding, as the existing literature on conditionality has found no relationship between the economic interests of powerful states and binding conditions in IMF agreements.

This chapter also put forth and tested the idea that the Fund's largest shareholders have multiple objectives when it comes to the composition of conditionality agreements. The non-binding, voluntary aspect of conditionality provides an opportunity for G5 governments to support interest-group-friendly conditions in conditionality agreements. By using conditionality to remove protective barriers in trade and finance, the G5 can use non-binding conditions to favor their domestic interests where the same interests are highly exposed, without the threat of the IMF loan being canceled for lack of compliance. The evidence from the statistical analysis supported the idea of intervention to reduce conditionality; however, the evidence on the latter point was less robust.

Although the results have established a link between the economic exposure of interest groups and the form of conditionality that borrowing countries receive, they also indicate that G5 governments might react differently to pressure from banks and exporters. The models that disaggregate binding conditionality into its components show that bank exposure drives variation in structural conditions whereas trade exposure drives variation in quantitative conditions.

The findings from this chapter also have broader implications. First, the results have implications for the literature which focuses on IOs and decision-making. One of the main arguments in this literature is that as IO policies become more complex and technical, politicians and their representatives will find it increasingly difficult to influence policy-output. The evidence presented casts some doubt on this claim; even the most technical and complex of IO policies are subject to change when states have a lot to gain or lose. When a policy decision comes with serious costs and benefits, political actors have strong incentives to overcome informational barriers and intervene to exert influence.

Finally, the results have wider implications for the debate over whether conditionality is an appropriate policy instrument and how it can be improved. Some critics argue that it should be abolished because it is unfair or inefficient. Others argue that it should be limited, with fewer structural conditions. The results presented here can serve as a baseline for this debate. Further research estimating the direct effect of conditionality in social outcomes in borrowing countries would be beneficial and should draw on some of the theoretical and methodological developments in this book. While I have not provided any evidence to show that conditionality has a negative effect on borrowing countries, the findings are generally not good news for conditionality, as G5 intervention to reduce the severity of conditionality defeats the very purpose for which it was designed – to reduce moral hazard.

# 9

## IMF Conditionality and the Asian Crisis

Although it has become eclipsed by the global financial crisis, the Asian financial crisis is considered one of the most dramatic episodes in recent economic history. It should come as no surprise that the IMF's role has been analyzed extensively in the years since the crisis.<sup>1</sup> The previous chapter has important lessons for those interested in understanding conditionality during the Asian crisis. It found a statistically significant relationship between G5 economic interests and the number of binding conditions, across hundreds of IMF agreements from 1997 to 2006. One would therefore expect there to be fewer binding conditions during the Asian crisis, given the exceptionally high exposure of the G5. However, despite the shareholders' exposure to the crisis, the affected countries received many binding conditions and in some cases hundreds of non-binding conditions. This chapter investigates this statistical abnormality by analyzing the issue of conditionality in Thailand, Indonesia, and Korea. It also asks a number of important questions. Why did conditionality deviate so much during the crisis? Which processes identified in the theoretical framework unfolded during the crisis? Which processes did not? Should the book's theoretical framework be modified in light of the Asian crisis or was conditionality in that period and that particular context unique?

To answer these questions, I begin with a description of G5 economic exposure and conditionality during the crisis. This basic overview establishes that conditionality was severe even though the shareholders were highly exposed. Following this, I analyze the response of domestic interests amongst the shareholders to the emerging crisis, finding that their reaction was broadly in accordance with the theory set out in this book. I then continue with an analysis of the impact of the G5 shareholders on negotiations over conditionality. Here the findings demonstrate why

conditionality during the Asian crisis deviated so strongly from the norm. In Indonesia, a group of reform-minded technocrats lobbied successfully for more conditions, and in Korea, pressure from US domestic interests led to the inclusion of additional structural benchmarks. The chapter ends with a discussion of the implications of the crisis for the IMF's practice of conditionality, finding that the crisis triggered a series of ambitious reforms that led to the end of binding structural conditions. Today, no structural condition is so important that the IMF is willing to "walk away" from one of its own programs if its borrower refuses to comply.

## Shareholder exposure

Many of the economies and societies of East Asia industrialized rapidly from the 1960s to the 1990s. The economic development of Hong Kong, Singapore, South Korea, and Taiwan was so impressive that they came to be known as the "Four Asian Tigers." Indonesia, Malaysia, and Thailand were known as the "newly industrializing economies," reflecting their improving reputations. During these decades of rapid growth, East Asia established and consolidated strong economic linkages with the G5 shareholders. Beginning in the late 1980s, there was also a resurgence of capital flows to Asia.<sup>2</sup> By the mid-1990s, G5 banks and exporters were highly exposed to Korea, Indonesia, and Thailand. Of these, Japanese banks were the most exposed; at the peak of their exposure, they reported \$39.4 billion in outstanding claims on Thailand, \$25.7 billion on Korea, and \$23.4 million on Indonesia.<sup>3</sup>

In Chapter 5 ("Testing the Argument"), I argued that it is important to consider each shareholder's exposure as a percentage of their total exposure to the world. This measurement estimates more precisely the importance of IMF funding to domestic interests. A closer consideration of this measurement during the Asian crisis shows that domestic interests in the United States, France, and Japan had similar levels of bank exposure to Korea. Figure 9.1 illustrates this finding; it shows that approximately six per cent of each shareholder's bank lending was concentrated in Korea. It also shows that Japan was the most exposed in Indonesia – at approximately five per cent – and in Thailand – at approximately ten per cent. In fact, the exposure of Japanese banks to the Asian crisis threatened the stability of its own financial system, which was already fragile in 1997. The crisis posed such a threat to global financial stability that a Washington Post Editorial said: "One possibility is a total collapse of the global financial system, spreading from South Korea to Japan and thence to the United States" (*Washington Post* 1998).

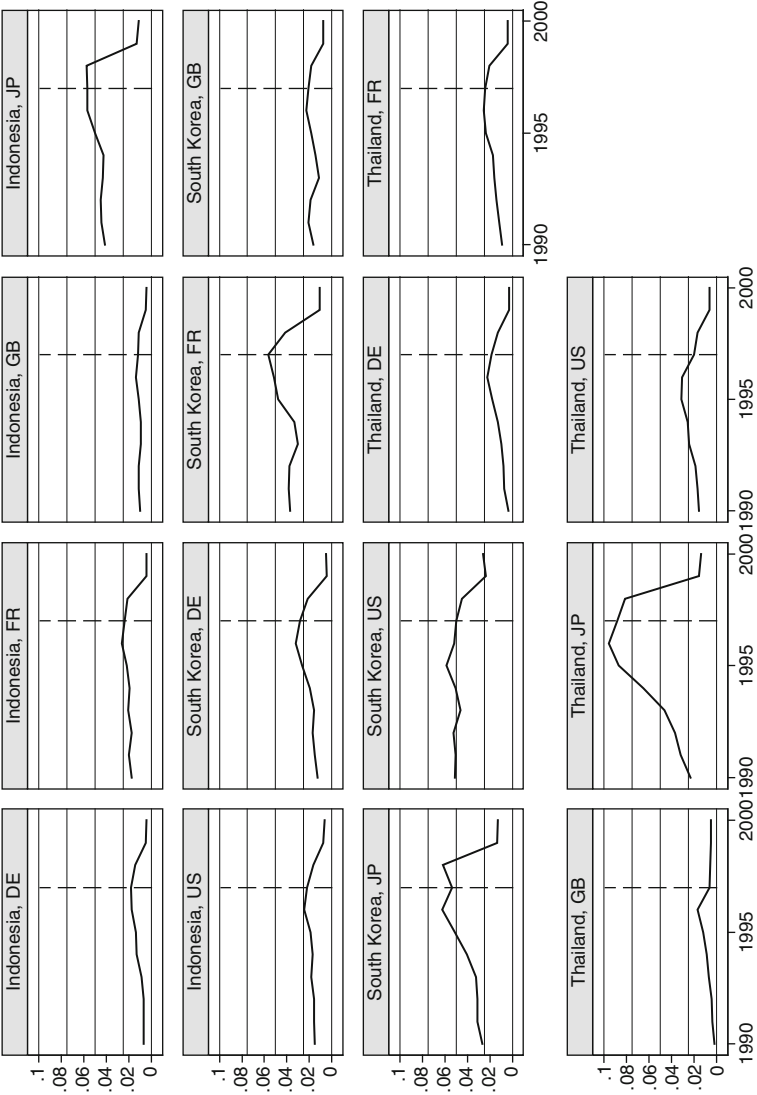


Figure 9.1 G5 bank exposure to Asian crisis economies

Source: The Bank for International Settlements (2012).

Note: The level of exposure (y axis).

One of the observable implications of this book's theory is that under such extreme circumstances, the shareholders should cooperate to support generous IMF loans with fewer binding conditions for Indonesia, Thailand, and Korea. In accordance with this view, there was a high level of cooperation among the G5 shareholders during the crisis both as a group, and among each shareholder, the IMF, and affected governments. Given the scale of financial support that was required, putting together credible IMF programs for the Asian economies was not easy – supplementary financing was necessary in order to put together loans that were large enough to restore market confidence. Thailand was the first to receive funding. The IMF's commitment of 2.9 billion SDRs was only a small portion of the final commitment of \$17 billion dollars. Indonesia's first SBA was 8.3 billion SDRs and subsequent EFF was 5.3 billion SDRs. The World Bank and Asian Development Bank offered \$8 billion, and Australia, China, Hong Kong, Japan, Malaysia, Singapore, and the United States agreed to provide a "second line of defense" in the event that these amounts proved insufficient (Boughton 2012: 525). In late 1997, a new mechanism – the IMF's Supplemental Reserve Facility (SRF) – was created to formalize the "second line of defense." It allowed the IMF to top-up its loans well above normal access limits which had been capped at three times a country's quota. Korea was the first to make use of the new SRF, gaining access to 25.4 billion SDRs.

## **Level of conditionality**

Given the exceptionally high exposure of the IMF's large shareholders to Thailand, Indonesia, and Korea during the Asian financial crisis, this book's theory would predict that each country should receive generous financing with fewer binding conditions. While the record-breaking lending packages support this argument, the high number of binding conditions does not. In this section, I examine whether conditionality was indeed too strict during the crisis by analyzing the balance between binding and non-binding conditions and the scope of conditionality across different policy areas.

The IMF's own conditionality dataset confirms that the number of binding conditions was exceptional during the crisis. Table 9.1 lists the number of conditions (by category) in Thailand, Indonesia, and Korea. It shows that Thailand, Indonesia, and Korea received at least two standard deviations more than the sample average number of binding conditions in the conditionality dataset from 1997 to 2006. The breakdown between the different types of binding conditions shows that the majority

were quantitative performance criteria. However, Table 9.1 shows that Indonesia received many binding structural conditions (SPCs) while Thailand and Korea received a modest number.

In addition to the high number of binding conditions, structural conditionality was a common feature of IMF programs during the Asian crisis. Table 9.1 lists the number of structural benchmarks. It shows that Indonesia received the lion's share of this kind of condition in its 1997 and 1998 programs. However, the modest number of structural benchmarks in the IMF's official dataset conceals the true extent of structural conditionality. The IMF used hundreds of "structural policy commitments" – for all intents and purposes structural benchmarks that do not appear in the official dataset – during the Asian crisis.<sup>4</sup> For example, a detailed list of commitments was included in Indonesia's 1998 program. The commitments covered fiscal issues, monetary and banking issues, bank restructuring, corporate debt and bankruptcy, trade, investment, deregulation, privatization, social policy, and the environment. As Indonesia's

*Table 9.1* Conditionality and the Asian crisis

<b>QPC (binding)</b>	<b>Approval date</b>	<b>Maximum</b>	<b>Minimum</b>	<b>No of reviews</b>
Thailand	August 1997	17	16	10
Indonesia	November 1997	18	13	3
Indonesia	August 1998	14	14	7
South Korea	December 1997	10	7	8
<b>SPC (binding)</b>	<b>Approval date</b>	<b>Maximum</b>	<b>Minimum</b>	<b>No of reviews</b>
Thailand	August 1997	2	1	10
Indonesia	November 1997	5	3	3
Indonesia	August 1998	8	4	7
South Korea	December 1997	3	1	8
<b>SB (non-binding)</b>	<b>Approval date</b>	<b>Maximum</b>	<b>Minimum</b>	<b>No of reviews</b>
Thailand	August 1997	1	0	10
Indonesia	November 1997	7	3	3
Indonesia	August 1998	10	5	7
South Korea	December 1997	3	3	8
<b>Global average</b>	<b>Mean</b>	<b>Minimum</b>	<b>Maximum</b>	<b>Standard deviation.</b>
Binding conditions	9.4	3	24	3.46

*Source:* Global average: conditionality dataset, 1997–2006. Country data: International Monetary Fund, Monitoring of Fund Arrangements Database (2012).



program continued, the number of commitments grew from 61 to 114. Similarly, Korea's 1997 SBA included a high number of structural policy commitments (increasing from 26 to 81 by the seventh program review) (Boughton 2012: 536).

Another important source of variation in conditionality is the extent to which conditions are distributed across policy areas. This is because critics have accused the IMF of demanding reforms that go too far beyond its expertise in finance and macroeconomics. Figure 9.2 supports this contention. While it illustrates that the most frequently applied conditions were targeted appropriately at the financial sector, it also shows that many conditions were applied in areas that were well outside of the IMF's core expertise. The third and fourth most frequently applied conditions focused on systemic and ownership reform and public enterprise reform. Sometimes systemic and ownership reform are essential to resolving a financial crisis, especially when a country's banking system has collapsed and must be restructured, but during the Asian crisis, many of these reforms went well beyond the immediate challenge of stabilizing a currency. For example, in Indonesia issues that were not relevant, such as the dismantling of the clove monopoly, aircraft program, and national car project, could have been postponed (Grenville 2004: 11).

To summarize, Korea, Thailand, and Indonesia received difficult conditions that were more ambitious in scope and more "binding" than would be considered normal under IMF programs. The addition of hundreds of "structural policy commitments" to their conditionality agreements complicates matters even further: for all intents and purposes, these commitments are structural benchmarks. As such, it is reasonable to say that the level of structural conditionality applied during the Asian crisis was exceptional. In the rest of this chapter, I seek to explain why conditionality varied so much along these different dimensions, whether the shareholders had an impact, and why the experience of these countries diverged so much from the norm.

### **Domestic interests in the shareholders respond to the crisis**

Economic and financial interests within the shareholders reacted strongly to the emerging crisis in Asia. G5 banks were involved in negotiations with each of the affected governments as well as their home governments. For example, in parallel with IMF negotiations, the Thai authorities met with Japanese banks and secured their promise to maintain credit lines (Boughton 2012: 510). During Korea's IMF rescue, the United States launched a massive and concerted effort to persuade creditor banks to

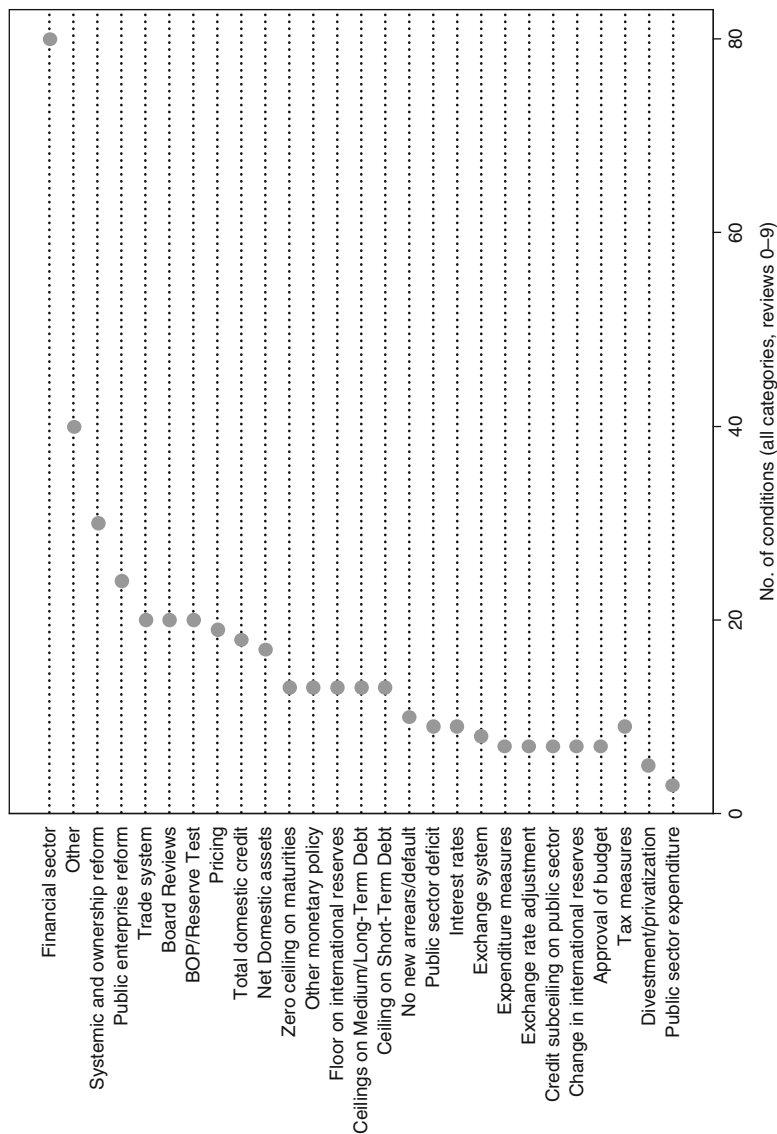


Figure 9.2 Scope of conditionality during the Asian crisis

Source: International Monetary Fund, Monitoring of Fund Arrangements Database (2012).

support Korea. Treasury officials asked commercial and investment banks to describe their exposure to Korea and then used this information to persuade banks to roll over their loans, extend due dates, and convert short-term obligations to longer-term ones (Rubin and Weisberg 2003: 237–238). According to Robert E. Rubin, US Secretary of the Treasury, this voluntary “standstill” went well beyond normal practice at the Treasury Department. More than 200 international banks were involved in the negotiations with Korea, including household names such as Bank of America, Chase Manhattan, Deutsche Bank, J.P. Morgan, Citibank, the Hong Kong Shanghai Bank, and Société Générale (Pearlstein 1998; Aggarwal 2003).

But the impact of the crisis on shareholder banks is only one part of the story. The exposure of US agriculture exporters gives another useful illustration of how political processes can unfold in response to an economic shock in another part of the world. According to the US Secretary of Agriculture, 40 per cent or \$23 billion of US agricultural exports went to Asia annually, meaning that this particular interest group was highly exposed to economic shocks in the region. As a consequence, agricultural interests lobbied government intensely to mobilize IMF support to offset their losses. The American Farm Bureau Federation (AFBF), North American Export Grain Association (NAEGA), and the National Cattlemen’s Beef Association (NCBA) testified that their members would be affected by the crisis. The NCBA said that they were highly exposed: approximately 76 per cent of all US beef exports were sold to Asian markets in 1996. They asked Congress to support IMF structural reforms to ensure greater access to Asian markets through trade liberalization. They also noted that previous crises had an impact on their members’ livelihoods: US beef exports declined by approximately 60 per cent immediately after Mexico’s financial crisis in 1994.<sup>5</sup>

In his testimony before Congress, the Secretary of Agriculture argued that without US support for IMF programs, he would be unable to issue export credits (known as GSM-102) because Asian importers would not meet the “creditworthiness criterion.”<sup>6</sup> With an inability to finance trade between the United States and parts of Asia, US agricultural exports would collapse. Subsequently several countries immediately entered IMF programs with the full backing of the United States, and the United States later issued the export credit guarantees.

Given Asia’s importance as a market for US agricultural products, it is crucial that we support the efforts of the IMF. The IMF stabilization programs and reforms are extremely important in continuing US agricultural trade with the Asian countries affected by the financial crisis.<sup>7</sup>

In his testimony before the House Banking Committee, the US Treasury Secretary, Robert E. Rubin, also agreed with this position:

As a consequence of the crisis, we've seen US exports to Asia, particularly in agriculture, drop significantly ... As this crisis so clearly demonstrates, the nations of the world are interdependent and our economic well-being is inextricably linked to the economic well-being of the rest of the world.<sup>8</sup>

The crisis also provoked a response from other US industries. For example, representatives of the steel industry testified before the House's Banking and Financial Services Committee on the Asian crisis and the role of the IMF. The United Steelworkers of America argued that better labor standards and social safety nets should be included in IMF programs.<sup>9</sup> Micron Technology, a semiconductor manufacturer, was highly critical of Korea's protection of its semiconductor manufacturers. Micron argued that Korean competitors were flooding the market with artificially low-priced products and that without strong conditionality it would be better to stop the IMF lending to Korea. On the other side of the debate, Boeing Commercial Airplane Group testified that sales to Asia and ultimately the jobs of American workers would be devastated by the crisis. It had planned to make 300 deliveries of aircraft to Asian customers between 1998 and 2000 but was expecting 60 fewer deliveries if the affected economies failed to recover. It reported that Garuda Airlines of Indonesia had already delayed the delivery of six jets and feared serious repercussions if the crisis spread to China, one of its major clients.<sup>10</sup>

Did domestic interests in Japan also lobby the government to affect IMF support? Lobbying in the Japanese political system is less visible than in the United States. Private industry and government maintain close ties through the cultural and institutionalized practice of *Amakudari*, where government officials retire to join organizations they had previously supervised. As such, the government's support for less conditionality during the Asian crisis was framed as being motivated by foreign policy concerns rather than catering to domestic interests. Nonetheless, there was much discussion in the *National Diet* on how the crisis was affecting Japanese companies that were struggling in the face of the crisis. The discussion in the House of Councilors initially focused on direct government financial support for affected companies rather than intervention with the IMF.<sup>11</sup> At a meeting of the financial committee of the House of Councilors on March 12, 1998, government committee member Haruhiko Kuroda said that the Japanese government had advised that

conditionality should be reduced for the affected economies. As the financial crisis worsened, Japanese banks reduced credit limits for the Asian economies to a much greater extent than did the US and European banks (Tokumaru 2009: 212). According to Nakamura *et al.* (2011), the crisis resulted in a number of irrecoverable loans and bankruptcies, which may have contributed to the collapsing value of the yen and Japan's own financial crisis. In 1997, the Bank of Japan was forced to inject massive liquidity into the market as major financial institutions collapsed on a regular basis in late November (Nakaso 2001: 8).

### **Impact of the shareholders on negotiations: motivations, successes, and failures**

While the lending practices of the IMF during the crisis followed closely the shareholder's economic exposure, there is less evidence that economic exposure reduced the number of binding conditions. In this section, I analyze the shareholder interventions which were motivated to change conditionality. I also assess the plausibility of some of the alternative explanations in the IMF literature, namely the role of geopolitics and the strength of the IMF's bureaucracy.

The only successful attempt to increase conditionality was the intervention of the United States to add structural benchmarks to Korea's IMF agreement. Jack Boorman, formerly a director of the IMF's Policy Development and Review Department, said that the US Congress "put over forty mandates on the US executive director in the Fund to go into all kinds of areas" (Goldstein *et al.* 2003: 453). In some instances, US domestic interests sought structural benchmarks that would limit the ability of the Korean government to bailout their competitors. For example, the President of the Interprovincial Steel and Pipe Corporation (IPSCO) said that his company had lobbied the Treasury Department so that US taxpayer dollars would not be used to subsidize competition in Korea, which was the sixth leading steel producer. His argument was that companies like Pohang Iron and Steel Company were unfairly subsidized and protected by the Korean government. He urged the US Congress to ensure that no IMF funds would be used to subsidize the Korean industry. He said he was pleased that Korea's IMF agreement included a provision that no government-subsidized support or tax privileges could be provided to bail out individual corporations.<sup>12</sup> In other instances, US domestic interests argued for a broad range of reforms to the labor market and to allow foreign companies access to Korean markets on better terms. Overall, the Asian crisis posed such a threat to some US domestic

interests that they lobbied to include more conditions. When economic exposure is highly concentrated among some groups, they can seek additional non-binding conditions to reduce their exposure.

In Indonesia, conditionality was shaped by a different set of processes. A range of credible sources have argued that the initial high level of conditionality was at the insistence of Indonesia's economic team (Blustein 2001; Rubin and Weisberg 2003: 247; Grenville 2004: 15; Boughton 2012). The team of pro-IMF reformers, known informally as the "Berkeley Mafia," had been educated at US educational institutions and held prominent positions in Indonesia's government and political system. The staff's good relationship with these reform-minded technocrats emboldened it to support their demands for a much more encompassing set of reforms than was considered normal practice for the IMF. While this may have been a "once-in-a-lifetime" opportunity to transform Indonesia's economy and society, many of the reforms challenged Indonesia's powerful elites, especially the owners of state-protected monopolies and their political allies – often members and associates of the Suharto family.<sup>13</sup> Since the demand for more conditions came from within Indonesia, the IMF's staff and shareholders did not oppose the ambitious agenda for reform. By contrast, there was a strong push from some of the G5 to go even further by insisting on structural reforms that addressed Indonesia's endemic corruption or "KKN" (the Indonesian acronym for corruption, collusion, and nepotism). According to Blustein (2001: 101), the Clinton administration was lobbied by religious and labor NGOs – both Indonesian and Western – who wanted more KKN conditionality. As a consequence, the IMF's US ED, Karin Lissakers, was particularly assertive about the need for anti-KKN conditionality. But the United States was not the only country pushing Indonesia. Many directors from the main creditor countries were also in favor of reform while at the same time skeptical of the government's ability to carry out the program (Boughton 2012: 537).

Indonesia's regime eventually reasserted control by overruling the technocrats and ignoring the bulk of the IMF's conditions. At the first program review in 1997, many performance criteria were not completed; only partially completed or delayed and numerous waivers were granted. The pattern of non-compliance continued into the second and third reviews until the IMF's staff and executive board ran out of patience, eventually abandoning Indonesia's SBA. The government was given a second chance with a new long-term adjustment program in 1998. The poor record of compliance continued under the new program, with frequent delays and numerous waivers for missed conditions. More specifically, Indonesia failed to meet a range of performance criteria related

to trade, reserve requirements, interest rates, tax measures, privatization, and domestic price measures. By contrast, Thailand and South Korea complied with the majority of the conditions. Goldstein (2001) estimated that they complied with roughly 70 per cent of the IMF's conditions while Indonesia only adhered to 20 per cent.

Indonesia's lack of compliance and the general breakdown of the relationship between its political regime, the IMF negotiators, and the G5 shareholders poisoned the atmosphere of cooperation and divided the shareholders. On the one side, the United States and European shareholders remained faithful to the pro-reform lobby and continued to demand anti-KKN conditions. On the other side, Japan and Australia pushed for less intrusive conditionality. During negotiations, the Japanese Vice-Minister for Finance, Eisuke Sakakibara, is reported to have "engaged in a two-hour heated argument with the IMF mission chief, Bijan Aghevli, at one point threatening that *If you ignore the opinion of the Japanese government to this extent, we will have to consider our options...*" (Lipscy 2010: 30). In the end, the IMF resisted Japanese pressure to reduce conditionality leaving a bitter legacy as, according to Lipscy, "many key Japanese policymakers remain sharply critical of the IMF's response to the Asian Crisis. One official described the IMF's use of conditionality in East Asia as *flagellation of dead bodies*." (Lipscy 2010: 30). Whether it was due to Japan's domestic weaknesses, or a lack of support from the other shareholders, its lack of influence at the IMF had consequences. In the short-term, the government mooted the idea of an "Asian Monetary Fund," presumably so it could exercise greater control regionally. However, the proposal was not well received by the United States and eventually shelved in favor of a new initiative to strengthen currency swap arrangements regionally (the Chang Mai Initiative). One interpretation of Japan's eventual support of the IMF is the overriding preference to preserve its influence as a member of the G5.

### **US strategic interests**

While previous high-profile IMF lending cases in Pakistan, Egypt, and Iraq have all had an important geopolitical dimension, US strategic interests did not translate into fewer conditions for Thailand, Indonesia, and South Korea. By contrast, the US supported more structural benchmarks for South Korea and Indonesia, even though it had considerable strategic links with both countries. The strongest links were with South Korea, where 37,000 US military personnel were stationed near the North Korean border (Rubin and Weisberg 2003: 248). While the Clinton administration was aware that the crisis might affect relations between

North and South Korea, it did not use it as an excuse to support less conditionality.

Indonesia was seen as a key strategic ally in South-East Asia. The US foreign policy team overseeing the bailout was afraid of the possibility of civil war if Suharto's position was undermined but the Clinton administration still adopted a hard line on conditionality (Rubin and Weisberg 2003: 248). Even in Thailand, where US strategic interests were moderate, the State Department, Defense Department, and the National Security Council wanted the US to make a greater contribution to Thailand's lending package because it had been an important military ally since the Vietnam War but were overruled by the Clinton administration. Taken together, the US had considerable strategic interests at stake in these countries yet it still backed tough conditions.

### **The IMF's bureaucracy**

The relationship between staff in the IMF and the borrowing country may explain some of the deviation in conditionality during the Asian crisis. The lack of trust and transparency in the early phases of negotiation, especially with Thailand and South Korea, may have led to more binding conditions. In the months leading up to the crisis, the Bank of Thailand had used financial trickery to disguise its dwindling supply of foreign reserves. Instead of making purchases, it increasingly made forward swaps of foreign currencies for domestic currency, so that it could continue to report a healthy stock of currency reserves. In early July 1997, under intense market pressure, the government moved to a floating exchange rate. This failed to stabilize the baht, and by mid-July, the financial markets had turned against the baht. According to Boughton (2012: 506), during this time, the Bank of Thailand was still refusing to provide comprehensive data on its foreign exchange reserves – almost two weeks after the crisis began. Both the lack of cooperation and the attempt to disguise the level of foreign reserves would have damaged trust between the IMF and the administration, leading potentially to more binding conditions, especially targeted at the operations of the Bank of Thailand.

Similar circumstances applied in South Korea. Like Thailand, the Bank of Korea's foreign exchange reserves were under pressure. According to Boughton (2012: 543):

A large portion of the central bank's foreign exchange reserves consisted of deposits in overseas branches of Korean banks, and those banks had committed the money to cover their own external debts.



The IMF had never encountered such a situation before, and the staff did not even know what questions to ask to uncover it.

When the Korean banking system ran into trouble, the central bank's foreign currency reserves were not adequate to cover foreign claims. Also, like Thailand, relations with the IMF were strained before the crisis. The IMF's Deputy Managing Director, Stanley Fischer, had tried to persuade Korean officials to admit to problems well in advance of the crisis, but they believed that their new status as a member of the Organisation for Economic Co-operation and Development (OECD) granted them some immunity from market pressure (Boughton 2012: 545). The government's failure to acknowledge the IMF's concern and its unorthodox foreign exchange reserves may have damaged trust, leading the IMF to demand more binding conditions.

So far I have argued that the presence in Indonesia of reform-minded technocrats and their interactions with staff and shareholders within the IMF explains the high number of binding and non-binding conditions. I have also argued that the concentration of G5 interest group exposure in Asia explains the exceptionally high number of non-binding conditions demanded of each country. US strategic interests, while considerable, were found not to have an impact on conditionality during the crisis. Explaining the high number of binding conditions was more challenging: the evidence suggests that neither the economic exposure of the shareholders nor the presence of strategic interests led to fewer binding conditions. Rather, relations with the IMF's bureaucracy may have been decisive in South Korea and Thailand.

### **From Asian crisis to the end of conditionality?**

After the crisis, the IMF came under intense and sustained pressure to reform. Some argued that its lending operations encouraged investors to take even greater risks in the knowledge that their losses would ultimately be covered. There were also some who argued that it had become blinkered by ideology. Others argued that it was a case of mission creep; an organization that had expanded beyond the mission set out in its Articles of Agreement. While these fundamental criticisms have always been present in some form or another, they were amplified strongly by the crisis.

Leading economists and top officials began to call for reform. One of the most influential contributions was made by the economist Martin Feldstein, who argued that the IMF was risking its effectiveness by the way it had handled the affected countries; its emphasis on major

structural and institutional reforms had gone too far, Feldstein (1998) argued, drawing focus away from the Fund's role in macroeconomic stabilization. This appeal to efficiency resonated with many officials within the organization. It was also shared by many influential politicians outside the organization. Robert E. Rubin, US Secretary of the Treasury during the Asian crisis, said that: *Many of the changes that the IMF pushed [in Indonesia] were outside its usual realm of expertise... Expecting the government to fix so many problems at once just wasn't realistic and probably blurred focus on the most urgent ones* (Rubin and Weisberg 2003: 246–247). Even the IMF's MD Horst Köhler, appointed after the crisis, expressed a critical attitude toward conditionality, arguing that the IMF should reduce the conditions it attached to its lending (Kahn 2000). In November 1998, the US Congress established the Meltzer Commission to make recommendations about future US policy toward the IMF and other multilateral institutions.<sup>14</sup> The Commission was highly critical of conditionality, arguing that the IMF should abandon structural conditionality completely.

The IMF responded to these criticisms by undertaking a major review of conditionality.<sup>15</sup> After the review, a new set of conditionality guidelines was adopted formally in 2002, replacing the 1979 guidelines. The new guidelines (IMF, 2002) argued that all conditions must be “critical” to a program's success. Throughout the guidelines, the principle of parsimony was emphasized: “program-related conditions should be limited to the minimum necessary to achieve the goals of the Fund-supported program or to monitor its implementation.” If any conditions were outside of the IMF's core areas of responsibility, the new guidelines stated that they must be justified, in detail, to the shareholders.

In 2005, the IMF's own PDR department conducted a major review of how the new guidelines had been applied. The PDR found that the new guidelines had worked – conditionality was more likely to be applied in areas of critical importance. It also concluded, however, that the number of structural conditions had not fallen since the Asian crisis and that greater care could be taken to set structural benchmarks only in critical areas. This finding was confirmed by the IMF's IEO in 2007 which agreed that while structural conditionality remained high in quantitative terms, it had been substantially reformed to focus on the IMF's core competences. An IEO survey of the IMF's staff captured some of the frustration with the new parsimonious approach, finding a strong perception among staff members that they had weakened IMF programs, especially in governance, social security, privatization, trade, civil service, pension, legal, and budgetary reforms.<sup>16</sup>

Taken together, the new 2002 conditionality guidelines and subsequent revisions set out ambitious new principles to guide the design of IMF programs. At the same time, the guidelines did not fundamentally change the rules of the game. Nothing in the 2002 or 2005 guidelines would have necessarily prevented another case like Indonesia's. It was not until March 2009, against the backdrop of the global financial crisis, that the IMF did what critics have demanded for years by discontinuing the use of structural performance criteria – the only binding structural reforms in IMF arrangements. The 2009 decision suggests that today no structural reform is so important to the IMF that it will refuse to lend if it is not undertaken. The IMF stated that it hoped the end of binding structural conditions will help “overcome the lingering mistrust that has marred its relations with some countries, particularly after the Asian crisis in the 1990s” (Andersen 2009).

## Conclusion

No other policy instrument has altered the relationship between states and IOs as much as conditionality has, and continues to do so, across the developing world. This chapter has demonstrated that conditionality was broader in scope and more “binding” during the Asian crisis. Trade and banking interests in the large shareholders were threatened by the crisis and lobbied their home governments for support. The G5 launched a massive and coordinated effort to resolve the crisis, with a complex series of bilateral and multilateral discussions between the G5, the IMF, private financial interests, and the affected countries.

Most importantly for the book's theory, there is evidence of shareholder intervention at the IMF to influence the nature of lending and conditionality in each of the affected countries. The pressure yielded results: some of the largest bailout loans in history were eventually offered to Thailand, Indonesia, and South Korea. Yet the implications for conditionality of the shareholders' interventions were not so clear cut. On the one hand, the G5 intervened successfully to increase the number of structural conditions in South Korea and Indonesia. The highly concentrated exposure of some domestic interest groups, such as US steel and agriculture, led to lobbying for more generous lending and even the inclusion of structural benchmarks. On the other hand, Japan, the most exposed of the large shareholders during the crisis, tried and failed to get the IMF to “tone down” the strictness and scope of conditionality in Indonesia. I argued that their lack of success was due to the temporary ascendancy of technocrats in Indonesia, whose

demands for more conditions were granted by both the IMF's staff and its shareholders. When this strategy backfired and the regime refused to comply with conditionality, the shareholders were locked in to their policy positions and could not reverse course. Finally, I suggested that the unusually high number of binding conditions in South Korea and Thailand was in part due to a lack of trust, transparency, and information. Where there is a lack of trust, for example, when the authorities have tried to hide information, the IMF is more likely to use binding conditions, regardless of the level of economic exposure.

## **Part III**

# **Implications**

# 10

## Theory, Evidence, and Reform

In this book, I demonstrated that the G5 have a central role in IMF policy-making. Furthermore, I argued that their preferences over IMF policies are predicated on the economic exposure of their domestic banks and exporters, which sometimes lobby them for protection following an economic shock in a developing or emerging market. As a result, changing economic linkages determine government preferences in the IMF's large shareholders which, in turn, affects IMF policy outcomes. This is all possible because the IMF's large shareholders have a much stronger grip on policy-making than is commonly recognized. While on the surface it appears that governments have a symbolic role only in IMF policy-making, a more detailed analysis of how the organization sets policies and makes decisions revealed that they have both the means and motivation to change the nature of program approval, lending, and conditionality.

The "means," or ability to change IMF decisions, originates in the G5's ability to dominate the IMF's Executive Board, punish the staff if they set policies that go against their interests, and actively seed and embed their favored policies within the formulation of IMF programs. The G5's "motivation," or incentive to influence decisions, comes from the distributional consequences of IMF programs, which can often be large enough to provide these governments with strong incentives to want to induce program approval, increase loan size, and change the nature of conditionality to protect domestic interests from economic shocks.

A central pillar of this argument is that exporters and banks possess both the resources and the ability to influence successfully their government's foreign economic policies toward the IMF. They do this in the knowledge that their government possesses both the resources and the ability to shape IMF policy to their advantage.

While I stressed the domestic sources of governments' foreign economic policies toward the IMF, I also outlined the most plausible way in which G5 governments cooperate to protect exporters and financial institutions, considering the constraints imposed on them by the IMF's rules and design. As the large shareholders turn to the international arena to defend domestic interest groups, I argued that they also cooperate through logrolling. Cooperation of this kind is by far the most likely, considering what we know about the rules and design of the IMF. Chapter 4 provided a detailed overview of how the organization sets policies and makes decisions. It found that the Fund's shareholders have substantial input into, and control over, the organization's day-to-day operations, casting much doubt on theories of IMF behavior that stress the bureaucracy's freedom and autonomy from their political masters. Finally, I tested several observable implications of my argument in four empirical chapters, presenting detailed empirical support for a link between G5 economic exposure and the IMF's most important policies: program approval, loan size, and conditionality.

To conclude this book, I first review the findings from across the empirical chapters, commenting on the empirical regularities and their substantive implications for my theory. Finally, I discuss the reform of the organization after the global financial crisis, the ascendance of China to the G5, and some of the broader implications of my argument and findings for our understanding of international relations and globalization.

## **Theory in light of the empirical findings**

The findings from the empirical chapters support the argument that developing and emerging markets with economic links to a member of the G5 receive much softer treatment from the IMF, even after controlling for a multitude of other pressures on the lending process. Even though G5 economic exposure is a major driving force, its impact varies across the different policies which I examine in this book. It appears to have the most impact on lending, followed by program approval, and then conditionality. More generally, the results indicate that the IMF's most powerful shareholders exercise control over policy decisions and use this control to assist financial institutions and exporters. One might expect that because the IMF has been charged with maintaining an open international financial system that it would tend to support private business interests like these anyway. On the contrary, the results show that the Fund is only a better friend to private interests located in powerful countries and tends to be an even better friend to those that

are able to “help themselves” by lobbying their government for assistance following an economic shock.

The findings from the empirical chapters also show that a number of economic conditions clearly matter when it comes to prominent IMF policy decisions. First and foremost, the presence of a financial crisis drives variation in lending and program approval. Such an event is not always well captured by a standard battery of macroeconomic variables and needs to be judged on a case-by-case basis. Market sentiment can go against a country and deny it access to capital markets even when various economic “fundamentals” appear to be stable. Other economic indicators drive variation in policy decisions but again this differs across the different outcomes in this book.

My analysis also finds little support for some of the dominant approaches to IMF behavior. US strategic interests (whether military spending or voting in the United Nations) only mattered for binding conditionality. While the findings on conditionality are in accord with Stone’s (2008) study, it is surprising that they do not extend to any of the other outcomes of interest in this book, particularly because so many other studies have found that US interests drive lending and program approval.

In addition to considering the economic determinants of program approval and the role of the United States, this book incorporated the role of the IMF’s bureaucracy by considering the incentives for rent-seeking among the staff during an IMF quota review and by including a variable to measure the changing relationship between the staff and their political masters (the index of delegation). On the balance of evidence, the bureaucracy appears to have had little impact on the outcomes of interest, only having a significant effect on variation in non-binding conditionality. Otherwise, neither a quota review nor changes in staff autonomy had a conclusive effect on any of the policy decisions. Along with Stone (2008) and others, I find little evidence that “hard” versions of the public choice approach to IOs work well in the case of the IMF. The findings also run counter to the more relaxed variants of this approach, which view the relationship as one between a principal and an agent. While these approaches model the relationship correctly, they do tend to give too little importance to the states that govern the organization.

The evidence from the case of Europe and Asia shed further light on the politics of G5 intervention at the IMF. Chapter 7 examined IMF lending to Iceland, Greece, and Ireland. It found that the IMF’s negotiators were unable to act contrary to the interests of the large European shareholders in Ireland and Greece. Furthermore, both countries received exceptional levels of financial support, even though some members of



the G5 were much more exposed than others. In Iceland, it found that domestic interests in the United Kingdom and the Netherlands were compensated after the financial crisis in Iceland. Both governments subsequently used the IMF to put pressure on Iceland to pay them back. Chapter 9 examined conditionality during the Asian crisis. It offered an explanation of why conditionality deviated so much from the findings of the statistical analysis in Chapter 8 and considered the question of whether the book's theoretical framework should be modified. However, it found that there was evidence of shareholder intervention at the IMF to influence the nature of lending and conditionality in each of the affected countries. On the one hand, the United States intervened successfully to increase the number of structural conditions in South Korea and Indonesia. The highly concentrated exposure of some domestic interest groups, such as US steel and agriculture, led to lobbying for more generous lending and the inclusion of more conditions. On the other hand, Japan, the most exposed of the large shareholders during the crisis, tried and failed to get the IMF to reduce conditionality in Indonesia. I argued that their lack of success was due to the impact of technocrats in Indonesia, whose demands for more conditions were granted by both the IMF's staff and its shareholders.

Nevertheless, further research could both improve and extend this book's argument. First, although program approval, loan size, and conditionality are among the Fund's most prominent and visible tools, they are not the Fund's only policy output. Rather, a substantial amount of the Fund's efforts are devoted to global, regional and country-level technical assistance and surveillance. In its mission to monitor the world's economy, the Fund also produces and diffuses knowledge and ideas about how its members should conduct their economic affairs. As a consequence, its effect on member-states doesn't cease after a country has exited an IMF program. Indeed, there is an emerging section of academic analysis which is only beginning to deal with its role in spreading ideas (Elkins *et al.* 2006; Mukherjee and Singer 2010) and how its other operations, such as surveillance and technical assistance, can also affect change (Momani 2006; Broome and Seabrooke 2007; Lombardi and Woods 2008; Fratzscher and Reynaud 2011; Moschella 2011; Breen 2012a). There is also an emerging literature on compliance with conditionality (Vreeland 2006), viewing compliance from several different perspectives: the borrowing country's decision on whether to comply (Mercer-Blackman and Unigovskaya 2004; Dreher 2006), the Fund's decision on how to treat countries that fail to comply (Stone 2004), and international investors' behavior following (non)compliance with

conditionality (Edwards 2005).<sup>1</sup> Promising avenues for future research include the IMF's effect on advanced industrial economies and its informational role in domestic politics.<sup>2</sup>

## **IMF governance and the rise of China**

In December 2010, the IMF announced some of the most important changes to its governance since the collapse of Bretton Woods.<sup>3</sup> One of the reforms was the transfer of a substantial number of votes to China, making it the third largest member of the organization. There were also important changes to the process of appointing directors. Traditionally, the Deputy Managing Director has always been a US citizen. In July 2011, it was announced that a Chinese citizen would be appointed to an additional Deputy Directorship. In addition, the G5's privilege that allows them to appoint their own directors was removed – all must now stand for election.

The reorganization of the IMF's governance will change G5 control of the organization. In particular, China, which became the world's second largest economy in 2012, will have substantially more input into decision-making, mostly at the expense of Europe. But it remains to be seen what China will do with its new votes. Will it behave as the other large shareholders have in the past, by cooperating over lending decisions? Or will cooperation breakdown among the large shareholders, loosening their grip on the organization? The difference between the structure of China's economy and the other members of the G5 suggests that China may have fewer incentives to cooperate.

The relationship between China and the IMF has often been strained to breaking point. For example, in 1995, there was a lengthy stalemate between the IMF and China when, according to Boughton (2012: 894), Chinese authorities jailed an IMF official. The IMF's MD, Michel Camdessus, refused to send IMF officials to Beijing after the incident. Even though the official was released in 1997, the incident remained deeply troubling to the IMF's staff; many were convinced that their colleague was led into a trap because the Chinese authorities had specifically requested the official's participation in an Article IV surveillance mission.

The relationship between the China and the IMF was tested again in 2007 when the People's Bank of China criticized the IMF's new bilateral surveillance framework, which it viewed as a veiled attempt to put pressure on China to depreciate the renminbi. More anecdotally, the refusal of China to enter the Financial Sector Assessment Program (an enhanced form of surveillance) until after the global financial crisis is

possible evidence of strained relations. Furthermore, in 2010, it was reported that China had pulled out of the annual meeting of the IMF in Tokyo over an ongoing territorial dispute with Japan.<sup>4</sup>

According to Wade (2011: 352), we should now think of a new “multipolarity in economic and financial affairs” involving the United States, the EU, and the BRIC (Brazil, Russia, India and China). China’s new position will reduce the IMF’s European bias and loosen the original G5’s grip on the organization. However, the advanced economies will still be able to form small coalitions with enough voting power to defend their interests and spheres of influence in the global economy. The alternative – of greater distributional conflict over the composition of international bailouts – seems less likely in the immediate future, given that the advanced economies have already opened the floodgates of IMF lending to a handful of European countries.

### **International cooperation in hard times**

Not long ago, it seemed like the IMF was “on the verge of irrelevance” (Rodrik 2009). A period of relative calm in the global financial system from 2004 to 2007 meant that few countries needed its assistance. Furthermore, most of the countries that had previously sought its assistance had either paid off their loans or let their agreements lapse. While some countries enthusiastically severed ties with the IMF, the lack of a major financial crisis had repercussions for the organization because it was dependent on the revenue generated from lending to finance its operations. Without a financial crisis in an emerging market, it quickly ran out of resources and had to take the step of downsizing for the first time since it was founded in 1944.

The global financial crisis saw a major reversal in this drift toward irrelevance. At their summit in 2009, the G20 group of industrialized and emerging economies agreed to strengthen the IMF’s role in the world economy and treble its resources to \$750 billion. With the crisis came also a surge in lending activity. Loans far exceeding normal limits were recently agreed with Mexico (47 billion SDRs), Greece (23 billion and 26 billion SDRs), Portugal (23 billion SDRs), Ireland (19 billion SDRs), Poland (19 billion SDRs), and Romania (11 billion SDRs). According to my argument, good portions of these loans were extended to satisfy the demands of interest groups in the G5.

But this is not the only way in which the Fund has responded to the crisis. Since its onset, nearly all of the policies examined in this book have begun to unravel. First, the Fund has eliminated much of the

conditionality from its programs, providing conditionality-free loans that are disbursed in single payments under the new “Flexible Credit Line.” Even low-income countries can now avail themselves of reduced conditionality loans under the new “Rapid Credit Facility.” Second, in March 2009, the IMF did what critics have demanded for years by discontinuing the use of structural performance criteria – the only binding structural reforms in IMF arrangements. This is a notable change in the direction of policy, as it implies the Fund is getting out of the business of micro-reforms and focusing on macroeconomic policy. Finally, even program approval is now automatically granted for some countries under “pre-cautionary” SBA (IMF 2010d). As national governments and policymakers continue to disagree over how to respond to the aftermath of the global financial crisis, two of the few areas of consensus were the decisions to increase the IMF’s capacity to respond and remove the policies designed to limit the use of its resources.

Why was this massive increase in the size of the IMF, accompanied by the removal of policies designed to limit moral hazard, such an easy point of consensus? And what does it tell us about the explanatory power of my argument, and its wider implications for international relations? First, the findings shed some light on the role that powerful states play in international economic regimes, showing that the states that originally constituted the post-war international regime still cooperate to maintain and share the benefits that flow from their creation. Following the Second World War, the 29 signatories of the Bretton Woods agreement reached a crucial compromise: they would abandon economic nationalism and create a new multilateral economic regime.<sup>5</sup> This book provides evidence that the main players involved in the post-war settlement are still at the core of the regime which they created and still manage.<sup>6</sup> This perspective on power and international relations differs greatly from theories of IMF behavior that stress the bureaucracy’s autonomy and organizational dysfunction (Barnett and Finnemore 2004). If an excessively autonomous and dysfunctional bureaucracy exists, why have the member-states allowed it to continue? Why have the IMF’s membership redoubled their commitment to expanding its power and activities during a period of turbulence in global finance?

This sort of behavior which I have described is not unexpected, however, as conventional IR theory posits that states collaborate through IOs to share the gains made from international cooperation. The recent period of global financial turbulence has validated this somewhat, as governments have moved to strengthen rather than abandon the IMF. However, the findings from this book add complexity, demonstrating

that in the case of high-level IMF decisions the gains from cooperation are distributed unevenly. In fact, some of the gains are distributed only among a smaller group of powerful states. This is not to say that the other members of the organization never benefit or share in the global public goods that the Fund aims to provide, but when it comes to lending decisions that have significant distributive implications, we should be mindful of the distribution of power in the international system, and how the rules of the organization reflect the distribution of power while also constraining the use of this power. This all goes back to the nature of IOs like the IMF: is their behavior better explained by their mission to resolve market failures or by the distribution of power? Other authors argue that even when it comes to dividing up the gains from cooperation, power matters. This is because there are “many points along the Pareto frontier” at which governments can engage in cooperation and conflict (Krasner 1991: 337). In this book, my argument and findings suggest that powerful governments cooperate with each other to share some of the gains in selected issue areas with distributional consequences, while also excluding other governments. This has also been the case in other settings. For example, “the Quad” (the United States, EU, Japan, and Canada) negotiated only among themselves in order to exclude developing countries from having too much input into Trade-Related Aspects of Intellectual Property Rights (TRIPs) during the Uruguay Round of trade talks (Helfer 2009: 42). Furthermore, scholars who have investigated international trade have concluded that the GATT only increased trade among Britain, Canada, France, Germany, and the United States. Rather than being a radical departure in the history of international trade, GATT merely supplanted pre-existing inter-war trade blocs (Gowa and Kim 2005).<sup>7</sup>

Second, this book shows that powerful governments cooperate in “hard times” to mitigate the effects of economic shocks on well-positioned domestic interest groups. In the aftermath of the global financial crisis, the IMF opened the floodgates to a handful of small European countries. In 2012, Iceland, Ireland, Greece, and Portugal – four small countries with a combined population of just under 27 million – account for 60 per cent of all outstanding IMF credit (from a group of 87 countries). This has led some, like Germany’s conservative Bundesbank, to criticize the IMF for weakening its lending standards (Riecher 2012).

By using the Fund to reduce the negative consequences of globalization on some domestic actors, the states that underpin the IMF reap exclusive benefits not available to other states. Indeed, their access to these sorts of privileges may well help to sustain their commitment to globalization and the maintenance of an open world economy. It may also explain why

there have been at least four failed attempts in the last century to agree on an international mechanism for restructuring sovereign debt and a possible weakening of financial regulation in the post-crisis world (Helleiner, 2008; Helleiner and Pagliari 2011). This is one of the reasons why suggesting appropriate reforms is so difficult. If decision-making becomes more technocratic and less political, it is quite possible that powerful governments might abandon the IMF and limit its operations. Although it is desirable to have an organization that works more efficiently for its members, many of its faults are predicated on the social and political processes that unfold in the domestic politics of its member-states. In some ways, the organization holds a mirror up to its member-states. In other ways, it can independently address the faults of its members by acting indirectly as an agent of change through the diffusion of more efficient policies and practices and also through the support of domestic groups that seek more efficient policies and regulations. Finding a balance is difficult. If the organization becomes overly technocratic against the will of its membership, many states might withdraw their support or abandon it altogether. The Fund needs to generate good ideas, policies and practices, seed them among its members, support their adoption, and hope that they are eventually deployed into domestic laws, policies, and institutions.

Many academics and policymakers have suggested that the Fund be freed from political influence altogether and given over to technocrats. Others suggest that it should be made democratic and do a better job representing the borrowing countries that it currently gives little voice to (Woods 2006). All of these suggestions for reform need to be viewed in the light of what is actually possible considering the political economy of the organization's 188 members. A technocratic reform that increases efficiency but reduces the role of the membership might lead the members to withdraw support. Democratic reforms designed to increase representation similarly might lead the large shareholders to withdraw their support from the organization and pursue regional arrangements.

Finally, the findings have implications for our understanding of globalization and openness in the world economy. With the rapid increase in global transactions over the last number of years, many developing and emerging markets have integrated increasingly with other economies. My analysis suggests that the composition of their economic links matters greatly in terms of how they are treated by the IOs that govern and regulate the world economy. According to my argument, IOs like the IMF will treat countries better where they are more "centrally" integrated within the world's great economic powers, over those that are more regionally or heterogeneously integrated within other countries.

# Appendix

Issues of measurement are central to my explanation of the political economy of IMF policies. In a series of robustness tests, I use alternative measures of some of the key concepts and also add a number of variables that were omitted from the full specifications on theoretical grounds. One key variable in the robustness tests is a borrowing country's past involvement in IMF programs. This variable takes the value of the number of IMF programs a borrowing country entered in the previous five years. According to Woods (2006), one of the reasons why this matters is that personal relationships are formed between the IMF's staff and officials in borrowing countries that persist for many years. As such, borrowing countries with "sympathetic interlocutors" that share Fund policy preferences can expect to receive more favorable treatment.

Although this variable is employed in much of the literature, I drop it from the full specifications and include it only in robustness checks presented in this Appendix (Bird *et al.* 2004; Conway 2007). There is a good theoretical reason to exclude it. While it captures a borrowing country's history of program approval, it also captures their history of political, economic, and strategic links with the IMF's staff and political masters. If the political variables matter, then a variable recording a country's past history of program approval would capture this, thereby introducing bias.

As an alternative measure of US strategic interests, I have used US–UN voting alignment in place of US military aid. This variable is a dyadic measure of voting affinity between the United States and every other member of the United Nations. Scholars that employ this variable argue that states which vote together are "closer" allies because they choose to vote with the United States under the same conditions as other IMF members. While this variable is now a standard measure of US strategic interests in the IMF literature, I include it only in the robustness tests because a change in affinity might reflect a reward for voting that occurred in the past or an incentive for voting differently in the future. US military aid, in contrast, is a more stable and long-term measure of strategic alliances.

A final set of robustness checks includes variables that measure domestic politics in borrowing countries. This takes account of the reality that domestic politics may have an impact on shareholder perceptions of a country's risk of default or debt restructuring. In an election year,

a government might come under pressure to renegotiate or withdraw from a conditionality agreement in response to societal demands. Consequently, the shareholders and staff should factor this into the design of a conditionality agreement, reducing the number of binding conditions in an election year. Indeed, Dreher and Jensen (2007) found that some countries receive fewer conditions prior to elections. A variable that measures the presence of an election to the executive or legislature is included to control for this possibility.

Furthermore, the number of veto players in domestic politics should also have an impact on shareholder perceptions of risk. More specifically, shareholders should prefer fewer conditions when a government faces strong opposition in domestic politics. Such governments will have difficulty making credible commitments to reform; political instability and time inconsistency problems increase the likelihood that an IMF program will terminate prematurely through exit or lack of compliance. To control for domestic opposition, a variable measuring the number of veto players is included in the empirical analysis.

While I posit the argument that the G5 wields influence over IMF policies, a wider group of states might have influence over Fund decisions. For example, each of the G7, including Italy and Canada as well as the G10, including Belgium, the Netherlands and Switzerland, all have IMF representation. The states that are members of these larger groups have access to international policy-making forums that overlap with some IMF functions but are not directly related to lending and conditionality. Each of these governments contributes to Fund policy and decision-making in a number of areas but, according to my theory, their influence does not extend to program approval, lending, or conditionality.

Nevertheless, I have coded a group of variables for robustness checks on the basis of a possibility that a wider group of representatives on the Executive Board has input into the core policies of the Fund. The variables that enter the robustness tests measure the bank exposure of the United States, the United Kingdom, France, Germany, Japan, the Netherlands, Switzerland, Belgium, Italy, and Canada.

Two alternative coding methods were used to capture exposure. The first captures each government's exposure as a percentage of the entire group. In this way, I take account of possible alternative bargaining strategies that governments might use at the Executive Board, whereby countries with larger shares of exposure are more likely to influence a policy decision. The second group consists of binary variables that take the value of "1" when a country is the most exposed bank lender from among the G10.



## Findings: IMF program approval

To test the robustness of the results, I made several changes to the binary regression models by including alternative measures of the key independent variables and additional control variables. The tables for the robustness checks (A.1, A.2, and A.3) are displayed below.

I first repeated the models with alternative measures of the economic exposure of IMF member states, both individual and in groups. Table A.1 presents new models on the probability of program approval which include control variables for IMF shareholders' bank exposure among the G10 as a percentage of total G10 exposure. Table A.2 presents similar specifications except that the control variables are binary variables that take a value of 1 in cases where the country has the highest level of bank exposure from among the G10. None of the specifications show any systematic relationship between other forms of economic exposure and the probability of IMF program approval. The only exception was in Table A.1, which shows that German bank exposure among the G10 is a robust predictor of program approval. In addition, Table A.1 shows that G5 bank exposure was not always robust when other control variables for exposure among the G10 were included. However, none of the variables that control for alternative configurations of economic exposure among G10 governments are correctly signed.

Table A.3, secondly, introduces new independent and control variables. In models one and two US–UN voting affinity is used to measure US strategic interests. Models three and four include a variable to measure a country's history of IMF participation. Models five and six include measures of a borrowing country's domestic political system. Finally models seven and eight use alternative measures of G5 economic exposure which measure bank exposure as a percentage of GDP rather than as a percentage of total bank lending. Similarly, G5 trade exposure as a percentage of total exports is substituted for total exports as a percentage of GDP. These alternative measures capture the exposure of banks and exporters in each member country of the G5 relative to the rest of the economy.

In the context of how these changes affect the results, US–UN voting was not statistically significant. A country's history of IMF program approval was highly significant. Domestic political variables in borrowing countries were not statistically significant. G5 economic exposure, however, is not robust to their inclusion. Finally, only G5 bank exposure was statistically significant when measured as a portion of GDP rather than total bank lending. Overall, the results show that the findings are

sensitive to changes in measurement and the inclusion of additional control variables and should be treated with some caution. In particular, the result that stands out is that G5 economic exposure is not robust to the inclusion of domestic political conditions in borrowing countries. While the results from models five and six run counter to my argument, G5 exposure is a robust predictor in the scores of the other models. Nevertheless, we can conclude from the robustness tests that the economic determinants of program approval – international reserves, GDP per capita, the presence of a financial crisis – all matter. In each of the robustness tests, these variables are statistically significant and correctly signed.

### Findings: IMF lending

The results for IMF lending robustness checks are displayed below in Table A.4, Table A.5, and Table A.6.

First, the main specifications including G5 trade and bank exposure were replicated with an alternative dependent variable: IMF credit extended to country  $i$  at time  $t$  in millions of SDRs (logged). Like the decision to replicate the models with an alternative statistical method, this choice of variable was motivated by its use in a previous study on IMF lending (Oatley and Yackee 2004).

Second, I substituted G5 bank exposure (as a percentage of total bank lending) with G5 bank exposure as a percentage of GDP. This variable captures the exposure of the banking industry in the potential or actual recipient of IMF finance relative to the rest of the economy (rather than the rest of the sector) in each member of the G5.

Third, the models were replicated with UN–US voting alignment in place of US military aid. UN–US voting is a dyadic measure of affinity between the United States and every other country computed using the S-score formula. Data are drawn from Dreher and Sturm (2006) and Voeten (2005). The logic underlying this choice of variable is that states that vote together are “closer” allies because under the same conditions as other IMF members they chose to vote with the United States. While I have argued that US military aid is a better measure of long-term strategic alliances, the former is widely used in the literature on IMF policies.

Fourth, the models were replicated with a time trend to account for developments that I have not modeled such as increasing openness in trade and finance. A variable to capture a borrowing country's previous relationship with the IMF was also included (number of programs in the previous five years).

Fifth, a number of variables were added to the base model to take account of domestic politics in the recipient or potential recipient of IMF support. These variables account for the possibility that G5 governments are responsive to domestic politics in the recipient and that the recipient governments themselves might have some influence over the approval and lending process. The variables added to the base model, including G5 bank exposure, were the number of veto players, a dummy for legislative and executive election years, and POLITY.

The results from the alternative model specifications are displayed in Table A.4. On the whole, they are comparable with those from the main specifications. For a select number of changes the findings diverged, but not in ways that affect the robustness of my argument. For example, in the models one and two where an alternative dependent variable was used, the coefficients on G5 bank and trade exposure are much larger. In these models, moreover, the presence of a financial crisis is not statistically significant, and instead, IMF loans are responsive to a change in the index of delegation. Besides this, none of the other robustness checks using alternative measures of the key concepts and indicators are noteworthy.

Finally, I considered the possibility that the economic exposure of other states and groups of states matters when it comes to explaining IMF policy outcomes like loan size and program approval. Table A.5 presents models that include variables to control for a powerful country's bank exposure among the G10 as a percentage of total G10 exposure. Table A.6 presents the results in a similar manner except that the control variables are binary variables that take a value of 1 where a powerful country's level of bank exposure is the highest from among the G10. Many different specifications showed little in the way of a systematic relationship between G10 bank exposure and the size of an IMF loan. Italian bank exposure as a percentage of G10 exposure was negatively correlated with the size of an IMF loan while US bank exposure as a percentage of G10 exposure was positive and statistically significant. The only finding from these models that was in any way systematic was that German bank exposure was correlated with significantly high loans on average, across several specifications. On the balance of evidence, however, G5 exposure appears to be a much more robust predictor of loan size, as German exposure among the G5 is not statistically significant and is sensitive to measurement. Overall, the empirical analysis is robust to additional control variables, alternative measures of some of the existing control variables, and alternative measures of the main explanatory variables, lending support to my argument on the causes of variation in IMF lending.

## Findings: IMF conditionality

Similar to IMF lending and program approval, several additional tests were performed for IMF conditionality (Tables A.7). The first change was to use alternative measures of G5 bank and trade exposure, measuring these variables as a portion of a G5 member's GDP rather than total bank lending or total exports (model one and two in Table A.7). While the findings from this alternation were roughly similar to the original specification, G5 trade exposure was not statistically significant. Second control variables were added to the models, including the number of veto players in a borrowing country, the presence of an election and POLITY. None of these additional variables were statistically significant (model three and four: Table A.7). However, following their inclusion, G5 bank and trade exposure lose statistical significance. Indeed, the only variable that attains significance following their inclusion is US military aid (model three). Further tests were carried out to determine if domestic political variables are significant when added to the base model and the base model with measures of G5 economic exposure. In these additional models, the domestic political variables did not attain statistical significance while G5 economic exposure remained robust.

Table A.1 IMF program approval and G10 bank exposure

Variable	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)	(11)	(12)	(13)
G5 bank exposure	0.08 (0.06)	0.08 (0.06)	0.09** (0.04)	0.10** (0.04)	0.09** (0.04)	0.09** (0.04)	0.10** (0.04)	0.09** (0.04)	0.08 (0.05)	0.09 (0.05)	0.09 (0.05)	0.08 (0.05)	0.08 (0.05)
US (per cent)	0.00 (0.00)	0.00 (0.00)	0.00 (0.00)	-0.00** (0.00)									
UK (per cent)	-0.00 (0.00)	-0.00 (0.00)	-0.00 (0.00)	-0.00*** (0.00)									
French (per cent)	0.00 (0.00)	0.00 (0.00)	-0.00 (0.00)			-0.00*** (0.00)							
German (per cent)	-0.00 (0.00)	-0.00 (0.00)	0.00 (0.00)				-0.00** (0.00)						
Japan (per cent)	-0.00 (0.00)	-0.00 (0.00)	-0.00 (0.00)					-0.00** (0.00)					
Belgium (per cent)	-0.39 (0.59)	-0.27 (0.56)							-0.43 (0.51)				
Canadian (per cent)	0.20 (0.56)	0.27 (0.56)								0.32 (0.49)			
Italian (per cent)	1.66 (1.51)	1.73 (1.48)									1.34 (1.58)		
NL (per cent)	0.96 (1.62)											0.67 (1.59)	
Swiss (per cent)	-1.66 (1.53)												-1.93 (1.44)
Observations	853	853	1301	1301	1301	1301	1301	1301	853	853	853	853	853
Countries	96	96	105	105	105	105	105	105	96	96	96	96	96
Log p. likelihood	-455.4	-456.3	-635.7	-640.4	-638.9	-639.0	-640.6	-640.1	-458.7	-458.8	-458.2	-457.9	-458.7
Chi2	74.21	76.04	127.4	144.1	141.4	140.4	142.5	141.7	65.92	63.62	62.68	63.69	63.65

Note: Logistic regression. Robust standard errors in parentheses.

\*\*\* $p < 0.01$ , \*\* $p < 0.05$ .

Table A.2 IMF program approval and G10 bank exposure

	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)	(11)	(12)
G5 bank exposure	0.11** (0.05)	0.11** (0.05)	0.11** (0.04)	0.11** (0.04)	0.11** (0.04)	0.10** (0.04)	0.10** (0.04)	0.12*** (0.04)	0.10** (0.05)	0.11** (0.04)	0.10** (0.04)	0.11** (0.04)
US banks	0.12 (0.21)	0.13 (0.20)	0.11 (0.21)	-0.03 (0.18)								
UK banks	-0.21 (0.34)	-0.19 (0.33)	-0.21 (0.33)		-0.42 (0.31)							
French banks	0.40* (0.21)	0.42** (0.20)	0.40* (0.20)			0.32 (0.17)						
German banks	0.75*** (0.27)	0.76*** (0.26)	0.75*** (0.26)				0.63** (0.25)					
Japanese banks	-0.19 (0.27)	-0.18 (0.27)	-0.19 (0.27)					-0.36 (0.25)				
Canadian banks	0.06 (0.40)	0.11 (0.39)							-0.04 (0.42)			
Italian banks	0.67 (0.68)	0.67 (0.67)								0.51 (0.69)		
Belgian banks	-0.25 (0.32)										-0.45 (0.28)	
Swiss banks	0.28 (0.84)											0.08 (0.84)
Observations	1301	1301	1301	1301	1301	1301	1301	1301	1301	1301	1301	1301
Countries	105	105	105	105	105	105	105	105	105	105	105	105
Log p. likelihood	-636.1	-636.3	-636.6	-643.2	-642.3	-641.5	-640.1	-642.3	-643.2	-643.0	-642.9	-643.2
Chi2	171.0	166.9	165.1	129.3	124.8	135.4	145.6	128.9	128.1	127.5	129.5	129.3

Note: Logistic regression. Robust standard errors in parentheses.

\*\*\* $p < 0.01$ , \*\* $p < 0.05$ .

Table A.3 IMF program approval robustness checks

Variable	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
G5 bank exposure/lending	0.13** (0.05)		0.09** (0.04)		0.04 (0.05)			
G5 trade exposure/exports		0.12 (0.06)		0.09 (0.05)		-0.04 (0.07)		
G5 bank exposure/GDP							0.08 (0.04)	
G5 trade exposure/GDP								0.14** (0.06)
Reserves	-0.09 (0.05)	-0.04 (0.04)	-0.13*** (0.05)	-0.07 (0.04)	-0.15*** (0.05)	-0.12*** (0.04)	-0.14*** (0.05)	-0.08 (0.04)
Current account/GDP	-0.02** (0.01)	0.00 (0.01)	-0.02 (0.01)	-0.00 (0.01)	-0.02 (0.01)	-0.02 (0.01)	-0.02 (0.01)	-0.00 (0.01)
Debt/GDP	-0.10 (0.19)	0.14 (0.13)	-0.06 (0.17)	0.12 (0.11)	-0.08 (0.18)	-0.02 (0.12)	-0.05 (0.18)	0.13 (0.12)
Debt service/GDP	0.01 (0.02)	-0.00 (0.02)	-0.00 (0.02)	-0.01 (0.02)	0.00 (0.02)	-0.00 (0.02)	0.01 (0.02)	-0.00 (0.02)
GDP per capita growth	-0.06*** (0.01)	-0.06*** (0.02)	-0.05*** (0.01)	-0.05*** (0.02)	-0.05*** (0.01)	-0.05*** (0.01)	-0.05*** (0.01)	-0.05*** (0.02)
GDP per capita	-0.13 (0.13)	-0.07 (0.11)	0.02 (0.10)	0.00 (0.10)	0.07 (0.12)	0.19 (0.12)	0.04 (0.11)	-0.02 (0.11)
Systemic transition	0.95*** (0.22)	1.42*** (0.27)	0.76** (0.32)	1.11*** (0.34)	0.80*** (0.29)	0.94*** (0.28)	0.84*** (0.28)	1.16*** (0.31)
IMF quota review	0.09 (0.19)	0.44*** (0.17)	0.26 (0.19)	0.46** (0.18)	0.23 (0.19)	0.42** (0.16)	0.22 (0.19)	0.37** (0.16)

Financial crisis	0.58*** (0.22)	0.68*** (0.23)	0.84*** (0.22)	0.86*** (0.24)	0.79*** (0.24)	0.78*** (0.25)	0.81*** (0.23)	0.86*** (0.24)
US military aid			-0.00 (0.00)	0.00 (0.00)	-0.00 (0.00)	0.00 (0.00)	-0.00 (0.00)	0.00 (0.00)
IMF delegation index	-0.01 (0.09)	0.14 (0.07)	0.09 (0.21)	0.46 (0.32)	-0.09 (0.08)	-0.08 (0.07)	-0.12 (0.07)	-0.02 (0.06)
Time trend			-0.04 (0.05)	-0.12 (0.08)				
IMF programme history			0.25*** (0.07)	0.24*** (0.09)				
US-UN voting	1.28 (0.85)	0.53 (0.70)						
Veto players					-0.02 (0.05)	0.05 (0.05)		
Election year					-0.35 (0.18)	-0.29 (0.17)		
POLITY					0.02 (0.02)	0.03 (0.02)		
Observations	1008	1216	1069	1358	1016	1134	1069	1358
Countries	99	114	101	117	92	103	101	117
Log p.likelihood	-504.3	-552.2	-531.6	-597.6	-517.3	-530.3	-537.4	-601.7
Chi2	184.6	121.3	155.0	110.4	144.0	152.7	133.5	100.4

Note: Negative binomial regression. Robust standard errors in parentheses.

\*\*\* $p < 0.01$ , \*\* $p < 0.05$ .



Table A.4 IMF loan size and program approval robustness checks

DV (outcome equation)	(1)	(2)	(3)	(4)	(5)	(6)	(7)
	Loan SDRs	Loan SDRs	Loan/quota	Loan/quota	Loan/quota	Loan/quota	Loan/quota
G5 bank exposure/ total lending	0.64*** (0.06)		0.17*** (0.05)	0.17*** (0.04)	0.15*** (0.04)		
G5 trade exposure/ total exports		0.77*** (0.09)					
G5 bank exposure/GDP						0.15*** (0.04)	
G5 trade exposure/GDP							0.15** (0.07)
Reserves	0.08 (0.06)	0.16*** (0.06)	-0.05* (0.03)	-0.07** (0.03)	0.02 (0.03)	-0.07** (0.04)	-0.05 (0.04)
Current account/GDP	-0.02 (0.01)	-0.01 (0.01)	-0.02** (0.01)	-0.02* (0.01)	-0.02* (0.01)	-0.02* (0.01)	-0.00 (0.01)
Debt/GDP	-0.42** (0.18)	0.07 (0.20)	-0.02 (0.15)	0.00 (0.14)	0.02 (0.11)	0.02 (0.15)	0.24* (0.14)
Debt service/GDP	0.01 (0.02)	0.00 (0.02)	0.01 (0.01)	0.00 (0.01)	0.01 (0.01)	0.01 (0.01)	-0.01 (0.01)
GDP per capita growth	0.02 (0.02)	-0.03* (0.02)	-0.03* (0.01)	-0.03** (0.01)	-0.01 (0.01)	-0.03** (0.01)	-0.05*** (0.02)
GDP per capita	-0.34** (0.14)	-0.14 (0.16)	-0.22** (0.10)	-0.10 (0.08)	-0.07 (0.06)	-0.04 (0.08)	-0.05 (0.10)
IMF quota review	0.06 (0.16)	-0.06 (0.17)	0.14 (0.15)	0.03 (0.16)	-0.08 (0.11)	0.05 (0.16)	0.15 (0.14)
IMF delegation index	0.50*** (0.07)	0.28*** (0.09)	0.08 (0.06)	-0.15 (0.17)	0.10* (0.05)	-0.07 (0.05)	-0.03 (0.05)

Financial crisis	0.19 (0.22)	0.23 (0.21)	0.45** (0.20)	0.67*** (0.20)	0.40** (0.17)	0.70*** (0.20)	0.77*** (0.23)
US military aid	0.00 (0.00)	0.00 (0.00)		0.00 (0.00)	0.00* (0.00)	0.00 (0.00)	0.00* (0.00)
<hr/>							
DV (outcome equation)	(1)	(2)	(3)	(4)	(5)	(6)	(7)
<hr/>							
US-UN voting			1.15* (0.69)				
IMF programme history				0.08 (0.07)			
Veto players					0.02 (0.04)		
Election year					0.20* (0.12)		
POLITY					-0.02** (0.01)		
Time trend				0.04 (0.04)			
<hr/>							
Approval (selection equation)	(1)	(2)	(3)	(4)	(5)	(6)	(7)
<hr/>							
G5 bank exposure/total lending	0.06** (0.03)		0.08*** (0.03)	0.07*** (0.02)	0.02 (0.03)		

(continued)

Table A.4 Continued

Approval (selection equation)	(1)	(2)	(3)	(4)	(5)	(6)	(7)
G5 trade exposure/total exports		0.06* (0.03)					
G5 bank exposure/GDP						0.06** (0.03)	
G5 trade exposure/GDP							0.09*** (0.03)
Reserves	-0.08*** (0.03)	-0.04** (0.02)	-0.04 (0.03)	-0.06*** (0.03)	-0.08*** (0.03)	-0.07*** (0.03)	-0.03 (0.02)
Current account/GDP	-0.01 (0.01)	0.00 (0.01)	-0.02*** (0.01)	-0.01* (0.01)	-0.01 (0.01)	-0.01* (0.01)	-0.00 (0.01)
Debt/GDP	-0.02 (0.11)	0.08 (0.07)	-0.06 (0.11)	-0.03 (0.10)	-0.05 (0.11)	-0.02 (0.10)	0.07 (0.07)
Debt service/GDP	0.00 (0.01)	0.00 (0.01)	0.00 (0.01)	-0.00 (0.01)	0.00 (0.01)	0.00 (0.01)	-0.00 (0.01)
GDP per capita growth	-0.03*** (0.01)	-0.03*** (0.01)	-0.03*** (0.01)	-0.03*** (0.01)	-0.03*** (0.01)	-0.03*** (0.01)	-0.03*** (0.01)
GDP per capita	0.01 (0.07)	-0.02 (0.06)	-0.06 (0.07)	0.01 (0.06)	0.05 (0.07)	0.03 (0.06)	0.00 (0.06)
Systemic transition	0.49** (0.24)	0.79*** (0.21)	0.26** (0.11)	0.37*** (0.18)	0.52** (0.22)	0.38*** (0.15)	0.39*** (0.16)
IMF quota review	0.13 (0.11)	0.21** (0.09)	0.04 (0.11)	0.14 (0.10)	0.14 (0.11)	0.11 (0.10)	0.18** (0.09)

IMF delegation index	-0.05 (0.04)	-0.00 (0.04)	0.01 (0.05)	0.03 (0.12)	-0.05 (0.04)	-0.06 (0.04)	0.00 (0.03)
Financial crisis	0.48*** (0.14)	0.51*** (0.14)	0.39*** (0.13)	0.53*** (0.14)	0.48*** (0.14)	0.51*** (0.14)	0.54*** (0.14)
US military aid	-0.00 (0.00)	0.00 (0.00)		-0.00 (0.00)	-0.00 (0.00)	-0.00* (0.00)	-0.00 (0.00)
US-UN voting			0.80* (0.49)				
IMF programme history				0.16*** (0.04)			
Veto players					-0.01 (0.03)		
Election year					-0.19* (0.10)		
POLITY					0.01 (0.01)		
Time trend				-0.02 (0.03)			
Observations	1069	1358	1008	1069	1016	1069	1358
Censored	826	1118	788	826	779	826	1118
Countries	101	117	99	101	92	101	117
Log p.likelihood	-877.4	-973.5	-728.3	-788.6	-768.8	-797.2	-874.8
Rho	-0.584	-0.229	0.937	0.903	0.0855	0.914	0.943
Chi2	220.0	151.0	47.89	75.88	60.79	70.76	62.37
Chi2_c	3.581	1.054	65.94	20.69	0.0942	29.00	74.50

Note: Robust standard errors in parentheses.

\*\*\* $p < 0.01$ , \*\* $p < 0.05$ , \* $p < 0.1$ .

Table A.5 IMF loan size and G10 bank exposure

	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)	(11)	(12)	(13)
G5 bank exposure	0.15*** (0.04)	0.15*** (0.04)	0.16*** (0.04)	0.18*** (0.04)	0.17*** (0.04)	0.17*** (0.04)	0.17*** (0.04)	0.17*** (0.04)	0.16*** (0.04)	0.16*** (0.04)	0.16*** (0.04)	0.16*** (0.04)	0.16*** (0.04)
US (per cent)	0.00 (0.00)	0.00 (0.00)	0.00** (0.00)	-0.00 (0.00)									
UK (per cent)	0.00 (0.00)	0.00 (0.00)	0.00 (0.00)	-0.00 (0.00)									
French (per cent)	-0.00 (0.00)	-0.00 (0.00)	-0.00 (0.00)		-0.00 (0.00)								
German (per cent)	0.00 (0.00)	0.00 (0.00)	-0.00 (0.00)			-0.00 (0.00)							
Japan (per cent)	-0.00 (0.00)	-0.00 (0.00)	-0.00 (0.00)				-0.00 (0.00)						
Belgium (per cent)	-0.14 (0.22)							-0.00 (0.00)	-0.13 (0.23)				
Canada (per cent)	-0.09 (0.32)	0.03 (0.26)							0.06 (0.31)				
Italy (per cent)	-1.75** (0.87)	-1.68** (0.85)								0.14 (0.62)			
NL (per cent)	-0.81 (0.78)										0.00 (0.82)		
Swiss (per cent)	-0.34 (1.05)												-0.74 (1.03)
Observations	853	853	1301	1301	1301	1301	1301	1301	853	853	853	853	853
Censored	646	646	1026	1026	1026	1026	1026	1026	646	646	646	646	646
Countries	96	96	105	105	105	105	105	105	96	96	96	96	96
Log p.likelyh	-648.0	-649.3	-920.9	-933.9	-932.6	-932.6	-934.2	-933.6	-660.6	-659.5	-659.9	-659.9	-660.5
rho	0.0800	0.0917	0.941	0.917	0.919	0.923	0.922	0.924	0.891	0.890	0.887	0.891	0.895
Chi2	124.2	116.2	61.52	48.53	47.71	49.03	50.18	50.54	35.90	36.15	35.31	41.00	36.59
Chi2_c	0.0648	0.0658	62.29	35.18	37.65	43.00	40.73	41.62	24.94	24.42	24.73	24.06	25.25

Note: Selection equation and variables from base model dropped to improve presentation. Robust standard errors in parentheses.

\*\*\* $p < 0.01$ , \*\* $p < 0.05$ .

Table A.6 IMF loan size and individual G10 exposure

Loan size	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)	(11)	(12)
G5 bank exposure	0.17*** (0.04)	0.17*** (0.04)	0.17*** (0.04)	0.18*** (0.04)	0.18*** (0.04)	0.18*** (0.04)	0.18*** (0.04)	0.18*** (0.04)	0.17*** (0.04)	0.18*** (0.04)	0.18*** (0.04)	0.18*** (0.04)
US banks	0.08 (0.17)	0.08 (0.16)	0.09 (0.16)	-0.04 (0.14)								
UK banks	0.15 (0.24)	0.15 (0.23)	0.16 (0.24)	0.03 (0.22)								
French banks	0.18 (0.14)	0.18 (0.13)	0.20 (0.13)		0.07 (0.12)							
German banks	0.50*** (0.19)	0.50*** (0.18)	0.51*** (0.18)			0.42*** (0.16)		0.02 (0.25)				
Japanese banks	0.12 (0.26)	0.12 (0.25)	0.13 (0.25)									
Canadian banks	-0.17 (0.25)	-0.15 (0.23)							-0.21 (0.24)			
Italian banks	-0.07 (0.34)	-0.08 (0.33)								-0.18 (0.33)		
Belgian banks	-0.11 (0.18)										-0.22 (0.14)	0.09 (0.47)
Swiss banks	0.20 (0.48)											
Observations	1301	1301	1301	1301	1301	1301	1301	1301	1301	1301	1301	1301
Censored	1026	1026	1026	1026	1026	1026	1026	1026	1026	1026	1026	1026
Countries	105	105	105	105	105	105	105	105	105	105	105	105
Log p.likelihood	-927.1	-927.3	-928.0	-936.0	-934.8	-933.7	-933.0	-934.4	-935.9	-935.5	-935.7	-936.0
Rho	0.917	0.916	0.919	0.920	0.916	0.922	0.922	0.919	0.919	0.917	0.921	0.921
Chi2	89.40	90.72	72.78	50.72	50.91	52.57	63.54	53.73	57.34	57.28	52.88	52.66
Chi2_c	41.20	44.22	46.91	46.80	45.19	50.65	53.57	42.70	46.96	46.32	48.26	45.54

Note: Selection equation and variables from base lending model dropped to improve presentation. Robust standard errors in parentheses.  
\*\*\*p < 0.01, \*\*p < 0.05.

Table A.7 IMF binding conditions robustness checks

Variable	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
G5 bank/GDP	-0.086** (0.034)							
G5 trade/GDP		-0.047* (0.027)						
G5 bank exposure			-0.060 (0.041)		-0.10*** (0.03)	-0.08*** (0.03)	-0.09*** (0.03)	-0.06** (0.02)
G5 trade exposure				-0.037 (0.027)				-0.04 (0.04)
Reserves	-0.020 (0.061)	-0.023 (0.036)	-0.012 (0.066)	-0.0097 (0.038)	0.06 (0.09)	-0.04 (0.05)	-0.05 (0.07)	0.01** (0.04)
Current account	0.012 (0.013)	0.011** (0.0051)	0.011 (0.013)	0.0072 (0.0073)	-0.00 (0.02)	0.02** (0.01)	0.01 (0.01)	0.01** (0.01)
External debt	0.051 (0.15)	0.028 (0.093)	0.030 (0.14)	-0.0027 (0.10)	-0.09 (0.25)	0.12 (0.12)	0.02 (0.14)	0.02 (0.09)
Debt service	0.018 (0.021)	0.011 (0.013)	0.0012 (0.028)	0.0020 (0.013)	0.04 (0.03)	0.02 (0.02)	0.04 (0.03)	0.02 (0.01)
GDP growth	0.036 (0.044)	0.0094 (0.019)	0.032 (0.048)	0.016 (0.021)	0.06 (0.06)	-0.00 (0.03)	0.01 (0.05)	-0.00 (0.02)
GDP per capita	-0.048 (0.076)	-0.077* (0.043)	-0.019 (0.083)	-0.036 (0.050)	-0.09 (0.11)	-0.07 (0.09)	-0.06 (0.07)	-0.09** (0.04)
IMF quota review	0.0012 (0.066)	0.066 (0.044)	0.021 (0.067)	0.066 (0.047)	-0.07 (0.09)	-0.05 (0.06)	-0.08 (0.10)	-0.06 (0.05)
IMF delegation index	0.13 (0.090)	0.050 (0.058)	0.076 (0.12)	0.090 (0.071)	-0.07 (0.15)	-0.14** (0.07)	-0.43 (0.38)	-0.47** (0.24)
Financial crisis	-0.031 (0.12)	-0.14 (0.11)	-0.076 (0.092)	-0.16* (0.088)	0.08 (0.12)	-0.08 (0.11)	-0.03 (0.11)	-0.13 (0.10)

US military aid	-0.0014*** (0.00040)	-0.0010** (0.00052)	-0.0014*** (0.00044)	0.00066 (0.00093)		-0.00*** (0.00)	-0.00** (0.00)
Pr(IMF Approval)	2.36 (4.87)	0.54 (2.43)	3.40 (5.43)	1.90 (2.62)	5.91 (7.34)	-0.44 (5.57)	-0.88 (2.76)
Veto players			-0.065* (0.036)	-0.049* (0.029)			
Election year			-0.057 (0.068)	0.028 (0.038)			
POLITY			0.014 (0.011)	-0.0052 (0.0099)			
US-UN voting					-0.19 (0.67)		
Time trend						0.15 (0.10)	0.16** (0.07)
Observations	189	389	185	366	112	189	389
Log p.likelihood	-458	-946	-438	-890	-257	-454	-940
chi2	179	101	295	140	182	183	115

Note: Negative binomial regression. Robust standard errors in parentheses. \*\*\*p < 0.01, \*\*p < 0.05, \*p < 0.1.



Table A.8 Data sources

Variable	Source
IMF loan (millions SDR)	International Financial Statistics
IMF loan/quota	International Financial Statistics
IMF program approval	International Monetary Fund
IMF conditionality	641 letters of intent, <a href="http://www.imf.org">www.imf.org</a> , 4/1997–2/2007
G5 trade exposure (per cent)	IMF's Direction of Trade Statistics
G5 bank exposure (per cent)	Bank for International Settlements
Reserves (mts imports)	World Development Indicators
Current account/GDP	World Development Indicators
External debt/GDP	World Development Indicators
Debt service/GDP	World Development Indicators
GDP per capita growth (per cent)	World Development Indicators
GDP per capita (log)	World Development Indicators
IMF quota review	International Monetary Fund
IMF delegation index	Brown (2009)
Financial crisis	Laeven (2008)
US military aid (mil. USD)	USAID (2008)
Systemic transition	Author's calculations
US–UN voting affinity	Dreher and Sturm (2006)
IMF program history	International Monetary Fund
Veto players	Beck (2001)
Elections	Beck (2001)
POLITY	Marshall and Jaggers (2002)

# Notes

## 1 Introduction

1. The literature on the effect of IMF programs on economic growth is substantial. For example, see Przeworski and Vreeland (2000, 2002), Barro and Lee (2005), Eichengreen *et al.* (2006b), Dreher (2006), and Pop-Eleches (2008).
2. This role was enshrined in the Board of Governor's second amendment to the IMF's Articles of Agreement in 1978. This amendment marked the emergence of the post-Bretton Woods IMF.
3. The Fund subsequently introduced the Extended Structural Adjustment Facility (ESAF) which was later renamed the Poverty Reduction and Growth Facility (PRGF) in 1999. It was once again rebranded in 2010 as the Extended Credit Facility under the aegis of the Poverty Reduction and Growth Trust (IMF 2010c).
4. This privilege was finally removed in 2011 and now all directors must stand for election.

## 2 Who Controls the IMF?

1. For more information on the IMF's financial programming systems, see Polak (1997, 1998), Mussa (1999), and Easterly (2006).
2. For example, in 2010, supplementary financiers provided Greece with €80 billion in addition to its €30 billion IMF loan (Volkery 2010). This pledge is separate from Greece's agreement with the IMF. Furthermore, with the onset of the global financial crisis, even a super-sized IMF is not capable of providing financing to many of the advanced industrial economies.

## 3 Domestic Interests and IMF Programs

1. According to leading international economists, there is little empirical evidence that IMF financing has gone toward directly "bailing out" bondholders, whereas the same cannot be said for banks (Roubini and Setser 2004: 13). Nevertheless, many governments and banks are themselves bondholders, so this distinction is not always so clear-cut.
2. Moreover, as banks cooperate to limit their losses through insurance and securitization, we should expect them to act in line with their aggregate exposure rather than according to the heterogeneity or intensity of exposure. See Tomz (2007: 197) for further information on why banks can punish more effectively than bondholders.
3. The formal process is coordinated via the Paris Club. While it sets out rules and norms for restructuring sovereign debt, negotiations are on an *ad hoc* basis (Rieffel 2003). More advanced attempts at cooperation through

international institutions, such as the IMF's recent SDRM initiative, have failed (Krueger 2002).

4. For a more detailed discussion of debt restructuring and the seniority of sovereign debts, see Roubini and Setser (2004: 249–288) and Rieffel (2003).
5. This organization is similar to the Paris Club, but it is even more informal as it dissolves after every meeting (Rieffel 2003: 2–3).
6. Data on US state-level export statistics were gathered from <http://tse.export.gov/> (Accessed date: February 26, 2010) and weighted by total US exports as measured by the IMF's Direction of Trade Statistics.
7. See Eichengreen (2003) and Krueger (2002) for suggestions on reforming the international debt regime.
8. On occasion, IMF programs have generated negative publicity for politicians and governments in other countries. Mexico's (1994) and Brazil's (2001) programs were widely reported in the US media and may have generated negative publicity for the incumbent US government. Greece's 2010 Stand-By Arrangement was also widely reported in the German media and may have had an impact on the outcome of regional elections.

#### 4 The Impact of the Shareholders on IMF Programs

1. See Houtven (2002: 74) and Lister (1984) for a discussion of special majority decisions.
2. Table 4.1 lists the voting share of ED and the size of their constituency in the group. It is broadly indicative of the distribution of votes over the course of this study (1983–2006). However, future work on the interactions among the shareholders will need to account for the change in the distribution of power after the Fourteenth General Review of IMF Quotas.
3. High-level forums such as these help member-states to coordinate their actions at the same time in multiple international organizations. For example, the IMF must work with organizations like the World Bank, Bank for International Settlements, and the Paris Club on some programs. In particular, Fund-Bank cooperation exists in long-term concessional lending programs such as the SAF, ESAF, PRGF, and now the Extended Credit Facility (ECF) programs.
4. Article XII, Section 3, Articles of Agreement of the International Monetary Fund, <http://www.imf.org/external/pubs/ft/aa/aa12.htm> (accessed date: May 9, 2009).
5. Another set of authors have attempted to explain influence through voting power indices; however, these do not take a position on the preferences of the various actors in the decision-making process (Dreyer and Schotter 1980; Lane and Berg 1999; Leech 2002; Alonso-Mejide and Bowles 2005; Leech 2005; Lane and Maeland 2006; Reynaud *et al.* 2007).
6. For example, Gould found that the staff have more discretion over the content of policy conditions than over lending and the phasing of loans to members (Gould 2006a). Martin (2006) also argued that EDs were much more autonomous in the Fund's early years.
7. Article XII, Articles of Agreement of the IMF (IMF 2010a).
8. For a discussion of IMF policy on governance issues see *The Role of the Fund in Governance Issues-Guidance Note*, EBS/97/125, July 2, 1997, Prepared by the

Policy, Development, and Review Department. Approved by Jack Boorman, International Monetary Fund.

9. This department was previously known as the Policy, Development and Review Department.
10. Interview with author. Executive Director of the International Monetary Fund, Interview date: March 18, 2008. Interviewee to remain anonymous.
11. Interview with author. Senior official on Managing Director's staff, March 19, 2008. Interviewee preferred to remain anonymous.
12. Interview with author. Senior official on Managing Director's staff, March 19, 2008. Interviewee to remain anonymous.
13. Interview with author. Senior official on Managing Director's staff, March 19, 2008. Interviewee to remain anonymous.
14. Interview with author. Executive Director of the International Monetary Fund, Interview date: March 18, 2008. Interviewee to remain anonymous.
15. In interview with author. Senior official on Managing Director's staff, March 19, 2008. Interviewee to remain anonymous.

## 5 Testing the Argument

1. Data coverage starts in 1983 because one of the main independent variables (G5 bank exposure) is only available from this year on.
2. The data start in 1997 because this is when the IMF started to publish letters of intent online.
3. The sample of LOIs is not ideal because there are cases missing where a country has not published its LOI. In order to determine if "missingness" followed a pattern, I examined a subset of the letters (initial letters only) and cross-referenced these with IMF annual reports and official statistics on the availability of LOIs. I found 21 cases where a country did not publish its initial LOI. Most of the missing cases were concentrated in the early years of the sample – 1997 and 1998 – with almost full coverage in later years.
4. In recent times, the IMF has offered pre-approved lines of credit with reduced conditionality to selected countries. However, from 1983 to 2006, there was no time lag between program approval and program entry; once the Executive Board had approved the program, the loan's first tranche was released immediately.
5. SDRs are an international reserve asset best described as potential claims on the currencies of the IMF members. Their value is based on a basket of major currencies reviewed by the IMF's Executive Board every five years (IMF 2012).
6. Gould has also considered variation in the "bank friendly" conditions (Gould 2006b). It is possible that the exposure of shareholder banks leads to an increase in "bank friendly" conditions.
7. As the number of binding conditions increases, so should the likelihood that a government will fail to implement a condition and have its program terminated.
8. A recent study by Stone (2011) has analyzed the number of waivers. Waivers are referred to briefly in a number of books and articles (Mussa and

Savastano 1999; Goldstein 2001: 73; Bird 2002: 803; Bird and Rowlands 2002: 835; Khan and Sharma 2003: 244; Teunissen and Akkerman 2003: 47; Babb and Buira 2004; Momani 2005a: 14; Allegret and Dulbecco 2007: 12).

9. Reforms to the organization's finances after 2008 weakened significantly this incentive.

## 6 IMF Lending

1. See Steinwand and Stone (2007) and Vreeland (2007) for overviews of the literature on participation in IMF programs.
2. The number of countries in each model varies from 101 to 118 depending on specification and data availability.
3. One notable exception is Stone's (2004) analysis of lending in Africa.
4. The basic difference between program types – the interest rate charged on the loan – is not an outcome that should affect the policies of interest in this study. The Fund's decision to offer lower interest rate loans is based on the borrower's ability to repay, global economic conditions, and humanitarian or development priorities.
5. One of the assumptions underpinning this model is that some countries want IMF programs but will not be offered to them at acceptable conditions. To take an example, in 1983 Tanzania had extremely few international reserves (at one point in 1983, the government had only two months of total imports in foreign reserves). According to Vreeland (2003b: 338), even though Tanzania badly needed a loan, its government refused to enter a program in 1983 because it did not get the conditions it wanted.
6. The Wald tests indicate that the models are significant. The Hosmer and Lemeshow statistics show that the models fit well, except for model four, which includes five dummy variables to test for the most exposed lender amongst the G5. The models also correctly classify between 77 per cent and 83 per cent of the outcomes (while  $p > 0.5$ ).
7. Several other important decisions were made in terms of the model specification. First, because an IMF program can be experienced on multiple occasions, the data are multiple failure data. The model is therefore adapted to handle recurrent events as opposed to the single failure event for which that survival analysis was originally developed. Second, the data are left truncated in this analysis, which specifies an origin time of 1983. The initial exposure event would theoretically be when a country first joins the IMF and therefore first enters the risk pool. In this analysis, all countries enter the risk pool in 1983. In addition, the decision to right censor the data was taken because observation ends in 2006 but program entry still continues after this point. Survival observation is, therefore, only partial because many countries that did not experience program approval in the sample may have subsequently entered a program or will do so in the future. The ability to censor the data in this way provides a further rationale for the use of survival analysis in addition to the other statistical methods employed in this chapter. Finally, the models are estimated with robust standard errors and clustering by country.

8. A further robustness test was carried out to establish if Cox's proportional hazards model would be suitable with these data. This model is non-parametric and does not specify the shape of the baseline hazard. I used robust standard errors and clustering by country, as well as generating time-dependent covariates by interacting the independent variables and the survival time function. This model did not fit the data well as IMF quota review and the IMF delegation index failed tests of the proportional hazard assumption. For a discussion of time-dependent covariates, see Golub (2007: 163). Box-Steffensmeier and Jones (2004) also recommended testing the proportional hazard assumption.
9. The Wald test confirms that the models are significant and  $p > 1$ , which supports the assumption that the hazard is not constant and increases over time.
10. The models that I estimate also employ the maximum likelihood estimator as opposed to the two-step estimator because it is generally considered to perform better (Puhani 2002). Moreover, to control for potential heteroscedasticity across countries, I use robust standard errors and clustering at the country level so that observations are independent across countries but not within countries. Finally, all independent variables were lagged by one year to avoid simultaneity and better reflect the time lag in the IMF's decision-making process, whereby IMF decisions are influenced by previous rather than current macroeconomic and other data.
11. Heckman's (1979) procedure starts with an equation that describes a linear relationship:

$$\text{IMF Loan Size} = \beta_0 + \beta_1 \text{ etc } \dots + u_1$$

The dependent variable, IMF Loan Size, is observed only according to a selection equation, where the dependent variable is a binary variable taking the value of 1 when an IMF program is approved and 0 otherwise.

$$\gamma_0 + \gamma_1 \text{ etc } \dots + u_2 > 0$$

Where  $u_1 \sim N(0, \sigma)$

$u_2 \sim N(0, 1)$

corr. ( $u_1, u_2$ ) =  $\rho$

The error terms,  $u_1$  and  $u_2$ , have correlation  $\rho$ . The value for  $\rho$  is a measure of the selection effect and is reported as rho. *Rho* is the correlation coefficient between the unobserved factors that determine selection into an IMF program and the unobserved factors that determine the size of the IMF loan. The intuition here is straightforward: if the unobserved factors that influence IMF program approval are correlated with the unobserved factors that influence loan size, selection bias is likely to be a problem.

12. Both before and after the transition, program approval should be subject to the same political pressures that I outlined in my theory. For example, Boughton (2001: 403) confirmed that Yugoslavia had significant commercial bank exposure and required IMF assistance in the 1980s when it struggled to meet its obligations to its creditors.

## 7 IMF Lending and the Crisis in Europe

1. The first program was a Stand-By Arrangement; the second program was under the Extended Fund Facility. Ireland and Portugal also received funding under the Extended Fund Facility.
2. Spain and Portugal had entered into IMF programs while in transition to advanced economy status in 1978 and 1983, respectively (Vreeland 2007: 30). Ireland, one of the worst performing advanced economies in the 1980s, had also come perilously close to requesting IMF support.
3. The data used to illustrate Figures 7.1–7.3 controls for the complex web of linkages in modern global banking by identifying the true source of counterparty risk. So, for example, if a multi-national corporation with operations in Iceland were to borrow from a US bank, the transaction would not be recorded as part of Figure 7.1 unless the corporation was headquartered in Iceland. For a more comprehensive account of the ultimate risk, data see McGuire and Wooldridge (2005: 76–78).
4. If the IMF were to finance the entire program, the loan would have been approximately 30 times Iceland's IMF quota, a level the Fund has not been designed to accommodate.
5. The estimate of government debt as a percentage of GDP was increased from 3.6 to 12.8 (Featherstone 2011).
6. ECOFIN is a special configuration of the Council of the European Union, representing the executives of EU member states.
7. Figures quoted from the SIPRI Arms Transfers Database (2012), Stockholm International Peace Research Institute (<http://www.sipri.org/databases/armstransfers>).
8. For a discussion of these methods, see Honohan and Laeven (2003). For a discussion of the blanket guarantee, see Honohan (2009b).
9. The Irish government first denied rumors regarding IMF support on September 17, 2010 and later on November 15, 2010.
10. Eamon Ryan, Minister for Communications, Energy, and Natural Resources, RTE Prime Time Special, November 28, 2011.
11. RTE Prime Time Special on the Bailout, November 28, 2011.
12. The details of these events were first made public by Kelly (2011).
13. In cases of government collapse, the IMF often seeks assurance from opposition political parties that they will support the terms of the program.

## 8 IMF Conditionality

1. Paris Club, [www.clubdeparis.org](http://www.clubdeparis.org) (Accessed Date: April 20, 2010).
2. Gould (2003, 2006b) found that “bank friendly” conditions are systematically added to IMF arrangements to show favor to private financial institutions.
3. There is also a much broader literature on structural adjustment programs. Most of it has been resoundingly negative about the impact of structural adjustment on development (Collier and Gunning 1999; Crisp and Kelly 1999; Noorbakhsh and Paloni 2001; Easterly 2005; Abouharb and Cingranelli 2006; Brown 2009).
4. The length of the program and the interval at which reviews occur is normally specified in the LOI. On average, program reviews occur every 4–12 months.

## 9 IMF Conditionality and the Asian Crisis

1. Blustein (2001) gives the best overall account of the IMF's role during the crisis. Prominent critiques of the IMF's role during the crisis include Feldstein (1998), Fischer (1998), Stiglitz (2002), Weiss (1999), and Rogoff (2003). More recent contributions from political science and international relations include Thirkell-White (2005), Copelovitch (2010a: Chapter 5), and Stone (2011: 170–173).
2. Investors were attracted to the region by the promise of greater profits. Low short-term US interest rates, which had declined from 1990 to 1994, incentivized capital flows to developing (Calvo *et al.* 1996: 125).
3. Bank exposure figures are from the Bank for International Settlements (Consolidated Banking Statistics, 2012).
4. These commitments are similar in all respects to structural benchmarks but they are not listed in the IMF's MONA dataset.
5. Hearing before the Sub-committee on General Farm Commodities of the Committee on Agriculture, House of Representatives, One Hundred Fifth Congress, Second Session, February 4, 1998. Serial No. 105–41.
6. Statement of Dan Glickman, Secretary of Agriculture, Before the House Committee on Agriculture, Washington, D.C. May 21, 1998.
7. Statement of Dan Glickman, Secretary of Agriculture, Before the House Committee on Agriculture, Washington, D.C. May 21, 1998.
8. Statement of Robert E. Rubin, Treasury Secretary, Testimony Before the House Banking Committee on the Global Economy, Washington, D.C. September 16, 1998.
9. Testimony of George Becker, President of the United Steelworkers of America, before the Banking and Financial Services Committee, U.S. House of Representatives, on the Asian Financial Crisis and the Role of the IMF, February 3, 1998.
10. Testimony of Raymond W. Bracy, Business Director, Asia Pacific, President, Boeing China, Inc., Boeing Commercial Airplane Group, Before the House Banking and Financial Services Committee, February 3, 1998.
11. Financial Committee of the House of Councillors, April 15, 1999. Kokkai Gijiroku Kensaku Sisutemu [The Diet Record Search System]. <http://kokkai.ndl.go.jp/>. Access date: May 3, 2012.
12. Testimony of Joseph D. Russo, President, IPSCO Steel Inc. Written Testimony Before the House Committee on Banking and Financial Services, February 3, 1998.
13. According to Woods (2006), the existence of “sympathetic interlocutors” such as the Berkeley mafia is essential to understanding the organization's treatment of borrowing countries.
14. The Meltzer Commission is officially known as the International Financial Institution Advisory Commission (IFIAC).
15. In one of the discussions on the reform of structural conditionality, an executive director commented: “We should keep in mind that one of the backdrops for this review was concern over excessive conditionality imposed in Indonesia in a crisis situation” MJ Callaghan, ED Australia. 2001. Conditionality in Fund-Supported Programs. Executive Board Meeting, BUFF/01/36. March 15. p. 44.



16. The IEO (2007) surveyed 300 economists within the organization (23 per cent response rate).

## 10 Theory, Evidence and Reform

1. Although my analysis contributes to this literature through my examination of the number of waivers granted for missed conditions, it was not possible to determine which countries failed to receive a waiver and were forcibly ejected from their IMF program.
2. Recent work on the IMF's role in the advanced economies includes its impact in European economies (Rogers 2012), Britain and France (Clift and Tomlinson 2004), its impact in Denmark, Sweden, Australia, and New Zealand (Broome and Seabrooke 2007), and Ireland (Breen 2012b).
3. The reforms were supported by the United States, who forced the European countries to give up two of their eight seats on the Executive Board (Wade 2011: 364). They achieved this by threatening to use the "nuclear" option that I referred to in Chapter 4 – the option where the United States can reduce the size of the Board from 24 to 20 seats.
4. Claire Jones and Jamil Anderlini. 2012. "Senior Chinese Officials Snub IMF Meeting." *The Financial Times*. October 10, 2012. <http://www.ft.com/intl/cms/s/0/b51dfd64-1284-11e2-868d-00144feabdc0.html#axzz28imgvnHZ> (access date May 10, 2012).
5. The United Kingdom, United States, and France were three of the 29 original signatories of the Bretton Woods agreement, with both Germany and Japan joining later in 1952.
6. For a theoretical exposition of this idea, see Ruggie's (1982: 393) concept of "embedded liberalism."
7. There is no consensus in the literature on this point. Further research indicates that the GATT/WTO has had a significant effect on trade among developed and developing countries (Goldstein *et al.* 2007). However, the benefits have been shared unevenly – going largely to developed countries (Subramanian and Wei 2003).

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# Index

## A

Africa, IMF lending in, 24  
agency slack, 55  
“agenda-setting” power, bureaucracy,  
14  
AIC (Akaike Information Criterion)  
score, 96  
Aldenhoff, Frank-Oliver, 17  
Amakudari, 149  
American Farm Bureau Federation  
(AFBF), 148  
Argentina, 48  
Armageddon option, 50, 51  
Articles of Agreement, IMF, 3, 13, 16,  
45, 49  
extracts from, 57  
Asian financial crisis, 141–56  
G5 economic exposure and  
conditionality during, 141  
Japanese banks exposure to, 142  
level of conditionality, 144–6  
shareholder exposure, 142–4  
Australia  
conditionality in, 152

## B

Bank Advisory Committee, 31  
Bank for International Settlements  
(BIS), 77–8  
banks  
blanket guarantee, 115  
economic exposure, 77  
G5 exposure, 88–9, 93, 106–7,  
116–8  
and IMF financing, 29, 30, 39  
binding conditions, conditionality,  
74, 75–6, 128, 133–6  
predicted rate of, 135  
BIS. *see* Bank for International  
Settlements (BIS)  
blanket bank guarantee, 115  
Blustein, Paul, 48  
Board of Governors, 13, 17

Boeing Commercial Airplane Group,  
149  
Boughton, James M., 153  
Bretton Woods system, 37, 47  
Brown, Chelsea, 77  
bureaucracy, 15–9, 153–4  
Greece, 114–5  
Iceland, 109–10  
Ireland, 119–20  
powers, 14

## C

Calomiris, Charles W., 21  
Carrubba, Clifford J., 52  
Celtic Tiger, 116  
change, defined, 133  
China, 47, 50, 51  
Chopra, AJ, 118  
Chwieroth, Jeffrey M., 18, 19  
Cold War  
impact, on IMF, 82  
concessional lending, IMF, 87–90  
concessions, political, 40  
conditionality, IMF, 4, 16–7, 71, 75–7,  
123–39  
agreement, 74  
and Asian financial crisis (*see* Asian  
financial crisis)  
binding conditions (*see* binding  
conditions, conditionality)  
dataset, 72–3  
G5 and, 123–5  
guidelines, 155  
in Indonesia, 151–2  
non-binding conditions (*see*  
non-binding conditions,  
conditionality)  
poisson regression model, 127–32  
by program reviews, 126  
quantitative performance criteria  
(*see* quantitative performance  
criteria (QPC))  
scope of, 126–7

- during Asian financial crisis, 147
- structural performance criteria (*see* structural performance criteria (SPC))
- variation in, 146
- waivers (*see* waivers, IMF conditionality)
- Conway, Patrick, 76
- Copelovitch, Mark S., 24, 51, 77, 88
- Council of Ministers, EU, 49
- Crédit Agricole, 111
- D**
- Darling, Alistair, 108
- dataset, conditionality, 72–3
- deposit guarantee scheme, 108
- doctrine of economic neutrality, 16
- Dreher, Axel, 77
- E**
- ECB. *see* European Central Bank (ECB)
- Economic and Financial Affairs Council (ECOFIN), 113
- economic exposure, G5, 77–80, 90, 93
- Ecuador, 21
- ED. *see* executive directors (ED)
- EEA. *see* European Economic Area (EEA)
- EFSS. *see* European Financial Stability Fund (EFSS)
- Egypt, 21
- EU. *see* European Union (EU)
- Europe, financial crisis in. *see* financial crisis
- European Central Bank (ECB), 105, 115
  - role as lender, 113
- European Economic Area (EEA), 106
- European Financial Stability Fund (EFSS), 113
- European Stability Mechanism, 113–4
- European Union (EU), 113
  - Council of Ministers, 49
- exclusion restriction, 98
- Executive Board, 6, 7, 13, 23, 24, 45, 48, 51
  - and conditionality review process, 126
  - negotiation with, 55
- executive directors (ED), 53–4, 65
  - term limits for, 49
- exporters
  - G5 exposure, 88–9, 93
  - and IMF financing, 29–30, 39
  - lobbying strategies, 33
- Extended Fund Facility, 4
- F**
- Feldstein, Martin, 154, 155
- financial crisis, 101
  - Asian (*see* Asian financial crisis)
  - as control variable, 80–2
  - in Greece, 110–5
  - in Iceland, 106–13
  - IMF programs and, 89–90
  - in Ireland, 115–20
  - Japan, 150
  - Mexico, 148
- Fischer, Stanley, 154
- Flanagan, Mark, 108
- Four Asian Tigers, 142
- France, 79
- functionalism, 20
- G**
- GDP. *see* gross domestic product (GDP)
- Geithner, Timothy, 119
- General Agreement on Tariffs and Trade (GATT), 20
- Germany, 51, 52, 105, 113
- Ghana, 29
- Gibbs, Alex, 54
- Golub, Jonathan, 95
- governments, 76
  - and IMF programs, 35–9
  - and lobbying, 31–5
- Governors. *see* Board of Governors
- Greece, 87
  - bureaucracy, 114–5
  - domestic politics, 114–5
  - financial crisis in, 110–5
  - G5 bank exposure to, 111, 112
  - role of G5 in negotiations, 111–4
  - security, 114–5
- Grímsson, Ólafur Ragnar, 110
- gross domestic product (GDP)
- growth
  - and IMF program approval, 93
  - macroeconomic variables and, 101

Group of Five (G5), 5–7, 24, 38, 40–1, 48  
 acceptance of IMF policy, 51–5  
 during Asian crisis, 141  
 banks and exporters, 88–9, 146  
 economic exposure, 77–80, 90, 93, 96, 133  
 to Asian crisis economies, 143  
 exposure  
 to Greece, 111  
 to Iceland, 106–7  
 to Ireland, 116–8  
 governance of IMF, 45–51  
 and IMF conditionality, 123–5  
 and IMF program approval, 98  
 and logrolling, 78, 79, 80  
 role in negotiations  
 Greece, 111–4  
 Iceland, 107–9  
 Ireland, 118–9  
 sanctions available to, 64–5  
 shareholders (*see* shareholders)  
 trade exposure, 101  
 voting power, 45  
 Group of Seven (G7), 22, 24, 35, 48  
 importance of, 46  
 Group of Twenty (G20), 118  
 Gunnarsdottir, Urou, 109

## H

Haruhiko Kuroda, 149  
 Hawkins, Darren G., 56  
 Heavily Indebted Poor Countries Initiative, 30–1  
 Heckman selection model, 98  
 results from, 99, 100  
 Hirschman, Albert O., 38  
 Hong Kong, 142  
 Honohan, Patrick, 116

## I

Iceland  
 banks, 106  
 bureaucracy, 109–10  
 dispute with United Kingdom/  
 Netherlands, 107–9  
 domestic politics, and IMF lending,  
 110  
 financial crisis in, 106–13

G5 bank exposure to, 106–7  
 security, 109–10  
 Icesave dispute, 107–9  
 IMF Stand-By Arrangement, Greece, 87  
 Independent Evaluation Office (IEO),  
 56, 59  
 individual investors, 29  
 Indonesia, 142, 153  
 during Asian financial crisis, 142,  
 144  
 conditionality in, 151–2  
 institutional checks, 61–4  
 interest groups  
 and IMF programs, 28–31  
 and lobbying (*see* lobbying, and  
 IMF programs)  
 International Monetary and Finance  
 Committee, 47–8  
 International Monetary Fund (IMF)  
 Articles of Agreement, 3, 13, 16,  
 45, 49  
 extracts from, 57  
 bureaucracy (*see* bureaucracy)  
 Cold War and, 82  
 conditionality (*see* conditionality,  
 IMF)  
 decision-making, shareholders role  
 in, 5–7  
 distribution of voting power at, 46  
 economic forecasts, 17  
 Executive Board (*see* Executive  
 Board)  
 as gatekeeper, 85  
 G5 governance of, 45–51  
 interest groups and, 28–31  
 international politics and, 43  
 large shareholders of, 23–5  
 lending, 85–103  
 capacity, changes in, 37, 38  
 concessional, 87–90  
 decisions, negotiations over, 87  
 and financial crisis in Europe  
 (*see* financial crisis)  
 non-concessional, 87–90  
 loans in SDRs, 73  
 loan size, 96, 98–103  
 lobbying strategies and, 31–5  
 managing director, 34  
 member-states, 55

- mission, 47–8, 64
- optimal policy approach, 15
- organizational culture, 18–9, 63
- policies
  - effects of politics on, 13
  - G5 acceptance, 51–5
  - on loans and conditionality, 4, 6
  - private financiers and, 25
- principal–agent relationship, 55–64
  - institutional checks and balances, 61–4
  - monitoring and reporting requirements, 58–9
  - rules vs. discretion, 56–8
  - screening and selection procedures, 59–61
- private actors and, relationship between, 34–5
- program approval, 73, 90–3
  - G5 and, 98
  - GDP growth and, 93, 95
  - probability of, 93, 94
  - variation in, 98
- program intervals, 93, 95–6
- public choice approach, 17–8
- quota, 23, 92
- reforms, 50–1
- role (in international relations), 1
- role (in world economy), 3–5
- sanctions, 64–6
- shareholders' impact on, 43–66
- Stand-By Arrangement, 3–4
- Structural Adjustment Facility, 4, 73, 74
- Supplemental Reserve Facility, 144
- Systemic Transformation Facility, 99
- as technocracy, 15–7
- United States position at, 21–3
- voting shares of, 50
- international organizations (IOs)
  - institutional design, 21
  - objectives, 20
- international politics, and IMF, 43
- international relations (IR)
  - IMF role in, 1
- Interprovincial Steel and Pipe Corporation (IPSCO), 150
- IOs. *see* international organizations (IOs)
- IPSCO. *see* Interprovincial Steel and Pipe Corporation (IPSCO)
- IR. *see* international relations (IR)
- Ireland
  - bureaucracy, 119–20
  - domestic politics, 119–20
  - financial crisis in, 115–20
  - G5 exposure to, 116–8
  - role of G5 in negotiations, 118–9
  - security, 119–20
- J**
- Japan
  - conditionality in, 152
  - financial crisis, 150
- K**
- Kang, Seonjou, 24
- Keynes, John Maynard, 57, 58
- Köhler, Horst, 155
- Korea, 142
  - during Asian financial crisis, 142, 144
  - IMF agreement, 150
  - IMF rescue, 146–7
  - negotiations with, 148
- Krueger, Anne, 36
- L**
- Lake, David A., 56
- Landsbanki, 107–8
- legitimacy, crisis of, 39
- Lehman Brothers, bankruptcy of, 106
- lending, IMF, 85–103
  - capacity, changes in, 37, 38
  - concessional, 87–90
  - decisions, negotiations over, 87
  - non-concessional, 87–90
- Lenihan, Brian, 116, 118
- letter of intent (LOI), 72
- Lipsky, John, 114
- Lissakers, Karin, 151
- loans. *see also* lending, IMF
  - IMF policies on, 4
  - size, IMF, 96, 98–103
- lobbying, and IMF programs, 31–5
  - domestic, 32–4
- logistic regression, 90, 91
  - substantive effects from, 92

logrolling, 52, 78, 79, 80

LOI. *see* letter of intent (LOI)

London Club, 31

Lundsager, Meg, 54

## M

Malaysia, 142

managing director (MD), IMF, 34, 59–60

Merkel, Angela, 115

Mexico, 32

financial crisis, 148

Micron Technology, 149

Momani, Bessma, 21

## N

NAEGA. *see* North American Export Grain Association (NAEGA)

National Cattlemen's Beef Association (NCBA), 148

NATO. *see* North Atlantic Treaty Organization (NATO)

negotiations

with Executive Board, 55

with Korea, 148

over IMF lending decisions, 87

role of G5 in (*see* Group of Five (G5))

shareholders' impact on, 150–2

Netherlands

dispute with Iceland, 107–9

Nielson, Daniel L., 56

non-binding conditions,

conditionality, 74–5, 131, 138

predicted rate of, 136

non-concessional lending, IMF, 87–90

North American Export Grain

Association (NAEGA), 148

North Atlantic Treaty Organization (NATO), 109, 114

## O

opportunity cost of membership, 36–7

optimal policy approach, IMF, 15

organizational culture, IMF, 18–9, 63

## P

Pakistan, 21

Papandreou, George, 110

Paris Club, 30, 31

PDR. *see* Policy, Development and Review (PDR)

Pickford, Stephen, 54

poisson regression model (PRM)

specification and findings, 127–32

Policy, Development and Review (PDR), 64

politics

bureaucracies and (*see* bureaucracy)

domestic

Iceland, 110

Ireland, 119–20

and IMF policies, 13

international, and IMF, 43

principal-agent relationship, 17–8, 55–64

institutional checks and balances, 61–4

monitoring and reporting requirements, 58–9

rules vs. discretion, 56–8

screening and selection procedures, 59–61

private financiers, impact on IMF policies, 25

PRM. *see* poisson regression model (PRM)

program decisions, IMF, 47

flow of, 48

program reviews, 72

conditionality by, 126

public choice approach, IMF, 17–8, 64–5

## Q

quantitative performance criteria (QPC), 74, 76, 129, 136–7

## R

reforms, IMF, 50–1

rent-seeking bureaucrats, 17–8

Rieffel, Lex, 48

Rubin, Robert E., 148, 149, 155

Russia, 107

## S

SAF. *see* Structural Adjustment Facility (SAF)

Sakakibara, Eisuke, 152

- sanctions, IMF, 64–6
- screening procedures, 61
- SDRs. *see* Special Drawing Rights (SDRs)
- Seabrooke, Leonard, 39
- shareholders. *see also* specific shareholders
  - economic/financial interests within, 146–50
  - exposure, Asian financial crisis, 142–4
  - impact on IMF, 5–7, 23–5, 43–66
  - impact on negotiations, 150–2
- Sigurgeirsdottir, Silla, 108
- Singapore, 142
- Société Générale, 111
- South Korea, 142, 153–4
- SPC. *see* structural performance criteria (SPC)
- Special Drawing Rights (SDRs), 37, 39, 47
  - IMF loan in, 73
- SPR. *see* Strategy, Policy and Review Department (SPR)
- SRF. *see* Supplemental Reserve Facility (SRF)
- Stand-By Arrangement, 3–4
- Stone, Randall, 3, 5, 24, 51, 77, 125
- strategic interests, 39–41
- Strategy, Policy and Review Department (SPR), 59, 62
- Strauss-Kahn, Dominique, 111, 118
- Structural Adjustment Facility (SAF), 4, 74, 75
- structuralism, 20
- structural performance criteria (SPC), 74, 76, 130, 137
- Supplemental Reserve Facility (SRF), 144
- Systemic Transformation Facility, IMF, 99
- systemic transition, 102
- T**
  - Taiwan, 142
  - taxpayers, and IMF financing, 29
  - technocracy, IMF as, 15–7
  - Thacker, Strom C., 21–2
- Thailand
  - during Asian financial crisis, 142, 144
- Thirkell-White, Ben, 39
- Tierney, Michael J., 56
- trade exposure, 78
- Trichet, Jean-Claude, 118
- U**
  - UN. *see* United Nations (UN)
  - United Kingdom (UK), 48
    - dispute with Iceland, 107–9
    - political system, 33, 47
  - United Nations (UN)
    - Security Council, 22, 40
    - voting patterns in, 21, 22
  - United States, 79
    - domestic interests, Asian crisis and, 150–1
    - during Korea rescue, 146–7
    - political power of, 47
    - position at IMF, 21–3
    - strategic interests of, 39, 152–3
    - voting power, 45
- V**
  - Vaubel, Roland, 17
  - Volden, Craig, 52
  - voting power
    - distribution at IMF, 46
- W**
  - Wade, Robert H., 108
  - waivers, IMF conditionality, 76–7, 132, 138–9
    - predicted rate of, 136
  - Wald chi-squared test, 102–3
  - Wald test, 102
  - Wall Street–Treasury–IMF complex, 34, 35
  - Weibull distribution, 95, 96
  - Willett, Thomas D., 17
  - Woods, Ngaire, 63
  - World Bank, 20
  - world economy
    - IMF's role in, 3–5
  - World Trade Organization (WTO), 20