Controlling Institutions

International Organizations and the Global Economy

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A model of informal governance

The argument is that international organizations are best understood as equilibrium outcomes that balance the power and interests of the leading state and the member countries. Institutional design is endogenous to this interaction, and includes membership, formal voting rights and informal governance procedures. The model that follows gives specific content to this claim by specifying how three particular forms of power interact. *Structural power* represents the outside options of the leading state and the externalities that its participation generates for other members.[1] *Formal voting rights* set the policy of the organization and create the parameters within which informal influence is exercised. *Informal influence* consists of participation in decision making and special access to information, and it allows the leading state to override the common policy when its vital interests are affected.

Hybrid institutional forms involving both formal and informal governance mechanisms are the norm because they make it possible to accommodate the interests of both strong and weak powers. Informal governance can be legitimate because the degree of conflict of interest between the leading state and the membership varies within the range of issues or cases that fall under an organization's competence, so the member countries tolerate a degree of informal influence in cases of special concern to the leading power in return for a larger share of decision-making authority in ordinary times. This tacit contract depends upon the restraint of the leading state, however, and the legitimacy and credibility of the organization can be eroded if informal influence is used too frequently.

The argument is laid out in the form of a formal model. Formalization makes it possible to define our terms precisely. Concepts such as power and legitimacy have diverse meanings, and defining them in mathematical terms makes

[1] Strange 1988.

it possible to indicate precisely what they signify in a particular argument. Furthermore, formalization makes it possible to detect logical errors that might be obscured in a prose argument – it imposes "accounting standards" for arguments,[2] assuring that conclusions really follow from assumptions. Beyond assuring clarity and logical consistency, however, a formal model is a uniquely powerful tool for discovering unexpected implications of arguments. Game theory is not useful for some purposes, such as explaining the origins of preferences or worldviews, but it is an ideal tool for exploring the effects of complex strategic interactions.

The model presented here is designed to be as simple as possible in game theoretic terms, involving no incomplete information and no dynamically evolving state variables, but it has a lot of moving parts. Precisely how the elements of institutional design influence one another would not be obvious without a formal analysis. For example, if US structural power increases, what is the effect on the distribution of formal voting rights? It turns out that this leads to a decrease rather than an increase in US formal control rights, because the United States comes to depend more heavily on informal influence. States with substantial structural power have greater informal influence, and they compensate for this by giving up formal voting rights in order to induce participation by a wider range of states. On the other hand, when the leading state's temptations to exercise informal influence grow, this leads to a decline in informal governance and a redistribution of control rights in favor of weaker powers, but also to a decline in the organization's legitimacy and significance. The precise meaning of these claims will be made clear below.

The key features of the model are as follows: (1) An international organization imposes a policy that is determined by weighted voting, but the United States has the ability to override the policy in a particular case, at some cost. The temptation to override the common policy is a random variable, so in a particular case it may or may not be attractive for the United States to do so. Voting represents formal control and the US override represents informal influence. (2) The member countries vote to determine the cost that the United States pays when it overrides their policy, so informal influence depends on the consent of the membership. (3) The United States can exercise an outside option that does not depend on multilateral cooperation, and chooses a level of investment in the organization, which provides positive externalities to the other members. This ability to impose costs on the membership by partially exiting the organization represents US structural power, and deters the membership from setting the cost of informal influence at a prohibitive level.

[2] Powell 1999.

(4) The United States proposes the distribution of vote shares in the international organization, and the members decide whether to participate under those terms. Assigning this bargaining advantage to the United States represents the unique role that the leading state plays in designing any organization in which it participates, in addition to the advantages due to the distribution of institutional memberships and vote shares inherited from the Cold War. This simplification of the bargaining protocol is not necessary in order to derive the main results, however. The key feature of the model is that institutional design is endogenous.

The model

The model is an extensive-form game of full and perfect information, with players the United States and n other countries. The sequence of play is as follows: The United States offers a vector of vote shares in an international organization to a subset $K \subseteq N$, and the members of K choose whether to participate. Subsequently, the members vote to set a cost, c, that will be imposed upon the United States if it chooses to override the organization's policy in a particular case. The United States then chooses its level of participation in the organization. Nature subsequently initiates a crisis, which is of variable importance to the United States, and the United States decides whether to preempt the expected policy in this case. Finally, if the United States has not exercised an override, the members vote to set the institution's policy. This sequence is illustrated in Figure 3.1. Countries i have ideal points a_i on the interval $(0, 1)$, and members of the organization receive utility:

$$u_j = \gamma \sum_i z_i - (1 - \lambda) z_j - |x - a_j|,$$

where z are the contributions made by each country i, λ is a political rent derived from voting power in the organization, γ is the degree of US participation in the organization, and x is the policy that is implemented. Non-members receive zero.

US utility differs from that of other countries in two respects. First, the United States is able to partially exit the organization, reducing its contribution and the weight it puts on the organization's policy to a proportion represented by $\gamma \in (0, 1)$. In addition, the United States receives a benefit, $b \sim U(0, \bar{b})$, if it overrides the standard policy and imposes $x = 0$. When it overrides the policy, the US incurs a cost, c, which is chosen by the membership. The US

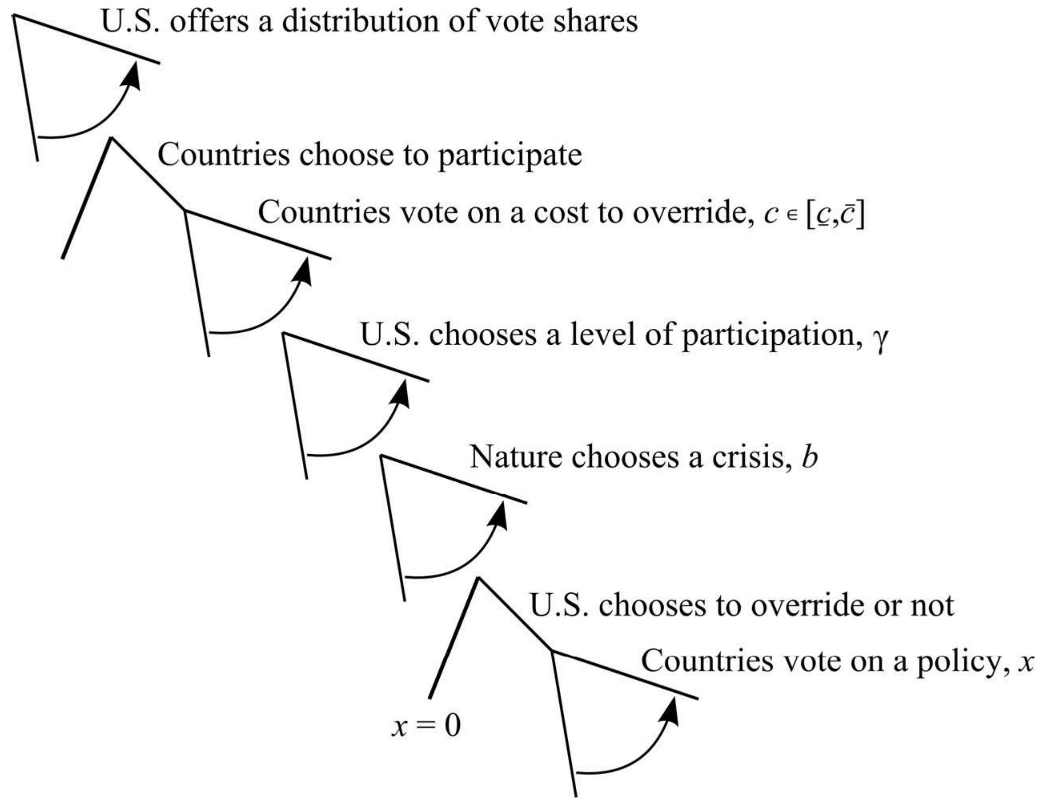

Figure 3.1 The sequence of play.

indirect utility function is as follows:

$$u_{US} = \gamma\bigg(\sum_i z_i - (1-\lambda)\gamma z_{US} - |x - a_{US}| + I(b-c)\bigg) + (1-\gamma)(R),$$

where R is a reservation utility available by exercising an outside option and I is an indicator variable, taking the value 1 if the United States decides to override the organization's policy and 0 if it does not.

Equilibrium analysis

The equilibrium concept is subgame perfection (SPE), and the best responses are found by backward induction. At the final node, if it is reached because the United States has not chosen to preempt, the countries vote on a policy, and the pivotal voter chooses the policy that corresponds to its ideal point, $x = a_p$.

At the previous node, the United States chooses to preempt the expected policy if the utility of overriding and setting a policy of zero exceeds the utility of not overriding:

$$-|0 - a_{US}| + (b - c) > -|x - a_{US}|.$$

There are two possible cases, depending on whether the pivotal voter prefers a policy lower than the US ideal point ($a_{US} > x$), or a policy greater than the US ideal point ($a_{US} < x$).[3] The threshold value of b that invokes the US override is:

$$b^* \equiv \begin{cases} c + x & \text{if} \quad a_{US} > x, \\ c - x + 2a_{US} & \text{if} \quad a_{US} < x. \end{cases}$$

It will be useful to note that the *ex ante* probability of overriding, p, is:

$$p = \begin{cases} 1 - (c + x)/\bar{b} & \text{if} \quad a_{US} > x, \\ 1 - (c - x + 2a_{US})/\bar{b} & \text{if} \quad a_{US} < x. \end{cases}$$

At the previous decision node, the United States chooses a level of participation, γ, to maximize the expected value of:

$$\gamma\Big(\sum_i z_i - (1 - \lambda)\gamma z_{US} - |x - a_{US}| + I(b - c)\Big) + (1 - \gamma)(R).$$

This yields the equilibrium level of US participation:

$$\gamma = \begin{cases} \frac{\sum z_i + 1/\bar{b} - R - a_{US} - c + (c+x)^2/\bar{b}}{2(1-\lambda)z_{US}} & \text{if} \quad a_{US} > x, \\ \frac{\sum z_i + 1/\bar{b} - R - a_{US} - c + (c-x+2a_{US})^2/\bar{b}}{2(1-\lambda)z_{US}} & \text{if} \quad a_{US} < x. \end{cases}$$

At the previous decision node, the countries choose the cost, c, which the United States incurs when it chooses to override the organization's chosen policy, taking into account the effect of this choice on the US decision to override and on the level of US investment in the organization. The pivotal voter maximizes:

$$\gamma \sum_i z_i - (1 - \lambda)z_j - |x - a_j|,$$

which yields the expectation,

$$\gamma \sum_i z_i - (1 - \lambda)z_j - (1 - p)|x - a_j| - pa_j.$$

[3] The two cases are equivalent when $a_{US} = x$.

Maximizing with respect to c yields the optimal cost. Again, there are two cases:

$$c = \begin{cases} \frac{\bar{b}}{2} - x - \frac{a_p(1-\lambda)z_{US}}{\sum z_i} & \text{if} \quad a_{US} > x, \\ \\ \frac{\bar{b}}{2} + x - 2a_{US} - \frac{a_p(1-\lambda)z_{US}}{\sum z_i} & \text{if} \quad a_{US} < x. \end{cases}$$

At the prior node, countries choose to participate if the utility of participating is greater than zero:

$$u_j = \gamma \sum_i z_i - (1-\lambda)z_j - E(|x - a_j|) \geq 0.$$

Because γ and c are continuous functions of x, this can be rewritten as a pair of conditions on x:

$$\underline{x}_j \leq x \leq \bar{x}_j.$$

Each country i chooses to participate as long as the pivotal voter is not too far from its ideal point, where "too far" depends upon the size of a country's contribution and the other parameters of the model. This interval is the country-specific participation constraint.

At the first decision node, the United States offers a distribution of vote shares to a set of contributing countries. In equilibrium, votes are offered only to countries that will agree to participate, and the distribution of votes determines the pivotal voter such that the relevant participation constraint is satisfied for all participants. For any distribution of country ideal points and contribution sizes there exists one or more feasible coalitions, where a feasible coalition is defined as a set of countries including the United States whose participation constraints have a non-empty intersection that includes the ideal point of at least one of the members of the set (the set that includes only the United States is always a feasible coalition). The United States offers a vector of vote shares that assigns the coalition member with the ideal point in the intersection of the feasible set that is closest to its own as the pivotal voter. From the US perspective, the utility-relevant characteristics of a coalition are its size and the ideal point of its pivotal voter, from which it is possible to calculate the endogenous variables of the model. Therefore, the United States is able to calculate the utility received from each feasible coalition, and chooses the coalition and pivotal voter that offers the highest utility.

There is no general solution for the distribution of votes because the countries can have arbitrary ideal points and contribution sizes, but it is possible to use the first-order conditions to characterize the trade-off that defines the US equilibrium strategy. US utility increases with the size of the coalition, which determines the benefits of collective action, and US utility decreases as the pivotal voter moves further from the US ideal point.

There are two cases. If $a_{US} > x$ in equilibrium, expanding the coalition would require the United States to shift vote share to countries that prefer still lower levels of policy, x. Expanding the coalition increases US utility, and making policy concessions (weakening the policy) decreases US utility, so the optimal size of the coalition is determined by this trade-off. If $a_{US} < x$ in equilibrium, expanding the coalition would require the United States to shift voting power to countries that prefer levels of the policy that are higher than the United States prefers. Expanding the coalition continues to be beneficial, but now increasing the stringency of the policy reduces US utility. Again, there is a trade-off between the size of the coalition and control over its policy, and it is optimal for the United States to balance the costs and benefits of expanding the coalition. To close the model, I assume that if the United States is indifferent between two possible coalitions, it chooses the one with the pivotal voter whose ideal point is closest to its own.

Discussion

The key insight of the model is to capture how structural power, formal control and informal influence interact. Informal influence is ubiquitous in international organizations, but this does not mean that formal control rights are unimportant; rather, formal rights of control determine the parameters within which powerful countries are allowed to exercise informal influence. In the model, although the leading state retains the option of overriding consensual procedures, the member countries choose the cost that the leading state pays when it chooses to exercise that option. In this sense, informal governance is subject to the consent of the membership. How formal voting rights are used, however, plays out in the shadow of structural power. Countries have structural power if they enjoy attractive outside options to multilateral cooperation and their participation in joint endeavors provides positive externalities to other participants. In the model, this is represented by the leading state's outside option, R, and its ability to influence the pay-off to multilateral cooperation by choosing the degree of its participation, γ. Countries with substantial structural power must be appeased, and in the model this deters the member countries from making the cost of overriding the institutional policy prohibitive.

The leading state has substantial influence over the design of institutions, and for the sake of simplicity the model assumes that the United States has proposal power and therefore holds all of the bargaining power. Nevertheless, the United States is willing to cede substantial formal control to member countries in order to secure their participation in the institution. It does so in spite of the fact that the member countries have different policy preferences and that they prefer to constrain the US ability to exercise informal influence. The United States is able to make these concessions because it anticipates that the members will be deterred from exploiting their formal control rights to prevent informal influence from being exerted when the US interest in doing so is very strong.

This confidence, in turn, rests on US structural power. The comparative statics of the model trace out the effects of shifting structural power.[4] Thus, for example, as the attractiveness of the US outside option increases, the United States shifts away from participation in the organization ($d\gamma/dR < 0$), which imposes costs on the rest of the membership. In response, the member countries reduce the cost that they impose when the United States chooses to override their policies in order to restore the incentives for the United States to invest in the institution ($dc/dR < 0$). The frequency with which the United States overrides the common policy increases ($dp/dR > 0$), and the balance shifts from formal to informal governance. The joint effects of reduced US participation and increased use of the US override undermine the value of the organization for the rest of the membership, making other countries less willing to participate ($du_i/dR < 0$). Thus, increased unilateralism and the shift towards informal governance undermine the legitimacy of the international organization.

In order to compensate for the decreased value of the organization to its members, the United States becomes willing to cede them a greater share of voting rights to shore up declining legitimacy. Whether it will in fact cede voting rights depends upon the distribution of ideal points of potential members, but the US best response shifts because countries become less willing to participate and because the increase in US structural power relaxes the trade-off between expanding the coalition and accepting greater constraints on US informal influence. Thus, surprisingly, increasing US structural power causes the United States to be more willing to give up formal vote share, shifting the pivotal voter further from its ideal point in order to expand the coalition of members. Conversely, as US structural power declines, the United States becomes less inclined to exercise its exit options, and the membership constrains the exercise of its informal influence as well. As US structural power

[4] Comparative statics are the effects of an exogenous variable on an endogenous variable, defined as the total derivative dy/dx, at the point of equilibrium. To convey the intuition behind the results I discuss them as if the best responses occurred sequentially, but in fact these relationships hold simultaneously in equilibrium.

declines, formal governance becomes more important relative to informal governance, the legitimacy of the institution improves among the membership, and the United States retains more formal control.

Another comparative statics exercise allows us to explore the implications of misbehavior by the leading state in the system. Informal governance rests on an implicit contract: the leading state will participate if it is allowed to exert informal influence, and the member countries consent to grant informal influence if it is not abused. If the leading state exercises its power to override the institutional policy too frequently, it undermines the value of the institution for the other participants. The implications follow from the comparative statics on the US temptation parameter, $\bar{b}$. If there is an exogenous increase in the expected benefit of overriding, this increases the probability that the United States decides to override ($dp/d\bar{b} > 0$), which leads the member countries to increase the cost that the United States pays when it does so ($dc/d\bar{b} > 0$). The member countries will not increase the cost sufficiently to fully offset the increased temptation, however, because increasing the cost leads the United States to exercise its outside options and reduce its level of investment in the organization ($\partial\gamma/\partial c < 0$). The combination of a higher probability that the common policy will be overridden and lower US participation lowers the value of participating in the organization for the other members ($du_i/d\bar{b} < 0$). In order to induce them to continue participating in the organization, the United States may (again, depending upon the distribution of country sizes and their ideal points) be compelled to offer to redistribute vote shares in the organization, shifting the pivotal voter further from its own ideal point. This appears to be exactly what happened in the IMF in 2008, where voting rights were redistributed in order to compensate for a perceived drop in the legitimacy of the organization that was linked to US micromanagement of the Asian crisis of the late 1990s and a series of crises in Russia, Argentina, Brazil and Turkey.[5]

Extensions

Formal modeling is an exercise in making choices. The objective is to incorporate the features that appear to be substantively most important to the subject at hand while retaining as much generality and tractability as possible. Occam's razor applies: simplicity is a virtue, and the simplest game that captures the key intuition of an argument is generally preferable to a model that incorporates unnecessary features. However, we can often learn important things by

[5] Further discussion of this is deferred to Chapter 10.

extending a basic model in various directions. The model presented here is the simplest game that captures the key insights of informal governance, and a number of extensions are possible.

Multiple leading states

There are m leading states, j. One of the leading states makes a proposed distribution of vote shares that all other members must accept or decline. Each leading state has the option of partially exiting the organization by choosing γ_j, enjoys the ability to override the organization's policy, and has a utility function with the same form as that of the United States in the model above, with the temptations of the leading states to override distributed independently. The leading states decide simultaneously whether to override the common policy, and state j receives the benefit and pays the cost of overriding only if it decides to override. If any leading state exercises an override, $x = 0$. In the utility function of all non-leading member states, the term γ is replaced by $\sum \frac{\gamma_j}{m}$. This model allows us to consider cases such as the WTO, which has two leading powers, and European institutions, which have had three or more at various points in time.

The formal derivation of the parallel results is omitted, but follows the same procedure as above. There are two important findings. First, introducing additional leading states leads to an increase in the equilibrium level of c. This can be interpreted as a shift in the organization's governance that deemphasizes informal governance and emphasizes formalized decision making. This follows from two considerations: (1) the frequency of overriding for any cost threshold increases as the number of leading states with independently distributed temptations to override increases, and (2) an override by any particular leading state creates a negative externality for all of the others, so increasing costs leads to a smaller reduction in participation by the leading states ($\partial\gamma/\partial c$ is reduced). In equilibrium, everyone prefers to make informal influence harder to exercise in order to restrain everyone else. Second, introducing additional leading states reduces the level of investment in the organization by each of the leading states. This can be interpreted as unwillingness to delegate extensive powers to an organization. This follows from the fact that an increased number of leading states override the common policy more frequently at any given level of c, making the organization less valuable, and that the equilibrium value of c is higher, making overriding less attractive. Outside options become more attractive because other states exercise informal influence and because it becomes more costly to do so oneself.

The substantive significance of these findings is to relate the number of leading states (or quasi-state groupings such as the EU) within an issue area to the design of international organizations and delegation of powers to them. The EU is an example of an organization with a relatively large number of leading states, which facilitates common investment in some issue areas by legalizing cooperation and making informal influence difficult to exercise. Where informal governance is the norm, common policies are very weak, as in foreign and defense policy. The WTO is an example of an organization with two leading powers, the United States and the EU, which retain informal influence but refuse to invest the organization with substantial executive or legislative powers. When important functions are delegated to the WTO, this is done through legalized adjudication procedures that minimize the possibility of exercising informal influence. These implications will be discussed further in later chapters.

Repetition

The game is infinitely repeated with common discount factor δ. Let $s = \{$vote shares, participation, c, γ, b^*, x, reversion$\}$ be a strategy profile for this game, where *reversion* specifies how the strategy next period depends upon the outcome this period, and let s^* be the profile that forms a Nash equilibrium in the stage game. Let s^{**} be a strategy profile of the repeated game that will be called a *cooperative equilibrium*, such that $b^*(s^{**}) \geq b^*(s^*), c(s^{**}) < c(s^*)$, and all players revert to s^* for the rest of the game if any player deviates from s^{**}. The strategy profile s^{**} forms a subgame perfect equilibrium of the repeated game for δ sufficiently high.

Proof Define continuation values as follows: V_L^N is the continuation value of a leading state for playing the Nash strategies of the stage game every period, and V_F^N is the corresponding continuation value for a follower state. V_L^* and V_F^* are the continuation values if all leading and following states play according to s^{**}. For δ sufficiently high, the profile s^{**} forms an SPE if $V_L^* > V_L^N$ and $V_F^* > V_F^N$ and the reversion strategies form an SPE.

Suppose that $b^*(s^{**}) = b^*(s^*)$ and $c(s^{**}) < c(s^*)$. In that case, $V_L^* > V_L^N$, because the leading state pays a lower cost in every period in which it chooses to override the common policy. Because the continuation value is higher in the cooperative equilibrium, however, for high enough discount factors the leading state would be willing to exercise restraint to maintain cooperation, so there exist $b^*(s^{**}) \geq b^*(s^*)$. Because the expected utility in every period is higher under the cooperative equilibrium, $\gamma(s^{**}) > \gamma(s^*)$. These results imply that $V_F^* > V_F^N$, because overriding occurs less frequently in the cooperative equilibrium and the leading states' participation is greater. The reversion strategies that support this equilibrium themselves form an SPE because they form the unique Nash equilibrium of the stage game.

The extension of the model to a repeated game captures the notion that the optimal functioning of institutions depends upon a social compact between powerful and weak states that is based upon an enlightened view of their respective interests. In a single-shot game, each state chooses strategies that maximize its short-run interests. In the context of repeated interactions, however, powerful states are willing to exercise restraint in order to sustain the benefits of cooperation in the future. Weaker states nurture this restraint by reducing the costs that they impose upon the powerful when they override common policies, so long as powerful states only do so when the temptation exceeds a particular threshold. There is an accepted range of legitimate deviations from formal rules, and an outer range of illegitimate deviations, and the difference turns on the circumstances of domestic politics or international strategic concerns that create the temptations.

Other possible extensions

A more complex extension would be to a dynamic game with a persistent state variable. For example, it would be possible to repeat the game but make institutions sticky, so that vote shares, the cost of overriding the common policy, or both are difficult to change. This extension would generate interesting insights about the development of institutions over time, and would allow us to make stronger claims about how the development of institutions depends upon countries' strategies. The current model can explore the effect of changing US preferences on institutions through comparative statics: if the expected benefit from manipulating the institution rises, countries respond by increasing the cost of overriding, and the United States responds by reducing its investment in the institution. This allows us to point to a key danger to international organizations, which is that the temptations of the leading power can lead to their gradual marginalization. A dynamic model would take the analysis a step further by exploring how the states of the world – participation, cost, etc. – can evolve over time in response to countries' actions. For example, we could learn whether changes are persistent or ephemeral, and whether some states are absorbing. Most of the specific properties of the dynamics, however – as opposed to the fact that the equilibrium is dynamic and its character shifts in response to country actions – would be highly dependent upon specific modeling assumptions, and would not therefore produce very general conclusions.

In addition, a number of extensions are possible involving imperfect monitoring of outcomes, incomplete information and signaling. Imperfect monitoring is a relatively trivial extension of the single-shot model: if the US decision to override is imperfectly observed (for example, the fact that an override has been exercised is observed with probability q), countries simply choose a cost level sufficient to induce the same equilibrium strategies as in the model analyzed above. However, in a repeated version of the model, where retrospective punishment strategies can achieve higher levels of restraint by the United States, imperfect monitoring will reduce the degree to which reputational equilibria impose restraint. For any discount factor, the possibility that overriding will not be detected lowers the threshold temptation necessary to provoke the United States to override the common policy, bringing the equilibrium strategies closer to those of the single-shot model. However, adding imperfect monitoring does not seem to enrich the substantive conclusions that we can draw from the model.

A variety of models involving incomplete information and signaling are possible. Extending the single-shot model to include incomplete information about the US temptation parameter is not particularly useful, because no informative signaling equilibria are possible. In a repeated setting, however, such an extension would again make it possible for the United States to build a reputation for restraint. This would also allow the model to generate insights about dynamics: US decisions to override the institutional policy would erode the cooperativeness of institutions, gradually leading to institutional procedures that restricted informal manipulation, which in turn would induce low levels of US investment. The particulars of the dynamics, however, would be dependent upon arbitrary modeling choices such as the number of repetitions and the nature of the uncertainty about US preferences.

In summary, the most substantively important extension of the model is to include multiple leading states. The main insight to be gained through repetition is the potential to generate restraint on the part of the leading states. The optimal functioning of international institutions depends upon mutual restraint: powerful states refrain from exercising informal influence outside of a recognized zone of legitimate deviations from the formal rules, and in turn weak states refrain from imposing formal rules that would curtail their privileges. This restraint does not qualitatively change the actors' behavior, however; it simply shifts the threshold for the temptation necessary to induce the leading state to intervene and the level of cost imposed when it does so. Indeed, the cost imposed when the leading state overrides the common policy in the static game can be interpreted as a reduced form parameter representing reputational costs in repeated interactions.

Other extensions of the model would generate substantively similar insights at the cost of introducing considerable additional complexity. Dynamic games (repeated games with state variables that evolve over time) and signaling models make it possible to explore dynamics and characterize equilibria in which future expectations and behavior depend upon current actions. A key insight of these extensions is that the quality of international institutions can evolve over time in response to choices that countries make, and in particular, that institutions can deteriorate if the United States overuses its prerogatives to exercise informal influence. The static game generates a similar insight, however. Varying the temptation parameter – the range of possible benefits from intervention – induces the member countries to be more cautious and set higher obstacles to informal influence, which in turn undermines the incentives for the United States to participate substantially in the organization. This is simply a comparative statics exercise, and says nothing about the dynamics of institutional evolution; but sharp conclusions about dynamics would in any case be dependent upon arbitrary modeling choices. The simpler model captures the essence of the matter.

Conclusions

International organizations have become increasingly important actors in international politics. Some critics have emphasized their autonomy,[6] while others regard international organizations as instruments in the hands of powerful states.[7] The approach presented here is decidedly state-centered. This is not to deny that the details of international governance owe a great deal to the strategies and beliefs of international agents.[8] However, the broad policies and many of the important details are worked out through formal and informal governance procedures that are established by states and in which states are the important actors. There are no international rogue agencies, because states remain the fundamental actors in international relations. The most powerful states retain the ability to control informally even formally autonomous institutions, and lack the ability to irrevocably delegate authority. The autonomous agencies are problematic not because they follow their own agendas, but because they can be captured by powerful states.

The puzzle for a state-centered theory of international organization is to explain why weaker states participate in international organizations, if their

[6] Vaubel 1986; Barnett and Finnemore 2004.
[7] Krasner 1985; Strange 1988.
[8] Abdelal 2007; Chwieroth 2009.

policies simply reflect the preferences of the powerful. The solution is informal governance. Informal governance facilitates an inter-temporal exchange between weak and powerful states. Weak states receive sufficient input into the formal governance structure to form a stake in it and to assure that they will benefit from the policies of international organizations on average, if not in every instance. Powerful states are willing to share power, because institutions are only useful to powerful states to the extent that they elicit voluntary participation. However, the most powerful states participate only when they are assured that they can assume control, albeit at some cost, when they deem that their core interests are affected.

Informal governance is in continuous tension, because the manipulation that makes power sharing tolerable for the leading state undermines the legitimacy and credibility of international organizations. However, legitimacy is essential whether international organizations are to serve their core purposes or be useful as instruments of power, and delegation is possible only to the extent that the participants expect that manipulation will be relatively infrequent. There must be sufficient agreement about common purposes that weaker states can expect to benefit from cooperation. International organizations are legitimate because, in equilibrium, the leading state chooses not to manipulate them under ordinary circumstances.

Ultimately, the terms of informal governance are themselves subject to negotiation and revision. If the United States exploits its ability to manipulate an international organization too flagrantly, other countries may use their formal voting rights to revise the organization's procedures and make this more costly. However, they are deterred from making informal influence too difficult to exert, because this would erode the usefulness of the organization for the United States, and ultimately lead it to be marginalized. The member countries implicitly consent to manipulation by the leading state or states, because they make this the price of their participation.

There are, therefore, three distinct forms of power in play in international organizations: structural power, formal control, and informal influence. Structural power represents the outside options a country enjoys and the externalities its participation in an institution creates for others. Powerful countries have attractive alternatives to multilateral cooperation and their participation in common endeavors magnifies the benefits of cooperation for all, so their interests must be accommodated. Formal control rights are embedded in the legal rules of international organizations, and may or may not correspond to variations in structural power. Countries that are strong in terms of structural power may nevertheless choose to disperse formal control widely in order to create legitimacy. Informal influence arises through participation in the decision-making process, informal consultation with the agents who are delegated authority to make decisions, and privileged access to information. Informal influence is invariably unequal, and cannot be wholly prevented by any constitutional scheme, but it can be reduced by promoting transparency and making decisions by majority voting. Most international organizations are not designed to be transparent or majoritarian, however. Countries with substantial structural power are accorded opportunities for informal influence in order to make participation attractive to them, which makes it possible for them to give up formal control of the organization without jeopardizing their core interests.

PART TWO

CASES

4

Informal governance in the IMF

The degree of the IMF's autonomy is controversial. The IMF was not designed to be the independent world central bank that Keynes envisaged; from the beginning, its members, most notably the United States, expressed a preference for a member-controlled organization rather than a supranational one.[1] However, the Fund's management and staff have gradually gained autonomy from the shareholder countries represented on the Executive Board, and critics of the IMF fear that this autonomy goes too far.[2] An alternative critique assumes that international organizations simply reflect the interests of a few powerful states, or of one. An impressive amount of evidence indicates that major shareholders are able to skew the distribution of IMF loans and to subsequently undermine the enforcement of conditionality.[3] Similarly, countries that enjoy special relationships with major IMF shareholders may be able to avoid extensive conditionality when they borrow from the Fund.[4] In almost all cases, the evidence indicates that the powerful shareholder that exercises influence over the IMF is the United States.[5]

How does a country that holds only seventeen percent of the voting power in an organization exercise a controlling interest in its activities? The argument made here is that the aspects of the IMF's formal design that make it appear to be so autonomous, and that allow it to exercise considerable

[1] Pauly 1997.
[2] Martin 2006.
[3] Thacker 1999; Barro and Lee 2005; Dreher and Jensen 2007; Eichengreen *et al.* 2006; Stone 2002, 2004. For a review of the recent quantitative literature on IMF lending, see Steinwand and Stone 2008.
[4] Polak 1991; Gould 2003, 2006; Copelovitch 2004; Dreher and Jensen 2007.
[5] My work on Africa found that France and Britain intervened on behalf of some of their former colonies with which they maintained close political ties (Stone 2004). Subsequent interviews at the Fund have confirmed this pattern but underscored that it is limited to Africa. In other regions, the United States firmly repulsed other G-7 countries that sought to interfere, as Japan discovered in Indonesia and Korea.

discretion in ordinary times, also make it extremely vulnerable to capture by a determined state that enjoys an organizational advantage. IMF standard operating procedures delegate substantial authority to management, weaken the Executive Board to the point that it is unable to exert effective oversight, and create substantial informational asymmetries among the shareholders and between the shareholders and management. Delegation, weak oversight and lack of transparency lower the costs when the United States assumes operational control, because its influence is difficult to observe.

In large part, the exercise of informal influence in special cases is made possible because of the broad consensus among the major shareholders about the IMF's objectives, which reduces the incentives for the medium-size players to monitor US activities. The United States exerts control of the IMF through informal participation, in a way that is similar to the way minority shareholders can effectively control publicly held corporations if they are willing to exert sufficient effort. The smaller shareholders are content to free-ride, because they know that their interests are unlikely to come into conflict with those of the United States in most cases. When these interests do come into conflict, the United States has an overwhelming advantage over other states in its capacity to participate informally in IMF decision making, and the informal practices of the Fund amplify that advantage.

IMF governance for general policies diverges from the pattern for lending decisions. General policies, institutional reforms and constitutional changes are analogous to legislative processes. The process of making these decisions involves minimal information asymmetries, little delegation to IMF staff, and direct involvement by the member countries; most importantly, the outcome of these decisions is of immediate interest to all members. Consequently, informal influence is minimized, and voting rules significantly influence the outcomes. On the other hand, lending decisions are of primary importance to the borrower, involve substantial information asymmetries among the other members, and involve broad delegation to IMF management and staff. Under these circumstances, informal power becomes effective when it is exercised. This provides the basis for an inter-temporal exchange: the United States retains the ability to decisively influence lending decisions, at the cost of giving up substantial control over formal decision making.

Formal rules and informal procedures

The IMF follows a complex set of formal procedures that are centered on the Executive Board, which are designed to provide legitimacy and democratic accountability to its decisions. IMF governance functions in practice according to these formal procedures during decisions about general policies, institutional reforms and constitutional changes. Voting rules play a key role in the IMF's formal procedures, and although formal votes are rarely taken, the decisions made by consensus reflect the distribution of votes and the majority requirements that apply to particular kinds of decisions.

Voting in the IMF is based on the same quota system that determines member countries' financial contributions and credit access limits. The quotas of new members are determined by formulas based on national product, trade volumes, openness, and financial reserves, which are intended to reflect both the members' capacity to contribute and likely need to draw on Fund resources. The formulas are essentially arbitrary, however, have been adjusted over the years, and are periodically subject to renegotiation, which underscores their political origin. The original quota formulas arose from an American effort at Bretton Woods to cloak in technocratic calculations its political judgments about what share of control it was necessary to cede to each of the major powers in order to secure their participation. The author of the original formula, Raymond Mikesell, recalls that Harry Dexter White charged him with devising a formula that would yield a quota of approximately 3 billion dollars for the United States, provide half that amount for Great Britain, and grant third and fourth place to the Soviet Union and China, respectively – parameters that had been set by the president and the secretary of state.[6] No guidance was provided on what data should be used for the formula; Mikesell found that the formula had to weight national output significantly to achieve the desired results, but he introduced trade openness to get closer. The proposed quotas were adjusted in a number of cases through bilateral bargaining, and several were adjusted subsequently during the Bretton Woods negotiations, so that the actual quotas deviated substantially from those produced by the formula. Mikesell was initially instructed to keep the formula confidential when he presented the proposed quotas at the Bretton Woods conference. Describing his presentation to the Bretton Woods delegates, Mikesell recalls:

> I... gave a rambling twenty minute seminar on the factors taken into account in calculating the quotas, but I did not reveal the formula. I tried to make the process appear as scientific as possible, but the delegates were intelligent enough to realize that the process was more political than scientific.[7]

Many of the delegates were not satisfied with their proposed quotas and

[6] Mikesell 1994, 22.
[7] Mikesell 1994, 35–6.

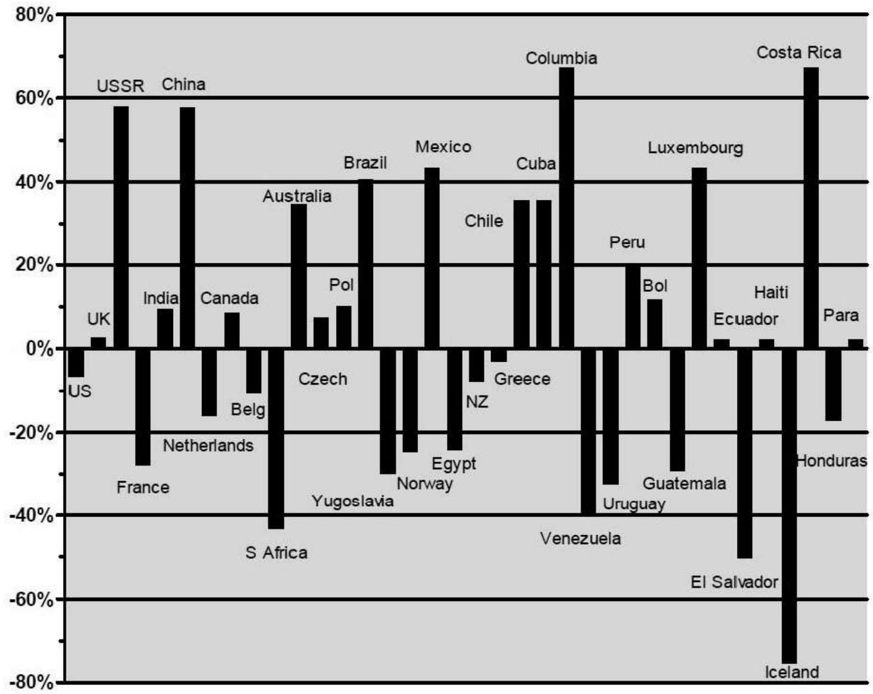

Figure 4.1 Deviations of Bretton Woods quotas from the formula.

Source: Report to the IMF Executive Board of the Quota Formula Review Group. April 28, 2000: 17 (www.imf.org); author's calculations.

demanded revisions, some of which were granted in bilateral negotiations. The French delegate, Pierre Mendes-France, objected strongly that the French quota had been set at a lower level than China's, but he failed to achieve a revision.[8] Figure 4.1 illustrates the wide range of variation of actual quotas determined at Bretton Woods around the quotas predicted by the formula. While there remained a strong correlation between actual quotas and quotas predicted by the formula, the wide range of variation reflects the fact that bargaining dominated the process.

In the years since the Bretton Woods conference, the US share of quotas has steadily declined as new members joined the IMF and faster growth in other countries changed the proportions of world trade and output. In addition, the quota formula has been revised several times. When necessary, however, the veto threshold has been adjusted downwards to assure that the United States retained effective veto power. It has played a significant role in formal policy making that the United States has always controlled a minority of shares, so it

[8] Mikesell 1994, 37.

could not directly control policies, but has controlled a share that was substantial enough to block adoption of new policies.

In contrast to general policy decisions, lending decisions are not made strictly according to formal rules. Instead, the balance between formal and informal governance varies significantly. In routine cases, the Executive Board delegates substantial authority to IMF management, which in turn delegates detailed decision making to staff. In cases that are important to major shareholders, on the other hand, the informal mechanisms for influencing IMF policy become decisive. The formal rules are further eclipsed when lending occurs in the midst of a crisis, and informal governance reaches its apex when the crisis occurs in a systemically important country. The more high-level attention a program attracts among the leading shareholders, the more the substance of decision making is shaped outside the formal process. The informal mode of governance diverges sharply from the formal one, and the differences are substantively important in terms of the distribution of authority within the organization and among the member states.

The formal rules are based upon universal participation and representation of the membership, democratic decision-making procedures for policy formulation and oversight and a voting mechanism weighted according to contributions to the Fund's capital. In contrast, the informal governance practices of the IMF centralize decision-making authority, limit effective participation and restrict the flow of information. The locus of effective decision making moves outside of the Executive Board to forums that better reflect the international distribution of resources, and management's formal proposal power is exercised informally by individual shareholders, which shape proposals before management brings them to the board. Shareholder countries' influence over decision making is not directly proportional to the distribution of vote shares and is not simply a function of the formal voting rules. Instead, participation in decision making varies depending upon the institutional capacity of the shareholding state and access to information. The Fund's informal norms strengthen the appointed management of the Fund *vis-à-vis* the bulk of the membership, but assure in practice that the G-7 countries acting in concert, and often the United States acting on its own, are able to exercise effective control over the Fund when they regard this as necessary.

In particular, three institutional features that might appear to strengthen the Fund's autonomy – avoidance of voting, a strong chair, and the centralization of information – in reality serve as backdoors that allow the United States to exert a controlling influence over lending decisions.

Voting is generally avoided on the Executive Board. Instead, the managing director, acting as chair, ascertains the "sense of the meeting."[9] Votes were called periodically in the early years of the Fund's existence, but this subsequently became very rare; for example, only five votes were taken between 1954 and 1972.[10] In principle, any Executive Director (ED) may call for a formal vote at any time, but a strong norm has arisen, which all of the EDs support, which discourages exercising that right. When voting occurs, the Executive Board minutes reflect the concern that this not become common practice:

> When votes have been requested since 1953, there have been expressions of regret, even by the executive director calling for the vote, at the departure from the "normal traditions" of the Executive Directors, and expressions of hope that it would be possible to continue to resolve issues "by the usual process of discussion."[11]

The practical implications of this practice vary across types of decisions. In discussions of general policies, this has usually meant that the weighted distribution of formal voting power was diluted, because the large shareholders made an effort to build oversized coalitions, and preferably to reach decisions unanimously, rather than impose their will by taking close votes. As an early IMF study concluded, "decision by 'the sense of the meeting' moderates the effect of weighted voting power."[12] During lending decisions, on the other hand, the norm of avoiding voting means in practice that almost all proposals pass unanimously. In effect, the Executive Board ratifies whatever the IMF management proposes.

According to the IMF's formal procedures, the managing director exercises a remarkable degree of gate-keeping power and proposal power as chairman of the Executive Board. No lending item can come before the board without the managing director's approval. In addition, amendments to country lending items are not allowed because they have been negotiated with country authorities before they are brought to the board for ratification. When the managing director is able to choose his proposal autonomously, such procedures assure that he can control the agenda and choose his most preferred policy from the feasible set. However, informal participation allows influential shareholders to control the substance of the management proposal, assuming the formal proposal-setting prerogatives of the chair for themselves. This allows the United States

[9] Rule C-10 of the Rules and Regulations, adopted in 1946, provides that "The Chairman will ordinarily ascertain the sense of the meeting in lieu of a formal vote. Any Executive Director may require a formal vote to be taken with votes cast as prescribed in Article XII, Section 3(i)." Quoted in Gold 1972, 197.

[10] Gold 1972, 196.

[11] Gold 1972, 198.

[12] Gold 1972, 198.

to exert effective control by participating much more actively than the other shareholders. The United States has a tremendous organizational advantage over other countries because it has a more extensive diplomatic corps, particularly important private financial institutions, numerous advantages in gathering information, and all of the advantages of having the IMF located in the United States capital, in addition to issuing the international reserve currency and commanding the resources of a superpower. Perhaps more important than these organizational resources is the informal deference that the other directors and the IMF staff accord to the United States. With the exception of France and the United Kingdom, which exercise substantial influence in their respective spheres in Africa, the United States is usually the only active participant.

The privileged position of the United States is strengthened by rules that centralize information. There are extensive formal rules that insulate negotiations about IMF programs from participation by shareholders through their EDs. Except for the borrower's representative, EDs do not participate in missions to countries or the negotiation of programs. In addition, they are not privy to the confidential documents that are key to the negotiations, the mission briefs that determine the parameters of the negotiator's discretion and the back-to-office reports about the progress of negotiations.[13] This centralization of information generally prevents EDs from influencing conditionality, but it does not prevent the United States from being fully informed. For example, the United States ED routinely interviews chiefs of mission before and after missions to Latin American countries, and in extraordinary cases such as Mexico, Russia, Indonesia and Korea, senior US Treasury officials were intimately involved in the details of the negotiations.[14] Confidentiality provides the IMF management with an information advantage over the Executive Board and a measure of autonomy,[15] but simultaneously allows the United States to centralize control.

[13] This may seem surprising; after all, the principal should want full access to information in order to monitor the agent effectively. When interviewed, however, IMF officials unanimously agreed that these documents were never provided to EDs. EDs reported that they never asked to see them, and they would not expect staff to comply if they did. There was broad agreement that these rules were necessary to safeguard the integrity of the bargaining process, because the directors could not commit not to reveal the staff's bottom line to the borrowing country if they knew what it was.

[14] IEO 2003. Although in principle any ED can request special briefings with staff, in practice only the US and French EDs regularly do so, and the French ED interviews staff only about missions to francophone Africa. An ED from a small European country explained that if he made such a request, it would be granted politely, but privileged information would not be forthcoming. If he persisted in asking for special briefings, he would expect to see a memo circulated requesting that EDs forebear from overburdening staff. In other words, his understanding was that the EDs were formally equal, but some were more equal than others.

[15] Martin 2006.

The Executive Board

According to the IMF's Articles of Agreement, the highest constitutional authority of the organization is the Board of Governors, but this body has delegated most of its authority between annual meetings to the Executive Board. The Executive Board exercises most of the functions of a board of trustees, and its decisions form the case law of the IMF and interpret precedents. The Executive Board consists of resident EDs (originally twelve, and currently twenty-four), of whom five are appointed by the largest shareholders, namely the United States, Japan, Germany, Britain and France, and 19 are elected by the rest of the membership for two-year terms.

The G-7 deputies, the deputy ministers of finance responsible for international affairs, have become the effective locus of decision making in cases of crisis lending.[16] The rank and expertise of EDs varies substantially, but most of the EDs from the leading shareholding countries are civil servants, and financial decisions in major crises are made at the political level. The deputies comprise the level where technical expertise meets political responsibility, and when decisions are too hot to make on their own responsibility, the deputies have the access within their governments to reach a decision within twenty-four hours. The G-7 deputies have formal meetings six times per year and know each other well, so they are able to conduct important business by conference call. The G-7 countries seek to avoid open disagreements in order to avoid sending destabilizing signals to markets, and having reached a common position, the G-7 countries almost always vote as a bloc on the rare occasions when votes are recorded. Except for rare cases, this takes most of the drama out of Executive Board meetings. The role of the G-7 has shifted somewhat in recent years, as the EDs from the EU have intensified their consultations and coordinated their positions, and as the G-20 has assumed new prominence in the wake of the global financial crisis of 2008. The G-7 deputies continue to be a critical locus of IMF governance, however.

By the 1990s, there were three distinct groups of EDs on the Executive Board, and they behaved quite differently. The G-7 EDs almost always supported the proposal made by management, because their positions had been incorporated into the proposal before a formal board meeting took place. If the positions of the G-7 countries clashed, this almost never took place on the board.[17] There is variation in the roles of EDs within the G-7; for example, the

[16] This is often the case when prominent institutional reforms are considered, as well as in crisis lending. For example, the Heavily Indebted Poor Countries (HIPC) initiative, which offered substantial debt relief, was developed by the G-7. Interview with IMF senior staff.

[17] The exception is the case of Mexico in 1995, which is discussed in Chapter 7, and is well documented in Copelovitch 2010. The dispute only came into the open because the United

Canadian ED tends to be more senior than his G-7 colleagues. The ED from the United Kingdom represents the Chancellor of the Exchequer and the alternate represents the Bank of England, so they sometimes take different positions. The Canadian and Italian ED are elected by multi-country constituencies, and the other G-7 EDs are appointed by their home countries. Representing multiple countries gives an ED a greater range of independence.[18]

The EDs from developing countries have a distinct role because they represent borrowers rather than net creditors to the Fund. Consequently, their main function is to represent their constituents to the board as borrowers. Because they represent multiple countries and their constituents participate actively in Fund programs, a significant portion of the workload handled by their offices involves accompanying IMF missions to the countries they represent. The developing country EDs follow a strong norm of solidarity, which makes them reliable supporters of management proposals to make Fund resources available to members. Developing country EDs generally do not have time to inform themselves on country matters beyond reading the staff report unless the matter involves one of their own constituents, and they do not receive the institutional back-up from their capitals that G-7 EDs enjoy. Although larger numbers of constituent countries come with larger staffs, the developing country EDs are the most thinly stretched because they have so many missions to which to send representatives. In effect, the only EDs who are likely to express opposition to proposals to use Fund resources at the board are those from small developed countries who represent multiple constituencies. These are the EDs who have been most active in probing the assumptions of Fund programs, and they are the ones who are most likely to abstain when a program is controversial. They are the most independent from their home capitals, because they represent constituencies of several countries, and they are not dependent on the goodwill of management or of the developing country EDs because they do not anticipate borrowing from the Fund. They are required to represent the interests of their constituents, however, which sometimes requires them to swallow their policy preferences. For example, the Dutch ED was critical of the program for Russia in July 1998, but did not participate in the discussion because his constituent, Ukraine, was up for discussion at the same time. The small European countries enliven the discussion and raise the level of debate, but they do not represent a real constraint on the management's ability to promote its agenda. Abstentions

States pushed a last-minute increase in the size of the loan to Mexico onto the agenda without allowing time for discussion by the G-7 deputies. Even in that case, one has to read between the lines of the Executive Board minutes to perceive the degree of disagreement among the directors.

[18] Interviews with former and present EDs; interviews conducted for IEO 2003.

do not block adoption of a decision, but they are rare nevertheless, and voting against a management proposal is almost unheard of.

Management

In IMF parlance, "management" refers to the managing director and the deputy managing directors – everyone else in the organization aside from the Executive Board members and their offices is "staff." The IMF management exercises a remarkable degree of formal proposal power, particularly in decisions that affect particular member countries. In most voting systems, a wide range of outcomes is possible given a distribution of voting power and preferences, and therefore whoever controls the power to make proposals is able to control the outcome.[19] The Executive Board is chaired by the managing director or by one of his deputies, and as chairman of the board, the managing director conducts the business of the board and generally has the last word. The management proposes all action items, and lending decisions are made on the basis of an up-or-down decision that does not allow amendments to be made at the board, because letters of intent have been negotiated and signed by the country authorities before the board meeting. In principle, the board could reject a proposal and send it back for renegotiation, although this might be disastrous in a crisis case; but even in ordinary lending, this has not occurred in recent memory.[20] Decisions of the board are written beforehand by staff in the form of the chairman's summing up, which is not circulated before the meeting but instead is read to the board at the conclusion of the meeting, sometimes with amendments that express issues raised during the meeting.[21]

This formal arrangement suggests a very independent institution with a powerful executive. However, informal consultations allow the leading shareholders to shape the agenda and craft proposals before they come to the board. Influence in this informal process is not circumscribed by the formal power inherent in vote shares and the formal voting rules. If only the formal rules were operative, the management would still seek to craft its proposals to guarantee a majority, and potential veto players – particularly the United States, as the

19 McKelvey 1976, 1979. Kalandrakis (2006) demonstrates that in a general bargaining model with sequential voting, there exist proposal rules that generate every possible distribution of the surplus, given any distribution of vote shares and discount rates.

20 Interview with IMF staff.

21 This is an interesting difference between the Fund and the World Bank, which otherwise has the same basic governance structure and the same distribution of vote shares. In the World Bank, the equivalent document is reviewed and sometimes revised by a subcommittee of the EDs before it goes to the board.

largest shareholder – would exercise disproportionate influence. An important implication of the formal voting rule, however, is that this influence would only operate in a negative sense: veto players could influence proposals that they could credibly threaten to otherwise oppose. There is some evidence, which is discussed in the concluding section of this chapter, that US influence over general Fund policies is dependent upon the ability to exercise veto threats in precisely this way. However, in decisions affecting individual countries, this is not the case. In country matters, the United States has an impressive degree of positive power. For example, it is able to promote lending even when the other leading shareholders are skeptical, and it can heavily influence the content of programs even when it has a strong interest in seeing them move forward.

The consequence of this system is that influence in the IMF over decisions that affect particular countries corresponds more closely to informal participation than to formal voting power. An example of asymmetric participation emerged in interviews with staff who indicated that the US ED always requested a special briefing before a country item regarding a Latin American country came to the board. In addition, in important cases, including Argentina, Brazil and Mexico, the US ED requested meetings to debrief the chief of mission before and after each trip abroad.[22] The US ED does not have any more access to confidential documents than the other EDs, but with these extensive briefings she was able to effectively monitor the progress of negotiations. The United States has a huge advantage over its peers in influence over the IMF because the Fund is located in the heart of the federal government, so contacts are almost costless. As a result, the briefings that the ED convened generally involved representatives of Treasury and several other US government departments, so the US government was engaged on many levels. Other EDs also have access to staff when they choose to exercise it, but the behavioral pattern is that they do so much more rarely. The degree of direct involvement of their capitals is generally much lower as well because of distance and time zones. A prominent exception, however, is that the French ED becomes deeply engaged in items involving francophone African countries, and missions to Africa often stop in Paris in order to brief the French Treasury.[23] During crises, the G-7 EDs are routinely briefed before the other countries, because it is understood that the key unofficial forum for making decisions about international finance is the G-7 deputies. This norm of prior consultation was only violated once in

[22] Interviews with IMF staff.

[23] Similarly, British EDs intervene on behalf of Commonwealth countries in Africa. For example, the British ED played a key role in restarting IMF lending to Kenya in the 1990s. Interviews and informal discussions with staff.

recent memory, in the case of Mexico in 1995, and the result was stormy.[24] In some cases management held briefings for the G-10 EDs rather than just the G-7 in order to address objections by the smaller European countries that they were being left out of the loop, and in the cases of Mexico, Indonesia, Korea and Argentina the board held additional, informal meetings in order to strike a balance between sharing information with the entire board and maintaining confidentiality.[25] However, these broader consultations supplemented rather than replaced the private consultations between major shareholders and management, and the most important contacts took place at a higher level than the EDs. The US Assistant or Deputy Treasury Secretary has frequent contact with the IMF managing director and his first deputy, and when the leadership of Treasury is effective, as it was during the Clinton administration, the line between the US government and IMF management becomes blurred.

Information asymmetry

Informal governance in the IMF relies on the high degree of secrecy that is reinforced by discipline within the IMF staff. The original rationale for secrecy was that under the Bretton Woods system of pegged exchange rates the Fund handled confidential information about future exchange rate adjustments that had significant market value. Long after the demise of this system, the Fund still occasionally handles very valuable information, but the market value of Fund documents has significantly eroded, and its shelf life is very short. Nevertheless, the IMF maintains an elaborate classification system for secret documents, and breach of confidentiality is regarded as a very serious offense within the organization.[26] The staff has a free-wheeling internal discussion of

[24] Interviews with IMF staff.

[25] Informal board meetings are called to share information and allow discussion when a formal board decision is not needed. They are closed, so the audience is restricted, and very limited minutes are kept. The fact that the meetings took place is recorded in the Executive Board minutes. Interpretation is from interviews with IMF staff.

[26] IMF documents are classified as public; for official use only (for example, staff reports circulated to the Executive Board); confidential (for example, Executive Board minutes and letters of intent, mission briefs, back-to-office reports, and much interdepartmental correspondence); strictly confidential (for example, the Whittome Report cited below and minutes of restricted board meetings); and secret (for example, correspondence with authorities, and mission briefs and back-to-office reports prepared during the Asian crisis). Each category of documents has an associated handling procedure, and the higher levels involve numbered copies and locked cabinets; only the lower levels are held in the archives. Documents regarded as internal – all documents circulated within individual departments and most of the interdepartmental memos generated during program development – are not registered on the Cyberdocs internal database of IMF documents, so the only record of their existence is in the department that holds them. During the Mission to Indonesia in 1997,

policy options, but it presents a monolithic view to the Executive Board, and the same is true at various levels within the organization. Subordinate staff members do not dispute the position taken by the chief of mission or the front office of a department when addressing management,[27] and staff closes ranks around management when it interacts with EDs. Staff members acknowledge that they would not express an opinion on or off the record to an ED that differed from management's official position. EDs, for their part, recognize that they cannot elicit unofficial opinions from staff, and rarely try.[28] They acquiesce in a system in which they are denied access to most categories of internal Fund documents, such as mission briefs, back-to-office reports and interdepartmental correspondence. This arrangement is intended to protect the integrity of the staff's technical judgments and to avoid undermining the Fund's position as trusted confidante *vis-à-vis* member countries. The effect, however, is that management is able to control the access of EDs to staff opinions and analyses.[29]

Informal governance predominates over formal governance throughout the project cycle in systemic crises. The roles played by the Executive Board, individual EDs, and the governments of major shareholders differ during pre-crisis surveillance, decisions about the use of Fund resources, the design of conditionality, and the enforcement of conditionality, but the problems involved in surveillance provide a stark illustration of the weakness of the Executive Board.

Surveillance

The IMF devotes considerable resources to bilateral surveillance of the policies of its members. Every member country is visited according to a regular schedule by an IMF mission, which prepares a staff report and reports to the

World Bank officials reacted with incomprehension when told by their IMF colleagues that they could not have access to documents that they themselves had written because they were now classified as confidential (Blustein 2001). This clash of organizational cultures is telling.

27 An exception within staff is the special role of the Strategy, Policy and Review Department, formerly Policy Development and Review (PDR) Department, which has the role of reviewing draft mission briefs and approving programs proposed by the area departments. A representative of this department accompanies every mission, and writes a report that provides management with an independent channel of information.

28 Interviews with former EDs and IMF staff.

29 In recent years the Fund has taken a number of important steps to increase transparency, including publishing letters of intent associated with IMF lending programs and providing public access to the Monitoring of Agreements (MONA) database on the internet. Although these steps have increased the external transparency of the institution, they have not changed the information asymmetries within the Executive Board, because all of this information was already available to ED.

Executive Board. The Executive Board devotes an average of 23 percent of its meetings and 22 percent of its time to Article IV surveillance that does not involve any use of Fund resources.[30] This surveillance has a variety of purposes, but a major focus in emerging markets is to detect early warning signs of developing crises and recommend corrective action before a crisis becomes full blown and requires drastic policy corrections. Assessments conducted after crises, however, invariably point to important failures to detect the warning signs. There is some selection bias here; when surveillance is more effective, crises may be avoided, so focusing on crises exaggerates the rate of surveillance failure. Nevertheless, a growing number of important cases have been documented in which surveillance has failed, and it is important to ask whether something about the IMF's governance hampers the surveillance effort. In addition, recent quantitative studies have found that IMF forecasting is systematically biased.[31]

The first evaluation of crisis management conducted by the Fund, the Whittome Report, found a disturbing pattern of surveillance failures in Mexico that led up to the 1994–95 crisis. Sir Alan Whittome, a retired Fund insider, concluded that "the culture, procedures, and incentives that have grown up in the Fund were inimical to an early recognition of the dangers facing Mexico."[32] Carefully reviewing the data available to the staff and when it became available, Whittome concluded that giving Mexico the benefit of the doubt was reasonable until the fall of 1994, when data that had been available to the Mexican government at the beginning of the summer were finally reported to the IMF, showing that reserves had declined and monetary policy had deteriorated. By the end of September the Fund staff had clear evidence that Mexico's macroeconomic policies were inconsistent with sustaining its exchange rate target, and that either an exchange rate realignment or a currency crisis had become inevitable. In spite of the data, however, the information that the staff provided in its report for the upcoming Article IV review failed to signal that anything had changed.

Whittome diagnosed the problem with surveillance in terms of three sets of issues. First, there was concern that anything presented in writing to the board has a large audience, because Executive Board documents are widely circulated in member countries and often find their way into the hands of the press. In the context of a potential crisis that could be triggered by the leakage

[30] IMF Secretary's Department. *Selected Workload Indicators of the Executive Board, Number and Hours of Board Meetings, 1997–2007*. Table 1.

[31] Dreher *et al.* 2008; Fratzscher and Reynaud 2007.

[32] Whittome, L. Alan. *Report on Fund Surveillance of Mexico, 1993–94* (Whittome Report). EBS/95/48. March 23, 1995: 35.

of sensitive information, therefore, anything critical of a member country that was sent to the Board had to be written in such dense code that it was difficult to separate the signal from the noise.

Second, EDs frequently act as protectors of member countries, and take issue with Staff reports that are perceived as critical. Staff is naturally risk averse about confronting member countries with critical analysis, especially when the country is in a vulnerable position that would make it react strongly. Earlier in 1994 EDs had criticized staff of the Western Hemisphere Department for "badgering" Argentina about its current account deficit (an issue that reemerged with a vengeance in 2001), and this had a chilling effect on the staff monitoring Mexico. In addition, during the Article IV consultations with Mexico in 1993, the ED representing Mexico had asked that language referring to the deterioration in the quality of data available from Mexico be removed from the staff report. Since no one objected and the report was edited to create a more favorable impression, the staff was justified in inferring that there was no interest on the board in receiving negative assessments of Mexico's policies.[33]

Finally, the staff's extraordinary discipline, which allows it to keep valuable information confidential and to present a unified view to the outside world, has the disadvantage that debate is shut off when management takes a position. As a result, the information that the Executive Board receives is systematically biased in favor of the management proposal. The management had frequently praised Mexico as an example of successful economic reform, and Mexico had made a great deal of progress. In 1994, furthermore, the managing director wrote letters placing his seal of approval on Mexican requests for financing from the United States and Canada. "It would not then be surprising," Whittome concludes, "if the staff found it awkward to raise doubts about the direction in which the economy was headed."[34]

The discrepancy between the reports sent to the Executive Board and the operational data on which they were based was sufficiently stark that it has led some observers to conclude that IMF staff must have suffered from "groupthink."[35] The IMF's policy advice to Mexico, Ngaire Woods argues, "had solidified into one optimistic scenario, which was adopted as an article of faith." She goes on to argue that Fund staff showed a systematic failure to recognize warning signs – a "faith-based blindness or seeming groupthink" – that reflected a dogmatic devotion to a narrow set of economic theories.[36] Reading IMF staff reports to the Executive Board could indeed convey this impression,

[33] Whittome Report, 30–1.
[34] Whittome Report, 25.
[35] Woods 2006, 60.
[36] Woods 2006, 63.

if they are taken to represent the staff's true views. Within the staff, however, there was wide appreciation of the dangers of Mexico's economic mismanagement, and the warning signs were not missed; they were simply downplayed in official reports. Reports to the Executive Board are not used as an opportunity to ring alarm bells.

A serious effort was undertaken to improve surveillance after the appearance of the Whittome Report. The Fund modernized its access to financial data and made a substantial effort to improve data reporting standards in member countries by establishing the Special Data Dissemination Standard (SDDS) in 1996. After the Asian crisis, the Fund went further by beginning to publish letters of intent, the documents that codify IMF conditional lending programs, on the internet. However, the staff continued to filter the information it passed on to the board. In each of the crises covered in this book, staff concealed from the board the problems it faced in obtaining access to confidential data, censored the data that it provided to the board because of concerns that the data would leak, and downplayed the severity of exchange rate risks in its reports to the board.

The most sensitive data concern central bank reserves. The Fund pressures countries to disclose this information, but countries facing impending crises often distort their central bank balance sheets to hide their vulnerabilities from the market, and are unwilling to disclose accurate data to the Fund. As noted above, this was a key problem in Mexico in 1994. Similarly, the Fund was unable to gain access to critical information about the balance of usable reserves in Russia (1996–98), Thailand (1997) and Korea (1997). A Fund surveillance team failed to recognize the risks that the Asian crisis would spread to Korea as late as October 1997, because the Koreans created a rosy impression of their finances, which only gradually crumbled as more information came to light. During the routine Article IV consultations in mid-October, before Korea asked for emergency assistance, it reported official reserves to the Fund of approximately $30 billion, or two months of imports.[37] It was not until late November that the mission was informed that a substantial portion of the Bank of Korea's gross foreign reserves was not usable for foreign exchange operations because they had been deposited in off-shore subsidiaries of commercial banks to allow them to service their short-term debt.[38] The staff report, which was dated December 3, dramatically revised the estimate of available reserves.

[37] IMF – Korea. *Briefing Paper for Negotiation of a Stand-By Arrangement.* Prepared by the Asia and Pacific Department (in consultation with other departments). Approved by Wanda Tseng and Joaquin Ferran. November 21, 1997: 5.

[38] The estimate used in Fund documents at the time was 25%. Blustein cites a figure of 40% (2001, 130, 140).

Taking the encumbrance of those reserves into account, the staff report concluded that usable reserves had fallen to a critically low level of $7 billion.[39] Because it had failed to detect how vulnerable Korea was, the Fund was forced to scramble to assemble political support for a rescue package that had to be much larger than it had expected.

The staff report, however, skated lightly over the fact that the Koreans had hidden the true dimensions of their problem from the Fund mission just a few weeks before. The report identified the "opacity of Korea's financial data" as a key structural problem, but this is a common observation in these reports, and did not signal the degree of frustration staff felt with the Koreans over this episode.[40] Certainly, some EDs were aware that the Koreans had been hiding their vulnerability from the Fund, but they did not learn about it from the staff report.

The fragility of Korean finances in December 1997 intensified concerns about secrecy and limited the information that staff reported to the board, as usable reserves fell to $3.9 billion on December 18 before recovering to $8 billion. The staff report for the December 3 program, cited above, was leaked to the Korean press, and the Korean government decided to publish it in response in order to control the damage, a decision that provoked a heated debate on the Executive Board.[41] In the run-up to the expanded program announced on December 27, therefore, management instructed staff to remove data on the daily level of Korean reserves from the staff report, citing concerns that the information could be leaked to the press.[42]

Beginning several years before the 1998 crisis, the Central Bank of Russia (CBR) engaged in an elaborate set of financial transactions designed to hide from the IMF and the market the fact that it was using substantial amounts of its reserves to buy state bonds, or GKOs.[43] When the deception came to light, the head of the CBR and his deputies insisted that IMF staff had to have been

39 *Korea: Request for Stand-By Arrangement*. Prepared by the Asia and Pacific Department (in consultation with other departments). Approved by Hubert Neiss and Joaquin Ferran. December 3, 1997: 11.

40 *Korea: Request for Stand-By Arrangement*. Prepared by the Asia and Pacific Department (in consultation with other departments). Approved by Hubert Neiss and Joaquin Ferran. December 3, 1997: 12.

41 *Republic of Korea – Request for Publication* EBM/97/118-1 – Final. December 9, 1997.

42 Fischer, Stanley. *Korea – Draft Staff Report*. Office Memorandum to Mr. Boorman and Mr. Aghevli. December 27, 1997: 1.

43 Price Waterhouse Coopers 1999, cited in Stone 2002, 143. The CBR held some of its reserves in numbered off-shore accounts in foreign banks that were wholly-owned subsidiaries, and sold $1.2 billion of Russian state debt to them, which allowed it to meet IMF targets for central bank net domestic assets and net international reserves. The IMF was informed of the transaction, but not informed that the foreign banks involved were owned by the CBR. The IMF hired the consulting firm to investigate after the new Russian government revealed the deception in 1998, and briefly posted the report on its website.

aware that these transactions were illegitimate, but had chosen not to pursue the matter.[44] The Russian officials claimed that IMF staff had colluded in their efforts to misrepresent their holdings of reserves, so that they would appear to have met the conditions for disbursing loan installments during the critical Russian presidential election of 1996. According to Sergei Aleksashenko, first deputy chairman of the CBR at the time, "Approving the tranche in 1996 was a political question for the Fund and for the Central Bank. No one was interested in knowing the details about the operations."[45] IMF officials rejected this interpretation.

Staff failed to give the Executive Board clear early warning signals about exchange rate risks in each of the crises discussed in this book. When it had the data and recognized the problem, the Fund staff wrote reports to the Executive Board that couched the warnings in cautious language about risks that was not readily distinguishable from the language used when there was no substantial evidence of danger. In the cases of Brazil and Argentina the evidence gradually mounted that the countries were engaging in fiscal policies that were inconsistent with their respective announced exchange rate regimes, a crawling peg in Brazil and a currency board arrangement in Argentina. However, even when the crises began to loom on the horizon, the staff never stated that the exchange rate was misaligned or warned that a significant policy change was necessary in order to avoid a dramatic correction. In Brazil, staff reports pointed to a loss of competitiveness, which could be a sign of an overvalued exchange rate, and reports touched on issues of debt sustainability, but there was never a "bottom-line judgment" about the risks of a crisis.[46] Staff members involved in those assessments emphasized that there was a strong presumption against challenging the authorities' opinion about their exchange rate, and that it would be unwise for staff to claim that the exchange rate was overvalued without compelling evidence that a crisis was imminent.[47] In Argentina, the Fund's advice consistently focused on labor market rigidities, rather than emphasizing the fundamental issue that the exchange rate peg was unsustainable in the presence of substantial fiscal deficits and a volume of public debt that could not be serviced without continued capital inflows.[48] The Treasurer's

[44] The CBR officials argued that it was apparent that there were no foreign banks interested in buying large quantities of Russian bonds in 1996, so Fund staff had to know that the transaction with its subsidiary, FIMACO, was illegitimate, and they did not ask for clarification. Interviews with Sergei Dubinin, November 17, 1999; with Sergei Aleksashenko, November 16, 1999; and with Aleksandr Potemkin, November 14, 1999, cited in Stone 2002.
[45] Interview with Sergei Aleksashenko, November 16, 1999, cited in Stone 2002, 144.
[46] Transcript of interview conducted for IEO 2003, 2.
[47] Interviews with IMF staff.
[48] Interviews with IMF staff involved with Argentina. One respondent disagreed with the interpretation that the staff had concealed information from the board, but agreed that staff had

Department and Research each expressed objections to the 1998 program during the internal review, but their concerns were not reflected in the staff report.[49] In all cases the fear of leaks from the board played a significant role in degrading the clarity of the messages that the board received, particularly in writing, which is the main form in which the board receives information from the staff. Staff in the Western Hemisphere Department accurately understood what was happening in Brazil and Argentina, correctly analyzed the danger of continuing with their current strategy, and were well aware of the risks. However, a warning about the exchange rate could not be put into a staff report, because it would find its way into the press.

In some cases, the perceived need to avoid offending country authorities or the need to close ranks behind management prevented the staff from sending danger signals that would have helped inform the board about the risks involved in a program. Regardless of the signal they received, staff pooled on a strategy of sending an ambiguous signal to the board. In several cases, the effect was that the IMF embarked on risky programs and the staff and management did not inform the board how risky they believed them to be. It is unlikely that the IMF would have made very different decisions had staff reporting been more forthright. The key informal decision makers in these cases had access to more candid assessments, both from their own sources and directly from management. The fact that the Executive Board received filtered analysis, however, undermined the quality of its work and made it less relevant to decision making in crises than it otherwise would have been.

The limits of board access to critical information and how they evolve over time are illustrated by the use of side letters. Side letters are private written agreements between management and country authorities that supplement formal conditionality, but are considered too sensitive for a variety of reasons to include in letters of intent. Side letters were originally devised as a way of preventing such information from leaking when it was presented to the board, and often not only the content, but even the existence of side agreements was not communicated to the board. Between 1997 and 1999 there were 28 side letters, usually covering exchange rates, interest rates, intervention in the financial system, expenditures, or enterprise restructuring. One side letter covered capital controls, three covered trade policy, and three covered price increases. There was intense pressure to reform this practice after the Asian crisis, and in 1999 the board passed a new set of guidelines for side letters that called for reducing their use and limiting it to issues that were market-sensitive. In addition,

to be very careful how concerns are conveyed to the board, and that the main signal sent about the exchange rate regime was that it required more labor market flexibility.

49 IEO 2004, 37 (web version).

it prescribed that the existence of side letters or oral agreements must be communicated to the board, and EDs must be permitted to read the side letters in a restricted session and return the copies to management. However, management is permitted to remove information from the copy circulated to the board if "disclosure would: (a) seriously hamper the authorities' capacity to conduct economic policy; or (b) confer an unfair market advantage upon persons not authorized to have knowledge of the information."[50] A Policy Development and Review Department (PDR) report on the use of side letters prepared in 2002 indicated that the new policy had been followed, and that the use of side letters had declined from 18 percent of countries using Fund resources to 7 percent. In at least two cases side letters were not used – oral agreements were used instead – because country authorities "were reluctant to use side letters because of the wider distribution under the revised procedures and doubted that the existence of the letter would remain undisclosed."[51] One case in which the board was not informed of the existence of an oral agreement was the augmentation of the program for Argentina in September 2001, in which Argentina committed to discussing a new policy framework – i.e., reevaluating its fixed exchange rate – with the IMF if its reserves fell below a threshold, which was set just above the level of outstanding Fund credit. Although the board was not informed, the G-7 deputies were, and some EDs knew about the agreement because their governments informed them.[52]

Policy issues

In contrast to the previous discussion of country items, the decision-making procedure for general policy issues conforms closely to the IMF's formal governance model. Although the norm of consensus decision making remains strong and management tries to avoid contentious votes on the Executive Board, dissenting votes are more common, and decisions correspond more closely to the vote shares of the members and the formal voting rules. In particular, the United States frequently does not prevail when it champions policy changes, although it can use its position as a veto player to prevent changes that it opposes or to bargain for policy changes when its approval is needed in order

50 "Use of Fund Resources – Side Letters." Executive Board Minutes. EBM/99/108. September 23, 1999: 62.

51 "Review of Side Letters and the Use of Fund Resources." Prepared by the Policy Development and Review Department in consultation with the Secretary's Department and Legal Department. EBS/02/89. May 28, 2002: 2–3, 6.

52 IEO 2004, 53, 56. There remains some dispute about whether a side letter or an oral agreement was used in this case. An ED who was informed about the agreement at the time insisted that it was an oral agreement.

to expand IMF quotas. Deference to management is much weaker on general policy issues than on lending, and the board takes a more active role in formulating policy.

To take a trivial example, there has been a long-term disagreement on the board about the compensation and size of Fund staff. The United States has consistently taken the position that costs should be contained by maintaining a lean staff, and that Fund staff were excessively compensated. Staff compensation does not have direct budgetary consequences for the shareholders, because the IMF's operations are financed by the interest it charges on its loans. However, as the provider of the largest share of the Fund's capital, US officials have traditionally felt that they contributed the largest share of the costs. In addition, US officials have taken a jaundiced view because Fund compensation exceeds the compensation of US government officials with similar levels of seniority and is tax free. EDs from developing countries, on the other hand, have preferred high levels of compensation for Fund staff. EDs and their staff are compensated according to Fund salary schedules, and they sometimes migrate from the Executive Board to staff positions. Developing-country views on this issue have generally prevailed when compensation changes have not required supermajority votes, reflecting the preferences of the majority of the board members. During 2007 and early 2008 the Fund was hit by a budget crisis, however, because demand for its loans had hit a record low, and the interest from the remaining loans was not sufficient to finance Fund expenses. In the corridors of the IMF, a frequently heard quip was that the Fund needed to "find another Turkey" – because Turkey had been a frequent user of Fund resources and its outstanding loans were about to be repaid. In order to balance the budget, the Fund sought Executive Board permission to convert some of its gold reserves into an investment account to generate income, but this required a supermajority vote. As a result, the United States was able to insist upon budget austerity, which led to a 10 percent cut in staff levels.

A more consequential example was the evolution of the Fund's policy regarding capital controls. The Fund's Articles of Agreement grant each member country the right to impose capital controls at its own sole discretion, in contrast to current account controls, which they are encouraged to phase out. In fact, the consensus view at Bretton Woods was that capital controls were a desirable instrument for managing the volatility of international capital flows, and the agreement foresaw the possibility of cooperative use of capital controls to prevent currency crises.[53] It was well understood at the time that commitment to fixed exchange rates and full employment was inconsistent with free

[53] Helleiner 1994; Chwieroth 2009.

capital mobility, although these relationships were formalized later.[54] It was not until the 1960s that the economics profession began to seriously question the wisdom of using capital controls, and the consensus that they were harmful did not emerge until the 1970s. The United States became an early advocate of abolishing capital controls during the Nixon administration after closing the gold window in 1971 and floating the dollar in 1973. European countries and Japan relied upon capital controls to manage the turbulence of the 1970s, however, and a clear majority on the Executive Board favored their continuation. Current account imbalances swelled after the abolition of the Bretton Woods system of fixed exchange rates, and differential responses to the oil shocks of the 1970s strained European efforts to stabilize their exchange rates. Meanwhile, American efforts to talk down the value of the dollar led to capital outflows that complicated the German Bundesbank's efforts to contain inflation. As a result, European countries, with strong support from Japan, sought a new IMF policy designed to implement cooperative capital controls in the spirit of the original Bretton Woods agreement. Any progress was blocked, however, by the stolid opposition of the United States.[55] While the United States was unable to achieve any movement in IMF policy in its own desired direction because it was isolated on the issue of capital controls, it was able to rely on its formal voting power to veto any policy shift in the opposite direction.

Recent research makes a convincing case that staff developed its own views, which coincided with those of the majority in the 1970s, because the views of the economics profession penetrated the organization with a lag as new staff members were recruited from among the graduates of top economics departments. Staff began encouraging developing countries to dismantle their capital controls in the 1980s, largely because the prevalent view in economics that capital controls were harmful to development had finally percolated through the Fund.[56] During this decade, however, important shifts in the positions of the G-7 countries permitted the staff to develop a new line. The shift to the right in French economic policy under Mitterand – the famous "U-turn," in which France opted for economic liberalism combined with European integration when the market proved in 1983 that Keynesianism in one country would not work – played a key role in shaping the new consensus.[57] France had been the last major hold-out against liberalization within the European Community, and had blocked the Anglo–German–Dutch proposal to liberalize capital flows in the early 1980s. With this policy shift, the way was open for agreement on

[54] Mundell 1960.
[55] Helleiner 1994, Chapter 6.
[56] Chwieroth 2009.
[57] Abdelal 2007.

the Single European Act of 1986 and the 1988 directive to abolish capital controls in Europe by 1992.[58] Meanwhile, Japan dismantled many of its capital controls under US pressure, and the Organization for Economic Cooperation and Development (OECD) adopted a strict set of requirements that members abolish capital controls. Michel Camdessus came to the Fund as managing director determined to liberalize capital flows.[59] The Clinton administration intensified the longstanding US preference for abolishing capital controls under Treasury Secretaries Robert Rubin and Lawrence Summers, but it was the fact that this view had become consensual that now made it possible to make progress on this agenda. By the 1990s, even many developing countries had dismantled their capital controls and adopted liberal economic policies.

The fate of two recent initiatives with regard to capital controls illustrates the ways in which policy issues differ from the treatment of country items in IMF governance. The first was the development of the proposal to transfer jurisdiction over capital controls to the Fund in 1997. The authorship of this proposal is controversial – Abdelal ascribes it to Camdessus, Chwieroth attributes it to the IMF staff, and journalistic accounts credit US pressure – but it is clear that it enjoyed the support of the IMF and at least the tacit support of the Clinton administration, although administration officials subsequently claimed that they had been skeptical. It moved through the various stages of IMF governance, from the Executive Board to the Interim Committee (the predecessor of the IMFC) relatively smoothly. The new policy guidelines were set to be finalized in spring 1998, but the eruption of the Asian crisis intervened and shook the consensus on the board. Nevertheless, sufficient momentum had been achieved that the proposal seemed likely to pass, and Camdessus continued to support it staunchly. By this point, even if it was not the original author of the proposal, the Clinton administration was strongly committed to it and pushed it forward. However, in the spring of 1998 a group of Congressmen led by Richard Gephardt threatened to withhold support for legislation to support an increase in IMF quotas, which requires House approval, if the new proposal for capital controls went forward. The United States withdrew its support, and the proposal promptly died.[60]

Over the next few years, abolishing capital controls became less popular in the economics profession, which began to emphasize the benefits of sequencing economic reforms and improving financial market institutions before

[58] Moravcsik 1998, 262–63, 269–73, 333–47.
[59] Abdelal 2007.
[60] Gephardt was Democratic House minority leader at the time, so his support was essential to a Democratic administration seeking a quota increase. He was a leader of the protectionist wing of the Democratic Party and took a skeptical approach to the international financial institutions.

liberalizing capital flows. Nevertheless, IMF staff remained firmly committed to the virtues of liberalization. When the Executive Board called on the Fund to develop Medium Term Strategy (MTS), therefore, one of the few substantive changes to IMF strategy that the staff proposed was to renew the proposal to grant the IMF jurisdiction over member country capital controls. The MTS went through an extensive interdepartmental review process and was proposed to the Executive Board by management, which had an incentive to anticipate objections. Nevertheless, the proposal was rejected at the Executive Board, and management was directed to redraft the MTS. In the end, the extensive staff work and the product of the interagency review was rejected wholesale, and management commissioned a narrow team of drafters to draw up a revised document that was much less substantive.[61]

These examples illustrate the view, which is widespread within the Fund, that the formal decision-making procedures are decisive during decisions about general policies. In the case of capital control policy, the US role seems to have been exactly what we would expect from its role in the formal decision-making structure. As the leading shareholder, it is able to block initiatives that it opposes, as it did to proposals to strengthen capital controls in the 1970s, and as it finally did to the proposal to give the Fund authority over capital controls in 1998. However, while US support is necessary for positive initiatives, it is not sufficient; policy changes only when a majority supports it. The United States was unable to shift IMF policy on capital controls to keep up with changes in its own views in the 1970s, and by the time US preferences for liberalization began to be implemented in the 1980s, reducing capital controls was no longer a strong US policy priority.[62] The emergence of a broad consensus among the countries represented on the Executive Board by the 1990s provided the space for the IMF management to promote liberalization under Michel Camdessus, and was more important than the Clinton administration's zeal for liberalization.

The development of the IMF practice of conditional lending provides an illustration of the interaction between formal and informal decision rules, because it involved both decisions about general policies, in which voting rules were decisive, and the gradual development of precedents related to individual countries, where informal influence was much more pervasive. The treaty establishing the IMF adopted at Bretton Woods in 1944 did not provide for conditional lending, although some of its language implied that access to Fund resources need not be automatic. For the first few years of its existence the IMF lent its resources without applying any formal conditions aside from seeking

[61] IEO 2009.
[62] Chwieroth 2009.

the approval of its Executive Board, and conditional lending was not established until 1952. The United States, which at this time was the primary net creditor to the IMF and held 30 percent of IMF quotas, insisted that loans should be accompanied with binding conditions, arguing that this was necessary in order to safeguard Fund resources. The United States was not initially able to prevail over the determined opposition of the other members, however, which expected to be net borrowers and therefore to be subject to the conditions.

Frank Southard, the US ED, announced the first steps towards conditionality as US policy in May 1948, in the form of guidelines for eligibility to draw on Fund resources, and almost immediately began applying these principles in individual country cases.[63] The other countries refused to adopt conditionality as a formal Fund policy, however, and the United States did not have the votes to establish the policy unilaterally. On the other hand, the United States was able to effectively use its 30 percent vote share to block action, and it brought Fund lending to a halt in 1950. In a form of partial exit, the United States used unilateral lending under the European Recovery Program as an alternative to IMF lending, and attached substantial conditionality to its support. The staff and management were alarmed that the impasse would render the IMF a dead letter, and advanced several compromise solutions that were rejected in 1949 and 1950. Finally, after substantial debate and several drafts, the Executive Board adopted the policy establishing the Stand-By Arrangement (SBA) as a conditional lending facility in 1952.[64]

Conditionality policy developed gradually during the 1950s. Phasing IMF programs, or disbursing loans in tranches, was first introduced in 1956, and the current practice of making disbursements conditional on meeting formal performance criteria was introduced in 1957. The application of phasing and conditions was uneven, however, and was most widely used in western hemisphere SBAs. The success of these programs was generally dependent upon substantial amounts of supplementary financing by the United States, and the United States was therefore strongly interested in program design and in a strong position to influence it. The US ED, William Dale, argued in 1966, "By establishing performance criteria related to public finance, credit policy, and the balance of payments, stand-by arrangements have in many cases provided an essential part of the basis on which sizable amounts of US assistance have been committed."[65]

Meanwhile, European countries' preferences about the design of condition-

[63] Gould 2006, 45.
[64] Gould 2006, 45–7.
[65] EBM/66/13. February 23, 1966: 5. IMF archives, quoted in Gould 2006, 78.

ality shifted as their roles shifted from net borrower to net creditor. Most west European countries had convertible currencies and current accounts by the end of the 1950s, and were much less dependent upon US financing than they had been early in the decade. As a result, policy on conditionality was much more consensual by the time of the first review of IMF conditionality in 1968 than it had been in the early 1950s. In fact, the EDs representing Germany and Canada appeared to be somewhat more enthusiastic about conditionality than the US ED, who suggested that conditionality might have gone too far and been too intrusive.[66] Germany had current account surpluses by the 1960s, and its main macroeconomic concern was preventing the resulting capital inflows from creating inflation. The guidelines adopted represented a compromise, instructing staff to limit binding conditions to the "minimum necessary," abolishing conditionality for low levels of access to IMF resources, and calling for greater uniformity in the application of conditionality.[67] Uniformity, in particular, is a concern of developing country EDs. However, the guidelines also represented an acknowledgment by the membership of the legitimacy of conditionality, and established the principle that all upper-tranche programs should have binding conditions.

Subsequent reviews of conditionality in 1979 and 2002 similarly called for reductions in the number of conditions and more uniformity of treatment, but also codified new practices that had arisen in the interim, such as medium-term lending in 1979 and financial sector conditionality in 2002. Meanwhile, applying the principles adopted in 1979 under rapidly changing conditions led to a dramatic expansion of conditionality in the 1980s and 1990s. The size of financial imbalances rose much more rapidly than IMF quotas, and long-term users of IMF resources accrued substantial debts, so that the majority of borrowers entered the upper credit tranches that called for substantial conditionality. The Reagan administration exploited the opportunity that this afforded to expand conditionality and give it a distinctive supply-side emphasis.[68] The nominal expansion of IMF quotas in 1983 was limited to 22 percent, so that inflation drove borrowers into higher credit tranches, and during the expansion the United States exercised unusually strong formal control over IMF policies because its vote share is sufficient to block quota expansions. Discussions within the Executive Board in July and August 1983 were initially deadlocked, as the United States resisted calls from developing countries to expand quotas and raise access limits in the wake of the Latin American debt crisis. France and Britain crafted a compromise within the G-7 under which access limits

[66] Gould 2006, 78.
[67] Gould 2006, 79.
[68] Kahler 1990.

were raised, but countries that exceeded the old limits would be subject to more stringent conditionality.[69] Two-thirds of IMF loan disbursements involved substantial conditionality by the end of the 1980s, compared to only one-quarter in the 1970s.[70] Based on archival research, Erica Gould estimates that the average number of performance criteria in an IMF program jumped from 7.1 during the period from 1974 to 1982 to 12.1 between 1983 and 1990.[71] Throughout the development of conditionality, it appears that the policy has only imperfectly represented US preferences, but has gradually come closer as the majority of the Executive Board became creditors and their preferences shifted to more closely resemble those of US representatives.[72]

The Executive Board plays a much more active role in debating and amending changes in general policies than it does in approving programs for individual countries. Whereas country lending items generally pass the board with minimal discussion, management proposals on policy issues are subject to intense scrutiny because they directly engage the interests of the whole membership. Executive Board policy decisions do not have the force of law, but they are more analogous to legislative than to executive decisions because they apply to wide ranges of cases, and they are watched carefully because they set general precedents. The aspects of executive delegation that facilitate informal participation – confidentiality, urgency and tight agenda control – are missing in general policy discussions. This different treatment of policy issues, which are subject to formal voting and open discussion, and country-specific executive decisions, which are subject to informal governance, has important implications for the distribution of influence within the organization. US influence over general policies reflects the US' status as the largest shareholder, but is restricted to a degree that is commensurate with its vote share. In contrast, US influence is much more decisive over country matters that directly concern only one or a few members.

[69] Boughton 2001, 881–82.
[70] Boughton 2001, 561.
[71] Gould 2006, 60.
[72] Gould (2006) interprets this history differently, but her data and historical evidence are consistent with the argument made here. She argues that the United States had a preference for weaker conditionality because the United States intervened to weaken conditionality in numerous cases, and countries that received substantial amounts of US foreign aid were subject to less conditionality. The argument here is that this is evidence of informal influence that leads to exceptions for favored states (see Chapter 8), but that the United States had a general preference for more stringent conditionality. The ability to make exceptions is only valuable if the general rule is onerous.

Conclusions

A critical argument of this book is that institutions are endogenous. Informal governance practices arise and persist because the states that participate in international organizations make trade-offs between the costs of ceding control to powerful actors and the costs of inducing those actors to withdraw from multilateral cooperation. The IMF Executive Board has the formal power to change these practices, and it engages in periodic self-assessments and makes reforms to its procedures, as it did when it began publishing letters of intent and discussing side letters. However, there are good reasons for the Executive Board to avoid disturbing the status quo.

First, the status quo works pretty well for the significant shareholders most of the time. They have a consensus view, with some allowance for differences of emphasis, about what sorts of economic reforms developing countries should be encouraged to adopt, and management shares this consensus, so there is no compelling incentive to monitor closely. Management's preferences are known, and shirking is not a relevant concern, so there is no significant principal–agent problem that would deter delegation. In the average country most of the time, furthermore, the United States does not exert special influence because it has no compelling incentive to do so and because manipulation of the process involves some costs. Thus, the costs of informal governance are usually modest for most of the shareholders. Furthermore, the mid-sized shareholders have a weight in discussions about general policies that is much greater than their weight in the international economy, so the costs of informality are outweighed by the benefits of enjoying a disproportional share of decision-making power in an international forum in which the United States is heavily invested.

Second, although individual EDs might prefer to increase the competency of the Executive Board, they do not have the authority within their own governments to initiate substantial reforms. Within the G-7, decision making on important issues occurs at the level of the G-7 deputies, who substantially outrank their respective EDs. This suits the United States because it finds it easier to achieve consensus within the G-7 than in a wider and more public forum, and it suits the other G-7 countries because membership in the G-7 gives them privileged access to information and a place at the table when the important issues are discussed. Developed countries outside the G-7 find the arrangement less satisfactory and are more likely to raise reform proposals, but also have less influence and less ability to introduce changes. Developing countries, until recently, have complied with these arrangements because they were net borrowers rather than net creditors, so they were willing to participate in spite of their relative underrepresentation. This has been shifting as countries such as China, India and Brazil have become increasingly important players in the world economy, and the shift of the locus of governance from the G-7 to the G-20 promises to increase their role in the future. However, when countries have shifted from net borrower to net creditor status in the past, their interests have generally aligned more closely with those of the United States, ensuring that it was relatively easy to maintain a consensus among the states that were powerful enough to change the rules.

Ultimately, institutional design depends upon the distribution of power and interests. Informal governance persists because it is useful for the United States to be able to manipulate IMF policies under special circumstances, and other countries acquiesce in institutional arrangements – a strong management, a weak Executive Board, and substantial secrecy – that make the costs of manipulating the organization low enough to be tolerable for the leading power.