Controlling Institutions

How is the United States able to control the IMF with only 17 per cent of the votes? How are the rules of the global economy made? This book shows how a combination of formal and informal rules explain how international organizations really work. Randall W. Stone argues that formal rules apply in ordinary times, while informal power allows leading states to exert control when the stakes are high. International organizations are therefore best understood as equilibrium outcomes that balance the power and interests of the leading state and the member countries. Presenting a new model of institutional design and comparing the IMF, WTO and EU, Stone argues that institutional variations reflect the distribution of power and interests. He shows that US interests influence the size, terms and enforcement of IMF programs, and new data, archival documents and interviews reveal the shortcomings of IMF programs in Mexico, Russia, Korea, Indonesia and Argentina.

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International Organizations and the Global Economy

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To Norma and Robert Koenig

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Preface

As I write these words, the international economy is emerging from its most serious crisis since the Second World War. The Great Recession began in the US housing market, but quickly spread through the global network of financial institutions to affect every country in the world, most much more severely than the United States. The crisis has underscored weaknesses that had become apparent earlier in the institutions that govern the global economy – the International Monetary Fund (IMF, or the Fund), the World Trade Organization (WTO) and the European Union (EU); each of these institutions suffers from a severe crisis of legitimacy and effectiveness. Sweeping changes have been proposed in the architecture of international governance, and significant reforms have been introduced in the IMF and the EU. Meanwhile, politics continues: many states are seeking unilateral or bilateral rather than multilateral policy solutions, and the existing international governance mechanisms appear to be inconsistent with the changing distribution of global power.

The IMF responded to the impact of the crisis in some of the peripheral countries, including Belarus, Hungary, Iceland, Latvia, Pakistan, Romania, Ukraine, and finally Greece, but its resources were woefully inadequate to address the problems in the core countries. As the crisis deepened, the IMF's leading members tripled the size of its available resources, but it was apparent that states and their central banks remained the major players in international finance. The EU was challenged by the depth of the financial crisis in its poorer members, which seemed to threaten the stability of the euro zone and called for coordinated responses that were slow to emerge. As a result, a renewed debate arose about changing EU governance mechanisms. It remains to be seen what the effects of the crisis will be on the trade regime, where the WTO has developed into a robust legal regime for adjudicating disputes, but has been unable to advance an agenda of liberalizing trade and investment rules since the close of the Uruguay Round. Each of these institutions is profoundly affected by shifts in the distribution of global economic power, each is struggling to establish its legitimacy, and each is continuously reforming itself.

This project began as a study of the governance mechanisms of the IMF, but as the principles behind IMF governance emerged, it became clear that the argument applied broadly to international organizations of all sorts. In 2007, the Independent Evaluation Office of the IMF asked me to write an evaluation of IMF governance during financial crises of systemic importance to the world economy. As a temporary insider, I was granted access to reams of fascinating documents and was given a guided tour through the corridors of power at the Fund.[1] Perhaps most importantly, I had the opportunity to interact on a daily basis with Fund personnel and test my hypotheses against the accumulated experience of numerous careers in the IMF. As the author of a previous book and several articles on the IMF, I thought of myself as a bit of an expert on the subject, but I soon learned that many of my preconceived notions were erroneous. In particular, I had long been aware that the United States exercised a great deal of influence in the IMF, but I had never really asked the question, how is it that a country with (now almost) 17 percent of the votes can exert so much control? Once I learned the answer, I felt that I had to write this book; and along the way, I discovered that the answer shed a lot of light on other institutions, including ones that are deliberately designed to be quite different from the IMF. I framed my emerging understanding in the form of a formal model that is broadly applicable to international organizations, and indeed to many other sorts of organizations. The project gradually developed into a book about international organizations that treats the IMF as a focal case rather than a book about the IMF and financial crises.

Some readers (including one anonymous reviewer) may be suspicious of the claim that a single model of informal governance can explain essential features of the politics of diverse international organizations. I suspect, and indeed hope, that the reviewer has struck upon a question that will arise whenever the book is discussed. Most critics will concede the empirical analysis and description of the IMF case, which inspired the model, but may question the claims that the logic of informal governance works in similar ways in diverse institutional settings, and that the model illuminates the reasons for institutions for different issue areas to be structured in different ways. Had I wanted to write an uncontroversial book, I could have done so by scaling back my claims to the least common denominator that would evoke general agreement. However, I would miss the opportunity to draw what I think is the essential insight from the model, which is that institutional design is largely determined by the

[1] As a condition of this access, I was required to maintain the anonymity of my interview subjects. I apologize for the consequent lack of transparency in the footnotes.

balance of power and interests – in a precise way that the model delineates – rather than by technocratic efficiency.

More broadly, the book contradicts the conventional wisdom among students of international organizations that these institutions are efficient by design and designed to minimize transaction costs.[2] This view reflects a strong intellectual tradition in the economics of organization,[3] and a very influential strain of research in international relations variously described as institutionalism, neoliberalism, or neofunctionalism.[4] I argue that institutional design is mainly a matter of balancing power and interests rather than of minimizing costs. While realists in international relations have long suspected as much, they have never had anything very precise or rigorous to say on the subject.

The last part of the book conducts a detailed empirical study of IMF lending using new data and a series of case studies focusing on financial crises in Mexico (1995), Indonesia (1997), Korea (1997), Russia (1998) and Argentina (2001). Readers may be surprised to find how decisively the United States controls the size of IMF loans, the conditions attached to them and their enforcement. This is an important empirical claim of this book, which will surprise some experts on the IMF. There is a substantial literature that has focused on US manipulation of the IMF, but it is generally believed that the G-7 countries share control of the Fund broadly, and it came as a surprise to me to discover the degree of US dominance of important lending decisions as I investigated the individual cases. This, in turn, was confirmed by statistical analysis with a global sample. My analysis could not always reject the hypothesis that other G-5 countries affected the size, terms and enforcement of IMF programs, but generally did so. When other G-5 countries had an effect, it was generally much weaker than the effect of US influence. Whenever a strong comparative test was possible because the measures of US influence and G-5 influence were not highly correlated, the results supported the hypothesis of US influence and rejected the hypothesis of G-5 influence. I published some of the first systematic evidence that the IMF was manipulated by countries other than the United States in an article about Africa in 2004, but revisiting those results, I found that French influence over the terms of IMF programs appears to be limited strictly to Africa, parts of which have been ceded by the United States as a *de facto* French sphere of influence.

Along the way, I have accumulated a large number of intellectual debts. Many of the people I mention here will disagree with some of the arguments I advance, and none of them are responsible for my interpretation of my

2 Koremenos *et al*. 2001; Hawkins *et al*. 2006.
3 Williamson 1985; Milgrom and Roberts 1992.
4 Keohane 1984; Milner and Moravcsik 2009.

findings or for any mistakes I may have made. However, they have improved the final product immensely with their comments, criticism, and occasional opposition. It was an extraordinary opportunity to work closely with the staff of the IEO, and particularly with Ruben Lamdany. I am grateful to former and current IMF officials for their cooperation in providing interviews and access to documents, to the IEO for its support and valuable input from its staff, and to Borislava Mircheva and Roxana Pedraglio for valuable research assistance. In addition, Leonardo Martinez-Diaz, Ruben Lamdany, Thomas Bernes, Nils Bjorksten, Mariano Cortes, Iqbal Zaidi and Borislava Mircheva provided valuable comments and numerous critical insights. The IEO operates within narrow parameters as a unit of the IMF, and in the end it was decided that my paper was too sensitive for them to publish.[5] However, I have immense respect for the people who try to evaluate the IMF from the inside, and I believe their research has led to numerous important findings.

I have been privileged to be able to present my findings over the last two years at some of the top political science departments in the United States, and I wish to thank the faculty and students at Princeton, Harvard, Yale, UCSD, Duke, Tufts, and Rochester for their penetrating questions and comments. I presented this work at the Conference on the Political Economy of International Organizations, the International Political Economy Society, and the Political Economy of International Finance, and at conferences at Beijing University and Jagiellonian University in Kraków, and I thank the audience members for their probing questions and valuable suggestions. Special thanks go to Graham Bird, Lawrence Broz, Clifford Carruba, Mark Copelovitch, Gary Cox, Christina Davis, Axel Dreher, Jeffrey Dunhoff, Simon Hug, Judith Kelley, Robert Keohane, Mareike Kleine, David Lake, Helen Milner, Timothy McKeown, Ashoka Mody, Andrew Moravcsik, Layna Mosley, Thomas Oatley, Eric Reinhardt, Kenneth Scheve, Christina Schneider, Beth Simmons, Branislav Slantchev, James Vreeland, Thomas Willett and several anonymous reviewers. I have received copious suggestions on selected chapters from Deniz Aksoy, Christina Davis, Jeffrey Dunhoff, Alexandra Hennessey, Simon Hug, Bob Keohane, Mareike Kleine and Christina Schneider. Above all, I thank my graduate and undergraduate students at the University of Rochester, who have forced me to hone my arguments. Several of them have served as research assistants at various stages, including Jeffrey Arnold, Youngchae Lee, Jeffrey Marshall and Martin Steinwand. I thank Jeffrey Marshall in addition for typesetting the book in LaTeX. Surjya Ray designed the cover, and I thank CBC for permission to use the photograph. The cover depicts a protest in Thessaloniki, Greece, on May 2,

[5] A summary of the findings was published in Stone 2009a, and is available at www.ieo-imf.org/eval/complete/pdf/05212008/BP08_14.pdf.

2010, after the Greek government announced the policy conditions attached to the agreement by the IMF and euro zone members to extend 110 billion euros in loans. The slogan on the central banner translates as "Down with the Junta of PASOK [the initials of the governing socialist party] – EU – IMF," leaving little doubt about how the protestors felt about multilateral institutions.

I wish to thank the publishers of some of my articles for allowing me to draw on them for short passages from my 2004 *APSR* article, my 2008 *IO* article, my 2008 *RIO* article, and my chapter in Milner and Moravcsik.[6] One table and one figure are adapted from the 2008 *IO* article. All of the data analysis is new for the book. My discussion of the Russia case in Chapter 8 draws heavily on my previous Princeton University Press book, *Lending Credibility* (2002), but all the other cases are based on new research.

6 Stone 2009b.

List of abbreviations

APD	Asia and Pacific Department, IMF
CAFTA	Central American Free Trade Area
CAP	Common Agricultural Policy
CDU	Christian Democratic Union (German)
CFF	Compensatory Financing Facility
EC	European Community
ECB	European Central Bank
EcoFin	Council of Economic and Finance Ministers
ED	Executive Director, IMF
EEC	European Economic Community
EFF	Extended Fund Facility, IMF
EMS	European Monetary System
EMU	Economic and Monetary Union
ESAF	Extended Structural Adjustment Facility, IMF
EU	European Union
G-7	Group of Seven
G-10	Group of Ten
G-20	Group of Twenty
GATT	General Agreement on Tariffs and Trade
IBRD	International Bank for Reconstruction and Development
IEO	Independent Evaluation Office, IMF
IMF	International Monetary Fund
IMFC	International Monetary and Financial Committee
MFN	Most Favored Nation status
MTS	Medium Term Strategy
NAFTA	North American Free Trade Area
OECD	Organization for Economic Cooperation and Development
PDR	Policy Development and Review Department, IMF

PRGF	Poverty Reduction and Growth Facility, IMF
PTA	Preferential Trade Agreement
QMV	Qualified Majority Voting
SAF	Structural Adjustment Facility, IMF
SBA	Stand-By Arrangement, IMF
SEA	Single European Act of 1986
SPD	Social Democratic Party of Germany
SPE	Subgame Perfect Equilibrium
UN	United Nations
UNSC	United Nations Security Council
WHD	Western Hemisphere Department, IMF
WTO	World Trade Organization