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 model illuminating the relationship among the main variables that would need to

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 trip-

ping 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 complex-

[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).

ities 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.

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

came to power and implemented a new kind of economic policy. These technocrats, mostly trained in the United States, embraced the new economic consensus and networked with one another, sharing advice and information. Former participating policymakers who shared "similar educations and beliefs in neoliberal solutions to key economic problems," attended the same conferences, subscribed to the same journals, and exchanged views in the same publications describe always feeling only "a telephone call away from each other" (Interviews: Naím 1995, Aspe 1995, and see also Williamson 1994). Their ascendancy in turn created openings for the IMF and World Bank to give advice and further disseminate the new economic policies. The result was a tide of economic liberalization in the 1980s (Dominguez 1997, Naim 1993, Nelson et al. 1994, Kahler 1992a).

Sociologists of ideas look to economics to explain the rise of the new consensus. Some write of a transformation of the discipline into a highly internationalized discipline, dominated and defined by an emerging class of "global experts" with "highly internationalized training (usually American)" who "claim to possess a universally applicable variety of expertise" (Babb 2001, 12). Subsequently the values and norms of the new economics were diffused by institutions, producing normative changes (Meyer and Rowan 1977) as well as changes in preferences and routines (Hoffman 1989, DiMaggio and Powell 1991). Governments became persuaded through dissemination, performance monitoring, seminars, publications, and the like (Kraatz 1998) and through a range of transmission mechanisms that has been elaborated by scholars of policy convergence, policy diffusion, and policy transfer (Dolowitz and Marsh 2000, Stone 2000). The result was a transformation ostensibly driven by beliefs and disciplinary training.

In Argentina, for example, Harvard-trained finance minister Domingo Cavallo brought about a "homogenization of economic thinking in Argentina," providing "the bridge that brought to Argentina the 1980s international consensus in favor of economic liberalization" (Corrales in Dominguez and McCann 1996, 51). Prior to Cavallo, Argentina had been divided between the advocates of statism (the stronger and more vocal majority) and those of free markets (a weaker and less self-persuaded minority). Yet in 1996, it was said that "today a consensus exists in Argentina, even among the left, that Cavallo's harsher version of economics—free convertibility, free trade, privatized public services, simplified tax systems, fiscal austerity—ought to be indelible features of the new Argentina" (Corrales in Dominguez and McCann 1996, 51).

In Argentina Cavallo's consensus did not persist. Within four years the bridge described by Corrales had collapsed. Argentinians of widely different political views converged in an anti-IMF and antineoliberal view of economic policy in the wake of that country's financial crisis. However, the rise of individuals imbued with a vision of economic reform that converged with that of the IMF and the World Bank had been crucial to the successes of the institutions not just in Argentina but elsewhere. So what role had the international financial institutions played?

Both the IMF and World Bank had facilitated negotiations between debtor

countries and their creditors. When governments enter international negotiations they open themselves up to new ideas, creating incentives for their own bureaucracies to prepare and advance ideas on an issue, often requiring their own officials to hire new experts or access new intellectual technologies. During negotiations governments learn not only from one another, but equally from their own adapting bureaucracies. The results often change their preferences (Putnam and Bayne 1987, Putnam 1988, Evans et al. 1993).

If we consider the case of Argentina, we can see how this process might work. Negotiations with foreign creditors and the IMF began in earnest in the early 1980s. Successive finance ministers had to fashion accords with both private and public international creditors. These finance officials soon came to know their counterparts in other countries across Latin America and worked intimately with interlocutors in international agencies. Negotiations were closely focused around the issues of external financing and debt rescheduling. The conditions seemed ripe for the kind of learning and international influence on which scholars of international relations focus.

Policies requiring technical expertise are the most likely to induce the "learning" effects of international cooperation. This is because "the diffusion of new ideas and information can lead to a new pattern of behaviour and prove to be an important determinant of international policy coordination" (Haas 1992). Where governments face uncertainty in international policy, they turn to networks of professionals with recognized expertise and competence in a particular domain. These networks soon form "epistemic communities" whereby professionals brought in to frame policy share normative and causal beliefs as well as notions of validity and a common policy enterprise (Adler and Haas 1992). The "epistemic community" not only informs international agreements, but shapes agreements in ways that entrench the positions of experts at the national level, leading to international cooperation and convergence which would not otherwise occur.

Underpinning the transmission of ideas are facilitating institutional arrangements. For a policy to succeed it will need to be taken up and pushed by an appropriate institution within government (Haas 1990, 1992). Indeed, international development agencies have long been aware of this. In the 1950s, the World Bank encouraged the creation of planning agencies, energy authorities, and the like within national governments that would be insulated from domestic pressures and responsive to bank preferences (Krasner 1999, 147). In the 1960s, the Inter-American Development Bank and the UN Economic Commission for Latin America gave technical support that bolstered the position of planning agencies and central statistics offices (Sikkink 1991, Tussie 1995). In the 1970s ideas about state-centered development "fit" very naturally in planning ministries (Sikkink 1991, Finnemore and Sikkink 1999, 268).

In the 1980s, the World Bank's desire to push trade liberalization did not find a home within trade ministries that derived power and revenue from tariffs and import duties. It was through other agencies with no stake in the protectionist regime that the World Bank pushed liberalization. For example, in Mexico the Central Bank supported trade liberalization, believing that trade liberalization

might assist in the control of inflation, not to mention in the control of the trade ministry (Heredia 1987).

The "epistemic" role of the IMF and World Bank is reinforced by the fact that they often step into crisis situations in which governments are uncertain. Armed with technical knowledge, the institutions foster the emergence of "technocrats" who understand and are sympathetic to their reform agenda. The practicalities of debt rescheduling and negotiations with the Bank and Fund constrain negotiations to a small, relatively insulated group. The result is to give specific policymakers and agencies considerable leverage. Hence the IMF and World Bank can bolster the position of policymakers who wish to undertake unpopular policies (Drazen 2001, Vreeland 2000, Ramcharan 2002, and see the older literature Putnam 1988, 457; Spaventa 1983, Remmer 1986, Edwards and Santella 1993, Vaubel 1986, and Dixit 1996). In Argentina, Cavallo's special relationship with the Fund and Bank gave him leverage over other agencies within the Argentine government, making him gatekeeper of the country's access to loans as well as to the ongoing support of the institutions, which was influential in persuading private capital markets to keep investing.

Behind the story of an emerging "epistemic community" lie political processes within countries that are equally if not more important. Economic reform during the 1980s was hugely contested in all countries and no less so in Argentina—as reflected in the vast literature on the politics of structural adjustment during the 1980s (Haggard and Kaufman 1989, Nelson et al. 1994, Remmer 1986). In other countries technocrats sometimes did not succeed in implementing neoliberal policies. Occasionally even in the absence of technocrats, neoliberal policies were put in place. In Argentina, a new democratically elected government took power from the military in 1983 and embraced a new and heterodox set of economic policies, which led it into confrontation with its creditors by the end of 1984 (Bouzas and Keifman 1985). Subsequently, as Robert Kaufman has analyzed, Argentina's policies were shaped by domestic politics and by economists with a different view of the IMF's then-orthodoxy (Kaufman 1990).

Far from snuggling into a new epistemic community, Argentinian policymakers attempted throughout the 1980s to play off the various actors within the community, variously invoking the U.S. Treasury and the World Bank in bids to persuade the IMF to soften its line. This alters the "epistemic community" view of why Argentina and other countries changed their economic policies, and it suggests two important caveats in respect to the relationship between "technical knowledge" and policy-making.

First, beneath every consensus lie many disagreements. In practice, technocrats often disagree about values, priorities, and even economic theories (Kapstein 1992). This is understated in the epistemic communities literature. Furthermore, even where experts or technocrats agree, the consensus among experts will not necessarily drive policy. John Ikenberry's account of the role of experts in the creation of the IMF and World Bank shows that the result was not driven by a pre-

existing expert consensus. Rather, what became a consensus was forged in response to policymakers' exigencies and questions. Politics drove the technocrats, and not vice versa (Ikenberry 1992). As evidenced in the previous chapter, the mission of the Fund and Bank is not informed by pure theory and empirical evidence. Institutional pressures and political factors also contribute to defining the mission of each institution. When they try to "sell" the result to borrowing countries, it is likely that even borrowers sympathetic to the underlying world view of the Fund and Bank will reject at least some elements of their prescriptions.

More profoundly, technical ideas shape politics only where they resonate with the political needs of the moment and provide opportunities to bridge old political divisions and build new coalitions (as elegantly put by Ikenberry 1992, 293). Ideas prevail not because they are the "best" ideas in a technical or professional sense but because they best meet the social, organizational, and political needs of key actors (Lakatos, and Musgrave 1970; Deane 1978; Blaug 1987). In the 1980s the Washington consensus offered a simple, intuitively appealing set of ideas and a vision of future competitiveness and wealth. In many ways this mindset fulfilled the role of an ideology in attributing blame and letting off steam, creating morale and optimism about the future, engendering solidarity or a particular identity, and permitting advocacy (Geertz 1964). Blame for the debt crisis and its aftermath was attributed to poor policy-making in developing countries. The future would be bright with the short-term pain of adjustment and reform leading to high growth and renewed access to capital markets. Old nationalist identities and solidarity were replaced with a new identity of entrepreneurialism, modernization, and integration into the world economy. Specific economic goals were prioritized and policies advocated. Neoliberal ideas offered not just a clear way to respond to a crisis but a whole new social language and rationale for reform (Woods 1995).

Like all politics, economic policy is the art of the possible. The IMF and World Bank operate in a marketplace not just of ideas but of politics and social forces. They supply ideas and prescriptions based (to some degree) on their technical analysis. They know that actual policies will be shaped by practical exigencies. Borrowing governments, for their part, will formulate policies in response to political, social, and institutional pressures, paying some heed to what Fund and Bank experts diagnose as the problem and propose as workable solutions.

In the 1980s the debt crisis discredited the more statist economic policies that preceded the Washington consensus and reconfigured social forces and priorities within debt-ridden countries. Thrown into crisis, policymakers in developing countries grappled for new solutions. In this context the prescriptions forged by the IMF and World Bank had attractions of their own. They offered governments a new paradigm that fitted policy into existing resources and promised a future of economic growth and recovery. The Washington consensus had the backing of institutions renowned for their technical expertise and resources. That said, it was also backed by significant bargaining power and leverage on the side of the international agencies.

Bargaining Power and Requiring Governments to Reform

The IMF and World Bank enjoy considerable bargaining power in their relations with borrowing governments. Countries mostly approach the institutions when they have little access to alternative sources of finance.[1] Bank and Fund loans are less attractive than private sector loans because they have many strings attached, including both formal conditionality and informal pressures and influences over the design, implementation, and procurement within programs and projects. For this reason governments heading into difficulty are often reluctant to approach the institutions—indeed, recall that in 1997 South Korea was determined not to approach the IMF. Only under strong U.S. pressure did South Korea eventually agreed to meet with the IMF's most senior officials dispatched to Seoul at the eleventh hour (Blustein 2001).

Once a country approaches the Bank or the Fund, it opens up a number of opportunities for the institutions and their most powerful government members to wield influence through penalties, conditionality, and advice. The institutions can refuse to lend to the country, thereby depriving a country of the emergency resources sought. Furthermore, when the institutions turn down a request for assistance, their action carries a second kind of penalty. Their refusal to lend will be interpreted by many other investors as an unwillingness to certify that a country's economic policies and prospects are sound. This can send a strong message to the markets and other potential lenders. Indeed, some countries will seek a positive certification even in the absence of a loan in the hope that this will help to catalyze funds from elsewhere.

When a loan is made to a country it is accompanied by conditionality. In practice, this involves some formal and some less formal requirements. In the World Bank rigorous requirements have always been complemented by looser, less formal agreements to undertake particular actions. Even three decades ago, as World Bank historians Mason and Asher detail, the Bank would complement detailed explicit conditionality with "supplementary letters" setting out the Bank's expectations with respect to borrowing government agencies on matters less formal than those covered in covenants, as well as "oral understandings concerning reciprocal obligations of lender and borrower" (Mason and Asher 1973, 420).

In the IMF conditionality is described across a spectrum from "hard" to "soft." Hard conditionality describes measures a country must meet in order to access any money. Typically this involves "prior actions" and "performance criteria," which are specified in the formal agreement. These can be waived where minor deviations from agreed targets are considered to be of a temporary or reversible nature. Soft conditionality refers to a wide range of other elements that the Fund will take into account in deciding whether or not to "complete" the reviews that are necessary to permit the disbursement of each portion of the loan.

[1] Normally this means they do not have adequate foreign reserves (Bird 1996). Economists debate the extent to which countries turn to the IMF because their balance of payments deficit increases (cf Santaella 1996, Goldstein and Montiel 1986 vs Knight and Santaella 1997, Conway 1994, Edwards and Santaella 1993).

Such soft conditionality includes things such as structural benchmarks, indicative triggers, and general undertakings in the country's letter of intent (Independent Evaluation Office 2002).

In formulating conditionality, the institutions' resources and "expertise" can be overwhelming. The technical weight of the analyses of the Fund and Bank staff put critics at a distinct disadvantage. In the words of one study, domestic actors simply cannot compete with the expertise and sophistication (or the "weight" and "depth") of the international financial institutions' technical work: "One interesting feature of the power dispute with the international agencies is the use of technical competence and research as a strategy to negotiate policy with the local administration and the intelligentsia. The imposition of technical criteria and the heavy emphasis on detailed and quantitative research about the problems at hand put local administrators at a great disadvantage" (Castro and Alfthan 1996, 18). In many cases, local officials wishing to present alternative policy recommendations have great difficulty matching the kind of technical work the Fund and Bank prepare. Proposing an alternative involves a long and arduous process of preparation to meet the Fund and Bank technicians head on.

Once agreed, conditionality is monitored by the IMF and the World Bank who have formal powers to apply sanctions if necessary on countries borrowing from them. If a country falls behind in implementing its agreed program or project, the institutions can suspend or cancel disbursements of loans (disbursements are made contingent on evidence that conditions being met). More serious sanctions can be imposed on a country if it falls behind in its repayments to the institutions. In the IMF this is covered by its arrears policy and in the World Bank by the nonaccrual policy. Further to this, until the late 1980s, the institutions would withhold funding from countries if they fell behind on their wider repayments obligations to the private sector.

The powers of the IMF and World Bank to require governments to reform are significant. They do not lend large proportions of global development financing but the timing of their loans gives them considerable leverage because they lend at times when governments have few alternative sources of finance. In spite of this advantage, it is easy to overstate their power and influence.

The imprimatur of the institutions is always cited by policymakers and commentators as an important signal to private investors, although in fact the evidence of the catalytic effect of IMF agreements is ambiguous at best (Mody and Saravia 2003, Cottarelli and Giannini 2002, Mosley 2000).

Conditionality is nowhere near as effective as either institution would like. They certainly can and do require a range of conditionalities from governments. But available evidence suggests that, for a number of reasons, they are seldom successful in imposing this (Killick 2002).

Where a country has strong support from a powerful shareholder within the IMF and World Bank, this can influence the package of policies the Fund and Bank are able to extract from a borrower. A government-in-need may be less compelled to agree if, as in the case of Russia, major shareholders on the boards of the Bank and Fund are prepared to exert informal pressure to ensure more

"understanding" agreements and conditions. In other words, when the economic and security interests of large powers are at stake, the Fund and Bank staff may find themselves on a leash. Similarly, when a country's crisis poses a threat to the international financial system, its government may find that it has more leeway since the institutions are under equal pressure to find a speedy solution—the usual package may be modified.

Access to information about their borrowers is vital for the IMF and World Bank, for on this depends their capacity to structure and offer loans as well as monitor conditionality. Yet each institution has to negotiate how much access they are granted to crucial information, policy debates, and decision-makers. A government wishing to hinder or limit the role of either international institution can simply close off access, albeit in many cases at obvious costs to its relations with the Fund and Bank staff. For example, prior to 1983 the World Bank was constantly frustrated by the Mexican government, who denied it access to crucial sectors of the economy. In the months leading up to Mexico's debt crisis in 1982, the World Bank (who had considerable exposure to Mexico) had virtually no information at all on Mexico's external public debt situation (Interviews: Knox 1995, Husein 1995, Binswagen 1995). Apparently the government claimed that statistics were held up due to computer difficulties. Without access, however, it was difficult for the Bank or the Fund to do its job and sensibly advise on areas of key economic policy.

In a more subtle way the nature of access to information can facilitate the mission of the IMF and World Bank. For a long time both sides could negotiate almost entirely in secret (now all countries are under pressure to permit the IMF and World Bank to disclose the content of agreements). The result was to forge a particularly narrow relationship between the Bank and Fund staff and very senior officials in specific economic agencies (typically finance ministries and central banks), cemented by each side's privileged access to information. The Fund and Bank would gain access through special relations with officials who in turn would benefit from the fact that they were the only policymakers with full information about the negotiations and positions of the Bank and Fund staff. This gave them a special gatekeeping role vis-à-vis the rest of government, empowering the individuals and the agencies with whom the Fund and Bank deal most directly.

The Fund and Bank have significant bargaining leverage in the face of crises, which force governments to supplicate for assistance. But this does not give either institution the power to impose a Washington-prescribed medicine. Rather, their mission has to begin by seeking out sympathetic policymakers or persuading existing leaders that specified reforms should be undertaken.

Finding Sympathetic Interlocutors

Where the Fund and Bank staff share technical expertise, methodology, and an orthodox economist's understanding of problems and solutions with officials in a borrowing country, their capacity to transmit (or reinforce) ideas is heightened.

As analyzed in chapter 2, a particular professional mindset dominates the work of the IMF and the World Bank. Where they encounter officials who share that same mindset as a way of managing political and economic problems, the task of persuasion is a joint effort in which the Fund and Bank staff team up with sympathetic local decision-makers to persuade others.

Two cases that reach back into the 1960s and 1970s highlight the ways in which the international institutions and foreign donors have relied on relations with particular officials with whom they can forge jointly agreed projects or policies. The cases indicate that it is not just a question of finding individual policymakers. Equally critical are the structures of government within which those individuals work and the bureaucratic and political incentives they face. The first case is that of India where the country's considerable national economic policymaking capacity and active sense of sovereignty and independence have for a long time forced the IMF and World Bank very actively to seek out and work with sympathetic interlocutors.

In the early 1960s the U.S. administration worked very closely with the World Bank setting up what became the Aid India Consortium. Further close cooperation resulted in sending two expert missions to India to examine its economic policies: the "three wise men" led by Oliver Frank in 1960 and the Bell Mission of the mid 1960s. The latter resulted in significant pressure on Indian policymakers to reform agriculture, liberalize industrial and trade controls, and devalue the rupee. India had a deteriorating balance of payments driven by two successive monsoon failures and two wars—with China in 1962 and with Pakistan in 1965. The result was an increase in the economy's dependence on foreign aid and loans (Joshi and Little 1994, 49).

The IMF, the World Bank, and the United States collectively used promises of external assistance to induce India to devalue and rationalize its tariffs and export subsidies. There was little domestic support for the devaluation (Joshi and Little 1994, 49). Subsequently, its perceived negative impact was blamed on World Bank pressure (Frankel 1978, Thapar 1991, Lewis 1997). The IMF would much later reflect that the result was "political backlash which gave reform a bad name and resulted in a fifteen year period before reforms could be tried again" (Krueger 2003). In fact reforms were attempted in concert with the IMF some nine years later in India.

Our concern here is with the conditions under which the World Bank team was originally able to persuade the government to reform. Retrospectives of the World Bank's work in India during the 1960s focus closely on the able, sympathetic, and technically competent interlocutors within the Indian government (Lewis 1997; Kapur et al. 1997, 293–98, 463–67). These interlocutors fostered a sense of success and ongoing commitment in the Bank and likewise in the Fund and the U.S. administration. The architect of the agricultural policy reforms so desired by the World Bank in India was C. Subramaniam, food and agriculture minister from 1964 to 1966. His beliefs about Indian agriculture have been traced by Ashutosh Varshney who depicts their culmination in an agrarian model that complemented the World Bank's thinking about these issues (Varshney 1989).

Equally important to the uptake of the World Bank's model was the bureau-

cracy and the way in which Subramaniam's institutional base—the prime minister's Secretariat—rose while the hitherto dominant Planning Commission was tamed (Varshney 1989). Subramaniam was able to attract critical elements of party support and finance for his reforms, and to build up a base of sympathetic colleagues. It was with this group that the World Bank worked so successfully.

Once a relationship with key policymakers had been established, outside agencies could use that relationship discreetly to find ways to smooth over problems. From an official perspective, USAID official John Lewis details the way the United States and World Bank turned to Subramaniam in 1965 in order to break an aid log-jam. Confidential negotiations that included President Johnson resulted in a secret treaty in which the Indian minister agreed to undertake specific policy commitments—over the objections of his colleagues—in return for an unlocking of U.S. aid (Lewis 1997, 113).

Finding the right interlocutors in the Indian case did not mean that the Bank, or any other external agencies, enjoyed plain sailing with India. In dealing with their Indian interlocutors, Bank staff seemed to have oscillated between respect and frustration. Indeed, in their 1973 history of the Bank, Mason and Asher wrote that by the end of the 1960s "what had previously been viewed as technical excellence in India was characterized as doctrinaire arrogance" (Mason and Asher 1973, 683).

In the early 1970s a radical-populism defined India's economic policies as Mrs. Gandhi surrounded herself with radicals in the wake of winning a heady unconditional surrender from Pakistan when that country attacked India by air in December 1971. But the radical-populism was short-lived. Mismanagement of food supplies and the oil price shocks of 1973 and 1974 contributed to political and economic disarray that drove Mrs. Gandhi to alter course.

In 1974 Mrs. Gandhi gathered around her an interministerial task force of senior bureaucrats to devise an anti-inflationary policy. These technocrats introduced tax and monetary measures that brought inflation under control and successfully devalued by stealth, manipulating the currency basket to which the rupee was fixed (Joshi and Little 1994, 54–56). One result of the new policies was to reforge relations with the IMF and World Bank. In 1972–73 India received no credit from the IMF and net multilateral loans of US$473 million. In 1974–75 India accessed US$522 million from the IMF and US$961 million in multilateral loans, which rose to US$1.29 billion in the following year (Joshi and Little 1994, 137).

In India where failure pushed policymakers to seek a new approach in the economy, the World Bank and the IMF gained openings into the policy debate. However, these openings could only be used effectively where sympathetic interlocutors in the Indian government were prepared to work with the international institutions. This meant that the IMF and World Bank had to tailor their advice and aspirations to fit within the domestic Indian economic agenda. They were most influential when policy was made by a small group relatively insulated from the wider political system. A similar set of factors affected relations with Indonesia.

Indonesia offers another case in which the World Bank and the IMF became highly involved during the 1970s. U.S. strategic priorities set the backdrop for their involvement. The extent of the international agencies' work in Indonesia depended on their relations with government officials. As with India, a consortium, initially called the Inter-Governmental Group on Indonesia and later the Consultative Group on Indonesia, was formed to bring together Western donors and lenders to Indonesia. Under that umbrella more specific working partnerships were formed.

Indonesia joined the IMF in 1967 and was required to implement a series of economic reforms orienting the economy toward exports and limiting the country's budget deficit, initiating a period of significant IMF influence over policy (Sutton 1982). Subsequently a very close relationship developed between the staff of the Bank and Fund and their interlocutors in the Indonesian government—a group of young U.S.-trained economists (or "technocrats" as they came to be called) who were brought into government by General Suharto (MacIntyre 1993, Yoon 1991, Soesastro 1989). In 1968 the Bank set up a Resident Mission in Indonesia (the Bank's first ever such arrangement), cementing the close relationship that existed between the Bank and Indonesian counterparts. It then increased its lending rapidly during the 1970s, giving its most senior staff member in Jakarta unprecedented powers to make loans and report directly to the World Bank president (Operations Evaluation Department 1999, Kapur, Lewis and Webb 1997, 467–71). On the Indonesia side, the bureaucrats were important since they wielded a lot of power over economic policy due to the heavily statist, centralized, and clientelistic system that had developed under Suharto (MacIntyre 1989).

The Fund and Bank lost some degree of influence once their technocratic Indonesian interlocutors lost some of their special position and power as the constraints faced by Indonesia changed in the late 1970s. Yet even within the "special relationship" between the government and the World Bank there were drawbacks. As later reported in an official evaluation of the World Bank's relationship with Indonesia: "The special relationship . . . created a situation where the Bank did not succeed in persuading the Government to heed some crucially important, but unwelcome messages to the country, let alone impose unwanted policies, lest the relationship be broken" (Operations Evaluation Department 1999, 16). The same would happen later on in Mexico (see chapter 4).

It is important to recall that the World Bank depends on lending to countries such as Indonesia who can borrow and repay, thus generating both opportunities for the Bank to lend large sums, and net income for the Bank from its lending activities. Added to that, Indonesia's impressive record of economic growth and poverty reduction were seen as adding luster to the Bank's reputation.

Elements of the relations forged with India and Indonesia can be found in the Fund and Bank's work with many other strongly statist countries allied to the West with whom the World Bank and/or the IMF formed close relations during the late 1960s and 1970s: for instance, Turkey, Mexico, Iran (in particular in the late 1970s), and the Philippines. Strong relations were initially developed with a particular group of young technocrats. Economic difficulties enhanced the lever-

age of both the ideas and the resources proffered by the IMF and World Bank. However, once the technocrats lost influence in government, the Bank and Fund lost a degree of leverage and influence. For this reason we need to examine the political institutions within which technocrats either rise or fall.

The Bureaucracy and Institutions of Government

We have seen that the IMF and World Bank are most likely to succeed where economic decision-making is undertaken by the executive or an insulated elite at the top of the government bureaucracy. This does not imply that authoritarian governments are better placed to pursue economic reform than democracies (the debate about this is reviewed by Sirowy and Inkeles 1990, Przeworski and Limongi 1993, Helliwell 1994). Although early studies suggested that authoritarian governments undertake "tough" economic adjustment more readily than democracies (Haggard and Kaufman 1992), subsequent studies contest this (Hellman 1997, Joyce 2004). In the end, the studies of authoritarian versus democratic regimes do not tell us under what conditions economic reform is most likely to be undertaken (Haggard 1986, Remmer 1984, Geddes 1995, Edwards 2003). But core political structures do affect when and where the IMF and World Bank are likely to be most influential.

In some political systems economic policy is made away from the hurly-burly of politics. This gives greater scope for the IMF and World Bank to engage technocratic interlocutors. There are several ways economic policymakers can be insulated from the rest of a political system, permitting them to pursue economic policy in close cooperation with the IMF and World Bank with relatively little constraint. Obviously at times of economic crisis executive authority is expanded (Haggard 2000). Or put in the words of the first deputy managing director of the IMF, a crisis can suspend "politics as usual" and provide a government with "considerable freedom—more than is usual in politics—to undertake reforms"; furthermore, "new governments may enjoy something of an advantage, especially those in democracies that enter office with a mandate for change" (Krueger 2003). Economic policy-making can also be insulated from broader political processes through delegation to specialized agencies such as independent central banks (Cukierman, Webb, and Neyapti 1992; Eijffinger and de Haan 1996), quasi-judicial structures for the management of trade policy issues (Hall and Nelson 1992), and centralized budgetary processes (Alesina and Perotti 1996; Perotti 1997; succinctly described in Haggard 2000, 42).

Where economic policy is mostly made within part of the bureaucracy, we must delve inside the bureaucracy to discover under what conditions the IMF and World Bank are most likely to find or persuade willing interlocutors. For inside government institutions, the impact of particular ideologies or ideas is affected by patterns of recruitment and administration as well as the capacity of institutions to innovate (Evans 1995, Evans et al. 1985, Hall 1986, Steinmo 1989, Adler 1987). The kinds of experts appointed to senior jobs and the qualifications de-

manded and recognized can shape the upper echelons of a government. If recruitment takes place almost exclusively among individuals with a particular type of training or degree, this can easily bias receptivity toward one set of ideas (Haas 1989, Miller-Adams 1997, Ascher 1983, Finnemore 1996).

Equally important are the bureaucratic structures that permit, or hinder, a turnover of staff. In the United States and Mexico, for example, the political appointment of senior civil servants means that each new president brings to office a new staff and potentially a new mindset. Change is thus more likely and more rapid than in the erstwhile UK-style career civil service where new ideas wait behind a long queue of retiring civil servants (Weir 1989 and others in Hall 1989). In the post-Communist world, Steven Fish has shown that "elite turnover" deeply affected the propensity of governments to reform (Fish 1998b).

Bureaucracies powerfully shape the actions of those who work within them. This requires us to pay attention to the norms, values, and processes of any agency tasked with economic policy. March and Olsen remind us that institutions are "collections of standard operating procedures and structures that define and defend values, norms, interests, identities, and beliefs" (March and Olsen 1989, 17). James Q. Wilson, in his empirical study of bureaucratic agencies, reminds us that preexisting attitudes, predispositions, preferences, and peer judgments, combined with the imperatives of the situation, all powerfully shape the responses and actions of bureaucrats (Wilson 1989).

Until recently the IMF and World Bank could work relatively easily with bureaucracies who enjoyed relative independence from the rest of the political system within borrowing countries. Each international institution could exercise some influence over domestic policy struggles by using the timing and quantity of small amounts of rapidly disbursable resources together with conditionality to bolster the position of their favored interlocutors. They could enhance the authority and resources of individual policymakers, privileging some and disempowering others. They were aided in this by the secrecy surrounding negotiations with the Fund and Bank and the fact that only a chosen few were party to negotiations. As required by their Articles of Agreement, they negotiated exclusively with one small group of officials—those at the head of the Ministry of Finance, Ministry of Planning, Central Bank, or the like. As a result, their interlocutors had privileged information and influence within their own political system.

More recently, the nature of relations between the Fund and Bank and borrowing governments has changed. Increasing transparency and publicity has opened the work of the institutions, making the old, more secretive approach difficult to sustain. Furthermore, as the reform agenda has deepened to include far-reaching institutional and social reforms, it has become apparent that a top-down approach does not produce sustained reforms. In the 1980s and early 1990s the "top-down" macroeconomic policies and trade liberalization reforms being urged by the IMF and World Bank did not require "deep" political implementation—a small group of technocrats *could* take these kinds of decisions. However, the deeper "good governance" reforms being urged by the mid 1990s could not be pursued in the same way (Naim 1995, Nelson et al. 1994). Recent thinking in

the Fund and the Bank recognizes the fragility of a reform process that relies on key individuals, suggesting that sustained reform requires a deeper commitment or support from the broader political system and society.

In several cases the mission of the IMF and World Bank has been blocked by the actions of parliaments. For example, in Russia in July 1998, the parliament flatly rejected a number of the tax reforms that were key conditions of an IMF loan that had been approved a day before. As will be discussed in chapter 5, the Russian president then turned to instituting the required reforms by decree. In Argentina in December 2001, after defaulting on $155 billion in foreign debt, the government acceded to IMF demands for monetary adjustments, spending cuts, and politically sensitive reforms to the system of revenue-sharing with the provinces. However, the parliament refused to move on a bill converting savings to bonds and flouted IMF orders by passing bills reforming bankruptcy rules and punishing "economic subversion"—removing money from the cash-strapped economy even though this sank Argentina further into threat of default on its loan payments to the World Bank (Valente 2002). In Turkey in 1998, parliament forced the government to break its promise to the IMF to hold down the wage increases of public sector workers.[2] In 1999 and 2000, the Moldovan parliament repeatedly rejected IMF-mandated privatization of wine, brandy, and tobacco enterprises in a political fight that brought down a government. (Eventually, despite Communist opposition, the privatization took place and the IMF relationship was restored.)[3] The Indonesian government declared in January 2003 that it would break free from its commitments to the IMF; parliamentary pressure, including a decree in October 2002 requiring the government not to extend the current IMF program, was a vital part of this decision.[4]

Both the IMF and the World Bank now adopt the view that they must go beyond ensuring that their counterparts are intellectually convinced about new policies, prepared to initiate reform, and use their political will to implement new policies and build a consensus around them (Johnson and Wasty 1993, Frischtak and Atiyas 1996). Each institution has begun to work with and to consider more systematically a wider range of processes within borrowing countries.

Nonetheless, there has always been an awareness within the IMF and World Bank of the way political institutions affect their role. A comparison of Mexico and Brazil is instructive. The Bank built a closer relationship with key government bureaucracies in Mexico than in Brazil, which had a far more complex political structure, a more open society, and a more prescriptive constitution. As the former director of the Latin American and Caribbean Department of the World Bank put it to me in an interview in 1995, when Bank-friendly technocrats came to power in Mexico, they all too quickly passed through (Husein interview 1995).

Within the political process there are several actors who may have a veto over

[2] "Politics cloud the economic horizon," *Middle East Economic Digest* (7 August 1998): 7.

[3] "Moldovan Government Resigns," *Deutsche Presse-Agentur,* 9 November 1999. "Moldova 'may face default' after parliament rejects privatization," *BBC Worldwide Monitoring,* 18 April 2000.

[4] Smitha Francis, "Indonesia's battle of will with the IMF," Network Ideas, 25 February 2003, http://www.networkideas.org/themes/trade/feb2003/tp25_Indonesia.htm.

economic policy. At the apex of any political system is the executive—the president or prime minister whose authority and strength depends on how much he or she must rely on the support of a political party, coalition, or legislature. The president, cabinet ministers, parliament, parliamentary committees, bureaucracy, and implementing agencies may all need to agree in order for a measure to be adopted and implemented. In theory, the more actors along the way who can veto or block a policy, the more difficult it will be to reform but the easier it will be to maintain stability and credibility (Tsebelis 1995). In practice, outcomes will depend on the respective roles of the executive, parliaments or legislatures, and political parties.

A large number of political parties within a political system will produce "fragmentation." Forging agreement among a large number of parties is difficult and further compounded when the system is strongly polarized, meaning that strong ideological differences drive actors in the system to differentiate themselves as occurred in Russia and in Turkey in the late 1980s (Haggard 2000).

Equally important is how political parties are organized and what incentives politicians face—such as to fall in behind a leader or to focus on individual, narrower interests. Some political systems encourage politicians to seek publicity and popularity for themselves with little need for party backing or support. This makes top-down economic reform difficult. The evidence demonstrates this in respect to "open list" systems where political parties do not control who gets to run for election (Carey and Shugart 1995) and multiple-member constituencies where there are several representatives from each constituency and so politicians have an incentive to appeal to selective parts rather than the electorate as a whole (Cox 1990, Myerson 1994). The structure of campaign financing can magnify these effects. By contrast, in a single-member constituency in a closed-list system, politicians face a much stronger incentive to tow the party line and the result, according to one study, is a greater provision of public goods and less spending on special interests (Edwards 2003).

In sum, political parties and the way they compete for power will affect the kinds of economic policy a government favors. So too will the electoral cycle. Econometric studies tell us that the higher the uncertainty about whether a government will be reelected, the more likely a government is to spend more and to tax less in order to try to buy support for itself (Roubini 1991, Edwards and Tabellini 1991, Annett 2000). Furthermore, a government facing an election is unlikely to initiate a program with the IMF within six months before the election (Bird and Rowlands 2000, Vreeland 1999, Dreher 2002, 2003), and more likely to enter into an agreement with the IMF after the elections are over (Przeworski and Vreeland 2000).

Political institutions heavily influence the leverage of the international financial institutions over policy. The IMF and World Bank have the most scope for influence where policy-making is highly centralized and insulated from the broader political arena. But this has increasingly failed to translate into an ability to ensure implementation. This is because each institution is trying to foster policies that require broader support and implementation by agencies outside the

narrow circle with whom the Fund and Bank negotiate. The result is a difficult trade-off between centralized and insulated policy-making that prioritizes a particular view of economic effectiveness, versus a messier, complex democratic process that is more open and transparent but can result in poor economic policies. Specific cases of this trade-off are further explored in subsequent chapters. Playing into either system are actors outside the political institutions—first and foremost among which are powerful interest groups whose support or rejection of particular measures can often influence policy.

The Role of Interest Groups and the Scope for Policy Capture

The IMF and World Bank have long held the view that they must persuade and garner support not just from governments but also from the private sector and other parts of civil society within countries if their mission is to succeed. Although they must work formally through the government, both the IMF and the World Bank engage and consult with an increasing range of interest groups in borrowing countries. So too they have begun to analyze the impact of policies on such groups through stakeholder analysis, which examines which societal groups will benefit or lose out from reform (World Bank 1996b). But where and how do interest groups shape policy and thereby the influence of the Fund or the Bank?

Governments rely on some degree of support from interest groups to stay in power (Ilchman and Uphoff 1969). These interest groups "enter the political arena in pursuit of their interests, with major effects on political outcomes" (Frieden 1991a, 7). As the incentives for groups and sectors changed—such as in the 1980s in the wake of the debt crisis in Latin America—so too government policies changed to accommodate new powerful interests (Bates 1981, Olson 1982). Put simply, international economic shocks created new opportunities and constraints that altered the agenda of powerful interest groups, empowering some and disempowering others (Frieden 1991b). On this view economic reform will be possible when a crisis or shock reconfigures social interests.

But what role does this suggest that interest groups play—do they set the agenda for politicians or do they exercise a veto over policies forged by politicians? The answer is to be found in political economy research. If interest groups were to set the agenda they would need to be organized in stable coalitions with dynamic sources of ideas that best reflect the interests of members. But this is not borne out by the evidence. Imperfect information means that interest groups simply do not know or are uncertain about the benefits they will enjoy if a particular policy is pursued (Rodrik 1996, Fernandez and Rodrik 1991). Alternatively, interest groups know how they will benefit but are hindered by uncertainty about how the overall benefits are distributed and how their rivals and others will benefit (Drazen and Grilli 1993, Alesina and Drazen 1991).

Imperfect information and uncertainty mean that interest groups tend not to set the agenda. Rather they respond to an agenda set by the government. In Africa, for example, Robert Bates depicts politicians creating and maintaining

coalitions of interests in order to ensure their political survival (Bates 1981). Sophisticated cross-class coalitions *result* from government policies. For example, farmers who benefit from seemingly adverse policies by using the market defensively coalesce with urban clienteles including both business and workers created by governments' use of nonmarket instruments. In this analysis, interest group coalitions are fluid and reactive.

The failure of interest groups to set the agenda is also born out in a later study by Bates and a team of researchers examining and comparing eight developing countries. They reported that "one of the most surprising findings of our case studies is the degree to which the intervention of interest groups fails to account for the initiation or lack of initiation of policy reform" (Bates and Krueger 1993, 454). A similar finding is made in a study of Indian agricultural policy (Varshney 1989). Indeed, sometimes interest groups are even unwilling to support policies that favor their interests. In Brazil, Chile, Ecuador, Egypt, Ghana, Korea, Turkey, and Zambia, scholars found that "in the context of comprehensive economic policy reform it is difficult for particular groups to calculate where their interest lie. Ideological struggles therefore can outweigh competition among organized interests as a determinant of policy change" (Bates and Krueger 1993, 456).

The power of interest groups lies in shaping policies within the preferences set out by governments and bureaucrats. Sometimes they even succeed in capturing the process of detailing and implementing policy. For example, Korea's financial liberalization began in earnest in 1991 when the government began to license merchant banks and to lift administrative controls on commercial credit. The result, as described by Stephan Haggard and Jungkun Seo, is "a case-study in how financial reforms can be captured not only in their implementation but in their basic design" (Haggard 2000, 37). The government was captured by the intense lobbying efforts of corporate conglomerates who used kickbacks to bureaucrats and politicians in order to shape both the design and application of policies.

The private sector is a powerful lobby within government, and sometimes this includes the lobbying of foreign direct investors. It is often assumed that increasing foreign direct investment (FDI) will open up an economy and result in lower protectionism (Bhagwati 1987 gives evidence of this). However, more recent studies show that the opposite can occur. For example, when foreign direct investors moved into import-competing sectors in Mexico, those sectors became more highly protected than other import-competing sectors with no FDI (Grether and Marcelo 1999). Industrial groups as a whole were very active in lobbying the government (Kraemer 1995). Foreign director investors were yet more effective in lobbying a government increasingly sensitive to their interests (Grether and Marcelo 1999). Overall, as a trade policy review of Mexico reported in 1993, a very high level of well-organized cooperation and linkage between the government and the private sector pervaded Mexican policy-making through the 1980s and early 1990s (GATT 1993). The real question is what should balance this influence?

In Africa although organized interest groups play virtually no role in setting the economic agenda, this has not prevented subsequent capture by specific in-

terests (Van de Walle 2001). The weakness of government capacity to implement policies and achieve outcomes has resulted in a government apparatus in many countries that has been used to create and extract rent (Mbaka and Paul 1989). Indeed, in some countries politicians are seen as "brokers of wealth transfers between the various interest groups" (Kimenyi and Mbaka 1993). Key to perpetuating such systems is the lack of any checks on governments by societal pressures, parliaments, opposition parties, or a free press (Migdal 1989).

The IMF and World Bank have long recognized private interests as a powerful force in politics. In an interview, a senior Bank official recounted that in Venezuela in the early 1990s the Bank failed adequately to understand rent-seeking and its relationship to particular government institutions. After strongly supporting a reformist government, they soon found that the well-established rent-seekers struck back, collapsing the reforms and revealing deep shortcomings in the Bank's analysis of fundamental policy structures and relationships and the likely impact of change (Husein interview 1995). Subsequently World Bank researchers have begun to flesh out the conditions under which policy becomes "captured" by private sector interests (Hellman 1998, Hellman et al, 2000).

The challenge for the IMF and World Bank is that they are likely to have influence where "rational economic policy" can be formulated away from the hurly burly of politics (Krueger 2003). Yet so too are vested interests, who may capture and distort outcomes for their own benefit. The alternative is economic policy made in a more transparent, openly contested, publicly debated, and democratic way. That process is likely to be messy, complex, and time-consuming, it will often thwart rapid reform, and it will certainly marginalize the role of the IMF and World Bank.

The IMF and World Bank transmit ideas about economic policy to a wide range of countries. Their influence depends not just on the individuals with whom they work but on the configuration of political institutions within borrowing countries. The rise of the Washington consensus in Latin America was facilitated by U.S.-trained technocrats prepared to embrace prescriptions proffered by the IMF and the World Bank. However, this occurred only in the context of an economic crisis that had thrown previous policies into discredit and imposed a new resource constraint on governments. Even then, however, not all governments facing similar circumstances adopted the same policies at the same time—Brazil and Mexico, for example, each responded differently in the 1980s and early 1990s to fiscal constraints.

The IMF and World Bank deploy a mixture of technical advice and coercive power in bargaining with borrowing governments. Each institution can variously lend or withhold resources, disburse or suspend payments, and impose various forms of conditions. Yet the institutions can successfully deploy this power only where they find and work with sympathetic interlocutors.

Sympathetic interlocutors must be both willing and able to embrace the priorities preferred by the institutions. Their willingness is influenced by circumstances and prevailing sets of ideas. For example, the debt crisis not only

discredited some existing ideas about economic policy but also demolished the resources necessary to implement them. In that context, new policies were actively sought and taken up by indebted governments. The Washington consensus offered one solution. Its persuasiveness was doubtless bolstered by the resources and expertise thrown behind it by the IMF and World Bank, as well as its roots in prevailing economic theories of the time in which many finance officials had been trained. But even then, the Washington consensus was implemented only under particular political conditions.

The ability of interlocutors to implement reforms is shaped by the configuration of political institutions, or "governance" within countries. Where economic policy is centralized and relatively insulated from other political pressures, the potential influence of the IMF and World Bank is high, particularly in bureaucracies with high turnover and adaptive capacity. Nonetheless, such systems are often characterized by only the narrowest form of accountability. Where economic policy is subject to a broader set of processes, party politics and electoral cycles will have a strong influence. The results will be messier and less easily controlled—albeit more open, and more transparent. In more open systems, the capacity of the government to change policy will depend on the number of "veto players" in the policy process.

Among potential veto players in economic policy, interest groups play a rather specific role. They do not set the agenda. Rather they respond to priorities set by the government. Despite their reactive nature, interest groups can capture the process of policy implementation, thereby altering the outcomes of economic policy. Their capacity to do this is greatest in systems that are not transparent and where formal systems of accountability do not function. These effects are illustrated in the next chapters.