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The IMF and the Politics of Financial Globalization

From the Asian Crisis to a New International Financial Architecture?

Ben Thirkell-White

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This book is dedicated to the 'Educational Trust'.

List of Abbreviations

ABRI	Angkatan Bersenjata Republic Indonesia (Indonesian Armed Forces)
ASEAN	Association of Southeast Asian Nations
*AWSJ**	*Asia Wall Street Journal*
BI	Bank Indonesia
BIS	Bank for International Settlements
BK	*Business Korea*
BN	Barisan Nasional
BOK	Bank of Korea
BULOG	Indonesian government food distribution service
DAP	Democratic Action Party
DFID	Department For International Development (UK government)
ED	Executive Director
EIU	*Economist Intelligence Unit*
EU	European Union
EOI	Export oriented industrialization
EPB	Economic Planning Board (Korea)
ESAF	Enhanced Structural Adjustment Facility
FDI	Foreign direct investment
FKI	Federation of Korean Industries
FSC	Financial Supervisory Commission (Korea)
FT	*Financial Times*
FSF	Financial Stability Forum
GAB	General Agreements to Borrow
GATS	General Agreement on Trade in Services
GATT	General Agreement on Tariffs and Trade
GDP	Gross domestic product
GNP	Gross national product
HICOM	Heavy Industries Corporation of Malaysia
HIPC	Highly indebted poor countries
IBRA	Indonesian Bank Restructuring Agency
ICA	Industrial Coordination Act (Malaysia)

* Abbreviations in italics are used for references to newspaper and periodical sources

ICMI	Association of Indonesian Muslim Intellectuals
IEO	Independent Evaluation Office
IFA	International Financial Architecture
IFI	International Financial Institution
ILO	International Labour Organization
IMF	International Monetary Fund
IMFC	International Monetary and Financial Committee (of the IMF)
INDRA	Indonesian Debt Restructuring Agency
IOSCO	International Organisation for government securities commission
IR	International relations
ISI	Import substituting industrialization
ITO	International Trade Organization
JP	*Jakarta Post*
KCIA	Korean Central Intelligence Agency
KCTU	Korean Confederation of Trade Unions
KISDI	Indonesian committee for solidarity with the Muslim world
KLSE	Kuala Lumpur Stock Exchange
KOPASSUS	*Komando Pasukan Khusus* (special forces command, Indonesia)
LDC	Least Developed Country
LIBOR	London Inter-bank Offer Rate
LLR	Lender of last resort
LTCM	Long-Term Capital Management
MCA	Malayan Chinese Association
MFN	Most Favoured Nation
MIC	Malayan Indian Congress
MLG	Multi-level governance
MOFE	Ministry of Finance and Economics (Korea)
MPR	People's consultative assembly (Indonesia)
NAFTA	North American Free Trade Association
NDP	National Development Plan (Malaysia)
NEP	New Economic Policy
NGO	Non-governmental organization
NICs	Newly Industrialized Countries
NIEO	New International Economic Order
NST	New Straits Times
NU	Nahdlatul Ulama (revival of the religious scholars, Indonesia's largest Muslim organization)

NYT	*New York Times*
OECD	Organization for Economic Cooperation and Development
PAS	Parti Islam Se-Malaysia
PCIJ Ser A	Proceedings of the Court of International Justice Series A
PDI	Parti Demokrasi Indonesia (Indonesian Democratic Party)
PDI-P	Megawati's 'new' PDI formed after her expulsion from the PDI
PPP	Parti Persatuan Indonesia
PRGF	Poverty Reduction and Growth Facility
PRSP	Poverty Reduction Strategy Paper
ROSC	Report on the Observance Standards and Codes
SCMP	*South China Morning Post*
SDDS	Special data dissemination standard
SDR	Special Drawing Right
SDRM	Sovereign Debt Restructuring Mechanism
SME	Small and medium sized enterprise
TNC	Transnational corporation
UEM	United Engineering Malaysia
UMNO	United Malays National Organization
UN	United Nations
UNCTAD	United Nations Conference on Trade and Development
USAID	United States Agency for International Development
USED	United States Executive Director (of the IMF)
USTR	United States Trade Representative
WSJ	*Wall Street Journal*
WTO	World Trade Organization

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1 Introduction

The International Monetary Fund's (IMF) response to the financial crisis that swept through Asia in 1997 provoked a level of controversy that had certainly not been seen since the debt crisis. 'Rarely in its 52-year history', said the *New York Times*, 'has the Fund been under such concerted attack from so many quarters' (*NYT* 1 February 1998).

The *Financial Times* (*FT*) and *Wall Street Journal* (*WSJ*) published scathing editorials and op-ed pieces by mainstream figures, such as Jeffrey Sachs and George Soros (11 December 1997 and 31 January 1998, respectively). In the United States, IMF funding was hotly debated in Congress throughout 1998. A whole host of eminent figures in the Washington establishment became involved including George Shultz, Paul Volker and Henry Kissinger. In Asia, there were street protests and riots and three governments changed hands.

Some economists felt the Fund had interfered unnecessarily with market processes (Calomiris, 1998), whilst others thought it should have pursued a less market-friendly strategy (Sachs, 1997). Almost everyone was disappointed by how long it took to deal with the crisis and how much it cost to do so. There were also concerns that the IMF was becoming overly involved in 'political' issues:

> A nation's desperate need for short term financial help does not give the IMF the moral right to substitute its technical judgements for the outcome of the nation's political process (Feldstein, 1998).

Since the Asian crisis, and those that followed in Eastern Europe and Latin America, there has been a long-running debate over the future of the Fund's role in the context of a 'new international financial architecture'. Controversy over the crisis and the new architecture are primarily about the IMF's role in promoting and managing financial globalization in emerging markets.

The Asian crisis was a crucial moment in a process of evolution for the Fund that had been going on quietly throughout the 1990s. It built on two trends that had begun during the debt crisis of the 1980s.

The first was a growing involvement with private capital flows to middle-income countries. During the debt crisis, a shortage of public funds had forced the IMF into involvement with rescheduling private sector syndicated loans in the context of financial crisis (Kraft, 1984). In the 1990s, in a context of growing bond lending and equity flows to emerging markets, the Fund became concerned with 'enhancing market confidence' and acting as a 'catalyst' for private finance. It saw its role as promoting free capital flows and the policies that were necessary to support them. The crisis coincided with attempts to alter the Articles of Agreement, the Fund's governing document, to make capital account convertibility an obligation (Fischer et al., 1998). During the Asian crisis, the Fund extended this market confidence approach into crisis management.

The second change was a growing interest in legal and institutional reform – 'good governance' (IMF, 1997a). In the 1980s, the IMF had become involved in microeconomic 'structural' reforms, but these were largely about reducing the role of government, rather than reforming it. Governance reform and political conditionality became key parts of the international aid discourse in the wake of the Cold War and were closely connected with democracy promotion (Crawford, 2001). For the IMF, though, the term has a more technical meaning, tied up with market confidence. Fund staff prepared research to suggest that good governance was essential for investor confidence and could therefore be seen as a macroeconomic necessity, rather than unwanted political interference (Dhonte, 1997). Better governance would produce financial rewards and was essential for financial stability. However, the technical and political governance agendas have not been kept entirely separate. Governance reform involves questions of transparency, accountability and fairness (IMF, 1997c). It has also been associated with a new relationship between the IMF and its member states that is slightly more open and involves attempts to engage domestic 'civil society'.

Controversy over the relationship between free capital flows and institutional reform is what debates over the Asian crisis were all about. It is the central issue in discussions of a new international financial architecture and, of course, it is the substance of the politics of financial globalization in middle-income countries. The IMF's new role in these processes is the core concern of this book.

My primary aim is to argue for a particular approach to these issues that is at odds with much existing writing. Ever since its creation, the IMF has tried to project an image of itself as a neutral technocratic organization.[1] Partly as a result, most research on the Fund has been concerned with *evaluating* Fund policy. There is a tendency to ask whether Fund policy is 'good' (relative to some technical, or sometimes political criterion) instead of asking who is in a position to determine Fund policy and what those people take into account when doing so.[2] The core argument of this book is that there is a need to redress this balance if we are to understand and evaluate the Fund's current role. Although it is impossible to understand what the Fund does without a good grasp of economics, my main aim is to discuss the Fund as an institution of political management.

1.1 A political approach to the IMF and financial globalization

There are four reasons why a more political approach to the Fund is important. The first two relate to understanding what happens in crisis countries. Pragmatically, the Fund's new institutional agenda requires sophisticated political management to ensure implementation. Merely providing technical blueprints for institutional reform is inadequate. Unless reforms are designed on the basis of an understanding of the political economy of target countries, what will emerge in practice may be very different from intentions. Reforms may be subverted or resisted for a range of different reasons.

Secondly, in normative terms, governance policies cannot be evaluated on the basis of purely economic criteria. Public institutions and policies reflect the outcomes of social change and political struggle as well as rational reasoning about economic outcomes. The IMF's reform agenda in Asia was officially designed to create market-driven systems for allocating capital. However, it had a profound impact on non-economic issues such as: inter-ethnic redistribution; social and political order; the level of economic risk societies were exposed to; corruption; authoritarianism; and forms of democracy and democratization. It is simply inadequate to think about the impact of IMF programmes in developing countries in purely economic terms.

These two points overlap. Evaluations that compare actual situations with idealized conceptions of good policy are only attractive as political rhetoric. It is easy to describe an attractive utopia. The real choice, though, is between plausible counterfactuals: current practice should be compared with the likely outcomes of policy rather than with the intentions claimed on its behalf. Plausible counterfactuals can only be identified on the basis of political economy.

Thirdly, even politically informed debates about whether or not the IMF did the 'right' thing in Asia have their limitations, particularly when they are conducted in general terms. Is capital account liberalization a good idea? Is corruption a bad idea? The complexities that a political-economy analysis of what happened in Asia reveal suggest that answers depend on context. Anyway, whether or not particular interventions were correct is only part of what should be considered. There are more fundamental questions about the basis on which decisions were made and who has the authority to decide. It is not that disputes over correct policy are insignificant, it is rather that they will never be resolved. There is no 'optimal' policy for the kinds of issues the Fund is now dealing with, so it is also important to discuss how the inevitable conflicts will be settled. Democratic practice is not so much about finding the right policy in particular circumstances as it is about ensuring that the policy-making process is, on balance, directed at the collective interest.

These issues are particularly important in the context of the Fund's new role, since arrangements appear to be changing. The central structure of IMF decision-making, where the core problems are to be found (weighted voting), is currently strongly defended. However, there are subtle changes in procedure going on that are potentially significant as starting points for reform.

The Fund's 'post-Washington Consensus' governance agenda is a departure from the powerful conviction, underpinning the Washington Consensus, that governments should be seen as 'the problem'. Although the new agenda has rightly been seen by some as part of a colonization of the social sciences by economists (Fine, 2000), it also takes the IMF into unavoidably political territory. Problems with implementing programmes are firmly on the agenda for discussion. The governance agenda and 'civil society engagement' both open space to debate political issues. The sheer political significance of the Fund's new agenda has also created new forms of mobilization. Implementation of complex institutional reforms requires widespread social cooperation. The politics of the IMF are no longer confined to debate between financial technocrats sitting on the IMF's Boards. They spread much wider into society and a broader range of actors can influence outcomes.

Finally, a purely normative critique that identifies 'bad' policy is not, in itself, politically enabling. It doesn't say enough about how to respond to the problems that have been identified. Calling for better policy is all very well, but what will make it actually come about? Worse, unless normative critique is tied to a realistic understanding of political causation, it may suggest inappropriate strategies. If the IMF is bad, we should abolish it (Danaher, 2001). If governments are corrupt, we should overthrow them (James, 1998). That is the counterpart of the point I made above about realistic evaluation of policies. Similar difficulties appear more subtly in sophisticated debates about an 'appropriate' role for the Fund in a new architecture, based on identifying an appropriate function for the institution, but with a limited understanding of how to achieve it politically (Council on Foreign Relations, 2000; De Gregorio et al., 1999; Eichengreen, 1999; International Financial Institution Advisory Commission, 2000).

Having said that, normative agendas are both important and impossible to avoid. This book is written as a critique of the Fund. Much of what I have said so far in this section could have been written by a political realist. However, if I am a realist at all, I am a classical realist rather than a neorealist.[3] I don't want to replace normative approaches with a more 'objective' form of politics. Rather I am anxious to show that normative arguments are attempts to appeal to 'everyone'. In the terms in which they are often discussed by realists, 'norms' seldom defeat 'interests' (Hurd, 1999; Krasner, 2000). However, that is because of an artificial distinction created between the two. Our interests are shaped by our normative views (Lebow, 2003). More importantly, a policy that is normatively problematic is problematic because it is against somebody's interests. Since economics, unlike security, is ultimately a partly cooperative activity, normative problems will trigger political difficulties, if only when the problems are particularly severe. My aim here is to show that normative problems with the way the IMF is operating are also a source of political resistance and so need to be dealt with, even from the point of view of the Fund's leading shareholders.

It should be clear that my political approach is a deliberate attack on much of the mainstream economics profession. I will argue, throughout the book, that rational choice assumptions, a blinkered utilitarianism, and a failure to do the work of testing idealized models against reality are increasingly problematic in the context of the Fund's new role. I am not denying that orthodox economic analysis is an extraordinarily powerful tool. I am merely suggesting that it is not enough on its own. Economic modelling needs to be integrated with other forms of social science analysis to realize its full potential and avoid, often unconscious, ideological bias. The rest of the social sciences can be obsessive about methodology. Economists are simply not self-conscious enough about their assumptions.

It may be less obvious that it is also a criticism of some of the radical writing on the IMF, which tends to compare the IMF to unrealistic ideals. There is a need to go beyond normative distaste, to put forward practicable and politically appealing strategies for change.

An agency-centred approach to globalization

That critique of both right and left-wing approaches to the IMF is very much the reasoning behind academic calls for a more agency-centred approach to financial globalization (Amoore et al., 2000; Cerny, 2000; Hay, 2001) and this book should be read in the context of those broader debates.

The broad argument is that early hyperglobalist discussions were empirically simplistic and politically disabling. If globalization is a technically inevitable force that has conquered the planet, there is little anybody can do except feel triumph (on the right) or despair (on the left).

There undoubtedly has been a shift along a continuum from a largely public international organization of credit to a far more diffuse and private one (Eichengreen, 1998; Germain, 1997; Helleiner, 1994; Pauly, 1997). Technology and changing forms of production have played a part. However, financial liberalization is also a product of active political decisions (Helleiner, 1994). That doesn't guarantee that no structural forces are at work. Political agents may believe that they have no real alternative but to act in ways that further financial globalization.[4] However, it does suggest a need to analyze the agency involved: why did particular actors make those decisions, what kinds of political process were at work, how might those processes be altered?

The politics of the IMF is an important part of what needs to be understood if we are to answer those questions. The promotion of financial globalization in middle-income countries is at the cutting edge of a process that has yet to be completed in the developing world (DFID, 2000; Hirst and Thompson, 1996).

Debate about the IMF's role in shaping countries' adaptation to financial markets is one manifestation of a broader debate about 'convergence' under globalization. The argument is that globalization exerts structural pressures towards a homogenization of policy. To maintain market confidence, macroeconomic policy needs to be centred on low inflation and fiscal conservatism (Baker, 2002). Competition for capital provides incentives to minimize regulation and encourage 'labour market flexibility'. In some versions, broader systems of (particularly corporate) governance are in the process of converging into a single model – either because it is superior or because uniformity enhances market confidence and facilitates cross-border transactions.[5] Each form of convergence is politically significant because it limits state autonomy.

Fund policy in Asia seemed to advance this view. The normative question is whether these forms of convergence really are essential and, if so, whether the costs imposed are worth whatever benefits capital flows deliver. In the context of the IMF, there are also questions about whether anything can or should be done to alter the choices countries face. The Bretton Woods system was partly designed to provide countries with greater space to pursue social and political objectives that might be at odds with the imperatives of international monetary integration (Ruggie, 1983). Many currently feel the IMF has reversed these priorities. For some, the international financial architecture embodies attempts to push countries to adapt their social and political environments to suit market imperatives (Best, 2003; Soederberg, 2004).

Another way of seeing the political approach I advocated above is as a way to uncover the political agency involved in these processes. By looking at the political causation surrounding IMF decision-making, programme negotiations, and programme implementation, we can see how particular actors respond to the pressures of financial globalization and understand why they do so. In particular, I will show that different actors in different contexts are confronted by very different choices, so the underlying politics takes us a long way from debates about market efficiency. By understanding these different choices we can see why some choose to resist globalization, and some to advance it, whilst others remain indifferent. We can also start to go beyond discussions of the IMF's intentions to look at the prospects for achieving its current agenda. That will also help us to imagine alternatives and to approach a strategy for achieving them.

1.2 In search of the politics of the Fund – the concept of legitimacy

I set out the agenda for the book in the previous section. In this section I want to outline how I will go about the tasks I outlined. The aim is to link a normative evaluation of the IMF's new role to an understanding of why it is as it is and how it might be changed. I want to produce a normative critique of the IMF that builds on plausible counterfactuals rather than normative ideals. I also want to show how normative problems signal a need for reform that should be compelling, even to the Fund's leading shareholders.

I begin, in Part I of the book, by exploring the Fund's own legitimating justifications: the reasons it argues states have for complying with its preferences. I then look at the general ways in which an emerging mismatch between those justifications and the Fund's contemporary role have tended to undermine their logic, as the Fund has moved away from the Bretton Woods vision. I show how current political challenges to the IMF are partly consequences of a longer-term decline in the political legitimacy of IMF institutions.

Part I's discussion of the logic of IMF legitimacy then provides the context for my examination of the various forms of political agency mobilized during the Asian financial crisis in Part II. Political challenges are not just significant because they subvert or obstruct IMF intentions in the short term. Seeing political challenges in the context of IMF legitimacy shows that some forms of challenge will also signal wider problems, suggesting the potential to mobilize a wider opposition coalition and for problems to recur in other contexts.

Finally, in Part III, contemporary debates over IMF reform are viewed in the light of the potential for reforms to defuse the tensions that emerged during the crisis, re-invigorating IMF legitimacy. The extent to which the IMF has responded to particular challenges tells us about different actors' ability to influence IMF decision-making through various currently existing channels. It will help us to draw together lessons learnt throughout the book about the politics of Fund decision-making. Equally the kinds of challenges that haven't been fully addressed provide indications of the political difficulties the Fund is likely to face in the future.

Essentially, then, there are two parts to the argument. The first concerns the logic of legitimacy claims. How does legitimacy work? What sorts of factors make an institution more legitimate? To what extent does the IMF fulfil these criteria and where do its legitimating arguments appear weak or problematic?

The second is more empirical and is concerned with the strategic choices involved in the maintenance of institutional legitimacy and the strategic implications of political challenges. What kinds of political challenge materialize in practice? In the light of the logic of IMF legitimacy claims, how significant are these challenges? Will they be repeated or attract a widespread coalition of resistance? To put it differently, are they simply reflections that the IMF regime is proving inconvenient to a particular country in the short term, or that it is unsatisfactory for a large segment of the membership over the medium term? How has the Fund chosen to respond and is the response adequate?

The two subsections that follow are devoted to explaining the logic of the way the book addresses those two sets of issues through a more detailed analysis of what I mean by political legitimacy. The first subsection is primarily concerned with the logic of legitimating arguments and the second with the politics of legitimacy maintenance.

1.2.1 Legitimacy and reasons for compliance

The approach I adopt to political legitimacy relies on David Beetham's work (Beetham, 1991; Beetham and Lord, 1998). Beetham argues that legitimacy is about giving actors reasons for compliance with institutional preferences. In particular, an institution needs to be able to persuade key actors that it serves a purpose sufficiently valuable to compensate them for the loss of freedom involved in complying with institutional policy.

Political legitimacy (in contrast with more normative or philosophical conceptions) is about whether institutional justifications are compelling to particular actors at particular times and in particular places. There is no need to decide whether institutional authority is justifiable in some absolute sense. What is important is whether relevant political actors are convinced by the justifications that are available. An institution's legitimacy is under threat when there are signs that a sufficiently wide group of actors may no longer believe that they have good reason to comply with institutional legitimacy (I will explore exactly what 'sufficiently wide' might mean further below). However, rejecting absolute normative conceptions in favour of a more pragmatic political approach focused on actor perceptions doesn't mean that we have to retreat into radical subjectivism about legitimacy:

> A given power relationship is not legitimate because people believe in its legitimacy but because it can be *justified* in terms of their beliefs (Beetham 1991, 11).

A variety of publicly available information about actors' beliefs in other contexts, combined with an acceptance of the importance of reason, can enable us to make sensible judgements about what will enhance or impair an institution's practical political legitimacy.

What kinds of evidence are relevant? Beetham argues that legitimating justifications tend to follow a set logical pattern. Power is legitimate to the extent that:

1. it serves a purpose that is valued by relevant actors, compensating them for the loss of autonomy involved in complying with institutional policy (purpose and performance)
2. power holders can claim some kind of (democratic, religious, technical etc.) authority, qualifying them to make judgements and wield power in service of the relevant purpose (authority)
3. power holders are restrained by a set of rules that ensure their power is only used for that purpose (legality)
4. positions of authority are confirmed by the express public consent or affirmation of appropriate actors (consent/legitimation).

The roles authority and legality play in bolstering institutional legitimacy should be clear. Consent serves two purposes. Widespread public consent to institutional authority provides a kind of peer pressure. It suggests others consider the institution to have a reasonable claim to authority, marginalizing dissent. Secondly, legitimacy is about consent over time – institutions may be inconvenient under certain short-term circumstances but convenient when viewed over a longer time frame.[6] Formal consent to institutional authority may make it easier to portray dissent as sour grapes rather than a legitimacy challenge, providing some moral and reputational incentives for members to accept institutional decisions.

Legitimacy is multi-faceted. It springs from a combination of performance and various kinds of institutional reassurance. Strength in some areas may compensate for weaknesses in others. An institution that has strong institutional safeguards may find it easier to pass off problematic performance as a temporary mistake rather than an abuse of power. Equally, poor institutional safeguards may be easier to tolerate if performance is good.

Legitimacy is about institutional resilience over the longer term. Legitimacy is a matter of degree rather than an all or nothing property, either present or absent. Some actors will always be unhappy about the restraints an institution places on their freedom of action. What matters, though, is whether the majority of actors are reasonably satisfied that the institution serves their interests over the longer term:

whether the general logic of an institution's legitimacy claims remains broadly credible in the light of its performance.

One part of understanding institutional legitimacy, then, involves making judgements about the relative credibility of the kinds of legitimacy claims that can be made in support of an institution's role. It involves exploring the factors that will tend to promote institutional resilience and areas of weakness that may result in political challenge.

The first part of the book assesses the IMF's legitimacy claims in these general terms, showing how they can be seen as attempts to meet Beetham's four criteria (purpose/performance, authority, legality and consent). What kinds of reasons might the IMF offer various actors for complying with its policy preferences? How logically compelling are those reasons? What kinds of events might be expected to put IMF legitimacy under threat?

Chapter 2 reviews the claims made in IMF publications and on the IMF website. Chapter 3 reviews changes in the IMF's role, from Bretton Woods to the eve of the Asian crisis in the mid-1990s. It shows that, while the Fund's role has changed significantly, its institutional arrangements have been much more stable. It argues there is a growing mismatch between the two, which is putting strains on the logic of legitimacy claims.

1.2.2 Legitimacy, power and politics

The fact that there are logical problems with an institution's legitimacy claims, though, doesn't necessarily translate directly into *political* difficulties. Legitimacy is always a matter of degree and is about institutional resilience or fragility. Weak legitimacy makes political problems likely but we cannot necessarily predict when they will actually occur. However, analyzing legitimacy does help us to understand the *reasons* for political difficulties and provides suggestions for possible routes to relegitimation.

The second and third parts of the book, therefore, need to move on to an empirical investigation of the ways in which the broad problems with IMF legitimacy claims set out in Part I actually turned into practical problems for the Fund in the context of the Asian crisis.

Part II looks at political responses to the IMF's interventions in Asia in a variety of domestic contexts. It carries out the kind of analysis of political mobilization that I discussed in section 1.1 above, identifying political forces that sought to support or oppose the IMF's post-crisis agenda in Asia.

Those forms of political mobilization are interpreted in terms of the broad arguments about legitimacy discussed in Part I. I look at how what happened in Asia tended to undermine the kinds of legitimating justifications the IMF has historically provided. I also assess reactions in terms of the political threats they offer to the IMF's continuing ability to function. The aim is to interpret responses in Asia in terms of the messages they give out about the IMF's ability to function over the longer term. What kinds of opposition can be expected and, in the light of earlier discussion of IMF legitimacy, what would need to be done to diffuse that opposition?

The Fund has limited coercive resources and is reliant on co-operation if it is to achieve its goals. It therefore needs to pay attention to signs of discontent. A challenge to IMF legitimacy is significant long before it gets to the stage of threatening the institution's very existence. We can imagine problems ranging from guarded expressions of discontent over particular policies, through more or less blatant non-implementation of Fund programmes, to a widespread exodus of the membership.

More legitimacy is better than less. An institution should want to maximize its resilience in the face of future potential problems and should take note of even relatively modest challenges. However, responding to problems will impose costs on the Fund, ranging from time and energy expended over persuasion to more significant policy change. Moves aimed to appease one set of actors may antagonize another. Deciding which political threats to respond to will involve a strategic exercise in balancing the costs of appeasement against the seriousness of the threat.

There are two aspects to this calculation. The first is about how threatening the challenge is to the logic of IMF legitimacy. Profound challenges to institutional logic are likely to attract greater dissent over time than individual disagreements about performance. If the powerful Federation of Korean Industries orchestrates a concerted PR programme, arguing the IMF programme in Korea is designed to reduce the *chaebol's* political influence, that may not be particularly problematic if the Fund programme is technically defensible, accords with Korean government preferences and appears to be good for the Korean economy more generally. On the other hand, a far more modest article by a journalist, working for the Jakarta Post, pointing out that the IMF has been pressurizing newly-elected Indonesian politicians to change the economic policies on which they were elected, may be much more significant because it plays to an interest (domestic sovereignty) that may be shared by a wide range of actors involved in the IMF regime.

The second part of the calculation is more explicitly political and concerns the extent to which the kinds of coalition that might emerge will be able to disrupt the IMF's continuing functioning. Issues affecting large emerging-market countries, for instance, may be of more concern than those affecting even a fairly large number of small island states.

Assessing threats is obviously ultimately a matter of judgement but a combination of an understanding of the basis of institutional legitimacy and the reasons actors may have for opposition to an institution points to the kinds of evidence that should be gathered to support the judgements made. The first two parts of the book, then, are concerned with gathering together and identifying some of this evidence.

Part III puts that evidence together in a way that helps us to assess the prospects for IMF legitimacy over the medium term. It will enable us to identify the kinds of political influence that are currently effective in influencing IMF reform – which political actors were able to get how much of what they wanted? It will also help us to assess the adequacy of the reforms to date in terms of the IMF's ongoing legitimacy by looking at the kinds of problematic issues that haven't been addressed in the current round of reforms.

1.3 The core argument

So far I have set out what I want to achieve, why it is important and how I intend to go about it. This section will provide a very brief sketch of the substantive argument, as a kind of roadmap to the much more nuanced and detailed presentation that follows.

I begin (Chapters 2 & 3) by introducing the original Bretton Woods vision for the IMF, partly as a historical comparison and partly because, although the IMF's role has changed significantly over time, its decision-making institutions have remained relatively constant.

The Fund was designed to prevent a recurrence of the Great Depression. The Depression was caused by countries making individually rational, but collectively disastrous, decisions to protect themselves by opting out of the international economy. The Fund's role was to give countries incentives to stay financially integrated by regulating the international monetary system, to increase stability, and by providing them with conditional loans to ease adjustment. Its core decision-making body, the Executive Board, was designed to exercise technical discretion within a broader reciprocal legal framework of international regulation.

The idea that the Fund embodied symmetrical, reciprocal relationships was always partly a convenient myth. With the collapse of the Bretton Woods system, though, it became a particularly implausible picture. The Fund ceased to have a significant role in global regulation. It became far more concerned with assisting a subset of the membership, the developing countries, with adjusting to an increasingly unregulated international system.

Adjustment became increasingly difficult and the conditions attached to lending expanded sharply. It became more difficult to see those conditions as springing naturally from countries' broader, pre-agreed obligations. Increasingly, conditionality was portrayed, instead, as technically optimal policy, developed by the Executive Board.

The original design of the Board as a technocratic institution, partly insulated from political influence, was useful here. However, it was *also* a representative institution. Representation took place on the basis of votes that were weighted to reflect countries' broad economic strength. That may have made some sense for a global regulatory institution but was more problematic as the membership became polarized between lenders, who effectively set conditions but would not be subject to them, and borrowers who had far less control. The conditions that emerged during the 1980s were very market-focused, partly because borrower states were chronically short of finance and partly because of technical and ideological conviction.

The Fund's new agenda for the 1990s in middle-income countries was more interventionary still, but also offered some potentially attractive features. The Fund was promising to help countries tap resurgent private capital flows by helping them to institute credible supporting institutional reforms – 'good governance'. This new agenda was more restrictive in shaping state policy. On the other hand, it did involve a welcome acknowledgement that state activity was important. Although the IMF has quite a technical view of good governance, the agenda also involved discussion of issues such as transparency, accountability and fairness. It held some promise, then, of addressing criticism that the IMF was an institution which did private deals with developing country elites at the expense of the rest of the population.

That promise was enhanced by a growing Fund interest in 'civil society engagement' and fostering programme 'ownership'. This new agenda raised two questions, which the book seeks to answer using case studies drawn from the Asian crisis. The first concerns whether countries were willing to accept the IMF's view of the trade-off between enhanced access to capital on the one hand, and a restrictive view of the role of the state on the other. The second is about the extent to which good governance and civil society engagement helped to diffuse domestic opposition to the new agenda and facilitate the extension of financial globalization.

Part II provides case studies of the Asian crisis. The case studies show the complexity of the politics surrounding these issues. I argue the Fund's new agenda had a domestic political significance that varied between country contexts, but which went way beyond questions of economic efficiency. Programmes had an impact on inter-ethnic redistribution, industrial policy, state-business relationships, welfare systems, the distribution of economic risk in societies and the very basis of political power.

The economics of IMF interventions were heavily contested. The liberal vision embodied in governance policy was more popular. Attacks on corruption and authoritarianism were, understandably, well received. However, it is less clear that the kind of neutral regulatory state the IMF was trying to construct commanded the same kind of popular support. Fund policies attacked systems of economic nationalism and inter-ethnic redistribution that had been an important basis of pre-crisis political power. The corruption involved in administering those systems was unpopular but that wasn't necessarily true of the underlying policy intent. In any case, I argue there are serious problems with a technocratic economic organization like the IMF introducing reforms that are as politically significant as those pursued in Asia.

On a more practical level, reforms also proved very difficult to implement. The intent behind them was very radical and attacked entrenched structures of power that were difficult to dislodge. In Indonesia, the governance agenda, and perhaps perceptions of civil society interest, drew the Fund into a battle with the government, which was one factor in creating a tumultuous political transition. The demise of Suharto is probably welcome, but any sanguine assessment of the political results should also take into account political instability and the persistence of corruption in Indonesia. In any case, the IMF's mandate is economic and it is certainly possible to argue that a more politically pragmatic approach would have been more economically successful, at least in the short term.

The Malaysian government certainly seemed to come to the conclusion that the IMF was best avoided and dealt with its crisis by introducing capital controls. The controls were much more successful than orthodox economists expected and raise interesting questions about the choices states face under financial globalization.

I argue (in Part III) that assessing Fund interventions in Asia is bound to be controversial. However, it is difficult to avoid the conclusion that the IMF's activities had a powerful political significance that the institution is not designed or authorized to deal with. I press the view that the governance agenda is not as benign as it appears at first sight. Combating authoritarianism and corruption are laudable aims but, in practice, the IMF's way of doing so also rules out social and industrial policy. The governance agenda, and the Fund's role more generally, involves trade-offs between market efficiency, on the one hand, and other legitimate political values on the other. Those trade-offs cannot (normatively) be made solely on the basis of technical expertise. Attempting to do so is likely to provoke political resistance that will subvert the IMF's intentions. A more explicitly political process will make policy-making harder, and hopefully less ambitious but also more effective and more legitimate.

I argue that the Malaysian response and various forms of more passive resistance to the IMF's agenda both suggest that the Fund's activities are politically fragile and that countries retain some real choice about how to respond to globalization. It is by no means clear that the 'new international financial architecture' has resolved the problems that triggered such controversy in Asia. The Bretton Woods agenda was designed to entice countries into choosing financial integration. The IMF is currently making the choice of integration look more difficult to make than it needs to be. It would achieve a more stable commitment to international integration if it also helped countries to keep that commitment more flexible and less ambitious, so that markets can remain in their proper place: subordinate to social life, regulated through political institutions.

Part I

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2
IMF Legitimacy: Principles and Institutions

This chapter will introduce the IMF and explore the core logic of the way it claims to operate. It pays particular attention to the relationship between the role the Fund was designed to perform and the institutional arrangements that shape its decision-making. Why does the IMF argue countries should do what it tells them? What reasons does it give? What is their logic and how convincing are they? In particular, are the kinds of authority embedded in Fund institutions appropriate for the tasks that it is carrying out?

The starting point for this investigation is documents that have been produced by the Fund itself. It is politically essential for an institution to be able to provide a credible and reasonably appealing account of its activities. Such self-descriptions are inevitably rose-tinted. At the same time, though, they automatically become standards for institutional accountability, which restrains extravagant claims. If an institution is clearly failing to do what it says it is doing, political challenges are likely. The more practice contradicts rhetoric, the more problematic legitimacy will become. An analysis of the claims the Fund makes about itself, then, is a reasonable starting point for understanding IMF legitimacy, albeit one that will need to be supplemented by more empirical analysis later.

I make two broad arguments in this chapter. The first is to press the point that states have always faced a choice between monetary autarchy and the restrictions that monetary integration places on their freedom of action. That choice has often been particularly acute for more peripheral ‘emerging markets’. Comparing Fund intervention with a voluntarist picture of sovereignty, seen as total internal economic freedom, then, is not terribly helpful. Rather we should assess the Fund on the basis of the difference it makes to the choices states face; to what they stand to gain and lose from monetary integration.

The second argument is that the Fund was designed for a particular kind of decision-making. The deliberate intent of the Fund's designers was to promote technocratic economic decision-making, whilst keeping political accountability fairly limited and indirect. Although, as we will see in Chapter 3, the Fund's role has changed over time, its institutional arrangements have been much more stable, so the logic underpinning its institutional arrangements has remained more or less the same. The key question for much of the rest of the book is about the extent to which that original vision remains an accurate picture of what the Fund has done in practice.

The chapter starts (section 2.1) with a brief statement of what the Fund says it is supposed to be doing, how it makes it decisions, and the reasons why it argues its role and institutions are appropriate. I then assess the logic of those claims at a general level using historical comparison and normative analysis (section 2.2) and conclude with a brief overview of the way the general principles feed into the specific activity of designing and negotiating conditionality (section 2.3).

2.1 IMF legitimacy, core principles

In Chapter 1, I introduced the idea that legitimacy claims have a particular logical structure. They are designed to show relevant actors that an institution serves a purpose that compensates them for the loss of freedom involved in compliance. Forms of institutional authority and legal restraint are designed to make those claims credible by providing institutional safeguards that prevent abuses of institutional power. Finally, actors' consent demonstrates formal commitment to the overall bargain embodied in the institution. That helps to make the distinction between the kind of temporary inconvenience that all rules impose and more fundamental problems with the overall institutional structure.

In this section I will review the kinds of arguments public IMF documents (speeches, pamphlets, web documents) provide in terms of each of these four elements of legitimacy.[1]

2.1.1 Purpose

Fund staff argue the IMF's role should be understood as a response to the breakdown of the inter-war Gold Standard and the Great Depression that followed. The key lesson learnt was that the maintenance of an open international economy required international cooperation around an agreed code of economic conduct. States had responded to economic difficulties by pursuing beggar-thy-neighbour policies. These individually rational actions created a collectively disastrous outcome: the breakdown of the system as a whole.[2]

The core of the IMF's role is therefore to provide a forum for economic cooperation in the monetary sphere based around a code of conduct agreed by the membership. That role of global regulation and 'enforcement' is designed to support the central obligation of maintaining current account openness (abolishing exchange controls), which remains the IMF's core purpose.

> The IMF is primarily a surveillance institution, and its other activities derive their legitimacy from the surveillance mandate laid out in the Articles of Agreement (Guitian, 1992, 12).

System breakdown is most likely when it becomes difficult or costly for countries to continue to abide by the rules. Adjustment to Gold Standard discipline involved deflationary measures in countries that were already experiencing economic problems, tempting them to breach Gold Standard discipline. The Fund's new regulatory role was designed to reduce the need for adjustment but could not eliminate it. As well as reducing the need for adjustment, then, the Fund would make adjustment easier when it was necessary, reducing incentives to defect.

The Fund would ease adjustment in two ways. The Articles provided for some exchange rate flexibility under Executive Board supervision. Secondly, the IMF would:

> give confidence to members by making the general resources of the Fund temporarily available to them under adequate safeguards, thus providing them with the opportunity to correct maladjustments in their balance of payments without resorting to measures destructive of national or international prosperity (IMF, 1992, Art 1(vi)).

In other words the IMF would provide insurance for members, lending them extra liquidity in times of need. However, the funds it lent were designed for a specific purpose and came from resources belonging to the membership as a whole. Once money had been lent, other members needed assurances that it would be repaid promptly in case they needed it. More importantly, the resources should be used in accordance with the Fund's Articles of Agreement (IMF, 1992, Art V s.3a) and 'without resorting to measures destructive of national or international prosperity'. To ensure that these conditions are fulfilled, it is a legitimate part of the Fund's purpose to attach conditions to its lending, particularly as those conditions would merely be a statement of the policies that a deficit country would need to adopt in any case.

Surveillance, conditionality and financing are all interrelated parts of the Fund's overall purpose of enforcing the code of conduct. All members are obliged to observe the code. Surveillance ensures that they do so, reducing the likelihood of imbalances in the system. However, the need to adjust cannot be eliminated, so finance is provided in times of need, attached to conditions designed to ensure that adjustment takes place without breaching the code.

2.1.2 Legality

The Fund's Articles of Agreement form part of international law. Membership is voluntary and states can choose to leave at any time. Choosing to join, though, involves agreeing to be bound by the Articles and the other obligations that are imposed (for example decisions by the Fund's Boards) under their terms. The Articles provide a set of legal rules that are applied uniformly and are equally binding on all member states. Within this framework, though, there remains room for discretion – something that is necessary given the complexity of the economic issues involved and the importance of tailoring policy to the specific circumstances of the countries concerned (Guitian, 1992).

2.1.3 Authority and procedure

What kinds of authority are available to support the discretion that needs to be exercised within the Fund's legal framework? As with most modern political institutions, the answer is a combination of representation and technocratic expertise. I will deal with each in turn.

In terms of representation, the Fund is keen to argue that:

> far from being dictated to by the IMF, the membership itself dictates to the IMF the policies it will follow. The chain of command runs clearly from the governments of member countries to the IMF…the IMF acts…as an intermediary between the will of the majority of the membership and the individual member country (Driscoll, 1998).

There are two representative structures within the IMF: the Board of Governors is ultimately in charge but the Executive Board is far more significant for day-to-day operations (see Figure 2.1). The Board of Governors is made up of representatives (usually the minister of finance

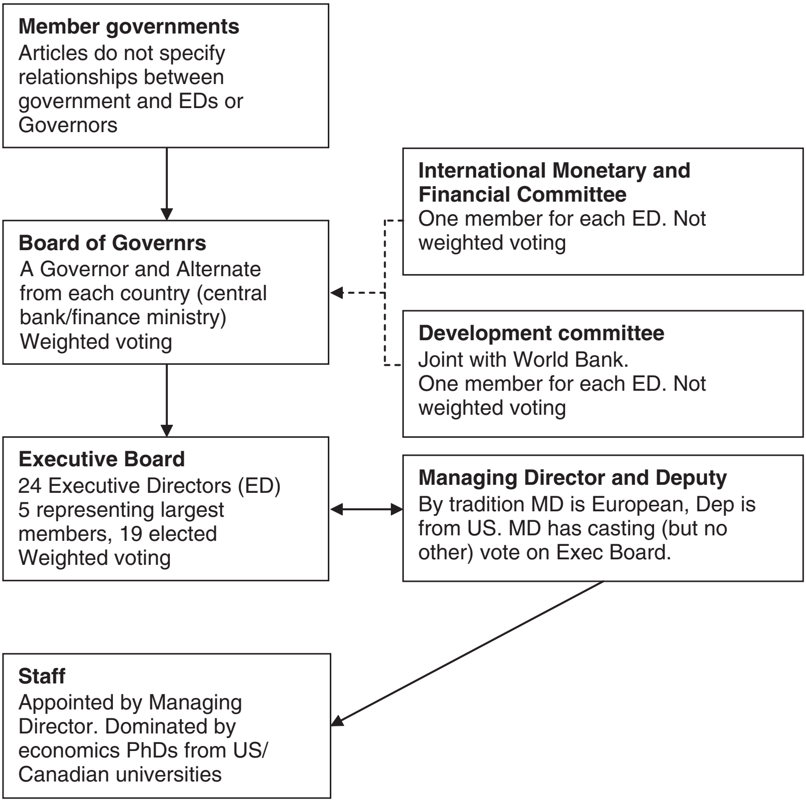

Figure 2.1 IMF decision-making bodies

or central bank governor) from each of the Fund's member countries. It is advised by the IMFC (International Monetary and Financial Committee, a group of 24 ministers – one representative for each Executive Director) and the less powerful Development Committee (which has similar membership, advises on developing country issues and is a joint committee with the World Bank).

The Board of Governors exercise semi-annual oversight of Fund policy at a very general level. The advisory committees are a response to the difficulty of carrying out meaningful discussion in a 192 member Board. Most discussion takes place within the IMFC and IMFC proposals are rarely significantly modified by the Board of Governors

Although the Board of Governors is ultimately in charge, the vast majority of what goes on within the Fund is carried out or supervised by the Executive Board. It is made up of 24 Executive Directors (EDs). The Fund's five largest shareholders (the US, Germany, Japan, UK and France) have an Executive Director each. Another three Executive Directors represent individual countries on a rotating basis (currently China, Russia and Saudi Arabia) while the remainder of the EDs are 'elected' by groups of countries. Countries are grouped broadly by geographical region. The arrangements for selecting representatives vary between different groups. In some, one country is clearly more powerful than the others and always appoints the ED, while in others appointments rotate. Alternate Executive Directors and support staff can be used to broaden involvement.[3]

The Board is headed by a Managing Director who does not represent any particular country and is chosen by the Board from outside the IMF. Traditionally, the Managing Director has always been a European and his Deputy an American, though there are no clear legal guidelines. The Managing Director, in consultation with the Executive Board, is responsible for appointing Fund staff, drawn from as wide a range of countries as possible. Although the Managing Director has no vote in Board meetings (except in the event of deadlock) his chairmanship of the Executive Board and responsibility for the staff makes the role an influential one.

Voting shares in the Boards are allocated in proportion to the amount that each country contributes to the Fund (its 'quota'), moderated by a modest allowance of equally distributed 'basic votes' to reflect the principle of sovereign equality. Quotas are determined by a complex formula intended to represent a country's significance in the global economy.[4] This system of voting is appropriate, it is argued, since it means that those countries that contribute most to the institution, and which have the greatest responsibilities for the maintenance of global monetary stability, also have the most control.

In any case most decisions are made by consensus and votes are rarely counted (Driscoll, 1998). The Secretary keeps a running tally of the 'sense of the meeting' and a vote is only called where the outcome is uncertain.

The task of applying the code of conduct in the context of the Fund's surveillance and conditional lending activities falls to the staff in collaboration with key officials of the member government concerned. The IMF likes to claim that the measures incorporated in letters of intent[1] are chosen by the government concerned (Driscoll, 1998). The staff's job is to assist in their selection and to make a judgement as to whether they will produce a satisfactory adjustment within the time scale allowed for the programme.

However, staff decisions are also closely monitored by the Executive Board and reviews of previous programmes form an important body of precedent. Once programmes have been formulated by a staff mission sent to the country concerned, they are moderated against other programmes by the Policy Development and Review Department for equality and consistency. They are then submitted via the Managing Director to the Executive Board for approval. The Executive Board almost always accepts programmes since it would be impractical for a staff mission to return to a country to re-negotiate conditions. However, if the Board is unhappy about a programme it will attach a memorandum to a letter of intent for the staff's future guidance (Stiles, 1991).

The heart of the Fund, then, is the Executive Board, which can have some claim to be a representative institution. However, justifications based on representation and the rule of law exist alongside arguably more significant authority claims based on technical economic expertise.

Even the Fund's legal framework, which we looked at in the previous section, is partly justified as a set of rational technical principles that will ensure the efficient functioning of the global economy. Executive Board discretion, exercised within that framework, is often portrayed by Fund staff as concerned with technical issues that are best dealt with by the kind of highly qualified economic experts found within the Fund (Polak, 1991; Southard, 1979). Where there is uncertainty and staff have to make judgements, they are guided by the equally rational principle of equal treatment given the situation of the country concerned (Gold, 1979; Guitian, 1992).

Deliberate attempts have been made to limit Executive Directors' accountability to their home governments.

> We want to aim at a governing structure doing a technical job and developing a sense of corporate responsibility to all members, and not the need to guard the interests of particular countries (Keynes quoted in Strange, 1973).

Executive Directors are to be drawn from the technocratic, economic arms of government. Consensus decision-making and the fact that most EDs represent more than one country also help to enhance this communal, technocratic point of view. Additionally, EDs are paid by the Fund (rather than their home governments) and work full-time in the IMF's offices in Washington.[6]

In other words the Fund is both a representative and a technocratic institution. The form of 'representation' it embodies is designed to foster a particular kind of internationally aware technocratic decision-making rather than to maximize accountability to domestic polities.

2.1.4 Consent

Consent to the general authority of the IMF is demonstrated by agreeing to the Articles of Agreement on membership. Specific IMF programmes are also voluntary undertakings and governments sign the documents required to enter into conditional funding agreements – sometimes at public ceremonies. Annual meetings of the Board of Governors provide further opportunities to emphasize broad acceptance of IMF policy in jointly approved statements.

2.2 Analysis

Now we have an overview of the ways in which the IMF has sought to explain and justify its activities, I can begin to provide some more critical analysis. This section continues to treat the issues at a fairly general level. It is concerned with the logic of the kinds of claims the IMF makes about each aspect of its legitimacy. It is designed to understand the logical strengths and weaknesses of the claims, with particular emphasis on the limits to the logic of Fund claims and the kinds of policies and decisions that might put them under threat. It prepares the ground for the discussions of actual Fund policy in Chapter 3 and the rest of the book.

2.2.1 Power and purpose

As we have seen, the core of the IMF's legitimacy claims is the argument that the discipline the IMF places on national macroeconomic policies is necessary in order to maintain the integrity of the international monetary system as a whole. Aspects of sovereignty are being traded in the interests of global monetary stability. The trade-off is likely to be most acute in the context of bargains struck over conditional financing for balance of payments adjustment, the primary focus of this book.

Sovereignty

Sovereignty is about both the place where the boundaries between the national and international are to be drawn and about the reasons for that division. The demarcation and the underlying justifications have always been the object of political struggle (Bartelson, 1995; Bierkesteker and Weber, 1996).

The literature here is vast and complex but for our purposes two points are important.[7] The first is that sovereign autonomy is the base line for discussion. Since Westphalia, the rule (if not always the practice) of international relations has been that states have *prima facie* control over their domestic affairs (Brownlie, 1998). Restrictions on domestic autonomy therefore need to be justified. The second point is that, at the same time, states *can* voluntarily agree to place restrictions on their autonomy through the medium of international law. So the International Court of Justice:

> declines to see, in the conclusion of any treaty by which a State undertakes to perform or refrain from performing a particular act, an abandonment of its sovereignty…the right of entering into international engagements is an *attribute* of sovereignty (the *Wimbledon* (1923) *PCIJ Ser A* Vol. 1, 25 cited in Brownlie, 1998, 290 – emphasis added).

In other words, (recent writing on the 'decline of the state' notwithstanding) voluntary international legal agreements, such as the IMF's Articles of Agreement, do not fundamentally undermine the principle of sovereignty, at least in legal terms.

However, as I argued in Chapter 1, the existence of legal agreement is not all there is to political legitimacy. It also matters how strong states' commitment is to what are voluntary and revocable agreements. What matters, then, is the extent to which the legal agreements concerned are capable of justification on the basis of the beliefs of key political actors. In other words what matters is the balance between losses and gains in agreeing to be bound by the IMF's Articles of Agreement.

The underlying tension between national autonomy on the one hand and international recognition and cooperation on the other has always been present in the concept of sovereignty. Understanding the nature of the bargains involved in the IMF's jurisdiction requires at least a brief discussion of the normative issues surrounding sovereignty and interdependence.

At a domestic level, states' claims to sovereignty have always been based on the idea that citizens' interests could only be satisfied if there was a final arbiter of political conflict within each territory, equipped with the coercive power to enforce its judgements (Hinsley, 1986;

Hobbes, 1991). There are two parts to that argument: a 'hard' argument about the need for a monopoly over legitimate force in the interests of physical security and a 'softer' argument about the need for a final point of legal decision-making in the interests of certainty and social order. Ultimately, political obligation is based on the efficacy of the state in providing citizens with these core collective goods (Dunn, 2000).

More recently, this rather stark vision has been complemented with the idea of 'popular sovereignty': some version of the idea that state decisions (more or less successfully) embody the will of a political community that has a right to self-determination.

From the domestic point of view, then, the cost of committing to international agreements is that they undermine domestic political legitimacy. The state is compelled to make decisions that are not based solely on the will of its own political community.

At the same time, however, from a more international perspective, states have never been autonomous units. State sovereignty has, itself, always been partly a collective project contributing to international stability. The idea of *prima facie* domestic autonomy was partly designed collectively in an attempt to provide greater stability in a Europe torn by religious wars. The idea of domestic autonomy and the recognition of the rights of other sovereign states developed more or less in tandem (Hinsley, 1986). Similarly, the existence of a single political authority for each territory facilitated the growth of international responsibilities. It made it possible to assign responsibility for the elimination of private extra-territorial violence and to create binding obligations between states such as trade treaties (Spruyt, 1994; Thomson, 1994).

In other words, the requirements of the international system have encouraged states to place legal restrictions on their own actions in the interests of collective international goals. The question is not whether it is possible to have a totally independent autonomous sovereign state that can do what it likes internationally. That has never been possible and the very idea of sovereign independence implies some restrictions on state behaviour. The real question is about how to strike the balance between a desire for domestic autonomy and the need for international negotiations in order to secure state goals. How much domestic autonomy should states be willing to surrender and what kinds of safeguards can they expect in return? The answers will vary over time, between states of different strengths and between different issue areas.

The choice, though, can usefully be seen as one about states' struggles to maintain their domestic political legitimacy in a context where their populations expect them primarily to serve the domestic interest and hold them accountable for the domestic effects of the international agreements they make (Pauly, 1997).

Collective action and international monetary regulation in developed countries

The IMF, then, needs to persuade states that, over time, the monetary cooperation it facilitates will be worth the costs in terms of lost autonomy and the domestic political problems it creates. However, that assessment needs to be made in the context of the realities of international monetary relations. The correct counterfactual is not a totally autonomous state able to do what it wants with monetary policy. A more relevant point of comparison is with the kind of monetary autonomy states could hope to have in a world of other states, also pursuing their own autonomous monetary policy.

Identifying counterfactuals of that type is notoriously difficult but one obvious place to look is the historical experience of the 19th century Gold Standard (and indeed the IMF's own accounts stressing the importance of the Great Depression invite us to do so).

What we find is that macroeconomic policy did fall within the formal domestic legal jurisdiction of sovereign states, rather than being regulated through international law or an institution such as the IMF. The Gold Standard system was the outcome of the individual choices of a series of different governments, albeit under the influence of British financial hegemony.[8]

However, even the Gold Standard required a high level of informal international coordination and even cooperation. Central banks tended to follow the lead of the Bank of England in setting overall levels of discount rates (and therefore economic activity). In times of crisis central banks were willing to lend reserves to their international counterparts. There were no international agreements institutionalizing behaviour but it was, nonetheless, a system based on a strong political commitment. Currency stability was to take precedence over domestic economic growth or employment, in the last instance. That internationalist political commitment, in return, reflected limits to working class influence prior to the extension of suffrage and the growth of labour parties in the early 20th century (Ruggie, 1983).

The strength of necessary political commitment during the heyday of the Gold Standard is easiest to see through a contrast with the inter-war years. Although the causes of the Depression are complex, a key factor was a growing doubt about governments' commitment to exchange rate stability. In the past, when countries appeared to be suffering from balance of payments problems, finance would flow in, anticipating the inevitable rise in central bank discount rates, making adjustment easier. Prior to the Depression, this mechanism was undermined by floating exchange rates, greater financial speculation and uncertainty over the potential for political pressure to complicate adjustment.[9]

The Gold Standard was re-established in the 1930s because the 1920s experience of floating rates had been so unsatisfactory. However, the underlying political problem remained and the international cooperation that everyone knew was required to resolve it was not forthcoming (Eichengreen, 1998; Pauly, 1997). Growth in US bond lending staved off the inevitable problems caused by trade imbalances between the US and a war-torn Europe (aggravated by US protectionism), but only until the Fed moved to raise domestic interest rates to burst the US stock market bubble in 1928. As capital was withdrawn from Europe and countries began to go into recession they resorted to trade and exchange controls and competitive devaluations in desperate attempts to preserve their own economies. The result was the Great Depression.

For defenders of the IMF the point is clear. The maintenance of a functioning international economy has always relied on international political coordination, whether institutionalized or not. The lesson of the Great Depression was that this political coordination was becoming more complex and, if anything, required greater institutionalization as part of a more sophisticated system for meeting states' increasingly ambitious macroeconomic goals.

International monetary affairs and the developing world

This standard story about the Gold Standard is principally a story about developed countries, though, and it is also important to get some idea of the very different situation of developing countries before the IMF was created.

Robert Triffin points out that the vision of 'automatic' adjustment in response to a powerful internationalist commitment never provided a good description of peripheral countries' experiences. Adjustments in Europe largely took place through adjustments in capital flows from the centre to the periphery rather than through adjustments to European prices and wages. Central bank discount rates in Europe could have significant effects on capital flows but macroeconomic changes in capital-importing countries had little effect. Peripheral countries tended to experience pro-cyclical capital flows that would boom when European economies were strong (and export prices high) and dry up when export prices fell as growth slowed in Europe and capital was repatriated.

> The nineteenth century monetary mechanism succeeded, to a unique degree, in preserving exchange rate stability…over a large part of the world. This success, however, was limited to the more advanced countries…The exchange rates of other countries…fluctuated widely, and depreciated enormously over the period. This contrast between the 'core' countries and those of the 'periphery' can be largely explained by the cyclical pattern of capital movements and terms of trade, which contributed to stability in the first group, and to instability in the second (Triffin, 1964, 9).

The inevitable crises in peripheral economies were dealt with in different ways depending on the size and cause of the debt crisis; the strategic position of the debtor country; the type of finance involved and the broader macroeconomic environment of the time.

At the most notorious extreme were late 19th century British interventions in Egypt and Turkey, where debt problems were used as an excuse for virtual colonization, but these are the exception rather than the rule.[10]

> Overt intervention was largely unnecessary. It was reserved for the subset of cases where political motives dominated, providing less of a cause than a pretext. Intervention was refused too frequently on exclusively economic grounds to argue otherwise (Fishlow, 1985).

As Palmerston put it in the 1840s:

> the British Government has considered that losses of imprudent men who have placed mistaken faith in the good faith of foreign Governments would prove a salutary warning to others (quoted in Lipson, 1989).

More often, sovereign debt was dealt with as an issue between a state and its private creditors. For what Fishlow describes as 'developmental defaulters' – countries experiencing a temporary liquidity crisis in the context of a trend of expanding exports – the settlements often involved a combination of temporary interest reduction combined with conditionality (Fishlow, 1985). In the more severe cases, that might include the hypothecation of government revenues. Nonetheless, on the whole continually expanding export markets, explicit sharing of burdens with creditors, the likelihood of a swift return to market access, and a political consensus that satisfaction of debts was a necessity tended to ensure that countries were willing to settle for these terms (Fishlow, 1989). Rather than being mediated by an international institution, issuing banks often acted as intermediaries between borrowers and bond-holders. Since they were not holders of the debt they were in a relatively neutral position, with an interest in pleasing both sides so as to promote future business in a relatively uncompetitive market (Fishlow, 1985).

For a minority of 'revenue defaulters', governments that had largely used up loans on consumption and were insolvent, penalties were much harsher. Negotiation was more difficult, more likely to be political, and could result in ceding significant national assets. However, even these settlements were usually coupled with significant debt write-downs.

In the 1930s, the situation was different. The generalized collapse of the global economy and the closure of US markets to imports from debtor countries made debt crises far more difficult to deal with, provoking widespread defaults and economic autarchy. Debt negotiations resulted in long periods of uncertainty for borrowers but default was much easier, write-downs were large and, after the war debts were often written off (Jorgensen and Sachs, 1989).

It is difficult to come to easy generalizations about the treatment of debt problems prior to the IMF's creation. The general economic climate, the type of debt, and the political nature of the relationships involved all had an influence. Two important points emerge, though. Firstly, peripheral countries' position has always been unsatisfactory and vulnerable to considerable economic interference in the event of capital outflows. As such there is plenty of scope for an institution like the IMF to improve matters, relative to what took place in the past.

Secondly, though, decisions about how to respond were generally made by free sovereign states on the basis of their preferred relationships to creditors and the financial markets at large rather than in relation to any set of politically agreed rules or negotiations between states.

Conclusions

This section has emphasized the claims of sovereign states to authority, based on ideas of popular sovereignty and the special place that clearly defined territorial jurisdictions play in maintaining order in the international system. It is those claims that the IMF needs to overcome if it is to be seen as politically legitimate.

At the same time, I have emphasized that the concept of sovereignty has always involved a tension between claims to autonomy and self-determination, targeted particularly at a domestic audience, and the realities of interdependence. That suggests that the base line for IMF legitimacy is quite low. At a minimum, the Fund can justify its existence if it can claim, credibly, to improve the management of the international monetary system relative to the problematic historical experience of weakly institutionalized international monetary relations of the kind that existed in the early 20th century.

2.2.2 Institutional safeguards–legality, representation and authority

Having established the Fund's potential political legitimacy in theory, then, we can move on to an investigation of the kinds of institutional arrangement that have been created in an attempt to guarantee practical performance. There are two parts to that. The first concerns the legal framework within which IMF decisions are made and the second is about the ways in which discretion is exercised within that framework.

Legality, consent and the rule of law

The IMF's legal framework might be thought to provide three kinds of reassurance. The first and most ambitious argument is based on the concept of the 'rule of law'. The requirement to produce universally binding rules affecting the entire membership should place restraints on the abuse of power and guarantee a sense of reciprocal obligation and benefit. Secondly, the obligations members agree to on joining the institution and the procedures for future collective decision-making are set out transparently. Later decisions are made explicitly and publicly, facilitating accountability and political challenge in the event of injustice. Thirdly, membership is voluntary, so countries have actively consented to abide by those rules as part of the accession process. How much reassurance do these arguments actually provide in the IMF context?

The rule of law argument can easily be overstated. Some kinds of rules do have this universally binding character. However, it is also possible to frame laws that will only effect some particular subset of the membership. The more differentiation there is within the membership the more likely it is that laws can be framed in general terms whilst only, in practice, restricting the actions of a few states. There will be few guarantees that laws will actually be impartial unless the law-making body is, itself, impartial.

The second point, about transparency and consent, is undeniably important. However, transparency is only effective to the extent that rules of conduct can be clearly specified in advance. All legal systems need to strike a balance between rules and discretion. Rules that are too detailed may fail to adapt to changing situations. Economists have tended to stress the need for flexibility in international macroeconomic policy as a reason for limiting the restrictions imposed by international economic law (Qureshi, 1999). If, however, rules are too general, consent to the rules themselves will leave open considerable uncertainty springing from the discretion that remains in implementation. That can be ameliorated to some extent by carefully stipulating how institutional discretion is to be exercised. However, the more discretion there is, the less weight can be placed on original sovereign consent when it comes to justifying particular institutional actions. In practice, the Bretton Woods agreement left the IMF's Boards with a fair amount of discretion and, as we will see in Chapter 3, the scope for discretion has generally increased over time.

Finally, sovereign consent is not as simple an issue as it may first appear. The decision to join the Fund is voluntary and members can choose to leave at any time. To that extent, continuing membership provides ongoing evidence of formal consent to IMF jurisdiction. However, as Gruber has pointed out in a recent book on international institutions, the idea that states face a choice between agreeing to international regulation or rejecting it in favour of the *status quo* is an oversimplification. Once two or more states have decided to set up an institution the range of choices has already been fundamentally altered. The choice is no longer between negotiating an institutional bargain and maintaining the status quo. States must now choose between either joining the *particular* institution that has been created or remaining on the sidelines while other states cooperate within it (Gruber, 2000).

In the context of the IMF, most prospective members were not present at the original Bretton Woods negotiations and had little influence on the way they were conducted. The IMF was shaped by bargaining between the US government, on the one hand, and the Europeans, led by the UK, on the other (Gardner, 1980). Other countries were faced with the choice of accepting the entire IMF package or none of it. Consent therefore need not imply wholehearted enthusiasm and certainly doesn't imply satisfaction with each individual part of the IMF's rules. It may be more accurate to think in terms of the grudging acceptance of the best of a bad set of options.

Overall, then, the legal aspects of the IMF's existence do provide an important base-line in restricting the abuse of institutional power. However, the degree of protection a legal framework can provide may be quite limited. It will depend on how much scope for discretion remains. It will also depend, crucially, on the inclusiveness and equity of the law-making process itself. In other words, the existence of law on its own is unlikely to provide sufficient comfort where mechanisms for decision-making and the exercise of discretion are unsatisfactory.

Technocracy, representation and accountability

On what basis, then, is discretion to be exercised at the IMF? Who will control changes to the IMF's institutional framework and on the basis of what kinds of authority? As we saw above, the IMF provides two closely related answers to that question, one to do with technical expertise and the other to do with representation.

The body that carries out the bulk of day-to-day decision-making within the IMF is the Executive Board. As we saw above, the Board has been designed to ensure that member countries have some form of representation but that their representatives are also encouraged to take a technical and unbiased stance in policy-making.

The model is very much a utilitarian one, in keeping with the dominance of economic thinking in the IMF's design (Gardner, 1980). The aim is to encourage decisions that maximize global economic welfare, rather than to create a forum for divisive struggle between competing national interests (Lister, 1984). Weighted voting is then justified on utilitarian grounds. Those with the largest stake in the global economy, and therefore the greatest incentives for sound economic management (and, arguably, the greatest responsibility for achieving it), should be given the largest say. Consensus decision-making re-enforces the image of a neutral, expert institution by presenting a united front to the outside world.

Utilitarian ideas are useful in presenting the case for an international institution like the IMF. Utilitarian calculations are apparently both objective and democratic in a way that is attractive to an international institution claiming to overcome national distinctions in the interests of the common good. They maximize aggregate welfare without making distinctions between particular people. Additionally, the stress on medium-term welfare effects and mutual gains embedded in utilitarian thinking helps to distract attention from issues about short-term justice that are often highly contested and difficult to resolve. So, for example, in a discussion of appropriate measures for dealing with capital account crises, Giannini argues that:

> The issue is often broached as one of achieving "a more equitable burden-sharing"…[however] When resources have been misallocated the question of who was responsible in the first place is of little economic relevance. What matters is that the misallocation be dealt with in the least costly way…the issue of moral hazard [ie efficiency and incentive effects] is logically distinct from that of ensuring equitable burden sharing (Giannini, 1999, 37–8).

Many decisions made on the basis of shorter-term distributive effects or national interests can then be dismissed as either misguided or self-seeking, narrow minded and therefore anti-democratic.[11]

Whilst it is important to acknowledge the potential advantages of utilitarian thinking it also has limitations. There are three key difficulties, which are likely to become more problematic as decisions become more complex: limits to the utilitarian conception of the good, political problems with the motivational purchase of utilitarian ideas and difficulties with asking to be judged on outcomes. I will deal with each problem in general terms and then conclude by suggesting the ways in which each becomes more salient as the Fund starts to deal with more complex issues.

Firstly, to what extent can utilitarianism help us identify 'good' policy? The formal models of welfare economics can clarify the issues that are at stake in decision-making, contributing to constructive debate and delineating the range of available options (Hahn, 1982). A thorough understanding of the outcomes of particular policies may reduce perceptions of conflict of interest. Ultimately, though, technical discussions can only distinguish between different means to pre-defined ends. The ends themselves cannot be thought of as simply a technical matter.

The utilitarian thinking on which much of modern economics is based theoretically aims to choose policies that will maximize the sum of individuals' 'utility' – in layman's terms, give people as much of what they want as possible.[12] Although one can imagine a very extensive conception of utility that includes the majority of goods that human beings value, the way the concept is used in practical economics is individualistic. The stress is on the narrow range of goods that can be converted into monetary terms (O'Neill, 1998; Sen, 1987). Other values like freedom and equity (Sen, 1987; Sen and Williams, 1982) or the importance of maintaining a political community (Taylor, 1982) are systematically undervalued.

One response might be to argue that the IMF is an economic institution concerned with economic welfare and that other bodies can seek to maintain these other aspects of the human good. However, there are problems with splitting up policy in this way. Economic decisions have spill-overs into other areas of social life. Once they have been made, social avenues are already closed off and other kinds of decisions made by different political bodies may not be able to compensate.

Even if we were to accept utilitarian value systems, there is a second problem about their political persuasiveness. As realists have often pointed out, where there are losers as well as winners, arguments of the form 'everyone in the aggregate will be better off if we do x' may not be particularly persuasive (Carr, 2001). If the differences are marginal or the distribution of gains and losses uncertain, the extent to which people are willing to risk being a 'loser' is likely to depend on their relationship with the 'winners'. As J. S. Mill put it, members of a nation 'cooperate with each other more willingly than with other people' (Mill, 1993, 391). Problems that are pure coordination problems will be more easily dealt with than those in which there is a distributional element. Once distribution comes into play, people who identify with one another will be more willing to make sacrifices in the interests of the common good. That is highly significant in the context of an international system in which nation states continue to command our political loyalties.

These kinds of political problems will be even more acute where there are doubts about the kind of utilitarian arguments that proceed from particular ends through technical calculation to appropriate policy. The principle problem here is that utilitarians ask to be assessed on the basis of outcomes but outcomes are uncertain and only appear in the future. They imply either a high level of confidence in the underlying expertise, or some mechanism for assessing success in practice and sanctioning failure when it occurs.

When decisions become more difficult and complex and an institution, like the IMF, can only control a small part of its environment (failure may result from poor policy *or* other external factors) the quality of the policies chosen and the reasons for their choice becomes the basis for evaluation. Under those circumstances, where results are hard to measure, expertise itself must come into question, particularly where there is public dispute amongst economists. Institutional authority then needs to be maintained on the basis that there were good reasons for the policies that were chosen. Those reasons, in turn, are unlikely to be purely technical in circumstances of expert uncertainty – risks have to be evaluated and trade-offs made between competing conceptions of the good.

In short utilitarian decision-making will become more problematic to the extent that:

- decisions have consequences that are difficult to see in terms of purely economic efficiency (either because they have strong distributional impact or because they have important non-economic effects)
- the underlying technical economics is uncertain
- outcomes are difficult to evaluate.

Once there are problems with utilitarian-based decision-making there will also be problems with Executive Board authority, since that authority is primarily based on expertise and utilitarian logic. Where the vision of a group of impartial experts debating optimum policies starts to come under threat, the justification for decision-making in secret on the basis of consensus also becomes problematic.

The Fund is also anxious to stress the representative aspects of decision-making. However, the form of representation and accountability involved is meant to support, rather than alter, the fundamentally utilitarian character of decision-making. The Board of Governors can exercise oversight from time to time but it meets only infrequently and is an unwieldy body. Executive Directors were deliberately paid full-time salaries so that they would live away from home country influence (Gardner, 1980; Strange, 1973). Representation provides some reassurance about the kinds of economists present to make decisions and offers the sanction of removal for poor performers. Consensus decision-making in conditions of secrecy, though, means that there are severe limits on the scope for day-to-day political oversight.

The logic of democratic political decision-making is very different. It is about public debate and discussion that takes place in the shadow of a certain underlying allocation of power based on equal voting. There is a struggle to form coalitions of influence through public appeals to common interests, in so far as these exist. The justification for vote distribution is far more significant than it is under the IMF expertise-based model and weighted voting is likely to look highly problematic where one can imagine stable coalitions of interest in which 'minority shareholders' have very little influence at all. Equally, the nature of public debate that takes place is highly important in securing institutional legitimacy and the lack of transparency involved in consensus decision-making can be deeply problematic.

Ultimately the point is that the representative aspects of Executive Board authority are quite thin. If one is inclined to think of Executive Board decision-making in very particular technical, utilitarian terms, they may be sufficient to ensure a variety of views are expressed and provide marginal reassurance to the countries involved. However, the further practical decision-making departs from this rather narrow, technocratic model, the more problematic Executive Board decision-making is likely to be. The representative aspects of Board decision-making are sufficient to provide a modest check on predominantly technocratic decisions but they are not sufficient to provide any more powerful kind of political legitimation.

2.2.3 Conclusions

Overall, then, this analysis suggests that there is potentially a place for an institution like the Fund.

The idea of a completely autonomous sovereign state has always been a voluntarist myth. Sovereignty is better thought of as the ability to make choices about where the balance between national preferences and the need for international collective action should be struck. Developing country experience under the Gold Standard shows that resolving those issues under anarchy or hegemonic leadership has not produced particularly satisfactory outcomes. The base line for IMF legitimacy, then, is not about whether the institution will place restrictions on developing country economic policy: it is about whether the restrictions that emerge are justifiable in terms of the benefits that can be obtained from the IMF monetary regime as a whole. Developing country relationships with private financial markets have always been problematic. The initial question at least is whether the Fund makes them less problematic than they might have been under other politically plausible arrangements.

From this point of view, the original Fund vision of multilateral, reciprocal arrangements between sovereign states, regulated by the rule of law was a potentially very positive one. However, the more detailed arrangements for weighted voting in the Executive Board showed that sovereign equality was to be balanced with economic power (or 'responsibility' as the Fund prefers to put it). There are also difficult questions about the balance between the 'rule of law' (which still relied ultimately on sovereign consent) and Executive Board discretion (driven by weighted voting).

The more the Fund's role corresponds with the vision of technocratic decision-making over essentially coordination problems, within the context of a reciprocally binding legal framework, the more acceptable Fund arrangements will be. The more it moves away from that vision towards more political and distributional questions and towards greater Executive Board discretion, the more problematic its decision-making arrangements will become. That is because Board procedures are not designed to foster transparent democratic deliberation with equal input from affected parties. Instead, they are designed for expert technical decision-making on behalf of states, with some fairly minimal *ex post* accountability.

The balance between these two visions of Fund policy in practice is something I will largely postpone until Chapter 3 where I review the Fund's changing role over time. However, since the main focus of this book is on conditionality, it does seem appropriate to explore what the arrangements for formulating particular Fund programmes tell us about the important balance between rules and discretion, technical decision-making and politics.

2.3 Decision-making in practice: formulating conditionality

Whilst I am interested in the politics of Fund decision-making in general, the particular focus of this book is on the formation of conditionality. It is therefore appropriate to extend the very general discussion so far to show how the general logic of Fund arguments applies to the particular case of negotiating conditionality.

The Fund has tried to argue that conditionality is fundamentally about ensuring countries comply with the obligations imposed by the Fund regime as a whole. The job of the staff, under Executive Board oversight, is to use technical judgement to interpret and apply these broad principles in an equal and appropriate fashion (Guitian, 1992).

I will address the extent to which the kinds of conditionality that have emerged in practice can still be thought of as a particular case of broader obligations in Chapter 3. For now, I am more concerned to explore institutional questions about the importance of rules and the division of labour between staff, borrower governments and the Executive Board.

The negotiation process begins when a country decides to approach the IMF for a loan. IMF staff from the relevant area department prepare a draft letter of intent in Washington, based on information they have at hand (particularly information gathered from recent Art IV surveillance). A staff mission, usually headed by a senior member of the area department, goes to the country concerned to gather further information and negotiate a programme with government personnel – usually drawn from the finance ministry or central bank. Once negotiations are complete, the mission returns to Washington and the agreed programme is moderated by members of the Fund's functional departments and submitted to the Executive Board for approval.

The legal framework

Although the Fund has often claimed that conditionality springs from the broader legal framework of international monetary obligations, there are actually very few legal restraints on the content of conditionality. Until very recently, the only available guidance came from broad principles enshrined in the Articles of Agreement and a very general set of rules set out in 1979. However, the Fund itself acknowledges that the 1979 guidelines have not been followed in practice (IMF, 2001c). Legal guidelines, then, may provide some very broad constraints and a focus for complaint where boundaries are pushed, but do not provide terribly detailed guidance for negotiators.

The staff and the Executive Board

What does guide staff positions in negotiations, then, and how much control does the Executive Board actually have? This is a highly contested question and arguments have been made for both Board and staff dominance.

What is universally accepted is that the Fund is a tightly managed organization in which there is a great deal of agreement about acceptable practice. Some of that comes from the cultural background of the staff. Fund recruitment has done much to redress the perception that staff's geographical origins were biased towards Europe and North America. However, educational backgrounds are extremely narrow. The vast majority have advanced degrees in macroeconomics from developed countries, particularly from elite Anglo-American universities (Momani, 2004).

There is also a good deal of anecdotal evidence to suggest that staff like to resolve issues before they are taken to the Executive Board, presenting a united front (De Gregorio et al., 1999; IMF, 1998). The situation is complicated by the fact that the Board only reviews programmes *after* negotiations have ended. As a result, it approves the overwhelming majority of programmes.

On the other hand, where the Board is not happy with programmes, it will also note its disapproval in order to influence future staff practice. The staff are very anxious not to invoke this kind of censure and will avoid putting anything into a programme that risks Board disapproval (Stiles, 1991). The result is a powerful system of 'self-censorship' that may be particularly effective for more junior members of Fund staff. That provides one explanation for comments reported by the IMF commissioned evaluation of the Enhanced Structural Adjustment Facility (ESAF):

> A number of ministers and senior officials…felt that the effectiveness of Fund missions depended too much on the personality of the mission leader, and how experienced and confident he felt about the support of the various departments (IMF, 1998, 36).

Ex post review, then, may encourage staff to 'play it safe' so as to avoid Executive Board censure. At the same time, there are other reports which suggest that the Board can be deferential to staff expertise and resources (particularly in terms of information). One Executive Director told me that the greater research resources IMF staff command place them in a stronger position to debate developing country policy than some borrower governments.[13] Despite a lack of formal rules, then, there are pressures towards conservatism, based on a body of existing precedent and on the staff's orthodox economic training.

Whilst that is the normal course of events, in programmes with a high political profile the staff may receive greater input during the negotiation process. So, for example, in the Asian context, US Executive Director Karen Lissakers told a Congressional committee that:

> in all of these programs there has been a fair amount of input from the Executive Board and various member governments including the US Government in consultation with management and senior staff. We try to stay in close touch to monitor the status of the negotiations and to secure inclusion of various policy measures that we thought were vital (House Banking Oversight Subcommittee, 1998).

More generally Stiles found that input from the Board or Managing Director was more common with politically high-profile programmes and, confirming the suspicion that accountability makes staff less flexible, that these countries tended to receive more favourable treatment (Stiles, 1991).

Staff positions, then, are strongly influenced by a kind of economic orthodoxy that is created in recruitment and fostered by the shadow of Executive Board review. Where new situations arise, there may be greater political influence but this has a tendency to be exercised informally initially, until the Board can convene to consider a more formal change in policy. Given limited legal guidance, the perception of a tightly controlled organization working through a particular kind of economic logic is central to the determination of conditionality on a day-to-day basis, with the more 'political' aspects of the Executive Board becoming more important in times of change.

The staff and the recipient country

If staff negotiating positions are driven by general considerations applied in a wide range of circumstances, what ensures that conditionality will be appropriate to the particular circumstances of borrower countries? If those general considerations are largely economic in character, how are political issues taken into account? One might expect the answer to both questions to come from the restraint placed on staff by the need to negotiate conditionality with borrower country governments. Indeed the Fund has been keen to stress this aspect of conditionality:

> We don't impose conditions on governments. If a program were to be imposed from outside, its chances to be fulfilled, to be implemented, would be minimal (Camdessus, 1993 quoted in Woods, 2000).

However, programmes are negotiated in secret so it is difficult to know what is really going on. In the past, at least, the IMF has been willing to act as scapegoat for governments that wished to introduce programmes they knew would be unpopular at home (Putnam, 1988; Southard, 1979). Government tendencies to portray programmes as imposed have therefore created considerable scepticism about this official position.

What research there is on the question suggests that Camdessus is overstating his case. Countries *are* able to influence the nature of programmes to varying degrees depending, amongst other things, on: their strategic importance to the IMF's major shareholders, their economic significance, the scale of their difficulties and the nature of the processes required to obtain domestic ratification of programmes (can the Finance Ministry decide on its own or do legislative bodies need to be convinced?) (Bartilow, 1998; Stiles, 1991)

For poorer, less politically significant countries with limited expertise, however, negotiations may be highly one-sided (Martin, 1991). A recent external evaluation of the ESAF commissioned by the Fund was highly negative on the question of programme ownership:

> Almost without exception, technical personnel in ministries and political leaders in the various countries who deal regularly with the Fund complained about what they saw as the Fund's inflexible attitude. They complained that the Fund often came to negotiations with fixed positions so that agreement was usually only possible through compromises in which the country negotiating teams moved to the Fund's positions…the Fund too often simply imposed its will, was generally insensitive to genuine constraints on policy-making…and was too quick to dismiss policy options favoured by government. (IMF, 1998, 36).

It is also important to note that in-country negotiations with staff are very much the final say in determining programmes. Borrower countries may not have any direct representatives to act as advocates in subsequent board discussions. Even where they do, country representatives cannot articulate any public criticism of programme contents as that might be taken as a signal that implementation was unlikely and funding should not be forthcoming.[14]

This seems to be a key weakness in institutional arrangements as it places a strong responsibility on the Executive Board to exercise restraint, so as to ensure that the Fund is not exceeding its mandate: using its power to pursue narrow economic or political interests. Of course, formal arrangements may under-emphasize the power of borrower countries somewhat – agreeing a programme is not necessarily the same as actually implementing it, for example. That may lead to some largely invisible restraint on negotiating positions. Nonetheless, Executive Board actions will be crucial to Fund legitimacy.

The principle restraints on Executive Board power seem to be the attempt to recruit neutral expert economists (rather than self-interested politicians) and the way in which the Board is embedded in a broader set of reciprocal relationships. Even if there are not precisely defined legal limits on Board power, there may be reluctance to set a precedent of intrusive conditions on one country that others would not wish to accept in the future. Economic training may suggest a relatively hands off approach to economic management and a tendency to see matters in technical rather than partisan terms.

However, these restraints are both relatively fragile and it is not difficult to imagine powerful members of the Board being tempted to override them. In particular, there is very little, in practice, which forces the Board to introduce conditionality that is related to the Fund's overall purpose, rather than simply something Board economists think is a 'good idea'. To some extent, then, the legitimacy of conditionality will be dependent on the Board exercising restraint in the interests of maintaining broader institutional legitimacy.

2.4 Conclusions

Overall, then, it is possible to imagine a legitimate institution that could act in the way the Fund describes:

(i) It would promote international coordination in the interests of the common economic good. In particular, it would allow for greater collective political control over financial markets in the interests of individual domestic social priorities.
(ii) That would involve placing constraints on state action in certain circumstances. It would be costly for states from time to time but overall they would gain.
(iii) States would pre-agree the kinds of constraints that would be acceptable and the goals the institution could pursue. Compliance with the resulting legal framework would ensure policies were supported by state consent.
(iv) Legal frameworks can never deal with unforeseen consequences though, so there would be a need for decisions to be made about particular cases. These decisions could be made on a utilitarian basis by a technically qualified Board, held to account by member states.
(v) Conditionality, the most coercive aspect of IMF authority, would be determined in a way that maximized recipient consent within the constraints set by staff negotiators under Executive Board supervision, whose task it was to enforce the legal restrictions the Fund was authorized to impose.

However, the Fund's institutions provide only limited guarantees that the institution will operate in this way in practice. The institution is designed to make a particular kind of decision but not to ensure that only that kind of decision is actually made. It will be crucial that it is possible to see actual Fund activities in terms of technocratic, utilitarian decision-making on issues of general application; the kinds of issues that one can imagine being appropriately dealt with by a multinational staff of economic experts. There is little to make sure that this is the case, other than the expectation that pushing the boundaries will trigger political resistance.

This danger is particularly apparent when it comes to negotiating conditionality. There is very little, institutionally, to connect conditionality with the Fund's broader purposes, yet the argument that the two fit together is crucial to the Fund's overall arguments. Conditionality takes place at the interface between national sovereignty and international coordination and it is crucial that it can be justified in terms of a coherent relationship between the two.

3
An Evolving IMF

The previous chapter was concerned with the fundamental logic of IMF legitimacy claims and with the institutional structure of the Fund. It showed how the Fund's authority claims were based on the argument that the institution was appropriately designed for the tasks it was intended to perform. The Fund has historically seen itself as an institution designed to produce solutions to a collective action problem. Its role is to ensure that countries continue to operate in a way that is supportive of a broadly liberal international monetary regime, even when it is inconvenient for them to do so. It is therefore designed to be a technocratic institution in which decisions are made through rational utilitarian calculation of the 'best' policy in a particular situation, within the context of a broader set of legally defined reciprocal obligations.

This chapter will investigate the accuracy of that picture by providing a general overview of the Fund's practical activities as the institution has evolved over time. As I explained at the beginning of Chapter 2, credibility is a matter of degree and we should not expect IMF accounts to provide a wholly accurate picture. What is important is the degree of divergence from the Fund's core self-image, particularly when that divergence plays to some of the weaknesses in the logic of IMF accounts that were identified in Chapter 2.

The chapter is divided into two parts, chronologically. The first part provides a basic outline of the economics of international monetary relations[1] and deals with the period from the Fund's founding to the late 1980s. That provides a background for the second section in which I look at the Fund's growing involvement in financial globalization during the 1990s.

The core argument is that the IMF's role has changed quite significantly from the original Bretton Woods vision but that its institutional arrangements have remained broadly similar.

During the 1970s and 1980s, the Fund's global regulatory role became less significant, whilst conditionality has expanded. Conditionality expanded at the same time as it was becoming less well embedded in a broader set of reciprocal legal obligations. Conflicts of interest between developed and developing country members sharpened. That placed far greater weight on Executive Board technical authority.

In the 1990s, a new role emerged for the Fund in 'good governance', which required even more significant reforms to domestic political institutions than the structural adjustment agenda of the 1980s had. The promise, though, was that these more significant interventions would mobilize far greater capital inflows, in a context of resurgent financial globalization. The question for Part II of the book is whether the technocratic Executive Board can be presented as a credible custodian of the balance between the benefits of capital flows and the costs of restricted domestic politics.

3.1 The IMF's evolving mandate

3.1.1 The early years

The political economy of monetary coordination and the Bretton Woods design

As I argued at the beginning of Chapter 2, the IMF's role is to regulate the international monetary system in the interests of system stability and mutual prosperity. What does that mean in practice, though?

The IMF's most fundamental purpose is to ensure that currencies can be freely exchanged (IMF, 1992, Art VIII). Convertibility facilitates international trade but it also requires countries to maintain a careful balance on their current account and means that each country's macroeconomic policy starts to acquire international significance. Inflation and deflation can spread across borders through currency exchange. That raises two sets of questions at the heart of the IMF's jurisdiction. How is the overall level of liquidity in the system to be regulated and which tools can countries use to adjust to the constraints imposed by any given liquidity position?

These questions of global liquidity and adjustment have always been at the centre of the politics of IMF policy-making. At one level there is a technical trade-off between systems that are stable, providing confidence in the future value of money, and systems that are more flexible, allowing space to help economies adjust to the business cycle.

However, once flexibility is introduced, there are interlinked political questions about *who* is to be allowed to control levels of liquidity and the kinds of flexibility that different actors should be allowed to employ.

Flexibility is important because, since Keynes, there has been a strong economic case for countercyclical macroeconomic policy, designed to regulate aggregate demand in the economy. If liquidity is too tightly controlled, recessions can be unnecessarily long and painful. On the other hand, too much flexibility leads to uncertainty about the future value of money, which can also be damaging, opening the door to speculation and undermining the confidence required for productive investment.

The Bretton Woods negotiations took place against a background of dissatisfaction with both the Gold Standard system and the unstable system of flexible exchange rates that replaced it in the 1920s and 1930s.[2] Both sides in the negotiations were concerned about instability, so the starting point involved tying all countries' exchange rates to the dollar, with the dollar tied to gold. However, Keynes, by intellectual inclination and interest as negotiator for a debtor country, also felt the Gold Standard tended:

> to force adjustments in the direction most disruptive of social order, and to throw the burden on countries least able to support it, making the poor poorer (Moggridge, 1992, Vol. 25, 27, 29).

He pressed for a symmetrical system of adjustment in which debtors and creditors would be forced to adjust. The US, as creditor nation, refused to accommodate him, only accepting the compromise I outlined in the previous chapter. The Fund would encourage international negotiations about overall levels of liquidity in an effort to make countries take into account global conditions. Ultimately, only debtors would be forced to adjust when they found themselves in balance of payments problems (essentially when they ran out of money). However, when that happened, the Fund would allow limited exchange rate adjustment under supervision and would supply finance to ease the adjustment process – two concessions that made adjustment significantly easier (generally less deflationary) than under Gold Standard conditions.[3]

There was then a second dispute over how much control the IMF (or more importantly, its creditor members) would have over the use of Fund resources. A country faced with balance of payments problems has two choices. It can either spend less by instituting demand-reducing policies or try to earn more by increasing supply (stimulating production). Demand-side policies are technically simpler and less risky but produce costly recessions. Supply-side policies are potentially less painful but are also more uncertain, more politically contentious and take longer to produce their effects. Since supply-side measures take longer, countries also require short-term financing to give them a breathing space for the new measures to take effect.

Keynes wanted to maximize the chances of adjustment through supply-side measures. He therefore pressed for more funds and minimal conditions on borrower countries. The US felt such an arrangement committed it to a blank cheque for financing post-war reconstruction in Europe and didn't place restrictions on countries that simply chose to spend more than they could afford. White, negotiating for the US, therefore pressed for limited resources disbursed subject to IMF determined conditions.

The final Bretton Woods agreement left conditions for borrowing ambiguous and both sides promised their respective legislatures that they had achieved their aims. Once the Fund was established, the issue initially created a stalemate in which the Europeans would not accept conditions and the US, in turn, would not allow the Fund to lend (Dell, 1981; Horsefield, 1969). In the end a compromise was adopted under which the first 25% of a country's quota could be drawn automatically with conditionality introduced as sums increased above that threshold. A limit of three years was set for repayment (Gardner, 1980; Horsefield, 1969).

Liquidity and adjustment under the Bretton Woods system

During the Bretton Woods era, the key policy issue debated within the Fund was a genuinely global one: the liquidity of the system as a whole.

With all countries tied to the US dollar, US monetary policy was central in determining global liquidity. Initially, there was a common interest in expansionary monetary policy to assist with post-war reconstruction in Europe. Although, in practice, the resources supplied to the IMF and World Bank proved insufficient and much liquidity was transferred as Marshall Plan aid (defusing the thorny question of conditionality in Europe).

From the 1960s onwards, though, unease grew over US expansionary policy. Initially, the problems loose monetary policy posed for the credibility of the dollar's peg to gold were regarded as less important than the international need for greater liquidity. Expansionary policy was accepted but safety measures for the dollar were also put in place in the form of industrial country (G10) agreement to provide extra liquidity to the IMF if required (the General Agreements to Borrow – GAB) and a system for the IMF to produce its own currency – the Special Drawing Right (SDR). Informally, there was also a good deal of central bank cooperation to support the dollar (Eichengreen, 1998).

Whilst, in some ways, these agreements demonstrated the kind of international monetary cooperation the IMF was designed to supply, there were also ongoing political conflicts over liquidity. The G10 attempted to reserve the GAB for their own use, outside the Fund. The Europeans, now creditor countries, wanted to retain tight control. Per Jacobson, the IMF Managing Director, had to struggle to keep the GAB under Fund control, drawing on US opposition to European control and developing country pressure to retain the principle of universal IMF obligations. Even so, he had to concede a G10 veto on IMF lending decisions under the GAB, undermining the idea that all Fund members were equal (De Vries, 1976; Ferguson, 1988). Similar struggles took place over the SDR but, again, the developing countries (now organized in the G24) forged an alliance with the US to keep the SDR universal and administered by the IMF.

Ultimately, though, there were limits to cooperation in support of the dollar. The re-emergence of capital flows in the late 1960s was making industrial country adjustment increasingly difficult. Disputes between a debtor US and creditor Germany in the mid-1960s resulted in two reluctant German revaluations (the only forced creditor adjustments in the whole Bretton Woods period). However, dollars still flowed out of the US and international tolerance for expansionary US policy began to wane. The last straw was massive capital flight from the US to Germany and Japan in 1971 combined with a US refusal to acknowledge any responsibility. Cooperation was not merely delaying American adjustment but allowing them to avoid it completely (Gowa, 1983; James, 1996).

The dollar was cut free from gold and European currencies were allowed to float, marking the end of the Bretton Woods period.

Adjustment during this period was a less controversial issue. During the 1950s, limited private finance and the discipline of the fixed exchange rate system limited the deficits that could be run up before going to the Fund. Since problems were relatively small, IMF conditionality was confined to demand-side measures (credit ceilings and fiscal retrenchment):

> [structural reform] insofar as the concept existed at the time, was not seen as a legitimate matter for international concern (IMF, 2001c, 3).

Although these measures were not entirely popular,[4] they were relatively straightforward technically, with little room for IMF discretion (Guitian, 1992) and left governments considerable choice in the details of implementation. IMF staff look back on this era as one of relatively positive relationships with developing countries (Finch, 1989). A review of representatives' statements at annual meetings reveals little general concern with conditionality, beyond some issues about equitable application (Ferguson, 1988). Disputes about overall levels of liquidity were far more significant.

Conclusions

In many ways the IMF's role during this period corresponded with the self-image we explored in Chapter 2. Debate revolved around a central global issue – the overall level of liquidity in the system. Countries were bound by a set of reciprocal obligations (fixed exchange rates) and were all (with the exception of the United States) likely to find themselves borrowing from the Fund. Constrained capital flows and the discipline of fixed exchange rates limited international monetary disequilibria and the need to adjust. Although adjustment was controversial, conditionality could be seen as a technical matter that flowed relatively naturally from the wider system of obligations embodied within the Fund.

Having said that, it is also clear that the Fund's role was never neutral and apolitical. Technical debate about the trade-off between confidence and flexibility was bound up with political struggles between creditor and debtor nations. In the early years the Europeans, as debtors, pressed the US for greater liquidity with less control. During the 1960s positions were reversed. Cold War relationships helped to ensure that mutually acceptable solutions were eventually reached. From a developing country point of view, these ongoing struggles between the industrialized countries helped to maintain some semblance of universality in the arrangements and limit more exclusionary proposals. Nonetheless, that was more to do with a general balance of geo-strategic power than any deep commitment to technocratic neutrality.

3.1.2 The rise of private finance – the 1970s and 1980s

The collapse of Bretton Woods transformed the Fund's role. There were some continuities with the original position but there were also significant changes that undermined some of the Fund's core legitimacy claims.

Fixed exchange rates to firm surveillance

The first change was an expansion and dilution of the Fund's role in regulating monetary relations globally. Under the flexible exchange rate system that emerged during the 1970s, fixed parity obligations were replaced by a less specific requirement to 'collaborate with the Fund and other members to assure orderly exchange arrangements and to promote a stable system of exchange rates' under the IMF's 'firm surveillance' (Art IV, 1, 3). Over time, the IMF interpreted this mandate broadly, taking the view that it had a legitimate interest in any aspects of member policy that might affect exchange rates (Guitian, 1992; Pauly, 1997).

However, it was no longer clear where the boundaries of acceptable behaviour were to be drawn. The firm legal obligation of fixed exchange rates was replaced with much wider country discretion, restrained only by international opinion. The IMF had influence over a wider range of policy but less authority to set the limits of acceptable behaviour in non-borrowing countries. That didn't mean these countries were free to do as they pleased, of course. Increasing interdependence (particularly as a result of resurgent financial globalization) meant occasional policy coordination was essential but this tended to take place under the auspices of the G7 or perhaps Organization for Economic Cooperation and Development (OECD), with the Fund's role reduced to the provision of information (Guitian, 1992; IMF, 1999a; Pauly, 1997).

The result was a severe dilution of the Fund's claims to act as a systemic global regulator presiding over a set of international legal obligations.

The transformation of balance of payments financing

The second change was a radical transformation of the adjustment mechanism. Private markets began to replace Fund resources as the principal source of balance of payments financing. Over time, this meant that the industrial countries lost any need to borrow from the Fund (the UK and Italy were the last to do so in 1976).

For developing countries, though, access to private finance was more precarious. The questions of finance and adjustment policy are closely interlocked. Although there remains some controversy over the issue, it is possible to argue that deficits caused simply by overspending (encouraged through loose fiscal and monetary policy) should be dealt with through fast-acting but painful demand-side measures. Deficits produced by changing structural conditions (changes in commodity prices or technological shifts) should be dealt with by supply-side measures that address the underlying problem (Bird, 1984). In practice though, it is often the availability of finance that is the determining factor, since finance is required to buy time for supply-side measures to take effect. I will therefore look at the finance side of the equation first before going on to look at changes in the content of conditionality in the next section.

The changes began with the first oil crisis, which caused serious balance of payments problems for oil-importing developing countries. Even at this stage, low-income countries had little access to private capital flows. They were forced to go to the Fund to finance their deficits. Fund staff were initially relatively sympathetic to the idea that deficits should be financed, viewing them as springing from structural problems. The Fund responded with new facilities, which were longer-term and more generous than standard arrangements (De Vries, 1987).

For middle-income countries things were initially even easier. Windfalls obtained by oil-exporting countries were reinvested in the London market, stimulating the nascent offshore 'euromarkets' (Helleiner, 1994). It became possible for middle-income countries to obtain private syndicated dollar loans on generous terms, enabling them to finance their balance of payments deficits without recourse to the Fund.

By the time the second oil shock struck in the late 1970s, things began to look far less comfortable. International economic opinion shifted towards an emphasis on adjustment in the face of chronic global inflation. Interest rates were raised dramatically, increasing the cost of developing country borrowing and, simultaneously, triggering developed country recessions that led to a collapse in export markets.

The result was the debt crisis. Earlier financing had leveraged countries' balance of payments positions so that when crises hit they were far more severe than in the 1960s. Fund resources did not expand to meet this challenge (Bird, 1995; Dell, 1981) and resources were severely strained, reversing the trend towards more generous adjustment lending for low-income countries and ensuring that public money alone could not deal with middle-income country debt problems. At the same time, now crises were debt crises, the overall amount of financing available was only partly determined by the Fund. It was also dependent on the deal that countries could strike with their (public and private) creditors over debt rescheduling or renewed finance.

During the late 1970s, then, the Fund began to find itself involved in debt negotiations. In theory this could be to everyone's benefit. An optimal solution would give countries sufficient short-term assistance and forbearance to maximize longer-term debt repayments. From a creditor point of view, too harsh a settlement may undermine the chances of future payments. A more generous settlement, though, involves taking a risk on countries' willingness to pursue good policy and make repayments over the longer term. Potentially, the IMF is in a position to use its political authority over borrowers in ways that ensure good policy. That should reassure creditors, making them willing to settle for a more generous package. At the same time it helps the borrower country to get better financial terms with less political embarrassment – sovereign control over economic policy is ceded to an international institution that has some public authority, rather than to mere private creditors (Finch, 1989; Pauly, 1997).

Whilst this kind of win-win outcome is possible in theory, it may be difficult to achieve in practice. Banks must be put under considerable pressure to see their interests in the kind of medium to long-term light that such a settlement requires. Countries will have incentives to overemphasize the repayment constraints they face. Uncertainty and conflict of interest will inevitably produce tensions, with banks tending to err on the side of adjustment and countries on the side of financing. The result is hard fought negotiations with the IMF playing a difficult mediating role.

During the 1982 Mexican crisis, banks were heavily exposed in Mexico and desperately needed the IMF to provide both financing and conditionality. The Fund was able to pressure the banks into agreeing a more generous package by refusing to lend unless the overall financial package for Mexico was adequate (Kraft, 1984). However, as the debt crisis receded through the 1980s, the banks were less exposed. They began to threaten to withhold finance unless the IMF negotiated a tougher package with more adjustment and less financing (Finch, 1989). From having some claim to being a neutral mediator, the Fund was increasingly open to the charge that it was acting as a debt collector for banks based in the countries with the largest vote in the Executive Board (Finch, 1989; Kapur, 1998). There was also a danger that Fund resources were being used only to repay creditors rather than finance domestic adjustment.

In terms of broader arguments about IMF legitimacy, the net result was that financing for adjustment in middle-income countries was no longer a largely public sector issue decided through political processes within the Fund. It involved more complex interactions between the Fund and the private sector, with the Fund reduced to a bargaining role. That bargaining role could result in mutual benefits, but its operation in practice became very controversial, with the Fund forced to play a role in choosing between debtor and creditor interests. At the same time, crises had become far larger without an equal increase in Fund resources, making adjustment particularly difficult.

The transformation of conditionality

Over the same period, conditionality expanded dramatically. It became far more detailed and started to cover a much broader range of policy areas.

Fund accounts tend to stress the economic forces driving this change. Intellectually, they corresponded with what John Toye has described as a counter-revolution in economic opinion against the Keynesian enthusiasm of the early 1970s. Economists became much more concerned about inflation and far more sceptical about the structuralist economics that had informed Latin American import-substituting industrialization (Toye, 1993).

Policy changes were also a rational response to the increasing size of balance of payments crises. Limited Fund resources, and some concerns about conditionality avoidance on the part of borrowers, triggered the more detailed demand-side conditionality of the late 1970s (De Vries, 1987). Later it was also clear that, given the scale of the problems involved,

> conditionality [should] include growth as [a] direct objective... without such an approach medium-term viability (and the revolving character of Fund resources) may be elusive (IMF, 2001c).

That focus on growth, in turn, meant that more detail was required in fiscal provisions to ensure that expenditure cuts were directed at greater efficiency rather than declining investment (Polak, 1991).

However, it is also clear that the extension of conditionality had a far more political aspect, relating to the by now familiar struggles between debtor and creditor countries over the volume of finance that is available and the degree of control the IMF exercises over adjustment.

The relatively generous response to the first oil crisis was partly a function of developing country political strength. Oil-producing developing countries had new power in international monetary affairs. Even for oil importers, the growing availability of private finance provided an alternative to borrowing from the Fund, which was used to push the Board to make IMF resources more attractive (De Vries, 1985).

Politically, developing countries were increasingly assertive within international institutions more generally during this period under the banner of a New International Economic Order (NIEO). Economic questions were fused with broader debates about the nature of the post-war sovereignty regime.

Arguably, classical 19th century sovereignty was something that had, in part, to be earned. Recognition was only given to states that were sufficiently powerful to demand it and that could demonstrate a degree of 'civility' such as the possession of a constitution. By the end of the Second World War, this situation had clearly changed. In the context of growing demands for decolonization, the UN Charter introduced the idea of a right to self-determination for all peoples. At the same time, the relatively novel multilateral character of the post-war international institutions such as the IMF began to promise more significant and institutionalized control over international relations. As part of the NIEO movement, developing country jurists like Mohammed Bedjaou tried to push these trends further, arguing that the UN sanctioned right to self-determination also logically implied a right to development. The argument was effectively that developing countries had a particular and non-reciprocal right to assistance but that this did not in any way compromise their standard right to sovereign self-determination (Jackson, 1990).

Writers such as Jackson and Krasner have argued that the NIEO challenges of the 1970s were an attempt to press forward the normative project of public international regulation as a way of compensating for developing countries' weak and problematic statehood and influence over international affairs (Jackson, 1990; Krasner, 1985).

In the context of the IMF, developing country assertiveness was reflected in concerted resistance to the first phase of expanded conditionality in the mid-1970s. Developing countries actively sought private finance and raised public complaints that conditionality:

(a) involved making too many policy changes in too short a time
(b) was too heavily geared to deflationary demand restraint, harming growth and resulting in political unrest
(c) was too heavily based on monetary targets which suggested monetarist thinking and which were not sufficiently tailored to individual country circumstances
(d) tended to have regressive distributional consequences

(e) concentrated on exchange rate depreciation which was ineffective (as the inflationary response outstripped the effects of incentives to increase supply) and would work better with trade controls (to encourage raw material imports rather than luxury goods) which the Fund would not allow.[5]

Politically it was argued that the measures were ideologically anti-socialist because of their distributional impact and because of their stress on reduction of state control in the economy. It was also suggested that there was favouritism in the application of conditionality, with industrial countries and their Cold War allies receiving more lenient treatment.

The controversy forced the IMF to conduct a limited review of lending procedures (De Vries, 1987; Ferguson, 1988). The result was the 1979 *Guidelines on Conditionality*, the only broad policy statement on the appropriate contents of conditionality produced before 2001. These guidelines included various provisions designed to ensure that countries' preferences would be respected and conditionality would be kept to a minimum. There was some evidence of a relaxation of conditionality over the next few years (De Vries, 1987).

However, developing country strength was short-lived. The guidelines ultimately had little influence on the development of conditionality.[6] Developing countries' deteriorating financial situation from the late 1970s onwards undermined their bargaining power. It was in that context that supply-side conditionality was introduced.

In a sense, supply-side measures were a response to some of the criticism that had been made of the Fund in the 1970s. The new conditionality was less narrowly focused on demand restraint and at least promised to promote growth. However, the new structural policies were ultimately extremely controversial. They were far more intrusive than even the conditionality of the late 1970s, raising sharp questions about domestic sovereignty. Additionally, attempts to restructure economies to create growth were not accompanied by extra finance. Countries were being asked to grow (increase output) and retrench on government spending at the same time. These requirements for growth combined with government spending cuts had a strong resonance with the ascendant neo-liberal orthodoxy of the Fund's leading shareholders during the same period. The view was that

> essentially, once the government 'got out of the way' private markets would allocate resources efficiently and generate robust growth (Stiglitz, 1998, 11).

The result was a gradual reversal of the trends towards sovereign assertiveness that scholars like Krasner and Jackson noticed in the 1970s as IMF (and for that matter World Bank) interventions became far more significant at the domestic level. During the 1980s the Fund sometimes used its non-interference out of respect for countries' domestic sovereignty as a defence against critics who complained about the adverse social consequences of Fund policy (Nowzad, 1982). By the 1990s, this was increasingly difficult because of the expansion in the scope of conditionality and, as we will see, the Fund found it harder to avoid debates about social policy.

3.1.3 Conclusions

It was over this period that relationships drifted most dramatically from the original Bretton Woods vision. As Fund accounts emphasize, there is a sense in which the Fund's two core functions remain in place – the IMF is still the only institution with a broad international membership in which international monetary relations can be discussed and regulated and it continues to provide finance to ease adjustment (Guitian, 1992).

However, changes in international regulation and the nature of adjustment have dramatically altered the content of those two functions in ways that do not sit easily with the original vision underpinning IMF internal governance. Four developments are particularly key in understanding both what had changed by the end of the 1980s and the challenges the Fund had to deal with as it reconfigured its role during the 1990s: declining Fund influence over international regulation; a collapse of any symmetry in members' obligations; a shift from public to private control over international financial flows (the beginnings of financial globalization); and the expanded scope of conditionality.

The Fund's role in international management has become much weaker over time. It no longer has a central role in regulating either global liquidity or exchange rate adjustment. It continues to produce some analysis of international monetary issues in its *World Economic Outlook* and *International Capital Markets* reports[7] and actually discusses a far broader range of issues than were included in its original mandate. However, countries' specific enforceable obligations are far more limited and the IMF's practical influence over monetary affairs at the global level is very limited (Pauly, 1997).

The loss of any global regulatory role, has also undermined one part of the IMF's claim to embody a set of (at least broadly) equal symmetrical obligations between countries. The other part of that claim, related to the provision of a common pool of funds available to the whole membership, has suffered too (Kenen, 1986). The changing international financial regime has meant that the membership is increasingly divided into one group of countries that expect to borrow from the Fund and another that does not. That collapse of symmetry weakened 'rule of law' arguments, which had promised some level of restraint on Fund power on the basis that more powerful legislating countries could expect to find themselves bound by the rules they made. As the membership's interests began to separate this was no longer the case.

It was perhaps no accident then that, as the importance of private international finance grew, the publicly controlled resources controlled by the Fund failed to respond. In that context the IMF's role began to shift away from exercising public authority over the volume of resources available for adjustment and towards being merely a catalyst for private re-financing.

Finally, conditionality expanded just as the traditional justifications for it began to become increasingly problematic. Originally the Fund had argued that conditionality flowed naturally from countries' broader reciprocal obligations as members of the regulatory regime administered by the Fund (Guitian, 1992; Nowzad, 1982). However, just as conditionality was expanding, countries' international obligations began to be much less clearly defined and the reciprocity underpinning those obligations started to look problematic.

Overall, then, events had taken the Fund in directions that played to the weaknesses I identified at the end of Chapter 2. The bitter pill of conditionality had previously been softened by the argument that it formed a part of a broader set of reciprocal arrangements to ease sovereign states' relationships with the international system. Increasingly, though, conditionality was becoming a matter of adjusting to the consequences of a largely unregulated system. Conditionality was no longer linked to any kind of international reciprocal arrangements, leaving only good will and a particular kind of economic mindset as institutional restraints on the Executive Board's ability to expand its scope.

Over this period, little was done to alter the IMF's institutional structures to bolster regime legitimacy. The only real institutional changes that did take place were modest adjustments to voting quotas to reflect changing economic realities. The principle that voting weights reflected economic strength remained unchanged, but decolonization produced new members. At the height of developing country power, oil exporting members were able to increase their voting shares (Ferguson, 1988) and, after a long campaign, Japan also achieved some recognition of its growing economic importance.

The overall result was a slight increase in the developing country share of the vote within the Fund and in the number of Executive Directors representing the developing world. However, from the point of view of individual developing countries there were offsetting effects. When the Fund was set up, 14% of the total votes were 'basic votes' shared evenly amongst the membership to reflect sovereign equality, rather than economic strength. The total number of basic votes has not increased at the same rate as votes relating to quotas and basic votes are now only 2% of the total (IMF, 2003).

3.2 Responding to financial globalization, the IMF in the 1990s

The agenda of the 1980s was problematic in terms of the arguments about legitimacy that I introduced in Chapter 2. However, it was also accompanied by a powerful consensus in the economics profession. Some of the details of Fund programmes were criticized, but there was also a strong core of agreement amongst economists that there were few realistic alternatives to something like structural adjustment (Williamson, 1983).[8] The Fund's institutional reassurances might have been wearing thin but it was able to compensate by placing increasing weight on its technical authority.

During the 1990s, though, there was an increasing feeling that structural adjustment hadn't actually worked, even on its own terms. The effects of programmes were less significant than expected. There was some impact on inflation and towards a more balanced budget but growth responses were poor, partly because expected capital inflows had not materialized, harming investment expenditure and therefore long run growth (Killick, 1995).

A number of reasons were proposed for these problems. The Fund had a tendency to blame non-implementation, and problems with the political systems of recipient countries. Critics argued that the Fund had always been over-optimistic about the potential for free markets to mobilize new investment without supportive public action through the state. In a sense, then, there was a movement to the middle ground from both the IMF and independent development practitioners in which mobilizing finance and the role of government in supporting development were to be the key issues.

The new agenda of the 1990s, then, was about how to stimulate and secure capital inflows (and therefore investment), with particular emphasis on the impact of domestic political institutions. It was about the politics of financial globalization as I described them in Chapter 1.

The Fund was promising to mobilize more finance but was also demanding more significant political reforms.

However, the difficulties of introducing this new agenda also led to a gradual re-conception of political relationships between the IMF and borrower countries in an attempt to broaden support for the new agenda.

3.2.1. Capital flows, market confidence and the 'catalytic effect'

Contemporary IMF documents emphasize the extent to which developing country governments, at least, had begun to be more receptive to market-friendly development by the end of the 1980s (Boughton, 2001). Controversy over the reasons for this change continues to rage but likely factors include:

- a reaction to the failure of earlier state led policies (particularly import substitution in Africa and Latin America),
- a growing recognition of the potential benefits of trade and foreign investment (i.e. a conversion to economic orthodoxy), perhaps because of increasing overseas education, or the hegemonic research output of the Bretton Woods institutions,
- an acceptance that the balance of power in the contemporary international economy simply leaves little choice but to adopt more market friendly measures.

One factor that was certainly important was the resurgence of capital flows to developing countries during this period – the rise of financial globalization. Between 1988 and 1995, total net Least Developed Country (LDC) external funding increased from US$37 billion to US$235.8 billion (IMF 1986, IMF 1996), though the majority of this was concentrated in middle-income countries.

As the capital drought following the debt crisis began to recede, the promise of capital inflows to middle-income countries provided incentives for pursuing more market-friendly policies in an effort to attract investment. Competition for investment, in turn, provided a further justification for IMF conditional lending that was distinctively different from its original purpose as bridging finance for current account balance of payments problems.

Since the present value of financial assets is heavily dependent on expectations about their future value, market confidence can have a large impact on asset values, capital inflows and therefore a country's balance of payments. For some time now,[9] the IMF has been arguing that IMF conditionality can enhance market confidence and have a 'catalytic effect', inducing capital inflows (Dhonte, 1997; Masson and Mussa, 1995). Market confidence became particularly important in the 1990s as the composition of capital inflows to middle-income countries shifted away from foreign direct investment and long-term syndicated loans towards shorter-term lending and portfolio investments.

The idea is that conditionality provides a commitment technology to enhance confidence in a governments' willingness to follow through on announced policy changes. The negotiation process can provide the IMF with superior information about a country's commitment to economic reform than is available to the markets. The IMF's willingness to commit finance in support of a programme, and the fact that the country stands to lose that finance if its adjustment effort falters, means that conditionality can provide valuable assurances to official lenders and the markets. The IMF's objectivity and superior technical knowledge may add additional credibility:

> conditionality outgrows its traditional posture as a frequently obtrusive means of enforcing creditors' views and becomes an instrument of governments to establish the predictability of their policies (Dhonte, 1997, 7).

The IMF's role in debt negotiations and its relationship to official creditors already meant that it was:

> committed to provide a credible assessment of the member's financing needs and to muster appropriate financing to cover them…[and] to fulfil an audit function, to verify the books, to assess the feasibility of policy adjustments, and to secure a reasonable measure of commitment by the authorities (Dhonte, 1997, 8).

The importance of credibility and the Fund's new role in enhancing private confidence also provide a justification for its gradual adoption of a concern with 'good governance' – questions about the political and institutional structures through which policies are determined and implemented. Since market confidence is crucially related to the predictability of policy, the way in which policy is made becomes as important as the policy itself:

> it is not only necessary to rely on a core team of national coordinators; in many cases, there must also be a strengthening of the whole

> civil administration, in particular the judiciary. An efficient civil service, backed up by a competent judiciary, is necessary for the solution of the authorities' time consistency problems and for the establishment of the rule of law, and thus for the creation of an economically secure environment. In this specific sense, 'good' governance is an integral component of Fund programmes (Dhonte, 1997, 11–12).

This, of course, is how the IMF has sought to link its original mandate with its new attempts to encourage the kind of 'convergence' of economic and governance policies under globalization that I discussed in Chapter 1. Once market confidence becomes the crucial determinant of balance of payments viability, because of its effects on the capital account, the range of policies that may have an influence on the exchange rate is vastly expanded. That also suggests the need for an expansion of the IMF's mandate to cover a far wider range of policies in the interests of enhancing and securing the process of financial globalization.

In the context of a greater acceptance of market-friendly policies and the resurgence of capital flows, the IMF was using the promise of enhanced capital flows to provide a new form of justification for conditionality and an expansion in its scope during the 1990s. Larger volumes of increasingly stable capital inflows were on offer if countries were willing to make ever greater efforts to attract them. The controversy, of course, was about what kinds of effort were required and whether such efforts were worthwhile.

3.2.2. Good governance

In fact, though, the situation was slightly more complex, because technical arguments about the economic effects of good governance were also combined with more political arguments about good governance as an end in itself. I will start by reviewing the technical factors driving the governance agenda and go on to explore links with more political developments that emerged in the wake of the Cold War.

The economics of good governance

In technical terms, the broader governance agenda reflected another period of 'learning' within the economics profession. As we saw in section 3.1, the increased focus on structural conditionality in the 1980s was accompanied by a political focus on the benefits of markets over states. In the late 1980s, though, it was possible to observe another shift in emphasis within the International Financial Institutions (IFIs). The World Bank's troubled experience with structural adjustment in Africa had made it increasingly conscious of the importance of the state for development (World Bank, 1989).

Evolving views about the contrast between East Asian and Latin American development were also important in changing ideas. Much of the Washington consensus was a particular reaction to Latin American experiences (Stiglitz, 1998). Initially economists had argued that East Asia had 'got it right' by its focus on export promotion rather than Latin American-style import substitution and by its less state-centred approach to development (Krueger, 1979). In the early 1990s a concerted academic attack was launched on the second half of this view, pointing out the extent of state intervention in fostering growth, particularly in the North East Asian Newly Industrialized Countries (NICs).[10] Under pressure from the Japanese, the World Bank produced a grudging acknowledgement of the importance of state policy for East Asian development in 1993 (World Bank, 1993), paving the way for its increasing interest in the state in the late 1990s.

By the time of the Asian crisis the focus had changed dramatically. In 1997, the World Bank's World Development Report took 'The State in a Changing World' as its theme (World Bank, 1997) and the IMF published a pamphlet and a guidance note on 'good governance' (IMF, 1997a; IMF, 1997d).

Although questions about the way government institutions operate clearly have the potential to be highly political, IMF and World Bank Articles of Agreement prevent them from becoming involved in politics.[11] Their approach has tended to be couched in technical terms, drawing on arguments about the role of the state in correcting market failures – building on developments in the economics of information within macroeconomics (Stiglitz, 1994).

The IMF was slower to become explicitly involved in governance than the World Bank, probably because it has historically had a narrower mandate than the Bank – the Fund has insisted that it is not a 'development institution'. Nonetheless the changing climate in the economics profession paved the way for greater involvement. The first official mention came in the Interim Committee's Autumn 1996 declaration *Partnership for Sustainable Growth* which argued that 'promoting good governance in all its aspects including ensuring the rule of law, improving the efficiency and accountability of the public sector, and tackling corruption' was an essential part of a framework in which economies could prosper. This triggered Executive Board discussions leading to the publication of the IMF's governance guidelines in August 1997 (IMF, 1997a).

The guidelines acknowledge[12] that 'it is difficult to separate economic aspects of governance from political aspects'. They try to deal with this issue by concentrating on 'economic' issues and explicitly stipulating that 'the IMF's judgements should not be influenced by the nature of a political regime of a country nor should it interfere in the domestic or foreign politics of any member.' (7).

The overarching criterion is that 'the staff should be guided by an assessment of whether poor governance would have a significant current or potential impact on macroeconomic performance in the short and medium term and on the ability of the government credibly to pursue policies aimed at external viability' (9). Within that limit, the IMF should concentrate on economic aspects of governance – 'improving the management of public sector resources' and 'supporting the development and maintenance of a transparent and stable economic and regulatory environment.' (5).

However, the guidelines go on to include a number of stipulations that it is difficult to imagine being implemented without interference 'in the domestic politics' of any member. The IMF is committed to 'providing a level playing field to foster private sector activity' (10) and 'limit[ing] the scope for ad hoc decision making [and] rent seeking…[through] liberalization of exchange, trade and price systems and the elimination of direct credit allocation' (2). Similarly, staff are told that 'IMF policy advice should … be based on broadly agreed best international practices of economic management and on the principles of transparency, simplicity, accountability and fairness' (13).

Good governance and democracy

It should not be surprising that this separation can be difficult to maintain. In parallel with the IFI's development of a 'technical' interest in 'good governance', bilateral donors had begun discussing 'good governance' in far more political terms, reflecting the changing political climate after the Cold War.[13]

This was not only a reflection of the kind of post Cold War liberal triumphalism exemplified by Fukuyama's *The End of History*. The end of the Cold War had created a new environment for foreign aid. In the past, Cold War priorities had provided a security justification for extending aid budgets but the competition for influence that was involved had placed restrictions on what could be done as part of the aid process. After 1989, 'Western governments felt freer than before to pursue basic political concerns *vis-à-vis* the governments of the South' (Stokke, 1995, p. 9). At the same time, appeals to democracy and human rights could be used to bolster flagging public support for aid budgets once more direct security justifications had disappeared (Lancaster, 1993). This was particularly clear in the rhetoric[14] of Clinton's foreign policy, with its emphasis on 'enlargement' (Talbott, 1996).

The bilateral agenda was less economistic and more explicit about the *type* of institution that was desirable. A new orthodoxy began to replace the conviction of 1950s and 1960s modernization theorists that authoritarian regimes were a necessity, at least in the early stages of economic growth (Cammack, 1997). In the post-Cold War 1990s (partly in response to the experience of transition economies (James, 1998)) democracy became compatible with economic growth or, for some authors, an essential prerequisite for it.

While the IMF and World Bank have tried to keep some official distance from this more explicitly political agenda, the boundaries are often blurred. So, for example, IMF external affairs' own publication (Finance and Development) includes an article arguing that interest in good governance reflects:

> a realization increasingly shared throughout the world that the world economy, and world institutions, can be a better guarantee of rights and of prosperity than some governments…economic reform and the removal of corrupt governments are preconditions both for the effective operation of markets and for greater social justice (James, 1998).

Conclusions

This, then, is the root of the politics of financial globalization as I described it in Chapter 1. During the 1990s, a focus on capital account liberalization and its potential to deliver greater capital inflows has been accompanied by a growing stress on the legal and institutional underpinnings of stable capital flows.

The failure of structural adjustment in Africa, combined with the growing prominence of new, information-sensitive approaches to macroeconomics have promoted the view that the mobilization of capital for development needs to take place within an 'appropriate institutional context'. The Fund has therefore expanded the scope of its policy interventions very significantly.

That expansion has been justified, primarily, on the grounds that institutional factors cannot be ignored when considering open economy macroeconomics. That argument became more persuasive in the 1990s with the resurgence of private international lending (in the wake of the 'lost decade' of the 1980s). Where it remained difficult to swallow, the associations that can be drawn between aspects of the macroeconomic governance agenda and political liberalization (transparency, accountability, the rule of law, etc.) held out some promise of securing broader political acceptance of the new agenda. Nonetheless it remained a very politically significant agenda that would have a profound domestic impact. As we will see in Chapter 4, the nature of institutional reforms was key in shaping the meaning of financial globalization for domestic actors during the Asian crisis.

Reflecting the ongoing weakness of IMF institutions, it was an agenda that was to be promoted on the basis of promised performance. Its success would depend very much on the extent to which costly institutional reforms really did deliver stable capital inflows.

3.2.3 Institutional change

As we saw in section 3.1, despite rapid changes in the nature of IMF operations, institutions changed little prior to the 1990s. The fundamental principles underpinning the Fund's institutions, particularly weighted voting, have remained in place. However, aspects of the Fund's relationships with borrower countries, which were always determined informally, rather than through the Fund's Articles, have begun to evolve. Essentially the moves have been away from a traditional conception of sovereignty in which the capacity of the Executive to speak for the country as a whole was unquestioned. As the Fund has increasingly become involved in 'behind the border issues' which are hard to see in terms of relationships between states, it has come under pressure to explain its policies to a wider range of domestic actors. That has reconfigured IMF-state-society relations in complex ways that have yet to fully work themselves out (Thirkell-White, 2004c).

Moving away from inter-governmentalism?

As we saw in Chapter 2, the original model of IMF decision-making was state-centred. The Executive Board was designed to insulate financially trained technocrats from their 'political' masters. Directors were state representatives and the form of representation involved was none of the Fund's business, in keeping with traditional notions of Westphalian sovereignty. In practice arrangements for domestic accountability varied widely between countries. In the US, as we will see in Chapter 8, Congress has no formal power over the United States Executive Director (USED) but can veto requests for increased IMF funding or for alterations to the Articles of Agreement. In the UK, parliament does not have similar powers, though the Treasury Select Committee periodically reviews UK policy towards the Fund.[15] In borrower countries, too, arrangements vary. In Haiti, for example, legislative consent is required for Fund programmes.

In many other countries (in this case, Houphouet Boigny's Côte D'Ivoire):

> standby arrangements were typically negotiated by a small technical group within the Ministry of Finance and then cleared by the President sometimes without even full-fledged cabinet discussion (IMF, 1998, 70).

As well as conforming with traditional conceptions of sovereignty, these arrangements were expected to encourage international agreement, since delegates at the Fund were more likely to have an international and pro-market outlook, facilitating international agreement. In fact, throughout the 1970s a common strategy, which the Fund tacitly condoned, was for governments to deliberately use it as a scapegoat for domestically unpopular policies. Louis Pauly has argued that this is *the* key service the Fund provides to both borrower and lender governments. It acts as a 'buffer' between states and global markets when difficult choices need to be made. So, even as recently as 1994, when the Clinton administration had to deal with the Mexican crisis:

> Domestic reactions to the exigencies of increasingly integrated capital markets clearly came into conflict with broad and deep foreign policy goals significantly associated with those markets. The costs [for the US Treasury] of too clear a choice were high. The IMF was available to help forestall that choice and to obfuscate it (Pauly, 1997, 125).

During the 1990s, the Fund began to become far less comfortable with this sort of arrangement. A number of changes took place that made it easier for a wider range of actors to monitor programmes. There were three driving forces behind these changes.

Perhaps the most important one is that, as programmes have become wider, they have become increasingly difficult to implement. Some early research on IMF programmes by Tony Killick noted that programme breakdown was running at over 60% in the early 1990s

(Killick, 1995). The IMF was aware of these problems and the Policy and Review Department observed that

> a substantial proportion of program interruptions are attributable to policy disagreements between governments and Fund staff (cited in IMF, 1998, 21).

Killick and his colleagues went on to suggest, using insights from agency theory, that domestic populations were able to inflict far more significant costs on governments than the withdrawal of IMF funding. It was therefore unsurprising that conditionality could only provide limited leverage, particularly as the Fund was, in any case, reluctant to use the sanctions at its disposal (Killick et al., 1998).

The Fund's major response has been to pay more attention to 'ownership' of programmes. That was, for example, a key part of the terms of reference for the Fund-commissioned external evaluation of ESAF (IMF, 1998). For some, this is still largely a matter of ensuring government support – 'if governments don't have a solid base of support for an IMF-sponsored programme, it won't work' – but for others it also includes the need for 'a broad-based social consensus' behind programmes.[16] In both cases, though, there was a feeling that negotiations needed to involve a wider range of groups if they were to result in programmes that were actually implementable on the ground. Under these circumstances the scapegoating function was a counterproductive short-cut to the kinds of genuine broad based 'ownership' that were required.

The second set of reasons relate to the broader changes in the Fund's mandate during the 1990s that we reviewed above. The shift towards social and developmental issues and the tentative reconception of sovereignty taking place in broader public international discourse during the 1990s combined to make it more difficult for the Fund to separate 'international' and 'domestic' issues. It may be that adopting the language of 'governance' was originally simply an attempt to legitimate increasing encroachments on developing country decision-making. Once the term had been introduced, though, it was bound to attract scrutiny from the NGO and development community. NGOs too were aware of the possibilities for 'scapegoating' and were keen to press the Fund to take notice of social issues and question the extent to which governments represented their own populations. The shift in discourse in the international community away from sovereignty and towards an insistence on democracy was clearly partly rhetorical. Nonetheless it inevitably created some new political pressure in the direction of greater openness at the Fund.

Thirdly, the issue of 'transparency' was becoming increasingly important. The US NGO movement had been pressing the Fund on openness since the 1990s[17] but it was the 1994 Mexican crisis that really forced a sea change at the Fund for two reasons. Firstly, the Fund was increasingly arguing that information provision and transparency at the national level was key to the kinds of good governance that would promote financial stability. It was difficult, under those circumstances, to refuse to publish Fund policy documents and the contents of conditionality. Secondly, Congress was furious about the ways in which it felt the Clinton administration had conspired with the Fund to mislead it during the crisis and therefore insisted on greater information provision as part of its agreement to provide finance for ESAF later in the same year.

The practical response to these pressures has been twofold. Firstly there has been a dramatic expansion in the range of documents that the Fund publishes. The Fund has issued press releases concerning the approval of stand-by credits including a summary of the conditions involved. In 1990 Argentina began to publish its full letters of intent and other countries have increasingly followed suit. Since 1996 a number of ESAF policy framework papers have been published. 'Public information notices' summarizing some key Executive Board decisions and a wider range of staff papers have also become available on the IMF's website. Negotiations themselves, in the Executive Board and with borrower countries, continue to be conducted in secret but the results are now available.

Secondly, the Fund has begun to expand, tentatively, the range of groups it consults, particularly in borrower countries. Under Camdessus' leadership the IMF began to reach out to labour unions in recipient countries.[18] By the mid-1990s, Fund staff were far more likely to talk about encouraging the 'ownership' of conditionality and there have clearly been changes to the operation of staff missions from the traditional model in which negotiations took place largely within finance ministries.[19] Mission leaders have increasingly had contacts with non-core ministries. In some cases they have also spoken to business, labour and NGO groupings. What was less clear by the time of the Asian crisis was what the status of these broader contacts with what the Fund was starting to call 'civil society' was going to be and what effect they would have on Fund legitimacy

The IMF and civil society?

While the Fund clearly feels it needs to reach out to a wider range of groups it has not yet fully defined how this is to work or what will be achieved (Thirkell-White, 2004a). There is a tendency to think more in terms of 'getting the message out', or perhaps information exchange, than altering policy:

> we value our interchanges with civil society… At an international level they can push sound macro-economic and structural policies…At the grassroots they can mobilise civil society to have a voice in economic policy debates, monitor government programmes, help explain the benefits and costs of various policy options and offer first-hand experience and expertise (Camdessus, 2000).

The problem with programme implementation, then, is mostly a lack of understanding and sometimes the interference of groups (including within government) with an interest in the *status quo*.

Here, two visions of the governance agenda are in competition. One is best captured by Ben Fine's description of the post-Washington Consensus as part of a colonization of the social sciences by economics in which existing concepts are subsumed into a technocratic utilitarian reasoning. The Fund develops 'good policy' and civil society buys in (Fine, 2000). The other, perhaps exemplified by Stiglitz, an economist who acknowledges that the issues at stake are now simply too significant to be left to experts (Stiglitz, 2000). This is terrain that is being fought over in defining the new development orthodoxy.

The Fund's new arrangements have certainly become increasingly complex as more actors are to be involved in formulating conditionality (see Figure 3.1). That includes not only civil society actors, but also the financial interests the Fund is negotiating with. Thinking about 'multi-level governance' within the European Union (EU) is helpful in identifying the difficulties with these kinds of fluid multi-level arrangement, which are not fully institutionalized. For some they represent the possibility of flexibility and inclusiveness, involving new stakeholders and adapting to changing circumstances. For others it is not enough to talk about 'involvement', what we need to know is who is listened to, how accountability will work and how to predict outcomes (Marks and Hooghe, 2004).

One of the tasks for the case-studies will be to see how the Fund's new engagement with a broader set of actors is working out in practice, particularly where the views of different actors (state, IMF, civil society) come into conflict.

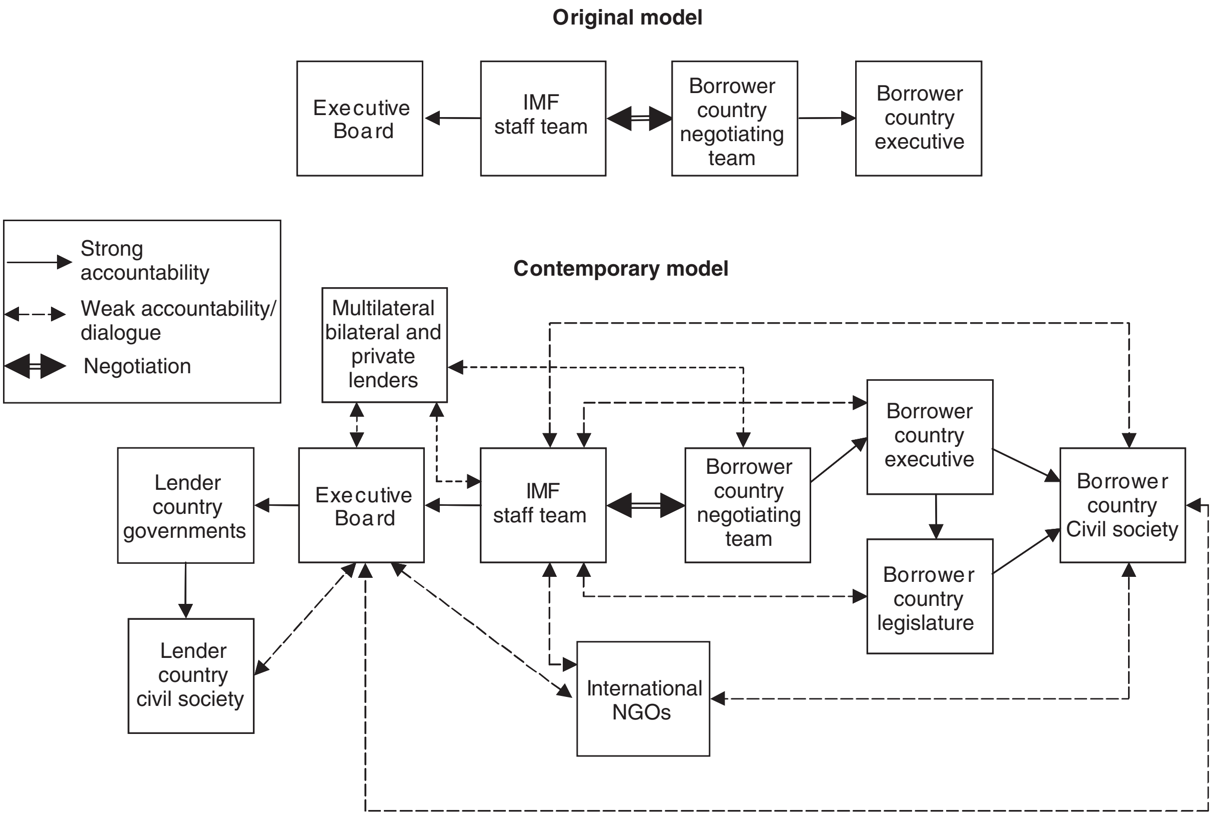

Figure 3.1 Old and New models of conditionality negotiations

3.3. Conclusions

The legacy of events in the 1970s and 1980s was to undermine the reciprocity that had, at least broadly, underpinned early Fund practice. It was harder to describe expanding conditionality as the logical consequence of a broader set of reciprocal international obligations, designed to preserve system stability. Executive Board discretion was less likely to be restrained by the possibility that all countries might borrow. Weighted-voting, therefore looked increasingly problematic. Overall, a great deal more weight would have to be placed on claims that the Executive Board could provide neutral, technically defensible solutions to countries' adjustment policies on the basis of economic reasoning.

The new agenda of the 1990s needs to be seen against that background. Resurgent capital flows promised new benefits for middle-income countries. On the other hand, the Fund could promise less in the way of public funds to insure against the risks of market-engagement. Instead, it promised to act as a catalyst for private capital flows by locking in market-friendly reforms in borrower countries. Those reforms were highly significant and took the IMF into sensitive domestic political territory and could only be implemented with the cooperation of a wide range of domestic actors.

The question was whether this bargain would turn out to be a good one, and whether it could be sold to the wider range of domestic actors that would be affected by the Fund's preferred reform agenda. A greater openness in IMF dealings with developing countries and 'civil society' was supposed to make the task easier.

On the other hand, the core decision-making body within the Fund, the Executive Board, had remained unchanged. It was still designed as a technocratic institution, insulated from political engagement. That raises questions about how much power, rather than simply voice, was to be transferred to the new actors involved in IMF decision-making. Would good governance and civil society engagement ease the politics of implementation or would they raise false expectations and create disillusionment? How could technical Executive Board authority be reconciled with more political engagement?

These are the questions we will explore in Part II, using the experience of IMF interventions in the Asian financial crisis.

Part II

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4
The Asian Crisis and the Case Studies

This chapter explains the relationship between the context I provided in Part I and the specific case studies of the Asian crisis that form the rest of Part II. I show how the discussion in Part I shapes the questions that are asked in the case studies, so it will be clear how the lessons from them fit into the argument as a whole. The chapter also provides a brief overview of core Asian crisis debates so these do not need to be repeated in each of the case study chapters.

4.1 The politics of IMF legitimacy and the case studies

In Part I, I introduced the IMF's new agenda. I provided some normative analysis of the relationship between the IMF's institutional arrangements and the tasks it is currently performing. I also introduced the historical experiences of the Gold Standard and the Bretton Woods period as points of comparison.

I argued the 1970s and 1980s had seen an expansion of IMF conditionality and a weakening of the broader set of institutional arrangements within which conditionality was embedded. The result was a growing reliance on Executive Board discretion, justified on the basis of technical expertise and economic performance.

The Fund's new agenda for the 1990s was developed against that background. It involved even more significant interventions in domestic affairs, particularly a 'good governance' agenda of institutional reform. That is obviously problematic against the background of increasingly narrow IMF technical authority. On the other hand, the new agenda also promised rewards for good performers in the form of resurgent capital flows. The contemporary politics of financial globalization in middle-income countries is all about whether the trade-off between capital access and political reform is a politically acceptable one. It is not a question that can be answered in the abstract or on the basis of general policy statements. That is why the Asian crisis provides such a useful case study. Controversy over the crisis sprang from the new evidence it provided about the nature of this core trade-off and the IMF's role in shaping it.

I also showed that, during the 1990s, concerns with programme ownership and transparency had changed the relationship between the IMF and states. The IMF was becoming less tolerant of scapegoating, more transparent and more willing to engage with 'civil society'. The combination of greater openness and a more domestically significant governance agenda means that the politics of deciding whether the new agenda is acceptable or not will take us far wider than simply discussions within the Executive Board. It will involve uncovering the different meanings the grand capital flow-institutional reform trade-off has for particular political actors in particular places. Which aspects of the governance agenda are welcomed, which are resented? Do the advantages help to defuse the ubiquitous political problems that follow financial crisis?

The first job for the case studies, then is to explore the ways in which a range of actors in target countries (Indonesia and Korea) evaluated IMF interventions. Since I am keen to make an argument for thinking about economic development in terms of political economy, I spend some time in each chapter drawing out the relationships between pre-existing economic policy and political structures. I explore the reactions of particular actors to IMF interventions in the context of the existing domestic political economy to show that they are only fully comprehensible in those terms.

I am also concerned to place political reactions in the context of the broader issues raised in Part I. I am not just interested in whether or not particular actors were in favour or against particular IMF interventions. I want to explore what that says about the IMF's new role and the kinds of institutional decision-making that support it. What is the political significance of the Fund's current agenda? Do the new aspects of the Fund's role make programme implementation easier or more difficult? How did the process of negotiation and any interactions with civil society support or undermine the ways in which the Fund is trying to justify its agenda? What does that say about the prospects for the new agenda more generally, in other contexts?

As well as my crisis countries, though, I am also interested in the ways in which other countries interpret the politics of negotiation and implementation in crisis countries. How is that likely to affect their attitudes to the Fund's agenda and influence future discussions of policy within the Executive Board?

I assess the reactions of significant non-crisis countries in Chapters 7 and 8. For reasons that should be clear from Chapter 2, I have chosen one country likely to borrow from the Fund and one that only lends to the institution.

I have chosen to use Malaysia as a borrower country. Malaysia is significant because its own involvement in the crisis meant assessment of what was going on in other crisis countries was far more than simply an academic exercise. As a result, reactions were particularly powerful and easy to identify. The Malaysian government debated going to the Fund but decided against it and, after an experiment with Fund-style market-based policies, pursued a different strategy involving capital controls. The Malaysian case study serves two purposes. It enables an analysis of the factors leading to negative reactions to the Fund agenda. It also provides at least some form of counterfactual for Fund reactions to crisis: it makes it possible to say something about what was an inevitable result of crisis and what was actually the Fund's responsibility, springing from the particular policy choices it promoted in crisis countries.

Both sets of evidence are difficult to interpret. Malaysia's closeness to crisis is likely to have triggered a more powerful response than might be expected from other developing countries. Comparison between the Malaysian, Indonesian and Korean cases will demonstrate the ways in which the political significance of Fund governance policies varies considerably between different country contexts. This makes it difficult to make firm judgements about the broader significance of Malaysian views. However, an analysis of the politics of crisis in Malaysia and the other case studies will put us in a place to consider some of the relevant factors when we come to put the politics of the crisis as a whole together in Chapter 9.

The final case study is of US reactions to the crisis and to IMF policy. Part of the controversy surrounding the crisis involved criticism that the US was pursuing a narrowly self-interested agenda through the IMF. After the crisis, though, the IMF came in for high-profile public criticism in the US and Congress threatened not to comply with IMF requests for further funding. Both issues raise questions about the politics of US-IMF relationships and high-profile debates provide a useful window into the political processes at work. As I explained in Chapter 2, institutional responses to political challenge are a matter of strategic calculations about when to make substantive changes and when to just come up with new arguments. Understanding the politics of US-IMF relationships provides some insights into how these strategic choices are made and therefore into the politics of post-crisis reform.

I draw lessons about the IMF's role and institutions at the end of each chapter. These conclusions are drawn together in Part III.

4.2 The politics of the Asian crisis

Before looking at the individual cases, though, it makes sense to get a feeling for the general debates surrounding the crisis. What happened? What was the broad thrust of the IMF response? Which alternatives were proposed and what was the political significance of the choices the IMF did make? Once those general debates have been reviewed, we will be better placed to explore the politics of crisis in particular countries.

The Asian crisis was essentially about a reversal of capital flows from very high inflows during the mid-1990s to a massive outflow beginning in 1997. That capital outflow, in turn, triggered exchange rate collapse, stock market freefall and widespread insolvency of banks and corporations.

The yen-dollar exchange rate, which had encouraged investment in Asia in the early 1990s, became less favourable in the run up to the crisis and there were some fears that rising wage rates were making some countries vulnerable to competition from China and Mexico, but nothing in these changes explained the magnitude of investment swings (Krugman, 1998; Radelet and Sachs, 1998b). It is difficult to avoid the conclusion that the crisis sprang from some combination of over-investment prior to the crisis and panic-induced disinvestment during 1997 and 1998. The controversy concerns the causes of the boom and bust pattern and the appropriate method for dealing with it.

The crisis, then, was a relatively pure financial crisis. The issues were centrally about the politics of financial globalization. The crisis experience provided new evidence on the balance between the potential benefits of liberalized capital accounts and the costs that countries might incur in adjusting domestic institutions to the imperatives of free capital flows.

The IMF was inclined to see domestic institutions as the key to the crisis (though it acknowledged other factors). Its remedy concentrated on 'fixing' those institutions in an effort to restore market confidence. For the Fund's critics, the problem was more with the operation of financial markets and should be resolved by various forms of administrative control (either temporarily to resolve crisis, or more radically, permanently).

Controversy over the crisis revolves around four technical issues:

- Did the fact that the crisis happened show free capital markets are inherently unstable, or did it highlight the need for Asian financial institutions to converge on a better, Anglo-Saxon model?
- What are the advantages and disadvantages of the kinds of nationalist economic policy pursued in the different Asian countries?
- Even if the Fund was right about the disadvantages of nationalist policy, were a combination of high interest rates, tight fiscal policy and radical governance forms likely to halt market panic and capital outflows?
- Would a more administrative solution to the crisis, involving debt standstills or capital controls, have a better chance of dealing with crisis?

In the face of on-going technical controversy it is also important to explore the political implications of choosing between the various options.

In this section, I will provide an overview of the Fund's response to crisis. I will then go on to introduce each of the four technical controversies and to suggest some of their political implications.

4.2.1 The IMF diagnosis

The IMF's emphasis was on domestic policy failure, although there was also some acceptance that there had also been problems with international capital markets.[1] Given that emphasis, its solution to the crisis concentrated largely on domestic reform:

> Although the roots of the current difficulties lie mainly in the countries most affected, developments in the advanced economies and global financial markets contributed considerably to the build-up of the imbalances that eventually led to the crisis…[but]…The main responsibility for taking appropriate measures lies with the countries concerned (IMF, 1997d, 40–41).

As we will see, that focus on domestic failure provided part of the legitimation for a crisis-resolution strategy concentrating on market-friendly domestic policy and reform in an attempt to re-establish market confidence.

The domestic policy failures, according to the Fund, sprang from:

> Limited experience among financial institutions in the pricing and management of risk, lack of commercial orientation, poor corporate governance, and lax internal controls…[leading to]..imprudent lending including relationship banking and corrupt practices (IMF, 1997d, 12).

The detailed reasons for the build up of pre-crisis debt varied between countries but the basic pattern was similar across the region. Governments had encouraged short-term lending when liberalizing capital accounts. Government policy, particularly the maintenance of fixed exchange rates, had encouraged market actors to underestimate risk. In some cases close relationships between government and business had created 'moral hazard'. Essentially, investors had been led to believe that firms would be bailed out by governments if they failed, encouraging investment without proper risk assessment. Poor corporate governance and lack of transparency provided additional reasons for foreign investors to rely primarily on the investment decisions of domestic banks rather than more independent risk assessment. Much of the credit build-up was in the form of short-term, foreign-denominated loans to the domestic banking system, which were then lent on very profitably to the domestic market, unhedged against exchange rate risk and at much longer maturities. Unfortunately, the banks involved were underdeveloped and poorly regulated and investment quality was often questionable.

For a combination of reasons, then, foreign debt tended to be directed through weak domestic banking sectors on the basis of perceived implicit government guarantees. Under these circumstances, risk was effectively country risk: what mattered to foreign investors was the government's ability and willingness to bail out the domestic corporate sector. The crisis began when it became clear that governments were unwilling or unable to do so. To make matters worse, 'lack of transparency delayed public realization of the scale of the problems' (IMF, 1997d, 10).

In Korea the problems revolved around close relationships between banks and large conglomerates – the *chaebol*. A history of government credit direction and, more recently, the sheer scale of particular banks' exposure to particular corporate groups made it difficult for banks to exercise market discipline. There were increasing signs of poor investment performance within these groups in the run up to the crisis (suggesting that they were getting more capital than was rational) but the markets may have discounted this because of (mistaken) perceptions that the government would not allow groups to fail. The occult nature of *chaebol* accounting practices may also have made it difficult to appreciate the severity of the crisis and poor banking practices concealed non-performing loans (Boresztein and Lee, 1999).

In Thailand and (to a lesser degree) Malaysia, the problem was over-exposure of bank and non-bank financial institutions to artificially inflated stock and property markets. Fixed exchange rates meant that currency exposures had not been properly hedged. The Thai government had also given the impression that it was willing to bail out finance companies more or less indefinitely. In Indonesia debt was often incurred directly by large corporations but there was very little available data on overall corporate debt levels.

Finally, central banks had been at best evasive over their reserve positions. The sharpest phase of the crisis in Thailand and Korea came when the markets received unexpectedly bad news about true reserve positions. That information was particularly crucial in an environment of moral hazard as it indicated that effective government guarantees no longer existed.

The crisis, then, was triggered by a collapse of market confidence, which, in fact, had been somewhat fragile even before the crisis. Particularly important were a loss of faith in domestic banking systems and government balance sheets. The largely short-term nature of foreign lending to the domestic banking system, in turn, made crisis countries particularly vulnerable to this kind of change in sentiment. Once investors began to withdraw, a self-perpetuating cycle began. Capital withdrawals forced exchange rate decline, which made it difficult for borrowers to repay their (largely foreign-denominated) debt, triggering further withdrawals and further exchange rate collapse. Once that cycle began it became individually rational for investors to withdraw on the expectation of further collapse, regardless of the viability of their underlying investments.

4.2.2 Alternative views

Although elements of this account are accepted by most observers at some level, there are strong and important disagreements about emphasis. Whilst some independent economists broadly supported the Fund position, others offered trenchant public criticism. For the Fund's critics, its analysis makes too many excuses for the way international investors were acting and obscures the extent to which patterns of boom and bust are endemic in financial markets.

Although different economists posit different mechanisms, the underlying dynamic of 'mania, panic and crash' is well documented.[2] The 'true' value of financial assets is determined by expectations about the future income returns on the underlying asset. Assessments of anything other than the very short term are difficult. Instead, investors find a reason to move in to a new market. That new investment triggers an increase in prices and therefore further investment. So, for example, economists have noted a pattern of very sharp capital inflows following emerging market capital account liberalization (McKinnon and Pill, 1996; Palma, 1998). A price bubble then grows during the 'mania' phase until prices become clearly unsustainable ('panic') and the cycle goes into reverse with withdrawals lowering prices and encouraging further withdrawal ('crash').

For the Fund's critics, the other factors listed in the IMF account (price bubbles, fixed exchange rates, poor banking practice, lack of transparency and moral hazard) may have been present to some extent but should be seen as the particular conditions that facilitated a far more general pattern of events in financial markets. There were problems in Asia but the problems were not as severe as the Fund implied and certainly didn't justify the sheer scale of boom and bust that was observed. The key weakness in Asia was a reliance on unstable short-term capital.

As part of that case, criticisms are also raised about much of the data the Fund relies on. Radelet and Sachs point out that, although many authors talk about real estate and stock market bubbles in the affected countries, very few provide any evidence. When the figures are reviewed, they suggest the need for modest corrections not massive price collapse (Radelet and Sachs, 1998a; Radelet and Sachs, 1998b).

On transparency, it is now widely accepted that there was enough data to raise serious questions about the build up of short-term debt before the crisis struck (Council on Foreign Relations, 2000). The Bank For International Settlements reports, for example, noted this build up as early as January 1996 and by June was arguing that the volume of flows to emerging markets was adding to:

> concerns related to the sustainability of the rallies seen in securities markets, the instability of short-term bank flows, and the spreading of the market tiering faced by Japanese banks to a broader spectrum of participants (cited in Wade, 1998).

The kinds of government-business relationships the Fund argued had led to an inefficient allocation of capital and therefore a decline in market confidence had been well documented for years and cannot, in themselves, have caused the crisis. As to the related moral hazard argument – that investors knew there were problems but invested anyway in expectation of a government bail-out – the markets were not acting as though that was the case. Credit ratings remained positive and interest rate spreads relatively low right up to the outbreak of the crisis. Moral hazard may have been a factor in Thailand and Korea but is hardly enough on its own to explain the crisis (Radelet and Sachs, 1998a; Radelet and Sachs, 1998b).

For these writers, there were problems with Asian banking, corporate governance and government policy but there are problems with government policy in all countries, particularly emerging markets. The problems were simply not enough to account for a crisis on the scale of the one that took place in Asia. We should be asking at least as many questions about the way international capital markets function as about Asian corporate governance. Market failure, rather than poor policy, was at the root of the crisis.

Conclusions

The difficulty is that the arguments are largely about the relative importance of a range of potential causal factors. The different factors and their effects are difficult to measure and separate empirically but the different interpretations and emphases have important consequences for thinking about crisis resolution and evaluating the IMF programmes.

I will look into some of the empirical detail further when we come to the country case studies but ultimately the evidence is inconclusive. Neither account is easy to dismiss as wholly intellectually dishonest.

The differences, though, are highly important politically. The Fund's approach is confident about the advantages of free capital flows but suggests the need for significant political engineering in Asia. The critics' approach reverses these priorities, arguing that more should be done to correct problems with market allocation of finance.

4.2.3 Crisis resolution

Despite controversy over crisis causation, there is general agreement that once the crisis took hold it involved a cycle of loss of market confidence, capital withdrawal, and exchange rate collapse, leading in turn to further loss of confidence. To stop the crisis this cycle needed to be broken.

The IMF's solution was to deal with the crisis by attacking the market confidence aspect of the situation; providing incentives for investors to return to Asia. There were three parts to that: large-scale lending and a tightening of fiscal policy to improve the prospects of debt repayment; high interest rates to signal good returns on new lending; governance reforms designed to address what the Fund saw as the root causes of the crisis and therefore reassure investors that Asia was safe for business (Fischer, 1998a; IMF, 1997d).

It is this market-based solution and the breadth of the reforms to corporate governance that the Fund felt were necessary to implement it that are at the heart of the controversy over crisis resolution.

Fiscal and monetary policy

The Fund's monetary and fiscal policy has been most widely attacked, even by economists that are largely sympathetic to the Fund world view. The programmes looked suspiciously like the typical response to a balance of payments crisis – deflationary policy to reduce demand for foreign goods until the balance of payments stabilizes – rather than appropriate policy to deal with the very different capital account crisis actually taking place. The Fund has argued that this is a misinterpretation of IMF intentions. The aim was to use interest rates as an incentive for re-investment (Fischer, 1998b). Fiscal policy tightening was a mistake, corrected later in the crisis, but at the time designed to provide government savings for recapitalizing the banking sector on the expectation that recovery would be swift (Boorman et al., 2000; Lane et al., 1999).

There is more or less unanimous agreement that the Fund's early fiscal policy was mistaken. However, there remain differences of opinion over how seriously that damages the Fund's technical reputation. For some it was a tricky judgement call on which the Fund went the wrong way. Others are more critical :

> quite frankly, a student who turned in the IMF's answer to the question 'What should be the fiscal stance of Thailand, facing an economic crisis?' would have gotten an F (Stiglitz, 2000).

When it comes to the interest rate position, though, opinion is more divided. Some see no alternative to the IMF approach (Corsetti et al., 1998). Others, though, argue that the Fund was ignoring the negative effect high interest rates could have on credit risk. A high potential rate of return on loans is no use if the borrower goes bankrupt because interest rates are too high (Kregel, 1998a; Kregel, 1998b; Radelet and Sachs, 1998a; Stiglitz, 2000).

Underlying these technical arguments about macroeconomic policy is the suspicion that tight money was partly a political decision. The Fund's 'judgement call' (if we're being charitable) was biased by a desire to reassure the Executive Board that crisis countries would be put under maximum pressure to spend their resources on repaying loans rather than reflating their economies. Some early comments from IMF staff reinforce this view.[3] On the other hand, Executive Board members have claimed macroeconomic policy was purely a *staff* decision (Stiglitz, 2000). One possible explanation is that staff were acting on what they *thought* were Executive Board preferences and the Board was bowing to what it thought was staff technical expertise (a pattern I suggested was likely towards the end of Chapter 2 above).

For most economists, though, the decision to raise interest rates was more or less inevitable if the crisis was to be resolved simply through market incentives rather than more interventionary methods such as payments standstills or compulsory debt roll-overs. In a sense the interest rate question is subsidiary to that larger strategic decision which we will explore shortly. That strategic decision, though, is also tied up with the Fund's views of the relationship between domestic governance problems and market confidence, so we need to examine those arguments before we can move on to the central issue.

Governance reform and market confidence

The Fund essentially makes two arguments for the importance of governance reform ('structural measures' in Fund parlance). Firstly governance problems caused the crisis. Secondly, dealing with those problems is essential to restoring market confidence:

> The problems of weak financial institutions, inadequate bank regulation and supervision, and the complicated and non-transparent relations among governments, banks and corporations were central to the economic crisis. IMF lending to these countries would serve no purpose if these problems were not addressed. Nor would it be in the countries' interest to leave the structural and governance issues aside: markets are sceptical of half hearted reform efforts (Fischer, 1998b).

In short, the Fund's claims are precisely the ones that we saw were key to the Fund's broader arguments about the importance of governance under financial globalization. Stable globalized financial markets are dependent on market confidence, which is, in turn, dependent on good governance.

Although the governance and market confidence aspects of the Fund argument appear closely related, it is important to point out that they are also logically independent. It is possible that governance problems did cause the crisis but that trying to fix them would not restore market confidence. It is also possible that, even though governance problems did not in fact cause the crisis, the market belief that they did so might mean governance reform was essential to resolving the crisis. I will therefore look at the two issues as two separate debates, starting with the question of governance.

As we have seen, the Fund's concerns with governance in the region were largely about the ways in which institutional arrangements encouraged a non-market (and therefore inefficient) allocation of capital. The Fund's concerns varied somewhat across countries, as we will see in more detail in the case studies. In Korea the problem was that too much capital was going to increasingly inefficient *chaebol*. Since that money was also directed through the Korean banking system, corporations had high debt-equity ratios which made Korean business particularly vulnerable to interest rate changes. It was a high-risk, low-return system in which bank practice and government policy combined to undermine market discipline (Boresztein and Lee, 1999). In Indonesia, there were similar sorts of problems with money lent directly to large, politically well-connected corporations and there were also a range of 'trade restrictions, import monopolies and regulations' driven by political considerations (IMF, 1997d).

The solution was a series of governance reforms designed firstly to reduce the role of the state in the economy and secondly to enhance market discipline more generally. These reforms were primarily portrayed as technical measures designed to enhance efficiency. However there was also a second argument at work that focussed on the opportunities that non-market relationships created for 'rent-seeking' and corruption.

On the basis of Fund accounts, one might think that the case was technically and morally straightforward. However, the Fund case is merely one intervention, albeit a very powerful one, in a debate that has been going on since at least the 19th century and which, for middle-income countries, is at the very heart of the politics of financial globalization. The mainstream debate on the problems globalization causes for the nation state has centred on a Northern agenda about state social and welfare provision and workers' rights (Mosley, 2003). In emerging markets, and particularly in Asia, the debate is more about industrial policy and economic nationalism. Since economic nationalism is, by definition, a fusing of economic and political goals, the debate quickly takes on a very powerful political significance that sits uneasily with the technocratic aspects of IMF authority claims.

Dismantling institutions designed to further industrial policy is a political move in the obvious sense that it requires countries to readjust policy to Fund preferences. However, the kinds of mechanism that are used to further industrial policy also create political relationships in the country concerned, so the effects of policy change are not confined to economic efficiency. Policy change is also likely to restructure the balance of political power in the country concerned. The case studies will provide a better idea of the political significance of industrial policy in different places. For now, I will concentrate on the trade-offs that are made in making economic judgements about the value of industrial policy.

The more technical part of the debate is ultimately about the ways in which economic growth takes place under late development. The neo-classical model of growth, underlying Fund prescriptions, sees growth as exogenous to economic policy. If the short-term allocation of resources is as efficient as possible, growth will naturally follow. Free markets and competition are all that are required to maximize growth.

However, there is also a long tradition of arguing that, for late developers, issues are more complex (Gerschenkron, 1962). Very strong market discipline on the allocation of capital will tend to induce a short-term outlook amongst investors. Economies of scale and scope and the risks attached to adapting technologies to domestic circumstances may be significant barriers to industrialization. Governments will therefore need to provide incentives for investment in strategic industries. Whilst traditional economists are sceptical that governments can do this effectively because of information constraints, the situation is slightly easier for *late* developers (Amsden, 1990; Woo, 1991). Strategy can be developed on the basis of experience with technologies elsewhere and doesn't involve making very contingent judgements about cutting-edge techniques. These investments are likely to be inefficient in the short term but may nevertheless be good policy.

Whilst there may be a theoretical need for this kind of intervention, many economists remain highly sceptical of governments' ability to implement effective industrial policy. Leaving aside the informational advantages that are supposed to be held by markets, as soon as governments are in charge of allocating resources or market opportunities ('rents' in the literature) there is a risk of corruption. From an economic point of view there are two problems. The first is that resources will be wasted in trying to capture rents rather than invested in production and the second is that allocatory decisions will be made on the basis of political influence rather than business expertise (Krueger, 1974).

For industrial policy enthusiasts,[4] on the other hand, the assumption that government rent allocation *will* create inefficiency and corruption is just that, an assumption. Rent-seeking may create severe problems in some circumstances and quite limited ones in others. What is necessary is an evaluation of the particular techniques that are used for allocating and monitoring rents in particular political contexts.

In fact there are a wide variety of policy techniques available to encourage longer-term investment horizons. Government can take on a very directive role, offering tariff protection, tax breaks, or subsidized credit to strategic industries. Alternatively, slightly more market-driven policies can be introduced like patents in industrial countries (which are essentially rents designed to encourage innovation), or an emphasis on bank rather than equity finance. In Asia, high debt-equity ratios and concentrated lending patterns between particular banks and particular companies were risky,[5] as the crisis demonstrated, but they also had a certain logic in the context of industrial policy. Close relationships encouraged trust and information exchange between companies so that banks could make decisions on the basis of future prospects as well as current earnings. Asian banking relationships were often a form of quasi-equity in which bank patience during a low-return investment phase might be rewarded with higher interest payments later on. That sort of relationship is impossible under a more Anglo-Saxon equity-based system in which relationships are more arms-length and contractual and based largely on published information (Porter, 1992; Singh, 1998).

Different techniques predominate in different countries and have different risks depending on the political context. There is no denying that industrial policy is a difficult strategy to pull off, requiring high levels of bureaucratic expertise and a business-government relationship that is collaborative without impairing bureaucratic independence (Evans, 1995). As we will see during the case studies, there were genuine problems with corruption in each of the crisis countries but the nature of these problems, and the advantages of various non-market interventions, varied considerably across different countries. The industrial policy arguments are strongest in Korea, more problematic in Malaysia and quite weak in Indonesia.

The first key criticism of Fund governance policy, then, is that it ruled out certain forms of legitimate development policy on the basis of questionable and rather blinkered technical conviction. That was particularly problematic because attacks on industrial policy have been a feature of US economic relationships with East Asia for a considerable period (Destler, 1995). Not only were claims to technical authority problematic, there was also the potential taint of political bias.

The second problem is that industrial policy also tends to be highly significant in structuring the domestic politics of countries that pursue it. Industrialization inevitably involves creating a sufficient concentration of capital to enable large-scale production and, therefore, creating and fostering a class of entrepreneurial domestic capitalists. Governments have always played some part in this process (even, for example, in the UK where the Enclosure Acts were a key adjunct to the industrial revolution). During that process, the state must channel resources to situations in which they will be used productively but it will also have to buy off powerful political opposition and may need to use resource transfers to secure political stability. Indeed in some states securing political and social harmony may itself be an important part of the development process.

Here again, the case studies will show the different ways in which capital redistribution was partly about industrialization but also very much part of the state-building process (and in Indonesia and Malaysia also the nation-building process). This close interaction between political and economic policy is uncomfortable for a quintessentially liberal organization such as the IMF. However, as soon as the Fund attempts radical interventions in domestic governance, they simply cannot be avoided, nor can they be dealt with by denial.

That raises two questions. The most serious one is about whether Asian corporate governance policies had anything to do with the crisis at all. Even if we accept that they did, though, the Fund's scepticism about the benefits of industrial policy may have caused it to underestimate the costs of dismantling economic nationalist institutions relative to other possible policy alternatives.

Whatever the relative costs and benefits, in the long term, of dismantling industrial policies, there are also independent questions about the extent to which committing to governance reforms was likely to trigger capital inflows by restoring market confidence.

I reviewed the Fund's arguments about market confidence and the catalytic effect briefly in Chapter 3. There are actually strong and weak versions of arguments about the relationship between IMF involvement and market confidence.

In the strong argument, merely signing a letter of intent should enhance market confidence because conditionality acts as a commitment technology. The IMF is risking its money and reputation on the policies concerned and the threat of credit withdrawal and public embarrassment ensures that the country concerned will implement the agreed policies. In the weak argument, good policies implemented under IMF advice will restore market confidence through their expected beneficial economic effects over the medium term as policies are implemented.

Graham Bird has mounted a concerted assault on the logic of the stronger version (Bird, 1997; Bird & Rowlands, 1997). He argues that the markets, rightly, take limited notice of announced policies unless there is some evidence that they will in fact be implemented. Without evidence, or at least the likelihood of implementation, the IMF's 'seal of approval' is unlikely to make much difference, particularly given that over 50% of IMF programmes are never completed. It is even possible that conditionality will be a negative indicator in some cases. The fact that the Fund felt the need to include measures in a coercive programme may imply that the government does *not* in fact want to implement them. Equally, on the historical evidence, agreement of a Fund programme is often an indicator of the need for future programmes – it is a lead indicator of trouble ahead rather than imminent recovery.

Finally, even the weak version will only be successful if Fund policies are actually likely to achieve results that foreign investors are looking for. Here Bird points out that different types of investors will have different requirements. High interest rates will attract currency traders and inter-bank loans (though since many such loans are denominated in LIBOR their effects may be limited) but may repel FDI since they have the potential to induce recession.[6]

In other words the catalytic effect is likely to be most successful where the Fund's self-image proves an accurate description of what is going on: where its policies are better than those a country would suggest and where conditionality is genuinely owned. That suggests that enhancing IMF legitimacy may be able to start a virtuous cycle of greater ownership and improved performance. However, if there is less confidence in the IMF's ability to press through reform, or in the quality of Fund advice, confidence in client economies may be elusive.

In the context of the Asian crisis, these criticisms were raised informally by Jeffrey Sachs who argued that the arrival of the IMF gives all the comfort of seeing an ambulance outside one's door (Radelet and Sachs, 1998a, 33). Sachs added another plank to the argument by suggesting that where market confidence is key, including large numbers of issues in a Fund programme may create problems that did not exist before. Once the Fund has told the markets these issues need to be resolved, the markets will not be satisfied until they have been, regardless of whether they caused any objective problems. The longer the programme the more bad news is given to the markets. The IMF was 'screaming fire in the theatre' (Sachs, 1998).

The issues surrounding industrial policy and the 'catalytic effect' are both controversial. What is important is that highly respected economists raised a coherent critique of the Fund approach in a variety of public fora. In the light of my discussion of the logic of technical authority in Chapter 2, we can see that technical uncertainty had the potential to be very damaging to IMF legitimacy.

Empirically the issues are difficult to resolve as there are a number of possibilities. If market confidence returned quickly it is possible either that the Fund's structural policies were appropriate or that the markets believed (wrongly) that they would be. If confidence did not return it could be because poor implementation undermined confidence; because the markets were waiting for results rather than merely efforts at reform (after all such policies would take a long time to implement); or because the markets were not impressed by the Fund's technical diagnosis.

In the event confidence did not return quickly, at least relative to the IMF's public expectations at the start of the crisis, as we will see from the case studies. However, why that was will need to be explored further in the case studies.

Politically both issues are also highly charged. Rent-seeking provides a justification for market liberalization, which is in the interests of foreign business, since it makes it easier to operate in the country concerned. The catalytic effect is important because it is a crucial justification for the Fund's market-based approach to crisis and for the extent to which the size of Fund resources has fallen behind volumes of world trade and capital flows. If the Fund's justifications for structural reform are weak, that raises the suggestion of political bias. If the catalytic effect is less powerful than the Fund would like to believe, that raises questions about market-based approaches to crisis resolution and undermines the arguments for structural reform and the case for the Fund's role in stabilizing financial globalization.

Lender of last resort, international bankruptcy and moral hazard

The issues of macroeconomic policy and promoting market confidence through governance reform are very important. In a sense, though, they are secondary to the most fundamental choice the Fund made about crisis. Once the crisis took hold, it was about a self-perpetuating cycle of capital withdrawals, causing exchange rate depreciation, which increased credit risk, causing further capital withdrawals. The question is how this cycle can be stopped.

The IMF chose to deal with the crisis by trying to persuade investors to stop withdrawing capital, by making the country look like a more attractive destination (higher interest rates, governance reforms, and a large injection of Funds). The question is whether or not something more concerted should have been done to forcibly stop the outflow of capital.

The 'correct' solution will depend on whether the crisis was best seen as a crisis of liquidity or one of solvency. If it is only a liquidity crisis, if there is nothing fundamentally wrong with the economies concerned save for market confidence, a market-based solution, combined with an injection of liquidity is a sensible solution. It is ultimately costless as the loans provided can simply be repaid (although there are issues about the appropriate charge for such high-risk lending). The Fund is playing a role analogous to a lender of last resort in domestic banking systems (Calomiris, 1998; Fischer, 1999a).

If, however, market confidence does not return, the lender of last resort role becomes very problematic. If the situation ultimately ends in bankruptcy, then the liquidity injection will have been transferred to banking system creditors who should in fact have incurred heavier losses than they did. A lender of last resort operation becomes a 'bail-out'. Creditors escape the consequences of their risky sovereign lending and the government is left with even higher debt owed to the IMF instead of private creditors.

The classic solution is to mitigate the risk by lending only at a penalty rate (so that the LLR is only called on in need) and on good collateral (so that something can be seized if things go wrong) (Bagehot, 1873). It is also important that there is a good domestic bankruptcy system in place, both so that liquidation is a realistic option (preventing the moral hazard that springs from banks which are immune to failure) and to assist in recovering some of the last resort lending if a bad decision has been made to attempt a rescue.

The problem with the IMF's operations in Asia is that there did not seem to be any sensible exit option in place. Domestic bankruptcy legislation was poor and there is nothing equivalent on an international scale. The IMF's injection of liquidity was not sufficiently large to eliminate risk to foreign lenders (and was in any case slowly disbursed in order to keep some leverage over the reform process). The idea behind the intervention was that the added effect of policy reform would compensate for the shortage of funds but this did not seem to work in practice.

What might the alternatives have been? There are difficulties with anything that really approaches an equivalent to bankruptcy at a domestic level since creditors cannot seize large parts of national assets to maximize their returns (although that was a solution occasionally adopted in the 1890s (Fishlow, 1985)). Instead solutions involve either an extension of more private funds while the country grows out of the liquidity crisis, some kind of debt rescheduling or write-down, or a combination of the two.

The difficulty is that there is a collective-action problem involved. Assuming that the country is going to recover eventually, it is in everyone's interests to provide the finance or debt forgiveness required in the short term. However, *ex ante* the results can never be certain and individual lenders may wish to avoid being exposed to the relevant risk. There is therefore a need for some kind of administrative solution capable of forcing creditors to come to the negotiating table. There are a number of possible options from sharing clauses in loan contracts, to 'moral suasion' from regulators (the option eventually adopted in Korea), to a legally sanctioned moratorium on debt repayments combined with supplies of interim working capital and probably with some form of capital controls.

The political controversy over the Asian crisis springs from the different distributional implications of these various possible approaches. The lender of last resort approach is always costless to creditors and either relatively costless or extremely expensive to crisis countries, depending on the outcome. The more administrative measures are all cheaper for the crisis country in the short term and more expensive for foreign creditors. However, there is a very important but inconclusive debate about how expensive they may be over the longer term. There is a danger that more aggressive forms of debt workout may impair future market access (either in particular countries that have recently rescheduled and might therefore do so again, or throughout emerging markets through the potential of future workouts), costing crisis countries more over the longer term.

As Giannini points out, the lender of last resort role creates:

> An enormous problem of legitimacy, because the lender of last resort function inherently involves redistributing resources. Up to a point, this may be done on a purely technical basis…Beyond that point…there is a tendency [domestically] for political institutions to become involved. There are also good grounds for believing this is desirable, at least up to a point, insofar as it helps to protect the legitimacy of the agent…within its technical realm (Giannini, 1999, 16).

There may ultimately be reciprocal benefits involved (everyone gains from greater financial stability) but there is a great deal of uncertainty and they are hard to quantify. In view of the incentives involved, it is hardly surprising that the institution charged with acting as LLR finds itself with either insufficient resources or insufficient discretion to carry out its role with the necessary speed and commitment.

The political problems are clear from the widespread criticism that the Fund's solution to the crisis ultimately bailed out foreign creditors at the expense of Asian governments (and therefore tax payers) (Kapur, 1998; Krugman, 1998; Radelet and Sachs, 1998b; Wade and Venerosso, 1998a). For others, though, the Fund was making a difficult choice about the relative costs of short-term crisis and longer-term penalties from reduced market access.

The counterfactual problems involved in assessing the likely consequences of different courses of action mean that this issue, like the others, remains contested.[7]

Of course, since the measures to restore market confidence that the Fund hoped would assist its liquidity injection were the structural and macro-economic measures reviewed above, the two sets of issues are also deeply interwoven. The structural measures were required to restore market confidence, so would they have been necessary if an administrative solution had been adopted earlier? Would that solution also have avoided the problems caused by high interest rates? In practice, market confidence failed to materialize. Was that because the structural measures were ineffective, because the Fund's diagnosis of a liquidity crisis was mistaken, or because funding was inadequate or disbursed too slowly?

4.3 Conclusions

The Asian crisis and the case studies that follow, then, help us to understand the complex politics of the choices at stake when emerging markets confront financial globalization.

It should already be clear that the crisis raised issues that were political as much as economic. The discussion in section 4.2 is more or less where economic debates on the crisis end. For us they are very much the beginning. Section 4.2 has explained the logic of economic arguments surrounding industrial policy and market confidence in the domestic context. It has also brought out some of the distributional significance of the more international aspects of the Asian crisis debates.

The technical arguments are all controversial, though, and it is by no means clear that economic debate and empirical evidence can resolve them conclusively. Their relevance for us is that the different arguments set the boundaries for reasonable debate over what went on in Asia. They therefore provide for different positions on whether or not Fund interventions were a good idea and on what that tells us about the way the Fund operates. The case studies that follow are concerned to identify and explain the ways in which different arguments were taken up in different places, what that says about the sustainability of the Fund's current role, and what might be done to reduce political controversy in the future.

5
South Korea

So far, our enquiry has tended to involve relatively general analytical questions about the adequacy of different kinds of economic and political arguments. The next four chapters will provide some extra empirical detail to flesh out the economic debates introduced in the previous chapter. The main emphasis, though, will be an analysis of political significance and political causation, through an exploration of concrete political agency. The economic issues discussed in the second part of Chapter 4 form the background for our discussion but what really matters here is how and why different arguments were taken up by particular political actors.

In Chapter 1, I argued that financial globalization would have a different significance in different social and political contexts. Even where there is technical consensus about the outcomes of particular economic policies, some of their effects will be more significant to particular actors than others. If we are going to answer the questions I posed in the first part of Chapter 4 about political reactions to IMF intervention and their significance for IMF legitimacy, we will need to uncover the political significance of IMF-approved policies in the different crisis countries.

This chapter, then, begins with a brief overview of the post-War Korean political economy to highlight the political relevance of the IMF's market-friendly agenda for financial reform in Korea. That will help us to see the kind of power that the IMF was exercising in Korea and the meaning IMF interventions had for particular domestic groups. I then provide a brief chronological view of the crisis, showing how the central debates reviewed in section 4.2 above played themselves out in Korea. I go on to draw out the political significance of the crisis and analyze the way in which the politics of crisis were managed.

I argue that the IMF's interventions in Korea are difficult to justify in purely economic terms. Its market confidence approach to crisis was not very successful. That raises questions about whether restructuring the Korean economy was strictly necessary in terms of the Fund's mandate. However, the measures were relatively popular in Korea for reasons that are largely political. It is possible to take away positive messages about the Fund's new agenda but there is also room for doubt about an increasingly political agenda, which may not be as economically essential as the Fund would like to suggest.

5.1 Background to the crisis

This first section sets out some of the context against which the crisis and subsequent IMF interventions acquired their political meaning. It begins with a broad outline of the technical economic arguments surrounding the 'developmental state' system in Korea. It shows how the economic logic of state-sponsored export-oriented industrialization had an accompanying political logic, related to state-building and the creation of a Korean capitalist class.

5.1.1 Technical controversy

The key technical argument in Korea concerned the consequences of close relationships between the Korean state, banks and a number of large, family-run business conglomerates (the *chaebol*).

For the IMF, too much credit had been delivered to the *chaebol* through the Korean banking system in the pre-crisis period. Banks had two sets of incentives to over-lend and to continue extending credit even in the face of poor performance.

Firstly, political patronage and the sheer economic might of the *chaebol* led to expectations that failing *chaebol* would be bailed out. Secondly, once banks were heavily exposed to particular *chaebol* they had incentives to respond to bad performance by supplying even more credit in the hope of creating future growth – the prospects of *chaebol* failure were simply too grave to contemplate. The overall effect was a lack of market discipline and inefficient capital allocation.

Matters were made worse by a severe lack of transparency in *chaebol* accounting and corporate governance practices. *Chaebol* tended to get their finance from the banking system, partly for historical reasons. During the 1970s and, to a lesser extent, 1980s the government had used credit allocation as a key mechanism for controlling the *chaebol* (Woo, 1991). As a result, there was little incentive to foster an equity market or to institute corporate governance rules that would promote transparency, allowing investors to make capital allocation decisions on the basis of objective information. Although, as we will see, state-bank-*chaebol* relationships had begun to change during the 1990s, limited information continued to provide incentives for maintaining the 'relationship banking' system. Lack of transparency hindered objective pre-crisis risk assessment. Worse still, the lack of an equity market meant that *chaebol* were very heavily leveraged: the majority of capital came from banks rather than shareholders, leaving corporations vulnerable to a rise in interest rates or a general economic downturn.[1] Reforming the system was essential to restore market confidence. It would also be good for the longer-term efficiency of the Korean economy.

For the Fund's fiercest critics, on the other hand, limits to market discipline were the secret of Korea's developmental state policies and therefore post-war Korean industrialization (Chang et al., 1998; Wade and Venerosso, 1998a). Competition had been limited and managed, maintaining incentives to compete and improve performance but on the basis of technological upgrading rather than price advantages. What had triggered the crisis was a relaxation of government control over the *chaebol* in the context of capital account liberalization in Korea during the 1990s. The developmental state system needed to work as a whole. Limited market discipline made sense in the context of a heavy state role to manage competition. Liberalization in the 1990s had removed restraints on market entry and the *chaebol* had over-invested in a rush to compete more fiercely in protected domestic sectors. The result was over-capacity funded by a short-term borrowing binge. It was market failure rather than lack of discipline that caused the crisis (Chang et al., 1998).

5.1.2 The politics of the developmental state

The developmental state system has never just been a set of valuable technical economic tools. It was driven by historical circumstances and political relationships as much as economic rationality (Cumings, 1998). For Chalmers Johnson developmental states have been:

> quasi-revolutionary regimes…[legitimated through] the overarching social projects their societies endorsed and they carried on (Johnson, 1999, 52).

The Korean developmental state was a revolutionary nationalist project designed to prevent re-subordination to Japan after the Second

World War and to protect Korea against communist threat from the North.

The *chaebol* were largely created by the state. Many *chaebol* started life on the back of patronage dispensed by Syngman Rhee in an effort to secure a conservative political bulwark against communism whilst, at the same time, building the basis of an industrial system. Those roots in illicit patronage were then used as a tool by Park Chung-hee to re-enforce the *chaebol*'s subordinate, if partly symbiotic, relationship with the Korean state.[2]

The developmental state relationship of 'embedded autonomy' (Evans, 1995) is often described in functional terms in the economic literature: a relationship that is close enough to ensure a good working relationship but sufficiently distant for the state to remain in charge. The political counterpart has been a power relationship in which a military-authoritarian state offered the *chaebol* favours in return for good economic performance *and* political support, including considerable political donations. Rather than growing up in opposition to a state-land owner alliance, the Korean bourgeoisie was always a creature of the state and a vital part of the state's overall economic project (Cumings, 1999).

The liberal vision of the bourgeoisie as the bearer of liberal and democratic values, then, sits uncomfortably in the Korean context. Korean corporations produce executive hagiographies stressing the company chairman's commitment to the national good. Economic downturns tend to be blamed on conspicuous consumption and a failure to strive towards national self-determination. The rhetoric is very different from a liberal celebration of individualism and equal opportunity to compete in the market place (Eckert, 1993).

For many Koreans, the *chaebol* issue is not just one of economics but is also tied up with Korean political authoritarianism, which was primarily legitimated on the basis of economic success. The *chaebol* were, again, key. They provided employment or at least the promise of social mobility in the future, paid reasonable wages and provided tax revenues that could be channelled to the countryside for those not yet directly benefiting. For those lucky enough to secure a *chaebol* job, the benefits were far reaching:

> The typical Hyundai worker drives a Hyundai car, lives in a Hyundai apartment, get his mortgage from Hyundai credit, gets health care from a Hyundai hospital, sends his kids to school on Hyundai loans or scholarships….(Woo-Cummings, 1999, 134).

Authority was also maintained through sporadic massive repression of any political protest or labour unrest, and the persistent and ubiquitous presence of the KCIA (Haggard and Moon, 1993).

Despite that combination of expanding economic opportunities and political repression, political dissent persisted. For a long time, it was largely confined to the student and labour movements. However, the development process created gradual social change in Korea. The urban working class expanded rapidly and, more slowly, a non-*chaebol* owning middle class of salary workers, managers, and small business owners began to emerge. The result was growing political pressure, which, in combination with one of the periodic crises of *chaebol* financing in 1979, was enough to bring down Park's regime. Struggles went on throughout the 1980s but the conservatism of the Korean middle class meant that it was not until 1987 that a wide enough coalition of support could be brought together to force a transition to democracy (Koo, 1993).

The immediate point of this struggle was a desire for political liberalization but it was also closely tied up with economic issues. The trigger for Park's decline was an economic crisis. By the early 1980s, a coherent economic criticism of *chaebol* dominance was beginning to be articulated in Korean domestic politics. The *chaebol* monopolized credit, starving the rest of the economy. Their size was driven as much by the imperatives of political power and patronage as by synergies between diverse business lines or economies of scale. Since the *chaebol* were family owned, concentration at the firm level also signalled a concentration of wealth in Korean society, actively assisted by government policy.[3]

Since Park's decline, all Korean presidents have felt that it was politically essential to do something about the *chaebol*. Chun Doo Hwan (1980–1987) and Roh Tae Woo (1987–1992) – the first democratically elected president) introduced legislation designed to curb *chaebol* product diversification and dilute ownership. They also attempted to prevent *chaebol* abuse of smaller subcontractors and to increase lending to SMEs through a system of bank lending quotas. Both, though, were caught on the horns of a dilemma. Attempts to reduce *chaebol* dominance through liberalization often resulted in further economic concentration, as the *chaebol* were best placed to profit from deregulation. The tendency then was to resort to legislation but this proved difficult to enforce because of *chaebol* power and political influence.

> The result was a regulatory albatross that, in the end, did not achieve its purpose…almost all major reforms of the last two decades…not

> only moved at a snail's pace, but went hand in hand with the proliferation of more regulations to obtain an economically desirable outcome. And few of the measures really worked (Woo-Cummings, 1999, 126).

Political liberalization under Rho created its own economic problems. Greater tolerance of union activism pushed up wages as the unions attempted to make up for past injustices. At the same time, political freedom started to erode the taboo on middle-class conspicuous consumption. Money politics was either becoming more important as democratic political parties started to compete for funds or was merely harder to conceal under democratic conditions. Observers began to describe Korea as the 'golf republic' and there were mounting concerns about the sustainability of Korean economic growth in the face of rising wage costs (Cotton and Van Leest, 1996; Oh, 1999).

5.1.3 Kim Young-sam and the background to the crisis

Kim Young-sam came to power in 1992 on the basis of a 'grand conservative coalition'. Kim, who had been considered a political radical, joined forces with the ruling party and Kim Jong-pil's conservative New Democratic Republican Party.

On the left of the coalition, and having received little support from his conservative 'allies' prior to election, Kim began his term with an attack on the corruption of old-style Korean politics. He released political prisoners, dismantled notoriously powerful political organizations within the military, instituted a 'real name' system for finance and real estate transactions, voluntarily declared all his assets and persuaded his ministers to do likewise, and promised to live frugally and not profit from his office. He took some steps to institutionalize appropriate political behaviour by passing new electoral laws that seemed to have more coercive bite than those of the past (Haggard, 2000).

However, this was only one part of the necessary agenda. The problem of *chaebol* dominance remained, coupled with concerns at declining competitiveness resulting from rising labour costs under Roh. This left a complex circle of demands that were difficult to resolve. *Chaebol* wanted more independence from government and the ability to fire workers, both of which, they argued, were essential for competitiveness. Labour wanted more autonomy from both management and government but without ending the Korean equivalent of the 'iron rice bowl'. Foreign trade partners, particularly the US, were again pushing for greater trade liberalization.

Gills and Gills argue that Kim Young-sam had three broad strategic choices available to him:

- Deconcentration first – domestic reform of the *chaebol* and measures to encourage SMEs could be carried out in conjunction with selective external opening so that domestic firms could adjust over time without the risk of external shocks.
- External opening first – particularly given US pressure, an attractive path would be to encourage domestic competitiveness through external competition. It would also force a transition from state direction to market regulation, again gradually reforming the *chaebol.*
- Democratization first – social goals should take priority over growth, at least for a limited period. An increase in welfare spending, redistribution of income from capital to labour and focus on social inclusion. Particularly important would be reforming the system of industrial relations to create less adversarial relationships (Gills and Gills, 2000).

Kim Young-sam appears to have been attracted to all three options for different reasons. The early moves outlined above suggested a deconcentration and democratization first approach. He also pursued further attempts at regulating the usual *chaebol* abuses: a focus on core businesses was encouraged, limits to *chaebol* holdings in private banks, limits on the expansion of subsidiaries, attempts to separate ownership and management through limits on family equity holdings and restrictions on cross payment guarantees.

However, after this first round of reforms, the *chaebol* began to assert themselves. Investment rates in Korea fell, overseas branches were set up instead and growth faltered as a result.

Some foreign opening was encouraged at this point in an attempt to substitute for *chaebol* investment. More importantly, though, the fear of unemployment and an emerging conservative middle class backlash against reforms caused political concerns for Kim. The business community used this opportunity to press for further foreign liberalization, to encourage Korean competitiveness, and for a return to growth oriented policies. The 'external opening' approach was beginning to triumph.

It was at this point, in early 1994, that Kim announced his *segyehwa* (or globalization) policy. It was a catch-all term potentially compatible with all three strategic goals. In addition to trade and financial liberalization it officially included: greater participation in multilateral institutions (including OECD membership), education, the rule of law, human rights, market transparency, enhanced labour-management relationships, and ecological sustainability (Ha, 1999).

In keeping with the gradual political shift towards the interests of the *chaebol* and an external opening strategy, highest priorities were trade and financial liberalization which meshed well with the new enthusiasm for mutilateralism in the OECD and World Trade Organization (WTO).

However, there were other aspects. Greater multilateral involvement was also intended to further foreign policy goals by weakening dependence on the United States. OECD rules would promote a more flexible labour market but would also require greater political rights for unions to accord with International Labour Organization (ILO) standards. Both *chaebol* and labour were therefore enthusiastic but in fact inevitable conflict was merely delayed.

The multilateral aspects of the agenda would enable Kim Young-sam to portray the changes as part of a strategy to ensure Korea's global prominence, overcoming likely resistance to greater foreign investment from an isolationist population. Participation in international organizations might also fend off foreign pressure in some areas by appearing to offer concessions in others. So, perhaps, accepting moves to encourage liberalization and small and medium sized enterprise (SME) growth while working with other developing countries against the labour and competition elements of WTO programmes. Finally, external pressure could be used to provide external support and even scapegoats for awkward domestic reform (Bobrow and Na, 1999). Foreign pressure towards competition could be used as a catalyst to resolve the domestic deadlock between labour, the state and the *chaebol* that had characterized Korean politics throughout the 1980s (Jwa and Kim, 1999).

Overall, though, the tendency for *segyehwa* to incorporate so many different agendas made it difficult to criticize. As we will see, it was only when the government was forced to choose between priorities that problems began to emerge.

5.1.4 Conclusions

The Korean crisis took place in a country that was already in the midst of a complex and drawn-out political transition.

The developmental state system had been the result of much more than a technical vision of state-directed late industrialization. It had also been created as a revolutionary nationalist project, sustained by a close alliance between the state and a largely state-created business class.

A transition to democracy in 1987 had only produced gradual change in the structure of political power in Korea and financial liberalization had only begun to change the economic system. Korea's response to globalization was still being fought out politically. Labour, the *chaebol* and sections of the bureaucracy remained poised between the advantages the old system offered them and the potential to gain from further liberalization if it was pursued in an advantageous fashion.

It is against that background that we need to see IMF interventions.

5.2 The crisis in Korea

Now that the political and economic significance of crisis debates is clearer we can move on to an examination of what actually happened during the crisis in Korea.

In this section I will largely concentrate on the ways in which the broader arguments about the crisis, introduced in Chapter 4, were articulated. I will begin by setting out the IMF's interpretation of the crisis and some of the evidence supporting the Fund position. I will go on to set out the alternative view put forward by the Fund's critics, before reviewing the political economy of the crisis in section 5.3.

5.2.1 The IMF diagnosis and remedy

For the Fund, the central factor was declining *chaebol* profitability in the face of rising wage costs and terms of trade shocks and against the background of the problems with market discipline explored in section 5.1 above. However, for a number of reasons, the international financial markets continued to invest in Korea prior to the crisis.

Firstly, there clearly were government efforts to deal with the underlying problems. It was only in late 1997 that it became clear these attempts would be unsuccessful.

During 1996, Kim was attempting to push through legislation to increase labour market flexibility. He set up a presidential 'Commission on Labour Management Relations' with representatives of government, business and NGOs. Employers were trying to make it easier to fire workers, introduce substitutes and stop pay during strikes and to adjust working hours at will. The unions, on the other hand, wanted greater political rights, legalization of multiple unions and greater bargaining power for public sector workers, particularly teachers.

No real compromise was reached but a series of NGO proposals were eventually submitted to the government. When it became clear that there would be opposition to the new legislation in the legislature, Kim arranged for it to be passed at a dawn session in the absence of any opposition MPs. The legislation itself was heavily biased towards employers but widespread public support for the general strike that followed was as much about legislative tactics as about the substantive content of the 'reforms'. Kim was ultimately forced to back down in the face of protest from the Korean public and international bodies such as the OECD and ILO (Kim and Moon, 2000)

Secondly, in mid-1997, a 'Financial Reform Commission' was also looking into a reorganization of Korean banking regulation. The proposal was to consolidate the supervision of banks, securities and insurance within a single body – the Financial Supervisory Commission (FSC), reporting to the Prime Minister. However, here the problem was ongoing turf wars between sections of the Korean bureaucracy. The Bank of Korea (BOK) was unhappy with its continued subordination to the Ministry of Finance and the Economy (MOFE) and this was making it difficult to put together credible legislation that would get through parliament.

Finally, there was an ongoing question about the extent to which the government would be willing to bail-out struggling *chaebol*. When the first *chaebol* failed in late January (medium-sized Hanbo Steel), it was nationalized and the management were dismissed. However, it quickly became clear that large-scale corruption had been involved in lending decisions. The involvement of Kim Young-sam's son in the scandal was enormously politically damaging to Kim's 'Mr Clean' image, eroding his political power and contributing to the legislative difficulties we have already reviewed. It also raised broader economic issues, though these were not yet seen as pervasive:

> How could major banks have lent such vast sums and gone on lending apparently with no proper appraisal of either the steel mill's viability or the true creditworthiness of the borrower (Economist Intelligence Unit (EIU), 1997).

When Sammi Steel and Jinro followed in March and April a more concerted response was called for. The government, driven by fears for the banking system as a whole, encouraged banks to continue lending to troubled *chaebol* by offering them support through the Korea Asset Management Corporation, set up by the government for this purpose.

Domestic market reaction was largely positive, though there were some concerns about moral hazard in the treatment of Jinro. Nonetheless, at this point, credit rating agencies began to downgrade major Korean banks citing very much the issues that concerned the Fund: directed lending, over-regulation, too much competition in the financial sector and concerns over bad loans (Economist Intelligence Unit, 1997).

By the time Kia had failed in June and then been bailed out and nationalized in late October after a lengthy political wrangle, market reaction had become sharply negative (see Figure 5.1).

> Until yesterday the signs were encouraging. Two troubled *chaebol*...were allowed to fold earlier this year...At last the government appeared to be retreating from its all-powerful role at the head of the economy...The banks swiftly took heed, and called in loans from other *chaebol* heading for problems. The painful shift from a centrally planned economy to one based on the market had begun. With the bailing out of Kia...the government has returned to the bad old days (*FT* 23rd October 1997).

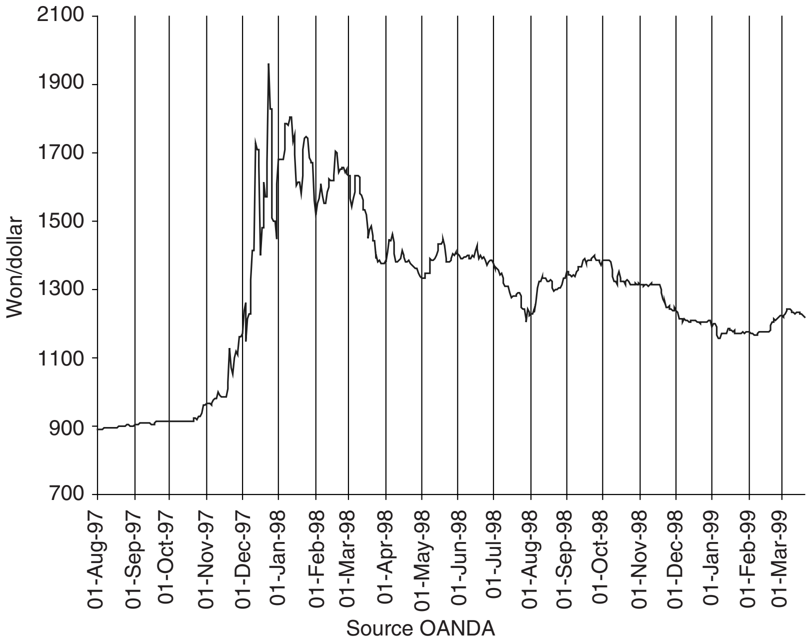

Figure 5.1 Won-dollar exchange rate

Standard & Poor's downgraded Korea's sovereign credit rating two days later, triggering a further round of capital withdrawal leading to further rating downgrades for Korean banks (*FT* 1 November 1997).

The last straw was parliament's failure to pass the financial reform legislation. A final attempt was made to calm the markets by announcing a package consolidating bank mergers and greater foreign access to the Korean bond market but it had little impact. Analysts were already saying that Korea had no alternative but to go to the IMF (*FT* 17 November 1997) and Camdessus was smuggled into Korea on the 23rd.

For the Fund, then, the crisis was about a lack of market discipline that encouraged banks to lend to *chaebol* despite declining profitability. Overlaying that fundamental problem were government failures to deal with the underlying issues through legislation and a pervasive problem with moral hazard. Investors hung on in Korea until it became clear that the government couldn't resolve problems in the Korean economy and then headed for the exits. The solution to the crisis was to restore market confidence by dealing with these underlying difficulties.

The Korea-specific features of the IMF programme, then, concentrated on *chaebol* reform. It promised to:

- limit the scope for *chaebol* owners to control large numbers of companies with limited equity stakes by outlawing cross shareholdings and cross guarantees
- make the *chaebol* more transparent by instituting consolidated audited accounts
- improve competition by removing limits on foreign equity ownership and by permitting mergers and acquisitions
- enhance banks' prudential regulation by placing all banks under the supervision of a single Financial Supervisory Commission and implementing Basel core principles
- open the banking sector to foreign competition
- secure central bank independence (Sohn and Yang, 1998).

The Fund programme also included various market-opening measures. The argument was that capital market opening would facilitate the capital inflows Korea would require for recovery. It would also remove the temptation for future government interference in the capital markets and, through the entry of more sophisticated foreign banks, enhance market discipline in the Korea economy.

Trade liberalization was not specifically justified, except to point out that it merely reflected an acceleration of previous WTO commitments. Presumably it could also be justified on the grounds of a further signal of government commitment to free markets.

5.2.2 Alternative views

As we saw above, critics felt the IMF had misdiagnosed the crisis. It was driven more by financial market failure than problems with Korean corporate governance. To the extent that there were difficulties they sprang from an erosion of government control over credit allocation. For some, abandoning the developmental state was a mistake (Wade and Venerosso, 1998a). For others it was ultimately a necessary move but could only be achieved through a longer process of adaptation, learning and regulation (Lee and Kim, 2000).

In either case, to resolve the crisis it was most important to deal with the debt issue directly. Capital account liberalization might eventually be a good idea, but it should be achieved at a more measured pace that allowed more scope for appropriate government regulation, not pushed forward quickly in the midst of a financial crisis.

The account of the crisis in sub-section 5.2.1 suggests that, rightly or wrongly, the markets *were* concerned about market discipline in the run up to the crisis, which strengthens the case for the Fund view to some extent. On the other hand, responses to the IMF programme were hardly euphoric. Crucially, for the critics, the first programme did nothing to stabilize the exchange rate. The turning point, chronologically, was the 'concerted' roll-over of short-term debt that took place on 24 December.

For the critics, the suggestion is that structural reforms were not necessary for crisis resolution and that these complex issues about domestic political economy should have been left to the Korean political system to resolve. The way to deal with the crisis was simply to negotiate a solution to the debt problem. For the IMF, on the other hand, it is still possible to argue that political uncertainty was undermining market confidence in the programme prior to Kim Dae-Jung's election. More concerted efforts at implementation coincided with the debt roll-over and market confidence was boosted by serious reform.

5.2.3 Conclusions

My own view is that the balance of evidence suggests financial markets were not working effectively. Fund complaints about corporate governance in Korea are accurate in the sense that the Korean system was not set up in a way that corresponds with Anglo-American norms. However, good investment practice should have taken that into account and adjusted risk assessments accordingly. It may well be that markets wanted the kinds of reforms the Fund was proposing but, if markets are less omniscient than some models suggest, that is not necessarily a good reason for instituting that kind of reform. The success of debt roll-overs suggests crisis can be resolved without doing exactly what the markets want, so there remains scope for political and technical judgement, independent of market preferences.

However, it is clear that technically credible arguments can also be made for the Fund position. The evidence is unlikely to prove conclusive either way and theoretical arguments are ultimately indecisive. That leaves scope for political debate. From the point of view of the politics of financial globalization, the question becomes one of the political support the different arguments were able to attract and how that influenced negotiation and implementation of the Fund programme.

5.3 Political interests and post-crisis reforms

The credibility of the economic arguments is, in any case, never all that matters in explaining outcomes. Whenever there is uncertainty there is room for different assessments of the risks of different policies or the plausibility of competing claims. It may not be that material interests always trump intellectual conviction in assessing plausibility but they are certainly likely to have a strong impact on risk assessment.

As I explained in Chapters 1 and 4, the political agency surrounding financial globalization is driven by the significance interventions have for particular actors. With a better understanding of the crisis, and the pre-existing political economy of Korea, we are in a position to understand the meaning of IMF interventions for Korea. How did Fund policies affect particular groups? Which factors were most important to whom, particularly in terms of the new governance agenda? How does that sit with the traditional basis of IMF authority? Were Fund procedures helpful in managing disagreements and tension? Did they help to make the Fund's position politically appealing, particularly in terms of civil society engagement? What does that tell us about the Fund's new role and the extent to which the Fund has the kind of political resilience I have argued is embodied in the idea of political legitimacy?

Corporate sector reform

Parts of the IMF programme designed to reduce the power of the *chaebol* were popular with large sections of the Korean population, as we might expect on the basis of the history presented in section 5.1. Data from a large-scale survey conducted in 1998 (Figure 5.2) indicates that *chaebol*-government relationships were the most popular explanation for the crisis (Shin and Rose, 1998).

However, the motivation behind reform was not necessarily identical with the IMF's concern for efficiency through market discipline. Kim Dae-Jung's central concern was with the *political* aspects of the state-business relationship (though expected efficiency gains were also an issue). Since he wrote *Mass Participatory Democracy* in 1971, he has been arguing that the *chaebol*'s market power and the tendency for patronage relationships to develop between business and government are anti-democratic.

He was labelled as an anti-business leftist when in fact he has always been closer to a classic free marketer with a preference for small and medium sized enterprises engaged in competition (Kim, 1985). The confusion came from the fact that, by Korean standards, his criticism of state control of the economy made him a radical. His

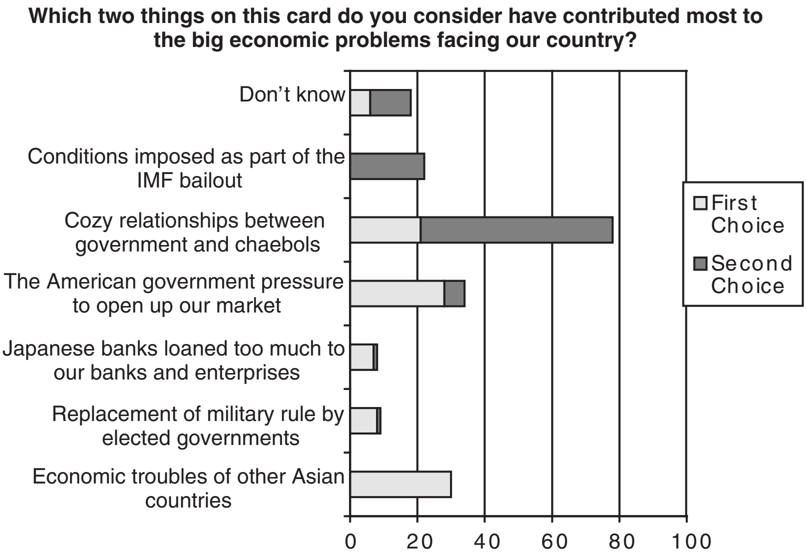

Figure 5.2 Opinion poll on crisis causation
Source: (Shin & Rose 1998)

concern with state intervention in the market extended to labour repression made it politically convenient for incumbent Presidents to label him a communist.

In fact mainstream Korean politicians have always been far more conservative than the radical student and labour movements and Kim was merely supported as the most radical politician available (Choi, 1993).

While popular opinion in Korea was in favour of restricting the *chaebol*, there were a number of countervailing interests. The Ministry of Finance and Economy stands to lose influence in a thoroughly deregulated economy[4] and civil servants were, in any case, threatened by crisis-induced government cut backs. The *chaebol* themselves, organized as the Federation of Korean Industries (FKI), were inevitably going to offer resistance. Finally, workers employed by the *chaebol* were in an ambiguous position. Extensive restructuring would mean job losses even if it ultimately suggested a weaker relationship between employers and government.

Market opening

As we have seen, financial sector liberalization was the area of *segyehwa* reform that received strongest *chaebol* support as it enabled them to free themselves from state control over credit allocation. However, broader market opening was more problematic, since they were major beneficiaries of domestic tariff protection. There was therefore a reformist strand within the Korean bureaucracy that had long favoured greater market opening, expecting it to force the *chaebol* to downsize or at least subject them to greater competition (Gills and Gills, 2000; Matthews, 1998).

In terms of the general public though, there were also important issues of national identity. The ideology of the developmental state has always been one of revolutionary developmental *nationalism*. The state-*chaebol* relationship was justified as a way to ensure national strength guarding Korea's independence from the North and Japan. Kim Young-sam's espousal of successful globalization as the mark of a strong nation in the new millennium had only partially counteracted these views.

From the beginning, it was clear that selling off considerable chunks of the Korean economy to foreigners was a deliberate intent of the programme (albeit in response to post-crisis capital shortages and in an effort to protect Korean jobs and economic growth). In an atmosphere in which asset values were deeply uncertain, there were real concerns that Korean assets would be sold to foreigners at knock-down prices.

Labour issues

Unemployment was, to some extent, an inevitable feature of the crisis. Labour was willing to accept job losses but wanted assurances that outstanding issues about political exclusion would be dealt with, that there would be a social safety net, that employers would suffer too and that efforts would be made to avoid job losses.

Macroeconomic policy and debt roll-overs

I addressed the national/international dimensions of the various options for crisis resolution from debt moratoria and repudiation at one extreme to complete government foreign bailouts of foreign investors at the other in Chapter 4. The initial IMF programme adopted a market-based approach. The second programme on Christmas Eve, though, included some concerted lending in return for a government guarantee. How hard (if at all) Korea had originally pressed for this solution in the first round of negotiations is unclear and the precise politics of negotiations are unknown. A recent report by the Fund's new Independent Evaluation Office (IEO) (based on full access to confidential Fund records) suggests that Fund staff did consider a roll-over in the early programme but decided it would be politically impossible (IEO, 2003). It may be that the Koreans took the same view.

My focus for now is primarily on domestic debates though, so I will review the significance of the narrower choices made about:

- the period of time over which the fiscal costs of the crisis would be met
- the speed at which interest rates would decline
- the political management of the inevitable negative economic consequences of high interest rates,

and the way those choices were justified and received domestically.

Tight money would theoretically encourage a swifter return to market access and provide banks with stronger incentives to force through corporate sector restructuring – limiting further waste of resources on trying to rehabilitate ailing corporate interests. The disadvantage was that it would produce a deeper recession, greater corporate bankruptcies, more unemployment and generally have a more adverse impact on the poor.

As the crisis progressed it became clear that credit rationing would encourage banks to direct what lending they were still doing towards larger corporate groups that had a stronger capital base and were more likely to receive government support. Bankruptcies and job losses were therefore concentrated in small and medium-sized enterprises.

That left a difficult dilemma, at least from Kim Dae-Jung's political perspective. High interest rates would encourage *chaebol* restructuring but they would also undermine the SMEs that Kim wanted to support as the heart of his new participatory economy. The strategy was akin to treating diseases with mercury: would the disease or the organism die first? For the opposition, tight money encouraged sales to foreigners, undermined the *chaebol*, and had a negative impact on Korean workers.

It should be no surprise, then, that the IMF's tight monetary and fiscal policies were heavily criticized throughout the crisis in the domestic and foreign media and by government ministers. Nonetheless, foreign political interests favoured a continuation of the status quo. High interest rates would promote corporate restructuring, a key factor in negotiating the second programme. Later, alliances were reported between the BOK and IMF on one hand (tight money) and MOFE and the World Bank on the other. Politicians seem, on balance, to have been pushing for faster interest rate cuts.

Summary

The kind of financial liberalization proposed by the IMF, then, had different political meanings for different actors.

Some groups, directly affected by the programme, had strong reasons to offer resistance – the *chaebol* being the prime example.

For many other Koreans, interests were mixed. Labour hoped to undermine employer power by discrediting the *chaebol* but also wanted to avoid job cuts. Small businesses could also expect to benefit from reduced *chaebol* dominance but the IMF's method of achieving that – market incentives through high interest rates – threatened to bankrupt them first. On the other hand, taking a longer-term view, they would be better off if they could survive.

In less directly material terms, there was political enthusiasm for reducing *chaebol* dominance, particularly if that put a brake on money politics. However, enthusiasm was tempered by economic nationalism and a reluctance to see the *chaebol* sold to foreigners at knock-down prices.

The overall effects on the economy would also be important but the extent to which the average Korean felt qualified to judge is doubtful.[5] It was important that a credible story could be told to the markets and it would have been self-defeating for politicians to pursue policy that was clearly catastrophic in economic terms.

Debates between broadly plausible policies, though, were not wholly or even mainly about efficiency. It was extremely important for politicians to articulate an agenda that was broadly appealing in its more obvious and direct effects on particular Koreans: questions about distribution or the kind of Korea they wanted to live in. That is essentially what I meant in Chapter 1, when I argued that financial globalization was likely to have different meanings to different actors, and would involve more than simply arguments about economic efficiency.

Overall there was the potential to mobilize popular support for the programme but there were also significant obstacles. There was room, then, for astute political management, which is where the Fund's new institutional agenda of broader outreach and the importance of political ownership becomes significant.

5.4 The politics of crisis management

We now have some idea of the political significance of IMF interventions. That political significance went well beyond technical questions of efficiency. Social forces were likely to be fairly tightly balanced on the impact of the Fund programme, the relationships between IMF, Korean political elites, and broader Korean society would be particularly key in determining the outcome. Programme implementation would require more than simply economic persuasion. The question now is how decision-making arrangements and institutions helped or hindered the prospects of implementation. How was the negotiation process perceived and what role did civil society engagement play in legitimating the programme? Could the Korean government and population be convinced that IMF interventions were at least a largely appropriate response to crisis, rather than unwanted interference in Korean affairs?

5.4.1 The IMF and the Korean state

Negotiations between IMF staff missions and government teams go on behind closed doors but the level of media attention on the Korean crisis means that press reports do provide some assistance.

Negotiations with the Kim Young-sam regime seem to have been fairly intense 'these are adversarial negotiations. Korea has no concept of a win-win outcome'.[6] The IMF accused the Korean government of releasing details to the press to whip up public opposition to the programme. The government retaliated by claiming that the IMF mission had made agreements, only to have them overruled by the IMF Managing Director, Michel Camdessus (*FT* 3rd December 1997).

Camdessus' involvement may reflect increasing political pressure on the Fund. There is certainly evidence of extensive US involvement in the negotiations. According to Bruce Cumings, 'even mainstream pundits found the International Monetary Fund to be the mere creature of US Treasury Secretary Robert Rubin and Deputy Secretary Summers' (Cumings, 1998, 52). High level US officials, including Summers, went to Seoul at the same time as the IMF mission and Rubin personally held up negotiations for 10 hours while insisting on new accountancy standards[7] (*NYT* 8 December 1997, Cumings, 1998, 53; Matthews, 1998) Academics were quick to point out the extent to which the IMF programme conformed with a long-term US agenda to open Korean markets and undermine the developmental state (see Chapter 8 for more detail).

Opposition politicians also expressed considerable reservations about aspects of the programme. Kim Dae-Jung, who would later become president, declared 5 December a day of 'national humiliation' but all three presidential candidates suggested they would like to re-negotiate aspects of the deal. Lee Hoi Chang (the candidate from Kim Young-sam's GNP) said the IMF was behaving like an 'economic conqueror'. There was some acceptance that corporate reform was necessary but Kim and Lee both felt IMF requirements for further capital account liberalization were inappropriate. Candidates were unanimously critical of IMF fiscal and monetary policy prescriptions (*Business Korea* Vol. 14 No. 12).

There was opposition to aspects of the programme, however it was certainly not absolute. Matthews argues there were three agendas in the negotiations. The IMF's calls for tight monetary and fiscal policy were largely non-negotiable. A second US agenda focused on securing greater US market access to Korea, particularly capital account opening, access for foreign banks, and related measures to improve corporate accounting. According to Matthews' contacts in the Korean Ministry of Finance, the Koreans traded concessions on this agenda (after all, as we have already seen, there were groups that favoured it anyway) for the inclusion of an agenda of their own: the labour market flexibility and corporate governance reform that Korean governments had been trying to implement since the 1980s (Matthews, 1998).

Matthews probably underestimates the IMF's own preference for a broader agenda. Much of the programme was, as he points out, atypical of past programmes, but it corresponds well with both the 1997 governance guidelines and programmes elsewhere in Asia. The details of which parts of the governance agenda were more or less acceptable to the Korean government remain unclear. The overall point, though, is that the Koreans were probably unhappy with the macroeconomic aspects of the programmes and some of the market opening requirements but also willing to use the IMF and US as scapegoats for other aspects of the programme.

As we will see, perhaps the most important convert to the IMF agenda was incoming president Kim Dae-Jung. Kim's initial opposition to the programme seems to have helped his election campaign (*FT* 11 December 1997, 20 December 1997), though other factors were probably more important.[8] Under (strongly resented) pressure from the IMF, Kim Young-sam called a meeting of the presidential candidates on 12 December at which he persuaded them to put their support behind the IMF programme.

What went on at that meeting is unknown. However, given the lack of transparency about the actual position of the Bank of Korea at this point and Kim's later claims to have been 'flabbergasted' at the scale of the problems, it seems likely that it was concerned with conveying the seriousness of Korea's position. The connection between the anti-*chaebol* aspects of the Fund programme and Kim's long-standing agenda to 'democratize' the Korean economy is also bound to have helped (Kim, 1985).

Implications

In terms of the way state-IMF negotiations are 'supposed' to work then, the picture is mixed. On the positive side, the Korean government was not as heavily coerced as some foreign and domestic critics have suggested.

The *nature* of agreement, though, is more problematic. It is by no means clear that the Korean government accepted the Fund programme because it saw it as the only 'correct' technical solution to adjustment under the constraints of an open capital account. There was disagreement about macroeconomic policy (and, of course, many economists would support Korean scepticism on that front).

When it comes to governance policy, it is even more difficult to see negotiations in technical terms. The technical vision behind the Fund's governance approach was contested and the reform agenda was highly significant politically. In the domestic context it involved re-thinking: the relationship between state-*chaebol* relationships and political power; Korean labour relations; the balance between short-and long-term investment preferences; regulation of foreign investment in Korea and (as we will see below) the Korean welfare model. Internationally, it played into long standing US-Asian trade conflicts.

It is much easier to see the outcome as a set of political bargains in which the Koreans were given rather limited room to manoeuvre, rather than as a technically indisputable consequence of the Fund's code of conduct. Perhaps more importantly, the US role in setting conditions was much more direct than the vision of technocratic Executive Board deliberation would suggest (though, of course, the Executive Board did eventually ratify the programme and the Europeans probably had no strong objections).

Having said that, there were also a range of political factors that encouraged political agreement and led to fairly enthusiastic attempts at implementation. Kim Dae-Jung seems to have calculated that there were political benefits to be had from the programme. It was broadly acceptable to him, at least in the face of IMF economic pressure (given the Fund's place as gatekeeper to international public funding and the self-appointed voice of the markets).

The programme provided Kim with an opportunity to use IMF and market pressure to help him deal with the political problems of reining in the *chaebol* and dealing with Korea's long-standing labour unrest. Those preferences were as much about altering the balance of power between different factions in Korean politics as they were about a particular (let alone an indisputable) conception of appropriate economic management.

Does any of that matter if the government was ultimately convinced? In the short term, probably not. However, it does raise two sets of potential problems in the longer term.

The first, which we will deal with more in later chapters, is that it sends problematic messages to middle-income countries that are less well disposed towards Fund preferences. If the Fund's new governance agenda is both highly significant politically and under-justified in technical terms, what does that say about the kind of power the IMF is exercising? It should be clear that this new agenda is difficult to justify in terms of the kinds of legitimacy claims we reviewed in Part I. It is much easier to justify in terms of a normative preference for democracy and a liberal preference for the formal separation of political and economic power. Those may (or may not) be desirable aims but they do not sit easily with the Fund's traditional mandate.

The second problem concerns the extent to which a controversial programme agreed by the state can then be sold to wide enough segments of the Korean population to ensure programme implementation and continuing political popularity. It is to that question that we turn in the next section.

5.4.2 Convincing Korean society

Successes

Opposition from politicians in the early stages led to significant concerns in the media. There were strong signs that some ordinary Koreans were unsure whether or not the crisis was actually caused by foreigners but fairly sure that it was being exploited by them:

> A senior US Treasury official backhandedly manipulated IMF negotiations to push for market opening while Japan used financial aid as a weapon to prop open the [Korean] domestic market for their goods (Editorial in the *Dong a Ilbo* 3rd December 1997).[9]

This point of view was, of course, particularly popular with the FKI – the *chaebol* trade association (*Korea Herald* 4 December 1997, 5 December 1997).

Early foreign and diplomatic assessments were negative about Kim's chances of winning over popular opinion, particularly because of considerable suspicion about Kim's 'populist' credentials:

> We could be in a position in which Kim Dae-Jung takes office in the midst of a financial emergency that is going to require a lot of pain and downsizing of South Korean business. Almost no-one thinks he will command the authority to pull it off (*New York Times* 20 November 1997, cited in Cumings, 1998).

However, once converted to the programme, Kim was quite successful in mobilizing popular support. His 'populism' was in fact a crucial advantage. It gave him credibility with the unions, facilitating his efforts to set up a 'Tripartite Commission on Fair Burden Sharing' (the Commission) to oversee negotiations between unions, *chaebol* and government. Camdessus explicitly assured the unions that the Fund would not stand in the way of appropriate concessions to labour and that was apparently an important factor in bringing the unions to the table (*FT* 14 January 1998) Kim also engaged in very astute political management of the crisis, using appeals to economic nationalism and democracy in his on-going battles with the *chaebol* for public opinion.

By the time the Commission met on 15 January, Kim had already forced the stalled financial reform bill through the National Assembly. He had also summoned chairmen of the top 5 *chaebol* to agree '5 principles of corporate restructuring' (the next 30 *chaebol* followed in February). This lent him credibility in brokering a deal in which labour would accept lay-offs and reductions in wages and working hours in return for assurances that the government would vigorously prosecute illegal labour practices by business and press for further corporate restructuring.

The agreement also provided for:

- 5 trillion Won for unemployment protection
- teachers unions and employees' associations for government employees to be legalized, unions' political involvement to be legalized, legalization of non-enterprise-specific unions
- legalization of lay-offs where there are 'urgent managerial reasons' including consequences of mergers and acquisitions but with assurances that business would endeavour to minimize downsizing and that it would be carried out on a rational and transparent basis.

Equally interesting, though, is the language of the Commission's announcements. It argued that the crisis sprung from a failure to adapt to the 'new economic environment' and that

> In particular, the government and business should be held accountable for their mistakes and for their inability in preparing against the economic crisis…all three representative parties of this tripartite commission will fairly share the unavoidable and inevitable burdens incurred…(Tripartite Commission, 1998, 165).

Although no measures on corporate restructuring were actually included in the Commission's final proposals, since these had been agreed elsewhere, specific reference to *chaebol* restructuring was made in the document:

> The government will implement a general policy for enhancing the transparency of corporate management including the elimination of debt guarantees for affiliated companies and the issuance of consolidated financial statements (Tripartite Commission, 1998).

Some effort, then, had been made to meet the criticism that labour was being asked to pay the price of management and government mistakes.

This narrow Tripartite Agreement was also supported by modest changes to the Korean welfare regime and by direct support for SMEs, meeting the concerns of two major groups outside the ambit of the agreement.

Social safety nets were particularly important for semi-skilled workers in smaller enterprises, since the *chaebol*-dominated unions were able to limit job losses in larger firms. In common with much of East Asia, welfare has been distinctly limited in Korea, with reliance placed on: low unemployment (historically around 2%), family support structures, and the *chaebol* lifetime employment system. However, urbanization, an ageing population and more flexible labour markets were undermining this arrangement prior to the crisis. Kim's response was significant but limited by concerns that welfare would undermine competitiveness. Nonetheless, unemployment insurance was extended to all firms with 5 or more employees and temporary relief was provided through workfare programmes, etc. (Haggard, 2000).

SMEs were particularly badly affected by the post-crisis credit crunch (Economist Intelligence Unit, 1998a). They were also a key part of Kim's political constituency. So, loans were rolled over twice and a variety of special SME funds (credit insurance, a central bank credit line, trade credits and four 'SME restructuring funds') were introduced (Haggard, 2000).

As well as these fairly concrete measures to neutralize opposition, Kim made efforts to win the broader support of the Korean people. He did this through tapping into strong domestic concerns with democracy and through a subtle re-configuration of Korean 'economic nationalism' which, in some ways, had been prepared for by Kim Young-sam's *segyewha* rhetoric.

Right from the beginning of the crisis, there had been some sympathy for an IMF-style response. In December, Business Korea argued that 'many Koreans are positive about the package' as it played into *segyewha* arguments about national competitiveness. Additionally 'it seems like Korea has been seen by some as an untrustworthy country in international society and it is believed that many Koreans are ashamed of such a reputation' (*Business Korea* Vol. 14, No. 12).

Kim built on these two sentiments in his political rhetoric. The Tripartite Commission argued that reforms provided scope for a 'second economic leap'.

> We understand that we must bear painful burdens, which we have never experienced previously. Nevertheless, if we cooperate and

> share the hardships resulting from these difficult times, we believe that we can overcome the upcoming challenges and create another "Miracle of the Han River" (Tripartite Commission, 1998).

He also drew on the Korean tradition of linking economic progress with a collective national struggle that I noted in section 5.1 above.

> We also appeal to the people to participate in our joint effort to conquer the current economic crisis by maintaining a diligent and frugal lifestyle. We ask you to conserve energy, refrain from taking overseas leisure tours, and engage in other like activities (Tripartite Commission, 1998).

While of dubious economic value, this sort of rhetoric struck a chord with the Korean people. Thirty eight per cent of Koreans saw a 'nation-wide frugality campaign' as the best way to raise confidence in the Korean economy (official press release 16 January 1998 – reproduced in Sohn and Yang 1998). The *Financial Times* argued that Korea was dealing with the crisis by a national mobilization resembling a war economy and Koreans ultimately donated a staggering US$2 billion in gold to replenish central bank reserves (*FT* 5 February 1999).

The other key rhetorical argument concerned the relationship between undermining the *chaebol* and promoting Korean democracy. Kim's inaugural speech blamed the crisis on democratic deficits springing from the collusion between politics and business and concluded that 'political reform must proceed everything else'… 'we can overcome today's crisis by practising democracy and a market economy in parallel' (Sohn and Yang 1998).

Overall, then Kim portrayed the reform agenda as one in which: big business will be forced to become more transparent while gaining greater autonomy from government; small business will be encouraged as the backbone of the new economy; labour will accept the costs of lay-offs in return for greater political representation, expanded social safety nets and more democratic enterprise relations; the Korean people will accept temporary hardship in the interests of creating a nation with the national image, competitiveness and globalized culture to compete in the 21st century world order; and foreign investment will be encouraged for the sake of competitiveness, offset by expanded exports to maintain national wealth.[10]

This strategy had considerable early success. A government survey in January 1998 found that 60% of 1,000 Koreans asked felt that the IMF programme would have a positive impact (Sohn and Yang, 1998, 296) and the Korea barometer survey carried out later in the year produced broadly similar results (Shin and Rose, 1998).

Ongoing challenges

Having said that, pockets of dissent remained and, if anything, seemed to grow as time went by. If the overall emphasis on breaking up the *chaebol* -government relationship was popular, there was less enthusiasm for the IMF's proposed mechanisms for doing so – preventing government bail outs of the *chaebol* and attempting to introduce market discipline through foreign entry. It is noticeable that, in the survey on crisis causation reviewed earlier (Figure 5.2) US pressure for market opening was a very popular first choice for crisis causation. In terms of crisis resolution, the same survey found that government subsidies were the second most popular solution to the crisis, considerably ahead of market liberalization.

Kim's method of dealing with the crisis was also far more state-centred than the IMF's preference for using market discipline to create rationalization in the wake of enabling institutional reforms. The government's official position was that it had:

> no intention to play a coercive role in forcing the breakup of the *chaebol*. We will leave it up to creditors and institutional investors to force reforms (Finance Minister Lee Kyu-sing, quoted in *FT* 23rd November 1998).

In practice though there was a great deal of intervention. That was clearest in Kim's enthusiasm for a series of 'big deals', forcing the 5 largest *chaebol* to concentrate on core business, exchange more peripheral subsidiaries, eliminate cross guarantees, and reduce debt-equity ratios below 200%.

The process was deeply confrontational, with sharp differences between the *chaebol* and the Blue House. The government accused the *chaebol* of obstruction and threatened to encourage banks to withdraw credit from offenders. The *chaebol*, meanwhile, tried to whip up nationalist sentiment in the hope that domestic banks would not be taken over by unsympathetic foreign management (Haggard, 2000). They also used a variety of accounting manoeuvres to maximize the apparent impact of relatively modest debt reduction.

For the second-tier *chaebol* banks were in charge of organizing debt restructuring. This looks closer to the IMF's model of creditor discipline

(Balino and Ubide, 1999) but even here the FSC exercised tight oversight of the process. So, for example, the first list of 20 'target companies' prepared by the banks was sent back to them by the FSC who asked for a longer list (eventually 55 companies) (Economist Intelligence Unit, 1998b). Foreign purchases were disappointing and much of the restructuring involved interest rate reductions more reminiscent of traditional Asian 'relationship banking' than the Fund's preferences (Haggard and Low, 2000).

There was also considerable resistance from labour, particularly as job losses began to spread from SMEs to larger businesses in 1998. The most high-profile dispute was a prolonged strike at Hyundai in the summer of 1998. At the height of the action, workers occupied a closed plant in Usan and riot police were preparing to go in when MPs intervened. They negotiated a deal cutting planned redundancies from 1500 to 277 (mostly female cafeteria staff) (Economist Intelligence Unit, 1998a). The Korean Confederation of Trade Unions (KCTU) also attempted to stage a 'general strike' in June 1998, though with only limited support. Both Korean unions groups walked out of ongoing Tripartite Commission talks in summer 1998 and again in February 1999.

Finally, despite Kim's attempts to reconfigure Korean economic nationalism, there were signs that nationalist dissent was growing in Korea by 2000. Well over half of the Korean population polled were against General Motors' take-over of Daewoo (Economist Intelligence Unit, 2000). During the April elections the opposition Grand National Party campaigned (only partly successfully) on the basis that Kim Dae-Jung was transferring wealth to foreigners and that liberalization should be halted or reversed. A late 1999 article by Kenichi Ohmae (of *Borderless World* fame) accused Kim of being an American puppet and abandoning Asian capitalism circulated widely to popular acclaim (Moon and Mo, 2000).

Implications

In some ways, the Korean experience has some very positive messages for the IMF's new agenda. Careful management of the relationship between the IMF, government and key social groups helped to present a positive interpretation of the Fund programme to groups that might have undermined implementation. IMF willingness to talk to the labour unions seems to have been particularly helpful.

On the other hand, the success of the Fund programme was reliant on very active political management undertaken by the Kim Dae-Jung government. Success was due more to the programme's expected political consequences than to any great popular enthusiasm for the economic reasoning behind it. In other words, Kim Dae-Jung, unlike the IMF, was very aware that the programme's success would depend more on its broader meaning to the Korean population than on narrow arguments about efficiency. He capitalized on concerns about authoritarianism, *chaebol* dominance and corruption but had only limited success in overcoming economic nationalist sentiment.

Propitious political circumstances were very important and those cannot necessarily be guaranteed in other places. The method of implementation was also more reliant on state action than market discipline. Both aspects are problematic for a Fund whose mode of operation requires it to come up with a set of measures that are capable of a more universal justification and transferable to other political and economic contexts. There is little in the Korean programme to suggest that people's natural liberal instincts or the Fund's technical credentials, alone, will be enough to secure implementation. Rather, the message is that, if the Fund is right about the institutional requirements for effective financial liberalization, only some countries are likely to have an appropriate social structure to underpin the changes required.

5.5 Conclusions

What does all this tell us about the nature of the IMF's new agenda and its ability to manage the political tensions involved?

The IMF's economic arguments were defensible but by no means entirely compelling. It is at least possible to argue that its governance reforms in Korea were not *necessary* (though they may have been desirable). They didn't seem to enhance market confidence, whereas a more concerted approach to the debt problem was more successful. At the same time, they were closely related to the long-term demands of at least one of the Fund's major shareholders.

In terms of the domestic meaning of financial globalization, we have seen that the Fund-mandated reforms had a wide ranging impact. Attitudes to the programme amongst the Korean population were shaped by their views on: democracy, clean government, economic justice, nationalism and even a form of economic asceticism. Economic efficiency was one factor but probably not the determining factor in selling the programme to the population.

The Fund's governance agenda and newfound willingness to engage with civil society do seem to have helped in programme implementation. Camdessus' support for the Tripartite Commission approach and reassurance to the unions seem to have been helpful. The governance agenda was obviously crucial to securing domestic support for the programme.

However, there were few signs that the Fund had designed its policies with Korean social and political conditions in mind. Much of the work in selling the programme was done domestically by Korean politicians. It was not so much that the Fund acquired renewed political authority through extensive public debate. Rather, there was a certain fortunate congruence between Fund policy and a set of social attitudes in Korea that were the product of a long period of social and political change. Korean success, then, need not necessarily make one more generally confident about the prospects for the IMF's new agenda. Success was more about 'performance' than the forms of authority the IMF has traditionally claimed.

As far as the Korean experience is concerned, that may not matter terribly much. However, there are dangers in terms of the messages that were sent to on-looking countries. The IMF programme is easier to justify in terms of liberal political values than it is in economic terms. It is questionable whether governance reform is really necessary, particularly in the context of crisis. The success of the programme seems to have owed as much to concerted debt roll-overs as it did to the Fund's ability to restore market confidence through governance reform. It is still possible to see political reforms as popular in the Korean context. At the same time, though, there are important questions about what would have happened if those reforms were not popular. The Fund's reform agenda was very much in line with long-standing US preferences for opening Korean markets and can still be seen as a set of very significant, externally specified, interventions in domestic Korean affairs.

6 Indonesia

If the Korean programme was largely a success, the Indonesian programme looks a lot more like a failure. Economic crisis quickly became political crisis. There was widespread political instability and bloodshed. Economic confidence in Indonesia is only just beginning to re-emerge, nearly six years after the crisis began.

In Korea I argued that Fund programmes were easier to explain and justify in terms of a liberal political agenda than they were in terms of the Fund's contestable economic claims. There, the liberal agenda commanded broad political support so the criticism was largely a point of principle.

In Indonesia, the political situation was very different both within government and outside it. If the Fund's agenda in Korea was mostly politically significant in theory (because it was pushing in a direction that Korean politics was probably going anyway), its Indonesian programme was enormously significant in practice. The IMF programme cut to the heart of systems of political patronage that had been essential to maintaining Suharto's power. Since 1965, those arrangements had maintained order and a relatively high level of economic growth at the cost of authoritarianism, restrictions on political liberties, corruption and injustice. The pre-crisis political economy was far more problematic than it was in Korea and, to that extent, the Fund's vision for a post-crisis Indonesia is more obviously appealing. However, the attempted transition involved a drastic and bloody re-engineering of the Indonesian political economy and much of the Fund's agenda proved impossible to implement fully in practice.

My approach in this chapter is to compare what happened in Indonesia with proposals made by some economists for a more pragmatic approach. That helps to show how the new governance and civil society agendas create important questions about the nature of IMF political authority. Deciding what should have been done in Indonesia is genuinely difficult and any assessment involves making uncertain counterfactual judgements. This chapter tries to provide the best available material for making those judgements but any conclusion will be controversial. However, whatever one's views of the final outcome, the Indonesian experience suggests the IMF was taking on a great deal of political power that was not well supported by Fund decision-making arrangements.

As with the previous chapter, I begin with the context within which the significance of Fund interventions needs to be understood. I then provide a brief account of the crisis itself, followed by an overview of the politics involved in forging responses. The different nature of the Indonesian political system means that, unlike the Korean chapter, this analysis is much more about the strategic calculations of elites than it is about popular opinion and popular reactions to the crisis.

6.1 Background to the crisis

6.1.1 Technical controversy

In some ways the technical debate over Indonesia is less complex. It has never been easy to defend Indonesian economic management in terms of a coherent industrial policy. Pre-crisis economic success was largely due to prudent macroeconomic management. Microeconomic interventions have often been justified in terms of either industrial policy or inter-ethnic redistribution but have actually been driven more by the imperatives of political patronage.

The controversy over the IMF programme is not over whether there was a strong economic justification for state intervention in the Indonesian economy. The question is how significant economic eccentricities were in causing the crisis and, relatedly, whether dealing with governance was a necessary or sufficient condition for resolving it.

That is particularly important because clear political opposition to the Fund's agenda was a key element in the failure of crisis resolution in Indonesia.

This background section, then, is about the ways in which political patronage distorted economic policy and how that fits into the broader Indonesian political economy.

6.1.2 The political economy of Indonesia's New Order 1965–1980

The problem of nation-building has been central to Indonesian political discourse since independence. Indonesia covers a vast area of land with a wide range of different ethnicities, languages and religions. Additionally, at independence, economic resources and education were heavily concentrated in the hands of ethnic Chinese and Europeans (Robison, 1986).

The danger of political disintegration provided justification for a highly centralized and authoritarian political system in which there was deep scepticism of any form of popular organization. On coming to power in 1965,[1] Suharto merged all pre-existing political parties into the nationalist *Parti Demokrasi Indonesia* (PDI) and the Islamic *Parti Persatuan Indonesia* (PPP). He also founded 'Golkar' – technically not a political party but rather an umbrella organization incorporating a huge array of pre-existing social groups (peasant groups, labour groups, bureaucrats, etc.) (Schwarz, 1999). It was very much a *state*-corporatist institution, designed as a vehicle for maintaining government support rather than a channel for the articulation of social interests (MacIntyre, 1992). The bureaucracy and military were very much the dominant 'social groups'. Other than that, under the doctrine of 'floating mass' the rest of society was to be depoliticized, with participation limited to 5-yearly elections.

Nationalism also provided the justification for economic policy. However, economic nationalism always had to compete with the drive for current economic efficiency. It was also always debatable where *pribumi* (indigenous Indonesian) interest ended and straightforward patronage began. The relative balance between these three elements (efficiency, nationalism and patronage) varied over time in response to changing economic and political circumstances (Robison, 1997).

During the 1960s, the emphasis was on macroeconomic stability and attracting foreign direct investment (FDI), in the wake of the virtual meltdown created by some of Sukarno's nationalist excesses. However, the investment laws introduced tended to encourage market-seeking FDI, which undercut existing domestic industry fuelling economic nationalist unrest (Robison, 1986; Winters, 1996).

During the 1970s, oil revenues provided space for greater economic nationalist experimentation. The early phase was largely funded through Pertamina, the state oil company, under the auspices of Ibn Sutowo. Ultimately his over-investment triggered a major debt crisis in the late 1970s but, in the process, it created some of the large

Indonesian conglomerates (often with Chinese partners) that would provide political support for later nationalist moves (Winters, 1996).

In the later 1970s, a raft of measures were introduced to direct credit to *pribumi* business, reserve some markets for *pribumi* endeavour and encourage *pribumi* equity participation. In practice, more was going on than simply attempts at ethnic redistribution and industrial deepening (MacIntyre, 1993). The largest use of state-directed credit was in dealing with Pertamina's debts. The other consistent beneficiary was the agricultural sector, partly due to anxiety about rural communism, but also because it appealed to both technocrats (comparative advantage in a labour-abundant economy) and the nationalists (a *pribumi* dominated sector). Indonesian government food distribution service (BULOG), the agricultural marketing board, was a key part of rural investment, stabilizing key commodity prices and serving as the vehicle for patronage in the form of monopoly distribution and processing contracts.

Some credit also went to *pribumi* industry but much was diverted to serve patrimonial interests and a good deal was never repaid, particularly by smaller borrowers (MacIntyre, 1993). Pressure to form joint ventures also had contradictory results. Large Chinese firms or indigenous firms with good political connections were more attractive partners than small indigenous business. Often domestic equity holders had their stakes financed by foreign partners and efforts to protect domestic markets were best exploited by large, pre-existing Chinese conglomerates (Robison, 1986).

Despite the increasing influence of patronage during this period, and resulting declines in foreign investment, there was considerable growth and technological upgrading. Import-substituting industries expanded strongly and gross domestic product (GDP) growth per annum was 7.7% between 1973 and 1981. Jomo et al. (1997) argue that Indonesia succeeded in avoiding the worst consequences of financial 'Dutch disease' by rapidly developing non-oil production and expanding non-oil exports. Between 1970 and 1980 agriculture declined as a share of GDP from 47.5% to 24.3%, with industry increasing from 19.8% to 43.1%. Much of this was the result of growth in oil revenues but manufacturing industry also increased from 10.9% to 13.4% of GDP in the same period and total factor productivity improved by a modest 0.9% (Jomo et al., 1997).

On the other hand, although some indigenous conglomerates emerged during this period, most were either Chinese-owned or had emerged from within the state itself (Robison, 1986).

Politically, economic nationalist policies were one way of dealing with political dissent in the 1970s. However, demands that surfaced in the early 1970s and culminated with the Malari incident in 1974 were only partly about economic nationalism. They also reflected middle-class concerns about increasing inequity and lack of political freedoms. This second set of demands were repressed rather than accommodated. The economic nationalist turn was accompanied by a tightening of political space with the passing of the Campus Normalization Law of 1978 and a series of press bannings in the 1970s and 1980s.

The state's support base was increasingly derived from the patronage opportunities that the nationalist shift had provided. Although overstated in some ways (Liddle, 1992), it is not surprising that academic accounts of the period tended to see Indonesia in the early 1980s as a 'patrimonial state' largely insulated from society, serving only itself (Anderson, 1983; Crouch, 1979).

Overall, then, the 1970s and early 1980s were a time of state centralization and increasingly dirigiste economic policies. Policy was officially designed to promote indigenous Indonesian business but in practice were as much about maintaining support for an authoritarian state through patronage. However, even in this period, the need to keep the economy moving in order to provide further patronage resources and in the interests of broader social legitimacy limited corruption – macroeconomic management was largely prudent (MacIntyre, 2000).

6.1.3 Political and economic liberalization in the 1980s and 1990s

Economic liberalization

Part of what facilitated the nationalist turn was the ability of oil prices to substitute for foreign direct investment. When the oil price fell in 1982, macroeconomic prudence began to take centre stage again, returning power to the 'technocrats' in Bappenas (the state planning ministry) and Bank Indonesia, just as a shift towards free market policies was taking place in the wider world. Equally, some of the larger Indonesian conglomerates were becoming less reliant on the state and had come to see it as restricting their activities. While wishing to retain state protection, they were anxious to make it easier to attract foreign investment and obtain access to sectors that had been state monopolies (Robison, 1997).

These priorities were reflected in the reforms that took place. Financial deregulation and relaxation of restrictions on foreign investment (both in terms of closed sectors and domestic equity requirements) were a key part of the reforms (Robison, 1997; Winters, 1996). Trade reforms were aimed, particularly, at removing import monopolies on upstream inputs to export-oriented industry. State monopolies on power generation, telecommunications, ports and road construction were opened to domestic and foreign investment. The state divested parts of some state enterprises and all of others.

However, reforms that were potentially less popular with big business – notably tax reform and the privatization of the customs service to boost state revenue – were also achieved, echoing the pattern of restraints when patronage threatened to get out of hand.

The reforms mobilized large amounts of capital. The private banking sector grew rapidly. By 1996 there were 200 domestic banks, domestic private banks accounted for 12 of the 20 largest Indonesian banks, and the private banks commanded 53% of funds in the banking sector (World Bank, 1995). Foreign investment, particularly from East Asia, increased rapidly in low wage exports and more sophisticated upstream production of chemicals, paper, pulp, power generation and construction (Jomo et al., 1997; Robison, 1997).

Contrary to the expectations of liberal reformers, though, the conglomerates' domination of the economy increased as a result. The politico-business families that had emerged during the late 1970s were best placed to take advantage of economic opening. Foreign investors' enthusiasm for politically well-connected conglomerates made the stock market a cheap source of funds. 'Inadequate rules and enforcement capacity allowed companies to go public without adequate disclosure, insider trading was rife and fake share scandals occurred frequently' (Robison, 1997).[2]

While considerable liberalization did occur in export sectors, cartels, price controls, entry and exit controls, exclusive licensing and public sector dominance remained widespread (World Bank, 1995). BULOG retained its central position in controlling access to domestic food and even allocated new monopolies during this period – notably the economically perverse clove monopoly awarded to Tommy Suharto amidst much controversy in 1990 (Schwarz, 1999) and a monopoly on fertilizer pellets granted to Suharto's grandson. Equally important was the state's ability to grant contracts for the construction, supply and maintenance of state 'mega-projects'.

Finally the rise of Habibie as Suharto's political protégé invigorated industrial policy. Habibie had an unorthodox vision of a direct leap into hi-tech industries, the most prominent example being his personal aircraft manufacturing project. Production was successful in that the plane was a reasonable product but it was by no means economically viable (Jomo et al., 1997).

Political liberalization

There were also signs of political liberalization. The shift in the modalities of patronage created tensions within the political elite, particularly between Suharto and sections of the military. These created a set of re-enforcing pressures towards partial political liberalization

During the nationalist period, Suharto's alliances with military figures such as Moertopo had helped in his economic nationalist struggles with the more orthodox economic technocrats. By the 1990s, the growing importance of politico-economic interests was alienating a faction of the military clustered around Moerdani, who felt the military's interests were being marginalized as resources were channelled to the emerging oligarchy.[3] The most obvious manifestation was controversy over Habibie's purchase of 39 ex-East German warships in 1994 (usurping military authority to secure refitting contracts for well-connected conglomerates). As new politico-business loyalties provoked tension with the military, the shift in priorities was re-enforced with Suharto seeking allies outside the state to balance military power. Factions within the military responded with pressure for greater political openness and social equality in the hope of breaking up the increasingly tightly-knit Indonesian oligarchy.

Neither the military nor Suharto wanted full democratization but growing openness did open space for political movements, which would become important during and after the economic crisis.

Suharto's energies were directed at capturing the Muslim middle class. Although possibly not his creation, ICMI (the Association of Muslim Intellectuals) was clearly supported by Suharto. ICMI was the source for a new collection of military and political bureaucrats loyal to Suharto and organized by Habibie. However, it also attracted a broader range of support encompassing contradictory political agendas. A variety of Muslims saw it as a long overdue avenue for the re-establishment of Muslim political influence.[4] That included right wing Muslims based in KISDI (Indonesian committee for solidarity with the Muslim world) and more moderate, populist, forces clustered around Adi Sasono and Amien Rais.

Sasono was connected with the NGO movement and was a champion of small-scale business, appropriate technology and the cooperative movement. However this was not just an Islam of egalitarianism and human rights. It also implied a preference for *pribumi* business, creating space to forge alliances with more conservative elements such as Suharto's brother-in-law Probosutedjo. Sasono publicly supported Suharto but was anti-military and had ambitions to turn ICMI into a mass political movement. Rais was more reformist, pushing for greater openness but, at least in the short term, within the confines of Golkar and the military-dominated state. ICMI, though, also attracted more radical reformers like Sri Bintang Pamungkas who was eventually expelled in 1996 for his outspoken criticism on issues such as human rights and corruption. Indonesia's largest Muslim organization, Nahdlatul Ulama (NU), stayed away from ICMI, because of concerns about becoming enmeshed in political power struggles.

There were also signs of a political awakening amongst the secular middle class in the flowering of a variety of NGOs and human rights organizations. These new groups had little direct effect in the short term. However, they became the object of increasing state repression during the 1990s, triggering further political mobilization. The trouble began when Suharto ended his flirtations with openness, banning three Indonesian news weeklies for their coverage of the warship fiasco. It escalated as Suharto became concerned that Megawati Sukarnoputri (leader of the PDI) was becoming a rallying point for middle-class dissent and, worse, was showing signs of forming an alliance with Abdurahman Wahid's moderate Muslim NU. Suharto responded by enlisting the help of more radical Muslim forces in KISDI and the military for a dirty tricks campaign against Wahid and, in July 1996, storming the PDI offices.

6.1.4 Conclusions

Overall, then, it is not surprising that the IMF was inclined to see the crisis in terms of rent-seeking. Economic and political management were deeply intertwined in New Order Indonesia. However, there were also important limits placed on corruption. It was not allowed to affect the overall macroeconomic position and the Indonesian economy did experience significant development.

More importantly, it would be a mistake to simply wish away the political logic of economic policy as 'irrational'. Compared to Korea at least, the rhetoric of economic nationalism in Indonesia was much more often merely a fig-leaf for patronage. On the other hand, it tapped into a strong vein of political support, given the history of *pribumi* economic marginalization and anxiety over national unity. The expectation that liberalization would automatically solve the problem was also misplaced. If anything the 'liberalization' that took place strengthened an increasingly narrow oligarchy and undermined any lingering control that the technocrats may have had over the Indonesian economy.

Prior to the crisis, though, a narrowing of the beneficiaries of patronage, combined with the gradual re-emergence of channels for political expression outside the confines of the state can be seen (in retrospect at least) as increasingly problematic for Suharto's political power.

6.2 The crisis in Indonesia

6.2.1 Crisis controversies in Indonesia

As with other countries in Asia, the Fund saw the crisis in terms of banking sector vulnerabilities combined with a collapse of market confidence. In Indonesia, though, market confidence problems were driven by a broader climate of poor governance and a consequent lack of competitiveness in the economy. It was also hard for the IMF to avoid the conclusion that banking sector problems were due more to a lack of state involvement in the sector than to state directed lending.

The Fund's solution therefore took the same broad form but the focus of structural policies was different. More importance was attached to 'the liberalization of foreign trade and investment, dismantling of domestic monopolies, allowing greater private sector participation in the provision of infrastructure, and expanding the privatization program' (IMF, 1997b)

Banking sector reform was central, as it had been elsewhere. It became clear relatively early on, though, that there would need to be bank closures together with 'steps to strengthen the legal and regulatory environment and establish strong enforcement mechanisms and clear exit policy' (IMF, 1997b)

These reforms were to be supported by a very significant effort to improve governance. New privatization procedures would be introduced to 'level the playing field for both domestic and foreign investors and thereby ensure investor confidence' (IMF, 1997b). Later a number of legal governance reforms were added to the programme including: central bank independence; a new competition law; new company law and accounting regulations; a consumer protection law; and new bankruptcy law.

The controversy over the Indonesian programme is largely about whether these measures were necessary and/or sufficient to actually restore market confidence.

There are two questions here. Were the widespread abuses in Indonesian economic management actually *causes* of the crisis (as opposed to merely economically problematic), given that they had been well known for many years prior to 1997? Secondly, did including such a wide range of measures in the IMF programme create market anxiety over matters that might not otherwise have been significant? For some, at least, the inclusion of extensive, immensely difficult reforms was akin to screaming fire in the theatre. For others it was more a matter of forcing Indonesia to pay for its bail-out than of actually resolving the crisis (McLeod, 1998; Pincus and Ramli, 1998; Radelet and Sachs, 1998a). After all, some of the trade measures went beyond pre-existing WTO commitments, something that had not happened to Korea.

For those inclined to take these views, the IMF should have concentrated on macroeconomic measures, combined with a much more direct attempt to deal with bank and corporate debt. It is notable that Indonesia never received the kind of forced debt roll-over that took place in Korea, for example.

In other accounts, though (including some later writing by the same authors), that view reflects widespread complacency about the real dangers of corruption in Indonesia. It is also possible to explain the timing of crisis by pointing to the increasingly concentrated forms of patronage that were emerging during the 1990s.

These technical controversies raise counterfactual questions that will be difficult to resolve, though I will discuss the evidence for the different positions in the next section. They also have a very powerful political significance. It should already be obvious that the Fund's policies cut to the heart of the patronage networks that were a key part of Suharto's political support. The fact that IMF policies would significantly alter the balance of power in Indonesia raises the stakes in the technical debate considerably. In practice, the political significance of the programmes also created problems with implementation (as we will see) and that makes it even more difficult to assess the outcomes of the Fund's 'technical choices'.

Overall, outcomes in Indonesia were much more problematic than those in Korea but assigning responsibility for the problems is difficult. What is clear is that the sheer political ambition of the Fund's Indonesian interventions is problematic for Fund legitimacy. Having said that, the options available to the Fund were also limited. In the section that follows I will draw out some of the political significance of IMF interventions, preparing the ground for an assessment of crisis management in section 6.3.

6.2.2 The crisis

Most commentators initially inclined saw Indonesia as a clear case of contagion. The rupiah came under threat in the wake of the Thai devaluation and initial government responses were in line with economic wisdom. The rupiah was allowed to float on 14 August, falling sharply but recovering as Bank Indonesia (BI) pushed overnight interest rates to 81% (World Bank, 1998), but the reprieve was short-lived.

In mid September, Finance Minister Marie Muhammed announced a package of measures including: fiscal retrenchment (particularly cancelling infrastructure projects); removal of import tariffs on 150 items; and the removal of 49% domestic equity requirements for listed companies. The markets saw that as a positive step but not enough to counter the credit risk arising from high interest rates (*FT* 17 September 1997). Behind the scenes, the technocrats had pushed for a more extensive programme but Suharto had rejected it, raising concerns amongst Indonesian insiders that he was more eager to take advice from his children (Haggard, 2000; Nasution, 2001; Soesastro, 2000).

Negotiations with the IMF began on October 13, and results were announced on November 5. The programme was followed by a brief exchange rate rise but the mismanaged closure of 16 Indonesian banks on November 1 created a widespread financial panic. The programme was also undermined by two swift failures in implementation. Bambang Trihatmojo (Suharto's second son) and Probosutedjo (his step-brother) refused to close their banks (*Jakarta Post (JP)* 2, 5 and 6 November 1997). Both eventually succeeded in staying in business under different names (*JP* 31 December 1997). Suharto also reinstated 15 postponed infrastructure projects, some of which provided benefits to the Suharto family without having any other obvious rationale.

As the cycle of deposit withdrawals and loss of confidence continued, BI pumped emergency credits into local banks. However, that only led to further attacks on the *rupiah* due to a combination of its inflationary consequences and the fact that recipient banks used credits to buy foreign exchange. Worse still, on December 9 Suharto announced he was seriously ill, sending the rupiah into freefall (presumably over fears about succession). Perceptions that the 6 January budget was wildly unrealistic, fuelled by US and IMF criticism, only made matters worse. By 15 January the IMF had negotiated a second package.

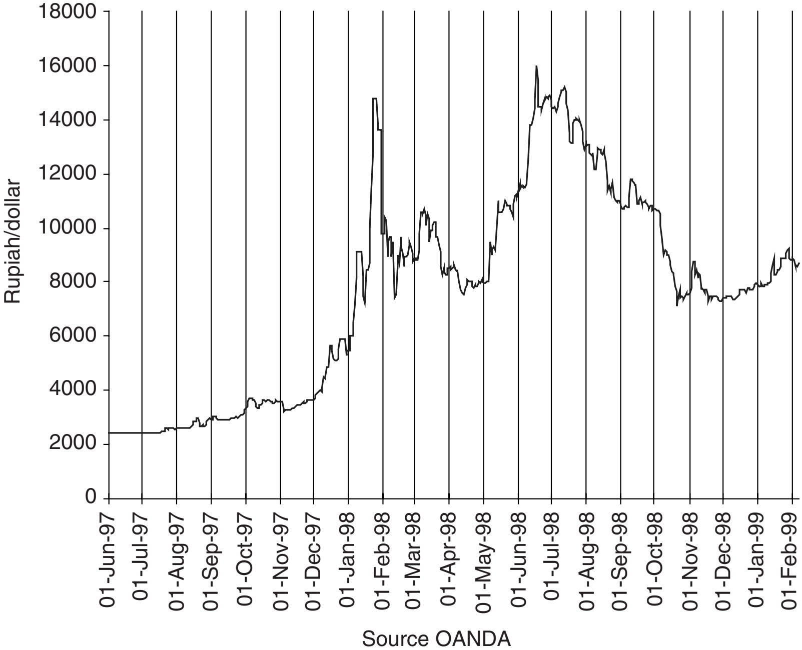

Figure 6.1 Rupiah-dollar exchange rate

It is clear that the first programme failed to solve Indonesia's problems but there is considerable debate about the reasons for failure. For the IMF's critics, the central problem was closing banks without being sufficiently clear about future closures or deposit insurance mechanisms (Radelet and Sachs, 1998a). Publicly, the Fund tended to place more blame on the signals sent by non-implementation but has also acknowledged mistakes (Lane et al., 1999).

In any case, when it came to the second set of negotiations, the Fund took the view that the only way to restore market confidence was an even more stringent set of reforms, signed publicly by Suharto with Camdessus looking on. The new programme promised: central bank independence; withdrawal of privileges for Tommy Suharto's 'national' car project and IPTN; elimination of cement, paper and plywood cartels; removal of restrictions on retailing; elimination of clove, flour, sugar and soybean monopolies and the phased elimination of subsidies on fuel and electricity. Despite that, the rupiah continued to fall, reaching 15,000 to the dollar by the third week in January (compared to 2,500 in July).

The situation only began to improve when a package of reforms aimed at restructuring the banking sector and rescheduling private debt was announced on 27 January (offering some support to critics' views that these were the real confidence issue). The package established the Indonesian Bank Restructuring Agency (IBRA) and provided a blanket guarantee of all domestic bank obligations. At this stage, though, no steps were taken to deal with the direct corporate debt of about US$73 billion.[5] Indeed the government was insisting, under IMF advice, that it would 'not get involved in negotiations and will not give any guarantee for corporate debts' (quoted in *JP* 7 February 1998).

At the same time, political events that had been developing since the autumn began to move to centre stage.

The crisis had boosted support for Megawati and Wahid and had begun to add NU support for calls to end corruption and human rights abuses. Perhaps more importantly, Amien Rais announced in September that he would stand against Suharto in the March presidential election. After his expulsion from ICMI in early 1997, Rais had attempted to court more mainstream support by playing down his anti-Chinese and anti-Christian rhetoric. This initially isolated him from more radical Muslim support in KISDI, its sympathizers in the military grouped around General Prabowo, and radical elements of Muhammidiyah and ICMI, without winning the support of NU (and the more moderate military grouping around General Wiranto) (Hefner, 2000; Mietzner, 1999).

However, as the economic situation continued to deteriorate in late November, Abdurahman Wahid (the NU leader) was becoming increasingly critical of Suharto. By January there were growing rumours of a Megawati-NU-Rais alliance.

Suharto's response to his political difficulties was to play for political survival by seeking out more radical support and looking for economic scapegoats, including the IMF and Chinese Indonesians.

In mid January, he nominated Habibie as his vice-president. This recreated the split within the Muslim community and the military with conservative 'regimist' Muslims seeing it as a further example of Suharto's commitment to the Islamic cause. He reinforced this move, suggesting that the crisis was part of a Chinese conspiracy – echoing a book circulated in January 1998 entitled 'The Conspiracy to Overthrow Suharto' written by a think tank reportedly funded by 'green' generals and two of Suharto's children.

This anti-Chinese move was evident in the arrest, on 23rd January, of Sofyan Wanandi, a leading Christian Chinese businessman, on questionable charges of a bomb plot. The head of the armed forces, understanding the signs, called 13 leading Chinese businessmen in January asking for 'donations' to the government and Prabowo held a large meeting of sympathetic modernist Muslim leaders at KOPASSUS headquarters (Mietzner, 1999).

Similar tactics were demonstrated over rice prices once exchange rate depreciation and inflation filtered through. Suharto initially succeeded in putting pressure on traders to provide a price freeze but this was plainly a temporary measure and there were growing concerns about what would happen when price rises took hold (*FT* 25 January 1998, *South China Morning Post* (*SCMP*) 25 January 1998).

Riots began to take place, targeted particularly at Chinese Indonesian rice distributors and traders, who dominate the Indonesian trade (*SCMP* 15 February 1998). Government spokesmen fanned the flames by suggesting price rises were due to speculation in the rice markets and pressed for a further freeze. This time, though, BULOG and Pertamina were also told to cut rice and fuel prices (respectively) (*JP* 5 February 1998) – 'we will have to be very careful when it comes to the price of kerosene so the less privileged will not have to shoulder too huge a burden' (Sudjara quoted in *AFX(AP)*17 February 1998). As with later riots, there was also some evidence of provocation with reports that rioters had been paid to participate (*SCMP* 18 February 1998).

Suharto also began to criticize the IMF, calling for an 'IMF plus' programme to address continuing exchange rate decline. He argued that the liberal ideas enshrined in the IMF programme conflicted with the Indonesian constitution (*Straits Times* 9 March 1998). An alternative was also provided by currency board evangelist Stephen Hanke of Johns Hopkins University, invited to advise at the instigation of Suharto's daughter Tutut and Peter Gontha (an Indonesian businessman)[6] (*Asian Wall Street Journal* (*AWSJ*) 10 February 1998). The currency board proposal provoked heated opposition from Fischer and Camdessus (*JP* 14 February 1998) culminating in delays to the disbursement of US$5.5 billion in loans from the IMF, World Bank and Asian Development Bank (*Asiaweek* 20 March 1998).

Meanwhile rioting and civil unrest were growing throughout the archipelago. A combination of imminent defeat and concern at political tensions forced Rais to pull out of the election campaign. NU and Muhammidiyah also made reluctant statements of support for Suharto and Megawati disappeared from the political scene (Mietzner, 1999). However, students began to protest at Universities around the country starting in Yogyakarta and spreading across Java. Hundreds of thousands gathered, calling for stabilized basic commodity prices, a transition to democracy and the elimination of corruption (Hefner, 2000; Schwarz, 1999).

Suharto's early cabinet appointments hardly calmed the situation. The cabinet had no notable ICMI members and was full of 'cronies' (including Tutut and Bob Hassan who ran the country's plywood cartel), losing him hard won Muslim support and inflaming students and the markets. Rais and Sasono began to tour campuses winning student sympathy.

The third IMF programme was negotiated in this tense atmosphere. The government argued that further reforms – particular further reductions in subsidies for food and fuel – posed a serious threat to political stability (*AWSJ* 16 February 1998). The programme (announced on 18 April) allowed the government to continue with subsidies until October (though initial price rises were to take place on 1 April) and to delay dismantling BULOG. The government was also to be given a greater role in debt negotiations. In return, Suharto agreed to give up the currency board.

There were some moves to implement this programme (suggesting an element of pre-election posturing earlier on) but it was soon overtaken by events. Suharto raised fuel prices sharply on 4 May for reasons that remain unclear, given government awareness of the risks involved.

In any case the price rise triggered riots in Medan in which Chinese shops were burned and looted. Riots escalated and, when four students were killed outside Trisakti University in Jakarta on 12 May, engulfed the city. The riots were partly spontaneous but there are also reports that the military left the city centre before the riots started and that black-clad *agents provocateurs*, widely identified as KOPASSUS (*Komando Pasukan Khusus* (special forces command)) units under Prabowo's command, were seen directing the violence (echoing earlier episodes of unexplained 'ninja killings' in NU controlled areas of Indonesia in 1996 (Hefner, 200)). Over 1,000 people were killed and large numbers of Chinese women were systematically raped.

Frenzied political manoeuvring followed in which Suharto unsuccessfully stepped up his attempts to exploit splits within *Angkatan Bersenjata Republik Indonesia* (ABRI) and the Muslim community (Mietzner, 1999). By 21st May it was clear that he no longer had any political support and he handed over power to Habibie.

Habibie, whether by inclination or through political necessity, was anxious to promote himself as a reformer and set about implementing some aspects of the IMF programme. There was also a noticeable change of emphasis from the IMF, paying far more attention to maintaining social stability and protecting the poorest (Government of Indonesia, 1999, *JP* 26 June 1998).

However, problems in implementation continued, particularly with attempts at banking and corporate sector restructuring. Populist pressure for the redistribution of assets grew with the appointment of Minister for Small Business and Cooperatives Adi Sasono, champion of a 'people's economy' based around a greater role for cooperatives and SMEs . There were also suggestions that assets seized by IBRA should be redistributed to *pribumi* or other measures taken to promote a Malaysian style ethnic redistribution policy[7] (*JP* 11 July 1998, 27 July 1998, 10 September 1998). Political stability was also in question with Habibie's position insecure and growing pressures for regional secession coupled with escalating religious violence.

Habibie failed to obtain sufficient support in the general elections of 7 June 1999 and splits within Golkar meant that the report on his term in office presented to the MPR in October was rejected (Bourchier, 2000). He was withdrawn from the presidential race and the presidency was eventually given to Abdurahman Wahid. Since then, implementation has continued to be haphazard and the Indonesian economy has yet to recover.

6.3 The politics of crisis management

6.3.1 Key controversies

The complex interactions between economic and political factors and the elite nature of Indonesian politics makes it more difficult to analyze the Indonesian programme in terms of elite bargaining on the one hand and governance/civil society/the general population on the other as I did for Korea. Instead, I will begin by exploring some key political questions surrounding crisis management, look at some counterfactual evidence about what else might have been possible and conclude by drawing out the implications in terms of IMF legitimacy.

The controversy over Indonesia is about whether economic meltdown was inevitable, given the build-up of corrupt economic relationships and the fragility of the Suharto regime, or whether it could have been avoided by more astute crisis management.

The strongest case against the Fund relies on the programme's failure to restore market confidence and the apparent success of the early January package, which involved an expensive but stabilizing debt guarantee. The argument is that the other 'confidence enhancing' measures were desirable in the long term but counter-productive in the short term and not related to the Fund's crisis management mandate.

The weakness of this argument is that the Fund can point to 'political factors' – principally non-implementation and mounting instability – to explain programme failure. The critics' response is that it is not good enough for the Fund to prescribe un-implementable measures and then wash its hands of the consequences as 'political' and beyond its control. If the Fund can argue that 'good governance' is important because of its macroeconomic effects, it can hardly ignore the macroeconomic consequences of foreseeable political meltdown.

The key questions, then, are:

1. Was there a programme that Suharto would have implemented, which would have resolved the crisis?
2. How should we evaluate the Fund's tactics of pressing for major governance reform in the second programme?
3. Was enough attention paid to social issues when the third programme was negotiated – could a different programme have avoided the riots?

These issues have a broader significance in terms of the Fund's new role. They raise questions about whether the Fund's governance agenda can be seen as economically necessary or merely politically desirable. When there are conflicts, should the Fund choose pragmatic policies in the interests of economic outcomes or stand firm with calls for good governance? They also speak to the issues I discussed in Chapter 3, about whether civil society, domestic governments or the IMF would be in charge in the context of the Fund's new agenda.

The first programme – derailed by Suharto?

Reports in the press suggest Suharto expected a low-conditionality first loan from the Fund, largely to add confidence in the government's textbook response to Thai contagion. As Suharto put it:

> We are not asking for money, as we already have policies…we just need the IMF to look at these programmes as it has experience (quoted in *FT* 20 October 1998).

However the final programme was far more extensive. There is some evidence that the Indonesian technocrats were partly responsible

(Soesastro, 2000). Reisenhuber argues that, once the IMF had ruled out any direct engagement with the debt problem, the technocrats agreed some kind of structural reform was the only remaining option. They agreed to a fairly wide range of reforms but none were performance criteria, leaving flexibility over the timescale for implementation (Riesenhuber, 2001).

The strategy, then, built on the idea of an IMF 'catalytic effect' (as discussed in Chapter 4 above). There were two problems, though: Fund concerns about 'bail-outs' and 'moral hazard' ruled out what may have been the most confidence-enhancing measures (debt guarantees/restructuring measures); and Suharto's political commitment to the structural measures was always doubtful. These problems came together in the bank closure fiasco, making it possible to argue about which was more important.

Arguably, Fund strategy made more sense in terms of IMF politics (particularly donor concerns about complicity in Suharto's authoritarian patronage) than Indonesian politics (the likelihood of implementation). The Fund and the Indonesian technocrats also seem to have over-estimated the strength of the 'catalytic effect' in the way that Bird criticizes, failing to realize that markets look beyond simple signals to assess the likelihood of real change, something that wasn't considered sufficiently.

Would a pragmatic approach have worked better? Suharto was not totally unwilling to deal with the crisis, but only within certain limits, which were uncomfortable for the Fund to accept, for reasons that were political as much as economic. Whether a compromise programme, asking for less governance reform and dealing directly with corporate and bank debt, would have worked must remain uncertain. The best evidence comes from market concerns with the effects of high interest rates on credit risk voiced back in September 1997 (see above) and, echoing the Korean experience, the relative success of the 26 January package.

The second programme – derailed by the IMF?

Whether or not the Fund was wrong about the first programme, it certainly made things worse with the second one. Suharto had already lost faith in Fund advice – he had always been strongly opposed to bank closures and felt he had been vindicated by the results. It was certainly clear that 'plan A' was not working.

By now, though, the 'governance' agenda had taken on a life of its own. The Fund was under increasing pressure to counter Indonesian corruption. The politicization of the issue was evident in the long queue of political leaders that sought to pressure Suharto to implement the second programme (see Blustein, 2001, Chapter 8). Equally Fund staff seem to have genuinely believed that the best hope for confidence was to put out an even stronger signal to the markets by promising an even more ambitious agenda of structural reforms.

Suharto insisted on negotiating personally with the IMF and World Bank, agreeing to everything in public but, in private, saying he was engaged in 'guerrilla war' (Riesenhuber, 2001). The Indonesia technocrats were apparently absolutely furious about the second programme. Wijoyo Nitisastro was so angry he refused to speak with Bank officials for months telling them: 'we've been working with Soeharto for thirty years and now you are destroying everything' (Schwarz, 1999).[8]

For some, at least, it was time for the Fund to switch to 'plan B'. It is certainly noticeable that this period also marked a shift in Suharto's strategy away from dealing with economic crisis and towards trying to maintain elite and mass political support.

The third programme and political crisis

Once Suharto had been re-elected, there were signs of a return to crisis resolution. The key question here, though, is what triggered the disastrous fuel price rises in early May. Are they another example of IMF political naivety? Here again, the problems were about the interaction between the IMF and Suharto, rather than an inevitable consequence of IMF policy. The price rises were mandated, but were to be introduced gradually. It is not clear why Suharto introduced them all at once. On the other hand, the Fund programme had little to offer the Indonesian population that the government could point to as evidence that it was 'doing something' to protect its people.

Why did Suharto introduce a sudden price rise? One possibility is that he was genuinely trying to convince the markets he was prepared to take 'painful' measures in the interests of reform. His mistake was to see hurting the masses as more politically expedient than hurting his elite support.[9]

Another, more Machiavelian, explanation is that he hoped violent responses to price rises would separate middle class support from working class animosity, renewing political support for the military enforced status quo. Support here comes from the suggestion that Prabowo and the radical Muslim military were responsible for fanning the flames of the riots (Hefner, 2000).

Either way, there is evidence Suharto was not doing all he could to diffuse political tensions, presumably because he thought *pribumi*-Chinese animosity would help his political purposes.

On the other hand, when we think in political terms about who stood to gain and who to lose from the second Fund programme, it is not difficult to see the political dangers. The rural poor were potentially well served by removing monopolies and price restrictions in the countryside. However, these potential gains also needed to be offset by the tendency for unemployed urban workers to return to the countryside in times of hardship (Booth, 2000).

In the medium term, the 'non crony' middle classes stood to gain from a level economic playing field. In the short term, though, they would be hit hard by high interest rates that had a disproportionate impact on poorly protected small business. Urban workers, too, were very vulnerable and removing subsidies in a context of already rising prices (because of exchange rate devaluation and inflation) was rubbing salt into open wounds. Long-standing animosities over the role of Chinese Indonesians in the economy and over Christian/Javanese immigration to the outer Islands were a further factor in political vulnerability.

6.3.2 Post-crisis events

The case against the Fund, then, is that its strategy was too uncompromising politically and therefore failed to achieve positive economic results. The critics' argument is that greater attention to safety nets and debt restructuring would have produced a better outcome. The Fund defence is largely that it pursued the 'right' policy in economic, and sometimes more implicitly, ethical terms.

To some extent this debate is about difficult counterfactual judgements; however aspects of post-crisis policy do provide some relevant evidence.

Corporate and baking sector restructuring

Would an earlier assault on corporate debt have produced superior economic outcomes?

When restructuring was pursued in post-crisis Indonesia, it proved extremely problematic and was rapidly captured by large Indonesian corporate interests. That suggests there may not have been a simple restructuring quick fix. On the other hand, it is difficult to tell how much less severe the problems would have been if dealt with sooner (Grenville, 2004). At the same time, problems with implementation draw attention to the need to evaluate IMF policy on outcomes rather than intentions.

IBRA was set up carefully with maximum safeguards to prevent political interference. It was to be politically independent. Audits of banks were carried out by overseas representatives of the big 6 accounting firms. Explicit criteria were developed for deciding which banks would meet which fate. Nonetheless, according to Fund staff:

> the experience of Indonesia indicates how poor governance undermines credibility in an otherwise well thought-out restructuring strategy, and adds substantially to the costs (Enoch et al., 2001).

Problems during the Suharto era should not be surprising.[10] However, difficulties continued under Habibie and Wahid. Most startling was the Bank Bali scandal in which difficulties with obtaining payments officially had enabled well connected officials to act as paid 'facilitators'. The company involved in the Bank Bali scandal was run by Golkar heavyweights and there were widespread reports that commissions were being used to finance Habibie's election campaign (Enoch et al., 2001; Haggard, 2000; Hamilton-Hart, 2000). There were also a range of other less high-profile indications of political interference. Habibie's Financial Sector Action Committee was certainly able to exert more political influence over the operation of a supposedly independent institution than the IMF felt comfortable with (Enoch et al., 2001).

When it came to the broader process of restructuring Indonesia's conglomerates, even more fundamental problems were exposed. The government, perhaps under IMF instruction, had been reluctant to become involved in corporate and banking sector bail-outs (Enoch et al., 2001; Hamilton-Hart, 2000). The banking sector guarantee eventually became unavoidable but the government continued to keep its distance from corporate sector restructuring for a considerable period.

The measures that were eventually announced were fairly minimal (a largely advisory body – the Jakarta Initiative Task Force – and a guarantee against any further devaluation, which was introduced after the *rupiah* collapsed) (Radelet and Woo, 2000). They were certainly not enough to compensate for the very problematic state of Indonesia's bankruptcy system, which also hampered IBRA considerably.

In the five years before the crisis, only 120 companies had been made bankrupt. A new law was introduced but the courts were unable to implement it:

> In the new bankruptcy court, judges have handed down a variety of creative rulings consistent only in their uniform ability to frustrate the creditors (Linnan, 1999b).

Linnan suggests that this was partly because of a feeling that the law was designed to favour foreign creditors at the expense of Indonesian debtors (Linnan, 1999a). It was also noticeable, though, that bankruptcy provisions were more likely to be successful against smaller rather than larger companies and corruption cannot be ruled out. Indeed, the crisis revealed a greater crisis of confidence in the Indonesian legal system.

Finally, quite apart from the lack of legal precedent to act as guidance, creditors and debtors had few incentives to negotiate. Thirty eight per cent of Indonesian corporate debt was owed to Japanese banks who were not in a position to acknowledge debt write-downs (Radelet and Woo, 2000). Corporate managers either hoped that time would rehabilitate asset values or, having already lost all their equity, had few incentives for anything other than corporate plunder (Linnan, 1999b).

Overall the process was painfully slow. The issues were particularly difficult for IBRA, though. As a public body it had to be concerned about allegations of favouritism. There were difficult trade-offs to be made between swift resolution and the danger of cheap sell-offs either to foreigners or the crony conglomerates. This clearly unnerved the Indonesian parliament which moved to stop the sale of Bank Central Asia. The World Bank and IMF were in favour of swifter resolution but were worried about the opaque negotiations that accompanied it (Robison, 2001).

The critics' view that corporate debt restructuring could have resolved Indonesia's problems more easily looks problematic, at least in political terms. Debt restructuring would almost certainly have involved bailing out Indonesia's crony conglomerates. Dealing with the problems earlier might have helped to minimize them and a strong Suharto, working with the Fund not at war with it, might have been better placed to limit the worst excesses. Ultimately, though, saving the Indonesian economy through restructuring would have involved supporting large-scale patronage.

On the other hand, it is important to note that one should not evaluate Fund policy as though it *achieved* what it set out to do. There is little evidence that political liberalization has checked Indonesian corruption. Experience elsewhere in Southeast Asia has shown that fledgling democracies can find it extremely difficult to suppress corruption, while willing authoritarian regimes can eliminate it. Post-crisis Indonesia has better regulation and the government is providing less active support for patronage but there are major doubts about whether the legislation is being implemented (Lindsey, 2000) and strong signs that patronage is alive and well (Robison and Hadiz, 2004).

Social safety nets

If, for the moment, we accept the broad thrust of Fund strategy, could the same broad aims have been pursued in a more politically sustainable fashion, with more attention, for example, to social safety nets?

The World Bank's attempts to deal with rising poverty in the wake of Suharto's fall met with a number of problems. The government was not accustomed to that sort of operation. There was little available information and a dearth of infrastructure for delivering welfare programmes.

Local government would normally have been the obvious choice but Golkar's structures reached down to the village level and there were serious concerns that funds would be diverted for political purposes in the run up to the elections. The most visible contribution of Indonesian NGOs and civil society during the crisis was to draw attention to these difficulties, particularly as calls for *reformasi* spread across the country in the Habibie period. In the end the World Bank felt compelled to stop funding safety net programmes around the elections out of fear for its already tarnished reputation on corruption in Indonesia.

Here again, the difficulties of implementing safety nets make it difficult to simply accept the critics' position. On the other hand, it is also clear that dealing with social problems was only going to be possible through the government. The choice wasn't between problematic social interventions or 'good' social interventions, it was between problematic social interventions or no interventions at all.

Populism and post-Suharto policy

Finally, the critics' claims rely on the belief that other policies could have been tried. The IMF argument, at least implicitly, is that Fund policies promoted the interests of the Indonesian people. Post-crisis events show that political aspects of Fund policy were popular, particularly the fall of Suharto and pressure on corruption. The Fund's economic policy, though, had very limited political support.

In section 6.2, I drew attention to Habibie's flirtations with populist economic policy. Even when the Indonesian electorate got to choose their political leaders, though, populist issues continued to trigger debate in the Jakarta Post and featured prominently in election campaigns.

Economics was not at the top of the agenda and when it was mentioned announcements were contradictory. A poll of the major parties published in *Warta Ekonomi* found Megawati's PDI-P most consistently in favour of limiting access to foreign investors, introducing capital controls and boosting the role of government in the economy (reported in *FT* 13 May 1999). Megawati herself told the *South China Morning Post* that she would not institute capital controls or ethnic redistribution but did see a need to deal with 'the jealousies sown between the rich and poor' – something that Hubert Neiss (head of the Fund's Asia-Pacific department) acknowledged was a concern for all the major parties (*SCMP* 19 May 1999).

During the campaign the *Jakarta Post* was happy to argue that 'populist economic policies have been the dominant theme in the political statements of some major political parties, populist programmes are the most attractive among the people' (*JP* 21 May 1999).

The IMF was certainly sufficiently concerned to send Neiss and Fischer to talk to Megawati. After the elections when it was clear that the PDI-P was the largest party, Fischer was photographed shaking hands with a smiling Megawati. An article in the *Jakarta Post* immediately questioned the implications for Indonesia's fledgling democracy given that the IMF appeared to have persuaded her to change the policies on which Kwik Kan Gie had been campaigning, including an exchange rate peg (*JP* 1 July 1999). Abdurahman Wahid, who was eventually made president, also had little to say about economic policy, except that it would benefit the poorest.

Indonesian leaders seem to have been content to go along with IMF policies since the economy was not the central issue in post-Suharto Indonesia. On the other hand there is less reason to believe that the IMF reform programme was top of the agenda or something that they were particularly keen to press forward.

Conclusions

An analysis of what happened after Suharto's fall primarily highlights the extent to which economics and politics were interlocked in

Indonesia. Debates based on what might be economically rational simply do not tell one very much about what was likely to happen. For the critics, that raises problems for any simple view of what else could have been done, though it is still possible to argue about how much could have been achieved if more effort had been made to keep Suharto on side.

In terms of the Fund's position, it draws attention to the dangers of asking whether Fund intentions were purer than Suharto's, without asking questions about the plausible outcomes of Fund policy. It highlights the extent to which the IMF's agenda became politically rather than economically driven. The evidence also weakens part of the Fund's claim to be acting in the interests of civil society.

6.3.3 The IMF and crisis management

What can we conclude about the politics of the crisis and the IMF's role?

Ultimately, any definitive assessment is hindered by complex counterfactual questions, particularly about whether the critics' economic proposals were viable.

However, there are some things that can be said with reasonable certainty. 'Confidence-enhancing' policies did not work as well as the Fund and the Indonesian authorities had hoped. There is a strong case that governance policies were counterproductive, driven more by political imperatives than economic rationality. It is also clear that the Fund pushed Suharto too hard to pursue programmes that, as a result, had little chance of implementation.

More importantly, accepting some responsibility for good governance forces the Fund into making very difficult choices. Under the old vision of the Fund's role all that matters is crisis resolution. In the new environment, even if the critics' macroeconomic views were right, the Fund would have been very reluctant to pursue policies that could have been seen as bailing out Suharto and his cronies at the expense of the rest of the population. Stephen Hanke's view that Fund interventions were *about* regime change are probably overstated (Hanke, 2003) but Fund officials have been happy to claim that Suharto's fall was an unintended consequence of the Fund's willingness to stand up to Indonesian corruption.

Whilst I have some limited sympathy for that Fund position, it also highlights just how significant the adoption of a good governance agenda is in terms of IMF power. The good governance guidelines (IMF, 1997a) try to argue that governance concerns are secondary to the overarching issue of macroeconomic stability: that they don't fundamentally change the Fund's mandate. Once the governance door is opened, though, it is very difficult to start drawing boundaries. It is not surprising that the Fund was tempted 'to substitute its technical judgements for the outcomes of the nation's political process' as Feldstein (1998) put it.

Similarly, once the Fund is to take into account the views of civil society, very difficult questions are raised if civil society appears to be in conflict with the state. The Fund certainly didn't bring down Suharto. On the other hand, it did mandate policies that would trigger a dramatic change in the balance of political power within the country. The logic of the decision to do so was very much that of the relationship between rent-seeking, governance and civil society. Suharto's patronage networks were economically damaging and therefore not in the interests of civil society. It would be wrong for the Fund to roll over and do what Suharto asked.

Whether the Fund was right or wrong to challenge Suharto is a very important and highly contested question. It will depend on difficult counterfactual judgements about both politics *and* economics. I have already reviewed the economic arguments between 'fire in the theatre' on the one hand and 'lack of political will'. In political terms, though, it is important to realize that options were not limited to Fund insistence on the 'correct' technical solution on the one hand and 'caving in' to Suharto on the other (Grenville, 2004).

Politics is about making complicated judgements with moral *and* prudential elements: politics is 'the art of the possible'. Even if the Fund should have been asking questions in terms of what was best for Indonesian civil society in the long term (which is already problematic for the Fund's traditional mandate) those questions need to factor in issues about available political outcomes. The choice is not between a patrimonial regime and an ideal liberal democracy, it is between Suharto's regime and its likely successor. My point is not so much about whether the choices that were made were actually correct as about the sheer political significance and uncertainty of the issues at stake. As I argued in Chapter 3, the relevant choices involve exactly the kind of political judgement that the Fund's institutions are ill-equipped to make.

6.4 Conclusions

This chapter raises many of the issues I discussed in Korea but in sharper form. The technical case for Fund interventions was problematic. Market confidence was hard to restore and dealing directly with debt produced better results. In any case, technical issues quickly became tied up with more political debates about corruption, authoritarianism and clean government. As we saw in Korea, the politics of financial globalization are highly significant in ways that take the Fund a long way from purely economic issues. It is important to acknowledge that addressing some of those governance issues was, quite rightly, popular with wide sections of the domestic population in both countries.

However, as in Korea, the politics of pre-existing arrangements couldn't be overcome simply by altering economic policy, but they had to be overcome if new policy was to be successfully implemented. In Korea, the Fund received full participation from the Korean state and the state, with some assistance from the Fund, was able to secure programme implementation.

In Indonesia, there was considerable resistance from government and that resistance created situations that highlighted just how politically significant IMF interventions were. It may be that the Fund didn't anticipate that its actions were effectively providing support for regime change. However, it *should* have realized that. Anyone who paid attention to the basis of political power in Indonesia would have seen the problem.

In a sense, though, its new governance agenda forced it into making the choice to challenge Suharto. There are strong signs that, once good governance was placed on the agenda, political pressure prevented the IMF from pulling back.

An alternative might have been to pursue more politically pragmatic options, which would have accommodated Suharto but would also have tacitly condoned Indonesian corruption. That option would obviously have been a difficult one to pursue and the outcomes remain uncertain. In terms of short-term economic results, though, it is difficult to dismiss out of hand. The political disruption that ensued in Indonesia was massively costly in economic terms, quite apart from the violence and unrest that has plagued Indonesia since 1998. Is governance *really* about economics then? If we think in terms of the Fund's mandate rather than in terms of what might be ethically 'right', interventions look difficult to defend. We are obviously in difficult territory here but my suspicion is that the question didn't occur to Fund staff, who tend to think in terms of idealized models of 'best policy' rather than about prospects for implementation and limits to political authority.

The judgements are not made any easier by the fact that Fund interventions do not yet seem to have delivered the corruption-free economic governance that they promised, even 6 years after the crisis.

Here again, political causation is key. Liberal reforms will only take place if there is a political coalition that will support them and that has the power to drive them through. As in Korea, the Indonesian middle class had historically been too closely connected with the state to be a natural carrier of liberal values. Suharto's political authoritarianism had also made it more difficult for independent groups to organize politically. There simply wasn't a political coalition in Indonesia capable of driving through the reforms.

That also raises difficult questions about the relationship between the IMF and civil society. One way to justify IMF policy might be to argue that the Fund had sided with the Indonesian people against an authoritarian state. However, in the absence of a functioning democratic system, it is very difficult to know who 'civil society' is and what it wants. What evidence there is suggests widespread popular enthusiasm for some of the political aspects of the governance agenda but a general disagreement about economic management. Even in a more democratic situation, 'engaging' with civil society involves choosing which voices to listen to and which to reject. The Fund's internal agenda clearly didn't leave much space for accommodating Suharto, but was it *really* responding to civil society either, or was it responding more to the imperatives of Executive Board politics?

For the purposes of this book, it is probably less important to come to final judgements about these issues than it is to point out the factors that seem to be involved in coming to a conclusion. The Fund is clearly not dealing with issues that fit comfortably with the kinds of institutional decision-making it was designed for. The decisions it was making were extremely significant and it is surely difficult to argue that the Fund has the right kind of political authority to be making them.

Overall, the message from both Korea and Indonesia is that the governance agenda is not wholly justified economically. If it is economically vital at all, it is only necessary against the background of a commitment to free capital flows and a reluctance to directly address the resolution of international debt problems. Aspects of the agenda, though, are politically appealing. They may help to provide a political silver lining to an economically painful process. However, that political silver lining comes with very significant changes to the domestic political economy, which undermine the prospects for future state intervention. The political significance of the governance agenda also makes implementation difficult. It triggers political resistance and pushes the Fund into difficult choices between the interests of the increasingly wide range of actors involved in the new agenda.

7 Malaysia

We have seen how the IMF dealt with crisis in Korea and Indonesia. Fund interventions had different political significance in each country. In Korea, the programme was largely about dismantling industrial policy and the associated close links between big business and sections of the political class. In Indonesia, it was designed to attack political patronage but doing so involved a radical restructuring of Indonesian political economy. Both examples showed programme implementation was politically highly charged and difficult to manage.

The Malaysian situation was different again, further emphasizing the wide-ranging significance of financial globalization, at least as promoted by the Fund. In Malaysia, non-market financial relationships had involved more credible and concerted attempts at ethnic redistribution than in Indonesia, though the process had also served to maintain political power.

After much debate, the Malaysian leadership rejected IMF-style approaches to crisis and introduced capital controls to prevent further outflows of capital and allow a more reflationary macroeconomic policy.

That is significant for IMF legitimacy in two ways. Firstly it raises questions about why Mahathir refused to go to the Fund, despite domestic pressure to do so. Was that a reaction to what had taken place elsewhere in Asia or to domestic political factors? Is similar resistance likely elsewhere?

Secondly, as well as flouting IMF advice, Mahathir spent a good deal of time promoting his alternative policies overseas as part of a political attack on IMF policy. There are therefore questions about the demonstration effects of Malaysian difference. Is the Malaysian example likely to be attractive to others?

7.1 Background to the crisis

7.1.1 Technical controversy

After some domestic political debate and struggle, Malaysia finally dealt with its crisis by introducing administrative controls to prevent further capital outflow in September 1998. The reaction in the financial press and the IMF was hostile. The controls would irrevocably damage long-term market confidence and were unlikely to work. Equally importantly, they were seen as a way to protect Mahathir's business 'cronies', damaging market discipline in Malaysia and hurting long-run productivity.

For Mahathir, controls were a way to protect Malaysia from speculation and the ravages of global financial markets. They gave government room to ease fiscal policy and interest rates, to re-start the economy. They ensured social priorities, as well as efficiency, could enter into government calculations. Government intervention in the Malaysian economy was about maintaining inter-ethnic harmony by improving the economic position of the Malays, who were the original inhabitants of the country but were economically disadvantaged. Controls were a short-term measure to secure social cohesion in the midst of crisis, without derailing broader economic development.

The debate, then, is partly about orthodox versus heterodox economics and partly about the extent to which pro-Malay policies were a socially desirable policy or simply a cover for political corruption.

7.1.2 Background to the crisis

Political and economic background

At independence, slightly less than 50% of the Malaysian population were *bumiputera* (literally 'sons of the soil' – Malays and some other indigenous groups). The remaining 50% descended from those encouraged by the British to emigrate to Malaysia, primarily from China (37%) and India (12%) (Ratnam, 1965, 2).[1] There was little integration between ethnic groups. At independence, only one in five city dwellers was a Malay. Most of those were government employees (Ratnam, 1965). The Chinese were involved in a range of mostly urban-based activities, with particular dominance in small and medium scale trading. The urban working class was also predominantly non-Malay. In terms of capital ownership, European companies controlled 60% of Malaysian output. The remaining 40% was mostly in Chinese hands. The only area where the pattern was reversed was in the higher reaches of the bureaucracy, which were an essentially Malay preserve (Roff, 1967, Chapter 4).

Malaysia has been an electoral democracy since independence but elections have always been won by a coalition of ethnic-based political parties under the leadership of UMNO – the United Malays National Organisation. UMNO was an elite-based party, formed in 1949 in reaction to British proposals for a Malay Union. It was initially joined in 'the Alliance' by a similarly elite-based Chinese party (the Malaysian Chinese Association – MCA), set up with British support, to counter the influence of the Malaysian Communist Party. The Malaysian Indian Congress (MIC) then saw joining the Alliance as its best chance of pursuing its multi-ethnic ambitions.

Evolving economic policy

During the 1950s, the coalition government practised positive discrimination in public sector employment and in awarding various licences and permits. Two public enterprises were also established to assist with rural development and there were some modest attempts at import substitution. Overall, though, economic policy was largely *laissez-faire*. There was significant economic growth during this process but it resulted in increasing intra-ethnic inequality (Snodgrass, 1980).

There was growing dissatisfaction in all ethnic groups: the Alliance political parties were doing a good job of favouring elite interests but poorer non-Malays felt unprotected and poorer Malays felt that redistribution was having little impact. In the 1969 elections, non-Malay opposition (particularly Gerakan, the Democratic Action Party (DAP) (both predominantly Chinese) and the Malay-Muslim Parti Islam Se-Malaysia (PAS)) made significant gains. Jubilant celebrations by Gerakan and DAP supporters triggered racial riots in which at least 196 people were killed (Crouch, 1996).

The government response was to broaden the governing Alliance into a more inclusive National Front or *Barisan Nasional* (BN). More importantly, it also instituted a New Economic Policy (NEP) designed to

> reduce and eventually eradicate poverty by raising income levels … [and] … accelerat[e] the process of restructuring Malaysian society to create economic balance, so as to reduce and eventually eliminate the identification of race with economic function.

Attempts at redistribution resulted in a significant increase in state influence over the economy. This included increased provision of infrastructure, the growth of state development corporations (particularly Petronas, the state oil company), and state owned corporations (including HICOM – the Heavy Industries Corporation of Malaysia). '*Bumiputera* trust agencies' were set up to hold shares, managed by the state on behalf of the indigenous population. These would: act as a form of forced savings scheme to accumulate capital for *bumiputera*s; spawn new economic projects in strategic sectors which could be divested to *bumiputera*s; and create human resource and technology spill-overs into the wider economy (Gomez and Jomo, 1999, 32). Discretionary dual pricing of shares also allowed some *bumiputera*s to acquire shares at par value or at a nominal premium. Finally the Industrial Coordination Act (ICA) of 1975 provided for a compulsory *bumiputera* quota of 30% ownership for all non-exempt companies (the most noticeable exemption being export-oriented companies – most of the foreign companies operating in Malaysia).

The resulting provision of infrastructure combined with tight labour regulation, tax incentives, partial exemptions from *bumiputera* shareholding requirements and new free trade zones encouraged foreign-financed export-oriented industrialization (EOI). This move was well timed, with developments in the international division of labour encouraging Transnational Corporations (TNCs) to out-source production.

Although EOI industries improved the Malaysian balance of trade, there was concern at their high import content and lack of backward-linkages with the rest of the economy. As a result Prime Minister Mahathir began a second stage of import-substituting industrialization (ISI) in the early 1980s with measures to promote heavy industry through HICOM and the promotion of the Proton national car project.

By the mid-1980s, a combination of commodity price shocks and poor performance by public enterprises was causing significant problems for the Malaysian economy. Mahathir turned to privatization as the way out of economic difficulties. He argued public enterprise had been a temporary vehicle to promote a *bumiputera* property-owning class, which should now be weaned from dependence on the state, creating a new breed of Malaysian entrepreneurs forming the basis of an internationally competitive industrial community (Gomez and Jomo, 1999).

Accompanying fiscal retrenchment balanced the budget but intensified the recession. The government responded with further domestic liberalization including a partial lifting of NEP equity requirements for export-oriented business. Timing was propitious since the low *Ringgit* made Malaysia an attractive location for Northeast Asian business, relocating in the wake of the Plaza Accord. An investment surge finally revitalized the economy, having a particularly dramatic impact on the Kuala Lumpur Stock Exchange (KLSE).

Changing political economy

Growing state involvement in the economy during the 1970s expanded the scope for political patronage. Business opportunities were granted to *bumiputera* business people (or politicians) who were expected to reciprocate with political and economic support for UMNO. In the 1980s and 1990s, privatization changed the character of these relationships but did not eliminate them. Large conglomerates emerged, specializing in state funded infrastructure contracts or licences to enter newly liberalized sectors like utilities and telecommunications.

Assets and contracts were sold to 'those who come to us with good ideas' as Mahathir put it (Khoo, 2000, 222). These corporations were therefore still beholden to the state. At the same time, they began to represent a larger share of the economy and, as the state began to rely on them to produce infrastructure, became increasingly powerful. There were concerns that these new conglomerates were concentrated on sectors that could benefit from patronage and political connections, rather than more competitive and productive activities such as export manufacture (which were still dominated by FDI) (Gomez and Jomo, 1999; Jesudason, 1989; Jomo et al., 1997).

Money politics was becoming increasingly important 'blurring the distinction between corporate and political power' (Gomez and Jomo, 1999). Not only were businesses tied to political interests, political parties were increasingly pursuing business opportunities on their own account. UMNO set up Fleet Holdings in 1972, which rapidly acquired companies including Renong Bhd, a huge corporation with interests in construction, financial services and the media. The MCA responded, briefly, with its own Chinese 'corporatization movement' though its main company collapsed amidst scandal in the mid-1980s (Gomez, 1999). UMNO claims to have sold off its business interests since 1992 but there is much speculation that key politico-business figures such as Daim Zainuddin hold shares on trust for the party.

This interpenetration of business and politics led to factionalism within UMNO, particularly evident during the 1980s recession. UMNO was:

> increasingly torn between its own financial needs, the ambitions of those ostensibly acting on behalf of the party, and its obligations as

'protector' and 'patron' of Malays desiring to accumulate (Gomez and Jomo, 1999).

Matters came to a head in a tussle for leadership that split the party in 1987. Analysts have argued the rebel party headed by Musa and Razaleigh represented smaller Malay businessmen and middle-ranking bureaucrats, whose interests in broader redistributive politics through the NEP were harmed by the turn to privatization (Khoo, 2000; Khoo, 1992).

The NEP and 'outsiders'

The economic recovery enabled Mahathir to consolidate his political position in the 1990s. Nonetheless, the 1980s recession demonstrated the difficulties of managing political tensions in Malaysia, spilling over from UMNO into broader inter-ethnic tensions over issues such as English language education and Chinese cultural expression.

UMNO's dominance of the political system is based on its position as head of a multi-racial coalition, which is supposed to exercise power in a way that balances the interests of different ethnic groups, guaranteeing national unity and stability. Effectively Chinese Malaysians have been asked to cede political power in exchange for limits on interference in their business interests.

Bumiputera employment and ownership quotas have been particularly problematic, affecting Chinese and foreign owned businesses. During the ISI period, there were also concerns about state restrictions on the scope for private business. However, foreign and Chinese business have accepted that direct political challenge is difficult, given the significance of Malay nationalism. There were also noticeable conflicts of interest between the two groups. Chinese business leaders hoped (vainly) to steer public enterprises into areas controlled by foreigners (Jesudason, 1989, 128–132). Foreign business benefited from the state's preference for granting pioneer status to foreign rather than Chinese business as part of its export drive.

The other group that have been left out are poorer Malays. The NEP created greater social mobility but less was done for rural communities.[2] As we have seen, the scope of direct NEP benefits narrowed during the 1990s as government policy shifted towards the creation of an elite class of Malay entrepreneurs.

The nature of the Malaysian political system has made it difficult for these 'outsiders' to mount a formal political challenge. All groups accept Malaysia needs to be governed by a multi-ethnic coalition of parties. Ethnic-based political allegiances, though, mean the simplest way to organize opposition is to press ethnic grievances harder than its BN counter-part. For the Malays, PAS has shifted between economic populist nationalism and an explicitly Islamic agenda, neither of which appeal to Chinese Malaysians. The (Chinese) DAP's liberal agenda is too threatening to NEP privilege (and, perhaps, too stridently secular) to appeal to Malays. Malaysians of Indian origin are left particularly marginalized with little economic or political power.

Similar factors have restricted the development of class-based politics in Malaysia. The inter-ethnic ruling coalition is also an elite coalition. The founding parties were set up to protect elite interests and, in the case of the MCA, as a deliberate counterpart to left-wing movements. UMNO's core support is a combination of business elites and the peasantry. The labour movement in Malaysia has remained fragmented along ethnic lines (Crouch, 1996; Jesudason, 1989).

Changes in economic policy during the 1980s and 1990s also narrowed the direct beneficiaries of NEP policies in urban areas. Many lower ranking bureaucrats were cut out of the system. Smaller businesses had less chance of benefiting and conflicts increased between conglomerates and smaller Malay businesses, acting as sub-contractors (Gomez and Jomo, 1999).

Although it has been difficult for Chinese Indonesians to exercise direct power through the political system, they have found ways to protect themselves. There was considerable capital flight from the country during the 1980s and 1990s (estimated at US$12 billion by Morgan Guaranty (Khoo, 1995)). Businesses concentrated on short-term activity offering quick returns in the non-tradable sector such as property and finance (Jesudason, 1989; Yoshihara, 1988). More recently, some large Chinese corporations have forged political alliances with influential Malays (Gomez, 1999), particularly as forms of government patronage altered in the 1990s.

Chinese structural power in the economy, though has also helped to make the state at least partially responsive to Chinese political demands. There have been limits to the impact of NEP policies on Chinese business. In periods of political turmoil, such as the UMNO split in 1987, the BN has had to rely on Chinese votes. Although the government stirred up ethnic animosity during the recession, when it came to the 1990 elections, significant concessions were made on cultural expression and a more sympathetic tone, at least, was adopted on the sensitive question of education (Crouch, 1996).

As well as responsiveness, there are also signs that the Malaysian state has become increasingly repressive since the early 1980s. The media are tightly controlled (Milne and Mauzy, 1999). The state has powers under the Internal Security Act to detain without trial. Although these are usually used to diffuse ethnic tension, those connected with opposition parties have been more likely to be detained (Crouch, 1996). There are also questions about the independence of the judiciary.[3] Government media control, already significant at election time, has been enhanced by outlawing mass political rallies (a key means of publicity for the opposition).

7.1.3 Conclusions

Malaysian economic policy, then, has been overshadowed by attempts at securing political stability through ethnic distribution. The government has tried to promote NEP policy as both positive economic nationalism that is good for the economy as a whole and a means for providing particular benefits to the Malay population. The system has diffused ethnic tensions but has helped to preserve fairly sharp ethnic cleavages, particularly in terms of voting patterns.

The predominance of ethnic political representation has made it difficult to read Malaysian politics. Debates about inter-ethnic relationships have been organized in ways that overshadow other kinds of political debate. However, during times of economic difficulty, some latent tensions have been exposed. The recession of the mid-1980s exposed continuing ethnic tensions. It also provided some signs of debate over the future of the NEP. Narrowing the scope of political patronage in the interests of faster growth was by no means universally popular amongst Malays. As the crisis was to expose, there was growing dissent amongst some Malays over corruption, elitism and, relatedly, the role of Islam in Malaysian politics.

7.2 The crisis in Malaysia

7.2.1 Crisis controversies

As I explained above, debate in Malaysia was over the extent to which capital controls should be seen as a sensible economic response to crisis or a way to protect Mahathir's political 'cronies'.

Mahathir argued that the capital controls were essentially a short-term regulatory measure designed to overcome irrational market panic – something that the Fund's 'confidence enhancing' measures elsewhere had failed to achieve. They would be combined with appropriate economic reforms but, in the meantime, would enable him to preserve domestic political stability (in the form of Malay preference) and prosperity (by avoiding recessionary macroeconomic policy in the face of massive capital outflows). Others saw them as a cover behind which he could bail-out well-connected businesses, whose poor performance and appetite for public money was responsible for collapsing market confidence.

In reviewing the crisis, then, it is important to determine:

1. the extent to which capital outflows were driven by market concerns about domestic competitiveness, suggesting market discipline should be allowed to weed out poorly performing businesses
2. the extent to which disputes over policy were about different economic convictions on the one hand, or politics and access to patronage on the other.

7.2.2 Crisis chronology

Malaysia, like other countries in the region, showed signs of asset price bubbles by early 1997. Bank Negara responded by restricting lending for property and share purchases in March. This triggered a gradual fall in the KLSE. By late May, when the Thai Baht was coming under serious attack, analysts asked questions about other regional economies. At this point, consensus was that Malay property companies were less indebted than their Thai equivalents. Malaysian banks were less dependent on collateral lending to the property market. It was also felt that the Malaysian system was more cohesive[4] and the government had more control over the economy. The fall in the KLSE was thought to be driven by foreign investors (contagion) who would return when they recognized regional variation within the region (*FT* 24 May 1997, *New Straits Times* (*NST*) 19 May 1997).

By late June, concerns were focusing on the trade deficit, which was expected to rise further as Bank Negara raised interest rates to defend the Ringgit (*FT* 21 May 1997). The trade deficit was attributed to a loss of competitiveness as full employment drove wages up faster than productivity and other currencies in the region depreciated. Finally, on 15 July, the Ringgit was allowed to float.

At this stage, Mahathir was touring Europe to encourage investment in Malaysia's 'Multimedia Super Corridor' project. Deputy Prime Minister, Anwar Ibrahim had been left to run the country. Anwar's response was orthodox. He raised interest rates while pointing to Malaysia's sound fundamentals and arguing that the problems would be temporary (*NST* 11 July 1997). Mahathir returned at the end of July and began to argue (with less orthodoxy) that the Malaysian economy was suffering from politically motivated speculative attacks by 'a certain powerful American financier'[5] (*NST* 22 July 1997).

Over the next few months, perceptions of a rift between Anwar and Mahathir continued. The principal areas of market concern were: Mahathir's enthusiasm for large infrastructure projects ('mega-projects') (*NST* 22 July 1997); his continuing insistence that economic difficulties were due to manipulative speculators rather than economic fundamentals (Mahathir, 1997b); the use of government controlled funds to prop up the KLSE; and unsuccessful attempts to regulate the market to prevent speculation.

The first attempt at regulation, a restriction on lending Ringgit over a certain value to foreigners, was designed to close the swap market in Singapore so interest rates could be lowered. The Ringgit rose but the stock market fell in compensation (*FT* 5 August 1997). The second involved changing stock market rules to prevent short selling of the 100 most valuable stocks on the KLSE. This was particularly unpopular

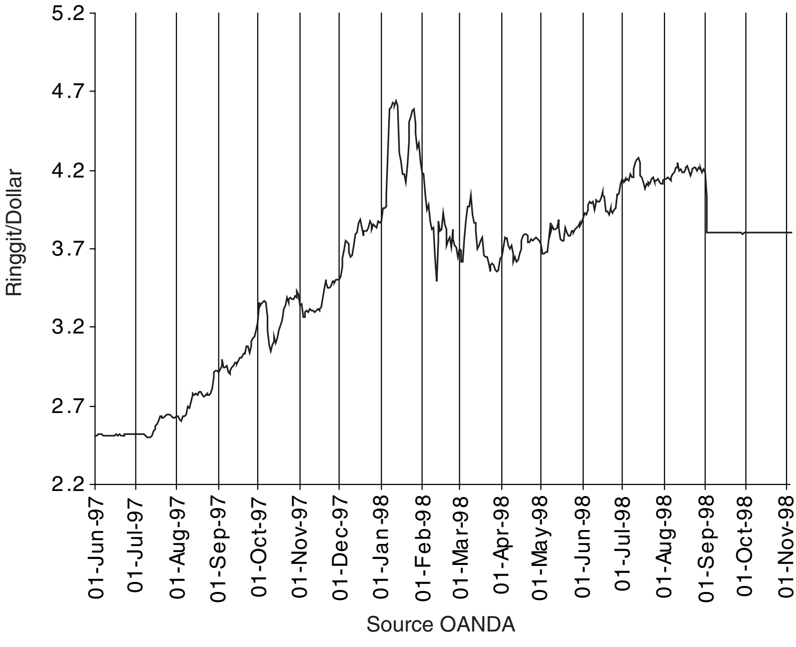

Figure 7.1 Ringgit-dollar exchange rate

with the markets, triggering a vitriolic response from analysts who claimed it demonstrated a lack of commitment to the free market that would undermine Malaysia's credibility for years.[6] Since the measures coincided with Mahathir's attempts to use government pension funds and cash-rich companies to prop up the KLSE, the stock market stayed largely stable. However, the fall soon materialized. Mahathir was forced to concede defeat and delay some infrastructure projects (*NST* 6 September 1997).

Meanwhile, Anwar made speeches to state governments urging restraint in project planning and defending commitments to a balanced budget (*NST* 23rd July 1997). He was not present at the meeting where Mahathir announced local pension funds would attempt to prop up the KLSE and it even became necessary for Mahathir to deny rumours that Anwar had resigned (*FT* 1 September 1997). It also fell to Anwar to calm the nerves of foreign investors after Mahathir's most high-profile attack on currency speculators at the World Bank annual meeting in Hong Kong. (*FT* 22 September 1997).

Contrasts between Anwar and Mahathir were probably overdrawn by the foreign media at this stage. Anwar's eventual ousting in September probably owes more to struggles for power within UMNO, partly provoked by foreign media reaction, than it does to radical economic differences.[7] However, power considerations spilled over into economic differences, particularly on the issue of corruption, given the history of struggles within the party over forms of redistribution and their effects on patronage (see section 7.1.2) Perceived differences remain important though, as they have coloured some foreign accounts of the Anwar affair and therefore market reactions to political events in Malaysia.

Despite promises of a realistic austerity budget, the measures Anwar announced in early October did not satisfy the markets. They were seen as part of a high-risk attempt to keep supply going in the hope that the country could export its way out of trouble. If the strategy failed, problems would be much greater in future (*FT* 21 October 1997).

During November, two corporate deals were widely perceived as attempts by Mahathir to bail out politically connected companies. A reverse take-over of Renong by United Engineering Malaysia (UEM) was allowed despite breaching stock market rules. Later, the government agreed to take-over the struggling Bakun dam project in a move that was widely seen as a bail out of Ekran.[8] The stock market fell rapidly in response. [9]

The Renong saga continued into January as Anwar attempted to revoke the waiver of stock market rules, only to have it reinstated in January 1998. Other 'bail-outs' occurred throughout 1997 and 1998. The list includes an investment in Proton by the state oil company Petronas, the merger of bedevilled former state Bank Bumiputera with Commerce Asset Holdings Bhd on terms favourable to the bank, the purchase of ailing Phillipino Steel by a Renong subsidiary and the transfer of its debts to Danaharta, the bail-out of scandal ridden Perwaja Steel by the state controlled Employee Pension Fund, and the purchase of Mahathir's son's shipping business by Petronas (Haggard, 2000).

Presumably as a result of the failure of more accommodatory policies, a supplementary budget was announced on December 6. This contained far more orthodox measures and was described as a 'virtual IMF' policy. However, it was noted that Mahathir was not present when the measures were announced. [10]

The economy rallied briefly in early 1998 but growing regional instability (particularly in Indonesia) and developments in the continuing Renong saga precipitated a further decline. The structure of the Malaysian political economy was increasingly questioned, with concerns that Malaysia was not undertaking the sort of restructuring measures the IMF had recommended in Indonesia and Thailand (*FT* 16 February 1998, 25 March 1998). In particular, there was pressure to encourage investment by removing restrictions on foreign ownership of shares in Malaysian companies (*FT* 6 May 1998, 23 March 1998,). There were also allegations of controls on the media aimed at hiding the extent of crisis (*FT* 24 March 1998).

In the run up to the UMNO General Assembly in June 1998 there was speculation that Anwar would bid for the leadership. While not actually contradicting Mahathir's policy line, he was willing to point out its dangers – corruption was a key concern at the heart of his differences with Mahathir. A speech given in Washington demonstrates this balance:

> there is no room for the rancid rhetoric of misplaced nationalistic sentiments and protectionists…However, their claims will gain legitimacy if the global community does not commit itself unequivocally to reforming the international finance regime….we do recognise that state interventions in the economy are fraught with risks…Legitimate affirmative action policies can also degenerate into perverse patronage, creating a breeding ground for the rent-seeking activities of leeches (*NST* 17 April 1998).

Speculation was re-enforced by a speech by the head of the Youth Wing immediately prior to the assembly, which was highly critical of corruption within the party. It was widely interpreted as the first stage of an attempted Anwar take-over. Particularly provocative, given the recent ousting of Suharto, was the adoption of the Indonesian phrase *KKN* (corruption, collusion and nepotism).

In fact, Anwar's conference speech called for national unity behind Mahathir. The debate on corruption was hijacked by Mahathir who claimed that all *bumiputera*s were his cronies and produced a list of all who had benefited from privatization (including many who were campaigning for transparency).

By late June, Mahathir's policy had triumphed. He appointed Daim Zainuddin as Minister of Special Functions, charged with dismantling the 'virtual IMF policy' in favour of more accommodatory policy (*NST* 26 June 1998). After that, a fiscal stimulus package was announced (*FT* 2 July 1998) and interest rates were lowered (*FT* 1 August 1998).

The stakes were raised again when Mahathir introduced controls on short-term capital flows on the 1st September. This move was greeted by outrage in the markets:

> With capital controls slapped on many, investors will not return to Malaysia for a decade or more, regardless of how attractive their asset values become. (Bridgewater, 1998 cited in Wade and Venerosso, 1998b).

The IMF was also unenthusiastic. Camdessus reportedly claimed that the controls were 'dangerous and indeed harmful', while Stanley Fischer said they were a step backward and would bring no long-term benefit (*International Herald Tribune* 17 September 1998 and *Reuters* 11 September, both cited in Wade and Venerosso, 1998b)

A day later Anwar was dismissed from office. His dismissal and subsequent trial on charges of sodomy and corruption triggered unprecedented outrage. Mass vigils of up to 10,000 people were held outside his house in early September, with protesters complaining about Mahathir's dictatorial behaviour and the lack of domestic press freedom (*FT* 11 September 1998). When access to Anwar's home was restricted, protests moved to the national mosque, where they were broken up by police (*FT* 25 & 26 September 1998). Further protests materialized when Anwar was sentenced in April 1999.

Shortly after the initial protests a Coalition for People's Democracy was formed from political parties, human rights groups and

NGOs (*FT* 28 September 1998). By mid-1999, this had also resulted in a political alliance between the DAP, PAS and the 'National Justice Party' established by Wan Aziza Wan Ismail (Anwar's wife). However, despite significant gains for PAS in Muslim areas, the Barisan Nasional easily retained its 2/3 majority in the November 1999 general elections.

7.3 The politics of crisis management

I began this chapter by arguing that the Malaysian case was interesting for IMF legitimacy in two ways. The politics of Malaysian reactions to IMF interventions elsewhere in Asia would provide some indication of possible reactions to the Fund's new agenda. Additionally, Malaysia's policies for crisis resolution provided evidence of the likely outcomes of heterodox solutions – something that is key to the ways in which the IMF has sought to justify its new agenda. There was the potential for Malaysia to provide interesting demonstration effects that might alter debates about the politics of financial globalization and the IMF's role.

As we have seen, the debate about the controls began with a simple condemnation from market analysts and the IMF on the grounds that the controls were a gross distortion of markets and were, in any case, unlikely to work. The Malaysian authorities, on the other hand, argued that:

> The experiences of the affected countries thus far clearly demonstrate that the traditional policy prescription has not produced results. In the case of Malaysia, the combination of high interest rates and tight fiscal policies further distressed economic activities and led to a contraction of the domestic economy …[controls] provided the stability required for recovery measures to be effective. What is perhaps most significant is that the economic recovery was achieved with minimal social costs to the most vulnerable segments of society (Mohamed, 1998).

Before we get on to an analysis of whether Malaysian policy was really driven by a technical reaction to the failure of Fund policies elsewhere and whether outsiders were inclined to read Malaysian policy as a technically superior solution it is helpful to dispose of the strictly economic evidence behind the two claims.

7.3.1 Economic framing of political debates

Part of this debate was resolved by the economic outcomes. The IMF's own assessment ultimately endorsed the controls' effectiveness in preventing outflows. It accepted that 'the authorities have pressed ahead with bank and corporate sector restructuring' and that 'the reduction in interest rates that accompanied the controls helped to contain the increase in non-performing loans of the banking system'. Fund staff argue that this is because the controls were comprehensive, well implemented and widely supported by the domestic business community. The Ringgit was fixed at the lower end of its real value and the country continued to push ahead with economic reforms (IMF, 1999b, 8–9).

Although that suggests a retreat from the position the Fund initially articulated, high-profile, and perhaps more political, Fund figures such as Fischer have continued to be negative about the controls.

> I believe that the controls introduced a year ago are not a good way to operate in the international financial system, particularly for a country anxious to attract foreign investors[11] (Fischer, 1999).

In terms of substantive criticisms, the Fund and other economists have had two lines of attack.

Part of a regional recovery?

Firstly they have argued that:

> The pattern of economic performance in Malaysia since the emergence of the crisis has in many respects been similar to that of other countries in the region. This makes it very difficult to disentangle the impact of Malaysia's capital controls from broader international and regional developments (IMF, 1999b).

Implicitly, at least, this is an acknowledgement that early fears were over-stated. The rapid outflow of capital that many expected to take place when the controls were lifted has not occurred and there has been no drastic effect on Malaysia's access to capital. [12] However, the controls were implemented at a time when the regional position was turning round (see Figure 7.2). They may not have been a disaster but there is also no evidence to suggest that they would be a successful way of dealing with crisis elsewhere, since they have not been tested against serious capital flight.

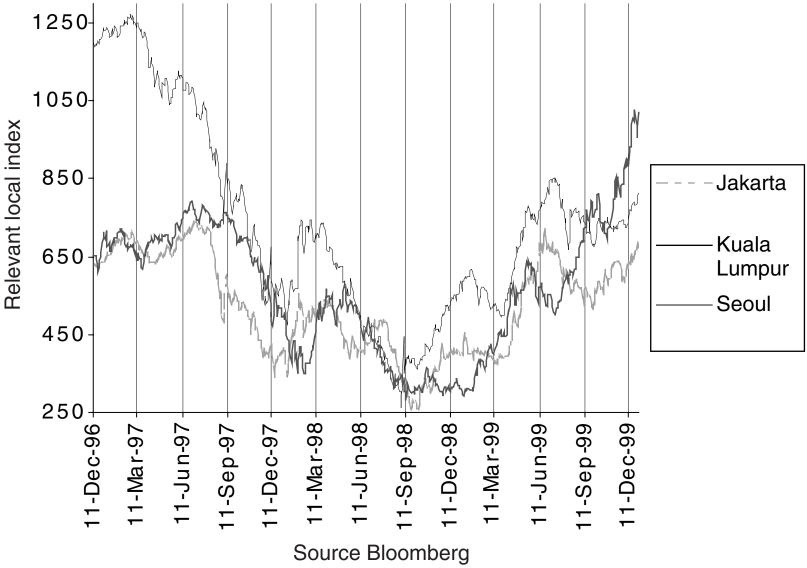

Figure 7.2 Stock markets during the crisis (not adjusted for exchange rates)

This is a widely accepted, but by no means impregnable position. Kapstein and Rodrik (2001) have argued that, whilst Indonesia and Korea may have been past their worst at this stage, Malaysia's attempts at economic stimulus in the summer of 1998 meant that 'pressure on the Ringgit reached its peak just before the Malaysian authorities decided to implement capital controls'. Malaysia faced offshore Ringgit interest rates of 20–40%, a depreciating exchange rate and declining reserves (Kapstein and Rodrik, 2001). Time-shifted regressions, comparing Malaysian responses in autumn 1998 to Indonesia and Korea's responses after their first IMF programmes, show far superior performance in the Malaysian case

Assessments of Malaysian policy, then, turn on difficult questions about the logic of counterfactual comparisons – how much can we learn by comparing Malaysia with the other crisis countries? Over what time period should comparisons be made? Which factors need to be controlled for? The Fund has argued, for instance, that better prudential regulation in Malaysia prior to the crisis limited banks' direct external exposure so that crisis effects were only felt indirectly through the effects of stock market and property price falls on the quality of bank portfolios (IMF, 1999b). The controls were never tested against the kinds of capital outflow that Indonesia and Korea experienced.

Some might also argue that Kapstein and Rodrik's technique, whilst pointing to problems with the regional recovery perspective, is too generous to Malaysia.

Those issues will remain controversial but it is important to note that, even at the anti-control end, the debate has shifted a long way from the knee-jerk, market-friendly reaction of both the IMF and financial analysts in autumn 1998.

Long-term effects – cronyism and competitiveness

Remaining debate concerns political economy aspects of the crisis. The technical argument here is that the imposition of controls allowed Mahathir to protect domestic business, preventing the kind of painful but beneficial restructuring that had taken place elsewhere in Asia. Even if the controls did little harm in the short term, they would damage Malaysian competitiveness over the longer term (Herald-Perkins and Woo, 2000; IMF, 1999b).

Although this view has become particularly significant, given the relative success of capital controls, debates about 'cronyism' and competitiveness had been important to media and market analysts throughout the crisis, as we have just seen.

Obviously effects on longer-term competitiveness are very hard to evaluate empirically: the longer the time period, the larger the number of intervening variables that will complicate the picture. However, concerns do provide a continuing technical justification for IMF disapproval of controls and of state-business relationships in Malaysia, which are at the heart of the politics of the crisis.

7.3.2 The political economy of crisis

Debates about the economic efficacy of controls, then, were closely tied up with questions about their political motivations and effects. Given the problems of distinguishing between economic arguments using the evidence, people tend to fall back on their convictions about the importance (or otherwise) of patronage in dictating Malaysian strategy.

Although the two were closely combined, it is helpful to treat the domestic and international politics of the crisis separately.

The domestic politics of crisis

We have already seen that domestic debates about *bumiputera* preference pre-date the crisis. The original political rationale behind the NEP – inter-ethnic accommodation through redistribution (or, for those more critical, Malay preference) – is still politically significant in Malaysia. However, during the 1980s and 1990s a shift took place away from general *bumiputera* preference as part of a broader programme industrial policy and towards the creation of a narrower class of independent entrepreneurs through liberalization and privatization. Elite Malays were keen to see themselves in these terms, arguing that the days of state handouts were over and that success was now based on know-how and talent (Sloane, 1999).

Considerable dissent over these moves continued both inside and outside UMNO. At the level of ideology, the new measures tended to unmask the elite character of NEP inter-ethnic compromise. In terms of interest, they narrowed the range of direct beneficiaries from NEP policies. The political significance of the 'governance-related decline of confidence' versus 'speculative market panic' debate in Malaysia was that it played into this pre-existing conflict over the extent to which the NEP had degenerated into economically damaging, narrow cronyism.

For IMF supporters, this was very much how NEP interventions were interpreted. The market's problems began with Mahathir's reluctance to ditch mega-projects in the face of contagion-induced shocks. Mahathir's market antagonism then added fuel to the fire. Implicitly or explicitly, both were regarded as due to his reluctance to put market efficiency and a level playing field above his 'crony' based political support.

Anwar was seen as the leading domestic proponent of this view. The extent to which Anwar consciously wanted to promote a more liberal agenda than Mahathir in early 1998 is debatable. However, this perception was certainly present and was amplified in the wake of the furore surrounding his dismissal, which, significantly, coincided with the imposition of controls.

In other words, it was possible for some to argue that the choice of capital controls was much more a political than an economic one:

> Mahathir rejected the IMF approach not because of the policy but because he was unwilling to accept conditions that required greater transparency, particularly in banking transactions, and clean from elements of cronyism and nepotism (Keadilan information chief Rustam A. Sani, quoted in Malaysiakini[13] 6 September 2003).

Support for this view comes from measures introduced to protect key 'crony' interests.

This view had some political popularity. It played to the long-established agenda of the non-Malay opposition. So, the DAP has been keen to point up the connections between controls, corporate bail-outs and economists' arguments about the potentially damaging effects on long-term Malaysian competitiveness. Even within the Malay community, some of the less tightly targeted government interventions in the crisis favoured a narrow group at the expense of the rest. Using capital from the Employees Pension Fund and Petronas to bail out economically fragile, politically connected companies had an immediate impact on the retirement savings of a far wider range of Malays. Small business was particularly badly affected by the credit crunch as interest rates were raised and were likely to be particularly aware that they fell outside the narrowing scope of UMNO patronage.

Mahathir, on the other hand, was keen to articulate a much more inclusive justification for a less market-friendly approach. At times, his rhetoric was simply a brand of populist economic nationalism designed for the domestic audience and it had some distinctly unpleasant aspects (the anti-Semitic character of his attacks on Soros). However, it also articulated a relatively coherent and plausible critique of the IMF approach to financial globalization.

Throughout the crisis, Mahathir was keen to confirm his general support for market processes. In the 21st century 'trade and productive investment must be the arteries, the veins, the tissue, the muscle and bone of our global prosperity' (Mahathir, 1997a). However, that didn't mean it was necessary to surrender completely to market forces, market confidence and market discipline as the IMF suggested.

Capital for 'productive purposes' was welcome but capital markets, like other markets, needed to be regulated because markets have 'no sense of commitment and responsibility' (Mahathir, 1997a) or 'morality' (Mahathir, 1998a). Malaysia's heterodox policies were about the task of regulating capital flows so that markets served society rather than vice versa (Mahathir, 1997b). The capital controls provided breathing space to pursue expansionary economic policy that would benefit all Malaysians.

He drew explicit attention to the NEP as both the source of political stability in Malaysia (Mahathir, 1998a) and as a relatively efficient form of industrial policy (Mahathir, 1998c). The IMF was trying to prevent Malaysia from pursuing either aim in the future:

> it will restrict our freedom to design and initiate new ways of stimulating foreign direct investments in our country and

> the implementation of new economic policies and strategies. Malaysia has always been innovative and that is why we have progressed (Mahathir, 1997c).

He conceded some Malays had benefited more than others but maintained the only way to create *bumiputera* business was to ensure that some entrepreneurs received a significant quantity of capital to create internationally competitive business (note the parallel with the arguments about industrial policy introduced in Chapter 4). Beneficiaries had been selected according to demonstrated ability and poorly performing Malay owned businesses had been allowed to fail (Mahathir, 1998c).

Bailing out large conglomerates is difficult to justify. However, with the exception of Mirzan Mahathir's shipping business, the major rescued companies all served some wider social purpose, as well as enriching their owners. Renong was involved in infrastructure projects. Proton and Perwaja were part of a wider programme of technological upgrading. Phillipino Steel had originally been purchased by a Mahathir 'crony' for foreign policy purposes. The use of private business to carry out infrastructure projects is part of the worldwide drive towards privatization. It does raise difficult questions but those are not confined to Malaysia, as controversy surrounding Private Finance Initiative projects in the UK or infrastructure contracts in Iraq demonstrates.

It is clearly the case that Mahathir's response to crisis was partly conditioned by his attempts to maintain political support and that corruption was involved. At the same time, though, dismissing it on those grounds also involves rejecting the positive aspects of NEP policies and the capital controls. It would be wrong to reduce everything to a simple moral judgement about 'corruption'. That was certainly an important issue but it was only one part what was at stake. Mahathir's choice also had implications for industrial policy, the balance of inter-ethnic economic and political power (or, perhaps, UMNO dominance) and, of course, broader strategies for dealing with economic crisis.

Domestic political reactions in Malaysia were mixed. Some Malays had direct material interests in the NEP whilst others received less: that politics of the UMNO split in 1987 was an early illustration of this division. Non-Malays were harmed materially by the NEP but may have been frightened of the consequences of unravelling it too quickly. Political opinion surveys are very rare in Malaysia. The complexities of the electoral system also mean that voting patterns are difficult to interpret. There was a sharp swing away from the BN in 1999 but not one that seriously threatened UMNO's power and UMNO recovered strongly in the 2004 elections. Continuing electoral support is not decisive but should provide pause for thought for foreign critics who would like to see the system radically transformed.

The international politics of crisis

Mahathir's defence of the choice to impose capital controls also led him to a critique of IMF interventions.

We have already seen that the thrust of his domestic defence was that an IMF programme would put market efficiency ahead of legitimate domestic policy instruments, designed to pursue social aims or heterodox industrial policy.

For Mahathir, it was IMF solutions to the crisis that were politically interested. Foreigners' fundamental problem with NEP policy was that it meant Malaysian rather than foreign businesses received infrastructure contracts. The IMF's high interest rate policies would ensure local companies would go bankrupt, leading to foreign takeovers at fire-sale prices (Mahathir, 1998b). It was no surprise, then, that high interest rates were combined with an insistence on liberalizing foreign investment rules.

More broadly, the IMF formed part of a post-Cold War alliance in which capitalists could do no wrong. The IMF and foreign financial markets fed off each other.

> We are also warned that these are powerful people. If we make noise or act in any way to frustrate them they would be annoyed (Mahathir, 1997b).

The idea of 'market discipline' served to undermine democracy

> the advocates of the free market insist that somehow the punishment of these Governments through their people is justified because in the end there would be a free market and absolute freedom for the capitalists to make as much money as they can for themselves (Mahathir, 1998d).

Mahathir argued that the controls stabilized the Malaysian economy without: having to 'kowtow to anyone', sacrifice full employment, expel migrant workers, reduce school enrolment, decimate the middle class, slaughter Malaysian entrepreneurs, suffer blood on the streets, sell off business at fire-sale prices, or go into massive foreign debt to the IMF or anyone else (Mahathir, 1999a; Mahathir, 1999b; Mahathir, 1999c).

Mahathir's views on the crisis were elaborated in a range of international fora including the Commonwealth and non-aligned movement. Although there was much press coverage of his more outrageous statements, a fairly consistent and more moderate message was articulated at, for example, IMF Board of Governors meetings. In the period after the crisis, Malaysian Governors argued that simply increasing transparency would not be enough to prevent future crises (the core of the IMF's approach). They called for better regulation of international markets and pushed the IMF to abandon moves to make capital account convertibility an obligation. They also complained that there was insufficient developing country representation in the post-crisis reform process.

7.4 Conclusions

The arguments Mahathir was making, then, are a clear challenge to IMF legitimacy. He attacked the Fund's technical credentials, emphasizing successful heterodox policies in Asia's past and accusing the IMF of closing off potential heterodox solutions in the future. He went on to accuse it of political bias in favouring markets over states, capital over labour, and international creditors over local debtors. He emphasized the social and political aspects of the debate about policy in Asia and used poor performance in Indonesia and Korea to justify his claims.

The argument was explicitly that Fund interventions should be seen as political rather than technical. It is also clear that what swung the balance towards making that criticism was a collapse of confidence in the welfare-enhancing effects of capital inflows. He was not challenging the virtues of market economies *per se*, he was simply calling for better regulation of capital flows in the interests of domestic social and political priorities. Overall, his attack amounts to a criticism of IMF legitimacy: of the decisions the IMF made and the ways in which it made them.

The capital controls also provide a potential demonstration effect to other countries. They were not a breach of the Fund's Articles or any other international law, yet they helped Malaysia to avoid IMF interventions and certainly weren't economically disastrous.

Both events signal potential political problems for the Fund. The question, though, is the extent to which other countries will follow the Malaysian example and challenge the Fund, directly or in the policies they pursue.

The domestic politics of Malaysian choices enter into the debate here. Mahathir's claims are logical in theory but they are undermined to some extent by perceptions of Malaysian corruption and authoritarianism. In a sense, that supports Mahathir's claim that IMF interventions simply were political. If we think in terms of the IMF's official mandate, economic concerns should have been all that matter. Arguments were made about the negative economic effects of corruption but it is clear that political mobilization and debates centred on ethical and political questions about justice and power maintenance. However, the political arguments are important and explain why his views did not receive universal support, even within Malaysia. They also helped to make it difficult for people to stand up on the international stage and support Mahathir's position.

The complexities of the underlying politics make it difficult to predict how similar questions will play out in other countries. In particular, it will matter how much the government is trying to pursue industrial policy, ethnic redistribution or other social and political goals by influencing capital allocation. The historical background, social structure and political arrangements in different countries will produce different results (as we have already seen when comparing Indonesia, Korea and Malaysia). Perhaps more importantly, outside the context of crisis, it is likely that financial bureaucrats will be left largely to themselves in formulating policy towards the Fund. Criticism is far more likely where other branches of government become interested in what is going on, since they are more likely to be aware of the political consequences of IMF-style reforms.

Some finance ministry officials may have an interest in maintaining control over capital allocation. However, all are likely to be aware that making 'anti-market' comments (including criticism of the Fund) risks impairing access to credit and investment. If crisis does not seem imminent this risk may not seem to be worth running. If it is imminent the dangers of rattling the markets are even more acute.

On better regulation of international finance and more developing country participation in decision-making, though, there is potential for greater solidarity. On the other hand, for low-income countries with little access to private finance, many of the issues are largely irrelevant at the moment. Here again, there may be insufficient incentives to 'cause trouble'.

8
The United States

We have now seen what the IMF was doing in Asia and how one other middle-income country reacted. In this chapter, we turn to look at the role of the Fund's largest shareholder, the United States, in the crisis and post-crisis debates.

The United States has a powerful influence over the IMF. It cannot do everything it wants within the Fund but it is difficult for the Fund to do anything that meets with US disapproval (Woods, 2003). We have seen there were allegations of undue US influence in creating the Korean programme. There were also signs of US pressure on Suharto to implement the Fund's governance agenda. On the other hand, the IMF's interventions were also highly controversial in the US and requests for an IMF quota review were debated in Congress for most of 1998.

This chapter is designed to see what shapes America's powerful influence on the Fund. It looks at the institutional relationship between the IMF and different branches of the US government, reviews relevant aspects of US pre-crisis foreign policy and explores the politics of debates about the Fund in the aftermath of crisis.

Understanding US-IMF relationships is vital for the book as a whole. If IMF interventions in Asia were problematic, we need to understand why. What kind of developed country agenda was driving the Fund's Asian policy? What was driving post-crisis dissatisfaction in the US? Does that dissatisfaction suggest political openings, or does it simply imply further conflict? This chapter will also introduce US positions on post-crisis reform.

8.1 Institutional environment

My main focus so far has been IMF conditionality and I have devoted some attention to the institutional relationships between the Fund and developing countries. An understanding of the importance of US debates now requires further information on the institutional links between the Fund and United States so that we can understand how different actors in lender countries can hope to influence IMF policy.[1]

8.1.1 Overview

The United States has two formal sources of influence over the IMF, its Governor and its Executive Director (ED) who are appointed by the President with Senate approval.

Day-to-day oversight of Fund operations is the responsibility of the Executive Director (Karen Lissakers, during the period reviewed). She reports to the International Monetary Affairs department. The Treasury supplies her with an economic advisor, three technical assistants and two administrative assistants at the Fund along with advice from the relevant Treasury department (Geithner, 1998).[2] The Treasury is accountable to American citizens through oversight by their elected representatives in the House (Senate and Congress) and through presidential elections.

In practice Congressional oversight is only exercised when the Executive needs permission for an amendment to the Fund's Articles of Agreement or, more commonly, for an increase in the US quota.[3] Congress tends to grant permission only subject to a list of matters that it expects the US Executive Director to promote using his/her 'voice and vote' during Executive Board meetings.

Treasury oversight, on the other hand, is continuous. Since the IMF offices are in Washington, the US Executive Director is probably held more closely accountable than any other. Thomas Dawson, an ex-US Executive Director, advised the House Banking Oversight Subcommittee that, in exercising its oversight it should 'lay it on Treasury not on the poor US director' (House Banking Oversight Subcommittee, 1998, 106). Treasury consults with the Department of Commerce and the US Trade Representative (USTR) to ensure the Executive Director is aware of any ongoing US trade issues. Unlike in the UK, for example, where the Department for International Development (DFID) has input into IMF policy, United States Agency for International Development (USAID) is not involved in IMF policy making, since the IMF is 'not a development institution'.[4]

8.1.2 Achieving US purposes within the IMF

Within the IMF, the Executive Director's job is to ensure Treasury policy (as influenced by Congress and USTR) is implemented by the

IMF. Testimony given by Treasury officials to the relevant Congressional committee suggests she does this by a combination of means. Since most decisions are made by consensus and formal votes are rarely taken,:

> the US must engage in coalition building to obtain the necessary support for its views on most issues. This is accomplished through a variety of channels including frequent contacts with the Management, staff and the Offices of Executive Directors, either individually or in groups. These efforts are often supplemented by contacts with the home governments of member countries, including within the G7 framework, other multilateral fora and bilaterally (Geithner, 1998).

In other words, formal Executive Board discussions are only one of the fora in which the US Executive Director tries to exercise her influence.

> The board discussions themselves can be quite fluid and lively; however much of my work is done behind the scenes through informal meetings and discussions with other Directors, with management and with senior staff (Lissakers in House Banking Oversight Subcommittee, 1998, 24).

Geithner, responsible for international affairs at the Treasury, went on to outline the US strategy for implementing controversial issues of concern to Congress that were not generally regarded as 'economic' such as labour rights and the environment. Pressure is put on IMF staff to research the 'economic' aspects of these issues. Pressure is then placed on the Managing Director to raise the issues in public fora, and discussions take place with other Executive Directors informally. Only then are issues brought up in public discussion or reviews of country programmes (Geithner, 1998).

8.1.3 Treasury and the administration

Treasury is largely in control of the USED's input into Fund policy.

High-level Treasury officials are appointed by the President as part of his administration and are primarily accountable to the White House.

Since US administrations are made up of outsiders rather than career politicians, there is a tendency for Treasury officials to come from business or academia. The circulation between academia, Treasury, Wall Street and the IMF has led many to complain that the Treasury, particularly under the Clinton administration, has been too willing to have its policy driven by Wall Street preferences (Bhagwati, 1998).

In keeping with a broader trend in Western countries since the late 1970s, respect for economic expertise and a preference for insulation from 'political interference' in economic management has led to increased respect for the 'expertise' of Treasury officials. Andrew Baker has argued that there is a self-reinforcing consensus within the G7 around a particular set of economic policies, particularly: free capital flows; flexible exchange rates; and independent monetary policy centred on inflation targets. Sound monetary and fiscal policies, aimed at medium-term price stability, ensure a broadly appropriate exchange rate by appealing to the markets. Exchange rates are largely a demonstration of the markets' verdict on domestic macro-economic policy. That perspective casts the Treasury role very much in terms of a particular relationship with the financial markets. There are modest opportunities for influence but its role is generally to ensure nothing is done to damage market sentiment (Baker, 2002).

The arguments around 'market confidence' I explored in debates on good governance are also evident in this perspective on economic management. Decisions are taken by technocrats (in close contact with the financial markets), rather than 'politically' motivated politicians. Treasury dependence on market confidence for the cost of borrowing to fund an increasing US government deficit may help to increase this idea of dependence on market views.

That agenda is open to challenge where it conflicts with the views of more politically-minded arms of government but, where Treasury is left to itself, it will dominate policy approaches.

8.1.4 Congress and the wider public

As I indicated in the overview section, the principal powers reserved to Congress under the Bretton Woods Agreements Act relate to the approval of quota increases or amendments to the Articles of Agreement. Congress is also able to pass specific legislation directing the way in which the Executive Director should act. In practice Congress has only tried to press compliance when Treasury asks it to approve an IMF quota increase.

Two important questions are raised here. How effective is the strategy and which issues interest Congressmen and why?

I will discuss the practical effects of the legislation that was passed as a result of debates on quota renewal in 1998 below. For now it is enough to point out that legislation of this kind is a relatively blunt instrument and its effectiveness will largely depend on Congress's ability to monitor the ED's compliance and impose sanctions. Congress cannot legislate for 'results': the ED can only do her best to press Congressional preferences within the Fund's decision-making bodies – consensus decision-making makes monitoring difficult. While the US exercises considerably more influence than its 17% of the vote would suggest, it cannot act alone and does not always achieve its goals.

Although the scope for continuous oversight is limited, the need for periodic Congressional approval can be a powerful lever. Legislation sends messages about Congress's preferences and issues that are likely to be raised when it is time for the next round of quota renewals.

It may appear unlikely that Congress would refuse a quota increase outright, but it is not impossible given recent difficulties in securing UN subscriptions. In any case, Congress may pass obstructive legislation or cause embarrassing delays in authorization.

What drives Congressmen to engage in this kind of scrutiny and what form can we expect it to take?

There has been much debate about the significance and desirability of a more 'activist' Congress on foreign policy issues. The US constitution is ambiguous about the division of foreign policy powers. During the 1950s Congress tended to bow to Presidential leadership. Since Watergate and Vietnam, though, Congress has become less content to abandon differences 'at the water's edge' (Lindsay, 1994). In relation to foreign *economic* policy, there have been similar fluctuations. In the 1950s, Congress tried to tie its own hands on trade policy, delegating much of its constitutional authority to regulate ' commerce with foreign nations' to the President. During the 1980s, this position was partly reversed with more active attempts to legislate on trade issues (Bayard and Elliott, 1994; Destler, 1995).

For some this is problematic because Congressmen tend to have parochial preferences, based on the short-term wishes of their state electorate, preventing them from adopting a more thoughtful, long-term, and national or even international perspective.

Lindsay (1994) argues persuasively that this is an overly simplistic conception of Congressional behaviour. Congressmen will wish to avoid providing public support for policies that the majority of their constituents oppose. However, in practice, the majority of American citizens are not that interested in foreign policy issues.

> Rather than slavishly following constituent opinion, members of Congress try to accomplish their personal, policy and political goals

> subject to a constraint laid down by constituent opinion (Lindsay, 1994, 34).

Lindsay suggests that although the strongest electoral incentives broadly favour silence on foreign policy questions (there is little to gain and much to lose), there can be political advantages in pursuing personal foreign policy goals. Involvement in Congressional committees can be good for the career of a Congressman seeking higher political office. The importance of the 'attentive public' – interest groups, particularly but not exclusively those with an ethnic basis (Jewish Americans, Asian Americans, African Americans) – can make foreign policy a vote winner and mobilize campaign finance. Taking a high profile stand on issues can gain media coverage, raising a politician's profile.

Committee posts can also be a route to advancement within the party and therefore to higher political office. They provide an opportunity to make a name for oneself within Congress. For those 'policy entrepreneurs' who become involved in foreign policy issues, electoral calculus remains important but largely in influencing the way policies are presented in public. The line between policy preference and 'pandering' to constituents can sometimes be blurred by astute presentation of policy issues in ways that constituents can relate to.

8.1.5 Summary

Treasury policy is particularly key in determining US positions within the Fund. But Treasury acts within political constraints imposed by the wishes of the President, Congress and less directly, the general public. Direct public influence on IMF policy is only likely on the back of very large political protest or concerted lobbying. Congress has more significance but only exercises intermittent oversight. Congressional interest could be driven by a number of reasons including the personal agendas of activist Congressmen as well as electoral incentives.

Oversight of Treasury policy is difficult because it is hard to keep track of exactly what is being done. Lack of transparency in Executive Board discussions is one reason for this, but influence is also exercised informally in ways that are extremely difficult to monitor.

8.2 Pre-crisis US foreign policy

This institutional environment shapes the kinds of power, incentives and interests particular groups bring to debate about IMF reform. We will see how those fed into controversies about the Asian crisis in section 8.3. Before that, though, we need to get a feeling for the background to the substantive issues that were involved in crisis debates. What kinds of patterns had shaped US foreign policy in the run-up to the crisis? In particular we need context on US attitudes to financial sector liberalization and economic relationships with particular Asian countries.

8.2.1 Clinton administration foreign policy

Clinton administration foreign policy should be understood against the background of debates about post-Cold War foreign policy and a longer history of Congressional ambiguity about trade policy.

Clinton came to power promising to concentrate more on a domestic agenda than his predecessor George Bush (senior). Intervention in the Gulf War had proved politically problematic. It had been costly and yet hadn't produced the outcomes that pre-War rhetoric about Sadam Hussein seemed to demand. By the 1992 elections, the financial costs of the crisis were becoming apparent to a US population already concerned about economic decline, while problems in Iraq clearly continued (attacks against the Kurds, controversy over weapons inspection etc.) (Dumbrell, 1997). The Iraq issue was the most important manifestation of a wider (and, of course, ongoing) debate about the costs of American leadership and the value, or otherwise, of multilateralism (Walt, 2000). At least since the Food for Peace programme was negotiated in 1990, Congress had also been pressing for greater control over the purse strings, now security was a less credible justification for aid spending (Lancaster, 1993).

The domestic economy was particularly important to Clinton policy and this spilled over into his administration's foreign policy priorities. 'I make no apologies for putting economics at the top of our foreign policy agenda', Secretary of State Warren Christopher told *Newsweek* (6 March 1995). The second key plank of Clinton foreign policy was 'enlargement': promoting democracy and markets abroad. Key figures such as Warren Christopher, Anthony Lake and Strobe Talbott publicly argued that promoting democracy was not merely 'idealist' but also represented the national interest (Talbott, 1996). It also helped to allay opposition to aid spending in at least some parts of Congress.

In the economic sphere, Clinton inherited concerns about American decline and trade imbalances with Asia that began under the Reagan administration. Although the root cause of the problems was Reagan-era macroeconomic policy, Congress was increasingly concerned about its trade deficit, particularly with Japan. The argument was that 'Japan's fundamental institutions – its economic and political systems, even its culture – were themselves barriers to trade' (Bayard and Elliott, 1994, 23). Congress pushed through the infamous 'Super 301' legislation, which put pressure on the administration to name 'unfair' traders and on USTR to retaliate for anything the US decide was a breach of international obligations. Stronger provisions for a 'results oriented' trade policy were defeated but demands resurfaced in the early 1990s.

Early Clinton administration policy was not immediately reassuring to those looking for a liberal multilateral trade agenda. Key Clinton administration advisers had published books promoting a 'strategic' trade policy in response to Asian competition (Tyson, 1992). Others, notably Jeffrey Garten and Theodore Moran, equated economic success with national security arguing that, in the new world order, economics was power, so trade issues should be seen in strategic terms (Garten, 1992). A National Economic Council was set up alongside the National Security Council in the White House.

This approach created outcry in both the economics and security communities (Krueger, 1995; Krugman, 1994; Wolfowitz, 1994). In fact, though, the reality was more modest than the rhetoric. Bilateral pressure was put on Japan, particularly a notorious dispute over car sales in early 1995 (Nau, 1995). However, the main emphasis was on obtaining market access abroad, rather than protection at home.

The major success here was the inclusion of services in the Uruguay GATT round. Here again, the root cause was domestic discontent about trade liberalization. As early as 1982, the Reagan administration had tried to push for a services agenda. The US economy was increasingly service-driven and there was a feeling that there was no longer much to gain in goods liberalization. However, doing so would be a challenge:

> Freer trade in services implies much more than free cross-border trade; it raises the broader issues of market access and, more generally, of doing business in a foreign country, which involves investment, regulation, and public and private anticompetitive behaviours (Dobson and Jacquet, 1998, 76).

In the US, financial services were particularly important and Wall Street, under the leadership of American Express, was key in lobbying for the services agenda (Dobson and Jacquet, 1998; Hoekman and Kostecki, 2001). Financial services was also the most problematic part of negotiations, extending beyond the Uruguay round, to the end of 1997. This agenda, too, built on disputes with Japan and Korea during the 1980s and 1990s. Both had made significant concessions under threats of unilateral US trade sanctions.[5]

The US position in services negotiations was particularly strident. By the expiry of the first Uruguay round negotiating deadline in 1995, the Europeans felt developing-country offers provided an important basis of agreement and were willing to leave further liberalization for the future. US financial institutions, though, put powerful pressure on the administration, arguing that reciprocity demanded emerging markets that were as liberal as the US system (conveniently ignoring the absence of internationally active emerging market banks). The US threatened to carve financial services out of Most Favoured Nation (MFN) obligations in an effort to win further concessions (Dobson and Jacquet, 1998).

By the mid-1990s, perceptions of economic decline were no longer driving trade policy. However, a booming Wall Street was still pushing hard for financial market openness through the OECD (the abortive drive for a multilateral agreement on investment) WTO (the services agenda) and IMF (calls to amend the Articles).

The connection between trade and financial agendas was also highlighted in the Mexican crisis of 1994. The Clinton administration's other major trade success (albeit a controversial one) was the North American Free Trade Association (NAFTA). When the Mexican financial crisis threatened to discredit the agreement, Congress was unwilling to fund the bail-out. The administration had got round this problem using the previously obscure Exchange Stabilization Fund, but Congress was furious, seeing this as a way to subvert its constitutional power over the purse strings. The Mexican affair was a demonstration of how much importance the Clinton administration placed on supporting cross-border financial flows and on how controversial that could be with Congress.

8.2.2 Economic policy in Asia

East and Southeast Asian were important in these developments. As early as 1993, Treasury told Congress that:

> Until the Korean Government allows domestic banks to compete in a market environment…there is little likelihood of major advances in equality of economic opportunity for foreign financial services providers (Frankel, 1993, 131).

More generally, in 1993, the Clinton administration set out a strategy to target economic relations with 10 'Big Emerging Markets', including Indonesia and Korea (Thailand was apparently just off the list) (Stremlau, 1994). The chosen countries were seen as regional leaders of potential strategic interest. Economic engagement was also intended to be a channel for pressure on human rights and political liberalization (Indonesian human rights policy was part of the debate). More importantly the aim was to open markets for IT, telecommunications, healthcare, transport, power generation and financial services. A particularly successful mission to Indonesia won a $2.5 billion contract for Mission Energy in East Java (Stremlau, 1994).

In terms of specific trade issues, USTR produces an annual 'Trade Estimate Report on Foreign Trade Barriers'. The 1997 report listed concerns in Indonesia and Korea, many of which went on to feature in Fund programmes. In Indonesia, key targets were: measures designed to prevent the export of unprocessed wood; the national car project; BULOG's intervention in food markets; and restrictions on foreign ownership in the banking and securities industries. In Korea the report totalled 19 pages. Particular emphasis, though, was placed on the banking industry. It cited

> High cost procedures and restrictions on…financial activities which are more reminiscent of an emerging economy than of one of Korea's level of development…despite its claims otherwise, the Korean government has actually accomplished relatively little deregulation of practical importance.

8.2.3 Treasury views on international monetary economics

The Treasury and G7 consensus on appropriate macroeconomic management that I discussed in section 8.1.3 is also an important influence in policy towards the IMF. That was clearly demonstrated in the response to the 1994–5 Mexican crisis, where the stress was on improving transparency, encouraging more rational market discipline (Kenen, 1996). Baker argues that Treasury officials explicitly regarded the post-Asia agenda for reforming the international financial architecture as a more proactive extension of the post-Mexico approach (Baker, 2002).

8.2.4 Summary

There is strong support for claims that IMF interventions in Asia reflected US priorities. Discontent with industrial policy in Japan and

Korea began with concerns about American decline during the 1980s. As the economy picked up in the 1990s, these concerns were replaced with an enthusiasm for the prospects for financial globalization. Clinton foreign policy was particularly focussed on economic issues reflecting the US electorate's post-Cold War preferences. Pressure for 'development' spending to have a social as well as strategic justification was also significant, particularly in relation to Indonesia, which had been the subject of some Congressional concerns prior to the crisis.

The aspects of the programmes relating to macroeconomic policy and finance owed much to the sort of economic wisdom espoused by the Treasury but it also reflected a wider G7 consensus and, perhaps to a lesser extent, a consensus amongst the economics profession in the US.

8.3 US responses to the IMF's role in Asia

If pre-crisis Treasury policy was so closely reflected in IMF programmes in Asia, why was there an outcry in the US media following the crisis? How far did that outcry convert into policy debates in Congressional Committees? Which issues were important and what was it about the crisis that triggered concerns? Who had access to those committee debates and therefore direct influence on policy outcomes?

I answer these questions by reviewing the different positions raised in Congress. I go on to outline Treasury reactions and influence from the wider public and conclude with a brief description of the tactics used in negotiation.

8.3.1 Congressional debates

Moral hazard, transparency and equity

What made the press when Congress came to debate IMF interventions, was an emergent anti-IMF alliance between left and right wing Congressmen brokered by Bernie Sanders, an independent left-winger (*FT* 23rd January 1998 (US edition), *American Banker* 15 January 1998). The issues uniting the parties were problems with IMF transparency and accountability (to Congress) and the view that IMF programmes bailed out foreign lenders at the expense of US and foreign taxpayers (moral hazard). Despite this agreement, concerns driving these issues were very different for left and right-wing Congressmen.

Right-wingers combined a fundamentalist faith in markets with a reluctance to spend money in multilateral fora. The problem with capital flows was that IMF bail-outs were undermining incentives for reform in borrower countries and lender banks. Only when the Fund stopped coming to the rescue would banks do their due diligence properly, in turn disciplining governments that pursued poor policy. If markets were left to themselves the system would adapt itself. In any case, bail-outs were extraordinarily expensive to the US tax-payer and lack of accountability made it difficult to get value for money:

> We should not commit US taxpayer resources unless and until we can answer the question 'will it be used in a way which protects our national interest?'…the IMF is not an open institution. Some argue that the Treasury Department bureaucrats wield tremendous influence at the IMF…but that is insufficient accountability to the American taxpayer (Bachus in House Banking Oversight Subcommittee, 1998 page 3).

Of course, as Chair Jim Leach was keen to point out, IMF quotas are a loan not a gift. They earn interest and are a US asset. The costs are the difference between that interest and market rates, and the fact that SDRs are less liquid.

Still, the headline sums involved can make a powerful political impression. External support for the free market moral hazard views came from right-wing think tanks such as the Cato Institute (Calomiris, 1998) and Heritage Foundation (Vasquez, 1998), some economists (*WSJ* 27 August 1997, 3 February 1998) and figures associated with the American Enterprise Institute (Lindsey, 1998).

On the left, concerns about moral hazard and IMF governance were driven more by equity considerations. Was it appropriate for US and Asian taxpayers to bail out large American financial institutions? Who would the IMF programmes benefit – powerful financial interests or labour and the poor? Was accountability to the Treasury going to provide comfort on those issues and would the negotiating process in developing countries enhance democracy?

In keeping with broader left-wing US enthusiasm for promoting international standards on labour rights and the environment, there were questions about why it was possible to force Indonesia (in particular) to set up an independent central bank but not to force it to implement core labour rights.[6] Supporting witnesses here came from Asian NGOs (Bello, 1998) labour unions (Becker, 1998), and left wing lobbies (Nader, 1998) and a number of Indonesian pro-democracy activists (see *AFX(AP)* May 8 1998).

Although, as I will argue below, NGOs were not particularly active in lobbying on Asia, left-wing Congressional concerns echoed pre-existing perceptions that Fund policies tended to hurt the poor disproportionately. In interviews I conducted in Washington in autumn 2000, left-wing Congressmen and their staff argued that, on the whole, they would rather there was no Fund, but they would at least press for more 'positive' conditionality. Bernie Sanders, for example, was also in the process of introducing legislation taking issue with conditionality in the highly indebted poor countries (HIPC) initiative and a further bill calling for small-scale human development.[7]

In some ways this kind of left-wing pressure is welcome in pushing a more social agenda on the Fund. However, it is also problematic. It is concerned to push a more developmental agenda but that is seen in terms of a particular NGO discourse of dealing with the poorest and the environment.

Social safety nets and investment in human capital are important parts of any development agenda. Labour rights and the environment are more controversial. They are both good things but they are also costly and the cost calculation may legitimately look very different in the context of a developing country. For example, the formally employed working class may already be a relatively privileged group (Pangetsu and Henytio, 1997). More generally, this approach offers little in the way of support for pursuing autonomous policy at the macro-level like Korea's industrial policy or Malaysia's ethnic distribution. Left-wing pressure is pushing in a broadly progressive direction, then, but there are problems with prioritization, particularly in the context of the political arrangements involved in Fund decision-making. Either consciously or unconsciously the interests of the American left in avoiding the loss of jobs to foreign sweat-shops can colour perceptions of appropriate development policy.

Security concerns

The Administration stressed the importance of engagement in the Asian region to show US solidarity with its Asian allies. Some Congressmen supported this view but others (particularly Jackson, Bachus, Roach and Malpass) were concerned by negative reactions in Asia:

> I have been to Asia five different times in the last fourteen months…And I am not saying I pick up a representative sampling

> of opinion, but I certainly hear and feel an undercurrent of anti-American, anti-IMF, anti-G7 backlash (House Committee on Banking and Financial Services, 1999, 130).

At least one senator felt the IMF had been instrumental in Suharto's fall (Locke, 2000). A number of Congressmen realized the IMF was closely identified with US interests and witnesses (both right and left-wing) confirmed this perception (Bello, 1998; Hanke, 1998; Nader, 1998). Others suggested (pointing to the ill feelings caused by early reluctance to get involved in Thailand (Connors, 2001)) that while there were risks to action, inaction was worse (Bergsten in (House Committee on Banking and Financial Services, 1998)).

Domestic effects and 'special interests'

In keeping with more electorally minded interpretations of Congressional behaviour, there was evidence that Congressmen were keen to connect issues to a domestic agenda. For those in favour of the IMF, Asian markets were an outlet for US goods, currency depreciation risked US jobs, and the crisis could be used to reduce Asian export dependence and enhance US market access. For those against, the question was why the administration could find money to prop up US banks while it couldn't find more to spend on medicare and why regulatory incentives encouraged US banks to lend to foreign governments rather than 'small businesses in my district'.

An entire session was reserved for US industrial interests: Boeing Asia, Micron Technology (manufacturers of DRAM chips), the American Forest and Paper Association, the American Farm Bureau, and IPSCO Steel Inc. The general perspective was pro-IMF, so long as it opened markets for their goods and did not involve 'bail-outs' of competing firms. There was a marked tendency to argue that corruption and crony capitalism had led to overcapacity and that the crisis was an opportunity to attack the unfair subsidies that had made it difficult to compete in Asia.

Perhaps one of the more interesting contributions came from Becker, representing the unions, and particularly US steelworkers. His testimony was, at one level, concerned about the effects on union members in Indonesia and, at another, worried about job losses for his members as a result of currency depreciation. He didn't seem to be aware of the conflicts of interest involved in that position (Becker, 1998).

Technical criticisms of the Fund

The technical issues I reviewed in other chapters made their way into Congressional debates, partly through academic witnesses but also via the versions that were published in the financial press, which were taken up by various Congressmen and placed on the record of Committee debates.

The possibility of moral hazard; whether there was a need for greater transparency; the desirability or otherwise of pegged exchange rates; the appropriateness of initial IMF-mandated fiscal policy; and the necessity of tight monetary policy for the resolution of capital account crises were all discussed.

The arguments different Congressmen took up were, unsurprisingly, chosen according to political perspective but the impact of the American academic economic elite is important. These expert economists lend credibility to politicians' statements and the fact that there was disagreement within the economics profession opened much of the space for subsequent political debate.

8.3.2 The Treasury, the Federal Reserve and the Clinton Administration

In the chapter on Korea, I suggested that the US Treasury had been heavily involved in negotiating the Korean programme. It should be little surprise, then, that figures from the Treasury and Federal Reserve were strongly supportive of the IMF. A huge amount of effort went in to persuading Congress to agree the quota increase.[8]

Early statements echoed IMF diagnosis of the crisis blaming domestic policy in Asia, particularly moral hazard and lack of transparency. Greenspan was particularly triumphant

> My sense is that one of the consequences of this Asian crisis is an increasing awareness in the region that market capitalism…as practiced in the West, especially the United States, is the superior model… (Greenspan, 1998).

Rubin was also keen to stress the potential advantages to the US, citing 'critical economic and national security interests' in Asia and pointing out that 'recent IMF programmes in Asia involved significant market-opening and structural reform measures' (Rubin, 1998). Others were less subtle describing the IMF as a 'battering ram for US interests' (Kanter, cited in Kapur, 1998, 115).

Congressional concerns about backlash in Asia were dealt with by stressing the extent to which the crisis itself, rather than the IMF, was responsible for political problems. Intervention was

> a creative response to the crisis, not a cause. The IMF program did include difficult measures, but implementing difficult measures is always necessary in restoring financial stability (Rubin, 1998).

On transparency and accountability, speakers emphasized the degree of control Treasury was able to exercise over the Fund. Various people in the Committee hearing suggested that the problem was not the degree of US influence but that some Congressmen had a problem with the way that influence was being exercised.

In relation to left-wing concerns, they pointed to pro-poor measures in IMF programmes (Lissakers, 1998; Rubin, 1998) and argued that, whilst they had pressed for more movement on core labour rights, consensus had been against them (Geithner, 1998; Lissakers, 1998).

Finally on moral hazard, Treasury officials acknowledged the issue but stressed the difficult nature of the choices involved. Letting matters take their course implied a small but significant chance of serious consequences for the US economy (Greenspan, 1998). More concerted efforts to involve the private sector such as work-out procedures or standstills risked impairing developing country market access and systemic instability as foreign investors became even more nervous of emerging markets than they were already (House Committee on Banking and Financial Services, 1998).

8.3.3 Beyond the Beltway

The issue of IMF funding is unlikely to arouse much interest amongst the American public as a whole but did raise concerns amongst a narrower attentive public. I have reviewed some of the views appearing in the financial press in other chapters. These give some indication of views circulating in the business and financial community. The range of groups providing Congressional testimony are another indication (business groups, financial practitioners, labour representatives and some Southeast Asian NGO activists).

It is perhaps worth noting, though, that there was little development NGO lobbying about the Asian crisis. Crises controversy was primarily about macroeconomic policy, though welfare effects are important. NGOs are better placed to contribute in debates over the Poverty Reduction and Growth Facility (PRGF) or HIPC initiative.[9]

Nonetheless, prior NGO views on structural adjustment remain influential in colouring Congressional debates.

The other major indication of public mood was provided by the growth of mass anti-globalization protests at Seattle and then other international economic meetings including the IMF annual meetings. This scale of social protest had not been seen in the US for many years and raised significant anxieties even within the Treasury. However, protests were difficult to interpret. Protestors came from a range of different groups with different aims, from environment and labour groups to anti-debt development campaigners. The direct effect of protest on political debates around IMF reform is hard to assess.[10]

Perhaps indicative is a paper published by key Clinton aides in Foreign Affairs prior to the 2000 presidential election. The article is called 'New world, new deal: a democratic approach to globalization'. It acknowledges an 'emerging backlash against globalization in the United States' but blames it on domestic factors: 'rising income inequality, job insecurity in a rapidly changing and harshly competitive environment, and a sense of powerlessness and uncertainty about the future'. The solution is 'policies to sustain America's expansion and give Americans the tools they need in the global marketplace' (lifelong education, health care and social safety nets). In other words the solution is largely a domestic one of paying more attention to policies that compensate for globalization's ill-effects in the hope that that will head off pressure about international issues (Bowman Cutter et al., 2000).

8.3.4 Negotiations and legislative outcomes

How did these broad views and interests feed into a more concrete legislative agenda and what tactics could the different sides use to press their claims?

Debates in Congress went on through much of 1998. Those opposing the IMF had particularly strong incentives to raise the publicity of the debate and went to considerable lengths to attract media attention.[11]

However, during interviews I carried out in Washington in 2000 it emerged that there was never any real doubt the quota increase would ultimately be passed.[12] The Republican House leadership knew the issue was important to the Clinton administration.[13] They raised continuous objections in committee debates and used their majority status to delay any vote on the floor of the House in the hope of obtaining concessions on other issues. Mainstream opinion in Congress, though, was persuaded that bailing out Asia was good for American jobs and for relations with the region, particularly in the context of an IMF programme that promised considerable market opening.

Nonetheless, dissenting interests did need to be assuaged and the final legislation, passed as part of the broader 1999 foreign spending appropriations act, contained a wide range of issues for the USED to address. Some of these measures were to reassure existing IMF supporters. Legislation called for the IMF to promote market-oriented reform, trade and financial sector liberalization, independent central banks, anti-trust law, bankruptcy legislation, better financial sector supervision, and more privatization. More specifically, it also called for 'opening of markets for agricultural products', and an end to Korean credit for the steel and semi-conductor industries, demonstrating the power of US industrial lobbies to influence Congressional debate.

For left-wing sceptics, there were attempts to ensure the IMF promoted core labour standards and environmental issues. The Fund was asked 'to the maximum extent feasible to discourage practices which may promote ethnic or social strife' (presumably a reference to Indonesia). It should prevent military expenditures and 'showcase' projects, encourage investment in human capital and social programmes to protect the neediest, and promote social equity. Finally it was to tailor its policies better to country circumstances and 'recognize that inappropriate stabilization policies may only serve to further destabilize the economy'.

Domestically significant, there were a number of measures to enhance the IMF's accountability to Congress; a key point of agreement between the sceptical factions. Treasury was asked to provide regular reports to Congress on its success in promoting the objectives of the legislation and the USED was instructed to press for greater IMF transparency and release of further data. The legislation also established an 'International Financial Institution Advisory Committee' (the Meltzer Commission) to investigate the possibility of future reform of all three Bretton Woods institutions.

The other key issue on which critics were united, moral hazard, also received attention. Here the wording reflected different political agendas, with some measures concentrating on involving creditors in crisis resolution and others on greater surveillance in the interests of prevention. The USED was to 'vigorously promote policies that aim at appropriate burden-sharing by the private sector' but the details included a mixed bag of proposals. Measures ranged from 'intensified consideration of mechanisms to facilitate orderly workout mechanisms for countries experiencing debt or liquidity crises' at the anti-banking end of the spectrum to calls for better surveillance and more information provision to the private markets at the other. It was noticeable though that the wording was mandatory for the prevention side but only required *consideration* of more anti-creditor measures.

8.3.5 Summary

Treasury approaches to Asia were challenged through the American political process. The primary issue that galvanized an opposition agenda was the sheer cost of crisis. That managed to unite a group of left and right wing protestors to call for less spending and more control over the IMF.

Beyond that, though, views diverged. Right wing concerns were about moral hazard and, less explicitly, driven by a broader scepticism of multilateral institutions. The left-wing agenda is perhaps best summarized as 'anti-globalization'. Their key concern was that private banks were being bailed out by taxpayers. There was also a feeling that the Fund was pushing a pro-market, anti-social agenda. However, there were conflicting issues about whether poor Americans or poor Asians were the principle victims. There was positive pressure, then, to consider the social impact of IMF policies. On the other hand, that pressure was more likely to take the form of more 'positive' conditionality on issues like labour rights and the environment, than pressure to give developing countries more autonomy to pursue industrial policy, for example.

In any case, despite the criticisms, mainstream opinion in Congress was probably broadly supportive of the Fund. It was only good political tactics that gave the criticisms such a high profile. Still, those tactics, combined with some awareness of the high-stakes political game the Fund was playing in Asia, did result in some fairly comprehensive, if contradictory, legislation.

8.4 Outcomes and analysis: Treasury policy after the crisis

In the previous section we saw Congressional concerns included: the cost of the crisis; IMF accountability; and a variety of social issues. The legislation also mandated the establishment of an International Financial Institution Advisory Commission to report to Congress on reform of the Fund and the various multilateral development banks including the World Bank.

The question now is how legislation would influence post-crisis Treasury policy on IMF reform

8.4.1 Treasury policy after the crisis

The cost of crisis was perhaps the core issue that galvanized Congressional opposition. Legislation included mandatory measures for crisis prevention but only advisory wording about enhancing procedures for debt work-outs.

That emphasis seems to have reflected underlying power and interests. The prevention aspect of the agenda was far more important in post-crisis Treasury policy. Treasury actively promoted proposals for a 'new international financial architecture' (IFA). I will look at the international politics of this new agenda further in Chapter 9. For now, what matters is that it was an attempt to generalize the broad thrust of the Asian governance agenda by establishing standards and codes for good financial practice. These would promote transparency and financial stability, making crisis less likely. The Treasury, under Summers, was keen to see assessments of compliance published so they could be enforced through market discipline (Summers, 1999).

The more administrative measures included for 'consideration' in legislation received less support. Treasury tended to argue that encouraging creditor participation in bail-outs and including collective action clauses in sovereign bond contracts were a good idea. However, it also favoured 'case by case' and 'voluntary market-based approaches'.

> we have become convinced that it is not appropriate for the official sector to mandate the terms of debt contracts between countries and their creditors (Summers, 1999).

Instead Treasury reiterated the standard principle that

> creditors should bear the consequences of the risks they assume, while not undermining the equally essential principle that debtors should honour their obligations and that the IMF should not encourage default (Summers, 1999).

These arguments are both remarkably weak. Public bodies frequently legislate what is permissible in private contracts. The second quote simply states the core contradiction without addressing it.

On IMF accountability, though, there were some positive moves. Treasury agreed to provide Congress with annual reports on the implementation of the new legislation, which has provided a focus for more on-going scrutiny of Treasury policy. Pressure to increase IMF transparency, though, was also given an interesting twist. Congress wanted more information on IMF *decision-making*. Treasury, on the other hand, pushed for more publication of IMF reports as a way of giving more information to the markets. This is a particularly clear indication of the tensions involved in the governance agenda, which has always been a combination of financially-driven reform and more politically progressive pressure for democracy.

Finally, Treasury became adept at re-describing existing Fund policy in terms of the social legislation Congress had introduced. The introduction of the PRGF and a renewed focus on social safety nets that had begun in the early 1990s were used in this way (US Treasury, 2000a). Still, if Congress hadn't achieved a great deal on this front, at least it was making it clear that these agendas should not be rolled back.

The other high profile result of the 1998 debate was the Meltzer Commission's report (International Financial Institution Advisory Commission, 2000). It was seen as largely a Republican document and has been influential on Bush Administration rhetoric about the IMF, but less influential on actual policy.

The report argued that the IMF should become an almost purely capital account institution, leaving low-income countries to the World Bank. It should provide short-term, low conditionality loans in times of crisis. Lending should be at penalty rates (to avoid 'moral hazard') and, instead of conditionality, countries should pre-qualify for assistance on the basis of permanent compliance with a set of rules for good financial practice. The OECD countries could then be given the chance to opt out of surveillance.

The administration rejected most of the proposals on the (sensible) grounds that they were politically and economically impractical (US Treasury, 2000b). However, there was advocacy for more expensive Fund facilities with rates rising as the term of the loan increased to provide incentives for 'graduation' (Summers, 1999). A heavily scaled-down version of the Meltzer proposals also appeared as the Fund's voluntary 'Contingent Credit Line' (see Chapter 9). The Bush administration, too, has quietly ignored many of Meltzer's more radical proposals.

Finally Treasury did make some modest moves in a positive direction that were not necessarily mandated by the legislation. There was some willingness to accept the case for Chilean-style capital inflow controls and an awareness that conditionality needed to be more narrowly focussed. Even here, though moves were somewhat contradictory. Conditionality must be narrower but it also needs to cover an increasingly wide range of issues.

> The basic principle is clear: programs must be focused on the necessary and sufficient conditions for restoring stability and growth. Intrusion in areas that are not related to that goal carries costs that exceed the benefits, and may undermine the legitimacy of the IMF's advice. But the stability of banking systems, issues of social cohesion and inclusion, and the capacity to enforce contractual arrangements – these will all, in many cases, be critical to restoring confidence, and they can and should be addressed as a condition for IMF support. (Summers, 1999).

8.4.2 Conclusions

Introducing legislation is clearly a fairly blunt instrument for controlling the Treasury. It didn't help, though, that the legislation in question was contradictory, largely because of the very mixed coalition that had pushed it through Congress. Treasury was able to pursue the measures it approved of. When it came to more problematic measures, it was often possible to describe a range of Fund activities as moves in the right direction. Consensus decision-making in the Executive Board makes it very difficult for Congress to know whether these 'positive' measures are the result of the USEDs efforts or simply part of the normal course of events.

On the other hand, Treasury was sent at least some clear messages and has clearly felt the need to respond. Perhaps most importantly, it is clear that Congress is not willing to continue bailing out US financial institutions at taxpayers' expense. There are also signs that Treasury, unlike the Meltzer Commission, has some idea of the limits international politics imposes on what can be done in international financial regulation. We will also see, in Chapter 9, that not all the aims Summers articulated could actually be implemented in practice.

It is still worrying, though, how closely aligned Treasury policy was with the wishes of Wall Street. On 'bailing in' the private sector, the rhetoric was so unconvincing that matters had been pushed beyond what even Treasury's economic logic could fully justify. On the other hand, the result of such successful stone-walling has been that there is still no solution to financial crises other than bail-outs – as the current Bush administration discovered in Argentina. Over the longer term, then, pressure will continue to subject Fund policy to a broader conception of the American public interest than simply the wishes of Wall Street.

8.5 Conclusions

It is probably not surprising to most readers that this chapter reveals a close alignment between American Treasury preferences and the IMF's activities in Asia. Structural policies can be understood as part of a long-standing agenda to open Asian markets, particularly to the US financial services industry. It is not surprising because the US Treasury has such influence in the Fund and Wall Street has such an influence on Treasury. The actors with the most direct interest in IMF-related affairs and with the best contacts in the Treasury work in Wall Street. Even when Wall Street isn't specifically telling Treasury what to do, Treasury personnel have been trained in the financial services industry and move in that kind of social circle. It is rare that the 'general public' in developed countries are sufficiently affected to become involved in debates about Fund policy and, even then, the Treasury is relatively protected from broader political input.

However, the picture is more complex than a simple political economy story about the dominance of outward-oriented financial and business interests. The Treasury position was challenged from a variety of angles. Most centrally, the sheer cost of financial bail-outs galvanized Congressional opinion and helped to attract public scrutiny to Treasury activities. Congress can make Treasury's life politically difficult. Although the final legislation had limited effects, it has not been totally irrelevant and has laid the groundwork for further pressure in the future. At the very least what happened in 1998 created far greater public scrutiny of the IMF's role than there has been in the past.

The influence of the Congressional left was in some ways positive. It raised the vital issues of equity, distribution, and development. That may not have provoked an enormous change in Treasury policy but it did at least signal strongly that there would be costs to backtracking on the more humanitarian agenda that underpins the positive aspects of good governance. It is good that there is ongoing pressure on the IFIs to do better at providing social safety nets, for example.

However, left-wing influence was also limited and, in some ways problematic. I explained my unease about some of the conceptions of 'development' that had filtered into Congressional views via the NGO movement. I see that kind of agenda as important but partial (a view many NGO staff would accept). This is less a problem with US politics, though, than a problem with the broader structures of IMF power relationships. My concern is not that those views are being pressed, it is rather that they may be pressed more powerfully than they should be: that the Fund's agenda will turn into an uncomfortable amalgam of technocratic treasury preference, moderated by a marginal poverty agenda, which wouldn't constitute a viable development strategy.[14] On a related note, it is important to recognize that encouraging IMF transparency and accountability will inevitably mean accountability to the Congressional right as well as the development lobby.

More peripherally, Treasury still has to work to get its agenda adopted within the IMF. We saw some of the ways in which it does that early in the chapter. It also has to accept the reality that developing country opposition can place limits on what is possible, as we saw in (somewhat half-hearted) acknowledgements of the need for more parsimonious conditionality. We will see more of the consequences of that in Chapter 9. For now, it is enough to point out that, although Treasury was able to interpret legislative pressure in a way that was unlikely to be terribly threatening to Wall Street, little seems to have been done to remove the danger of financial crisis. Summers' arguments against doing more about debt work-outs were looking distinctly thin and the Bush administration has not come up with anything better. There is a growing consensus within the economics community that work-outs are a necessity. There is currently a good chance that Treasury will keep having to go back to Congress to pay for bail-outs and when they do there should be plenty of credible experts willing to challenge the current position.

Overall, then, the events of 1998 provide reasons for very cautious optimism, at least in comparison with some radical views of IMF practice and in comparison with the very limited oversight of Fund affairs that took place in the past. However, it is important to be very cautious about public oversight of the Fund's role in developed countries, which already have disproportionate power over the institution.

Part III

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9
From Crisis to a New Architecture?

I have looked at the general logic of the IMF's new role in financial globalization against the background of Bretton Woods responses to the Great Depression (Part I) and explored the political economy of current practice through case studies of the Asian crisis (Part II). It is now time to draw together the lessons learnt. This chapter will provide a critical evaluation of the Fund's new role, explore the politics that shape it and use the lessons drawn to assess post-crisis reforms and the new international financial architecture.

In Chapter 1, I said the primary aim of this book was to argue for a more political approach to the IMF. I set out four reasons:

- the IMF's new role is politically demanding. Policy formulation needs to incorporate an assessment of what is politically possible;
- the new role is politically significant. Policy evaluation should incorporate the political as well as economic effects of policy. Evaluation should also be based on a comparison of empirically plausible counterfactuals rather than on comparing unrealizable 'ideals' with actual practice;
- the new role is so complex that it is difficult to make general evaluations of whether certain kinds of policy are 'correct'. The question of how policy is decided and who gets to decide may be more relevant and is certainly more fundamental;
- finally, a normative critique of the Fund that is combined with an analysis of political causation is more likely to lead to effective strategies for change. Normative criticisms are likely to be more persuasive if we can show that they connect with political resistance. Political resistance also indicates forces that might be harnessed behind an agenda for change.

Drawing together the lessons of the book so far will substantiate these claims. I will organize my discussion around the conception of political legitimacy introduced in Chapter 1.

Section 9.1 will provide a critical analysis of the IMF's new role, drawing on the case studies from Part II and using the historical background introduced in Part I as a point of comparison. In particular, I will point to the political meaning and significance of the IMF's new role and the kinds of political factors that need to be involved in any evaluation. Section 9.2 will explore the extent to which the politics of IMF decision-making are adequate for its new role.

In Chapter 1, I argued that normative criticisms were most politically important when they fed into concrete political challenges. Section 9.3 will discuss the political forces that might promote or resist the kinds of reform proposed in sections 9.1 and 9.2. Finally, section 9.4 will provide an overview of debates about a new international architecture, which will show how the discussion in sections 9.1–9.3 can help us to both understand and criticize what has taken place.

9.1 The IMF and the politics of financial globalization

In Chapters 1 and 2, I argued the Fund's new role in the politics of financial globalization is about the trade-off between the potential efficiency advantages of financial integration on the one hand and the restrictions engagement implies for state autonomy on the other. One reason the Asian crisis was such an important event was that it forced political actors to re-evaluate the nature of those choices. It provided a public demonstration of what is at stake in financial globalization and of how the Fund viewed its role in promoting capital account liberalization.

This section will explore the two aspects of that role. It will ask what kind of power the Fund is exercising and what benefits it might provide to emerging markets, with particular reference to the historical points of comparison introduced in Part I (the Gold Standard and the Bretton Woods system).

9.1.1 Good governance and institutional reform

One of the clearest messages from the case studies was the sheer political significance of IMF-mandated institutional reforms. That suggests a significant reconfiguration of the Fund's traditional role, which it is by no means clear that the institution has fully come to terms with.

The political aspect of Fund reforms is important for two reasons. Firstly, there is a danger that the Fund is not fully aware of the significance of the choices it is making for countries. Secondly, creating programmes that can actually be implemented will require a greater understanding of political causation.

The political significance of institutional reform

The IMF argued its governance agenda was economically necessary and suggested, sometimes implicitly, that it was politically desirable. In the case study analysis, I have pointed to the danger that political aspects of the agenda may become legitimation for reforms of questionable economic importance. The governance agenda conflates economic and political issues in ways that are politically advantageous domestically (in selling policy to populations) and internationally (in trying to forge common interests between the financial and NGO communities – see Chapter 3). That curious amalgam of interests, though, creates a distinctly mixed agenda and may prevent the kind of informed political debate necessary to make governance reform politically sustainable. To further that debate we need to unpack the political and economic aspects of the agenda.

The IMF's approach to institutional reform seems to be to compare current practice with an idealized conception of 'good policy'. The vision of 'good policy' is a liberal ideal in which 'good' economic practice and 'democracy' are closely aligned, echoing the development orthodoxy of the 1990s in which democracy and development 'go together'.

Whilst there are connections between the economic and political aspects of liberal good governance, there are also tensions (Beetham, 1999). Important issues of prioritization are obscured in IMF debate and analysis (Thirkell-White, 2003). Sometimes, the Fund has an overly narrow view of what is economically possible because its preferences for liberal norms make it reluctant to acknowledge the possibility of pursuing collective goals (or more cynically, because those norms legitimate the project of opening markets for its leading shareholders). There is too much faith in markets and too little acknowledgement of market failure. At other times, economic aims are given an attractive political gloss that is misleading.

The freedom to engage in market activity provides an independent basis of power outside the state, which can help to boost citizen power and hold the state to account. However, the citizen body may also want to place restrictions on market processes to further collective social goals. Examples include a collective acceptance of decreased economic efficiency in the short term in the interests of greater productivity in the future (industrial policy) or an acceptance that the economic efficiencies of markets need to be set off against political values (equity considerations, inter-ethnic cooperation and their effects on political order). Markets are there to serve society rather than the other way round (Polanyi, 1957) and individuals' market activity sometimes needs to be restricted in the interests of other social goals.

The IMF, though, is inclined to see deviations from liberal individualism as evidence of the capture of rational policy by 'vested interests' (Boughton and Mourmouras, 2002; Ivanova et al., 2001). The possibility that domestic politics may have different, yet legitimate, priorities tends to be rejected out of hand.

In the Asian context, two issues provide good examples of the problems. The first is rent-seeking and corruption. Some state credit allocation in Korea, Malaysia and Indonesia was inefficient and part of undemocratic forms of political patronage. On the other hand, it is difficult to explain Korea's post-war economic success without discussing industrial policy. Industrial policy may *risk* corruption but sometimes that is a risk worth taking and other means should be found to deal with the corruption problem. The IMF shouldn't tolerate embezzlement of its funds but there is a danger that sharp lines are being drawn inappropriately across grey areas, when the real justification is more about market opening than corruption. Rather than debating the appropriate role for the state in different political and economic circumstances the Fund labelled *all* discretionary credit allocation as both inefficient and corrupt.

Transparency is a similar issue. Making budgets public can be good for both politics (helping citizens hold the government to account) and economics (allowing investors to make rational decisions). However, for economists, transparency may also mean predictable policy-making that takes away government discretion, from independent central banks to fiscal constitutions. There is a danger that the priority becomes transparency for the markets, disguised as political transparency. Or, at least, that one is vigorously pursued while the other is neglected.

There are certainly good things about the governance agenda. It is difficult to object to attempts at combating corruption and authoritarianism. The problem is that talking in terms of idealized liberal models obscures the difficult issues of trade-offs and prioritization involved, particularly when one takes into account the difficulties of implementation and limits to what is possible. The problem, then, is particularly one of the politics through which governance priorities are decided. The Fund has been delegated authority to deal with a set of economic issues. It is not charged with deciding on a more holistic conception of 'good policy'.

In that light it is worth recalling how far IMF interventions took the IMF from questions about pure economic efficiency. In Korea, reforms would alter the balance of power between industry and financial institutions; large and small business; and the different political parties that drew their power from those political constituencies. It would also alter levels of risk that all Koreans were exposed to, partly by making it easier to bankrupt failing firms, but also through knock-on effects on the labour market and Korean welfare systems.

In Indonesia and Malaysia, even official justifications for state intervention had always been more explicitly political, relating to increased opportunities for the 'indigenous' population. In practice, redistribution between broad ethnic constituencies had sometimes been a cover for narrower attempts to secure political support through patronage. At one level, then, the Fund was right to focus on corruption but patronage was also about maintaining order and addressing social inequalities. As the Malaysian case demonstrates particularly well, decisions about the benefits of these systems require complex judgements about political and social, as well as simply economic, issues. At least in public, the Fund does not discuss these issues, implying that they should be subordinated to a particular conception of economic efficiency. I have argued that too much is at stake to decide matters in this way.

Political interventions and political causation

What is politically desirable, then, *should* be part of debate in a normative sense. At the same time, even if we accept the IMF's normative judgements about the 'right' thing to do, its intentions are likely to be frustrated without a more politically informed consideration of what is at stake. The Washington Consensus perspective was that politics was essentially the problem. Governments needed to get out of the way so that markets could function better. The Fund's current 'post-Washington Consensus' approach is more obviously about restructuring social and political relationships. That raises difficult questions of political causation. Who is going to push forward this kind of social engineering? Who is likely to resist? How can the chances of success be maximized?

These questions cannot be answered in terms of functionalist economic reasoning about good and bad policy or direct material interests. Existing political systems in Asia embodied complex moral choices and the outcomes of historical processes of political struggle and change. If the Fund's views about economic welfare were correct then the 'right' policy should automatically have something to offer the population (at least on balance). However, since there are other, more political, factors at work, actors' incentives will be different, political action will not be as expected and there are few guarantees that outcomes will be what the Fund is intending. Failing to engage in complex ethical and political arguments with domestic groups will result in policies that fail to win political support.

The chances of implementation, then, depend on a complex set of political and social relationships. There is no guarantee that a particular society will have a social structure that allows even willing elites to drive through liberal reforms (Moore, 1966; Rueschemeyer et al., 1991).

In our case studies we saw how the close relationship between state and bourgeoisie in each Asian country made the middle classes unlikely carriers of liberal values. Over time, conditions had changed in Korea. However, looking at Indonesia, it is easy to be sympathetic to Richard Robison's conclusions:

> Restructuring these regimes is no technical matter of policy fixes – of separating the 'natural' market from the intervention of politics and vested interests or of better leadership and more clever policies. No less than any other, the neo-liberal agenda is embedded in coalitions of interest and power…[in Indonesia] the neo-liberal agenda has not been successful in assembling a broad and powerful political coalition (Robison, 2001, 1 & 20).

Domestic politics may not always produce politically or even economically attractive results. However, for the reasons I introduced in the previous section, we should be cautious about accepting IMF claims to want to do better for domestic populations (see also section 9.2). Even where the Fund's intentions are good, a proper appreciation of what is possible is essential to ensure that outcomes match intentions.

9.1.2 Financial globalization, sovereignty and the Fund's new role

The Bretton Woods vision was of an IMF that would give countries incentives to stay integrated with the global economy. It would ease the sharp choices they faced under the Gold Standard between an internationalist economic commitment on the one hand and increasing democratic pressure for protection against the pains of adjustment on the other. A more institutionalized, but also more flexible, system of regulation would secure international commitment, but make it less demanding. Additional incentives would be provided by loan capital to ease adjustment.

For some, the IMF's role in Asia shows these priorities have been reversed. Emphasis has returned to reorganizing domestic institutions to support financial integration, rather than making integration less demanding and more attractive. In contrast with the Gold Standard period, the requirements of integration were being legislated rather than left largely a matter of convention. Not only are the IMF's interventions imposed by an international rather than domestic logic, the requirements of that logic are being interpreted in a particular way, reflected in the controversial governance agenda.

Although that may be a partial description of the Fund's *intentions*, it paints too bleak a picture. The IMF does still provide countries with financial assistance and countries have the option of exchange rate devaluation, which was not possible under the Gold Standard.

More importantly, we shouldn't overestimate the Fund's power to achieve its aims. Attempts to make capital account liberalization compulsory under the Fund's Articles failed, partly in response to the experience of the Asian crisis. Malaysia also demonstrated that some countries (at least) are still able to take a different course. Capital controls limited the effects of crisis, avoiding the need to go to the Fund.

The Fund has abandoned its global regulatory role and has little coercive power, except when crises strike. If capital controls can help countries to avoid crisis, there is little the Fund can do except offer censure, as it did in Malaysia but with few tangible effects. It is not by any means obvious that the markets 'punished' Malaysia either. In the end they are driven by profit not revenge.

The problem is arguably more with the things the Fund wasn't willing to do than with what it did. In particular, it was reluctant to debate which kinds of capital controls might be desirable and too slow to do something to resolve the collective-action problems involved in debt renegotiation. Fund support and assistance for these measures could leave countries facing an easier choice in favour of financial integration, by making the choice less demanding.

Governance policies are part of this choice. I have just argued that deciding whether or not the Fund's policies are desirable is a complex process involving ethical, political and economic judgements.

The Fund argument is partly that, regardless of those judgements, governance reforms are *necessary* (Fischer, 1998b). I raised some empirical questions about that in the course of the case studies; market confidence didn't seem to respond quickly to governance interventions. In any case, reforms were certainly only necessary against a background commitment to free capital flows.

The point of my arguments about governance, above, was that the complex issues involved should not be dealt with solely on the basis of economic reasoning. Capital account choices therefore need to be left open. Pragmatically, as the Malaysian case demonstrates, if the Fund forces governments into making unnecessarily difficult all-or-nothing choices, there is a risk that they will embrace capital controls. In any case, the case studies also raised important questions about whether governance reforms *can* be implemented. The logic of the Fund position is that, if they can't, there will be further crises. Crises are unacceptably costly and, again, may push countries towards the capital control option. A more pragmatic approach might achieve more: a broadly open system of capital accounts, with some kinds of sanctioned controls and viable debt work-out procedures. Sharpening the choices, on the other hand, risks a concerted counter-reaction that the Fund may be unable to control.

9.1.3 Assessment and alternatives

Overall, I have argued that the Fund's new role is not an all-out attack on state power. Rather, it represents an attempt to press a particular interpretation of the choices states face when confronting financial globalization. The Fund's new role relies more heavily on state power than in the past, but it is to be exercised in a particular way. I have also argued that, while there are some positive aspects to the governance agenda, the Fund's conception of the choices states face is unnecessarily limited. Its position is hard to justify morally.

At the same time, although the Fund can draw on large financial resources to support its attempts at persuasion, its coercive resources are limited and attempts to sharpen states' choices may be prudentially counter-productive.

The Fund is not making full use of its potential. It could be discussing appropriate forms of capital control. More importantly it could be more involved in facilitating debt work-outs. It could even be used to provide new forms of regulation at the global level that might make international capital markets function better; proposals that have been canvassed include a greater role in dealing with currency imbalances and better prudential regulation of hedge funds (Akyuz, 2000; Ocampo, 2001). That potential is the reason why I think radical calls for abolition of the Fund are mistaken.

However, the Fund needs to be reminded that globalization is about choices that may be reversed. As Polanyi famously argued, unregulated markets have a tendency to destroy themselves. The Bretton Woods vision was about encouraging countries towards openness, not about forcing it on them. Current practices risk undermining the goals the IMF is trying to pursue.

This is now a position that is beginning to be shared by high-profile, mainstream, (if slightly heterodox) economists. It is broadly the position Stiglitz has promoted since his departure from the World Bank (Stiglitz, 2002) and it is also very much the argument Dani Rodrik has been making about the WTO, which he argues should see itself:

> not as an institution devoted to harmonization and reduction of national institutional differences, but as an institution that manages the interface between different national systems (Rodrik, 2001, 45)

It is possible to imagine a Fund that saw its role as supporting the choices countries make over financial globalization, whilst trying to make fuller integration more attractive. That would involve a greater willingness to let countries balance the imperatives of capital account mobility with other legitimate goals such as social and political stability or even industrial policy.

9.2 IMF decision-making and the Fund's new role

In the previous section I argued that the way the Fund was exercising its role provided only questionable benefits for emerging market countries. Centrally, the level of IMF commitment to capital mobility ruled out other ways in which the institution could be operating. Whether one accepts that commitment or not, there were also questions about the extent to which governance policies could really be justified, particularly in economic terms.

All this matters because the IMF still needs to persuade states (and increasingly also domestic populations) of the merits of its new role. That role is currently highly controversial. In Chapter 1, I argued political and institutional arrangements should help to create confidence in institutional decisions by legally restraining them and ensuring the decision-making procedures were appropriate to the kind of task that was being performed. The IMF's institutional arrangements should help to boost confidence in its claim to serve countries' interests. How much support do current IMF decision-making procedures provide for the Fund's new role?

9.2.1 Technical and political authority at the international level

In Part I, I argued that some of the institutional reassurances embedded in the Fund's original arrangements had been undermined by changes in the global political economy since Bretton Woods. Reciprocal legal obligations (the fixed exchange rate system) had largely disappeared. The symmetry of the Fund's original operations had also declined, so policies developed countries agreed to were unlikely to affect them, limiting incentives for restraint. At the same time, it was much more difficult than it had been in the past to see conditionality as largely the logical consequence of a broader inter-state legal agreement about acceptable international monetary conduct

The solution the Fund has increasingly been adopting is to claim that Executive Board technical expertise could identify objectively optimal policy.

Decision-making within an internationally agreed framework of conduct?

The absence of a legal framework is a particularly acute problem in relation to capital account openness. There is no formal international commitment to open current accounts. The Fund's Articles were actually designed to prevent it playing any role in resolving financial crisis. Article VI prohibits lending in the face of a 'large or sustained outflow of capital'. The IMF could only justify its intervention in Asia using 'fancy legal footwork'. That echoes a broader pattern.

> When the membership has agreed that the Fund should perform a new task … the Fund has usually found a way to do so without recourse to amendment (Polak, 1998, 49).

We have seen that the Fund's new agenda all springs from its commitment to free capital flows. Yet the membership has never made any formal international agreement to that norm. The Fund can't make the strong claim that its globalizing policies spring from a pre-agreed collective political commitment to a code of international conduct. Instead a heavy burden of authority is placed on Executive Board. It was designed to exercise narrow authority delegated by states. It is currently trying to persuade states that they have good technical reasons to take on a new kind of international commitment, which, as we saw in section 9.1, also has highly significant consequences for the nature of social and political life. The technical logic of Executive Board decision-making is very different from the political logic of international legislation.

Economic expertise?

The commitment to a capital account role is the most fundamental example of increased Executive Board power and discretion, but it is part of a much broader trend, reviewed in Chapter 3. As the membership has become more divided, weighted voting has looked increasingly problematic. In a sense, economic rationality is being used to try and convince the Fund's membership that problematic political arrangements need not be as troubling as they appear at first sight, rather than using justifiable political arrangements to offer confidence when performance falters.

The Fund should be concerned that Board technical authority is insufficient to drive through the new agenda. In contrast to the relative consensus of the 1980s, the economics profession was noticeably split over responses to what happened in Asia:

> Traditional crises respond to traditional medicine. We know how to diagnose them and how to treat them…the problem for the future will be how to cope instead with 'high-tech' crises with a dominantly financial as opposed to macro-economic component…and it is much less obvious how to deal with these…problems (Eichengreen, 1999).

Not everyone thought the Fund had got it wrong. However, a large section of the mainstream economics community was highly critical. For politically inclined critics (including those involved in crisis countries), it was quite easy to build on economic disagreement to argue the IMF was pursuing a Western-driven agenda, benefitting the financial interests of leading members. Free capital flows are good for investors, not for borrower countries. A market-based solution to crisis reflected foreign investor preference rather than economic rationality. Market opening supported fire-sales rather than competitiveness. Political arrangements were, if anything, undermining rather than supporting claims to technical expertise.

When it comes to the governance agenda, it is also possible to argue that Board decisions can't be understood in purely technical terms. The

Fund's early role largely involved specifying the magnitude of macroeconomic adjustment required to deal with relatively small balance of payments problems on current account. It was relatively easy to argue that the non-efficiency aspects of those decisions (how would fiscal cuts happen, who would gain, who would lose) could be ignored by the Fund and dealt with by others. The discussion in section 9.1 should make it clear that arguing in those terms is no longer credible. The Fund's new role simply affects too many non-economic issues. That is the point I was making in the section 9.1 about the trade-off between technical questions about efficiency and other political and social values.

Making that kind of trade-off is not a technical matter of deciding the appropriate means towards given ends. It involves political and ethical judgements about the extent to which the values of market freedom and economic efficiency are to dictate the nature of social life. Those can only be made as political and, ideally, democratic decisions.

I am partly offering a normative critique to the effect that the Executive Board is not qualified to make the kinds of decisions it has been making. However, again, there are practical implications. As I pointed out in section 9.1, the Fund does not have unlimited coercive resources. It needs to give countries good reasons for following its advice. In the context of its current agenda, technical economic reasons are not enough, even in the absence of doubt about the IMF's technical competence when faced with capital account crises.

9.2.2 Civil society engagement

In some ways the reconfiguration of the Fund's relationship with developing countries can be seen as a partial acknowledgement of the problems with its increasingly political mandate. Greater transparency over the policies that it is pressing, more attention to civil society engagement, the more appealing aspects of the governance agenda, and a reluctance to let states treat it as a scapegoat are all moves away from power and towards legitimacy at the domestic level.

However, there are two interrelated problems with 'civil society engagement'. The first is that the IMF's technical economic instincts are to try and work out what 'good policy' looks like and then to expect civil society to buy into it. Secondly, even where a more accommodatory approach is considered, the political incentives the Fund is faced with leave it little space for adapting to civil society concerns. The difficulty is that civil society engagement is a fundamentally political activity; it involves engaging in power struggles, not simply gathering information and reading off preferences. It can support legitimate institutional arrangements but it can't substitute for them.

A technocratic approach

Although the Fund's thinking about civil society is embryonic, tendencies can be identified. The same impoverished conception of the political that I discussed in section 9.1, shapes Fund views about civil society engagement. A preference for rational choice methodology and the conviction that objectively welfare-maximizing policy can be calculated create a very particular vision of civil society. There is a tendency to have a fixed idea of what civil society *should* want to promote and to be surprised if it doesn't do so in practice.

Fund writing on political economy makes this particularly clear. 'Politics' tends to come into play when 'special interests' prevent implementation of the 'right' policy. (Boughton and Mourmouras, 2002; Ivanova et al., 2001) When thinking about civil society, then:

> The role of stakeholders outside government may in some instances be to promote narrow interests rather than the general welfare. The distinction between 'vested interests' and 'civil society' is critical but may be ambiguous or controversial (IMF, 2001b, 20).[1]

Representing 'vested interests', though, is exactly what *all* civil society groups do. They are subsets of the population, organized to pursue particular interests or points of view. There seems to be a hope that it will be possible to engage with civil society and read off *a* view of positive policy, or perhaps a tendency to look for sections of civil society that echo Fund views.

A political perspective

In practice, the relationship between government and civil society groups in modern democracies is a complex one. Space for civil society is important for democracy. It enables popular preferences to be articulated and pressed in public debate. Civil society is a sphere in which non-state actors can organize and acquire power to resist arbitrary state action. However, the process is not one in which *a* civil society opinion emerges. Governments will be confronted with a range of incompatible demands and preferences. It is then government's job to try and forge a policy programme that has majority appeal and to implement it effectively. Governments need to exercise political judgement about how to respond in policy terms and how to secure political support for their policy agenda.

When 'engaging', the Fund will have to choose which voices it wants to listen to and which it wishes to reject. It will be difficult to convince populations that the outcome of decision-making processes is actually democratic because the Fund is ultimately responsible to its membership in proportion to weighted votes, not to domestic populations. That, along with its technical views, will shape the voices it listens and responds to. The civil society agenda, as it stands, leaves all the work of legitimation to be done at the domestic level, without necessarily giving governments the flexibility to make the kinds of compromise that are involved in forging political agreement.

Lessons from the case studies

The case studies help to illustrate these points. In Chapter 5, I argued the success of the Korean programme was as much to do with a fortunate coincidence of interests as it was to genuine dialogue, negotiation and adaptation. There were only very marginal signs of flexibility on the Fund's part and its programme was heavily shaped by external pressures. Fund willingness to talk to civil society was helpful at the margins in supporting Kim Dae-Jung's astute political management, but the programme's success was more due to inter-state processes.

The Indonesian case makes these problems far more obvious. The Fund's governance agenda forced it to choose between the state and what it saw as civil society's interests. As I argued in section 9.1, those kinds of choices need to be evaluated in political and strategic as well as normative terms. Politically, it is difficult to be too disappointed by Suharto's departure. On the other hand, the Fund's preferred liberal political economy has yet to emerge and, in the meantime, Indonesia has suffered from very costly political instability. If the IMF is really an *economic* institution, was challenging Suharto strategically more sensible than agreeing a compromise programme?

In any case, did the IMF programme really reflect civil society views? There is strong evidence that sections of Indonesian civil society supported the governance aspects of the programme. However, there was opposition to the Fund's liberal conception of economic management. Failures in implementation suggest that Indonesian civil society as a whole was not sufficiently behind the programme to make it happen. That points to the difficulties of deciding what 'civil society' might 'really want', particularly in a situation where domestic political institutions are not functioning effectively. Can we be entirely comfortable about the basis on which the IMF is likely to decide?

At that point, it is worth linking discussion of implementation with the kind of civil society engagement going on in the developed world. We saw that NGOs in the United States were active in lobbying Treasury to use its influence in pressing for particular reforms. It is important for US-based civil society to press different conceptions of national interest from those of the Treasury, if that helps to persuade Treasury to accommodate emerging market preferences. However, there is a danger that US civil society shapes IMF preferences for 'good policy' (rather than empowering domestic states). Policy becomes the curious amalgam of economic preference, moderated at the margins by NGO values, which I explored in section 9.1. Some US-based preferences, particularly human rights, may be universally applicable. When it comes to economic management, though, narrow concerns with rural poverty, the environment and labour rights may or may not reflect the preferences of emerging-market civil society as a whole. There is a danger that such input will re-enforce the problems with the failure to prioritize governance issues that I discussed in section 9.1.1

Overall, civil society is important for democracy but it is only part of what makes a democratic political system. The political incentives decision-makers have to listen to different groups are also vital. The IMF's growing interest in openness is a good thing. An awareness of the need for public debate is an important step forward and could be a positive input into the domestic decision-making process in times of crisis. The problem is not with debate, it is with the way in which debate leads to *decisions* and with who has the power to influence those decisions. From that point of view, it is important to be circumspect about civil society engagement in practice. There is a danger that, without more fundamental reform, engagement will largely reproduce existing power structures, or even place well-meaning but inappropriate additional burdens on borrower country citizens.

9.2.3 Assessment and alternatives

The thrust of my argument in this section and section 9.1 is that the IMF's new role cannot be thought of in purely technical terms. The kind of normative and political debate that needs to underpin the Fund's current role has a different logic.

It is possible to engage in rational debate about normative and political issues but that debate is rarely conclusive. Democracy is not a technical exercise. It is about a combination of open public debate and the discipline of equal votes. It is an ongoing process of winning consensus through discussion, compromise and bargaining, that ensure input from those affected by policies. Debate within political institutions, then, should be the 'organized mid-point or focus of the society-wide circulation of informal communication' (Habermas, 1996, 182).[2] The process of debate should create public confidence in the policies that are ultimately chosen and the incentive structures of the institutions where debate takes place should ensure a just outcome when unanimous agreement becomes difficult. A more democratic way of dealing with political issues should produce fairer policies *and* policies that have a better chance of implementation.

There is a place for technical economic reasoning but only within a framework that forces interaction with the more normative and political issues the Fund is confronting. That is why I see questions about the politics of Fund institutional arrangements as more fundamental than technical debates about its appropriate economic function under financial globalization. What is wrong with the Fund is at least as much about who decides policy as it is about policy content.

Obviously the vision of democratic decision-making I have briefly sketched is an idealized one. However, it clarifies what is wrong with current arrangements and suggest the directions for reform. The fundamental problem is that there is no clear political agreement about the ends the Fund is supposed to serve. That agreement can still only come from political agreement, which under contemporary conditions probably means the agreement of sovereign states either collectively or individually.

The collective option might be for the Fund to do the difficult political work of recodifying its mandate to establish clearer rules and principles about what its role actually is: to re-establish what states have agreed is *necessary* in terms of a shared conception of the international monetary system. It would have to be done politically in the context of negotiations to amend the Articles, though, not through the technocratic, weighted voting procedures of the Board.

The other possibility would be to accept that there was no such international political agreement and allow states more scope to make choices about the shape of their domestic political economies (as I suggested in section 9.1).

I concentrate on *state* decisions because of the arguments I made in section 9.2.2 about the importance of an appropriate institutional environment within which civil society engagement takes place. I am aware that is a problematic position but it is one I am driven to by anxiety about decisions which are made by people that will not be charged with implementing them. There are serious problems with the political process in many of the IMF's client countries. However, I am not convinced that letting the IMF decide politics for them is the right solution. Other, more explicitly political processes in the countries concerned, or possibly beyond, are required to fix that kind of problem.

If neither of those two options for returning decisions to a political process can be fully achieved, the Fund needs to move as far towards them as possible. It needs to support any compromise with institutional reforms to enhance its political legitimacy. There isn't space here for a thorough exploration of the possibilities. However, starting with the most radical first, all of the following might be positive moves. If they cannot be implemented in full, at least they provide guidance for positive directions.

There are two core arguments for current decision-making arrangements – especially weighted voting and technocratic independence. The first is that the IMF should be politically independent so bias springing from broader international relationships can be kept out of economic decision-making. The second is that countries which are borrowing from the Fund have few incentives to impose conditions on themselves that would result in repayment. The solution to both might be to have a more political body within the Fund, which conducted debates in public about the broad principles that should drive IMF policy and was based on a voting system that comes closer to sovereign equality. The Executive Board could then return to a task of implementation, if necessary on the basis of weighted voting, so long as there was a method for the political body to exercise scrutiny. This is broadly the model proposed in (De Gregorio et al., 1999) but I would like to see the political body much more firmly in charge.

More modestly, various things could be done, within the constraints of weighted voting, to bolster what limited power developing countries have. Groups that elect Executive Directors could be reorganized to increase the representation of African countries, without altering votes. Perhaps more importantly, steps could be taken to improve the resources available for making technical arguments in support of developing country positions. Mid-career hires from developing country governments to the Fund staff might boost the diversity of views within the Fund. Greater access to the Fund's research staff and additional resources for developing country Executive Directors' offices could also improve matters.[3] Finally developing countries would be well advised to require legislative approval before accepting programmes. That would give them greater negotiating power (Putnam, 1988) and help to enhance domestic debate over these issues.

These ideas are obviously more a general gesture at the kinds of things that might be done than a set of detailed proposals. The important point is that, for the reasons I have discussed, Fund legitimacy is becoming thin. It is hard pressed to give countries reasons why they should trust its judgement and accept its authority on the issues it is deciding. The Fund needs to carry out some combination of: enhancing its political authority; re-specifying its mandate through a legitimate political process; or scaling back its role. Otherwise, as I will argue in the next section, the kinds of political problems that emerged during the Asian crisis are likely to continue.

9.3 The politics of crisis

So far, I have presented a critique of the Fund's role in Asia and sketched some directions for reform. The essence of my argument has been that the Fund's political legitimacy is wearing thin in the context of its new role.

In Chapter 1, though, I suggested two reasons why logical, normative analysis alone is insufficient. Firstly, there is a danger that attempts to provide 'objective' analysis of legitimacy will not connect with actors' actual political motivations. Claims that an institution has legitimacy problems are more persuasive if there is also evidence of real political challenge on the ground, articulated in broadly the same terms as the normative analysis. Secondly, normative critique is not terribly enabling unless it can connect with strategies for political change. By looking at the kinds of political mobilization that are actually taking place in reaction to IMF interventions, both critical and supportive, we will be better placed to understand the politics of IMF actions and to develop strategies for change.

In this section I want to draw out the evidence our case studies provided about the extent to which the normative problems I have identified so far in this chapter translated into political opposition, particularly opposition that challenged the basis of IMF authority. That will help us to evaluate the extent to which there will be political pressure to press forward the kinds of reforms I identified in section 9.2.

9.3.1 Middle-income countries

Middle-income countries have two ways to influence Fund decision-making. Firstly they can press their point of view through the Executive

Board and at Board of Governors meetings. If a sufficient consensus can be mobilized around a particular position, perhaps through the G24 grouping of developing countries within the Fund, that might force a change of policy. Below that threshold, reasonably widely articulated criticisms may embarrass the Fund, particularly given the problem of weighted voting. Finally, dissent within government or society may create the danger of more passive resistance: seeking alternatives to borrowing from the Fund or preventing the implementation of signed programmes.

The case studies in Chapters 5–7 demonstrated each of these problems / strategies. The most active resistance came from Malaysia. Instituting capital controls was something the Fund had no legal power to prevent and which helped Malaysia to avoid borrowing (though Malaysia's greater financial strength may also have helped here). Mahathir and the Malaysian Executive Director raised challenges to Fund policy at the Board of Governors and in other international fora. Mahathir argued that Fund policy was technically flawed, politically biased and prevented the government from pursuing legitimate social goals.

Indonesian resistance was more of the passive variety. Suharto questioned Fund policy from time to time but largely by complaining about the advice he was given, rather than proposing an alternative way for the institution to do business. Non-implementation was a far more important problem and it is by no means clear that implementation problems have yet been resolved (Robison and Hadiz, 2004).

In Korea, there were fewer reasons for concern. It is possible to argue, then, that Korean 'political will' ensured implementation and that the superior results in Korea show how successful the Fund's agenda can be when political will is present. However, the evidence of Chapter 5 suggests an alternative view, which is that interventions in Korea were particularly propitious for IMF-style interventions. Even then, the agenda was subverted to some extent by Kim Dae-Jung to suit his political purposes: in particular corporate sector restructuring was far more interventionary than the market-based approach favoured by the Fund. There was also increasing nationalist resistance to some aspects of the programme as time went by.

In terms of the probability of resistance to an agenda like the one the Fund pursued in Asia, the picture coming out of the case studies is one of considerable complexity. As we saw in section 9.1, the political significance of the Fund's essentially liberal agenda varies in different contexts. Whether or not a political coalition can be mounted to support Fund-style reforms depends on whether or not there are broad sections of society that stand to gain from a more impersonal and neutral role for the state in economic management. One of the peculiarities of political economy in Asia was the extent to which the capitalist class had been deliberately created by the state. That has tended to make them less likely to be bearers of liberal values than one might expect from popular histories of the development of liberal capitalism in Europe.

Within the kinds of constraints posed by the social forces present in particular places at particular times, there is some room for political manoeuvre. Astute political management (in the style of Kim Dae-Jung) may make it possible to push some reforms through, despite the difficulties. The overall message, though, is that the Fund's new agenda makes very high demands on administrative capacity and propitious political circumstances. Without greater Fund flexibility it is difficult to be confident that even civil society engagement and the governance agenda will ensure implementation. Indeed it may be counterproductive in economic terms if it hinders pragmatic engagement with states. It also places a very heavy responsibility on the Fund, laying it open to criticism if things go wrong.

Likely problems with implementation, then, should be cause for concern at the IMF. Even its most powerful shareholders may be compelled to recognize that there is a case for greater pragmatism in conditionality. As we saw in Chapter 6, there was some chance that even the recalcitrant Suharto might have been willing to implement a less demanding programme. The Fund's leading shareholders may get more by asking for less. That is unlikely to happen, though, without a change in the Fund's deeper institutional arrangements, to provide staff with political incentives towards greater pragmatism.

What about the more challenging agenda articulated by Mahathir, then, which accused the Fund of over-stepping its mandate, usurping the domestic democratic process and acting in the narrow interests of Western financiers, rather than the broad interests of the international monetary system as a whole? Ultimately it is the possibility that other countries would draw similar messages from Fund involvement in Asia that is most potentially damaging for the Fund.

It is very difficult to tell what developing country Executive Directors 'really think'. There are costs to articulating 'anti-market' views in public and insiders report widespread fear of offending the Fund unnecessarily (Stiglitz, 2002). It is strategically rational to avoid fighting battles that you cannot realistically win. The obstacles in the way of challenging the Fund's agenda are increased by the growing difficulties in articulating a common 'developing country' position through the G24. There has been some dissent over the Fund's new agenda, as we will see more clearly in section 9.5. However, there was perhaps less resistance than the normative criticisms raised in sections 9.1 and 9.2 might have suggested.

As Azizali Mohammed the G24 coordinator at the Fund has put it:

> the sharp divergence in interests was reflected in differing approaches to financial architecture reform. The 'emerging-market' members did not like the Group to take positions that most other members wanted to espouse (e.g. an international bankruptcy regime or a lender of last resort) for fear that anything that sounded radical might impair their access to private markets (Mohammed, 2001, 4).

There are a number of possible reasons for this limited resistance. The first is that there was not unanimous resistance to the Fund's agenda even in crisis countries. For some, the trade-off between the benefits of liberal financial flows on the one hand and Fund-mandated institutional reforms on the other is still worth making. That may be because they have a strong interest in continued capital inflows. Others clearly welcomed the political aspects of the IMF's agenda. Many in Malaysia, for example, were convinced by the links that have been made between Mahathir's authoritarianism and state control over the economy or simply stood to benefit from a scaling back of the NEP.[4] Points of principle about the nature of IMF authority can become less relevant when IMF policy is appealing for one reason or another (legitimacy is about performance as well as institutional safeguards).

A second, related, reason is that middle-income country representatives at the IMF are drawn from finance ministries and central banks. They have a liberal economic training, which makes it more likely that they will think in similar terms to Fund staff than an average member of the domestic population. Civil servants may be less aware of the political consequences of economic policy than their colleagues in legislatures and may stand to gain resources for financial reforms. That is particularly likely in countries that are not contemplating a crisis, where there may be few incentives for the more politically aware branches of home governments to scrutinize Fund policy. Additionally, criticizing 'market-friendly' Fund policies in public risks damaging countries' own credit-rating by signalling possible intentions to do something 'anti-market' at home. Azizali Mohammed notes a

> significant fault line [between the G77 and G24 that] derives from the fact that the G-77 in New York is run by each country's Permanent Representative at the United Nations and reports to Foreign Ministers. The G-24 representatives at the political level are Governors of the IMF or the World Bank and are either Ministers of Finance or heads of Central Banks. The latter tend to be quite acutely aware that their pronouncements can affect their country's standing in private financial markets...central bankers tend to be perhaps even more 'market sensitive' than their Ministerial counterparts and both consider it essential to maintain their credibility as an expert group (Mohammed, 2001, 6).

The authorities in Latin America countries were particularly anxious to appear market-friendly during the crisis, given the pressure they were already under from the financial markets. They stressed the fact that Latin American neo-liberal reforms during the 1980s had already eliminated the kinds of interventionary state policy that the Fund blamed for the Asian crisis.[5]

Overall there was criticism, and we will see more evidence of that in section 9.4. However, it was fairly muted, relative to what one might have expected. That is partly a function of financial bureaucrats' incentives. When a crisis looks far off, there are serious risks and limited rewards in radically questioning economic orthodoxy. It is also to do with their own training and liberal outlook, not to say the influence of the domestic financial sector. The political challenge is perhaps greater, then, from ordinary populations. Here part of the lesson from the case studies is that it is difficult to make general comments about the nature and focus of resistance. In Asia the governance agenda was particularly significant. In Latin America, welfare and labour rights may be more important. On the other hand, the experience of implementation in Asia suggests that even in propitious circumstances the Fund's agenda is over-ambitious. It will be very difficult indeed to avoid the fact that the post-Washington Consensus agenda simply is a political one. If it is really essential for international financial stability, that implies significant long-term problems for a purely technocratic globalization project.

9.3.2 Developed countries

In Chapter 8, we saw how the politics of developed country interactions with the IMF shapes input from the Fund's leading shareholders. Here again, there were significant challenges to the IMF's agenda but they were uneven and their effectiveness was also limited by the shape of the Fund's institutional arrangements.

It is not difficult to see why Western countries' core interest in the Fund's involvement with middle-income countries is with the promotion of market opening. The actors with the most direct interest in IMF-related affairs in the US and with the best contacts in the Treasury work in Wall Street.

The structure of IMF decision-making, in which policies are decided by lender countries and pursued by borrower countries, helps to limit debate about the political and economic consequences of Fund policy. It is rare that the 'general public' in developed countries are sufficiently affected to become involved in debates about Fund policy and, even then, the Treasury is relatively protected from broader political input by the limits to Congressional oversight of IMF policy.

It is no wonder, then, that the popular image of the Fund on the left is one of free-market fundamentalism in the interests of transnational business. Although that is not a wholly inaccurate vision, it is only a partial one.

Congressional interventions in post-crisis debates may have been problematic in some ways but they do show that it is possible to push a broader public interest. In the case of the crisis, the political challenge was driven by the sheer cost of bail-outs and to a lesser extent the way that cost was distributed. Western publics may have limited incentives to mobilize around attempts to promote market openness abroad generally. Where the corollary of openness is a large domestic tax bill for bailing out highly profitable private financial institutions, though, apathy can be overcome.

Once the costs of global financial openness become apparent, links can be forged with wider concerns about the nature and costs of foreign policy; globalization; development and the environment. In Chapters 3 and 8, I identified ways in which, since the Cold War, there has been more pressure for a humanitarian justification for aid, focussing on human rights, democracy, poverty and human need. It would be a mistake to be too starry-eyed about that. There is considerable evidence that the priorities determining the dispersal of funds have changed little. However, at least where that agenda doesn't threaten core concerns, it has triggered changes in IFI and development policy. Aspects of the governance agenda and a new found interest in poverty and social safety nets in IFI programmes are both the results of that and, if left-wing criticism during the crisis didn't do much to push that agenda forward, it did at least signal that there would be costs to pushing it back.

The other factor pressing for change is at least some awareness of the politics of adjustment. Policy-makers seemed to realize that IMF programmes were mandating very significant political and social change, creating potential for a political backlash. That was a perspective with potential bi-partisan support, which could moderate a blind drive for financial liberalization. The current security environment is likely to make it ever more clear that there are good reasons to ask searching questions about the social and distributional consequences of Fund policy.

On the other hand, in terms of decision-making and accountability, there is a problem with an institution in which the 'broader public interest' is the broader public interest in the United States or Europe. Even the Congressional left is likely to have a fairly undifferentiated picture of developing country interests. It may include progressive elements but is unlikely to be aware of the difficult trade-offs that need to made in creating developing country policy. It is not surprising that many developing country authorities see calls for labour rights and environmental measures, for example, as covert protectionism.

Worse, increasing the influence of Congress will also include the interests of the Congressional right. That will tend to provide Treasury with support on its market liberalization agenda and in its resistance to debt-workouts or capital controls.

What might that analysis of the US situation tell us about other developed countries? The fundamental incentive structures remain similar. Financial bureaucrats are in charge. Pressure for market opening from financial institutions and internationally active business are likely to be the most powerful influence on policy. At the same time, those influences will be moderated to a greater or lesser extent by foreign policy concerns and lobbying from development groups.

In other words, the most fundamental problems with US relationships to the Fund are likely to be replicated in other places. However, if one aim of this book has been to point out the areas where there is scope for change, it is also important to recognize the potential for variation. The relative political importance of the different groups mobilizing around financial policy will vary considerably. Some countries have more internationally-active financial sectors than others (one might think particularly of the UK, US and Germany) and there are also variations in the practices of international business (hence Japan's relative sympathy to some 'Asian' positions during the crisis). Of course, even where financial market openness remains a key goal, there is also room for differences of opinion about how to achieve it.

More research needs to be done on comparative foreign economic policy and the different institutional arrangements that shape various countries' relationships with the Fund. The nature of differences on policy issues only comes to light occasionally (on debt workouts for example) partly perhaps because differences are minor and partly because of the lack of transparency in the negotiations that shape positions. The US case study presented here can only provide a broad guide to the processes at work, which would benefit by being fleshed out with other examples.

9.3.3 Conclusions

This section provides some hopeful messages for IMF reform. The IMF is not an all-powerful institution. The good governance and civil society agendas are already partly responses to the limits to Fund power in securing the implementation of programmes agreed amongst financial elites. Whilst there are serious potential dangers in the radical market-supporting reforms of the post-Washington Consensus (Fine, 2000), the new agenda also opens new spaces for debate, largely because it covers issues that are so clearly political. Political challenges to the Fund's agenda did take place in both the developing and developed worlds.

Having said that, calls for reform were limited. There is no doubt that, despite my reservations, the liberal politics embedded in the Fund's new agenda were welcome to wide sections of Asian populations and valuable in reducing Congressional criticism. If, as I have argued, countries retain some choice about how engaged they wish to be with the global economy, that may help to explain why more don't choose to keep more control. The technical complexities of economic debates are important here. The Fund seems to have done a better job of translating those debates into politically appealing terms (anti-corruption, pro-democracy etc.) than its critics have done in translating their ethical concerns into viable economic programmes.

The politics of financial globalization are complex. It is difficult to talk of 'developing country interests' since, as we have seen these vary within and between countries. Some of those that were persuaded by the positive sounding governance agenda might have been less enthusiastic about Fund programmes as a whole if they had a better understanding of what is at stake economically. Debate on such complex issues is very narrowly confined in developed and developing countries alike. One task that is important for those that would like to see changes to how the IMF does its work is to inject pragmatic, politically progressive solutions into debate. A growing heterodoxy in the economics profession and increasingly sophisticated NGO engagement with macroeconomic issues (organizations like EURODAD and the Jubilee network) provides some hope here.

Probably more importantly, the institutions that shape Fund policy also continue to shape the reform agenda. Domination by financial bureaucrats is almost as important as domination by developed countries in shaping IMF priorities. It is not just voting shares within international organizations that shape outcomes, but also the ways in which the 'national interest' is represented and fed in to those institutions. Criticisms of Fund policy are most likely to be heard internally if expressed in the language of economics and supported by reputable experts – one reason why Joseph Stiglitz's attacks have been so obviously resented. As we will see, there were developing country criticisms of Fund procedures and they have forced post-crisis changes. However, those criticisms were quite limited and didn't present a radical challenge.

The fact that IMF institutional structures are designed in a way that keeps criticisms from being debated internally, though, is not entirely a sign of institutional strength. The largest problems in Asia were with ensuring that the Fund's new agenda was actually implemented. Making market-friendly policy is not necessarily the same as creating market-friendly societies. Indeed a central criticism of the Fund in North and South has been that it has an extremely narrow world-view that is not shared by most people. The kinds of political mobilization I have outlined explain the fairly limited extent of the reform agenda to date. However, they also suggest that limiting the reform agenda is not a way to deal with the long-term problems. As I explained in chapter 1, political legitimacy is about resilience. The Fund may have headed off challenges for now, but it also needs to deal with the underlying problems.

9.4 Towards a new international financial architecture?

In sections 9.1 and 9.2, I mapped out an agenda for reform that might deal with the principal criticisms of the Fund's current role. In section 9.3, we saw that there were pressures for change but these pressures were limited. In particular, political pressures for change were filtered through the Fund's own institutional structures and developed-country finance ministries. Political opposition was interpreted through the IMF's technocratic mindset and criticisms aired in developed countries were more likely to have an impact than those aired in the developing world.

In this section, I turn to debates about post-crisis reform. I argue that the nature of post-crisis reforms shows the kinds of normative problems and related political pressures I have identified are producing pressure for reform. Change has taken place in broadly the directions I suggested in section 9.2. At the same time, though, the fact that political pressure is filtered through IMF institutions, technocratic debate and pre-existing political structures has shaped and limited outcomes, leading to what I argue are very partial, incomplete reforms.

Codifying the Fund's mandate: standards, codes and crisis prevention

In section 9.2, I argued one of the most fundamental problems was that the Fund's discretion was no longer connected to a legally codified view of acceptable behaviour in the international monetary system. The most concerted reform activity in the immediate post-crisis period can be seen as an attempt to address this problem by establishing a series of 'standards and codes' for good international practice.

Unfortunately, though, there were significant problems with the way the codes were written. They were produced by a body called the Financial Stability Forum (FSF), a collection of financial bureaucrats mainly from the G8 (plus Hong Kong and Singapore) together with representatives from a range of international public and private organizations (OECD, World Bank, IMF and 'expert bodies' such as IOSCO and the BIS). Sub-groups of the membership were commissioned to prepare particular standards.

The standards cover a vast range of issues (in 30 *categories*), though 12 have been identified as 'key standards for sound financial systems'. Core issues covered include: data dissemination; corporate governance; insolvency; securities regulation; banking regulation and accountancy. They are not legislation. Rather, they set out in more or less general terms what countries need to make sure is in place (lawyers have drawn a loose analogy with EU directives (Giovanoli, 2000)). Some are quite precise (like data standards) whilst others (like the OECD corporate governance standards) provide for some flexibility in implementation, partly as they need to mesh with the broader legal system of target countries (Pistor, 2000).

The key problem with the standard-setting system was that it was carried out as an 'expert' process with very little emerging market participation. The argument was that expert and private sector bodies would be quicker at producing codes than more formal public bodies and the process would be less politically sensitive (Eichengreen, 1999; Thirkell-White, 2004b).

Randy Germain argues that the process of negotiation has opened spaces for discussion that have not been available in the past. He identifies a nascent public sphere for the discussion of global finance, on the basis that debate increasingly requires the creation of consensus and must, therefore, be carried out on the basis of evidence and rational public justification (Germain, 2004). Whilst I accept the view that there is a glimmer of positive movement here, debate remains very narrow and is dominated by a group of financial technocrats and their private sector interlocutors, based primarily in the developed world (Claessens et al., 2004).

The overall result is not equivalent to the kind of political recodification I called for in section 9.2. There is some recognition of that, particularly in a tendency for officials to play down the codes, describing them as merely good advice, at least some of the time. However, in contrast with that 'informal guidance' vision, there were fairly concerted G7/8 attempts to get the standards implemented as part of IMF surveillance and conditionality.[6]

That attempt has witnessed unusually concerted resistance from the G24. The developing country grouping in the Fund has argued that the exclusive nature of the decision-making process has undermined confidence in the appropriateness of the codes to developing country circumstances. In particular no attempt was made to assess the technical and financial requirements for implementation. They have pushed, successfully, for a model of voluntary implementation, coupled with technical and financial assistance, rather than a more coercive form of conditionality (Mohammed, 2003).

The codes remain influential though. The promise of technical assistance following assessment has made finance ministries fairly enthusiastic about signing up for voluntary 'Reports on the Observance of Standards and Codes' (ROSC) and the 'Financial Stability Assessment Programme' (FSAP) carried out by the Fund and World Bank.

The FSF intended the standards to work as the focus for 'market discipline'. Whilst the markets are interested in the kinds of issues the codes cover, at the moment analysts that are aware of the codes at all (Mosley, 2001) tend to regard them as one source of information amongst many:

> A number of institutions said they relied heavily on their in-house assessments which were based on information from private research firms, official sources and their local offices, rather than external assessments such as ROSCs (Financial Stability Forum, 2001, para 27).

Again, that is partly a result of G24 success in pushing the Fund to produce reports that are a flexible assessment, taking into account the differences between countries, rather than the sort of numerical pass/fail rating favoured by the markets.[7]

Overall, the Standards and Codes are clearly not a welcome return to politically legitimate restraints on Fund discretion, protecting the sphere of sovereignty. As Jacqueline Best has put it:

> This new financial architecture recognizes the limits of a disembedded global economy. Yet rather than seeking to reign in the forces of liberalization by re-embedding international finance in the norms and practices of particular states, advocates of this new regime seek to embed a new universal set of financial norms and institutions (Best, 2003, 378–9).

Although that may have been the intent, though, familiar problems with an overly technocratic procedure, incapable of securing political consent, have distinctly limited the effect of the codes in practice.[8]

It is debatable, anyway, whether they would have solved the problems that occurred in Asia. Better prudential regulation of financial institutions is undeniably important. However, the main focus of reforms has been on increasing 'transparency' by releasing more data to the markets. In Chapter 4 I raised the possibility that crisis is driven by more fundamental problems or was more to do with a failure to use available data effectively.

In any case, limited progress on the standards and codes agenda raises important questions about how crises are to be prevented. The Fund has abandoned any attempt to formally institutionalize any obligation of capital account liberalization and is talking more seriously about 'sequencing' capital account liberalization but it has certainly not abandoned the overall project (Rogoff, 2003). All that has changed for financial stability, though, is that: developing countries have accumulated costly reserves; all countries are paying more attention to debt levels in their macroeconomic policy; and there is some tentative acknowledgement that controls on capital inflows may be useful in the 'boom' phase of a financial cycle. It is by no means clear that those changes are enough to prevent crisis.

Work-outs and 'bailing in the private sector'

If the institutional reforms that the IMF thinks are required to deliver financial stability will be hard to implement (and potentially inadequate), crises will continue. Since the costs of crisis were so important in triggering political debate, one might have thought that there was a common political interest in a solution, placing greater cost burdens on private creditors. The magnitude of the crisis did trigger significant debates about these issues. There is a broad acceptance that something needs to be done to promote more orderly debt workouts.[9] The problem, though, is in the distributional implications of any particular strategy.

The politics of debates on sovereign debt restructuring have yet to be fully researched. However, there appears to have been a debate between one view emphasizing the need for international rules about this issue and another arguing that, since every case was different, a 'case by case' solution had to be adopted.[10] The fault lines were not solely between creditor and debtor countries. Canada and some of the European countries were interested in a rules-based approach while the US and some of the Latin American countries were opposed. That suggests differences may be as much about different national perceptions as they are about material interests.

Debate about debt restructuring revolved around the potential for more concerted solutions to raise investors' assessments of emerging market risk, increasing the costs of borrowing. It should not be difficult to see why Argentina, for example, did not want to offer public support for debt workouts when rising risk premia were already pushing it towards a financial crisis of its own.

There were signs that even US opinion fluctuated on the issue. After the fairly negative response of the Clinton administration, the debate was revived when the Bush administration appointed Anne Krueger as Deputy Director of the IMF. She put forward proposals for a 'Sovereign Debt Restructuring Mechanism' (SDRM) (Krueger, 2002). Presumably that had some kind of Bush administration sanction, perhaps driven by the emergence of a costly financial crisis in Argentina. Secretary

O'Neill also made positive noises about debt workouts. However, any enthusiasm there may have been was ultimately quashed by concerted Wall Street lobbying. Latin American opposition continued and anecdotal reports suggest that last-minute financial sector lobbying may also have undermined some European support for the proposal.

All that is now on the table when debt restructuring is discussed is more attention to and research on the inclusion of collective action clauses in bond contracts. Those can make striking a deal easier but they still do little to force financial institutions to the negotiating table. The IMF has revisited its policy on 'lending into arrears' – providing finance to countries that are not up to date on their debt payments – which could boost countries' bargaining position, stopping investors from using short-term desperation to push through a dubious deal. However, the current agreement is that it will only do so when negotiations have already begun (IMF, 2002).

This is probably the most central issue in the Fund's crisis policy. Financial sector lobbying has prevented substantive change, despite a widespread consensus in favour amongst academic economists. The current situation is both clearly unjust and counterproductive, in that chaotic debt rescheduling is costly for participants in the short term and prevents the kind of recovery that could help investors to recover some of their investment over the medium term.

Conditionality and ownership

Early IMF responses to criticism over Asia accepted problems with fiscal policy but continued to claim structural policies were essential (Boresztein and Lee, 1999; Fischer, 1998b). Horst Kohler spent a good part of his early tenure as Managing Director of the Fund talking to developing country representatives. They drove home concerns about the scope of structural conditionality (IMF, 2001a).[11] The Fund responded with a review of its conditionality procedures and a report on 'strengthening country ownership'.

Both reports showed the Fund was aware that more parsimony and prioritization was required to 'safeguard the effectiveness of the institution and the legitimacy of its activities' (IMF, 2000a) There was recognition that some structural measures had been introduced because they were a good idea rather than because they would help to resolve crisis.

In September 2002, the IMF introduced its first new guidelines on conditionality since 1979. The guidelines say that conditionality should 'normally consist of macroeconomic variables and structural measures that are within the Fund's core areas of responsibility'.

Additional conditions can also be introduced, though they 'may' require more detailed explanation (Para 7 (a)). Interestingly the Managing Director's original 'Interim Guidance Note', issued in 2001, said that additional measures would *have* to be justified, suggesting that the Fund's leading shareholders continue to oppose institutional attempts to narrow policy. The new guidelines show that the institution is aware of the problems and is trying to do something about them. At the same time there continues to be political pressure for an expanding agenda. Only time will tell whether the guidelines have more impact than their predecessor.[12]

The report on enhancing ownership also shows awareness of some of the issues the Fund was facing in Asia. There is a growing acknowledgement that staff need to engage with more than the finance ministry if policies are to be implemented: making agreement with sympathetic technocrats doesn't secure implementation. There is a discussion of the need to hire staff from broader social science backgrounds, to encourage awareness of 'domestic heterogeneity'.[13] However the approach outlined in the report seems more concerned with working on pro-reform factions to get what the Fund wants, than engaging in wider political debate, dialogue and compromise. There are overlaps here with the report's discussion of civil society engagement. If the Fund cannot acknowledge it is engaging in *politics*, it is forced to oscillate between declaring some kind of interest in wider groups but also insisting that, in the end, the sovereign power must decide.

Having said that, the report does also press staff: to consider 'programmes that differ from the staff's preferred options as long as the objects of the programme are not compromised'; to build negotiating capacity in borrower countries; and to present more than one alternative to countries when negotiating programmes.

Overall, there is more sense here that the organization is trying to move in the right direction. However, broader political pressures, including an unwillingness to think of implementation in terms of a political process, continues to limit what can be achieved.

Lending

In terms of lending facilities, the agenda has been set by the right-wing US concerns raised in the Meltzer report. The Fund has adopted a Contingent Credit Line, which is supposed to increase market confidence by enabling countries to sign up for a fast-disbursing credit line if they are willing to commit to a series of relevant policies. In fact no country has yet signed up. That seems to have been partly because of the cost of the facility and partly because, despite pre-qualification, disbursement would not be automatic. The Fund has already eased the terms once in an attempt to drum up clients but the initiative continues to show embarrassing signs of insufficient consultation.

Under US pressure, the Fund has also changed the charging structures for its facilities, introducing interest rates that increase over time to prevent long-term reliance on Fund finance. That move was met by bitter resistance from developing countries and the post-communist countries (suggesting the potential for interesting political alliances in the future). Increases still went through but at a lower level than originally planned.

Developing countries have pressed for greater willingness to use the SDR as a source of international liquidity, in the face of contagion, indicating greater faith in an injection of liquidity than in any solution to debt restructuring that is likely to emerge from the IMF process (Mohammed, 2001a). However, G7 countries remain resistant.

Other institutional reforms

I have argued that the most fundamental issues in all this, though, are political. In some areas there does seem to be an IMF interest in moving towards reform (particularly on conditionality and debt restructuring). However, even in the issues where Fund staff are at least moderately flexible, constraints imposed by the Fund's leading shareholders within the institution continue to colour what can be done.

The issue of quotas and voting shares within the institution has been discussed continuously since the crisis. A range of highly complex adjustments to the quota system have been proposed, not least by an internal Fund team. As this book was going to press, the G24 made one of its most public attacks on the quota system in recent memory at the 2004 autumn meetings. However, there was no movement from the Fund's leading shareholders. Rodrigo de Rologas, the new Managing Director, was forced to make conciliatory noises but concluded that a change in quotas would require a political consensus that did not yet exist.

All that has happened are the positive, but rather modest, steps of providing more research staff for the Executive Directors for Africa and establishing an 'independent evaluation office' (the IEO). The IEO has produced some good reports, which offer modest criticism of the kind the Fund's Board might be prepared to accept (IEO, 2003). However, criticism is hardly radical and it is not clear what incentives there are to actually do what is proposed.

9.4.1 Conclusions

The IMF was put under genuine pressure as a result of its interventions in Asia and it has responded, sometimes in ways that are to be welcomed. There have been attempts to rein in conditionality, though it remains to be seen how successful they are. There has been discussion about a more sensible system of debt work-outs, though results have been very limited. There have even been attempts to clarify the Fund's mandate, though these have perhaps been most problematic of all.

In terms of the politics of change, the popular image of a US-controlled institution is a modest exaggeration. Treasury did not receive everything it wanted. The standards and codes have not been made compulsory. Very little progress has been made on the Meltzer agenda, even under the Republican administration. Limits to sovereign debt restructuring mechanisms were partly the result of European and Latin American support. On the other hand, the outcomes hardly reflect radical challenges to the *status quo*.

That highlights the fact that what has not happened is any fundamental re-thinking of the way in which IMF decisions are made. Reforms continue to be filtered through the lenses of a particular kind of economic thinking – particularly noticeable, for example, in the (frankly bizarre) view that a private sector approach to standard setting would be less politically controversial than a public one. Again, it is important to point out that developing-country interests have had some influence in shaping outcomes. However, financial interests in developed countries continue to dominate, particularly on 'core issues' such as the new Basel Accord, which has been pushed in a particularly irrational direction by financial market pressure (for details see (Claessens et al., 2004)).

In the end, though, as I argued at the end of section 9.3, such a limited agenda is bound to be counter-productive. Financial lobbying has prevented reforms that damage financial markets' short-term interests. However, the markets have not achieved the reforms they wanted to re-shape the world in the image of idealized markets. 'Reforms' which are obviously unbalanced and introduced without broad consultation will not produce the kind of political consensus required to do what is necessary to stabilize the international monetary system. The result, so far, is a set of reforms that have done little to resolve the problems that appeared in Asia.

Creating a more legitimate Fund is a difficult task but it is not one that can be avoided. Perhaps the most obvious indication comes from on-going problems in Argentina. Despite the influence of the Meltzer report on Republican rhetoric, it has been very difficult for Republican Treasury spokesmen to explain to Congressional committees what as changed in crisis management since the Clinton administration.[14] The Argentinean bail-out was the largest in history and has provoked considerable Congressional criticism. The architecture reform process so far has given few reasons to believe that what happened in Asia could not happen again.

10
Conclusions

The IMF was established with a purpose that was as much political as it was economic. It was designed to legitimate the international monetary system. It would give states incentives to stay internationally engaged and provide a forum for debate on system management. Debate would take place within a legal framework, setting out the core obligations that shaped the system. That system would introduce new flexibility and security into the system so that states had greater incentives to stay engaged.

Over time, though, its role has changed and the institution has become increasingly polarized. The Fund's attempts to promote financial globalization have taken place in a context where the custodians of large, secure, financial markets try to pressure smaller, more insecure emerging markets into financial liberalization, coupled with radical institutional reforms. The need to *entice* countries into global engagement has been largely forgotten. In any case, I have argued that the effects of the kind of radical integration the Fund seems to envisage are too demanding on domestic institutions, leaving little scope for specifically developmental policy.[1] I have suggested that the Fund's new agenda is normatively problematic and may also be counterproductive in the longer term. It sharpens the choices countries face, rather than making a moderate level of integration look attractive.

Thinking about these issues in terms of *politics* is extremely important. Economists tend to see 'political factors' as something to be avoided. Political influence signals the intrusion of irrational struggle into sensible policy-making. However, politics is also about the way in which people who will be affected by decisions can ensure that their input is taken into account. It is political imbalance that has allowed the Fund to drift in such a problematic direction. Decisions made by one group *for* another are bound to be normatively and politically problematic. The Fund, of course, denies that this is what is taking place. I have pointed to some leeway for manoeuvre but all the evidence is that countries continue to be faced with a very sharp all-or-nothing choice.

Politics becomes particularly important as the Fund strays into issues with powerful normative and political content, like the governance agenda. Human interests and values are diverse and sometimes incompatible or incommensurable. Differences and conflicts need to be dealt with and negotiated. Market activity is only one part of social life. As I have tried to show, economics is not independent of broader social processes. It shapes them and is shaped by them. It needs to take place within a broader socially and politically legitimate framework, which may look different in different contexts. Those social and political issues need to be negotiated. One cannot, then, decide what 'right policy' is outside a political process. I have therefore tended to identify problems with the Fund's political process, rather than take firm positions on substantive policies (which I have suggested are sometimes more ambiguous than critics acknowledge). The Fund, though, tends to deny the politics of its role. That is highly problematic. Denying politics risks denying human diversity and choosing authoritarianism (Crick, 1982). It is also likely to be counterproductive in the longer term. Engaging in legitimate politics is the only way to ensure that policies command the consensus that is required to sustain them. We may not like the way a set of political processes is working but that is a reason to engage politically in an attempt to improve them, not a reason to try and avoid politics in favour of a spurious technical certainty.

The other reason it is important to think politically is to recover choices over the process of financial globalization and to identify the potential for change.

I have argued that existing Fund politics is unsatisfactory. We have seen that IMF decision-making is dominated by the developed countries rather than developing countries and, in all countries, by finance ministries rather than wider populations. The institution has been designed to forge a powerful internal consensus on what should be done. That internal consensus shapes policy and also shapes responses to political challenge, providing incentives not to listen to criticism and helping insiders to believe that their position is secure and defensible. However, that situation is partly legitimated by denying the political nature of the Fund's role. Simply to point out that its role *is* political is to challenge current arrangements. I have also shown that, by looking carefully at the politics of Fund-state interactions, we can appreciate some of the limits to IMF power. By understanding the logic of the politics that shapes the Fund's role we can see when choices are made and by whom. We can therefore see where to organize if we do not like the choices that are being made and how to challenge those choices. As Fund staff often point out, many of the problems are as much with the Fund's leading shareholders as they are with the institution.

I have shown that an internal consensus within the Fund is not enough to prevent a certain political fragility to the new agenda. The post-Washington consensus is seen as economically essential. I have been ambiguous about the governance agenda. I am concerned that too little attention is paid to issues of prioritization and that it can be hijacked to a very narrow kind of liberal government, designed to serve external financial interests rather than domestic priorities (though these may overlap to some extent). However, it is potentially an advance on the Washington Consensus denial of any public role for the state. It raises issues of politics and there is potential to push it in a more politically engaged direction. My hope is that attempts to confine debate over such a political agenda to questions of economic calculation is bound to fail, creating political opportunities.

At present that potential is most obvious in the problems encountered in the implementation of the Fund's new agenda: in the failure to connect internal consensus with external consensus. Financial crisis is very costly. Without dramatic, and by no means universally popular, institutional reform, free capital accounts cannot be stabilized. Even if the Fund's technical analysis is correct, it is faced with three choices: it can do the political work required to popularize its agenda; continue expending vast sums to deal with crisis; or accept a narrower role, with less commitment to free capital flows. That dilemma inevitably points towards capital controls and orderly debt work-outs, though it may take more financial crises before that lesson is learnt.

A range of political strategies might follow from that conviction, depending on one's ultimate aims. My inclination has been to push towards a greater reliance on national-level political processes, even if creating the necessary insulation from capital flows may have some economic costs. I have tried to present a vision of politics that involves debate and persuasion, against a background of institutional structures that provide incentives to take equal account of different voices. Imbalances of power in the international system make that kind of arrangement particularly difficult to imagine on the international scale. Domestic politics, too, may be deeply unsatisfactory, but I am personally more comfortable with the prospects for domestic political organization to create change, than I am with political and social re-engineering undertaken by international institutions, particularly an institution like the IMF which was never designed for that purpose. The danger of grand re-engineering is that it relies on creating morally-inspired visions in the abstract, which are not forged through the agreement of those involved, or informed by the political realities of the context in which they are introduced.

What does that say for the IMF's role? It doesn't necessarily prescribe any particular role but it does place an emphasis on the IMF as a political institution whose role is in *persuading* countries to pursue particular economic activities. The IMF would be a more successful institution if it was forced to do the political work required to achieve consensus, rather than insulated in a way that produces idealized and inappropriate solutions. That is the case I made for the institutional reforms I sketched in section 9.2. I do accept, as I said in Chapter 1, that interstate cooperation is essential to achieve collective economic goals and that states will face internationally agreed constraints on their domestic behaviour. My personal view, though, is that the restraints embodied in the Fund's institutional agenda and the standards and codes process are unnecessarily and unacceptably broad. The IMF should shape and enforce rules for acceptable collective conduct but those rules cannot be imposed by a narrow subset of the membership. That kind of short-cut will ultimately be counter-productive because it fails to do the work of winning agreement and compromise that is an essential part of the political process. The Fund's policies may really be in the general interest. If they are it should be able to win the arguments. If it can't, whether or not the ideas are correct, there is little chance of implementation.

In a sense, I am promoting a Bretton Woods vision in which the Fund's role is to provide incentives for states to choose international integration. States, on the other hand, will place limits on their integration on the basis of trade-offs between potential economic benefit and the need for public action to meet the peculiarities of the domestic situation. That certainly need not mean a return to fixed exchange rates and capital controls, though. There are a wide range of possible arrangements: capital controls are not an all-or-nothing choice and exchange rate coordination can take place on a regional as well as an international level. Debates about what exactly is appropriate are perhaps best left to economists. My purpose has been to stress the politics of what is at stake and to make a case for putting social and political arrangements first.

What kinds of political agency can be expected to press this kind of an agenda forwards? Perhaps the central problem I have identified is the extent to which 'international' debate is dominated and monopolized by financial technocrats and by an overly narrow conception of 'economic expertise'. That situation is partly driven by structures of power that need to be challenged, but I am anxious about thinking in terms of a dominant 'transnational capitalist class' with a unified set of interests that are very difficult to challenge. Some of what underpins the politics of the Fund *is* an imbalance of power between those with resources (in the core) and those without (in the periphery). The debate around debt work-outs is the most obvious manifestation of that. No solution is wholly attractive because making creditors accept the risks they are supposed to be being compensated for taking may impair capital flows in the future. However, part of what sustains current relationships is more malleable, as it is based on the system through which interests are represented. That can and should be challenged in some of the ways I suggested in section 9.2. However, the institutions themselves also create constraints.

Those constraints, particularly finance ministry dominance, suggest the need for a more 'global' (rather than inter-state) politics, which can counter some of the ways in which inter-state arrangements shape world politics. In the IMF's case, the problem is one of an insulated debate carried out in technocratic terms. However, I have also shown some anxiety about the popular civil society solution to this problem. The anti-globalization and NGO movements can overestimate the commonality of interests between 'the people' in different countries. 'Outsourcing' simply does improve living standards in the developing world, albeit from a very low base, creating conflicts of interest between the relatively well off in the 'South' and the poorest in the North. There are dangers that a 'poverty' agenda for development may not serve Southern interests. Again, it is important to emphasize conflict of interest and politics.

There is scope for trans-national action but it is a second-best solution, reflecting power imbalances in the global system. It is important that it is carried out in a way that empowers domestic politics, rather than substituting for it.

Strategically, one useful form of action would to build on emergent heterodox approaches to development economics that have a greater awareness of the complexities of social and political life in the developing world. The dominance of research output from the Bretton Woods institutions, and its narrow focus, leaves those who wish for an alternative vision of development with limited intellectual resources. That helps to sustain the cosy relationships between developing country finance ministers and the IMF. Although creating better economics is clearly an elite project, it is probably a necessary one, given the way the politics of international finance continues to be conducted. There may be an emergent financial public sphere (Germain, 2004), but it is certainly not yet 'pluralistic, close to the grass roots, and relatively undisturbed by the effects of power' (Habermas, 1996, 182) In the short term broader input into that technical debate of a kind that can challenge prevailing views in their own terms would be a valuable second-best.

Over the longer term (and more idealistically), there is a need for education and empowerment of broader populations to debate economic issues, particularly (though not exclusively) in developing countries. That will involve a combination of education and more sustained attempts to reframe technical debates in ways that can be publicly debated. There obviously are transnational roles to be played here, particularly in working in developing countries to enhance grass-roots politics (perhaps building on the Poverty Reduction Strategy Paper (PRSP) model). The outcome will not be forging *a* consensus about international financial governance or producing *a* more appropriate vision for the Fund, though. Rather, it will be a better informed and more inclusionary *politics* of financial globalization.

Notes

Chapter 1 Introduction

1. 'We want to aim at a governing structure doing a technical job and developing a sense of corporate responsibility to all members, and not the need to guard the interests of particular countries' (Keynes quoted in Strange, 1973) 'the Fund is to a high degree a technocratic organization' (Polak, 1991, 30).
2. That is clearly true of the accounts written by economists (Bird, 1995; Killick, 1984; Killick, 1995; Pastor, 1987; Edwards, 1989), but also of many political treatments, even if the evaluation is done in relation to political concerns (Korner et al., 1986; Payer, 1977; Sidell, 1988). Exceptions include Lister, 1984; Martin, 1991; Pauly, 1997; Stiles, 1991; Strange, 1973.
3. For the distinction, see Lebow, 2003.
4. Haggard and Maxfield, 1996 provides an argument about middle-income countries in broadly these terms.
5. Critical reviews of the literature on broad macroeconomic policy convergence include Hay, 2000 and Garret, 1998. On convergence in corporate governance see Pistor, 2000 and Palepu et al., 2002.
6. An important part of the case neoliberal IR writers make for international regimes (Keohane, 1984).

Chapter 2 IMF Legitimacy: Principles and Institutions

1. The account given is primarily based on Guitian, 1992 and Driscoll, 1998 but similar statements can be found in a much wider range of IMF speeches and publications.
2. There continues to be dispute over the causes of the Great Depression, of course. Nonetheless the 'lessons' referred to in IMF accounts (the dangers of beggar-thy-neighbour policies and the need for international political cooperation to support the monetary system) are broadly accepted (Dell, 1981; Eichengreen, 1998; Ruggie, 1983).
3. Lister (1984) and author interviews with developing-country Executive Board members.
4. For discussions see (IMF, 2000b; Lister, 1984; Mikesell, 1994).
5. A document, signed by appropriate domestic authorities, outlining the policies that will be adopted in exchange for funding.
6. The IMF's location in Washington was a partial defeat for Keynes' technocratic vision. He had had hoped it could be set up in New York (the financial, rather than political, capital of the USA) (Gardner, 1980). For a defence of these arrangements, see (Lister, 1984).
7. This section has had to be kept very brief. It contains various simplifications and generalizations. The general effect of those simplifications is to present a picture that is sympathetic to the idea of international institutions and supportive of arguments that states maintain much of their formal sover-

eignty under globalization. I provide considerable qualifications to that position as the book goes on.

8. Except where otherwise stated, the discussion that follows relies heavily on Eichengreen, 1998.
9. Whether the blame should lie with the speculators (Nurske, 1944) or governments for providing them with opportunities (Freidman, 1953) remains contested.
10. Lipson, in similar vein, argues that gunboat diplomacy in Latin America was usually in response to some more serious issue such as breaches of international law in the way creditors were treated (Lipson, 1989).
11. The attraction of utilitarian thinking on resolving coordination problems, of course, underpins neoliberal institutionalist approaches to international organizations (Keohane, 1984; Keohane, 1990).
12. In fact the word ‘want’ here is problematic. There are difficult questions about whether utility should be thought of as what people think they want (their preferences) or what will in fact make them happy.
13. Confidential interview, Washington DC, October 2000.
14. This position was driven home in confidential author interviews with developing-country Executive Directors and their staff, Washington DC 2000.

Chapter 3 An Evolving IMF

1. The account provided here is, obviously, very cursory. The aim is to set out the key conceptual information required for non-specialists to understand what the politics of international monetary relations are all about, rather than to provide a cast-iron and rigorous account of the relevant economic theory. For a good introduction to open economy macroeconomics, see Krugman and Obstfeld, 1997.
2. On the history of Bretton Woods negotiations see Gardner, 1980.
3. Keynes also attempted a rearguard action with a ‘scarce currency clause’ designed to force creditor adjustment in extreme circumstances but the clause has never been invoked (Gardner, 1980; James, 1996).
4. Prebisch had developed his structuralist critique of orthodox IMF-style adjustment in the 1950s. However, academics only began to note conflict in the late 1960s (See for example Krasner, 1968).
5. The list is taken from (De Vries, 1985) but the same criticisms can be found in other reviews eg. Bird, 1984; Williamson, 1983.
6. So much so that by 1990, Polak’s review of the 1979 conditionality guidelines concluded ‘these restraining provisions have not prevented the intensification of conditionality in every direction that the guidelines attempted to block’ (Polak, 1991, 53–54).
7. Though even here, the recent Fund-commissioned external evaluation of the surveillance function concluded that there was insufficient international focus in the IMF’s activities (IMF, 1999a).
8. There was no shortage of radical criticism of structural adjustment. However, much of this criticism failed to separate the effects of crisis from the effects of the IMF’s particular choices. No-one was articulating a radically different agenda that dealt with the situation countries actually found

themselves in. Compare, for example, the chapters in Killick, 1984. Of course, that consensus was in the context of developed-country reluctance to meet financial crisis with greater financial resources, which would have opened up different possibilities.

9. Dhonte argues that this began with the IMF's role in encouraging concerted lending during the debt crisis. It is therefore a trend that began with the IMF's growing involvement in debt issues reviewed in the previous section.
10. For the debate on the 'developmental state' see Amsden, 1990; Wade, 1990 and the case study discussions in Part 2 of this thesis – particularly Chapter 5 on South Korea.
11. The IMF, for example, is required to 'respect the domestic social and political policies of its members' (Article IV Section 3 (b)).
12. The quotations that follow are all from (IMF, 1997a). The numbers in brackets indicate the paragraph numbers in that document.
13. For more information on the development of political conditionality see Crawford, 2001.
14. In reality, the distribution of funds between countries did not provide much evidence of a change in priorities in the US or indeed in Europe (Olsen, 1998).
15. For some (by now slightly dated) information on other jurisdictions see Gerster, 1993.
16. Quotes are from interviews with Jan Arte Scholte in 1996 cited in O'Brien et al., 2000, 187.
17. Particularly Friends of the Earth – US, Centre for Concern and the Bretton Woods Project (O'Brien et al., 2000, 183).
18. Management issued instructions to resident representatives in 1995 to cooperate with the ILO and foster links with local unions. (O'Brien et al., 2000).
19. See for example IMF 1998.

Chapter 4 The Asian Crisis and the Case Studies

1. What follows is essentially my gloss on (IMF, 1997d), which provides the fullest account of how the IMF saw the crisis when it struck. I have tried to convert that account into a more accessible style. Where I have drawn on other documents they are cited.
2. For the classic account of the history of crises see Kindleberger, 1978. Mechanisms posited include sheer exuberance, imperfect information, herding effects, gradual decreases in perceived risk over time during the boom cycle (Kregel, 1998b), moral hazard (Krugman, 1998) and something loosely analogous to a domestic bank run (Diamond and Dybvig, 1983; Radelet and Sachs, 1998a).
3. See comments made by Mussa in Chote, 1998.
4. Except where otherwise stated, the discussion of rents that follows relies heavily on Khan and Jomo, 2000.
5. Equity investment is less risky than bank loans because loans need to be repaid at the same rate regardless of company performance or broader business cycle trends. Shareholders, by contrast, share risks, so dividends and the underlying value of the investment fluctuate with company performance.

6. Bird has attempted empirical tests to evaluate the catalytic effect. He found different types of effect with different sources of finance. Fund approval did have a modest effect on public sector finance but there was no evidence of a positive effect on private finance (Bird and Rowlands, 1997).
7. The historical experience is in any case mixed. There seem to have been few lasting penalties for non-payment in the aftermath of the Great Depression but then default was relatively widespread. Renegotiating bond contracts was nonetheless a very lengthy process leading to considerable uncertainty (Eichengreen and Portes, 1989; Jorgensen and Sachs, 1989).

Chapter 5 South Korea

1. This 'high-risk' strategy has long been a feature of Korean corporate governance and has got the system into trouble before. Woo points out that, in the past, this too helped the government to emphasize its dominance over the chaebol (Woo, 1991).
2. For this era of Korean history see Amsden, 1990; Kohli, 1999 and Cumings, 1984.
3. The best review of domestic criticisms of this type is Lee, 1997.
4. As far back as 1993, there were bureaucratic disputes about the pace and extent of liberalization between a free market EPB and a protectionist MOF and BOK (Gills and Gills, 2000) Although the MOF and EPB were merged by Kim Young-sam, internal rivalries persisted.
5. The Korea barometer survey was modified when pilots suggested (unsurprisingly) that many Koreans didn't feel qualified to answer the more technical questions about the crisis (Shin and Rose, 1998).
6. A 'Western diplomat' quoted in the *Financial Times* 2 December 1997.
7. Cummings claims 'sources in Washington' admitted that several reforms had been specifically demanded by US Treasury officials. Later, US officials trying to persuade Congress to renew IMF quotas re-enforced this impression – see Chapter 8 below.
8. For example, forging an alliance with Kim Jong Pil to widen his regional support, Kim Young-Sam's involvement in the Hanbo scandal and minor incidents tarnishing Lee Hoi-Chang's 'Mr Clean' image – see Economist Intelligence Unit, 1997a; Economist Intelligence Unit, 1997c.
9. See also *Business Korea* Vol. 14 No. 12, *FT* 8 December 1997, 12 December 1997.
10. See speeches reproduced in Sohn and Yang, 1998.

Chapter 6 Indonesia

1. Suharto's Indonesia reflected both reactions against the Sukarno era (particularly in macro-economic policy) and continuities with it (centralized political power and attempts at economic nationalism) but, for reasons of space, I will say little about the earlier period. For further details see Robison, 1986; Schwarz, 1999.
2. See also Kwik, 1993 and *Tempo* 10 April 1993.

3. During the 1980s, military logging and transport monopolies were eroded by changes in forestry legislation. The creation of Sekneg cut the military out of state contract allocation (Robison and Hadiz, 2004).
4. There is a history of Muslim disappointment and political marginalization that goes back to the 1940s, when references to an Islamic state were removed from the draft constitution. Muslim hopes that enthusiastic participation in the elimination of the Indonesian Communist Party in 1965/6 would reap rewards were also unfulfilled. In the mid-1990s, muslim groups were deeply resentful at being forced to formally adopt the secularist doctrine of *Pancasila*. Paradoxically, though, the retreat of groups like Nahdlatul Ulama from formal politics created space to channel student political energy into Islamic groups in the universities (Hefner, 2000; Schwarz, 1999).
5. At this stage the total figure was unknown, only being revealed in February.
6. For Hanke's account of this incident see Hanke, 1998; Hanke, 2000.
7. On the Malaysian approach see Chapter 7.
8. See also Reseinhuber's (2001) more extended account of these negotiations.
9. Much market commentary during the crisis, reproduced in regional and international financial papers, stressed the need to see government willingness to introduce 'painful' measures of one kind or another.
10. See Haggard, 2000 for details.

Chapter 7 Malaysia

1. By 1996, these figures had become 61%, 30% and 8% respectively (Gomez and Jomo, 1999).
2. Though rural elites could benefit from UMNO patronage (Crouch, 1996, 39).
3. Demonstrated during legal battles over the UMNO split, and more recently during the Anwar affair – see Crouch, 1996 and discussion below.
4. 'If the going gets rough in Malaysia, the strong are likely to come swiftly to the aid of the weak' (*FT* 21 June 1997) – there is some irony here given later claims about crony capitalism.
5. Referring, as everyone knew, to George Soros.
6. See for example the quotations cited in *FT* 30 August 1997.
7. See for example Anwar's speech to the UMNO Youth Wing in which he claimed that the country was involved in economic battle 'no less significant than the struggle for independence' (*NST* 5 September 1997). Anwar also made repeated calls for better regulation of currency trading (Ibrahim, 1997) while, as we will see in the next section, Mahathir was keen to show a continuing interest in capital investment in Malaysia. See also Funston, 2000.
8. According to Lex in the FT, an example 'of the sort of crony capitalism and opaque market practices that suggest the government is more concerned with helping its friends than achieving an equitable environment for all' (*FT* 21 November 1997).
9. See Haggard and Low 2000 for further details and the discussion in the analysis section below.
10. He was at a meeting in Langkawi and, when questioned by the media, appeared less than enthusiastic about the measures. See also Mahathir, 1998a where he claims the policies were always against his inclinations.

11. The speech was made at a conference that Mahathir also addressed. Kohler seems to have a slightly more positive view. He warns that controls become more problematic over time but explicitly accepts that the controls were not the disaster that had been expected (Kohler, 2000).
12. Compare Athukorala, 2000; Haggard and Low, 2000; Herald-Perkins and Woo, 2000.
13. Malaysiakini is a news website providing the only politically independent coverage of Malaysian politics – http://www.malaysiakini.com.

Chapter 8 The United States

1. Of course institutional relationships and political cultures will vary between countries but the US example will at least give some indications of what one might expect to take place elsewhere.
2. Geithner was the Treasury Under Secretary for International Affairs in 1998 and now works for the Fund's policy development and review department.
3. See, for example, Thomas Dawson's testimony in House Banking Oversight Subcommittee, 1998, 105–6.
4. Personal communication from USAID external affairs.
5. Over threatened 301 action in Korea in the late 1980s, and as part of the 'Structural Impediments Initiative' talks with Japan.
6. See particularly the comments by Sanders and Frank in (House Committee on Banking and Financial Services, 1999).
7. Sanders acknowledged that the legislation had no chance of getting passed but was introducing it to raise awareness (These initiatives are documented on his website – http://www.house.gov/sanders).
8. Some Treasury officials claimed liaising with Congress took up 50% of their time rather than the normal 25% (Baker, 2002). Documents promoting the Fund to Congressmen appeared on the Treasury website and officials addressed committees (Geithner, 1998; Rubin, 1998).
9. So, for example, policymakers couldn't tell me about any NGO involvement. Jean-Marie Griesgraber, an experienced lobbyist on Fund issues working for Oxfam US, told me that she had not been involved at all. There was some suggestion that Friends of the Earth US had done some lobbying on deforestation in Indonesia. Treasury officials complained that they had found it difficult to get feedback for the upcoming conditionality review. On HIPC, though, pressure for debt cancellation organized through the Jubilee network has been enormously significant.
10. For a variety of academic interpretations of the significance of events in Seattle see Millennium Vol. 29 No. 1.
11. Confidential interview with staff reporting to key anti-Fund Congressman autumn 2000.
12. A view expressed by pro and anti-IMF politicians, Congressional staff (committees and reporting to particular Congressmen) and Jim Orr at the Bretton Woods Committee.
13. Clinton made this clear in his 1998 State of the Union address and other interviews.
14. For the polarization between the two in debate around the World Bank see Kanbur, 2001.

Chapter 9 From Crisis to a New Architecture?

1. See also discussions of the extent to which different civil society groups are 'representative' in Dawson and Bhatt, 2001.
2. As well as this quotation, I draw much of the inspiration for the discussion of democracy in this chapter and the next from Habermas' recent and more practical work on the relationship between constitutions, law and procedural conceptions of democracy. I also draw on Beetham's multi-faceted conception of democratic legitimacy (Beetham, 1999).
3. For a fuller treatment of some of these themes see Evans and Finnemore, 2002.
4. Malaysian financial journalists I spoke with in Kuala Lumpur in 2003 were initially sceptical of the capital controls, seeing them as an example of cronyism and authoritarianism. Over time, though, they were inclined to revise their opinions. Anwar Ibrahim, recently released from prison, continues to insist that the controls should be seen in terms of cronyism and corruption.
5. See Summers, 1999 and G7 statements following the summit in Okinawa, July 2000.
6. See the IMF 'Factsheet' on ROSCs and FSAPs (and the examples of reports) available at http://www.imf.org
7. For some early evidence on implementation see Walter, 2003.
8. This position is even accepted by some financial institutions – see comments by Robert Gray of HSBC to the UK Treasury Select committee's review of Fund policy 18 February 2000 (available on the House of Commons website).
9. There is a related argument here about the advantages 'constructive ambiguity' can have in reducing moral hazard (Giannini, 1999).
10. The G24 also commissioned research on this issue and it featured in G24 communiqués (Kapur and Webb, 2000).
11. See Summers' comments on conditionality quoted in Chapter 8. Similarly, the staff's response to calls for parsimony in the External Report on ESAF was also to argue that the membership was putting them under pressure for greater intervention (Evans and Finnemore, 2002).
12. For an early assessment in low-income countries, which suggests progress is at best mixed, see Killick, 2002.
13. In implementation, this requirement was undermined by also insisting that staff had a graduate qualification in macroeconomics. An applicant for the economist programme, selected for her political science background, told me the recruitment procedure was entirely based on macroeconomic expertise.
14. For a broader account of the similarities between financial policies under Clinton and George Bush junior, see Thirkell-White, 2004d.

Chapter 10 Conclusions

1. For an overview of the ways in which market integration is particularly demanding for emerging markets see Mosley, 2003.

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