1997). An in-depth study of the U.S. politics of aid to India documents that in the spring of 1966 the departments of State and Agriculture were pushing for more food aid with less conditionality for India (Paarlberg 1985, 144–57). Taking the opposite view was the White House and a very hands-on president determined to keep India on a short leash, particularly in light of India's criticisms of U.S. policy on Vietnam (Varshney 1989, 313). What the U.S. executive seemed not to understand was that the more strongly they pushed the Indian government to submit on economic policy, the more the Indian government had to prove that it was not kowtowing to the United States—principally through ever stronger criticism of the United States in Vietnam (Paarlberg 1985).

The United States is the largest shareholder and the home base of the IMF and World Bank. It enjoys a high degree of influence over both institutions, which it has maintained even as its relative contributions to the institutions have decreased. Yet the U.S. government, riven with competing foreign policy cliques, does not control all that the institutions do.

In the 1940s ideas, beliefs, and values played a critical role in creating the institutions. A bold new vision of international cooperation displaced an alternative, less formal, decentralized form of coordination that could have met U.S. interests. In the design and governance of the institutions a modest equalizing principle was enshrined and a degree of independence was conferred on the institutions, belying the view that the most powerful state at the time would simply create a structure maximizing its own control.

Through time the relative independence of the IMF and the World Bank has been eroded. The Cold War added political imperatives to the preferences of their major shareholders, as did the end of the Cold War and the desire to ensure a particular kind of transition in the former Soviet bloc. Furthermore, as each institution has expanded, it has become more reliant on direct U.S. approval for some portion of its resources. This has given the United States more influence within each institution. However, this does not mean that the United States dictates all policies of the institutions.

U.S. preferences are not always clear cut. Nor are the means to achieve them. As this chapter has illustrated, there can be competing voices and lobbies within the United States about a country and how it should be treated by the multilateral organizations. This opens up a space for the institutions to provide alternative technical ideas and financing plans for a member country, and to broaden the debate about the goals of their policies within that country. Furthermore, as I will explore in the next two chapters, even where the preferences of the most powerful shareholder in the IMF and World Bank are clear, those goals still need to be translated into policies that are in turn implemented and enforced by other governments.

Put simply, U.S. geostrategic motives and pressures have defined the parameters within which the IMF and World Bank work. But translating those preferences into policy requires ideas about ends and means, and instruments and institutions to implement them. Here the IMF and World Bank play a crucial role, not entirely controlled by the Unites States, which we will now explore.

Chapter 2

THE GLOBALIZING MISSION

When the Bank and Fund were created, there was no existing history or economic theory that would assist in defining to whom they should lend or under what conditions. Nor did their charters assist in answering how they might practically achieve the broad objectives set for them. Each institution would have to define its tasks and tools. Although from the start political influence was rife within each institution, national interests could not determine operational decisions. Why? Because as Krasner has so aptly put it, life at the Pareto frontier presents several alternatives (Krasner 1991). Even where a powerful state's objectives are clear, the choice of how to achieve those objectives is often unclear.

The IMF has to interpret the "adequate safeguards" provision—so brutally fought for in the Bretton Woods negotiations. What conditions should be imposed on borrowers to safeguard the institution's resources? In the World Bank, staff members decide which projects best foster development and what constitutes an appropriate program to support with loans. Economists offer competing answers to these questions. So what determines the result? In essence economic theories and politics collide and merge in the work of the IMF and World Bank. New ideas, debates, and theories certainly seep into each agency—especially when political and bureaucratic incentives are aligned. If a powerful shareholder does not back an idea or policy it is highly unlikely that it will be (at least openly) pursued. Equally vital are the incentives staff face to adopt new ideas. In the World Bank, for example, ideas that open up new lending possibilities will best fit with the "disbursement culture" that has long rewarded staff for how much they lend rather than the quality of those loans (Portfolio Management Task Force 1992).

This chapter burrows into the economics behind the IMF and World Bank, exposing how technical ideas are shaped by political and bureaucratic imperatives, starting with the first efforts of the Fund and Bank to implement their mandates.

The IMF Defines Its Tools

Once conditionality was established at the core of the IMF's work, members and staff of the institution had to work out what conditions to set for the use of Fund resources. Countries would approach the Fund for assistance. The IMF staff needed a way to diagnose the problem and prescribe or adjudicate a solution. What theories could be used to determine what borrowing countries should do in order to rectify a balance of payments deficit?

Obviously on some occasions direct political pressures would be brought to bear on the content of conditionality. Powerful members would add or shape conditions, attaching these to assistance such as occurred in the standby arrangement with Korea in 1997 (Feldstein 1998, Blustein 2001, Kirk 2000). However, not all cases attract such political attention and even when they do, the IMF staff still require an approach to understanding balance of payments difficulties that permits them to set down and justify conditionality.

Early on in the life of the IMF a particular model emerged that promised to resolve these questions. The Polak model, named after its author, offered staff a way to diagnose and prescribe conditions for any economy facing a balance of payments crisis (Polak 1957, De Vries 1987, Frenkel and Goldstein 1991). As Polak himself has written, the simplicity of the model was essential to its success (Polak 1997). The original model required few data. It focused attention on a key variable that governments could control—domestic credit creation. Crucially, it linked a country's domestic economic policies to its balance of payments position. This opened the door for IMF conditionality. It meant that to help resolve a balance of payments problem, the IMF would need to address domestic economic policy in its member countries.

The starting point of the Polak model is what was known as the "absorption approach" to the balance of payments, that a country with a balance of payments deficit was absorbing too many resources in consumption and investment, relative to what that country can produce. With a couple of simplifying assumptions, it will follow that a country which increases domestic credit too rapidly will encounter increasing balance of payments deficits reflected in a loss in central bank reserves. The golden rule of the model is that a country's money supply should expand at a rate not faster than the country's growth of real gross national product (Polak 1997). On the basis of this analysis, where a country has a balance of payments deficit the Fund's prescription focuses on reducing government spending, increasing taxes, and reducing domestic credit creation. The model implies a very neat set of policy prescriptions.

The Polak model emerged neither as state of art economics nor as pure practical expediency. It arose out of theoretical work Polak was undertaking in Washington, D.C. (Polak and White 1955) and a practical mission he led to Mexico in 1955. In Mexico, officials had for some time been working to stave off a balance of payments crisis. In his work with the Bank of Mexico, Polak formalized a technique for ensuring external stability and avoiding a new devaluation of the peso. His report on Mexico proposed a way of estimating the amount of money

that could "safely" be created over a four-year period, based on estimates of output and of the increase of foreign exchange reserves and loans to the government (Polak 1997; James 1996, 140, cites the original report). The great advantage of Polak's new approach was that it used data on assets and liabilities in the banking system, which were more widely available and reliable than the national accounts data that other previous approaches to analyzing the balance of payments required. In other words, it was eminently practicable.

Subsequently the original Polak model evolved to take into account improving data and a wider range of instruments governments can use to control their economies. In the late 1990s the model began to give way to other approaches to understanding and resolving financial crises. Over four decades, however, the Polak model was the foundation for IMF financial programming and conditionality, and had profound implications for countries seeking to use IMF resources.

IMF conditionality requires countries to rectify balance of payments problems using stringent fiscal and monetary policy measures. The original rationale for this was that other policies would not work. For example, import restrictions could lead to only a short-term improvement in the balance of payments deficit. For this reason the IMF conditionality for a long time set purely monetary targets for borrowing countries, even though the Fund argued that this did not make Fund programs necessarily "monetarist" (IMF 1987).

Even during its early days the Polak model was subject to much criticism for imposing too much austerity with too little attention to the social consequences. Indeed, some of the criticism surfaces in the documents of the IMF and World Bank themselves. Contrasting with the official positive line (Fleming 1963, De Vries 1987), an internal IMF memorandum of 1963 concludes that it was "not too strong to say that the Colombian case tends to support many of the recent criticisms of [Fund] stabilization programs" (James 1996, 143). In 1966 a World Bank report accused the Fund of discouraging savings, undermining confidence in developing countries, and imposing harsh stabilization measures in the wrong-headed belief that balance of payments problems were short- as opposed to long-term (James 1996, 143). By the 1980s these kinds of criticisms became more vociferous as Fund conditionality was applied to debt crisis countries and accused of increasing poverty and curtailing growth in those countries.

Critics have long argued that built into the Polak model and its successor "financial programming" models are conservative biases. For Fund staff working with countries in deficit, a critical variable is output. This has a value that officials themselves must estimate, for the "safe" level of money that a government can create is based on an estimate of the country's growth of real gross national product. In practice, the IMF plays it safe, calculating output on the basis of an estimate of the country's capacity to pay for imports, whether from exports of goods and services, or from inflows of capital. For this reason the result, in the words of two analysts, is that "a conservative judgment is usually made" and "this leads to austere policies in terms of government expenditure" (Fine and Hailu 2000, 5).

A recent review by the IMF's Independent Evaluation Office highlights a

slightly different reason for the perception that Fund programs produce austerity. "Programs typically assume rapid recovery, and therefore tend to push for greater fiscal adjustment to make room for private investment." However, as it turns out, the assumptions about the pace at which private investment demand will recover are unrealistic (Independent Evaluation Office 2003, 47).

Stepping back from financial programming models in the IMF, it is worth considering the alternative ways the IMF might have defined its task and tools, for there were other theories on which the IMF staff might have based a diagnosis and solution to balance of payments problems (cf. Barnett and Finnemore 2004, chap. 3). In his original plan for the institution, Keynes laid out one possibility, which is reflected in article VII, "Replenishment and Scarce Currencies," of the IMF's Articles of Agreement. Keynes wanted to treat balance of payments surpluses and deficits as systemic phenomena requiring international rules and responsibilities on the part of both surplus and deficit countries. Any surplus country would be required to take action to reduce their surplus or to have their currency declared a "scarce currency" by the IMF, which would permit other countries to take restrictive measures in respect of that currency thereby affecting the exports and so forth of the surplus country (Keynes 1971–89, vol. 25, 401–2, 474).

Another alternative for the IMF would be to focus on deficit countries but to address more squarely the external causes of deficits. For example, the institution might pay more attention to exogenous shocks that create mayhem in vulnerable economies such as their inability to increase export earnings, short-term fluctuations in commodity prices, and volatility among key currencies (Killick 1990b). The Fund has only ever taken incidental actions in respect of these issues—establishing compensatory loans to deal with the former, and surveillance reports to deal with the latter (more on this in chapter 6), yet they were extensively analyzed some two decades ago (Dell and Lawrence 1980, Helleiner 1986a). More recently, others have shown that balance of payments crises are influenced by financial contagion and the volatility of global capital markets and consequent vulnerability of countries almost regardless of their domestic policies and institutions (Williamson 2002). Criticism of the IMF's approach in neglecting international causes resurfaced prominently after the East Asian crisis (Radelet and Sachs 1998, Sachs 1998, Krugman 1999).

Why has the IMF eschewed these alternative approaches to analyzing and resolving balance of payments problems? Two interrelated reasons stand out, one institutional and the other political. Institutionally, it is much easier for the IMF to deal with the domestic causes of balance of payments deficits. It has the tools and the leverage to exact promises of policy reform from borrowing governments. It has no such capacity in respect of industrialized country trade protectionism, macroeconomic policy, or currency arrangements. The Fund could encourage members to use capital controls, and it does have the power to declare a currency scarce and permit other countries to impose limitations on the freedom of exchange operations in the scarce currency (article VII [3]). In this regard the Fund runs up against the explicit preferences of its most powerful member—

the United States—which over recent years has pushed hard in the opposite direction, urging the membership of the IMF to rewrite its mandate to forbid capital controls and ensure the liberalization of members' capital accounts. Hence by the end of the 1990s even as the IMF's analysis was uncovering the costs of capital account liberalization in countries without highly developed and strong domestic financial system, the institution was nevertheless still positively advocating liberalization (IMF 1999b).

In defining its craft, the IMF is heavily constrained both by its capacity and by the limits put on it by its most powerful members. Within these constraints for a long time the Polak model and successor financial programming models made life relatively easy for the Fund. They provided a way to use available information to diagnose problems and to prescribe solutions that lay within the jurisdiction of the institution. That said, financial programming was severely challenged during the 1980s as the IMF sought an appropriate response to the debt crises that afflicted so many developing countries. Subsequently the IMF's approach would be further stretched in the Fund's efforts to facilitate systemic transformation in the former Eastern bloc countries and in dealing with collapsing and conflict-ridden states in Africa. In each of these later phases the Fund worked closely with the World Bank in defining and promulgating policy conditionality—even though the Bank's starting point, to which we will now turn, had been a different one.

The World Bank and the Pursuit of Economic Growth

From the outset the World Bank's objectives were broader than those of the IMF. Once postwar reconstruction had been dealt with (principally by the Marshall Plan), the Bank's central objective was development—a broad mission for which the Bank would employ a wide range of instruments. From early on development was defined as the promotion of economic growth, although the contents of the Bank's growth model have changed over time.

In the early years the Bank lent primarily for large public sector infrastructure projects, reflecting a particular view of growth and the need for industrialization. The Bank's view of development was based on a widely accepted belief that in developing countries resources needed to be transferred out of the traditional sector and into an advanced sector whose growth would be driven by the investment of profits generated in that sector (Lewis 1954). Owing to the savings-investment gap and the balance-of-payments constraint faced by developing countries, foreign lending and aid were required to facilitate this process (Bruno and Chenery 1962). The government's role in developing economies was central.

The World Bank had an important part to play. Industrialization required an adequate infrastructure of railways, roads, power plants, port installations, and communications facilities. This "public overhead capital" "customarily provided by the public sector" required both planning and investment (Mason and Asher 1973, 458). The Bank could assist by helping to meet foreign exchange require-

ments for capital infrastructure and providing technical expertise on investment planning and engineering. The result was a loan portfolio dominated by power and transportation projects, which came to account for 78 percent of lending to poorer countries by the end of the 1950s (Kapur et al. 1997, 86). At the same time, the Bank could guide the overall economic policy of its borrowing members so as to ensure "sensible public sector development programs" and "policies designed to promote the mobilization of foreign and domestic capital and its allocation through market forces to its most productive uses" (Mason and Asher 1973, 459).

Subsequently, the World Bank's view of its contribution to economic growth in borrowing countries expanded in two significant ways. First, there was a shift away from the focus on large public infrastructure loans toward a broader range of projects. This enabled the Bank to lend more and reflected the Bank's increasing involvement in India, Pakistan, Sri Lanka, and in Africa. Previously, the Bank had been reluctant to move into areas such as agriculture, industry, commerce, and financial and personal services for these were seen as the realm of private investment. However, by the late 1960s the Bank began to emphasize industry and agriculture. Its experience in India had demonstrated the need to ensure balanced growth across the economy and to reform prices in agriculture. In Africa the Bank became more aware of the importance of human resource development and lending to support education (Mason and Asher 1973, 472).

As well as broadening its range of projects, the Bank's view of development also shifted toward the overall policy framework and institutions within borrowing countries. Early Bank lending in Latin America had already made clear the importance of macroeconomic policy. In 1947 the Bank rejected a loan proposal for Chile on the grounds that the country was suffering from "unbalanced budgets and deficit financing, its need to limit non-essential imports and build up foreign exchange reserves . . . unsatisfactory system of multiple foreign exchange rates . . . unsatisfactory tax and exchange relationships with foreign enterprises" (Kapur et al. 1997, 82). In refusing to lend to Chile the Bank was exercising de jure conditionality over issues on which it would later focus more avidly. In India by the mid 1960s the Bank's focus became agricultural and macroeconomic policy reform to address artificially low interest rates and the overvalued exchange rate (Mason and Asher 1973, Kapur et al. 1997).

The Bank's concerns with exchange rate and macroeconomic policy soon brought it face to face with IMF missions attempting to address the same issues. Resulting tensions between the agencies led to a formal concordat between the Bank and Fund in 1966. The IMF was given primary responsibility for exchange rates and restrictive systems, adjustment of temporary balance of payments disequilibria, and financial stabilization. The World Bank would deal with development programs and the evaluation of projects (James 1996, 144). Yet this issue would recur with a vengeance in the 1980s.

The big change in the World Bank came in the late 1960s when Bank president Robert McNamara attempted to change the Bank's focus on development defined as economic growth measured as the rate of increase in per capita gross national product (GNP). McNamara rapidly expanded the Bank both in terms

of lending and research. He advocated a broader conception of development, which paid attention to nutrition, literacy, family planning, employment, and income distribution, to which end he demanded detailed analysis—on this he is worth quoting:

> We do not want simply to say that rising unemployment is a "bad thing," and something must be done about it. We want to know its scale, its causes, its impact and the range of policies and options which are open to governments, international agencies and the private sector to deal with it. (McNamara, cited in Mason and Asher 1973, 476)

Two institutional features hindered the Bank's move into a broader conception of development—and indeed have plagued any such move since the 1970s. First, there was a political problem with expanding the Bank's goals beyond growth in per capital GNP. The Bank's Articles of Agreement prevent it from taking politics into account in making lending decisions, and equally from any political interference in its member countries. These decisions are left squarely within the realm of sovereign governments. If the Bank were to aim explicitly at political, social, and welfare objectives, it would fall foul of this injunction. At most it could aim to enhance the capacity of a government to address these other objectives. That said, even if governments agreed to a wider set of policies, the Bank would have to be able to define what these were.

The second problem for the Bank was a practical problem. The institution did not have the research or expertise to analyze and explain the social and political conditions in borrowing countries. The institution started out with a research department described as "small and underfunded" (Mason and Asher 1973, 467), particularly in comparison with the IMF (Horsefield 1969). This department was hugely expanded under McNamara (Kapur et al. 1997), yet the challenge of making a broader conception of development operational would remain elusive into the twenty-first century. In 2000 the Bank staff still complained that they lacked the knowledge necessary to understand the politics of economic reform and to take it into account in designing conditionality (Branson and Hanna 2000, 6).

Revealingly, the Bank's analysis has always been deeply affected by the way the institution is organized. From its inception the Bank was organized into technical departments, which appraised projects, and area departments, which examined growth rates, import requirements, and so forth. Practically it is easy to understand why the Bank, initially created for project lending, would be structured in this way. Falling between the stools of technical and area departments was a capacity to systematically trace how development policies and processes came together in specific settings—an analysis that would have been invaluable in forging practical cases or models for use in formulating development strategies. As the Bank's historians Edward Mason and Robert Asher put it:

> The Bank's research has never been organized so as to generate a systematic account of development processes or for the principal variants from the norm or

be taken into account in assessing development prospects. (Mason and Asher 1973, 467)

An alternative approach would have been for the Bank to use country comparisons or groupings significant to development to test a range of theories and alternative models of development (Stiglitz 1998 echoes this). Mason and Asher argue that this would have generated more useful models specifically applicable to different kinds of economies. Countries might have been grouped as labor-surplus economies or export-oriented economies or with due regard to characteristic differences in structure of production between small economies and large economies at similar per capital income levels, and among economies of similar size at different per capital income levels. The conclusion about the Bank's research that Mason and Asher regretfully came to in 1973 was that "the only grouping of developing economies that has emerged from Bank experiences is the product of administrative organization rather than of politico-economic analysis" (Mason and Asher 1973, 467).

A later criticism of the Bank was that it exhorted all countries to undertake similar policies without properly analyzing the likely effects of them all so doing. By organizing policy advice region by region, the overarching implications were lost. A key example is commodity exports. As the Bank exhorted developing countries across the world to increase their commodity exports in the 1980s, it failed properly to analyze the impact on world prices of all countries doing the same thing. Writing in 1990, Killick bemoans how little research had been done on this issue, citing just one study of such effects that is confined to African producers (Koester et al. 1987, cited in Killick 1990b). In that study, the evidence showed that an increase in exports of cocoa from all African producers would seriously reduce the world price of cocoa such that producers would lose instead of gaining from additional investments in the crop (Koester et al 1987). For other commodities, one would need to take into account the effects of export increases in other parts of the world being advised by the World Bank. A similar criticism would later be made of the IMF and its failure to properly leverage its capacity to collate, aggregate, and analyze the effects of policy across regions and across the world economy (IMF, External Evaluation 1999a).

In summary, the structure and operational needs of the Bank and the IMF have shaped the ways each institution defines and operationalizes its purposes. Both the IMF and the World Bank draw heavily on economic theory and a staff of expert economists. However, the knowledge they draw on is equally shaped by institutional imperatives and limitations. To some degree each institution must fashion its policies to fit the resources available. This means that their knowledge is influenced by the way they are organized, the kinds of information and data available, and the incentive each faces to adopt a model that can be used for all member states. These variables reduce the discretion of staff and make it easier for the institution to maintain consistency and coherence. It is these features that shaped the knowledge and policies of the IMF and World Bank as they evolved in the 1980s.

The Debt Crisis and the Rise of the Washington Consensus

The 1970s were marked by an explosion of international lending by banks. Using growing Euromarkets, major commercial banks began rolling over short-term deposits into what were effectively long-term loans mostly to developing or emerging market economies (Helleiner 1994, Darity and Horn 1988, James 1996). The activities of the banks were fueled by their desire to profitably recycle OPEC surpluses. The result was a "sudden escalation" in developing country debt, which created what the IMF described in 1976 as a serious vulnerability on the part of borrowers to any shift in access to external credit or export earnings (IMF 1976).

The heady 1970s came to an abrupt halt in 1979 when the U.S. Federal Reserve hiked up interest rates in a shift to control inflation through contractionary monetary policy. Debtors faced exponentially higher interest rates and commercial bank creditors unwilling to extend new credit (Aggarwal 1996). Suddenly dozens of developing countries could not meet repayments to commercial and official creditors (Cline 1984). Adding to their woes, they also faced a new political environment in the North.

During the 1970s governments in the United States, the United Kingdom, and Germany had been willing to open up a dialogue about international economic management and North-South relations (Brandt 1980, Cox 1979). However, by 1980 in each country a strongly market-oriented government of the right had come to power. The new "neoliberal" governments were skeptical about foreign aid and critical of the profligacy and corruption within developing countries. President Reagan had won the U.S. election promising a much tougher foreign policy toward the "evil empire" of the Soviet Union as well as toward all other countries hostile to the United States. In economic policy the Reagan administration, like Prime Minister Thatcher and Chancellor Kohl, focused on monetary policy as a tool to control inflation and on privatization as a way to improve efficiency in the public sector. After a decade of big governments, the new political agenda in these countries was about rolling back the state and unleashing market forces. But the debt crisis forced each of them to accept a form of public intervention.

When the Latin American debt crisis broke in Washington, D.C., in 1982 it was immediately obvious that creditor governments would need to intervene. Several large international commercial banks were heavily overexposed in Latin America (Cline 1984). Creditor governments needed to ensure that their own large, overexposed banks did not go bust and bring down the international financial system (Kaletsky 1983). Several institutions could play some part in averting this threat, including the IMF, the Bank for International Settlements, the World Bank, the U.S. Treasury and Federal Reserve, and their counterparts in other industrialized countries. Adding to the economic pressures, creditors also feared that a politically unstable Central and Latin America would fall prey to geostrategic advances by the Soviet Union (Kissinger Commission 1984).

The IMF soon emerged as the lead agency managing the debt crisis. Unsur-

prisingly, it turned its existing tools and expertise to the task at hand. The Polak model defined the problem as a short-term liquidity crisis or balance of payments deficit due to excessive domestic credit creation and prescribed contractionary policies, which would stabilize the economy and permit the servicing of debt. Each debtor government was required to clamp down on government spending and increase interest rates. In all cases this led to a severe contraction in the economy and did little to alleviate the crisis. For some this was unsurprising for even outside of the debt crisis, the Fund's approach had been described as "overkill" because the Polak model systematically underestimated the demand-side effects on output (Dell 1982).

The IMF's approach had evolved as a solution to countries facing a short-term liquidity problem. However, in the early 1980s this was not the ailment faced by Latin American governments. High interest rates, poor investment decisions, a global economic downturn, and massive debt burdens meant that their repayment obligations far exceeded their capacity to pay. In essence, the debtors were insolvent. However, the IMF had no tools on hand to deal with that larger problem.

In 1982 neither the IMF nor any other international agency had the powers of an international bankruptcy mechanism to ensure that while safeguarding the system, the costs of dealing with bad debt could be fairly apportioned between lenders and borrowers. Indeed, such a system was not proposed within the IMF until 2002 (Krueger 2002, IMF 2002d). In the 1980s at most the IMF might have exercised power under article VIII (2b), which provides that certain international contracts will not be enforceable in the courts of member countries when they are in conflict with restrictions approved by the IMF. In theory, this could have been used to prevent creditors taking action against a debtor before an orderly debt workout had been negotiated. However, courts in major industrialized countries have interpreted this article in widely different fashions (Gold 1989).

Once deployed, the IMF brought to bear its existing tools and expertise, providing credit (alongside banks and industrialized country governments) to enable the debtors to meet their immediate debt repayment obligations. In return, the debtors were required to undertake "stabilization." Each government had to reduce public sector expenditure and investment, eliminate government subsidies, increase the cost of goods supplied by the government, increase income and sales tax, set positive real interest rates to discourage capital flight and increase savings, rationalize and stabilize the exchange rate, and reduce inflation. This prescription was the first rendition of what would later be called the Washington consensus. It fit well with the new neoliberal ideology being expounded in Northern creditor countries.

The combination of new loans and tough conditionality worked to protect the international financial system using existing international institutions. No major bank collapsed in spite of their high exposure to Latin America. The prescription ensured that debtors met their repayments in a timely and orderly way. Indeed virtually all banks continued to pay dividends throughout the 1980s (Sachs and Huizinga 1987). However, as one banker recognized in testimony to the U.S. House of Representatives at the time, borrowing governments were meeting their

interest payments by accepting new loans, hence their overall debt mounted and mounted (Bogdanowicz-Bindert 1985). The result was good for the banks but disastrous for the debtors.

By 1985 debtor countries undertaking stabilization were sliding ever deeper into recession and indebtedness. A new debt strategy and some revision to the "stabilization" solution was urged on the U.S. Congress in hearing after hearing as bankers, academics, and officials warned policymakers of the dangers of default, unrest, a collapse in U.S. export markets and threats to U.S. commodity supplies (U.S. House of Representatives 1985a, 1985b, 1985c).

Why did the debtors not default? One group of Latin American debtors had declared after a conference in Quito in early 1984 that debt service ought to come second to development, proposing to limit debt service in relation to export earnings (CEPAL 1984). A more radical position was formulated a few months later by a larger group of debtors meeting in Cartagena (Banco Nacional de Comercio Exterior 1984). The resulting "Cartagena Consensus" was further refined at subsequent meetings in Mar del Plata (13–14 September 1984) and Santo Domingo (7–8 February 1985). Yet no collective action by debtors emerged (Ffrench-Davies 1987, Kugler 1987). Preventing any collective default was the fact that debtors did not all fall into crisis at the same time, and also that each debtor could relatively easily be induced to accept a special deal with creditors (O'Donnell 1985, 1987; Whitehead 1989).

Some individual countries attempted unilateral action. In 1985 in Peru a new president facing debt interest and repayment obligations that exceeded the country's total anticipated export earnings, declared that the country's debt service would be limited to 10 percent of export earnings. In Zambia after large-scale riots broke out at the end of 1986, a new national "alternative" to IMF-sponsored adjustment was announced, including limiting debt service to 10 percent of net foreign exchange earnings and including IMF loans in the unilateral default. In Brazil at virtually the same time a unilateral moratorium on interest payments on Brazil's outstanding debt was announced. However, in all these cases unilateral action proved short-lived.

A change in the debt strategy did not occur until 6 October 1985 when secretary of the U.S. Treasury James Baker III outlined a new plan for managing the debt crisis at an IMF meeting in Seoul, Korea, soon dubbed the "Baker Plan" (Baker 1985). The new plan had three elements. First and foremost the plan reinforced and further entrenched structural adjustment conditionality: "comprehensive macroeconomic and structural policies to promote growth and balance-of-payments adjustment and to reduce inflation" (Baker 1985, 9).

Second, the Baker Plan involved more lending by both the IMF and the World Bank and other multilateral development banks for structural and sectoral adjustment. The U.S. secretary of the treasury referred to the "ample room to expand the World Bank's fast disbursing structural and sector adjustment lending in support of growth-oriented policies and institutional and sectoral reform," proposing that the Bank could raise its disbursements to principal debtors by 50 percent. Together with increased lending from the Inter-American Development

Bank this would provide an addition $9 billion annually or $27 billion over three years (Baker 1985, 10).

The third element of the Baker Plan was to increase private banks' lending to around $20 billion over three years. This led to much debate in the United States about how banks might be persuaded to stump up more money—in essence throwing good money after bad. Congressmen sought to uncover hidden guarantees or promises being made to the banking sector (see U.S. House of Representatives 1985a and 1985b). Yet the short-term key priority for banks was to ensure that debtor governments met their interest payments on time. If interest payments were postponed or capitalized then a bank would have to reclassify the loan. For that reason, banks focused on ensuring new loans were made to debtors. These included both concerted private sector loans and new loans from the multilateral organizations—indeed commercial bank creditors had begun to insist on World Bank financing as a condition of their reschedulings even before the Baker Plan (Watson et al. 1986, Husain and Diwan 1989, Boughton 2001, 1001).

Repaying the banks was further ensured by more stringent conditionality and new forms of monitoring. Debtors were now required to embark on new deeper "structural adjustment," emphasizing supply-side reforms rather than purely demand-side measures. However, the conditionality paid no attention to supply-side measures that developing countries themselves were urging—viz. the need to enhance investment in "tradeables," that is, exporting and import-competing activities (G-24 1986). The Baker Plan implied that the Fund would lend more, apply deeper structural adjustment conditionality, and offer a new role of "enhanced surveillance" whereby the Fund would monitor countries not already within Fund programs so as to report on their performance to private sector creditors (Boughton 2001, 429).

For the World Bank the new strategy channeled more of the institution's resources and research into structural adjustment and policy-based lending. Already in 1980 the Bank had launched Structural Adjustment Lending (SAL) programs and in 1981 the World Development Report had focused on adjustment. The new demands of debt crisis management pushed the Bank further in this direction and also into a new turf battle with the IMF.

The Baker Plan envisaged that the Bank and Fund would work closely together to produce joint programs and conditionality with individual countries (Baker 1985). The United States strongly advocated such a joint approach (the board minutes are cited by Boughton 2001, 647). However, other countries protested vociferously. They argued that cross-conditionality would further reduce the bargaining power of borrowers (G-24 1986). In the end the United States accepted a much-diluted approach whereby the Fund and Bank would agree on a joint policy framework paper, which would be approved by both Executive Boards prior to each institution negotiating its own conditionality. The institutions also elaborated rules about collaboration and began some minimal participation in each other's missions. The result as later described by Fund historian James Boughton was a set of rules that "helped staffs to keep from tripping over each other's feet when they were both responding to the same fire alarms" (Boughton 2001, 1002).

The rules on collaboration broke down over Argentina in 1988 when the World Bank announced a new loan to that country before the IMF mission had completed its negotiations with the Argentine authorities. Argentina had prepared a new economic plan that the United States wanted to support (Pastor and Wise 2001, Machinea 1990). The IMF managing director and staff wanted to see further tightening in Argentina's fiscal policy. Unusually, the IMF's managing director Michel Camdessus refused to yield to direct pressure from the U.S. secretary of the treasury to approve a loan to Argentina until the fiscal policy issues had been addressed (Boughton 2001, 521).

Meanwhile across Nineteenth Street at the World Bank officials were under equal pressure from the United States to approve a loan (*Economist* 11 March 1989; Aggarwal 1996, 441). The World Bank had long disagreed with the Fund's position on Argentina, arguing that more stringent fiscal policy made it too difficult for the government to implement the very reforms the Bank was trying to finance. On 25 September, the president of the World Bank announced his support for a package of four loans to Argentina totaling $1.25 billion. The conditionality attached to the package included a "Letter of Development Policy," which stipulated macroeconomic policies that were at the heart of the IMF's negotiations with the country. The move was a direct affront to the conventions and accords that governed relations between the IMF and the World Bank.

The Bank's loan to Argentina produced a bitter feud between the organizations as the respective heads failed to agree on a form of words that would capture a new agreement about collaboration (Boughton 2001, 1003). The world's press went to town (*Financial Times* 26 September 1988, *Wall Street Journal* 26 September 1988). In the end, the two institutions agreed on a new concordat governing their collaboration (World Bank *Annual Report* 1989b).

Meanwhile the overall debt strategy desperately needed revising. The situation in debtor countries was not improving. Rioting in Venezuela in March 1989 reflected a couple of years of widespread discontent in Latin America as growth failed to materialize. Legislators in Japan, Europe, and the United States found themselves under pressure to come up with a better solution. Public criticism of them was mounting for having used taxpayer money to bail out banks, ensuring first and foremost that public interventions served to have debtors make their interest payments (Sachs 1986, 1989; Calvo et al. 1989). Legislators in the United States began to debate regulating banks to prevent such bailouts in the future (U.S. House of Representatives 1989).

Crucially, by the late 1980s the bargaining position of the banks had changed (Aggarwal 1996). The most exposed commercial banks had provisioned themselves so that their debt exposure no longer posed a risk to stability in the international financial system (Lissakers 1991). Citibank's much publicized decision to add $3 billion to its reserves in 1987 led the way on this. Furthermore, outstanding debt was increasingly being diffused into secondary markets (Cline 1995).

A new approach using debt relief to reduce interest rates was floated by Japan and by France. This became known as the Miyazawa Plan following its announcement at the G-7 in June 1988 in Toronto. Soon other countries began to support the idea of a change in the strategy (Cline 1995). Yet it took until 10 March 1989 for the United States to change its position and thereby unlock a new official approach (Lissakers 1991).

Intellectually the case for debt relief was being put together in several forums. Although it was taboo to refer to debt relief in public, some work was being done within the IMF (Dooley 1986; Corbo, Goldstein, and Khan 1987) as well as in the World Bank (Husain and Diwan 1989, Claessens 1990, Claessens and Wijnbergen 1990), and in the Inter-American Bank economists had been quietly working for some time on the issue (interview with Chief Economist Ricardo Haussman). In June 1988 in the IMF a debt group was set up secretly to generate new ideas—few other staff members knew of its existence (Boughton 2001, 483). Outside of the institutions several prominent economists were also making the case for debt relief (Williamson 1988, Sachs 1989, Frenkel et al. 1989).

There was also an emerging practice of debt reduction through market operations (Blackwell and Nocera 1989). The Fund implicitly supported debt reduction in Bolivia and Costa Rica in 1987, as it did when Mexico concluded a path-breaking deal with Morgan Guaranty Bank to exchange part of its bank loans for bonds, which would be partially guaranteed by the U.S. Treasury (Boughton 2001, chapter 11; Lissakers 1991, 237). Chile had also begun to structure some debt relief (Aravena 1991).

In the U.S. key economic policymaking figures remained opposed to debt relief (Lissakers 1991). These included Secretary of the Treasury James Baker and Federal Reserve chairman Paul Volcker (until mid 1987). It was not until after the new secretary of the treasury Nicholas Brady took office in early 1989 that the United States shifted its official position. He recalls that the debt strategy had become "ludicrous." Banks were being coerced into "doing more of what was bad" (Interview with Secretary of Treasury Nicholas Brady 1994).

After conferences with the IMF, Brady's deputy David Mulford and the G-7 prepared a new approach, which was unveiled on 10 March 1989. The "Brady Plan" permitted some degree of market-based writing down of debt whereby a few debtors undertook to replace part of their debt with bond swaps, which would reduce their overall liability (Fried and Tresize 1989). The banks, recalls Nicholas Brady "hated it but it was the only game in town" and the administration was prepared to "push and shove and keep on pushing and shoving" (Interview with Brady 1994). The conditionality part of the debt strategy was not altered. More structural adjustment continued to be demanded of debtors. The same prescription was also applied to systemic transformation in the former Soviet bloc and to combating economic failure in sub-Saharan Africa. Stabilization and adjustment seemed to provide both Western donors and policymakers in transitional and developing economies with a simple, clear prescription for economic policy in a world full of baffling new complexities and vulnerabilities.

What Embeds the Washington Consensus in the Bank and Fund?

In 1990 economist John Williamson coined the term "Washington consensus" to describe the policies of stabilization and adjustment that prevailed as a framework for virtually all tasks undertaken by the Fund and Bank as of the early 1980s (Williamson 1990). "Consensus" referred to the seemingly unassailable agreement among experts as to the fundamentals of good economic policy. The "Washington" part of the label highlighted that these experts were on the whole based in Washington, D.C.—in the Fund, the Bank, the U.S. Treasury and Federal Reserve, and some of the think tanks that concern themselves with these issues.

The need for a policy consensus arose because the debt strategy depended on debtors tightening their belts. Creditor countries were unwilling to provide greater financing or to force creditors to take more of a loss. If debt repayments were to be made, then financing and adjustment had to be balanced. The less finance made available to debtors, the more adjustment they would have to undertake. In the 1980s the clear priority of the debt strategy was to save the banks (Sachs and Huizinga 1987, Lissakers 1991). The result was that debtors had to adjust hard. As the debt strategy evolved the financing of it was reshuffled alongside a minimal fine-tuning of the terms of adjustment. This underscores the questions of what determined the content of conditionality and how and why was a consensus maintained within the institutions?

The terms of adjustment or the content of conditionality during the debt crisis was influenced by the economic diagnosis and prescription of the crisis *as interpreted* within the IMF and the World Bank (Helleiner 1981). A number of characteristics of the institutions stand out in shaping this interpretation. The first of these is the provenance and training of the staff in each institution, which only in very recent years has begun to diversify.

In the IMF a 1968 study of senior management revealed that just under 60 percent were from English-speaking industrialized countries (Strange 1974, 269). In 2001 this had not changed radically. Some 42.1 percent of department heads were from industrial English-speaking countries along with 55 percent of senior personnel managers (IMF Diversity Annual Report 2001, 21). The IMF's Diversity Report also highlights the severe underrepresentation among senior management of economists from Africa and the Middle East, noting that although the Fund hired record high numbers of new staff in 2000–2001 it "missed the opportunity to improve diversity" (IMF 2001c, 19).

In the World Bank a 1991 study of the Policy, Research, and External Affairs departments showed that some 80 percent of senior staff were trained in economics and finance at institutions in the United States and in the United Kingdom (Stern and Ferreira 1997). In the IMF at the time it was reported that some 90 percent of staff with Ph.D's received them from the United States or Canada (Clark 1996). In 2002 the Human Resources Department in the IMF reported

that the institution employed 1,231 economists of whom 59 percent received their most advanced degree in North American universities (IMF 2002c).

Many economists would argue the facts stated above simply reflect that the best economics departments of the world are to be found in the United States (with the UK and Canada trailing close behind), and that the Fund and Bank hire the best. Equally however, several features of the organizations skew them in this direction. Unlike most multilateral organizations, the IMF and World Bank have no nationality quotas to ensure that all countries are represented both formally in the governing councils of institutions, as well as informally among the technical staff. This was rejected by the United States in the early planning stages of the institutions.[1] Furthermore both institutions work exclusively in English with no requirement to work in other languages. Recent historians of the Bank argue that this has weighted employment in the Bank significantly, not just geographically (favoring South Asia over East Asia and Britain over other European countries), but also overwhelmingly toward graduates of institutions that taught in English (i.e., predominantly in the United States and UK) (Kapur et al. 1997, 1167).

The similar graduate training shared by staff in each organization gives them a shared, albeit narrow, methodology and particular understanding of the world, its problems, and their solutions. This makes it difficult for ideas from outside of the "profession" to be taken seriously or to percolate into the mindset of the institutions. The term *profession,* which is widely used by neoclassical economists, I highlight deliberately. It underscores the extent to which this kind of economics is a discipline, like medicine or law, requiring the command of a specific body of abstract and complex knowledge, which is then brought to bear on a particular case (Brint 1994, McDonald 1995).

As a profession, neoclassical economics has both a technical and a normative, value-laden aspect to it. Just as doctors are taught to value human life above other goals, economists are trained to value efficiency above other goals (Evans and Finnemore 2001, 17). The professional discipline becomes a way of examining problems, of defining their essential features, and considering solutions. It becomes a way of "taming" the most intractable problems by reducing them to the core elements that the professional expertise can digest and prescribe from. This professionalism is vital to the work of the IMF and the World Bank. It is on this that their claim to specialist knowledge and technical expertise is founded.

Put another way, the IMF and the World Bank do not claim to know the local circumstances of their borrowers. They do not send anthropologists into the field to examine the social institutions and values that underpin working practices, markets, and political life in a country. They send professional economists who "cut through" the details of local circumstances, and "tame" the complexities of economic problems, extracting indicators and specific policy goals from what might otherwise be a morass. This is the application of professional expertise. It has several positive advantages for the IMF and World Bank. It makes it easier to claim that they are treating all members similarly. It keeps politics out of the equation. And it brings all problems within the professional ambit of staff.

[1] In early negotiations on creating the organizations, the United States blocked any such requirement, although the management of each institution is required "subject to the paramount importance of securing the highest standards of efficiency and of technical competence" to "pay due regard to the importance of recruiting personnel on as wide a geographical basis as possible" (IBRD Art V, section 5, and IMF Art XII, section 4).

There is also a psychological advantage to having a clear, narrow mindset in the work of the IMF and World Bank. Junior officials are regularly sent to faraway places to analyze rather alien and difficult situations. As mentioned above, a clear blueprint of models and policies provide the Fund and Bank staff with a well-structured starting point from which to define the problem, map out the stakes, prescribe a solution, evaluate the chances of success, and assess the implications of their prescription. Obviously, the simpler and clearer the model the more usefully it fulfills these functions.

The downside of professionalism for the IMF and the World Bank is that there is very little room for local knowledge. Local knowledge is messy, political, intractable, and very difficult to make judgments about. Nevertheless, it is vital to the definition of economic problems and their likely and practicable solutions. This point is made by critics of the World Bank (Ferguson 1990, Gran 1986, Escobar 1995). The point is also increasingly recognized by the institutions themselves, as evidenced in their increasing push for "local ownership" of policies and programs (see chapter 5). Their reasoning is that policy prescriptions simply don't work unless there is local ownership and commitment to implementation. However, this poses an inherent contradiction for both the Fund and the Bank. The advantages accruing from professionalism would be difficult to sacrifice in the name of a wholly new "local" and "messy" way of working. We will discuss this further in chapters 5 and 6.

The staff of the Fund and Bank are professionals bringing a particular framework to bear on problems emerging in different countries the world over. Necessarily this implies a degree of insensitivity to local circumstances which many argue persistently hampers the mission of each institution. The advantage has been that the institutions have retained an enviable coherence and reputation for professional expertise. They have also very often managed skillfully to avoid the pitfalls of overtly political analysis and prescription. Nevertheless, in some cases the professionalism and coherence of the institutions can lead to a certain kind of blindness and overrigidity that leaves them unable to deploy their formidable expertise.

Disagreements among staff within each of the Fund and Bank are ultimately resolved by appeals up the chain of command. If a heated debate emerges within a country mission it will go up the chain possibly right to the head of the Area Department. If that person finds that the Policy Development and Review Department disagrees with him or her, they might even remit the issue further up the hierarchy. In the extreme an issue will finally be settled by the first deputy managing director or the managing director of the IMF.

Hierarchy combines with centralization within the IMF and World Bank to ensure a high degree of conformity. Ultimately all staff account back to head-

quarters in Washington. This prevents staff "going native" or interpreting their work or methods in ways that diverge from the institution. In recent years this feature has become weaker in the World Bank as it has decentralized and come to rely more heavily on consultants and staff outside of its permanent operational structures (more on this later). By contrast, in the IMF the sense of one-of-us is further bolstered by a reluctance to decentralize, a smaller staff, lower turnover, and imperviousness to information, advice, or criticism coming from outside its own walls (see Kuzcynski 1988, 124). This is changing at a very modest speed.

In both the IMF and the World Bank political pressures and bureaucratic features combine to entrench a particular world view. This set of ideas is not a direct reflection of the interests of the most powerful members of the organizations, even though powerful members get to influence it. Prevailing ideas are shaped by economic analysis, institutional constraints, and bureaucratic organization. These latter factors also create somewhat of a straight-jacket around the thinking of each organization, as is illuminated in studying their reactions to a crisis.

When Consensus Is Blinding

In 1994 both the Fund and the Bank failed to foresee that their largest debtor was in dire economic trouble. As Mexico's exchange rate and economy went into free-fall at the end of 1994, both the IMF and the World Bank were accused of having had their heads in the sand. Subsequent evidence suggests that the experts failed fully to recognize the risks faced by Mexico and failed to consider anything other than optimistic scenarios for the economy. The case illuminates several political and institutional features that lock the Fund and Bank into a particular pathway, hobbling their ability to foresee or help to prevent a crisis. Some three years later, backing up the lessons drawn from the Mexican case, South Korea would go into financial crisis and be attended to by an IMF hobbled by some of the same factors.

In Mexico a crisis seemed unlikely to the IMF and the World Bank for a number of reasons. In 1993 Mexico's economic future looked set to flourish. Under the tutelage of the IMF and the World Bank, the Mexican government had built steadily on a set of economic reforms commenced a decade earlier. These reforms now seemed to be cemented in place by the completion of the North American Free Trade Agreement (NAFTA) and by Mexico's accession to the OECD. Likewise, a couple of years later South Korea was undertaking liberalization, urged on by the IMF to liberalize more rapidly, and acceded to the OECD in December 1996. In each country, an IMF article IV consultation conducted just prior to each respective financial crisis revealed little concern on the part of Fund staff that the country faced a risk of financial crisis.

In Mexico a financial crisis began just two months after its October article IV consultation. In December 1994, after a period of economic policy difficulties the Mexican government widened the exchange rate band by 15 percent (Lustig 1995; Sachs, Tornell, and Velasco, 1995). Within weeks Mexico was on the verge

of default as investors withdrew. The country's vulnerability to capital inflows and outflows suddenly became a nightmare. From Washington, it looked as though risks were posed to international financial stability as Mexico's problems threatened to create a "Tequila effect" spilling across Latin America, causing capital flight from the whole region (IMF 1995b, Gil-Diaz and Carstens 1995, Calvo and Mendoza 1995).

Extraordinarily, in spite of warning signs earlier in 1994 and even back in 1993, neither the IMF nor the World Bank picked up on urgent warnings about Mexico, nor did either institution issue any kind of urgent warning to the Mexican government. Yet there were several warning signs which either institution might have noticed. Many of these are documented in the institutions' own publications from which most of the information below has been derived (IMF 1995a, 1995b, 1995c; World Bank 1996a). Similarly, in the case of Korea, a review by the IMF's Independent Office of Evaluation has uncovered documents and internal debates to which more attention should have been paid (Independent Evaluation Office 2003a, Annex 2, 95, notes the doubts that began to surface in 1997 about the timing and sequencing of financial liberalization as per Folkerts-Landau and Lingren 1998, a draft of which had been circulating within the IMF in late 1997).

In Mexico in early 1994, the country's current account deficit had been exacerbated by an uprising in Chiapas, which the government found very difficult to deal with and which markets were reacting to adversely. Further, an increase in long-term U.S. interest rates forced down bond prices, and in particular the value of Mexico's Brady bonds. In international markets, there was a significant rise in the risk premium being charged on Mexican debt. Yet in official documents neither the IMF nor the World Bank went beyond their usual states of "concern" about the economy (IMF 1994a).

In April 1994, the markets (and the Fund and Bank) became aware that the Mexican government was substituting *tesobonos* (Mexican peso-denominated government bonds, carrying a dollar guarantee) for CETES (U.S. dollar-denominated instruments). Yet an IMF staff visit undertaken in mid 1994 was not alarmed by the swiftly increasing stock of *tesobonos,* even while financial markets were reacting to the shift. While foreign investment continued to flow into Mexico, a closer investigation into the nature of investment would have revealed that it was creating new vulnerabilities for the Mexican economy. Certainly, once Mexican's monetary data up to April 1994 were released (in August 1994), the shifts should have been apparent to both the Fund and Bank. So, too, later in 1994 the institutions should have more carefully noted the shortening of maturity of new government security issues, the drop in foreign holdings of short-term public debt, and the drop in stock market prices.

In South Korea there was a similar failure on the part of the IMF to find and examine negative signals in the marketplace. In that case between August and September 1997, outside analysts have pointed to two such indicators. The yield spread of Korean Development Bank dollar-denominated bonds had begun to widen, and other signals indicated a diminution of market confidence in the value

of the currency (Park and Rhee 1998; Independent Evaluation Office 2003a, Annex 2, 97).

In Mexico, equally worrying, figures released in early September 1994 revealed that Mexico's imports had grown by 25 percent over the second quarter of 1993, and that the country's current account deficit had increased to 8 percent of GDP on an annual basis. In the same month, in a vain hope to reassure the investment community, the government announced a Pact for Welfare, Stability, and Growth (PABEC), which did nothing to correct the deteriorating trade balance or to tighten up the loosening financial policies. At least by this point, the IMF or the World Bank should have sprung into action. Yet a senior World Bank official at the time was expressing a positive view (Edwards 1995), as were IMF staff (see IMF Country Report of January 1994, following 1993 Article IV consultations with Mexico). Why was this the case?

Obviously the IMF and Bank cannot loudly report negatively on one of their member economies. If they did, they would risk catalyzing the very crisis they would hope to avoid. Furthermore, the institutions rely heavily on the cooperation and openness of governments in the countries with whom they work. They have no automatic right of access to confidential and sensitive statistics and policy questions. Once granted access, the institutions must use information carefully and without breaching confidentiality. To do their job they must ensure continuing good relations and continuing access. The risk of adverse analysis is that a government would simply close off access. This would prevent the institutions from performing most of their functions. Yet the result is to hobble their capacity to undertake clear-sighted analysis. In the cases of Mexico and South Korea the IMF was given incomplete data, yet failed to follow up on this.

In hindsight it is clear that in April 1994, World Bank staff should not have accepted the assurances of Mexico's Central Bank that they would not defend the exchange rate band if it became unsustainable, and that they were shifting to a monetary anchor (World Bank 1996). The weakness of both Fund and Bank staff in the ensuing months to push for better information and more evidence of assurances has been explained by the Bank as due not just to "respect for the competence of the Mexican technical team" but also to "some element of deference to such a large and important client country" (World Bank 1996: these elements are also highlighted in the IMF's confidential internal study IMF 1995c). In the case of South Korea, the report of the IMF's evaluation office notes that "there was insufficient data on Korea's short-term obligations (though some relevant data sources were overlooked)" and that staff did not attempt to request the appropriate data more forcefully (Independent Evaluation Office 2003, Annex 2, 97).

Finally, although the IMF often notes that Mexico had no standby program with the IMF at the time and therefore little influence—and indeed the same is true for South Korea—this wrongly understates the IMF's responsibilities when it undertakes article IV surveillance of its members, and its overall responsibility for financial stability.

In the case of Mexico the reputations of the IMF and the World Bank were on the line. Both institutions had given the country their "stamp of approval." The reforms Mexico had undertaken over the late 1980s and early 1990s had been perceived by many within the international financial community, including the World Bank and the IMF, as "spectacular, lasting, and the envy of any reform economy" (Dornbusch and Werner 1994, 266). Mexico's special status as a role model for other developing countries is reflected in *Economic Transformation: The Mexican Way,* by the former Mexican finance minister, Pedro Aspe, who describes the "profound transformation of the economy," which rendered it (i.e., in 1993) "much better prepared to face the uncertainties of a rapidly changing and challenging world and to respond more effectively to the social needs of our population" (Aspe 1993, xiii). The involvement of the IMF and World Bank and their commitment of resources to Mexico was a sign of confidence that the government had implemented (and would continue) liberalizing reforms, and that these would almost inevitably lead to economic success.

Not only would a warning or pessimistic note from the Bank or the Fund risk catalyzing a crisis, but it could also signal a failure of the Fund and Bank's more general project: of persuading countries to liberalize and deregulate their economies. Indeed, very soon after Mexico's crisis, other countries such as Brazil, India, and Korea were arguing the case for slower or different types of reform with a note of triumphalism—pointing to Mexico as evidence of failure of the prescriptions of the Fund and Bank (Hale 1996, 2, 21).

In Korea in 1997 a similar stricture existed. IMF staff papers and board discussions consistently reflected a concern that Korea should be persuaded to liberalize faster and more deeply. This was part of a more general over-enthusiasm for greater capital account liberalization (Rogoff 2002, Independent Evaluation Office 2004). The result was to leave little space for economists within the institution to step back and to examine what vulnerabilities the specific timing and sequencing of liberalization had set in place in Korea.

In both Mexico's crisis of 1994 and Korea's crisis of 1997, the international financial institutions had their reputations and the credibility of their policy advice on the line. The failure on the part of officials within each institution fully to recognize the risks of a crisis was not due to the blindness or stupidity of particular individuals. Both crises reveal much about how the structure, organization, and ideology of each institution affect its work.

In Mexico and in Korea the experts became blinkered. The more they invested in a positive scenario, the less they were able to consider alternative outcomes. In Mexico, officials involved at the time admitted in a highly confidential internal assessment of the handling of the crisis that little effort was made to consider any kind of contingency plan should their positive assumptions fall through (IMF 1995c). In Korea, Fund staff displayed "excessive optimism" regarding Korea's ability to prevent speculative attacks on the *won,* and "underestimated the risk of a breakdown in funding the capital account."

Why did this occur? Both the IMF and World Bank have conducted internal and confidential reports about their internal failings in respect of Mexico, and the IMF's Independent Evaluation Office has conducted a study in respect of Ko-

rea, all of which are revealing, as are the oral accounts of participants involved (see World Bank 1996a; IMF 1995c, Independent Evaluation Office 2003a; interviews).

What became clear after Mexico's crisis at the end of 1994 was that there had only been one scenario considered on Washington's 19th Street. To cite the Bank's internal report on the crisis: "Insufficient effort was devoted to developing 'what if' scenarios" (World Bank 1996a). Indeed, after the crisis a very senior World Bank staff member pointed out that "what is to some extent intriguing . . . is not that the Mexican economy faced a major currency crisis, but that so many observers were shocked by this turn of events." In his view the "prophetically similar crisis" suffered by Chile in the 1970s should have alerted officials (Edwards 1996). Yet such a scenario was not being considered and that official himself had earlier adhered to the positive view (Edwards 1995). Social psychologists would interpret the over optimism and screening out of any evidence that ran counter to the group's beliefs and story as a form of "group-think" or "belief-consistent behaviour" (t'Haart 1990, Wegner and Vallacher 1980).Their approach offers a useful framework for analyzing responses to events in Mexico and Korea respectively.

Importantly, as both Mexico and Korea headed toward crisis, several analysts *outside* of the IMF and the World Bank managed to read the signals. In respect of Mexico, throughout 1994 highly respected economists were forecasting a variety of warnings. Among the more famous were Rudiger Dornbusch who advocated an immediate devaluation, and Guillermo Calvo who advocated not devaluation but an immediate arrangement with the U.S. Treasury (Dornbusch and Werner 1994, comments by Calvo, 298–303). Most warnings focused on the appreciation (or "overvaluation") of the peso and what it reflected and implied for the economy. The critics of the government policy highlighted the lack of growth and fragility in monetary and exchange rate policy.

By contrast the IMF and World Bank continued to believe in the success story. While outside economists asked questions about the sustainability of Mexico's reforms, inside the IMF and the World Bank the positive consensus remained. For example, the Fund's January 1994 Country Report on Mexico recognized some of the danger signs: both that the Mexican exchange rate was appreciating and that net inflows to the public sector were increasing. Yet, the interpretation was that "it was felt that such a real (i.e. inflation-adjusted) appreciation would not affect export competitiveness significantly because of the positive effects of the structural reforms." Later in the staff appraisal we find: "During 1993 the peso continued to appreciate in real effective terms as customarily measured and eroded further the margin obtained in the 1980s. However, the strong expansion in manufacturing exports would indicate that the structural reforms in recent years and wage restraint have compensated so far" (IMF 1994b, 7, 12).

Similarly in the World Bank, to quote a later document, "the Bank's program in Mexico was shaped by a strongly positive view of the Mexican strategy and the successful stabilization it had achieved." In hindsight, it was recognized that "given the growing warning signs of potential trouble, the Bank should have been better prepared to respond." More specifically, in the area of macroeconomic policy, Bank staff had an "overly-optimistic view on what had been achieved by earlier reforms in the sector" (World Bank 1996a).

In both the IMF and the World Bank, there was a strongly doctrinal rationale for the positive interpretation. Staff maintained a belief throughout 1993–94 that Mexico's current account deficit was not a cause for undue concern because it was essentially a *private sector phenomenon.* They argued that so long as public sector finances were (or seemed to be) more balanced, the private sector could be relied on to adjust itself. Yet, it is unclear that there is any real evidence of an actual case where the private sector has adjusted to such deficits without a damaging spillover into public finances. Indeed, Fund research into the issue had raised this question (Boughton 2001).

In respect of Korea, IMF staff concluded that Korea was "relatively well equipped" to handle further external pressures without making any early attempt to analyze rigorously Korea's vulnerability to a cutoff of external short-term financing (Independent Evaluation Office 2003, Annex 2, 96). Although researchers had exhaustively catalogued the liberalization measures that had been undertaken in South Korea and in other countries, they did not draw attention to the growth in borrowing by Korean overseas bank affiliates. These were simply catalogued as part of the liberalization of outflows of direct investment (Johnstone et al. 1997). By thinking about capital account solely in terms of transactions between residents and nonresidents, the staff failed to treat borrowing by affiliates as potentially equivalent to borrowing by their parent institutions (Independent Evaluation Office 2003, Annex 2, 95). The result was to underestimate vulnerabilities in the South Korean economy.

Not only were officials in both institutions continuing to interpret events according to one rather narrow, optimistic framework, they had also insulated themselves and did not seek out external sources of information. For example, throughout 1993–94 the IMF staff relied on the debt data being published by the Mexican Central Bank, which had a two to three month lag. What they might have done—indeed what some other financial actors, such as Reuters did—was track the Mexican government's debt by following the results of auctions of governments securities (Hale 1996). In respect of Korea, they relied on an incomplete reporting on the part of the Korean authorities about their reserve position (Independent Evaluation Office 2003, Annex 2, 96), and as mentioned above, failed to investigate market signals. The crucial point here is that alternative sources of information were available, yet the Fund staff chose to rely on what the Mexican and South Korean governments made available to them. In the case of Mexico, they were even prepared to endorse this information by using it as a basis for giving assurances about the Mexican economy to the Bank for International Settlements in mid 1994.

Looking back, what we find is that in respect of Mexico while the IMF and the World Bank issued their usual caveats and concerns in economic reports and forecasts, along with some credit rating agencies and many private investment institutions, they held fast to the view that the appreciation of the Mexican cur-

rency was a natural companion to capital inflows and foreign investment and reflected a high rate of absorption in the Mexican economy. This contrasted with private investors' forecasts (Hale 1996). Debt, or a trade deficit, on this view, was not a problem so long as it was in the private sector.

In a raft of Fund and Bank publications, we find the belief in Mexico's reform process buttressing optimistic accounts of Mexico's prospects and covering over warnings or evidence to the contrary. Indeed even after the August 1994 elections, both the Fund and Bank were prepared to continue giving upbeat and optimistic assessments of the Mexican economy. Their reports and statements tended to report sources or signals from the market that were *positive*, yet only very exceptionally to pick up and report any major *negative* signals or outside commentaries. In essence, the experts were screening out any alternative information or warnings and at the same time constantly buttressing their optimistic accounts, which in retrospect, looks ever less warranted by the facts they might have paid more attention to at the time.

The optimism of the IMF and the World Bank rested largely on the belief that Mexico's successful program of stabilization, privatization, and deregulation, topped off with NAFTA and OECD membership, gave it a credibility and strength that would carry it through temporary difficulties. The maintenance of this view, even in the face of evidence to the contrary, was astonishing. The positive consensus seems to have seriously eroded the standards of evidence, which ought to have been applied alongside critical appraisal of the Mexican economy and policy. A similar statement can be made in respect of the IMF's work in South Korea.

Further exacerbating the failure to read the warning signs were the pressures within the institutions not to rock the boat. As in most hierarchical organizations, staff do not try to "second-guess" the upper management or, if relevant, the Executive Board, preferring instead to play the tune their superiors would most like to hear. The effect is a subtle form of self-censorship and a suppression of strongly critical or alternative views, which has been recognized by staff in both the IMF and the World Bank. In the words of a Bank official: "The ethos of the Bank is that no one challenges his supervisor, there is no room for boat rocking" (Sherk 1994, n. 19).

Finally, in respect of Mexico there was all too little sharing of information within and between the IMF and World Bank themselves. To cite the World Bank's analysis of lessons to be learned, "the macro concerns of staff were not well-known to top management . . . and within the country department, many staff and even some managers working on sectoral issues were unaware of the macro concerns of their colleagues. As a result, their policy dialogue continued to be based on the assumption that the stabilization program would stay on track" (World Bank 1996, IMF 1995c). Furthermore, the Executive Board of each institution remained silent. A later enquiry into the IMF's response to the crisis found that members of that Executive Board simply did not robustly push doubts or concerns that they may have had at the time (IMF 1995c).

The events of 1994 highlight several institutional features of the IMF and the World Bank that entrench a policy consensus. Having lent significant resources to the country and strongly endorsed it, the institutions obviously had a big stake in Mexico's success. Their prescription for growth and stability had solidified into one optimistic scenario, which was adopted as an article of faith. An equivalent, optimistic faith seemed to guide the IMF staff's interpretation of South Korea's vulnerabilities in 1997 in the wake of that country's initial ventures into capital account liberalization.

The faith-based blindness or seeming groupthink within the international financial institutions comes about partly because they rely on a template. The Bank and Fund have each forged conditionality that permits it to reconcile limited lending with the objectives of enhancing macroeconomic stability (in the case of the IMF), growth, and development (in the case of the World Bank).

The template is necessary because it guides staff working in countries all over the world, permitting them to act with the full backing of their institution and to put agreements in place with a minimum of time and resources. Put another way, staff have no incentive to venture beyond what the institution, as a whole, will take responsibility for. The result is conformity, which is entrenched by the hierarchical way in which each institution is organized. In both Mexico and in South Korea, the United States and its G-7 partners who command a controlling share of votes on the boards of the Fund and Bank failed to mitigate or contain groupthink in either institution. To the contrary, the explicit preferences of the United States seem to have driven the institutions further into a blind spot from which a crisis could not be seen.

The debt crises of the 1980s thrust the IMF and World Bank into the role of preservers of international financial stability. Major shareholders gave neither institution the political incentive, expertise, or resources to do anything but require debtors to undertake costly rescheduling and harsh stabilization and adjustment. It was in this crucible that the Washington consensus was born. Only once the vulnerability of international commercial banks had attenuated was any rebalancing of the debt strategy considered. But the imprimatur of the Washington consensus lives on not just for political reasons but equally for institutional ones.

Although changes have been undertaken in the IMF and World Bank since the Mexican crisis of 1994 and the South Korean crisis of 1997, core tensions persist and are perhaps inevitable. The staff of the IMF and World Bank must work with a vast array of countries, prescribing targets and sectoral reforms intended to enhance economic growth and performance. At the operational level there is very little room for experimentation or for taking account of local circumstances and knowledge. Individual staff members face a strong incentive to stick to a blueprint belonging to their institution they risk less personally if things go wrong. If all staff speak with one voice and prescribe the same things, then it is the institution as a whole that must bear the brunt of any criticism. At the general level this has its political justifications. The institutions must be seen to treat

borrowers "equally" in terms of access to resources and conditionality. They need to ensure quality control and managerial direction over hundreds of professionals working in all corners of the world.

Templates permit the Fund and Bank to "stand above" local knowledge and to claim a universally applicable expertise, based squarely in the discipline of economics. Disciplinary boundaries and methods assist them in forging coherency and unity, as do their own governance structures and hierarchy in particular. However, just as these features make life easier for the institutions, they also hobble them, as is illustrated by the crises in Mexico at the end of 1994 and in South Korea in 1997.

The institutions themselves are the first to admit that their success or failure lies in politics. Ultimately economic growth and equity depend on the strength and efficacy of a country's governance structures and institutions. But these preconditions for success lie beyond what the IMF or World Bank systematically takes into account in prescribing economic policies. Both are aware of the gap. The World Bank has attempted to begin at least to capture policy processes and the practices of policymakers in its series of "Prem Notes." The IMF has made various attempts to explore what a political economy analysis might add (Wimmer 2002). Yet as this chapter has demonstrated there are powerful incentives for each institution to continue to define its mission in narrow, more technocratic and replicable ways—and for staff members to want to work in this way rather than risk doing things differently and being held individually responsible for results. In the next chapter I examine the results from the other side of the equation, exploring what factors in borrowing countries lead the IMF and World Bank to succeed or fail in their respective missions.

Chapter 3

THE POWER TO PERSUADE

The mission of the IMF and World Bank is not just to produce and propose ideas but to persuade borrowing countries to implement them. On the face of it, this may seem easy. The IMF and the World Bank are powerful and coercive instruments of the international community and bastions of a dominant way of thinking about economic policy and the global economy—or so they are perceived across developing, emerging, and transition economies. Wealthy countries dominate the board of each agency and have arrogated to themselves the right to choose the head of each organization. Furthermore, when the institutions lend, their wealthiest members can bolster conditionality by bringing to bear considerable political pressure of their own.

Yet the IMF and World Bank do not always succeed in their mission. As staff within each agency put it, "politics" too often gets in the way. To succeed the IMF and World Bank must find willing and able interlocutors in borrowing governments. In the 1980s the prospects looked hopeful. A wave of market-opening economic reforms in a host of borrowing countries brought to power technocrats and like-minded policymakers from Latin America across to parts of sub-Saharan Africa. On one view this wave was due to a shift in consensus about economic policy, which the IMF and the World Bank helped to disseminate across the developing world. This chapter examines this and how subsequently the institutions have sought to transmit ideas and how their work is affected by the configuration of politics within borrowing countries.

Fostering a Global Consensus

In the 1980s many Latin American countries embraced the market-oriented reforms of the Washington consensus. The explanation for the regionwide transformation was simple, or at least appears to be. Economically literate technocrats