1 *The International Monetary Fund in the global economy*

Introduction

This is a book about the impact of globalization on international politics. To be more specific, it is a book about the connection between changes in the composition of international capital flows and changes in the politics and policymaking of the International Monetary Fund (IMF, or Fund), the central institution of global financial governance. Financial globalization – the explosive growth in the size, depth, and complexity of international markets – is the defining characteristic of the contemporary world economy. Indeed, international financial integration today has reached (and in many ways surpassed) levels not seen since the "first globalization," in the era prior to World War I (WWI).[1] Over the last three decades private international capital flows to developing countries have grown exponentially, from nearly zero in 1970 to $491 billion in 2005.[2] Daily foreign exchange trading has increased from $850 billion in 1986 to $3.2 trillion in 2007.[3] In the first quarter of 2007 commercial banks reported $25 trillion in total foreign claims, up from $17 trillion in 2005.[4] At the same time, international investors held over $20 trillion in sovereign and private bonds, with net issuance increasing at a rate of 18 percent per year.[5]

Unfortunately, as starkly illustrated by both the current global crisis and the major upheavals of the 1980s and 1990s, this resurgence of financial globalization has been accompanied by a corresponding increase in the frequency and severity of financial crises.[6]

1 Frieden (2005); James (2001); Frankel (2000).
2 World Bank (2006).
3 BIS [Bank for International Settlements] (2007a).
4 BIS (2007b).
5 Ibid. By comparison, worldwide annual trade (exports) totaled $12.4 trillion in 2006 (http://stat.wto.org).
6 Bordo *et al.* define financial crises as "episodes of financial-market volatility marked by significant problems of illiquidity and insolvency among

The macroeconomic impact of these crises has been dramatic and severe: cross-country estimates suggest that the output losses resulting from recent crises have, on average, equaled over 10 percent of GDP, while the fiscal costs of resolving banking crises in developing countries exceeded $1 trillion in the 1980s and 1990s.[7] The damage caused by financial crises also has real and costly implications for individuals. Crises nearly always result in severe inflation and rising unemployment, both of which undermine living standards and contribute to rising levels of poverty in crisis-stricken countries. Furthermore, government bailouts of failed banks can result in dramatic reductions in social spending, and bank failures can eliminate the savings of millions of citizens. For example, many of these adverse effects were starkly apparent during the height of Argentina's financial crisis in 2001–2002, when unemployment rates approached 25 percent, poverty rates surpassed 50 percent, and the collapse of several major financial institutions wiped out the savings of many middle-class Argentines.[8] Closer to home, the fallout from the subprime mortgage crisis has had substantial real effects on the US economy: unemployment and home foreclosures are on the rise, economic growth has ground to a halt, and millions of individuals have seen their retirement savings washed away as financial markets have collapsed.

More broadly, financial distress in one country can have severe consequences for broader regional and global financial stability. This risk of cross-border financial "contagion" has increased dramatically in recent years, as a result of the surge in global financial integration and capital mobility. Indeed, sharp reversals in the direction and magnitude of international bank lending and bond financing now frequently transmit financial instability from one market to the next with nearly unprecedented speed. For example, the collapse of cross-border

financial-market participants and/or by official intervention to contain such consequences" (2001: 55). Financial crises encompass both banking crises, in which financial distress erodes the capital reserves of the banking system and results in the failure of major banks in a country, and currency crises, in which governments face speculative attacks on their exchange rates. In most major financial crises, both elements (banking distress, currency crashes) are evident.

[7] Barth, Caprio, and Levine, (2005); Caprio and Klingebiel (2003); Hoggarth, Reidhill, and Sinclair (2003).

[8] Mishkin (2006).

interbank lending in 2007/8, as a result of the subprime mortgage crisis in the United States, led directly to the failure of Northern Rock (the eighth largest bank in the United Kingdom) and the dramatic collapse of Iceland's economy. Similarly, Thailand's financial and currency crisis in mid-1997 rapidly escalated into a global problem, as international investors pulled their money out of South Korea, Indonesia, and other east Asian markets and instability spread to a number of eastern European and Latin American countries.

In short, cross-border financial crises have become a defining feature of the international financial system over the last three decades. In this environment, the IMF has occupied center stage in efforts to manage these crises and restore global financial stability.[9] Above all, the Fund's key role has been that of de facto international lender of last resort (LOLR): it has served as a source of emergency financing to countries facing financial and currency crises or an inability to repay their international debt.[10] Since the onset of the Latin American debt crisis in 1982, the IMF has provided over $400 billion in such loans to developing countries. Most recently, the Fund has lent more than $85 billion in credit to eighteen countries (including Belarus, Hungary, Iceland, Latvia, Pakistan, Romania, and Ukraine) hit hardest by the global credit crunch.[11] In exchange for this assistance, the Fund has gained substantial control over economic policymaking in its borrower countries through its use of conditionality – the policy reforms it requires in return for credit.

The IMF's role as lead crisis lender in the global economy has transformed it into one of the world's most powerful multilateral institutions. At the same time, however, the Fund's central role in global financial governance has subjected it to a firestorm of criticism in developing countries and the industrialized world alike. The IMF's critics have assailed it for a variety of shortcomings, including failing to maintain global financial stability, misdiagnosing the causes of (and solutions to) financial crises, exacerbating poverty in the developing world, and catering

9 On the sources and mechanisms of contagion, see Claessens and Forbes (2001) and Eichengreen, Rose, and Wyplosz (1996).
10 Strictly speaking, the IMF is not a true lender of last resort, as it cannot issue its own currency and its loans do not meet Walter Bagehot's (2006 [1873]) classic criteria. Nonetheless, the IMF is the closest substitute to a LOLR in the current world economy (Kenen 2001).
11 See www.imf.org/external/np/fin/tad/extarr1.aspx.

to the demands of Wall Street bankers and rich-country governments.[12] These critiques intensified in the aftermath of the major financial crises of the mid to late 1990s, as numerous academics and policymakers advocated the radical curtailment of the IMF and its lending policies.[13] Indeed, even those deeply involved in shaping global policy responses to these crises, such as former US Treasury secretary Robert Rubin, called for substantial reform of the "international financial architecture," in order to avoid the need for future large-scale IMF loans and to enhance global financial stability in the coming decades.[14] In short, virtually no one in today's global economy is happy with the IMF, and almost everyone has a proposal for how it should be reformed.[15]

The policy debate about the IMF's role in governing the global financial system is important, but it has developed in the absence of a full and clear understanding of how the Fund operates and makes policy decisions. In fact, analytical studies of the IMF and its policies are surprisingly limited given the amount of ink devoted to more normative critiques of the Fund.[16] This gap in the political economy literature is problematic, in view of the substantial variation in the IMF's lending policies over the last two decades. During this period many of the IMF's loans have far exceeded the standard amount of financing these borrowers were eligible to receive under the Fund's quota-based credit system; others, however, were substantially smaller in size.[17] Similarly, the Fund's use of conditionality has varied greatly over the last twenty years, with some loans containing only a handful of conditions, while others require the borrower country to implement a wide variety of economic policy reforms in exchange for IMF credit.[18]

[12] See, for example, Stiglitz (2002).
[13] Calomiris (1998); Meltzer (2000).
[14] Rubin (1998).
[15] Eichengreen (1999), Kenen (2001), and Truman (2006) provide comprehensive surveys of these proposals.
[16] See Stone and Steinwand (2008) and Joyce (2004) for surveys of the existing empirical literature on IMF lending.
[17] The IMF operates similarly to a credit union: each member state provides a portion of the Fund's lendable "quota" resources and is eligible to borrow in proportion to these contributions. Country quotas are determined largely by country size: a country's gross domestic product (GDP) and its quota are almost perfectly correlated (0.92). See www.imf.org/external/np/exr/facts/quotas.htm.
[18] Appendix 1 illustrates the substantial variation in IMF lending from 1984 to 2003. I discuss this variation in both loan size and conditionality in further detail below.

Until very recently, explaining this variation in IMF lending was a topic of interest only to academic economists, central bankers, and economic policymakers. By and large, the economics and policy literatures treat the Fund as an apolitical institution whose policies are set by its staff of macroeconomic experts, based on a combination of country-specific and global macroeconomic factors.[19] Variation in IMF lending, in this view, is simply the result of cross-national differences in borrower countries' financial needs and economic characteristics, as well as changes over time in global financial conditions such as world interest rates and levels of financial stability. This "technocratic" view of IMF lending contrasts starkly with popular perceptions of the Fund, however. The conventional wisdom among the media, politicians, and the general public is that the IMF is an overtly *political* institution. Nevertheless, there is considerable disagreement about the nature of politics within the IMF. Some observers accuse the Fund of being a "pawn" or "lapdog" of the government of the United States.[20] In this view, the IMF provides "bailouts" (i.e. large loans on lenient terms) to countries deemed important by the US Treasury or national security officials, whether or not such policies are warranted by economic conditions. In contrast, others attack the Fund for being a "runaway" bureaucracy, neither accountable to its member states nor responsive to the needs of its borrowers.[21] Former US Senator Lauch Faircloth (Republican – North Carolina) articulated this view most colorfully during the Asian financial crisis, when he attacked the Fund as "a set of 'silk-suited dilettantes' given to a diet of 'champagne and caviar at the expense of the American taxpayer.'"[22] From this perspective, the IMF is yet another example of the threat posed by globalization to national sovereignty and governments' economic policy autonomy.

While recent studies in international political economy provide some empirical support for each of these political views of the IMF, scholars continue to disagree about the key economic and political determinants of Fund lending behavior. Indeed, despite the recent

19 Knight and Santaella (1997); Bird and Rowlands (2003); Joyce (2004).
20 David E. Sanger, "A Fund of trouble: as economies fail, the IMF is rife with recriminations." *New York Times*, October 2, 1998.
21 Ibid.
22 David Rogers, "IMF funds approved by Senate." *Wall Street Journal*, March 27, 1998.

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surge in scholarly work on the IMF, many critical questions about the Fund and its policies remain unanswered.[23] What explains the substantial variation in the size and terms of IMF loans? To what extent is IMF lending driven by political factors rather than economic concerns? Why does the Fund treat some countries more generously than others, and why does this vary over time, even for individual borrowers? In whose interests does the IMF act? More broadly, what do the politics and policies of the IMF tell us about the dynamics of policymaking within international organizations in general? This book offers answers to these empirical and conceptual puzzles.

The argument in brief

My central argument in this book is that the IMF's lending policies have varied systematically over the last two decades in response to changes in patterns of financial globalization. Variation in the composition of private international capital flows, I argue, has shaped the preferences of both the Fund's largest shareholder countries and its professional staff economists over IMF lending decisions. In turn, changes in these actors' preferences explain variation in the size and terms of Fund loans over time and between cases. Thus, IMF lending is not a technocratic process; rather, the Fund is a highly political institution whose policies depend on the interests of not only its largest shareholders but also its bureaucrats, both of whom exercise partial but incomplete control over IMF policymaking. In order to explain the politics of IMF lending, it is therefore necessary to understand how the composition of international capital flows has changed over time, as well as how these changes affect the preferences of the key actors involved in Fund decision-making.

In contemporary global finance, countries borrow in different ways from a number of different lenders. Some governments rely on bank lending from a handful of large commercial banks located in the advanced industrialized countries, while others issue sovereign bonds to investors around the world. In some countries governments are the

[23] Recent studies include those by Dreher and Jensen (2007), Broz and Hawes (2006), Gould (2006), Vreeland (2005), Copelovitch (2005), Oatley and Yackee (2004), Stone (2008, 2004, 2002), Dreher and Vaubel (2004a), and Thacker (1999).

primary international borrowers, while in others private firms have joined in the search for foreign capital. Finally, some countries borrow funds primarily from one or two of the world's largest economies – such as the United States or the United Kingdom – while others have a more heterogeneous portfolio of country creditors. This variation in the composition of international capital flows shapes the politics of IMF lending in two ways. First, it determines the preferences of the Fund's largest shareholder countries, the "G-5" governments (the United States, Japan, Germany, the United Kingdom, and France), over the size and terms of IMF loans. These countries exercise de facto control over the IMF executive board and act collectively as the Fund's political principal. At the same time, they are also home to the largest private creditors in global markets, including the world's largest commercial banks. As a result, the financial exposure of G-5 commercial banks heavily influences G-5 governments' preferences over IMF lending policies. Consequently, IMF loan size and conditionality vary widely based on the *intensity* and *heterogeneity* of G-5 governments' domestic financial ties to a particular borrower country. When private lenders throughout the G-5 countries are highly exposed to a Fund borrower, G-5 governments collectively have intense preferences and are more likely to approve larger IMF loans with relatively limited conditionality. In contrast, when G-5 private creditors' exposure to a country is smaller or more unevenly distributed, G-5 governments' interests are weaker and less cohesive, and the Fund approves smaller loans with more extensive conditionality.

Second, variation in the composition of private international debt also shapes the IMF staff's own preferences over the characteristics of Fund loans. While G-5 governments exercise ultimate control over the IMF's lending decisions, the Fund's professional staff enjoys substantial autonomy over its day-to-day operations. The IMF staff acts as the member states' agent in negotiating lending arrangements with borrowers, and it enjoys agenda-setting power over the executive board: the board cannot approve a loan without first receiving a staff proposal. Moreover, while the executive board formally has the authority to amend staff proposals, it rarely does so in practice.[24] These delegated responsibilities give the staff significant influence over IMF lending. As with G-5 governments, IMF staff

[24] Martin (2006); Gould (2006); Southard (1979).

preferences over Fund loan characteristics vary systematically based on patterns of financial globalization. Unlike G-5 governments, however, the IMF staff is focused more broadly on the Fund's key policy objectives: assisting borrower countries in resolving their balance of payments problems and facilitating their return to private international capital markets.[25] IMF programs, therefore, are not intended to be a long-term substitute for private capital flows; rather, a Fund loan is intended to signal to private international creditors that "a country's economic policies are on the right track, it reassures investors and the official community and helps generate additional financing. Thus, IMF financing can act as a *catalyst* for attracting funds from other sources."[26]

Triggering this "catalytic effect" on private capital inflows has been a key policy goal of the IMF since the Latin American debt crisis of the 1980s. Two changes in the composition of international capital flows have made achieving this goal more difficult for the Fund, however. On the one hand, the composition of *international creditors* has changed, as bondholders have increasingly replaced commercial banks in global financial markets. On the other hand, the composition of *international borrowers* has also evolved, as private firms have joined sovereign governments in search of foreign capital. Together, these changes in international debt composition have significantly complicated the IMF staff's central policy goal of "catalyzing" private capital flows. The shift from bank lending to bond financing, as well as the shift from sovereign borrowing to "private–private" flows, has increased collective action problems among private international creditors and made it less likely that they will respond to an IMF loan with new lending of their own. At the same time, the shift from sovereign borrowing to "private–private" debt has also reduced the efficacy of IMF conditionality. In sovereign borrowing cases, the logic of conditionality remains intact: the Fund can provide a loan covering part of a government's payments deficit, while requiring it to undertake policy reforms aimed at closing the rest of the financing gap. In cases in which non-sovereign debt predominates, however, standard

[25] My claim is not that G-5 governments are uninterested in these goals. Rather, I argue that such concerns are often subordinated to their domestic financial interests, whereas they are the primary concern of Fund bureaucrats.
[26] See www.imf.org/external/pubs/fr/exsp/what.htm.

IMF macroeconomic conditionality is less effective: even if the government undertakes policy reforms, these reforms will not necessarily solve the country's balance of payments problems, which are driven primarily by private borrowers' behavior.

In response to these changes in the composition of international capital flows, I argue, the IMF staff has altered the characteristics of the lending programs it designs and proposes to the executive board for approval. All else equal, the Fund staff has proposed larger loans with more extensive conditionality to countries whose external debt consists of larger shares of bond financing and non-sovereign borrowing. In these cases, more IMF financing and more extensive policy adjustment are necessary, since stronger signals are required in order to generate "catalytic financing" from a disaggregated, heterogeneous group of private international lenders. In contrast, when international capital flows consist primarily of sovereign bank lending, IMF loans typically are more modest in size and contain somewhat fewer policy conditions.

In sum, the IMF's lending policies have varied substantially over the last two decades in response to variation in the composition of international capital flows. Changes in the patterns of financial globalization shape the preferences of both key actors involved in IMF decision-making: G-5 governments and the Fund's professional staff. In turn, IMF lending behavior varies over time and between cases in accordance with shifts in the composition of private international lending to the Fund's borrower countries.

The IMF and international relations

Given the IMF's central role in governing global financial markets, understanding and explaining what it does is a critical issue not only for economists and those interested in international finance but also for international relations scholars studying both international political economy and international cooperation. Indeed, by focusing on the politics of IMF lending, this book engages one of the core puzzles in international political economy: what is the relationship between markets and politics? Ultimately, it offers two answers to this critical question. First, it argues that global markets shape international politics by influencing the domestic preferences of the largest countries in the world economy – countries that are both the major creditors in the international financial system and the dominant political actors within the IMF. Second, the book argues that the structure of global financial markets also shapes the preferences of supranational bureaucrats within the international financial institutions. In particular, changes in the composition of international capital flows shape the IMF staff's own expectations about market actors' responses to the Fund's lending policies. Thus, this study provides important insights into the complex and dynamic patterns of interaction between states, international organizations, and markets in the contemporary global economy.

More broadly, understanding the IMF and its policies has important implications for theories of international cooperation and international institutions. In particular, it enhances our understanding of the internal politics and policymaking processes within international organizations. By focusing directly on the dynamics of policymaking within one of the largest and most important multilateral institutions, this book sheds light on an important yet under-researched question: what exactly do international organizations do, and what factors most affect their behavior? Surprisingly, international relations scholars have paid relatively little attention to this question about the policies, or "outputs," of international institutions. Rather, most work in the field has sought to develop and test theories of various "outcomes" of international cooperation. For many years scholars of international institutions sought primarily to explain states' initial decisions to engage in cooperation and create international institutions.[27] More recently, the literature has shifted toward explaining other types of "outcomes," including choices about the design of international institutions,[28] as well as the sources of and variation in compliance with the rules they produce.[29] This extensive literature on outcomes has significantly enhanced our understanding of both the "beginning" (cooperation/institutional design) and "end"

[27] Keohane (1984); Snidal (1985); Martin (1992); Martin and Simmons (1998).
[28] Raustiala (2006); Koremenos (2005); Koremenos, Lipson, and Snidal (2001); Abbott and Snidal (2000).
[29] Von Stein (2005); Simmons and Hopkins (2005); Simmons (2000); Downs, Rocke, and Barsoom (1996); Chayes and Chayes (1993). The literature on international cooperation and institutions is too extensive to summarize here fully and adequately. See Martin and Simmons (1998) and Simmons and Martin (2002) for comprehensive overviews.