

*Informal Governance:
International Organizations and the Limits of U.S. Power*

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Introduction: International Organization and U.S. Power

Government is gradually replacing anarchy in the international system, and international governance is largely accomplished by means of international organizations. International organizations have proliferated, have expanded in membership, have acquired new legal enforcement powers, and have extended their reach into the details of domestic political economy in their member states. A few, including the International Monetary Fund (IMF, or simply the Fund), command significant resources and wield considerable authority.

For the most powerful state in the system, international organizations are an essential instrument of effective statecraft, and for most other states under most circumstances, they are the only forums in which anything can be accomplished. International organizations are useful, to powerful and weak states alike, because they can extend credibility and legitimacy to efforts that would otherwise lack credibility and legitimacy. This often makes the difference that makes multilateral cooperation feasible; and the challenges posed by an increasingly interdependent global economy typically demand coordinated responses.

The legitimacy and independence of international organizations are always compromised, however, because they exist in a system of states, and states enjoy very unequal power resources. International institutions have consequently developed informal procedures that accommodate the interests of the most powerful states. However, if these informal procedures are abused, the legitimacy and usefulness of the organization can be undermined. Any characterization of the role of an international organization in the system, therefore, is a snapshot of a dynamic process, as its informal

internal procedures and its external legitimacy and functions change in response to state strategies. In the post-Cold War world, most shocks to the system originated in the foreign policy interests of the leading state, the United States; but even this is changing as the distribution of power shifts.

International organizations are compelled to navigate the treacherous vortex created by U.S. power. If they stray too far from the current, they become irrelevant to U.S. policy, and may find themselves adrift; yet if they are captured by the United States policy preoccupations of the moment, they lose their legitimacy. An example of the first tendency is the United Nations Security Council, which the United States has marginalized when it failed to support U.S. policies in the former Yugoslavia and Iraq. An example of the latter is the World Trade Organization, which has become so tilted towards U.S. and EU preferences that it has lost much of its legitimacy in the developing world. Organizations of which the United States is not a member, such as the European Union, face similar dilemmas with respect to their own most powerful members, as Germany and France have repeatedly demonstrated. However, in the absence of a single dominant member, informal governance is more broadly shared and negotiated among a handful of major players (Moravcsik 1998).

The existence of power politics, the frequency of informal manipulation and the possibility of forum shopping put important limits on the autonomy of international organizations. However, these practices also highlight the significance of international organizations as instruments of state power. Even in the case of international security, where states guard their freedom of action most jealously, international organizations play a key mediating role. Despite its global military reach, the United States finds that

the use of force is less costly and more effective when employed in conjunction with an international organization. In international trade, the United States has attractive outside options and can often exert more leverage through bilateral bargaining than through the World Trade Organization; yet the WTO can also serve as an effective fulcrum. Indeed, U.S. influence inside and outside the WTO often complement each other. In international finance, the United States remains the most important player because it issues the global reserve currency, but the integration of global capital markets makes multilateral coordination necessary to manage contagion during financial crises. Furthermore, constitutional barriers generally prevent the United States from reacting to financial crises that originate beyond its borders with the speed or resources that the IMF is able to muster. In each case, international organizations are deeply influenced by U.S. power, but U.S. power also rests in large part upon the ability to influence international organizations.

For all other states in the international system, the choices are starker. Only American elites seriously debate the significance of international organizations, because only the United States is able to exercise attractive unilateral options. In some cases, members of the European Union are able to exercise an effective threat of exit from another organization by acting as a group; but they are able to do so only because their commitment to the EU is so strong. For European, Japanese, Chinese, Russian and Brazilian elites, the geography of the international system is defined by the opportunities and constraints created by international institutions. Most foreign policy objectives can only be achieved by working through international organizations, and this is increasingly

true of domestic policy objectives as well.¹ As these countries become increasingly integrated into the world economy, and the world economy places increasing burdens on the global environment, the number of fundamental national interests that can only be achieved through international organizations expands. These states have limited informal influence within international organizations, but membership and formal privileges in international organizations represent significant elements of their national power.

International organizations loom still larger in the calculations of poor countries with weak states, which are most vulnerable to internal conflict and most exposed to the vicissitudes of global markets. In these countries, international organizations are often important players in domestic politics. They can cause governments to fall, or prop them up; they can create irresistible pressure to carry out policy reforms; they can forge or shatter political coalitions (Pop-Eleches 2009). Leaders of these countries find that the only way to exert effective leverage over international organizations is to appeal to the leading states in the system—usually, to the United States—to exert informal influence on their behalf. This intervention tends to undermine the credibility and autonomy of the international organization involved, which may weaken its legitimacy vis-à-vis third parties (Steinwand and Stone 2008; Stone 2002, 2004, 2008). It also comes at a cost to the client state, because the United States extracts political concessions in return for its

¹ Even apparent exceptions seem to reinforce this generalization. The Russian clash with Georgia in August 2008 demonstrated a willingness to use force unilaterally and showcased the rebounding capabilities of the Russian military, but came at a cost that earlier Russian leaders would have been unwilling to pay in terms of isolation from Europe and hardening of NATO. Russia's withdrawal of its long-standing application to join the WTO, for which it had made numerous political concessions, simply recognized the inevitable.

intervention, and these concessions may reduce the legitimacy of the organization in the eyes of the client state's population.

This is a book about how international organizations really function, through a combination of formal and informal rules. The book's empirical core is based on extensive qualitative work in the IMF archives and interviews with IMF Staff and executive directors, as well as quantitative work using the IMF's records of conditionality. The argument applies broadly to other international organizations, because informal governance is ubiquitous, but it applies with important variations. The terms of informal governance are negotiated differently in different contexts, and depend upon the distribution of issue-specific power and interests. Understanding how the informal practices of institutions differ from their formal rules and how the varieties of governance respond to changing circumstances has implications for the role of international organizations in U.S. foreign policy and for how that role is changing.

Chapter 1 outlines the book's main argument and explains how the mechanisms of informal governance relate to broad debates in political science about international power and legitimacy, on the one hand, and to the particular issues of delegation to international organizations and institutional design, on the other. The formal model developed in chapter 2 defines the terms of the argument precisely and derives implications from it for institutional design, delegation, performance, and legitimacy.

Chapter 3 describes the formal and informal governance arrangements of the IMF, emphasizing the institutional features—a weak Executive Board and delegation to a

strong Management—that preserve a back channel that allows the United States to control the organization. Chapter 4 makes a similar qualitative analysis of the World Trade Organization, and chapter 5 presents the case of the European Union, which allow the model to shed light on the logic of institutional design. The model focuses on the use of exit options by powerful countries and informal influence outside formal channels, which are common features across the three institutions, although the balance of formal and informal governance varies substantially. The comparative statics of the model indicate that the degree of long-term conflict of interest among the members of an institution and the number of leading powers in its issue domain account for the variation in delegation across institutions and across issue areas within each institution.

The empirical core of the book concerns the International Monetary Fund. The three chapters that follow trace the course of an IMF program through its product cycle, from decisions about the amount of access allowed to IMF resources, to negotiations over conditionality, and on to enforcement of conditionality when programs go off track. The testable implications of the model are that U.S. informal influence over the Fund should be observable when the United States pushes for exceptions to rules, that these exceptions should only be made for important countries, and that they should be made when the borrowing country has an urgent need for IMF financing. These claims are tested statistically using the Monitoring of Agreements Database (MONA), which contains the IMF's records of conditionality, including which conditions were implemented, modified or waived, and when programs were suspended. The mechanisms involved are illustrated with reference to six major financial crises: Mexico (1994), Indonesia (1997), South Korea (1997), Russia (1998), Brazil (1999) and Argentina (2001).

The concluding chapter returns to broad themes of legitimacy and change in international organizations. The model suggested that power and legitimacy interact in precise ways, and traces out the implications of two kinds of change: change in U.S. structural power, and change in the range of temptations the United States faces to intervene. As American structural power declines, the United States is compelled to act with greater restraint in order to maintain the legitimacy of international organizations, and the role of formal governance in shaping the policies of these organizations should become more important. However, if the temptations that the United States faces to exploit its remaining informal influence rise as U.S. structural power declines, the legitimacy of international organizations is likely to be jeopardized. There is striking evidence that this has occurred in the IMF and the WTO.

Chapter 2: A Model of Informal Governance

The argument is that international organizations are best understood as equilibrium outcomes that balance the power and interests of the leading state and the member countries. Institutional design is endogenous to this interaction, and includes membership, formal voting rights and informal governance procedures. The model that follows gives specific content to this claim by specifying how three particular forms of power interact. *Structural power* represents the outside options of the leading state and the externalities that its participation generates for other members (Strange 1988). *Formal voting rights* set the policy of the organization and create the parameters within which informal influence is exercised. *Informal influence* consists of participation in decision making and special access to information, and it allows the leading state to override the common policy when its vital interests are affected.

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

The argument is laid out in the form of a formal model. Formalization makes it possible to define our terms precisely. Concepts such as power and legitimacy have diverse meanings, and defining them in mathematical terms makes it possible to indicate precisely what they signify in a particular argument. Furthermore, formalization makes it possible to detect logical errors that might be obscured in a prose argument—it imposes “accounting standards” for arguments (Powell 1999), assuring that conclusions really follow from assumptions. Beyond assuring clarity and logical consistency, however, a formal model is a uniquely powerful tool for discovering unexpected implications of arguments. Game theory is not useful for some purposes, such as explaining the origins of preferences or worldviews, but it is ideally designed for exploring the effects of complex strategic interactions.

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

decline in the organization's legitimacy and significance. The precise meaning of these claims will be made clear below.

The key features of the model are as follows: 1) An international organization imposes a policy that is determined by weighted voting, but the United States has the ability to override the policy in a particular case, at some cost. The temptation to override the common policy is a random variable, so in a particular case it may or may not be attractive for the United States to do so. Voting represents formal control and the United States override represents informal influence. 2) The member countries vote to determine the cost that the United States pays when it overrides their policy, so informal influence depends on the consent of the membership. 3) The United States can exercise an outside option that does not depend on multilateral cooperation, and chooses a level of investment in the organization, which provides positive externalities to the other members. This ability to impose costs on the membership by partially exiting the organization represents U.S. structural power, and deters the membership from setting the cost of informal influence at a prohibitive level. 4) The United States proposes the distribution of vote shares in the international organization, and the members decide whether to participate under those terms. Assigning this bargaining advantage to the United States represents the unique role that the leading state plays in designing any organization in which it participates, in addition to the advantages due to the distribution of institutional memberships and vote shares inherited from the Cold War. This simplification of the bargaining protocol is not necessary in order to derive the main results, however. The key feature of the model is that institutional design is endogenous.

The Model

The model is an extensive-form game of full and perfect information, with players the United States and n other countries. The sequence of play is as follows: The United States offers a vector of vote shares in an international organization to a subset $K \in N$, and the members of K choose whether to participate. Subsequently, the members vote to set a cost, c , that will be imposed upon the United States if it chooses to override the organization's policy in a particular case. The United States then chooses its level of participation in the organization. Nature now chooses a country to experience a crisis, and the United States decides whether to preempt the expected policy in this case. Finally, if the United States has not exercised an override, the members vote to set the institution's policy. This sequence is illustrated in Figure 1. [Figure 1 about here]

Countries i have ideal points a_i on the interval $(0,1)$, and members of the organization receive utility

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

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

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

imposes $x=0$. When it overrides the policy, the US incurs a cost, c , which is chosen by the membership. The U.S. indirect utility function is as follows:

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

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

Equilibrium analysis

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

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

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

Thus, if $a_{US} > x$, the threshold value of b that invokes the United States override is:

$$b > c + x \equiv b^*$$

If $a_{US} < x$,

$$b > c - x + 2a_{US} \equiv b^*$$

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

$$1-(c+x)/\bar{b}$$

If $a_{US} > x$, and

$$1-(c-x+2a_{US})/\bar{b}$$

If $a_{US} < x$.

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

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

There are two possible cases. If $a_{US} > x$, (the pivotal voter prefers a policy lower than the United States ideal point), this yields the equilibrium choice,

$$\gamma = \left(\sum_i z_i + 1/\bar{b} - R - a_{US} - c + (c+x)^2/\bar{b} \right) / 2(1-\lambda) z_{US}$$

On the other hand, if $a_{US} < x$, (the pivotal voter prefers a policy greater than the United States ideal point), the equilibrium choice is:

$$\gamma = \left(\sum_i z_i + 1/\bar{b} - R - a_{US} - c + (c-x + 2a_{US})^2/\bar{b} \right) / 2(1-\lambda) z_{US}$$

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

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

which yields the expectation,

$$\gamma \sum_i z_i - (1-\lambda) z_j - (1-p)|x - a_i| - p a_i$$

Maximizing with respect to c yields the optimal cost. Again, there are two cases. If $a_{US} > x$,

$$c = \frac{\bar{b}}{2} - x - a_p(1-\lambda) z_{US} / \sum_i z_i$$

If $a_{US} < x$,

$$c = \frac{\bar{b}}{2} + x - 2a_{US} - a_p(1-\lambda) z_{US} \sum_i z_i$$

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

$$U_i = \gamma \sum_i z_i - (1-\lambda) z_i - E(|x - a_i|) \geq 0$$

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

$$\underline{x}_i \leq x \leq \bar{x}_i$$

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

At the first decision node, the United States offers a distribution of vote shares to a set of contributing countries. In equilibrium, votes are offered only to countries that will agree to participate, and the distribution of votes determines the pivotal voter such that the relevant participation constraint is satisfied for all participants. For any distribution of country ideal points and contribution sizes there exists one or more feasible coalitions, where a feasible coalition is defined as a set of countries including the United States whose participation constraints have a non-empty intersection that includes

the ideal point of at least one of the members of the set. (The set that includes only the United States is always a feasible coalition.) The United States offers a vector of vote shares that assigns the coalition member with the ideal point in the intersection of the feasible set that is closest to its own as the pivotal voter. From the United States perspective, the utility-relevant characteristics of a coalition are its size and the ideal point of its pivotal voter, from which it is possible to calculate the endogenous variables of the model. Therefore, the United States is able to calculate the utility received from each feasible coalition, and chooses the coalition and pivotal voter that offers the highest utility.

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

There are two cases. If $a_{US} > x$ in equilibrium, expanding the coalition would require the United States to shift vote share to countries that prefer still lower levels of policy, x . Expanding the coalition increases U.S. utility, and making policy concessions (weakening the policy) decreases U.S. utility, so the optimal size of the coalition is determined by this trade-off. If $a_{US} < x$ in equilibrium, expanding the coalition would require the United States to shift voting power to countries that prefer levels of the policy that are higher than the United States prefers. Expanding the coalition continues to be beneficial, but now increasing the stringency of the policy reduces U.S. utility. Again,

there is a trade-off between the size of the coalition and control over its policy, and it is optimal for the United States to balance the costs and benefits of expanding the coalition. To close the model, I assume that if the United States is indifferent between two possible coalitions, it chooses the one with the pivotal voter whose ideal point is closest to its own.

Discussion

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

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

This confidence, in turn, rests on U.S. structural power. The comparative statics of the model trace out the effects of shifting structural power.³⁰ Thus, for example, as the attractiveness of the U.S. outside option increases, the United States shifts away from participation in the organization ($dy/dR < 0$), which imposes costs on the rest of the membership. In response, the member countries reduce the cost that they impose when the United States chooses to override their policies in order to restore the incentives for the United States to invest in the institution ($dc/dR < 0$). The frequency with which the United States overrides the common policy increases ($dp/dR > 0$), and the balance shifts from formal to informal governance. The joint effects of reduced U.S. participation and increased use of the United States override undermine the value of the organization for the rest of the membership, making other countries less willing to participate

³⁰ Comparative statics are the effects of an exogenous variable on an endogenous variable, defined as the total derivative dy/dx , at the point of equilibrium. To convey the intuition behind the results I discuss them as if the best responses occurred sequentially, but in fact these relationships hold simultaneously in equilibrium.

($dU_i/dR < 0$). Thus, increased unilateralism and the shift towards informal governance undermines the legitimacy of the international organization.

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

Another comparative statics exercise allows us to explore the implications of misbehavior by the leading state in the system. Informal governance rests on an implicit contract: the leading state will participate if it is allowed to exert informal influence, and the member countries consent to grant informal influence if it is not abused. If the leading state exercises its power to override the institutional policy too frequently, it undermines the value of the institution for the other participants. The implications follow from the comparative statics on the United States temptation parameter, \bar{b} . If there is an

exogenous increase in the expected benefit of overriding, this increases the probability that the United States decides to override ($dp/d\bar{b} > 0$), which leads the member countries to increase the cost that the United States pays when it does so ($dc/d\bar{b} > 0$). The member countries will not increase the cost sufficiently to fully offset the increased temptation, however, because increasing the cost leads the United States to exercise its outside options and reduce its level of investment in the organization ($\partial\gamma/\partial c < 0$). The combination of a higher probability that the common policy will be overridden and lower U.S. participation lowers the value of participating in the organization for the other members ($dU_i/d\bar{b} < 0$). In order to induce them to continue participating in the organization, the United States may (again, depending upon the distribution of country sizes and their ideal points) be compelled to offer to redistribute vote shares in the organization, shifting the pivotal voter further from its own ideal point. This appears to be exactly what happened in the IMF in 2008, where voting rights were redistributed in order to compensate for a perceived drop in the legitimacy of the organization that was linked to U.S. micromanagement of the Asian crisis of the late 1990s and a series of crises in Russia, Argentina, Brazil, and Turkey.

Extensions

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

However, we can often learn important things by extending a basic model in various directions. The model presented here is the simplest game that captures the key insights of informal governance, and a number of extensions are possible.

1. Multiple leading states

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

The formal derivation of the parallel results is omitted, but follows the same procedure as above. There are two important findings. First, introducing additional leading states leads to an increase in the equilibrium level of c . This can be interpreted as a shift in the organization's governance that deemphasizes informal governance and emphasizes formalized decision making. This follows from two considerations: (1) the frequency of overriding for any cost threshold increases as the number of leading states with independently distributed temptations to override increases, and (2) an override by

any particular leading state creates a negative externality for all of the others, so the effect of increasing costs in decreasing participation by the leading states, $\frac{\partial \gamma}{\partial c}$, is reduced. In equilibrium, everyone votes to make informal influence harder to exercise in order to restrain everyone else. Second, introducing additional leading states reduces the level of investment in the organization by each of the leading states. This can be interpreted as unwillingness to delegate extensive powers to an organization. This follows from the fact that an increased number of leading states override the common policy more frequently at any given level of c , making the organization less valuable, and that the equilibrium value of c is higher, making overriding less attractive. Outside options become more attractive because other states exercise informal influence and because it becomes more costly to do so oneself.

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

2. Repetition

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

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

Suppose that $b^*(s^{**}) = b^*(s^*)$ and $c(s^{**}) < c(s^*)$. In that case, $V_L^* > V_L^N$, because the leading state pays a lower cost in every period in which it chooses to override the common policy. Because the continuation value is higher in the cooperative equilibrium, however, for high enough discount factors the leading state would be willing to exercise restraint to maintain cooperation, so there exist $b^*(s^{**}) < b^*(s^*)$. Because the expected utility in every period is higher under the cooperative equilibrium, $\gamma(s^{**}) > \gamma(s^*)$. These

results imply that $V_F^* > V_F^N$, because overriding occurs less frequently in the cooperative equilibrium and the leading states' participation is greater. The reversion strategies that support this equilibrium themselves form a SPE because they form the unique Nash equilibrium of the stage game. QED.

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

3. Other possible extensions

A more complex extension would be to a dynamic game with a persistent state variable. For example, it would be possible to repeat the game but make institutions sticky, so that vote shares, the cost of overriding the common policy, or both are difficult to change. This extension would generate interesting insights about the development of institutions over time, and would allow us to make stronger claims about how the

development of institutions depends upon countries' strategies. The current model can explore the effect of changing U.S. preferences on institutions through comparative statics: if the expected benefit from manipulating the institution rises, countries respond by increasing the cost of overriding, and the United States responds by reducing its investment in the institution. This allows us to point to a key danger to international organizations, which is that the temptations of the leading power can lead to their gradual marginalization. A dynamic model would take the analysis a step further by exploring how the states of the world—participation, cost, etc.—can evolve over time in response to countries' actions. For example, we could learn whether changes are persistent or ephemeral, and whether some states are absorbing. Most of the specific properties of the dynamics, however—as opposed to the fact that the equilibrium is dynamic and its character shifts in response to country actions—would be highly dependent upon specific modeling assumptions, and would not therefore produce very general conclusions.

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

United States to override the common policy, bringing the equilibrium strategies closer to those of the single-shot model. However, adding imperfect monitoring does not seem to enrich the substantive conclusions that we can draw from the model.

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

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

when the leading state overrides the common policy in the static game can be interpreted as a reduced form parameter representing reputational costs in repeated interactions.

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

Conclusions

International organizations have become increasingly important actors in international politics. Some critics have emphasized their autonomy (Barnett and Finnemore 2004), while others regard international organizations as instruments in the hands of powerful states (Krasner 1985; Strange 1988). The approach presented here is

decidedly state-centered. This is not to deny that the details of international governance owe a great deal to the strategies and beliefs of international agents (Abdelal 2007, Chwieroth 2009). However, the broad policies and many of the important details are worked out through formal and informal governance procedures that are established by states and in which states are the important actors. There are no international rogue agencies, because states remain the fundamental actors in international relations. The most powerful states retain the ability to control informally even formally autonomous institutions, and lack the ability to irrevocably delegate authority. The autonomous agencies are problematic not because they follow their own agendas, but because they can be captured by powerful states.

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

Informal governance is in continuous tension, because the manipulation that makes power sharing tolerable for the leading state undermines the legitimacy and

credibility of international organizations. However, legitimacy is essential whether international organizations are to serve their core purposes or be useful as instruments of power, and delegation is possible only to the extent that the participants expect that manipulation will be relatively infrequent. There must be sufficient agreement about common purposes that weaker states can expect to benefit from cooperation.

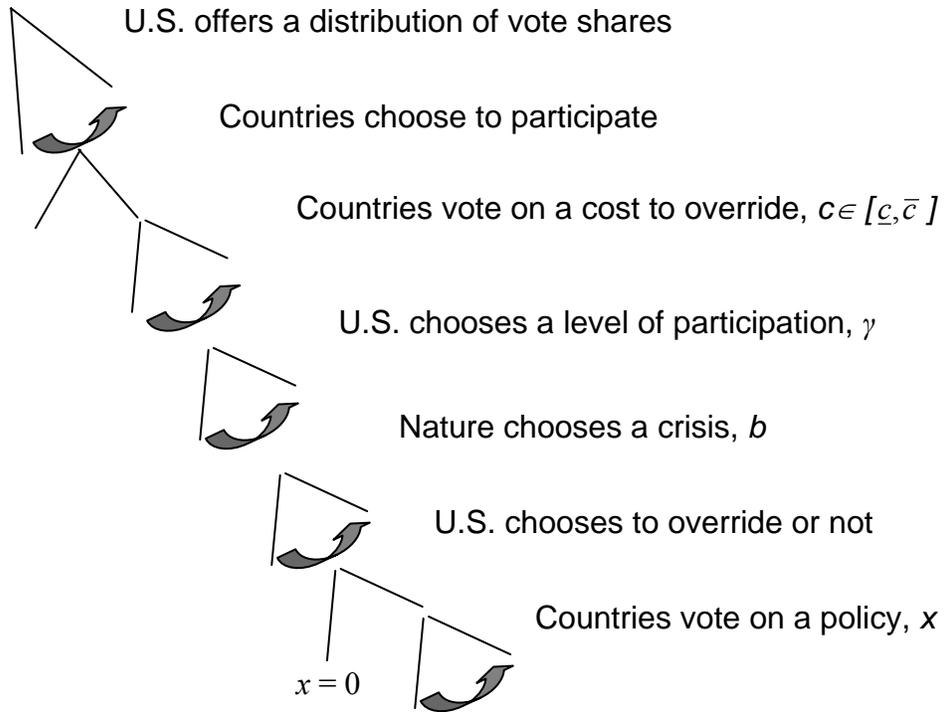
International organizations are legitimate because, in equilibrium, the leading state chooses not to manipulate them under ordinary circumstances.

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

There are, therefore, three distinct forms of power in play in international organizations: structural power, formal control, and informal influence. Structural power represents the outside options a country enjoys and the externalities its participation in an institution creates for others. Powerful countries have attractive alternatives to multilateral cooperation and their participation in common endeavors magnifies the benefits of cooperation for all, so their interests must be accommodated. Formal control rights are embedded in the legal rules of international organizations, and may or may not correspond to variations in structural power. Countries that are strong in terms of

structural power may nevertheless choose to disperse formal control widely in order to create legitimacy. Informal influence arises through participation in the decision making process, informal consultation with the agents who are delegated authority to make decisions, and privileged access to information. Informal influence is invariably unequal, and cannot be wholly prevented by any constitutional scheme, but it can be reduced by promoting transparency and making decisions by majority voting. Most international organizations are not designed to be transparent or majoritarian, however. Countries with substantial structural power are accorded opportunities for informal influence in order to make participation attractive to them, which makes it possible for them to give up formal control of the organization without jeopardizing their core interests.

Figure 1: The Sequence of Play



Appendix: Proofs

Lemma 1: U.S. utility strictly decreases as the ideal point of the pivotal voter moves further from the United States ideal point.

Proof:

$$\frac{dU_{US}}{dx} = \frac{\partial U_{US}}{\partial x} + \frac{\partial U_{US}}{\partial c} \frac{\partial c}{\partial x} + \frac{\partial U_{US}}{\partial \gamma} \left(\frac{\partial \gamma}{\partial x} + \frac{\partial \gamma}{\partial c} \frac{\partial c}{\partial x} \right)$$

Note that, in equilibrium, $x = \alpha_p$. There are two cases, $a_{US} > x$ and $a_{US} < x$. It is possible to sign each of the partial derivatives:

	$a_{US} > x$	$a_{US} < x$
$\frac{\partial U_{US}}{\partial x}$	>0	<0
$\frac{\partial U_{US}}{\partial c}$	<0	<0
$\frac{\partial U_{US}}{\partial \gamma}$	>0	>0
$\frac{\partial c}{\partial x}$	<0	>0
$\frac{\partial \gamma}{\partial x}$	>0	<0
$\frac{\partial \gamma}{\partial c}$	<0	<0

Therefore, in the first case, $a_{US} > x$, where x moves closer to a_{US} as it increases,

$$\frac{dU_{US}}{dx} = (+) + (-)(-) + (+)((+) + (-)(-)) > 0$$

In the second case, $a_{US} < x$, where x moves further from a_{US} as it increases,

$$\frac{dU_{US}}{dx} = (-) + (-)(+) + (+)((-) + (-)(+)) < 0$$

This proves the lemma.

Chapter 8: Enforcement

The International Monetary Fund enforces the conditionality attached to its lending facilities by suspending disbursement of loan installments, or tranches, if borrowing countries fail to implement the associated conditions. The IMF Executive Board formally approves all disbursements of Fund resources. When a performance criterion is not implemented by its review date, this provokes an automatic suspension of the corresponding disbursement unless the Board decides to issue a waiver or modify the conditions. According to Staff, the requirement to seek Executive Board approval for changes to conditionality can constrain Management's discretion and consequently reinforce its bargaining position with country authorities. However, Management has discretion to recommend waivers or modifications to the Board or to adjust the schedule of reviews and disbursements, and in practice its recommendations are not overruled. Because of the combination of Management discretion and consensus decision making, it is easy for major shareholders to use their informal influence to urge Management to propose waivers for favored client states. Since the status quo outcome is that the program is suspended until every performance criterion is met, shareholders' informal influence has the effect of relaxing the enforcement of conditionality.

Management's dilemma is as follows. After a program goes off track, it is generally optimal to modify it, because the original macroeconomic forecast is no longer valid and key performance indicators may no longer be achievable. Furthermore, even when a program goes off track because the government has made political decisions not to implement its conditions, it is optimal ex post to renegotiate in order to give the government incentives to modify its policies when the original set of targets is no longer

realistic. The problem is that governments know that it is optimal for Management to renegotiate ex post, and this creates moral hazard: governments have weak incentives to implement conditionality if they anticipate that they will be rewarded with weaker conditionality when they renege on their commitments. The IMF Management tries to ameliorate the moral hazard problem by developing a reputation for enforcing conditionality rigorously, and resists efforts by shareholders to undermine its reputation; but it is ultimately understood by all of the participants that different rules, and a different reputation, apply to countries that have substantial influence in Washington (Stone 2002, 2004).

The key argument of *Lending Credibility* was that the IMF's reputation is built on differentiated strategies for enforcing reputation once a program goes off track (Stone 2002). Some countries face rigorous enforcement: no modifications or waivers; disbursements are delayed until the corresponding conditions are implemented. Other countries are subject to a fluid set of conditions that are renegotiated periodically as the targets are missed. The first set of countries should miss their targets less frequently, but face lengthier program suspensions when they fail to implement their conditions. The second group of countries receives more waivers and faces shorter program suspensions, because there is pressure on the IMF Management to renegotiate their targets in order to bring them back on track. As a result, they have weak incentives to implement conditions, and they face frequent program suspensions.

The United States has used informal contacts to obtain waivers for a number of countries that play important roles in U.S. foreign policy, including Zaire and the Philippines in the 1980s, Egypt in the early 1990s, and subsequently Pakistan and

Turkey. Among the post-Communist countries, Russia and Ukraine have frequently received waivers because of direct contacts by U.S. officials, which have sometimes occurred at the highest level. My previous study of 26 post-Communist countries found that countries that received substantial amounts of U.S. foreign aid were subject to much shorter program suspensions when their programs went off track. They received waivers or their conditions were modified so that they could quickly get back into good standing. As a result of the weak incentives that they faced, their economic policies were more inflationary, and they failed to implement conditions and went off track more frequently (Stone 2002). Another study of 53 African countries revealed a similar pattern with respect to U.S. foreign aid, and also found that countries with close ties to France and Britain received similar treatment (Stone 2004). Using different samples, Edwards (2005) finds that U.S. aid decreases the probability of program interruptions, and Pop-Eleches (2009) finds that states with voting patterns similar to the United States in the UN general assembly have a lower probability of program interruptions.

This chapter extends and revises these findings in several respects. First, it takes advantage of the data on conditionality in the MONA database to refine its statistical tests, as explained below. Second, it uses the theoretical model of informal governance to generate more precise hypotheses. As the previous chapter explained, the informal governance model predicts a conditional effect of measures of U.S. interests on IMF policies: U.S. intervention should only be observed when the borrowing country is important to the United States and has an intense need for IMF support. Third, this chapter explores the robustness of these findings by using multiple measures of U.S. interests: foreign aid, bank exposure, exports, UN voting affinities, and military alliance

patterns. These measures are only weakly correlated and capture different dimensions of U.S. foreign policy interests, so effects that are robust across measures are persuasive evidence of a pattern of deliberate intervention.

In addition, this chapter explores the collective governance of the Fund by examining the evidence of U.S. control as opposed to more widely shared influence by the G-5—the United States, Japan, Germany, the United Kingdom, and France—which are the largest IMF shareholders and the only countries to appoint (rather than elect) their own Executive Directors. The model of informal governance is consistent with informal control either by a single leading state or by a group of leading states, and other international organizations demonstrate each pattern, but I have argued that the IMF is an example of unusually strong U.S. control. An advantage of using multiple measures of U.S. interests is that some of the measures, particularly foreign aid and alliances, are weakly correlated with the corresponding measures for the other G-5 countries and consequently provide strong tests of U.S. vs. G-5 effects.

To foreshadow, the chapter finds strong evidence of U.S. influence over the enforcement of conditionality that is robust across measures, and confirms that this influence is invoked only when countries are vulnerable to sudden reversals of international financial flows. Consistent with the model in *Lending Credibility*, this influence is exerted after a disbursement is suspended and affects the duration of the suspension. Where comparative tests are possible, the evidence points to U.S. influence rather than collective governance by the G-5, although some of the results are inconclusive in this respect. The argument is illustrated with two case studies, Russia

(1996-98) and Argentina (2000-01), which represent distinct reasons for urgent U.S. intervention.

Data

The data cover 99 countries that participated in IMF programs between 1992 and 2002. During this period, 92 of the 99 countries experienced at least one program suspension, for a total of 752 program interruptions. In this set, 78 countries experienced short program interruptions of one or two months in duration an average of 4.7 times; 77 countries experienced suspensions of 3 to 8 months an average of 3 times; 67 countries experienced suspensions of 9 months or more an average of 1.6 times; and ten countries experienced very long interruptions of 24 months or longer.

The MONA data make it possible to overcome some important data limitations of previous studies of IMF program enforcement. First, previous work has had to rely on interpolation to determine when an IMF program was suspended. The IMF does not announce when a program goes off track, it simply suspends the next scheduled tranche of a loan facility. Thus, the only available measure of program suspensions was an interruption in the pattern of loan disbursements; but it was not always clear when the next scheduled disbursement was supposed to occur, or when disbursements were cancelled at the request of country authorities (as happened in Poland in 1994, for example) rather than because of non-compliance. The MONA data include the schedule of disbursements and its subsequent modifications, so it is possible to fix the exact date of program suspensions.

Second, previous studies had no independent measure of program compliance. Non-compliance was inferred when programs were suspended, and often the undisbursed portion of a facility was used as a proxy for partial compliance, but it was impossible to observe non-compliance that was not accompanied by a program suspension. The MONA data include the content of conditionality being tested at each review date and indicate which conditions were judged by the IMF to have been implemented, so it is possible to measure compliance with conditionality independently from enforcement. This avoids serious problems of inference. For example, if we observed in a previous study that democracies were subject to less lengthy program suspensions (Stone 2002, 2004), we could not be certain whether this occurred because democracies implemented their programs better and got back on track more quickly than autocracies, or because the IMF was less rigorous in punishing democracies.¹⁶¹ More broadly, because studies of implementation and enforcement used the same dependent variables, it was impossible to determine whether any of the effects found were due to variations in implementation or to variations in enforcement—or whether non-findings were due to contradictory effects that cancelled each other out. Using independent measures of compliance and suspension makes it possible to resolve these issues.

Third, previous studies were unable to control for variations in conditionality that might affect compliance and enforcement. As we saw in the previous chapter, the substantive scope of conditionality varies substantially, and there is no reason to expect it to be equally difficult to achieve compliance with narrowly defined programs and with

¹⁶¹ The results of the analysis reported below indicate that the rigor of enforcement does not depend upon Polity scores, which suggests that these effects had been correctly attributed to variations in implementation in these earlier studies.

sweeping reform plans, which typically involve many more structural benchmarks. In addition, it is reasonable to expect the IMF to take the difficulty of compliance into account when determining whether to declare a program off track. As we will see below, the number of categories of conditions that have not been implemented is a strong predictor of the duration of program suspensions, while the number of categories of conditions being tested is strongly associated with leniency. Controlling for conditionality and implementation removes an important source of heterogeneity in the data, and also makes it unnecessary to control for domestic political factors that are related to implementation when we study enforcement.

As in previous chapters, five key explanatory variables are used to measure a range of U.S. economic, political and military interests: U.S. foreign aid, the exposure of U.S. banks, U.S. exports, affinity in voting in the UN General Assembly, and similarity in military alliance profiles. Foreign aid is a monetary measure of how much importance the donor attaches to a particular country or regime, but says nothing about why particular countries are important. Bank exposure and exports, on the other hand, measure narrow economic interests that motivate U.S. intervention on behalf of particular countries. Votes in the UN General Assembly capture the similarity of two countries' foreign policies. Alliance portfolios represent military commitments for mutual defense, which are associated with intense national security concerns. These five dimensions of U.S. interests represent distinct reasons for the United States to have intense interests in a particular country. Taken together, these variables offer a nuanced view of the politics of enforcing IMF conditionality programs.

The analysis proceeds as follows. The key dependent variable is the duration of suspension episodes. The logic of *Lending Credibility* (Stone 2002) was that Board members exert influence after a program has been suspended to shorten the duration of suspensions. They do this by lobbying for waivers of conditionality or modification of its terms, which makes it easier and less politically costly to get programs back on track. In addition, the MONA data allow me to take a closer look at the substantive implications of lax enforcement by analyzing the number of waivers that are granted when a suspended program comes back into good standing. This provides a second check on the logic of the argument. If it is true that informal influence over enforcement operates through the manipulation of Management's discretion about whether to seek waivers, this discreet influence should leave traces in the pattern of waivers.

Duration of Program Suspensions

The primary means for shareholders to exert influence on behalf of a borrowing country is to contact Fund Management after a program has been suspended. This should have the effect of reducing the duration of program suspensions. The dependent variable for tests of this hypothesis, therefore, is the duration of program suspensions in months. As discussed above, the theory does not pin down which measures of U.S. preferences should be associated with intense motivations to influence conditionality, so my approach is to use a range of subjectively plausible indicators that are weakly correlated with each other and that capture a variety of motivations. The theory of informal governance does make a precise conditional prediction, however: influence should be exerted when there is a combination of latent U.S. interest in the borrowing country and intense need for IMF

financing on the part of the borrowing country. In short, the United States exerts its influence on behalf of a borrower only when a borrower that has a lot of chips decides it is time to cash them in. Consequently, each of the models that follow use interaction terms between measures of U.S. interests and measures of borrower-country vulnerability to sudden reversals of external financing: trade/GDP, debt service/exports, and the percentage of debt held in short-term instruments.

I want to separate the rigor of enforcement from the government's record of implementing conditionality, so in the models that follow I control for the number of categories of conditionality in which the borrower has failed to implement conditions. I also control for the number of categories of conditions covered in the current review, on the assumption that Management makes allowances for the scope of conditionality when assessing country performance. Both of these measures are robustly significant across models: countries that have missed more categories of conditions have longer program suspensions, while countries that were required to implement more conditions have shorter ones. Because I control for conditionality and implementation, I do not have to control for political factors that might affect program suspensions through effects on conditionality or implementation. (It is better to control for the intervening variables.) However, I also control for the possibility that the rigor of IMF enforcement of conditionality systematically depends upon factors such as political regime, GDP per capita, or government capacity. Similarly, central bank reserves in months of imports is used to assess the possibility that bargaining power affects the rigor of enforcement. I find no systematic evidence that these variables affect enforcement once we control for

the scope of conditionality and program implementation, although they have substantial effects on conditionality and implementation.

The full tables of results of models testing for interactive effects of U.S. aid, U.S. bank exposure, U.S. exports, UN voting affinity and alliance patterns are reported in the appendix as Table A8.1. The models are parametric duration models using the Weibull distribution.¹⁶² The table in the appendix is mainly useful for researchers, who can use it to understand how the models were specified and replicate the results. In order to conduct meaningful hypothesis tests or to understand the substantive significance of the results—whether they are big or small—we have to calculate predicted probabilities or marginal effects, which are presented in Table 8.1. Since the quantities of interest in this case are interactions between variables, the hypothesis tests represented by the significance levels reported in the table in the appendix are not particularly informative. The significance test for the coefficient for U.S. aid, for example, is only valid when trade/GDP, debt service/exports, and short-term debt are equal to zero. In order to test the hypothesis that U.S. aid has a significant effect when countries are vulnerable to disruptions on international financial markets, I test the joint effect of the coefficient of U.S. aid and the coefficients of its interactions with trade/GDP, debt service/exports, and short-term debt, evaluated at the desired levels of vulnerability. These are the hypothesis tests reported in Table 8.1. [Table 8.1 about here]

¹⁶² The Weibull model estimates a monotonically changing hazard rate (which may be increasing or decreasing) with time-varying covariates. Observations of suspensions that had not ended by the end of 2002 are right-censored.

Table 8.1: Duration of Program Suspensions: Substantive Effects

		Median duration (months)	Change in duration (months)	Percentage change	<i>p</i>
<u>All variables at means</u>		5.8			
	<u>Vulnerability</u>				
U.S. aid	High	3.4	-2.4	-41.4%	0.03
	Mean	5.4	-0.4	-6.9%	0.97
	<u>Vulnerability</u>				
U.S. bank exposure	High	4.2	-1.6	-27.6%	0.05
	Mean	4.2	-1.6	-27.6%	0.00
	<u>Vulnerability</u>				
U.S. exports	High	3.8	-2.0	-34.5%	0.15
	Mean	6.2	0.4	6.9%	0.52
	<u>Vulnerability</u>				
UN voting opposition	High	3.4	-2.4	-41.4%	0.00
	Mean	5.0	-0.8	-13.8%	0.02
	<u>Vulnerability</u>				
Alliance patterns	High	3.4	-2.4	-41.4%	0.05
	Mean	5.0	-0.8	-13.8%	0.09

Note: Effect on the predicted median duration of increasing the variable in the left column by one standard deviation, conditional on the levels of trade/GDP, debt service/exports and short-term debt. High vulnerability signifies one standard deviation above the mean.

Table 8.1 reports the substantive effects calculated from the models reported in Appendix Table A8.1. In each case, the effects shown are for a one standard deviation change in the values of the measures of U.S. interests. “High” levels of vulnerability to external financial shocks are one standard deviation above the sample means, respectively, on each of the three vulnerability measures. When all variables are held at

their means, the median predicted duration of a program suspension is 5.8 months. When U.S. foreign aid is increased by one standard deviation and vulnerability measures are at their mean, there is only a small decrease in the predicted duration, to 5.4 months, and the effect is not statistically significant. As the borrower crosses into the top third of the vulnerability distribution, however, the effect of U.S. foreign aid becomes statistically significant, and the expected duration drops 41 percent to 3.4 months. The patterns across the other measures of U.S. interests are broadly similar.

Increasing U.S. bank exposure to a single country by one standard deviation—about 2 percent of total foreign exposure of U.S. banks—decreases the median suspension duration by 27.6 percent to 4.2 months. For the sake of comparison, this represents a quadrupling of the average level of U.S. bank exposure to a particular country, but is substantially lower than the peak levels of exposure in the sample to Argentina (8.8%), Brazil (14.6%) and Mexico (18.5%). The effect of bank exposure on suspensions reported in the table does not appear to vary significantly as external vulnerability changes, but this is due to aggregating contradictory effects. The pattern is in fact consistent with the broader pattern when vulnerability is measured in terms of trade/GDP and debt service/exports—interactions with these variables strengthen the effects of bank exposure that reduce the length of suspensions—but the pattern reverses for short-term debt. Short-term debt weakens the effect of bank exposure and counteracts the effects of the other two vulnerability variables, so the combined effect of increasing all three is insignificant. A possible interpretation of this result is that banks have weaker

incentives to lobby when debt is held in short-term instruments.¹⁶³ The other measures of vulnerability have the familiar effect of strengthening the effect of bank exposure on duration. The expected duration falls by two months, or almost 35 percent, when bank exposure and vulnerability are high and all other variables are at their means. These results are presented in Table 8.2. [Table 8.2 about here]

Table 8.2: Substantive Effects of Bank Exposure

Effect of an increase in U.S. bank exposure by 2.1% (one standard deviation)

	Predicted duration (months)	Decrease (months)	Percentage decrease	p
<i>All variables at mean</i>	5.8			
<u>Effect of bank exposure:</u>				
Trade, debt service & short-term debt high	4.2	1.6	27.6%	0.05
Trade, debt service & short-term debt low	4.2	1.6	27.6%	0.00
Trade & debt service high	3.8	2.0	34.5%	0.02
Short-term debt high	5.0	0.8	13.8%	0.02

Note: Predicted median duration. High and Low indicate one standard deviation above or below the mean; all other variables held at their means.

The effect of U.S. exports has only marginal statistical significance, even at high levels of external vulnerability, but this is not because the estimated effects are small—in fact, the effects of a standard deviation of exports are comparable to those of a standard deviation of foreign aid, reducing the median duration 34.5 percent, to 3.8 months.

¹⁶³ When bank exposure to a developing country takes the form of short-term debt, the banks are substantially protected against the risk of default, because they can refuse to roll-over their loans or demand higher interest rates if the risks change. This should weaken banks' incentives to coordinate their actions or to lobby their governments to bail out their debtors. Therefore, the assumption that short-term debt, or roll-over risk, affects only the intensity of borrower interests and not U.S. interests may not hold for the case of bank exposure, although it does hold for the other measures of U.S. interests.

Rather, the weak significance is due to the very large standard errors around the estimated effect. The correct interpretation of this result is not that the effect is near zero, but rather that the effect is probably quite large, but cannot be estimated with enough precision to rule out the possibility that it is zero. The estimated effects increase substantially as the level of vulnerability rises, but so do the standard errors, so that significance levels improve slowly.

UN voting has a strong association with the duration of punishment, and it varies sharply with vulnerability. When borrowers have average exposure to external shocks, the effect of (the preferences reflected in) UN voting is to reduce the length of suspensions modestly, by less than one month; when external vulnerability increases by one standard deviation, however, expected suspensions shorten by 41.4 percent, to 3.4 months. As vulnerability drops further, the effect of UN voting becomes insignificant, and when vulnerability drops to very low levels the effect switches signs and significantly extends the length of suspensions. As we found in the previous chapter, these effects occur when countries oppose rather than support U.S. votes in the United Nations. The United States intervenes on behalf of countries that generally oppose its preferences in the UN, but only when they are vulnerable to financial crises. Recalcitrant regimes that are not vulnerable to sudden reversals of external financing do not benefit from U.S. patronage, and in fact have substantially longer than average program suspensions. For countries that are not vulnerable that oppose the United States in the UN General Assembly one standard deviation more than average, the expected suspension duration is two months longer than average, an increase of almost 35 percent (significant at $p=.01$).

Pakistan and Egypt are examples of countries that frequently oppose the United States in the UN, and both have called upon the United States to intercede on their behalf with the IMF. Pakistan has repeatedly failed to fulfill the conditions attached to its programs, and has turned to the United States for help managing the Fund on numerous occasions. Its programs were interrupted for non-compliance seventeen times between 1990 and 2002, or roughly 1.5 times per program year, and the length of those interruptions ranged from very short—1 to 2 months eight times—to two very long suspensions. The last long suspension from IMF and World Bank financing occurred while the Clinton administration was punishing Pakistan for developing nuclear weapons, and was brought to a close when the Bush administration required Pakistan's assistance in the 2001 war against Afghanistan. Similarly, Egypt supports U.S. initiatives in spite of, rather than because of, the inclinations of its leaders and the pressures of public opinion, and Egypt has been a stark example of the failure to enforce IMF conditionality. U.S. intervention on behalf of Egypt became a prominent example of the IMF's credibility problem during the 1980s and early 1990s.

Alliance patterns show a strong substantive effect: U.S. allies and countries that share allies with the United States have program suspensions that are sharply reduced in length. A country one standard deviation closer than average to the United States alliance network has an expected duration that is reduced by over 40 percent to 3.4 months. This effect, again, depends upon vulnerability. The duration rises to five months and the effect of alliance portfolios becomes only marginally significant when vulnerability to external shocks drops to mean values, and durations continue to rise while the effects of alliances become ever more insignificant as vulnerability falls below

the mean. These results are easy to interpret. U.S. allies have a constant claim on U.S. attention. Security issues demand high priority, and allies can rely on their counterparts in the United States defense and foreign policy bureaucracies to interpret their needs to Treasury. These ties and relationships are not drawn on lightly, however, so they only have a practical influence on IMF enforcement of conditionality when the borrowing country is sufficiently vulnerable to reverses of international capital flows to prioritize its interactions with the IMF in its foreign policy.

Robustness and discrimination

Statistical results are convincing to the extent that results are robust to alternative specifications and tests discriminate effectively between alternative theories. Robustness can be thought of in three ways: measurement robustness, specification robustness, and methodological robustness.

Measurement robustness is important in cases where there exists no single, obvious measure of the quantity of interest. In this case, the intensity of U.S. interests in a particular country has no obvious metric, and can be expected to vary over time and across countries with respect to different issues. Some countries are important because of their economic ties and others because of their strategic military locations, and the balance between these sources of U.S. interests shifts over time with the salience of security and economic crises. The results presented above demonstrate an impressive degree of measurement robustness.

A second form of robustness check is specification robustness. The results have been subjected to a range of alternative specifications, and they are broadly consistent

across specifications. First, I have experimented with dropping control variables and including additional control variables related to the domestic politics of borrowing countries, and while significance levels and substantive effects vary, the qualitative effects do not change. Robustness appears to be provided by the strong anchoring effect of controlling for conditionality and implementation, which soaks up the effects of domestic politics on the duration of suspensions. Second, I have nested these models in larger models that include all of the measures of U.S. interests and their interactions or subsets of them, and the results are consistent with those presented above for U.S. foreign aid, bank exposure, UN voting and exports. The effect of alliances becomes statistically insignificant in models that include U.S. aid, but the pattern of increasing effects with increasing vulnerability remains. Here, robustness appears to be provided by the low correlations among most of the measures of U.S. interests, which suggests that they really capture distinct reasons for the United States to have strong interests in particular countries rather than simply representing different measures of the same underlying latent variable.

A third kind of robustness check is methodological. The results presented here are produced by a parametric Weibull duration model, and alternative methods for analyzing the data are possible. The Weibull model estimates a parameter that determines how rapidly the baseline hazard rate increases or decreases over time, but assumes a monotonic rate of change. The exponential model, for example, is a special case where the hazard rate does not change as a function of time, and the Weibull is more general. A parametric hazard model is appropriate if we have prior beliefs about the shape of the hazard. In this case, I expect a monotonically decreasing hazard, because

unobserved variation in the difficulty of implementing conditionality across countries should screen the sample of programs that are off track until only the hard cases are left, and this is consistent with the estimated results.

The results using a non-parametric Cox model instead of Weibull are qualitatively the same, but significance levels drop: U.S. aid and bank exposure are only marginally significant, exports and alliances become insignificant, and only UN voting remains strongly significant. There is, unfortunately, no direct test of the hypothesis that the Weibull results fit the data better than the Cox results, or vice versa, because the likelihood functions computed by the models are not conformable.¹⁶⁴ A likely explanation for the differences between the Weibull and the Cox models is that the Cox model allows for a very flexible and non-monotonic hazard function, so if some countries consistently have longer durations than others—which is the essence of the argument made here—the Cox model may attribute these cross-sectional variations to the shape of the hazard function rather than to the independent variables.

Another form of methodological robustness check is to include fixed effects. Country-specific fixed effects are impractical because there is not enough variation in the dependent variable to calculate all of the country coefficients, and in any case country fixed effects would absorb all of the cross-sectional variation in the importance of particular countries, which are the quantities of interest, into theoretically uninformative country effects. However, the results are robust to the inclusion of a variety of specifications of regional fixed effects, and the results reported include the most

¹⁶⁴ They effectively treat the definition of observations differently, so their likelihoods cannot be compared meaningfully. This rules out comparisons based on the Akaike information criterion or the Bayesian information criterion, and also rules out tests of non-nested model fit such as the Vuong test or the Clarke test.

important regional effects—sub-Saharan Africa, Latin America, and the countries of the former Soviet Union.

Another approach is to estimate a frailty model. Parametric hazard models such as the Weibull model make a proportional hazards assumption, which is analogous to the OLS assumption of no omitted variables: if there is unmeasured heterogeneity in the data this assumption does not hold and the results are biased. Of course, there is always unmeasured heterogeneity in the data, so a common approach is to estimate a frailty model, which estimates an additional parameter to correct for the resulting bias. All of the results are robust to estimation of a frailty model with shared regional parameters over nine regions.¹⁶⁵

In summary, the results are very robust to alternative measures, alternative specifications, and alternative models. Every measure is not statistically significant in every specification of every model, but this is nearly the case. UN voting is significant across the board, and U.S. aid and bank exposure are almost always significant and always at least marginally significant. The pattern holds across the board that measures of U.S. interests have substantially stronger effects when countries are highly vulnerable to external financial shocks, and in most cases those effects are only significant when countries are in the top third of the distribution on at least one dimension of vulnerability.

¹⁶⁵ The nine regions, coded by Przeworski et al. 2000 and extended, are Latin America, the Caribbean, sub-Saharan Africa, North Africa and the Middle East, South Asia, South-East Asia, East Asia, Eastern Europe and the former Soviet Union, and Oceania.

Waiver of Conditionality

A further test of the robustness of the results is to generate additional testable implications of the model that predict effects on additional dependent variables. An alternative way to measure lax enforcement of conditionality is to count the substantive concessions, or waivers, that the IMF grants to countries when their programs come back on track after a suspension. When program suspensions are cut short because of informal influence, this should show up in adjustments to conditionality, which may take the form of waiving performance criteria. The measure used here is derived from the MONA dataset and counts the number of types of conditions, ranging from zero to a possible maximum of 19, on which waivers were granted in a particular review. Observations are recorded when a program suspension ends. The dataset contains 688 instances when a suspended program came back on track after a successful review, and in 35 percent of those cases the Executive Board granted at least one waiver, for a total of 546 waivers. Two or more waivers were granted in 21 percent of program resumptions, three or more were granted in 12 percent of cases, and four or more were granted in 6 percent of cases. The maximum number of waivers granted in a single successful review was eight, which occurred in Russia in 1998 and in Zambia in 1999.

Since the dependent variable is an event count and I expect to observe over-dispersion—countries that receive one waiver in a given review are more likely to receive additional waivers—the appropriate statistical model is a negative binomial count model. The hypothesis of over-dispersion is confirmed in the analysis to a high degree of confidence. The regressors specified in the models are identical to those for the duration

models presented in the previous section. The full results of the analysis are presented in Table A8.2 in the appendix.

The analysis of waivers provides additional support for the hypothesis of informal governance, although the results are positive for only two of the five measures of U.S. interests: foreign aid and exports. Joint tests of significance for these variables and the interactive measures of vulnerability, with all other variables held at their means, are presented in Table 8.3. [Table 8.3 about here]

Table 8.3: Effects of U.S. Influence on Waivers

Negative binomial regressions

	<i>High vulnerability*</i>		<i>Mean vulnerability</i>	
	Substantive Effect	<i>p</i>	Substantive Effect	<i>p</i>
U.S. Foreign Aid	46.3%	0.03	14.9%	0.21
U.S. Exports	65.3%	0.02	-2.4%	0.91

*Significant interactions are one standard deviation above the mean, insignificant ones are at mean values

Table 8.3 introduces additional evidence that U.S. informal influence reduces the enforcement of conditionality. U.S. foreign aid and U.S. exports have significant effects that increase the incidence of waivers. The substantive effects of these measures of U.S. interests on the incidence of waivers are substantial when countries are highly vulnerable to sudden reversals of external financing. A one-standard deviation increase in U.S. aid, or \$137 million in the set of IMF program participants, increases the incidence of waivers by about 46 percent (the 95 percent confidence interval ranges from 6 percent to 87 percent). Increasing U.S. exports by one standard deviation, or by \$584 million in the set of countries under IMF programs, increases the incidence of waivers by an estimated 65

percent (the confidence interval ranges from 11 to 119 percent). Each of these effects appears only in the presence of high vulnerability; at mean levels of vulnerability the effects are insignificant.

Discrimination

A final consideration is discrimination among alternative theories. The results have two significant advantages in terms of theory discrimination. First, the specification of an interactive effect between measures of U.S. interests and measures of borrowing country vulnerability to external financial shocks is consistent with the theory of informal governance, but seems too specific to be subject to ad hoc explanations or explained by omitted variables. Second, only the theory of informal governance explains a common pattern of interactive effects across variables that measure U.S. economic, political and strategic interests.

A separate question is how well the results discriminate between the hypothesis of U.S. informal control of the IMF and collective control by the G-5, and this calls for additional analysis. Up to this point, all of the hypotheses tested have measured U.S. interests. The measures that are most likely to discriminate among U.S. preferences and those of other G-5 countries are those that are not highly correlated across countries. Measures that are highly correlated are less able to provide sharp tests. The correlations across measures are presented in Table 8.4. [Table 8.4 about here]

As noted in the previous chapter, bank exposure and UN voting provide weak discrimination among national interests because they are so highly correlated among the G-5 countries. Replications of the analysis of the duration of program suspensions using

Table 8.4: Correlations of Measures of U.S. and G-5 Interests

	Foreign Aid	Bank Exposure	Exports	UN Voting	Alliances
United Kingdom	0.12	0.96	0.36	0.82	-0.55
France	0.29	0.72	0.36	0.84	-0.56
Germany	0.15	0.47	0.34	0.78	-0.56
Japan	0.15	0.36	0.38	0.76	-0.64

Sample: country-months under program suspensions, 3,724 observations

average bank exposure rates and average UN voting scores for the G-5 countries other than the United States—Japan, Germany, the United Kingdom and France—are qualitatively identical to the results presented above using U.S. measures. Because the other G-5 countries vote similarly to the United States, countries that vote similarly to the United States must also vote similarly to the other G-5 countries. Bank exposure to particular countries varies quantitatively across G-5 countries, but the other G-5 countries' banks are highly exposed to most of the same countries as U.S. banks. There are important regional variations, however: French banks are more highly invested in Africa, and Japanese banks are more highly invested in East Asia.

Foreign aid and alliances provide strong comparative tests of U.S. versus G-5 control. Foreign aid correlations within the sample are quite low: the correlation with U.S. foreign aid ranges from .12 for Britain to .29 for France. Replications substituting total aid from other G-5 countries for U.S. aid find that the predicted pattern does not hold for aid donors other than the United States. The results are reported in Table 8.5.

[Table 8.5 about here]

Table 8.5: Effects of U.S. vs. G-5 Aid

	Substantive Effect	<i>p</i>
<i>U.S. Aid</i>		
High vulnerability	-35.5%	0.03
Mean	--	0.97
<i>Other G5 Aid</i>		
High vulnerability	--	0.21
Mean	-8.2%	0.01

At average levels of vulnerability, U.S. foreign aid has no statistically significant effect. However, program suspensions shorten as aid recipients become more vulnerable to external financial shocks, and this effect is highly significant for the top third of the distribution of vulnerability. In contrast, aid from other G-5 countries is associated with a substantively marginal but statistically significant decrease in the length of program suspensions at average levels of vulnerability, but this effect becomes insignificant as vulnerability increases. Aid from other G-5 countries does not reduce the duration of program suspensions for the countries that have the strongest incentives to ask their patrons to lobby the Fund, which suggests that the mechanism of informal governance is generally limited to the United States.

Alliances reveal a similar pattern. As Table 8.4 indicated, S-scores for alliances with the United States are negatively correlated with S-scores for alliances with the other G-5 countries. The United States is allied with the other G-5 countries, of course, but the correlations reflect the fact that U.S. alliance commitments are flung widely around the world, and do not generally coincide with those of even its closest allies. Results of replications of earlier models that substitute alliance portfolios of other G-5 countries for those of the United States are reported in Table 8.6. [Table 8.6 about here]

Table 8.6 Effects of U.S. and G-5 Alliances

Dependent variable: Duration of program suspensions

	Substantive Effect	<i>p</i>
<i>U.S. Ally</i>		
High vulnerability	-14.0%	0.04
Mean	-10.1%	0.09
<i>U.K. Ally</i>		
High vulnerability	-3.6%	0.67
Mean	-6.0%	0.17
<i>French Ally</i>		
High vulnerability	-3.1%	0.72
Mean	-5.9%	0.18
<i>German Ally</i>		
High vulnerability	-3.6%	0.67
Mean	-6.0%	0.17
<i>Japanese Ally</i>		
High vulnerability	50.0%	0.06
Mean	6.4%	0.42

Table 8.6 reports the results of tests of the joint significance of alliance portfolios and their interactions with trade/GPD, debt service/exports, and short-term debt, evaluated at the means of the three vulnerability levels and at one standard deviation above the mean. The results for U.S. alliances are calculated from the model reported in Table 8.2, and the other results are calculated from analogous models that substitute the alliance portfolio of a different G-5 country and its interactions for the corresponding U.S. variables. Only the United States variables are statistically significant in the predicted direction. U.S. alliances are marginally associated with reduced length of program suspensions at mean levels of financial vulnerability, and the effects become stronger and highly significant as vulnerability increases. In contrast, none of the other alliance portfolio measures is significantly associated with reduced duration of program suspensions. British, French and German alliance portfolios, furthermore, have weaker and less significant effects as

vulnerability increases. Only Japanese alliance portfolios have any discernible effect, and their effect takes the opposite of the predicted direction.¹⁶⁶

Discrimination between the hypotheses of U.S. influence and G-5 influence becomes sharper when we turn to the analysis of waivers. Replications of the analysis of

Table 8.7: Effects of Other G-5 Interests on Waivers
Negative binomial regressions

	<i>High vulnerability*</i>		<i>Mean vulnerability</i>	
	Substantive Effect	<i>p</i>	Substantive Effect	<i>p</i>
G-5 Foreign Aid	-13.8%	0.40	-17.1%	0.03
G-5 Exports	16.7%	0.06	-4.0%	0.65

*Positive interactions are one standard deviation above the mean, others at mean values

the number of waivers granted when programs are allowed to come back on track indicate that none of the statistically significant results survive when measures of U.S. interests are replaced by analogous measures for the other G-5 countries. The results are summarized in Table 8.7. [Table 8.7 about here]

In each case, the results presented replicate the models presented above, which also represent the ones that are most favorable for the hypothesis of G-5 influence. The models substituting total aid from Britain, France, Germany and Japan for U.S. foreign aid do not approach statistical significance, although the results gradually move in the predicted direction as trade increases as a percentage of GDP. Exports do not discriminate as clearly between the U.S. influence and G-5 influence hypotheses, because

¹⁶⁶ Since the Japanese alliance portfolio is sparse, and the U.S. alliance portfolio is wide-ranging, the positive effect of Japanese alliances may simply be the mirror image of the U.S. effect. Japanese and U.S. alliance portfolios are correlated at -0.64.

U.S. exports and exports from the other G-5 countries are correlated ($r = .45$ for the set of program participants). However, the effects of U.S. exports are substantially stronger and more significant. At high levels of vulnerability, total exports from Britain, France, Germany and Japan are estimated to have an effect that is in the same direction as the effect of U.S. exports. The effect is only marginally significant, however, and the estimated effect of U.S. exports is 4.6 times greater and highly significant.

In summary, these results support the hypothesis of U.S. influence rather than the hypothesis of G-5 influence whenever the measures of national interests differentiate U.S. interests from G-5 interests sufficiently clearly to permit a sharp test. For the analysis of the duration of program suspensions, the two measures of interests that allow a sharp comparative test of the hypothesis of U.S. versus G-5 control, foreign aid and alliance portfolios, support the conclusion that the United States exercises disproportional informal influence over the duration of program suspensions. The results of replications using bank exposure and UN voting to measure interests are equally consistent with the interpretation that the G-5 exercise collective control over program suspensions and that the United States exercises sole control—the measures are simply too highly correlated to permit a comparative test of these hypotheses. The results for waivers follow a similar pattern. Replications replacing the two variables for which measures of U.S. interests were found to have significant effects with parallel measures for G-5 countries—total aid and total exports from Britain, France, Germany and Japan—find much weaker effects of measures of G-5 interests. The results establish that U.S. foreign aid is associated with the issuance of waivers, and foreign aid from other G-5 countries is not. G-5 exports had a marginally significant effect, but the substantive impact was much weaker than that of

U.S. exports. On balance, the evidence indicates that informal governance of the IMF is exercised by the United States, and that the role played by the other G-5 countries is marginal.

Cases: Russia and Argentina

Two cases serve to illustrate the mechanisms by which the United States exerts its informal influence over the enforcement of IMF programs, the ways in which U.S. intervention depends upon the financial vulnerability of the borrowing country, and the diversity of motivations that the United States has for intervening on behalf of particular countries. The United States intervened extensively on behalf of both countries when they ran into difficulties with the IMF, but Russia and Argentina presented very different challenges to U.S. policy makers. Russia played a critical role in the Clinton administration's foreign policy, as the most important former Communist country and the lynchpin of a regional security strategy based on reassurance after the end of the Cold War. This is reflected in the fact that Russia was a substantial recipient of U.S. foreign aid. At the height of its influence in Washington, in 1996, Russia received \$416 million in U.S. economic aid, or approximately two standard deviations more than the average country that participated in IMF programs during this period. Russia did not rate very highly on most of the other measures of U.S. interests, however. Russia accounted for about 1 percent of foreign lending by U.S. banks and \$278 million in U.S. exports, or about a quarter of a standard deviation above the mean on each variable, so economic interests provided only weak incentives for the United States to interfere in Russian relations with the IMF. Russia was about half of one standard deviation more supportive

of U.S. votes in the United Nations than average, and was half a standard deviation further from the United States' system of military alliances than the average country, so these strategic dimensions of U.S. interests do not account for Russia's extraordinary treatment. Rather, Russia was important to U.S. interests for the collection of strategic concerns that motivated U.S. foreign aid, and this is captured in the statistical analysis.

On the other hand, Argentina has not been a substantial recipient of U.S. foreign aid since the end of the Cold War, but has been a very important economic partner. Throughout the sample period, lending by U.S. banks to Argentina averaged 4.5 percent of their total holdings of foreign assets, more than two standard deviations above the mean, and hovered between eight and nine percent of foreign assets between 1993 and 1996. Bank exposure declined from that high point but remained high relative to the sample, and Argentina became the most important emerging bond market by the year 2000. U.S. exports to Argentina were consistently higher than to Russia, averaging \$339 million per year, and reaching \$417 million in 2001, or half a standard deviation above the mean. Argentina was more critical of U.S. voting in the United Nations than Russia during most of the sample period, and was much more closely linked to the United States' network of military alliances—1.7 standard deviations more closely than the average IMF program participant. Argentina's influence was based on its economic importance, particularly to U.S. banks, on its close ties to other important U.S. allies—particularly Brazil, Chile, Mexico, Spain and Italy—and on its skepticism towards U.S. global leadership, which created an incentive for Washington to bolster sympathetic Argentine governments.

Russia

The failure to enforce conditionality in Russia has become emblematic of the broader IMF credibility problem. After the dissolution of the Soviet Union, Russia negotiated a Stand-By Agreement (SBA) in 1992, and no sooner was the ink dry on the agreement than the Central Bank of Russia tripled the money supply. Had Russia been an ordinary country, it would have been several years before the Fund tried to reengage—indeed, most of the mismanaged economies in the region, such as Ukraine and Bulgaria, had to wait—but the United States mobilized the G-7 to promote Russia’s case, and the Executive Board created a new, low-conditionality facility, the Systemic Transformation Facility (STF), to accommodate Russia. Russia received an STF in 1993 whose major condition was an inflation target of 7-9 percent per month. Despite the leniency of these conditions, which staff in the European II Department protested, Russia went off track again, and the second disbursement of the STF was delayed; but again the United States pressed Management for a waiver to allow the second disbursement to take place in 1994.¹⁶⁷ In the meantime, Russia’s monetary policy had been tamed, but fiscal policy went off track, particularly in the form of weak tax collection and budgetary subsidies to enterprises.

After a collapse in the exchange rate in the fall of 1994, Russian policymakers forged a consensus around a new policy framework, which anchored monetary policy with an exchange rate band beginning in 1995. Russia and the IMF negotiated another SBA to accompany the new policy stance and incorporated the highly unusual precaution of requiring monthly monitoring of conditions. For about nine months, Russia appeared

¹⁶⁷ Interview with Hernandez-Cata, February 17, 1999, cited in Stone (2002).

to be implementing its conditions. Fiscal policy slipped out of control after the 1995 parliamentary elections, however, which President Yeltsin's supporters lost to representatives of the far left and far right of the political spectrum, and the budget deficit expanded rapidly during the presidential campaign in the spring of 1996. Meanwhile, Russia was negotiating with the IMF to replace its expiring Stand-By with a three-year Extended Fund Facility (EFF), and President Clinton publicly urged that Russia's IMF support not be cut at the critical point.¹⁶⁸

Looking backwards, it is hard to recapture the sense of crisis that reigned in the spring of 1996. The G-7 countries were convinced that Russia was at a turning point: if the Communist leader Gennadyi Zyuganov won the election, Russia's chances of consolidating democracy and market reform seemed lost. The dramatic fiscal expansion during the election campaign threatened a twin crisis on the exchange market and the market for government bonds (*Gosudarstvennyye kratkosrochnye obligatsii*, or GKO), and the Central Bank of Russia used hidden purchases of bonds and rubles to fend off the crisis. Under the circumstances, the Executive Board issued waivers covering Russian fiscal policy and debt, and the program was not suspended until the month after the election. Russian Central Bank officials believed that they had avoided a politically disastrous financial crisis by days in June and July 1996, while Yeltsin was hospitalized between the first and second rounds of the election.¹⁶⁹ There does not appear to have been any dissent within the G-7 about issuing these waivers; and although the Board only learned later about the secret manipulation of Russian reserves that spring, it was fully

¹⁶⁸ *New York Times*, January 31, 1996, 1.

¹⁶⁹ Interviews with Dubinin, Aleksashenko and Potemkin, cited in Stone (2002).

aware that Russia was not abiding by the key conditions of its program. Nor was the IMF Management unwilling to grant waivers in this case; even Staff, which usually took a more orthodox stance on Russia than Management, explained the decision in terms of geopolitics rather than macroeconomics.¹⁷⁰

Had 1996 remained an exception, it might have been possible to avoid the financial crisis and partial default that occurred in August 1998. However, the program was suspended for only one month, and efforts to enforce conditionality throughout the rest of 1996 and 1997 were brief and inconsequential. In fact, although Russia's programs were suspended for non-compliance with key fiscal and monetary conditions once in 1995, three times in 1996, three times in 1997 and twice in 1998, these suspensions lasted only one or two months until the end of 1997. This accommodating stance prevented the IMF from exercising whatever leverage it had. Meanwhile, rapid capital inflows temporarily reduced Russia's reliance on IMF financing and blunted the effects of program suspensions. Russia became a high-yield emerging market and conducted a rapid expansion of fiscal policy that was financed by capital inflows into the booming stock market and the market for GKO's. It was not until Russian markets felt the contagion effects of the Asian crisis at the end of 1997 that President Yeltsin began to understand the urgency of fiscal reform, by which time it was too late to avert the crisis. The IMF delayed one disbursement by three months in late 1997 and one by four months in early 1998, but rapidly reversed itself when the Russian bond market was seized by panic in May. The IMF rushed to negotiate a new package of reforms and financing,

¹⁷⁰ Interview with Horiguchi, November 8, 1999, cited in Stone (2002), 138-40.

announcing that it would lend up to \$11.2 billion to Russia in 1998 as part of a two-year package of support including the World Bank and bilateral lenders totaling \$17.1 billion.

By the time the eleventh-hour rescue package was announced on July 20, 1998, however, market actors had drawn conclusions about the seriousness of Russian reform promises and the credibility of IMF conditionality in Russia. Although the package was unprecedented in size and contained a reform agenda of extraordinary breadth, it appeared to improve market conditions for only a few days. Capital flight accelerated in early August in spite of frantic purchases of dollars by the Central Bank of Russia, and demand for government bonds vanished. Even at this late date, the IMF was prepared to consider another bail-out for Russia, and Stanley Fischer pitched the proposal in a conference call with the G-7 Deputies. The origin of this proposal is unclear, but Fund insiders agree that it could not have been made without American support. The controversial July package had already strained the consensus in the G-7 to the breaking point, however, and the Deputies, led by Germany, refused to be persuaded.¹⁷¹

On August 17 Russia ran out of funds, and the value of the ruble collapsed. Russian banks had taken advantage of interest rate differentials, borrowing heavily in dollars and lending in rubles, so the abandonment of the exchange rate band and the collapse of the bond market created a wave of insolvencies. The government and central bank declared a moratorium on debt service by private banks, and Yeltsin dismissed the government and the chairman of the central bank, ending Russia's last experiment with liberal politics.

¹⁷¹ Interview 6.

Argentina

Weak enforcement of conditionality was less obvious in the case of Argentina than in the case of Russia, but it was pervasive throughout Argentina's relationship with the IMF in the 1990s, and it laid the groundwork for the subsequent crisis.¹⁷² Argentina's remarkably successful financial stabilization in the 1990s was based upon a currency board arrangement embodied in the Convertibility Law, which fixed the peso to the dollar at a one-to-one parity and obligated the Central Bank to hold reserves equal to base money. This was more rigid than Russia's exchange rate regime, but shared the same underlying weakness: fiscal deficits and expanding debt made the policy framework acutely vulnerable to shifts in market sentiment and unsustainable in the long run. Argentina consistently missed IMF targets for its fiscal deficit, and the debt grew from 29 percent of GDP in 1992 to 41 percent in 1998, and rose to 50 percent by 2000. Staff repeatedly voiced objections to the planned EFF for Argentina in 1996-98 because of its weak fiscal provisions, but the Management overruled these concerns, and the staff reports to the Executive Board did not disclose these objections.¹⁷³ Fund insiders regarded the level of Argentina's debt burden as barely sustainable even in the presence of the toughest economically feasible fiscal policy, and only as long as market perceptions remained favorable. It was high enough to lead to exploding debt dynamics—debt so high that debt service drives it steadily higher as a percentage of GDP—if market sentiment became unfavorable.¹⁷⁴

¹⁷² Mussa 2002.

¹⁷³ IEO 2004, 36. This assessment was confirmed in interviews with IMF officials involved in the negotiations.

¹⁷⁴ Mussa 2002, 16-17.

Argentina failed to meet its targets under the EFF in 1997, and the program moved into a series of increasingly lengthy suspensions. However, continuing inflows of short-term capital financed Argentina's growing fiscal deficits and made it unnecessary for Argentina to draw on the IMF's resources—or to call on its shareholders to help unlock them. The burden of servicing the debt rapidly rose, from 4.9 percent of gross national income in 1996 to 9.9 percent in 2000, and this increased Argentina's vulnerability to sudden reversals of external financing. Market sentiment shifted in the fall of 2000, and it became clear that Argentina would be compelled to abandon its pegged exchange rate and would probably be forced into default if a major rescue package were not forthcoming. Argentina had been treating its IMF program as precautionary in 2000, but it turned to the Fund with a request to draw on the program and asked for a substantial augmentation in November. Argentina missed its target for the fiscal deficit in September, and would have missed the target for the December review as well, had it not been modified. Staff was divided over whether it was advisable to expand the size of the loan facility under these circumstances, but Management strongly supported the program at U.S. urging. The United States represented the lone voice strongly favoring the program in the G-7, and the other members deferred in spite of their reservations.¹⁷⁵

Staff in the IMF's Western Hemisphere Department believed that this was Argentina's last chance. A substantial package of financial support was assembled and the conditions of the precautionary program were revised: fiscal conditions were loosened to accommodate the poor performance of the economy, but structural

¹⁷⁵ Blustein 2005, 101.

conditionality was increased in an effort to compensate. Staff believed that a failure to implement the program, and particularly to meet the fiscal conditions that had already been weakened, would make the crisis inevitable. The consensus view was that if the program went off track after December 2000, the IMF should not extend itself further and Argentina should be allowed to fail.¹⁷⁶

The program almost immediately went off track. Two finance ministers and the central bank governor resigned in rapid succession, and Argentina missed its targets for the first quarter of 2001 for the Federal fiscal deficit, the consolidated deficit of the public sector, the primary surplus, aggregate debt and short-term debt. The March review was delayed. At this point, the staff had serious misgivings, and the analysts closest to the front believed that the program should be suspended indefinitely. Short-term interest rates had jumped to 1000 basis points above U.S. Treasury bonds—to a level of about 14 percent—and the Argentine debt was no longer sustainable at those interest rates. In the context of a Management decision to go forward, however, Staff could not express a contrary view.¹⁷⁷ The Staff Report to the Executive Board for the May review used extraordinarily optimistic assumptions to build a case that the debt could still be sustainable, including growth rates that could not be attained at the current level of interest rates, primary surpluses (fiscal surpluses before debt service is included) that had not been reached even in the best years in the 1990s, and interest rates that were no longer being offered.¹⁷⁸ Misgivings were raised in the Executive Board, particularly by

¹⁷⁶ Interviews with IMF staff members.

¹⁷⁷ IEO 2004.

¹⁷⁸ Mussa, 77-81.

the British Alternate ED, but the decision to grant the waivers, further relax the conditions, and keep the program on track had been made informally at a higher level.¹⁷⁹

The most controversial stage of the Argentine program came in August 2001, when the government requested an \$8 billion augmentation (discussed in Chapter 6). At this point the program was effectively taken out of the IMF's hands by the United States Treasury, which conducted negotiations with the Argentine government and won approval from skeptical members of the G-7.¹⁸⁰ Within the United States government, Treasury was heavily lobbied by officials from the National Security Council and the Departments of State and Defense, who were in contact with their Argentine counterparts and emphasized that the collapse of the Argentine economy would have broader negative consequences for U.S. policy in the region. The White House received calls from the presidents of Brazil, Chile and Mexico warning of the dire consequences for U.S. influence in Latin America—and for the influence of the IMF—if Argentina did not receive emergency assistance. Argentina pulled out all the stops.

The most optimistic Staff put the chance of success of the program at 20-30 percent at this point, and prominent voices including Kenneth Rogoff, the new head of the Research Department, were strongly opposed. However, none of this dissent was communicated to the Executive Board. A Mission returned to Washington from Buenos Aires shortly before the proposal went to the Board and brought back a pessimistic

¹⁷⁹ Mr. Collins, the UK alternate ED, called for a “Plan B” in case the debt did not turn out to be sustainable and pointed out that “...the staff paper could have prepared a more in-depth analysis of the differences in the revised program from that agreed in January.” Executive Board Minutes, May 21, 2001, EBM/01/53.

¹⁸⁰ Taylor, 80-88; Blustein 2005, 145-51.

assessment of the unwillingness of provincial governors to go along with the new zero deficit law that was supposed to be the basis for meeting the program conditions in the fall. Although by September Staff in the Western Hemisphere Department believed that the probability that the authorities would be able to implement the key fiscal target of the program was very low, they could not raise doubts of this nature without solid evidence. In communications with the Executive Board, the benefit of the doubt goes to the country authorities.¹⁸¹ The Executive Board, meeting a week before September 11, 2001, passed the review of the Argentine program together with the augmentation, but the meeting was memorable for its unusual degree of open criticism and several pointed abstentions from the final vote.

In the case of Argentina, as in the Russian case, the effect of a pattern of persistent non-enforcement of conditionality was that the sustainability of the foreign debt gradually deteriorated, and when the crisis came, the political system failed to respond. Far from tipping incentives in the direction of reform, the IMF weakened the incentives to come to grips with urgent problems. Argentina was no better able to reform its finances in September than it had been earlier in the year, and its policies failed to inspire confidence in the market. Capital flight accelerated in the fall; indeed, many observers inside and outside the Fund argued that IMF financing had simply provided a brief breathing space that allowed individuals and foreign financial institutions to withdraw their capital. The IMF had lost its credibility as an arbiter of sound policies, and as a predictable source of soft financing, it diluted market discipline. The collapse of the exchange rate, the banking system and the government followed in January, and

¹⁸¹ Interview 2.

Argentina went into default on its foreign debt. Riots forced the resignations of two presidents. The country moved into a deep recession, investors lost much of their wealth, and wages and employment dropped sharply.

Conclusions

Russia and Argentina are extreme cases because these were countries that were able to call on significant leverage with the United States and that found themselves in such dire circumstances that they were willing to cash in their influence. In short, they were textbook cases for the exercise of informal governance. They were not typical cases, but they provide ideal illustrations of the mechanisms and logical consequences of informal influence. The IMF is subject to cross-pressures from its biggest shareholder that lead to inconsistent enforcement of conditionality and interfere with its mission as a guarantor of market stability. In extreme cases, the Fund has no credibility, conditionality becomes almost meaningless, and the IMF becomes no better than a captive—and at worst a facilitator—of the policies that run national economies into the ground. In both cases, the pressure to relax the enforcement of conditionality came unambiguously from the United States. U.S. motivations were different in the two cases—in Russia primarily strategic, in Argentina primarily economic—but the logic of a coincidence of powerful U.S. interests and intense interests in the borrowing country was the same.

Just as case studies are valuable for spelling out mechanisms and provide a weak basis for generalizing, statistical analysis is a powerful tool for generalizing and is poor at establishing causal mechanisms. The statistical analysis in this chapter demonstrates that the pattern of informal governance—the United States intervenes to relax enforcement in

countries in which it has strong interests, but only when those countries perceive a strong interest in asking for U.S. intervention—is consistent with the evidence of a global dataset. These tests are stronger than previous ones in the literature because the sample is global rather than regional, the data provide better measures of the key concepts, and the data contain controls for implementation and conditionality. The results are robust to alternative measures of U.S. interests, alternative specifications, alternative methods, and two different dependent variables. The tests sharply discriminate the theoretical model of informal governance from alternative explanations, because the model predicts an interaction between U.S. interests and borrower interests that is hard to account for with ad hoc explanations and that is unlikely to be due to omitted variables. U.S. foreign aid, bank exposure, exports, UN voting and alliance patterns are all associated with weak enforcement of conditionality, but only when borrowing countries are vulnerable to sudden reversals of international financing.

Some of these tests also discriminate between the hypothesis of U.S. influence and broader influence by the group of G-5 countries—including Japan, Germany, Great Britain and France as well as the United States—while others do not. Some of the variables measuring U.S. interests, particularly UN voting and bank exposure, are highly correlated with measures for other G-5 countries, so it is impossible to distinguish effects of U.S. interests from those of the other countries. Indeed, since some of these interests are common—the failure of a European bank affects the interests and stability of the United States banking system, for example—it may be impossible in principle to determine where one country’s interests end and another’s begin. However, some of these tests, notably those involving U.S. foreign aid and alliance patterns, strongly point

to U.S. influence and not to the influence of other leading members of the IMF Executive Board. When the statistical evidence is less clear, as in the case of economic interests, the historical record helps with interpretation. For example, several European countries had stronger economic interests than the United States in avoiding a default by Argentina, but it was the United States that pushed the IMF to continue lending when Argentina repeatedly missed its budget targets. Similarly, Germany was more highly exposed to default by Russia, but took a harder line on enforcing IMF conditions in Russia than the United States, particularly after 1996.

The evidence presented thus far indicates that informal influence is pervasive throughout the IMF product cycle, from decisions to provide access to Fund resources (Chapter 6) to the design of conditionality (Chapter 7) and on to the enforcement of conditionality reviewed in the present chapter. The statistical patterns at each stage are consistent with informal influence: countries that are important to U.S. interests and vulnerable to reversals of external financing receive concessions from the IMF. Case studies illustrate the mechanisms by which the United States exercises influence at each stage, the motivations for doing so, and the consequences. Informal influence systematically weakens the incentives for the recipients of IMF financing to implement reform and prudent financial policies, and this imposes long-term costs because the United States has an interest in supporting the policies that the IMF promotes. The benefits to the United States of interfering in IMF governance are diverse, and are harder to measure than the costs, but appear to be compelling in the short term. The statistical evidence shows that the motivations involve foreign policy, economic interests and military security, and the case studies illustrate a wide range of reasons that operate in

particular instances. The reasons are perhaps aptly described in the model as uniformly distributed temptations, however, because U.S. foreign policy tends to be dominated by short-term objectives and election calendars rather than by long-term strategic planning.

Chapter 9: Conclusions

This book began by setting out a theory of equilibrium institutions, which was organized around the concept of informal governance. Formal and informal governance represent alternative social choice mechanisms—the former based on voting and formal rules, the latter based on power and informal influence—and these two mechanisms coexist in international organizations. The choice of procedures that incentivize or delegitimize informal governance mechanisms is a critical step in institutional design, and in equilibrium the mixture of these modes of governance in international organizations balances the power and interests of strong and weak states. Chapter one situated this argument in political theory, and chapter two formalized it as a game-theoretic model.

The second part of the book explored the implications of this theory in three international organizations chosen for case studies: the International Monetary Fund, the World Trade Organization, and the European Union. The cases demonstrated two propositions. The first proposition is that, in spite of the variety of issue areas, the varying memberships and the differing contexts in which these organizations operate, informal governance mechanisms play important roles in each of them. Formal rules are also important in each organization, but in each case, the functioning of the organization cannot adequately be understood without taking into account the many ways in which informal governance mechanisms modify or overrule the formal procedures. Scholars who study the EU and the WTO have directed considerable attention to this phenomenon, but they have generally failed to connect the dots, because they have not appreciated that

informal governance mechanisms exist primarily to serve the interests of powerful states, while formal rules are generally designed to protect the weak.

The second proposition to emerge from the case study chapters is that the balance between formal and informal governance varies substantially across international organizations in ways that are consistent with the expectations of the model. The model of informal governance generates comparative statics that relate the balance of formal and informal governance to the distribution of structural power (outside options and the externalities created by exit) and to the prevalence of temptations to override institutionally determined policy outcomes. When structural power is concentrated and temptations are weak, institutions that allow for substantial informal governance are chosen because they motivate the leading state to participate intensively, and the costs associated with informality are tolerable for the rest of the membership. Under these circumstances, institutions can be delegated substantial executive powers, and decision making can be consensual and non-transparent. On the other hand, as power becomes more dispersed or temptations become stronger, institutions must be formalized to reduce the abuse of power. Under these conditions, it is still possible for strong institutions to emerge in issue areas where cooperation is highly valuable, but it has to take relatively transparent, legalized forms. The locus of decision making shifts from the executive to the legislative arena, and the majority of delegated powers are judicial. If, on the other hand, cooperation is not valuable enough to induce powerful states to accept legal constraints, institutions will be weak when power is dispersed and temptations run high, and powerful countries will seek alternative means of accommodating their interests. These case studies are not tests of the theory. Instead, their function is to take soundings

to determine how well it fits empirical examples, illustrate its usefulness in explaining important institutional variations, and assess its broad applicability. The cases suggest that not only can the static differences between the IMF, the WTO and the EU be broadly explained by the model, but so can the ways in which various issues are handled within each organization and the broad shifts in the powers and competencies of each organization over time.

The third section of the book was more rigorous, and used a combination of quantitative analysis and qualitative research to test hypotheses drawn from the model in the context of IMF lending. According to the model, informal governance is exerted sporadically, when the interests of powerful countries are directly engaged, and it is used to make exceptions to formal rules. In the case of the IMF, exceptions to rules are generally beneficial to borrowers, rather than to creditors, and powerful countries are creditors. Waiving the rules can be beneficial to the United States, however, if this makes it possible to provide support for a valued ally, or if the borrowing country offers concessions to the United States in return. It is difficult to measure these concessions directly, but the theory implies that informal influence is exercised when U.S. interests in a country and borrower interest in a loan are simultaneously intense.

The model does not specify why particular countries are important to U.S. policy; in fact, it represents these motivations as a random variable, suggesting that they cannot be perfectly predicted. Consequently, this study uses five variables to proxy U.S. interests that capture a wide range of possible motivations for the United States to exercise informal influence: U.S. foreign aid, U.S. bank exposure, U.S. exports, affinity for U.S. voting patterns in the United Nations General Assembly, and alliance patterns.

Similarly, although I cannot directly observe the urgency of the borrower's need for financing, it is possible to measure variables that make countries likely to need IMF assistance, and therefore more willing to make concessions in order to obtain it. This study employs three dimensions of vulnerability to sudden reversals of capital flows: trade openness, debt service as a percentage of exports, and short-term debt as a percentage of total debt. Countries that have open economies, are highly leveraged, and depend upon continued access to capital markets to roll-over short-term credits are vulnerable to international financial shocks. The theory predicts that informal governance will be exercised, and the rules will be waived, when countries that are important to the United States have significant external vulnerabilities that make them willing to cooperate with U.S. objectives.

Three chapters examine successive stages of the IMF product cycle and find remarkably robust evidence of informal governance. Chapter six investigates access to Fund resources and finds that two of the U.S. interest variables, bank exposure and exports, are strongly associated with larger loans as a percentage of IMF quotas, but only when borrowers are unusually vulnerable. Chapter seven uses IMF records of conditionality to construct a variable measuring the substantive scope of conditionality, and finds that all five interest variables are associated with reduced conditionality, but again these results obtain only in the presence of substantial vulnerability. Chapter eight measures enforcement of IMF programs in two ways: the duration of program suspensions when programs go "off-track" because countries fail to comply with their conditions, and the number of waivers of conditionality the IMF grants when a program comes back into good standing after a suspension. The evidence shows that all five

measures of U.S. interests are associated with reductions in the rigor of program enforcement, but again these effects are conditional: they appear only when countries are unusually vulnerable to external financial shocks. Each of these chapters draws on country cases drawn from a set of particularly important recent crises to illustrate the mechanisms of informal governance.

The case studies—Mexico (1995), Korea (1997), Indonesia (1997), Russia (1998), Brazil (1999) and Argentina (2001)—were not discussed systematically, so before returning to the book’s broader themes, this chapter briefly returns to a discussion of the six crisis cases and the reasons for the shortcomings of IMF performance. Each program had specific shortcomings, and five of the six went off track. Problems arose at each stage of the IMF product cycle, but the underlying mechanism was the same. In each case, informal governance allowed the United States to insert its preferences into the process of program design and implementation, ultimately undermining the credibility of the IMF. Although the forms of intervention appear idiosyncratic in the context of the individual case studies, each type of U.S. intervention that emerges in the case studies is consistent with a strong pattern of quantitative evidence presented in one of the previous chapters.

Six Crises and IMF Performance

A quarter century ago, Williamson summarized the charges of the IMF’s critics as including a doctrinaire adherence to free markets, insensitivity to individual country conditions, and the overriding of national sovereignty.¹⁸² The Fund continues to be

¹⁸² Williamson 1983.

criticized for ignoring borrowers' domestic political constraints and applying one-size-fits-all policy prescriptions without sensitivity to context.¹⁸³ Especially following the Asian crisis, the IMF was faulted for conditionality that sought to control too many policy variables, many of which extended beyond its traditional areas of competence;¹⁸⁴ moreover, it was claimed, such conditionality did not promote growth and may have damaged economic performance.¹⁸⁵ Sympathetic insiders and the Fund itself have conceded that conditionality may have been superficially implemented as a consequence, requiring a shift to greater "ownership" of reform by country authorities and "streamlining" of its content.¹⁸⁶ The analysis of this book suggests that these criticisms, although perhaps justified in some cases, are largely beside the point. The central obstacle to improving IMF performance is informal governance. The danger posed by delegating powers to international organizations is not that they will pursue autonomous agendas, but that they will be captured by the most powerful state in the system. Likewise, the shortcomings of IMF programs are generally related to politically motivated inconsistencies in design and implementation.

¹⁸³ Meltzer 2000, Easterly 2001, and Stiglitz 2002.

¹⁸⁴ Feldstein 1998, Hills, Peterson and Goldstein 1999, Goldstein 2001.

¹⁸⁵ Feldstein 1998. An extreme example of the proliferation of conditions is the program introduced in Ukraine on the eve of its financial collapse in 1998, which contained 227 prior actions and performance criteria (Ukraine 1998). Goldstein (2001) judged conditionality to have been excessively intrusive during the Asian crisis. Based on their conclusion that IMF-supported programs are associated with lower GDP growth rates, Przeworski and Vreeland (2000) inferred that lending is conditioned on inappropriate policy measures.

¹⁸⁶ Khan and Sharma 2001 and Drazen 2002 call for greater ownership, and IMF 2005 introduced the initiative to streamline conditionality.

The six crisis cases demonstrate some important common features as well as significant variations. The United States, in particular, played different roles in the various cases that reflected different U.S. interests. In addition, the way in which informal consultations took place evolved over time, in part in response to the crises themselves, and in part because of leadership changes at the Fund and in the U.S. government. These variations highlight the fact that the Fund's informal governance is a moving target. Summary indicators of the six cases are presented in Table 9.1. [Table 9.1 about here]

Ordinary IMF programs do not excite controversy, and each of these six cases did, but most of the action took place outside of the Executive Board. The Mexican case was unique in that Executive Directors representing two G-7 countries abstained from the vote to approve the program, and in subsequent cases the Management and the U.S. Treasury were careful to avoid a repetition of this experience by engaging in prior consultations at a higher level. Conference calls including all of the G-7 deputy finance ministers (the "G-7 Deputies") became an informal institution. Left out of the G-7, EDs representing small European countries were free to express critical opinions, and two abstained from the vote on the last-minute augmentation of the Argentine program in September 2001. Other EDs would have liked to do the same, but were instructed to vote in favor of the Management proposal by their governments.¹⁸⁷ The Russian rescue in 1998 was a similar case in which several of the EDs were unenthusiastic, but in this case there were no abstentions. Focusing on variations in outcomes on the Executive Board, however, would both overstate the differences among the cases and understate the degree

¹⁸⁷ Interviews 10, 3.

of disagreement that prevailed about all of them, because the Board was not the forum in which the real decisions were made.

Table 9.1: Summary of the Six Crisis Cases

	<i>Mexico</i>	<i>Indonesia</i>	<i>Korea</i>	<i>Russia</i>	<i>Brazil</i>	<i>Argentina</i>
<u>Use of Fund Resources</u>						
Billion USD	2/1/95	11/5/97	12/3/97	7/20/98	12/2/98	3/10/00
percent of quota	\$17.8	\$10.0	\$21.0	\$13.8	\$18.3	\$14.0
	679%	490%	1938%	425%	600%	800%
<u>Surveillance failures</u>						
Reserve levels	Gross reserves		Usable reserves	Gross reserves		
Banking Sector		Non-performing loans	Short-term foreign liabilities			
<u>Conditionality</u>						
Fiscal balance (% GDP)	0.50%	1.00%	0.00%	-5.70%	-4.70%	-2.40%
Structural benchmarks	14	63	15	82	60	30
<u>Waivers</u>						
Previous program	0	NA	NA	19	NA	1
Crisis program	7	7	1	2	1	5
Structural compliance	NA	73%	87%	NA	48%	58%
<u>External sector</u>						
Exchange rate regime	Managed float	Managed float	Managed float	Band	Crawling Peg	Currency board
Devaluation						
after one month	16.8%	27.5%	45.6%	26.7%	63.6%	0.0%
after six months	8.1%	188.5%	1.9%	262.3%	46.3%	295.0%

Sources: IEO 2003, 2004; MONA; Letters of Intent; Staff Reports; PINs; IFS

An important element of variation across the six cases was the attitude taken by the United States: in several cases (Mexico, Russia, Argentina, Brazil) the United States pushed the skeptical membership to extend Fund support, but in the Korean and Indonesian cases it put the brakes on a more ambitious bailout using bilateral contributions. The degree of U.S. influence was not related to variations in how its

preferences related to the formal voting rules, which is consistent with the argument that U.S. influence does not depend upon threats to actually resort to a vote. In particular, U.S. influence does not appear to have depended on whether the United States sought a bigger or smaller loan package, or whether it held a credible veto threat; it was decisive regardless.

Nevertheless, the style and modalities of U.S. influence varied significantly. The partnership between Larry Summers at the U.S. Treasury and Stanley Fischer as First Deputy Managing Director of the IMF worked very smoothly, indeed almost seamlessly during the Clinton administration. As a result, it was often difficult, even with the use of documents and participant interviews, to tell where U.S. policy ended and Management strategy began. In contrast, the IMF had a much less congenial relationship with the O'Neill Treasury in the early part of the George W. Bush administration. O'Neill and Taylor initially disengaged from the Fund and criticized it for engaging in ill-conceived bail-outs, but then scrambled to take over the management of the Argentina program, and in places insisted on a strategy that the Fund regarded as incoherent.¹⁸⁸ Their policy towards the Fund was more similar to the Summers policy in substance than in style, however, and the difficulty of saying no to Argentina induced them to drop many of their early rhetorical differences. The Bush administration demonstrated that the United States was still powerful enough to exert substantial control over the IMF even without finesse and sophistication, but also that the effectiveness of informal governance depends on these qualities. The Clinton administration was no less guilty of abusing U.S. power, but it did so more subtly, because it understood much better that American power rests

¹⁸⁸ Interviews 2, 13, 4, 11.

largely on consensus, and that the usefulness of international organizations as instruments depends on their legitimacy.

Although the substance of conditionality tends to be delegated to the Fund, there are variations across the cases, and particular G-7 governments became more intensely involved in some countries than in others. In each of the crisis cases, where U.S. preferences clashed with those of other members—as in the case of structural conditionality in Indonesia and Korea, or in the case of supporting the preferred Brazilian exchange rate regime in 1998—U.S. preferences prevailed. In most cases, however, U.S. preferences did not differ significantly from those of other G-7 countries or from the strategy preferred by the Fund, so the degree of influence that the U.S. exerted over outcomes is difficult to ascertain. The variation in the breadth of structural conditionality across the crisis cases depended mainly upon the timing of the program—structural conditionality was at its height during 1997 and 1998—and the conditions of the case at hand. Brazil and Argentina had straightforward fiscal and exchange rate problems, so far-reaching structural reforms did not seem to be called for. (Most of the structural conditionality in the Argentine program, for example, was related to taxation or expenditures.) On the other hand, particular conditions were routinely included in programs because they suited leading shareholders, and the country that exerted the overwhelming influence in the crisis cases was the United States.

In the six cases considered here, the most important cases of IMF lending in the last two decades, major rescue packages failed to reverse the erosion of market confidence in five cases. Only the program for Mexico succeeded in rapidly restoring confidence in the financial system. In part, this success was due to timing: a significant

depreciation of the peso had already occurred before the program was initiated, while each of the other countries suffered dramatic devaluations while under IMF programs. In part the stabilization of the Mexican economy reflected the credibility of the bilateral U.S. guarantee, however, which reflected a much deeper commitment than the United States was willing to make in any of the other cases. In three cases, Indonesia, Russia and Argentina, repeated rescue efforts failed, and financial markets did not respond to infusions of official support. In each case, it was clear to market participants that the government was not committed to a credible reform program with real prospects of success, and that the IMF lacked the credibility to enforce its conditionality. In two other cases, Korea and Brazil, programs initially failed to restore confidence, leading to dramatic collapses of the national currency and all of the damage that these can cause to domestic financial systems. In each of these cases, it was only after the G-10 central banks adopted plans for coordinated rescheduling of commercial bank debt that the flight from the currency was stemmed. Similar approaches would not have been feasible in the other cases, however, because bank exposure represented less significant shares of indebtedness in the other countries. In the case of Mexico, sufficient financing was provided to meet short-term demands for foreign currency, and confidence returned; in the other cases, IMF lending was predicated on the assumption that it would catalyze private-sector participation. This assumption consistently proved to be false.

The fact that IMF lending to countries with systemic importance fails to generate catalytic effects that mobilize private capital flows is a symptom of the damage that informal governance does to IMF credibility. Catalytic effects could arise if market participants learned something new when they observed an IMF program. The new

information might be about liquidity; but in these large crises, IMF rescue packages were anticipated and priced into the already depreciating value of assets, and provided no new information. Alternatively, catalytic effects might arise because IMF programs promised credible economic reforms; but credible reforms require credible enforcement of conditionality, and countries that are important to key shareholders are routinely able to circumvent arduous or politically risky conditionality. Whenever performance was poor in important countries, enforcement was weak. A growing body of research indicates that IMF lending generally does not have catalytic effects, and the governance of the Fund during crises may be an important element in the explanation.¹⁸⁹ Only bank lending responds strongly to IMF lending, and only when the G-7 countries coordinate efforts to coerce their banks to refinance their loans to support an IMF program (Gould 2006, Copelovitch forthcoming). The fact that catalytic effects do not follow major rescue packages undercuts the core of the IMF strategy for dealing with these crises.

The most consistent pattern across the six cases is the failure of surveillance, whether in the form of Article IV consultations or in the form of monitoring of conditionality, to identify risks of systemic crises in time to contain them, or to candidly assess the risks of proposed lending. Although the Fund has assimilated numerous lessons from the experiences of the six crises reviewed here, most of which have been articulated by outside observers—the emphases on better data standards, more transparency, streamlined conditionality, an exceptional access framework, contingent credit lines, and proposals for new frameworks for dealing with sovereign debt—it has

¹⁸⁹ This literature is reviewed in Steinwand and Stone 2008. See Bird and Rowlands 2002, Eichengreen et al. 2007, and Jensen 2004. Bird and Rowlands find catalytic effects in middle income countries but negative effects in their full sample; Mody and Saravia (2003) find lower bond spreads under a program for countries with mid-levels of reserves, but higher spreads for those with low and high reserve coverage.

not come to grips with the fundamental governance problems that make the Executive Board an ineffective locus for surveillance. An important part of the problem is that the secrecy that surrounds IMF decision making makes it difficult to hold the institution or particular individuals inside or outside the Fund accountable for the roles they played during crisis management. The Fund has greatly increased the number of documents that it makes public in recent years, but information on the details of its decision making is not disclosed to the outside world or distributed within the organization, and this undermines its ability to learn from its own experience. This is not accidental; it is a consequence of the informality and non-transparency of IMF governance.

The trade-off between autonomy and legitimacy dominates proposals to reform the IMF and to redistribute voting shares among its members, but the debate is inadequately informed by historical evidence and empirical data. The evidence suggests that the dangers of an autonomous IMF have been greatly overstated, and that the limitations on the Fund's autonomy are a more serious concern. The Fund typically exercises autonomy, but that autonomy can be revoked when the United States exercises its informal influence over the process of program design. This intervention distorts the application of conditionality and contributes to the IMF's credibility problems. The combination of informal governance with secrecy about the details of decision making is not without cost. The consequences are a loss of credibility and transparency.

As one IMF insider told me, "If they ever succeed in reforming this institution, it will become irrelevant." The model of informal governance suggests that the balance of formal and informal governance is an equilibrium outcome, which reflects the distribution of power and interests among the membership. Under both Republican and

Democratic administrations, the United States has found the IMF to be a remarkably valuable instrument of foreign policy, and it has not perceived a need for fundamental reforms that would make it less malleable. Attempts by the rest of the membership to carry out reform could reduce the willingness of the United States to invest authority in the IMF, making the institution less valuable to the broader membership. The degree of buy-in by the main shareholders is already a scarce resource, as the Korean crisis demonstrated in 1997. As a practical constraint, decision making must represent those who are able to promise substantial infusions of official financing and who have access to the private financial institutions most likely to help resolve crises.

Legitimacy, Crisis and Change

The model of informal governance offers an explanation, then, for the puzzle of why the membership has refused for so long to reform IMF procedures to improve institutional performance, in spite of the fact that IMF insiders and officials representing the shareholders understand the ways in which informality undermines their common interests. However, the model also sets out the conditions under which meaningful reform can occur. The model suggested that power and legitimacy interact in precise ways, and traces out the implications of two kinds of change. First, a change in U.S. interests can have far-reaching consequences that undermine the legitimacy of institutions. If the U.S. temptation to intervene in an organization increases, this leads other countries to raise the barriers to informal influence by reforming internal procedures and increasing the transparency of decision making. The United States responds by exercising informal influence less frequently, because the cost of doing so

publicly is prohibitive in all but the most urgent circumstances. In the long run, however, this causes the United States to reduce its commitment to the organization, and this may lead to institutional decline as other countries find the organization correspondingly less valuable.

This seems an apt description of the situation that prevailed on the eve of the global financial crisis of 2008, and in that sense the informal governance model offers an explanation for the crisis of legitimacy that the IMF was widely believed to face at the time. The United States had overplayed its hand over the previous fifteen years in a series of high-profile cases involving Mexico, Russia, Ukraine, Indonesia, Korea, Brazil, Argentina and Turkey. Many of these missteps took place in phases of IMF programs other than the design of conditionality—for example, in the cases of Mexico and Korea, the amount of access to IMF resources was critical. In the cases of Russia, Ukraine, Argentina and Turkey, U.S. pressure led the IMF to relax the enforcement of conditionality, which provided temporary relief to unstable governments, but ultimately caused these countries' economic policies to fail. Meanwhile, although borrowing governments appreciated U.S. help managing the Fund, resentment grew over the political and economic quid pro quos that the United States extracted in return. Furthermore, in the wake of the terrorist attacks of September 11, 2001, U.S. foreign policy focused single-mindedly on the Middle East and put low priority on developments elsewhere. International institutions, including the IMF and the World Bank, were increasingly viewed as instruments of that policy, and the priority of defense policy overrode considerations of building long-term communities of interest. Under the

administration of George W. Bush, unilateralism replaced multilateralism as a basic feature of U.S. policy.

As a consequence of these developments, countries that were able to exit the IMF-sponsored insurance regime chose to do so, and self-insured against international financial risks by undervaluing their exchange rates and accumulating international reserves. This was costly for these countries, tying up hundreds of billions of dollars that could have been used for investment in unproductive financial assets and transferring a substantial percentage of GDP to the United States in the form of seigniorage. In addition, this defensive strategy fueled the macroeconomic imbalances that helped to create the crisis that followed in the United States. Meanwhile, the Fund found itself virtually without customers, and since the interest it charges on its loans finances its operations, it announced plans in early 2008 to cut its payroll by 10 percent. For the United States, the consequence of the IMF's unpopularity was the loss of a convenient conduit of influence. The abuse of informal governance procedures tends to undermine the legitimacy of international institutions, and the exploitation of asymmetric interdependence tends to lead to its erosion. For the international system, the consequence of the IMF's legitimacy crisis was the weakening of a key advocate for open markets, economic reform and financial stability.

The perception of legitimacy problems within the Fund led to widespread calls for reform before the 2008 crisis. The Fund's public rhetoric acknowledged the legitimacy problem and for the first time adopted the view that the IMF itself had to be reformed, and the Executive Board adopted a number of documents designed to address these

concerns. None of these has so far touched the fundamental issues of the role of the strong Management and weak Executive Board, but they did lead to some procedural

Table 9.2: Changes in IMF Quotas, 2008

<i>Top Ten: Increasing Shares</i>			<i>Top Ten: Decreasing Shares</i>		
	<u>Change</u>	<u>Quota</u>		<u>Change</u>	<u>Quota</u>
China	0.88	3.81	United Kingdom	-0.64	4.29
Korea	0.61	1.36	France	-0.64	4.29
India	0.42	2.34	Saudi Arabia	-0.41	2.8
Brazil	0.31	1.72	Canada	-0.37	2.56
Mexico	0.27	1.47	Russia	-0.35	2.39
Spain	0.22	1.63	Netherlands	-0.3	2.08
Singapore	0.18	0.59	United States	-0.29	16.73
Turkey	0.15	0.61	Belgium	-0.26	1.86
Ireland	0.13	0.53	Switzerland	-0.19	1.4
Japan	0.12	6.23	Australia	-0.18	1.31

Source: www.imf.org. The table displays country quotas as percentages of total quotas.

changes in the handling of confidential information and the publishing of letters of intent. In addition, in order to shore up the legitimacy of the institution, formal vote shares and quotas were reapportioned in 2008. Table 9.2 summarizes the most significant changes. [Table 9.2 about here.] These changes do not correct the mismatch between the distribution of IMF quotas and the distribution of financial power in the world economy, although they move in that direction, but they do shift vote shares on the Executive Board away from the United States and its closest allies.

The second mechanism that the model identifies that can lead to reform of institutions is that change in the structural power of the United States affects the balance of formal and informal governance. For example, if outside options become less attractive to the United States, other countries will become less willing to accommodate

U.S. interests in order to induce U.S. participation in multilateral institutions. As a result, barriers to informal influence will rise, which will cause the United States to exercise its influence over common policies less frequently. Conversely, as U.S. power declines and the institutions become more formalized, the rest of the membership will find participation in common institutions more valuable.

After decades of resistance, the IMF seems likely to be headed towards reform either because U.S. misbehavior makes the status quo intolerable for the other powers or because the relative decline of U.S. structural power makes them less inclined to defer to U.S. interests. Whether the net effect is to weaken or strengthen the IMF, however, depends on the outcome of the race between U.S. decline and U.S. misbehavior. If the United States resists the temptation to abuse its informal influence while U.S. structural power declines, the effect will be to increase participation in the multilateral regime as it becomes more formalized. On the other hand, if unilateralism precedes structural decline, the net effect of reforming the IMF will be to cause the United States to disengage, leading to a general decline in participation in the institution.

Institutions and the Legitimacy of Cooperation

This book has set out a theory that contends that international organizations can best be understood as the product of the rational calculations of the leaders of states, which have conflicting interests and unequal power resources. Cooperation is generally possible if it is valuable enough to the participants, but the terms under which it takes place depend upon how power and interests are distributed. To the extent that the leading

state has attractive outside options and its participation is important to the other states in the system, they will be compelled to defer to its preferences over institutional design. However, to the extent that other states have attractive alternatives, the leading state will have to accommodate their interests as well if it regards their participation as desirable. In principle, a variety of exchanges could be made that would balance the interests of strong and weak states, but the only credible trade-off is one that allows strong countries to deviate from cooperation when their interests are intense—because they cannot commit not to do so—and transfers an extra share of authority in ordinary times to the rest of the membership to compensate. Informal governance, then, is for the benefit of powerful countries, and it allows powerful countries to avoid outcomes that they could not commit to tolerating. Lesser powers give tacit consent to informal channels of influence because they find the formal rules of the institution advantageous enough that they benefit on average from participating as long as the informal mechanisms are not abused.

This account of international organization has three broad implications.

First, the theory explains the variety of international organizations. The fundamental intuition is that institutional design balances the participation constraints of strong and weak countries. As a consequence, the balance that is struck between formal and informal governance in any particular institution depends on the distribution of issue-specific power and the issue-specific temptations that arise to overrule common policies. Alternative explanations for institutional design that focus on transaction costs are less persuasive, because they fail to provide a role either for power or for conflict of interest. While transaction costs surely explain some elements of institutional design, all

institutions are not efficient or Pareto optimal. The evidence presented here suggests that the most important elements of institutional design are explained by the distribution of power.

Second, the theory provides an account of the normative aspects of international governance. International organizations are legitimate in the narrow sense that they are subject to the consent of self-interested states, or the elites that control them, and that these states would not participate if rational calculations did not indicate that they would benefit in expectation. States consent explicitly to institutional rules and implicitly to informal procedures, and the institutions of the international system constrain their behavior in important ways and provide the menu from which many of their strategies are drawn. States have identified extensive areas of common interest, and most of these issues are governed by international organizations. The international system is not, therefore, well characterized by conventional notions of anarchy. As is true of all institutions, however, international organizations internalize elements of anarchy, in the sense that outside options are reflected in the informal governance procedures that define how the formal rules function in practice. International cooperation is negotiated, and the bargaining depends on the resources and outside options that states bring to the table.

Third, the theory provides a systematic explanation for the characteristic dysfunctions of international organizations. Powerful states delegate authority to international institutions, but they do so in ways that allow them to retain substantial degrees of control. Influential states manipulate the rules, insist on privileged treatment for their own interests, and exploit their control of the agenda, and these strategies undermine the ability of institutions to provide effective international governance. The

results are that international institutions suffer from credibility problems, that progress in forging new cooperative projects is slow, and that cooperation in many areas is blocked by the entrenched interests of founding members. These problems appear to be an inescapable consequence of the fact that international organizations exist in a system of states with unequal resources. However, there are important variations among institutions, and some of the major institutions of the international system have changed dramatically in recent decades, becoming more formalized as they have taken on new competencies. The evidence appears to support the theoretical prediction that international governance improves when the distribution of power becomes more egalitarian. This is a hopeful sign, from the vantage point of the early Twenty-first Century, as we anticipate the gradual decline of U.S. power and the rise of numerous competing power centers.