

Legitimizing the IMF: lessons from the Asian crisis

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**The candidate confirms that the work submitted is his own and that appropriate credit
has been given where reference has been made to the work of others**

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Abstract

The thesis sets out to answer three questions: what caused the IMF's apparent crisis of legitimacy in the aftermath of the Asian crisis, why were the subsequent reforms so limited and what does that apparent paradox tell us about the politics of IMF policy-making?

Criticism of the Fund's role in Asia was largely criticism of Fund performance but the performance issues fed into pre-existing difficulties with the relationship between the Fund's role and its institutional structures. Essentially, the Fund's role had expanded in developing countries and contracted in developed countries but its institutions remained unchanged. The result was a growing imbalance between institutions designed to ensure IMF technical authority and an increasing need for more political kinds of legitimacy. The increasingly intrusive nature of Fund conditionality has also changed the audiences for Fund legitimacy claims as cooperation from domestic populations became more important to secure implementation. The first part of the thesis explores these developments providing an analysis of the logic of the IMF's traditional legitimating justifications and a historical view of its evolution over time.

The second part of the thesis examines the political consequences of these growing tensions in the context of the Asian crisis. Through four case studies (Indonesia, Malaysia, Korea and the US) it explores the nature of the new conditionality, the politics of programme implementation, forms of political resistance that materialised, and the nature of the relationship between the Fund, states and civil society. It argues that moves to engage civil society have created some modest successes but are ultimately limited by the overall institutional framework within which they operate. Internally, the Fund remains an institution dominated by developed countries despite being principally responsible for developing country policy. It is also dominated by financial elites in both developing and developed countries.

Legitimacy is about the credibility of authority claims but the *political* significance of those claims lies in the extent to which they are able to attract political support and trigger political resistance. A combination of modest reforms, new arguments and public ambivalence or incomprehension have currently reduced political dissent but the possibility of further resistance, and therefore reform, in the face of subsequent crises persists while institutions remain unreformed

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Abbreviations

ABRI	The Indonesian army
ASEAN	Association of Southeast Asian Nations
<i>AWSJ</i>	Asia Wall Street Journal
BEM	Big emerging market
BI	Bank Indonesia
BK	Business Korea
BOK	Bank of Korea
BULOG	Indonesian government food distribution service
CCL	Contingent Credit Line
CPI	Consumer price index
DAC	Development Assistance Committee (OECD)
DAP	Democratic Action Party
DFID	Department For International Development (UK government)
ED	Executive Director
<i>EIU</i>	Economist Intelligence Unit
EOI	Export oriented industrialisation
EPB	Economic Planning Board (Korea)

¹ Abbreviations in italics are used in bibliographic references to newspapers, legal sources and journals

ESAF	Enhanced Structural Adjustment Facility
FDI	Foreign direct investment
FSC	Financial Supervisory Commission (Korea)
FSSA	Financial Sector Stability Assessment
<i>FT</i>	Financial Times
GAB	General Agreements to Borrow
GATS	General Agreement on Trade in Services
GATT	General Agreement on Tariffs and Trade
GDP	Gross domestic product
HICOM	Heavy Industries Corporation of Malaysia
HIPC	Highly indebted poor countries
IBRA	Indonesian Bank Restructuring Agency
ICA	Industrial Coordination Act (Malaysia)
ICMI	Association of Indonesian Muslim intellectuals
IFA	International Financial Architecture
IFI	International Financial Institution
ILO	International Labour Organisation
IMF	International Monetary Fund
IMFC	International Monetary and Financial Committee (of the IMF)
INDRA	Indonesian Debt Restructuring Agency
IR	International relations
ISI	Import substituting industrialisation
ITO	International Trade Organisation
JITF	Jakarta Initiative Task Force
<i>JP</i>	Jakarta Post
KAMC	Korean Asset Management Corporation
KCFTU	Korean Federation of Trade Unions
KCIA	Korean Central Intelligence Agency
KCTU	Korean Confederation of Trade Unions

KISDI	Indonesian committee for solidarity with the Muslim world
KKN	Corruption collusion and nepotism
KLSE	Kuala Lumpur Stock Exchange
KOPASSUS	<i>Komando Psukan Khusus</i> (special forces command, Indonesia)
LDC	Least Developed Country
LIBOR	London Inter-bank Offer Rate
LLR	Lender of last resort
LTCM	Long-Term Capital Management
MCA	Malayan Chinese Association
MD	Managing Director (of the IMF)
MFN	Most Favoured Nation
MLG	Multi-level governance
MOFE	Ministry of Finance and Economics (Korea)
MPR	People's consultative assembly (Indonesia)
NAFTA	North American Free Trade Association
NDP	National Development Plan (Malaysia)
NEP	New Economic Policy
NGO	Non-governmental organisation
NST	New Straits Times
NU	Nahdlatul Ulama (revival of the religious scholars, Indonesia's largest Muslim organisation)
NYT	New York Times
OECD	Organisation for Economic Cooperation and Development
OPP2	Outline Perspective Plan 2 (Malaysia)
PAS	Parti Islam Se-Malaysia
<i>PCIJ Ser A</i>	Proceedings of the Court of International Justice Series A
PDI	Parti Demokrasi Indonesia (Indonesian Democratic Party)
PDI-P	Megawati's 'new' PDI formed after her expulsion from the PDI
PMA	An Indonesian foreign investment law

PPP	Partia Parsatuan Indonesia (United Development Party)
PRGF	Poverty Reduction and Growth Facility
ROSC	Report on Standards and Codes
<i>SCMP</i>	South China Morning Post
SDDS	Special data dissemination standard
SDR	Special Drawing Right
SME	Small and medium sized enterprise
TNC	Transnational corporation
UMNO	United Malays National Organisation
UN	United Nations
UNCTAD	United Nations Conference on Trade and Development
USAID	United States Agency for International Development
USED	United States Executive Director (of the IMF)
USTR	United States Trade Representative
<i>WSJ</i>	Wall Street Journal
WTO	World Trade Organisation

1 Introduction

The IMF's response to the financial crisis that swept through Asia in 1997 provoked a level of controversy that, if not wholly unprecedented, had certainly not been seen since the debt crisis broke in 1982. 'Rarely in its 52-year history' according to the New York Times 'has the fund been under such concerted attack from so many quarters' (*NYT* 1st February 1998).

Criticism from left wing development economists and UNCTAD should not perhaps be too surprising (Akyuz, 1998; Kapur, 1998; UNCTAD, 1998; Wade & Venerosso, 1998a). However, criticism also emerged from far more conservative corners and achieved a far higher public profile.

One of the most ferocious critics was Jeffrey Sachs, who had previously been widely credited as the architect of big bang adjustment in Russia (Radelet & Sachs, 1998a; Radelet & Sachs, 1998b).

Jagdish Bhagwati, an enthusiastic long-term advocate of free trade, published a tirade against what he called the 'Wall-Street-Treasury Complex' arguing that pressure for free capital flows was undermining consensus behind free trade and giving globalisation a bad name (Bhagwati, 1998; Bhagwati, 2001). Joseph Stiglitz, Chief Economist at the World Bank, was quite critical while in office and positively vitriolic once he had resigned (Stiglitz, 2000). Perhaps most damning of all, Martin Feldstein, former chairman of the President's Council of Economic Advisors under the Reagan administration published an article in *Foreign Affairs* arguing that:

The IMF would be more effective in its actions and more legitimate in the eyes of emerging market countries if it...[confined itself to] maintaining countries' access to global capital markets and international bank lending...A nation's desperate need for short term financial help does not give the IMF the moral right to substitute its technical judgements for the outcomes of the nation's political process (Feldstein, 1998)

Dissent spread from academic papers to the international financial press. The *Financial Times* published a series of highly critical editorials and op-eds about IMF intervention with titles such as 'Capital Punishment' (Martin Wolf 17th March 1998), 'IMF is a power unto itself' (Sachs 11th December 1997) and a 'proposal' by George Soros calling for better regulation of international

finance (31st January 1998). Sachs was also featured in the *New York Times* ('The Wrong Medicine for Asia' 3rd November 1997). Even the *Wall Street Journal* was worried that the crisis was causing a policy backlash that was 'the most serious challenge yet to the free-market orthodoxy that the globe has embraced since the end of the Cold War' (4th September 1998). Indeed it published a series of calls to abolish the Fund, though these were largely because it interfered with the workings of the market rather than because it was damaging to developing countries (25th August 1997, 3rd February 1998).

In the US, IMF funding was hotly debated in Congress throughout 1998. A whole host of think tanks and eminent figures in the Washington establishment became involved including George Schultz, Paul Volker, Henry Kissinger, the Cato Institute, the Heritage Foundation, the Institute for International Economics and the Brookings Institute. There were calls for the Fund's abolition from both left and right-wingers.

In Asia too, there were rumblings of discontent. Kim Dae Jung, soon to be elected Korean president, declared the IMF's arrival a 'day of national humiliation'. Suharto argued that Indonesia needed an 'IMF plus' programme and that the IMF's policies were unconstitutional. Workers from the Korean Federation of Free Trade Unions (KCFTU) appeared on the streets of Korea bearing signs saying 'I'M F ired' (Malhotra, 2002) and the *New York Times* reported that

Almost every night in Thailand, a stream of television commentators chafe at the humiliation of witnessing their country's leaders negotiate every element of national economic policy -- from interest rates to budget deficits -- with economists who work largely in secrecy out of the I.M.F.'s offices off Pennsylvania Avenue (*NYT* 1st February 1998)

Discontent in Asia fed back into the debates in Washington. Kissinger's intervention in the debate was largely to warn of the potentially negative effects for international relations in Asia. Various Congressmen who visited the region in 1998 raised similar concerns in committee debates (see Chapter 8). After Seattle, protestors also took to the streets at the IMF and World Bank autumn meetings. The combination of these protests, violent unrest and police overreaction at the G7 summit in Genoa, and terrorism in the United States meant that in 2001 the Fund annual meetings had to be cancelled for fear of violent clashes.

The IMF was firstly accused of getting its policies wrong. The crisis involved huge outflows of capital from the Asian region, starting with speculative attacks on the Thai Baht in mid-1997. IMF analysis tended to stress aspects of domestic policy as key causes of the crisis, though there was an acknowledgement that the markets had overreacted. It tried to resolve the crisis by promoting market confidence through a wide range of structural reforms, different in each country but linked by a concern for 'market discipline' and by enticing capital to return with tight monetary and fiscal policy (IMF, 1997e).

For some, particularly but not exclusively on the left, its enthusiasm for free capital flows and the pressure exerted for liberalisation were the fundamental *cause* of the crisis in the first place (Bhagwati, 1998; Sachs, 1998; Wade & Venerosso, 1998a). High interest rates and tight fiscal policy

in the context of a huge credit shock made matters worse - a criticism raised particularly early by Sachs. A more appropriate solution would have dealt directly with the outflow of capital underlying the crisis through some form of debt work-out procedure. For others, on the right, IMF intervention reduced the incentives for governments to dismantle corrupt business-government relationships and prevented market discipline (Calomiris, 1998, *WSJ* 3rd February 1998). There was also concern about the appropriateness and relevance of the IMF's structural policies – particularly those mandating further capital account liberalisation.

However, arguments were not simply about IMF performance. More fundamentally they were about the IMF's legitimacy: whether it had the authority to become involved in capital account issues and whether it had the right to impose structural conditionality centred around good governance.

The immediate IMF response was to raise its media profile significantly with key staff making public speeches and publishing defences in journals and the press both in Asia and the West¹.

Later on a reform process was initiated in the context of wider discussions about a new 'international financial architecture' reflecting a growing acknowledgement that the crisis was caused, in part, by problems with the financial markets themselves rather than simply by poor domestic policy.

It is clear that the IMF has realised it has a legitimacy problem. Managing Director Michel Camdessus said during his retiring press conference that his biggest failure was that in spite of increased transparency:

We have not been able to change attitudes towards the image of the institution. There are still people around the world who can, without provoking an outcry, say that the IMF kills babies...we will have to continue working hard to explain that...these necessarily tough programs serve a common good (Camdessus, 2000b)

More explicitly, Stanley Fischer his Deputy gave a speech in Paris in which he talked extensively about the 'need to safeguard the legitimacy of the institutions that are involved in managing the [international monetary] system' arguing that 'The Fund for example, must not only operate in the interests of the international common good, but be recognized to do so by the public'. He stressed the need for transparency, surveillance that placed pressure on all countries (not just emerging markets) and accountability through representative channels (Fischer, 2000).

However, at least at the time of writing (spring 2002), the reforms that have taken place in practice have been quite limited. The IMF has: established an independent evaluation office; extended pre-existing moves towards greater transparency; expanded its surveillance to deal more explicitly with capital account issues; and undertaken a review of its conditionality with a view to greater focus. It has also been involved in a process of codifying a series of 'rules of the game' for international capital flows. However, these rules have largely been designed to encourage developing countries to

¹ All senior management speeches and press articles appear on the IMF website (<http://www.imf.org>) under the 'speeches' and 'views and commentaries' sections respectively.

adapt to market preferences rather than to deal with the instability of capital flows more directly (Akyuz, 2000; G7, 1999; G7, 2000; Ocampo, 2001). The hope is that better crisis prevention will resolve the problems without the need to forge international agreement around a more radical cure.

The reforms have been dominated by developed country 'experts' and have provided little opportunity for developing country political input. Although there has been significant movement on a few issues, the concerns of the G24 have largely remained unaddressed. Several high-level developing country officials I interviewed in Washington privately dismissed the entire international financial architecture reform process as largely irrelevant: for them at least it did not address the real issue of unstable capital flows.

This account suggests three questions that this thesis will address. What exactly caused the IMF's crisis of legitimacy? Why were the ensuing reforms so limited? What does the resolution of that apparent contradiction tell us about the politics of IMF conditionality in middle-income countries and therefore about the future prospects for IMF legitimacy?

Before going into more detail about how those questions are to be answered, I need to start by explaining what I mean by legitimacy and why I think it is a useful concept for analysing the IMF.

1.1 Legitimacy and power

The analysis is framed in terms of legitimacy for a number of reasons.

A legitimacy crisis followed by attempts at re-legitimation seems to provide a good description of what has been going on at the IMF over the last four years. The issues raised were not just about problems with particular aspects of performance. They related to far more fundamental questions about the Fund's appropriate role and even whether it should continue to operate at all.

Legitimacy is also a particularly appropriate concept with which to analyse an international financial institution. Like all international institutions, the IMF is reliant on state cooperation to achieve its purposes and must concern itself with securing government consent. Thinking in terms of legitimacy focuses attention not just on the internal politics of institutional decision-making but also on the issue of actors whose interests need to be taken into account if the IMF is to continue operating successfully.

In terms of political analysis, legitimacy is about both investigating the reasons actors might have for complying with an institution's directives and the strategic factors that determine when lack of conviction turns into political challenge. I will deal with these logical and more political aspects in turn.

Legitimacy and reasons for compliance

International relations writing from a rational choice perspective has provided useful insights about the circumstances in which inter-state cooperation can be beneficial (Keohane, 1984) and those in which it is likely to be difficult (Krasner, 1991; Mearsheimer, 1994). Writers like Keohane have

argued that international institutions can resolve coordination problems by providing states with reasons to trust each other's commitment to a cooperative strategy (the prospect of repeated interactions enhancing incentives to act cooperatively, greater information flow, collective sanctions etc.). Realists, on the other hand, such as Mearsheimer and Krasner have emphasised the problems that can occur when, even if everyone is better off because of the creation of an institution, the fact that some states gain more than others still threatens institutional legitimacy.

However, which impulse dominates depends to a large extent on how states define their interests – something that tends to be taken as a given in rational choice writing (Wendt, 1999). Uncertainty about economic causation means that it is particularly difficult to determine actors' interests objectively in the context of the international political economy² so *reasons* for compliance with an institution's directives are interesting objects of enquiry. What will reassure states that the relevant institution is providing a good deal? What accounts for uncertainty about that in different contexts and what methods of persuasion are available? What accounts for different actors' susceptibility to particular arguments?

Reasons for compliance are the essence of arguments about legitimacy. Exercises of power require justification³. That justification will need to show that power is being used to serve a purpose (provide a good) that compensates actors for the loss of freedom that springs from the exercise of power. A fully legitimate institution would therefore be able to claim that, even if it wasn't able to employ some kind of coercive sanction to back up its power, actors would have good reason to comply with its policies. In practice, of course, legitimacy is always a matter of degree and the justification given will involve a number of different elements some of which will be more persuasive than others.

The multi-faceted nature of legitimacy is important as it has sometimes led to confusion in the literature, particularly between different social sciences. Lawyers have been concerned with questions about whether power is exercised in a way that conforms with existing laws or rules. Philosophers have pointed out that this alone is insufficient and that we also need to know whether those rules can themselves be justified by some objective criterion of justice or right: whether an institution embodies a kind of power that any reasonable un-biased observer would, on reflection, accept as rightful. Finally sociologists and political scientists have been suspicious of this notion of objective moral values as both too demanding (since what matters is the views of particular actors that the institution is trying to control) and not demanding enough (in that the idea of acceptable 'on reflection' can deprive justifications of their practical motivational force). They have therefore tended to follow Weber in arguing that all we can say is that a structure of power is legitimate if those subordinate to it believe it to be so (Weber, 1968).

David Beetham argues that these different perspectives can be reconciled to some extent if we understand that we are looking for reasons for obedience but that those reasons will be complex

² On the difficulties of determining 'real human interests' more generally see (Geuss, 1981)

³ The arguments that follow are largely based on (Beetham, 1991) and (Beetham & Lord, 1998)

and comprised of a number of different elements. For a political understanding of legitimacy, we do, as social scientists, need to investigate the beliefs of actually existing relevant actors rather than some kind of objective philosophical justification. However, the relevant beliefs are wider than simply belief in the legitimacy of the powerful.

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

We can still therefore investigate *reasons* for obedience, albeit reasons for particular people at particular times and in particular places.

What kinds of reasons are involved? Some writers make a distinction between obedience based on self-interest (which they do not consider indicates legitimacy) and obedience based on some feeling of moral duty or on concepts of 'appropriate behaviour' that have been socialised. There clearly is a distinction here. One can imagine that obedience based on self-interest may be more transitory and in some respects less secure than the other two. In practice, however, these different kinds of motivation are likely to overlap⁴ and will be difficult to separate in terms of behaviour. I therefore take a broader view which is willing to ascribe legitimacy to an institution that actors obey simply because they believe it is in their best interests to do so⁵.

Philosophical and ethical views about justice and right will often be important in making the argument as will legal restrictions on the way power is to be exercised but legitimacy is multi-faceted and can take different forms under different circumstances depending on the role power is supposed to be serving.

Beetham argues that, since the underlying problem with the exercise of power is that it interferes with aspirations to freedom⁶, legitimating arguments are likely to have a particular logical structure in order to overcome this central concern. Power will be legitimate to the extent that:

1. it serves a purpose that is valued by relevant actors and which can therefore provide compensation for the loss of freedom involved in obedience (purpose and performance)

⁴ Consider the reasons why most people broadly obey speed limits when driving – habit (appropriateness), respect for the law or concern over potential danger to others (duty), fear of punishment or injury (self-interest). Usually some combination of these is operating simultaneously. Equally any socialised consideration of 'appropriateness' may well rely, ultimately, on a conception of 'enlightened self-interest' or will need to have had some such justification in order to become established in the first place – though in some cases it is possible for such habits to persist once their underlying rationale has disappeared.

⁵ I therefore consider the neo-institutionalist IR theories such as that of Keohane (1984) to be a subset of legitimating arguments. 'Best interests' is obviously a fairly wide ranging description and more or less inclusive conceptions of what 'interests' entail in terms of identification with other actors or concerns with a longer term perspective can have a strong influence on likely behaviour (Wendt, 1999)

⁶ I talk about 'aspirations' to freedom to signal the dangers of voluntarist approaches. In practice legitimating arguments will often involve discussion of the true counterfactual to compliance with an institution's directives – an agent's freedom is always constrained by the structures he/she confronts. Restrictions on freedom are therefore restrictions relative to an appropriate counterfactual – something I discuss further in Chapter 2

2. power holders can claim some kind of (democratic, charismatic, religious, technical, moral etc.) authority which qualifies them to make judgements and wield power in a way that serves the relevant purpose (authority)
3. power holders are restrained by a set of rules which ensure that their power is only used for that purpose (legality)
4. positions of authority are confirmed by the express consent or affirmation of appropriate actors and by recognition from other legal authorities (consent / legitimation).

The sense in which the first 3 aspects enhance legitimacy – provide reasons for compliance – should be readily apparent. They are designed to ensure that the loss of freedom involved in exercises of power is kept to the minimum required to provide the compensating benefit. The fourth part, legitimation and consent, is also partly about providing reasons for compliance. To the extent that an institution involves reciprocal obligations, evidence of consent by others is obviously an important factor. Consent by others may also provide an encouraging example or at least suggest that there will be little support for dissent thus offering further reasons for obedience – a futile challenge to authority is rarely a prudent course of action. Finally the very act of formal consent imposes a certain moral obligation and means that later derogation will have effects on the reputation of the country concerned⁷.

This very general conception of legitimacy is helpful when it comes to looking at international institutions. A key difference between these organisations and states (a more usual object of study in political science) is the fact that their jurisdiction is defined functionally rather than territorially. Since they perform particular tasks, the way they are legitimated will depend on the task that they perform, making it difficult to come up with a general account of the legitimacy of international organisations in the way that Hobbes' theory, for example, uses the centrality of security as a justification for political obligations at state level. Legitimacy problems may spring from changes in role; changes in decision-making methods; or changes in the beliefs and norms of relevant actors. The relationship between the tasks performed and institutional legitimacy will form a central theme of the thesis.

Legitimacy, power and politics

Ultimately the reason legitimacy matters for political analysis is that it helps us in understanding and ideally predicting behaviour. Why not, then, simply adopt a more traditional approach with a focus on power? In fact the two are difficult to separate in a context where interests are uncertain and are in part defined according to actors' technical views about economic causation. Here radical perspectives stressing the relationships between power and knowledge-as-ideology are suggestive,

⁷ Reputation effects are often (but not always) underestimated by realist writers. Developing country policy makers I interviewed at the Fund clearly regarded breaches of international legal obligations as a very serious matter (though of course that may have been partly a matter of self presentation). *In extremis* it is clear that states will be willing to breach such obligations (Krasner, 2000) but for much of the time the increasingly dense networks of interstate contracts make this a dangerous strategy, particularly for weaker states.

though for reasons I discuss below, only partly relevant to the current investigation (Adorno & Horkheimer, 1997; Foucault, 1980; Geuss, 1981). Writers like Stephen Lukes who argue that power is a deeply contested concept tend to do so because they are concerned about how one can talk meaningfully about exercises of power (persuading people to do something that is not in their interests (or perhaps that they do not believe is in their interests)) when those interests are partly defined through structures of knowledge which themselves are partly the products of particular forms of power (Lukes, 1986). Attempts to persuade actors that various things are in their interests – the process of legitimation – is therefore itself a form of power.

Similarly, the persuasiveness of ‘reasons for compliance’ is not independent of the consequences of non-compliance some of which will involve the exercise of coercive power. That is very much the point Hobbes makes about the need for sovereign power to back up any contractual settlement (Hobbes, 1991). My claim that, to be wholly legitimate, an institution should be able to persuade actors that compliance would be in their best interests even if the institution had no coercive power is therefore useful from a analytical point of view but more problematic when it comes to separating the effects that legitimacy has from those of power calculations.

That close power-legitimacy relationship might appear problematic for the thesis, particularly if my intention was to contribute to debates in IR theory about the relative importance of ‘ideas’ and ‘power’ in the international system⁸. Fortunately, my purpose is simply to come to a better causal understanding of the politics of IMF decision-making with a focus on the difficulties in securing implementation of conditionality and the implications that those difficulties may have for the politics of the IMF.

My choice to explore these issues in terms of legitimacy is not an attempt to deny the importance of power. It is rather a way into looking at power struggles which acknowledges that they are heavily influenced by actors’ beliefs in a context of considerable uncertainty. Analysis in terms of legitimacy also reflects an attempt to find a middle way between the kind of approach adopted in early ‘idealist’ IR writing about institutions which placed too much emphasis on their legal constitutions and a reaction against that approach that has tended to focus on countries’ power interests to the exclusion of any institutional analysis. What goes on within an institution is important in determining policy outcomes but analysis is insufficient without some exploration of the politics of implementation. That is particularly important in international institutions, which have to rely, largely, on outside actors to ensure enforcement and implementation.

Legitimacy draws attention to the relationship between what goes on within an institution and issues about cooperation outside it, partly because legitimation is itself a strategic exercise. Setting up justifications for the exercise of power places restrictions on the ways in which that power can

⁸ For an approach to legitimacy that does attempt to do this see (Hurd, 1999). Hurd takes a positivist approach in which ideas and power are largely separable and asks whether ethical considerations can persuade states to act against their own interests. My broader conception of legitimacy is partly an attempt to avoid this issue which I believe is epistemologically problematic and not particularly helpful in understanding behaviour.

be exercised without harming legitimacy. From the point of view of the powerful, the costs involved can be offset by the costs saved if the quality of cooperation is enhanced or costly coercion can be avoided. From the point of view of those whose compliance is desired the justifications offered will have varying degrees of persuasiveness and the quality of compliance will partly depend on the potential costs of various kinds of resistance. Discussions about legitimacy therefore always have power considerations in the background.

Legitimacy, methodology and the thesis

In the thesis, I proceed by examining the reasons that the IMF suggests various actors' have for compliance and looking at the circumstances in which those reasons are challenged in practice both within the institution and outside it. I then look at the ways in which the IMF responds to those challenges. The implication is that challenges to legitimacy, particularly in the form of failures to comply with IMF directives, send strong signals that the institution has political problems that need to be resolved.

What triggers this resistance can be understood to a significant degree by the relationship between legitimating arguments, beliefs of the audiences for legitimacy claims and institutional behaviour (i.e. in terms of legitimacy). Legitimacy is always a matter of degree and things need not get as far as an outside refusal to comply with IMF policy preferences before it is possible to talk about a crisis of legitimacy. Legitimacy is about the resilience of an institution's authority over time and even dissent and challenges that are not immediately threatening may send signals that should not be ignored about strains on institutional authority and the potential for future problems. How much reform is likely to take place, though, depends on which particular audiences start to find legitimating accounts less convincing and the resources those actors are able to mobilise (or threaten to mobilise) in order to press for political change.

.When I come to identify the most important audiences for legitimacy claims in the second part of the thesis - whose voices have most influence - I am starting to unpack the power structures behind struggles over legitimacy which I then use to assess the adequacy of current reforms. However the majority of the investigation tends to leave power considerations to one side in favour of understanding how actors perceive their interests to be served or threatened by the IMF - I am concerned to ask *why* political challenges arise.

This is an interesting question because so many issues surrounding the IMF's role remain uncertain. That is why persuasion is an important part of the dynamics of IMF politics. There is uncertainty about economic causation. That means that there is considerable uncertainty about what *is* in fact in various actors' best interests and about how much power various actors actually have to impose their will over the international political economy. That is one reason behind the heated debates over the continuing role of the state under globalisation. It is this potential for uncertainty about interests and power that makes legitimacy important. Reducing uncertainty and providing reasons to trust authority is therefore, as neo-institutionalist IR writers remind us, an important part of what institutions can do: a part of the aim of institutional creation.

It is in dealing with these issues of uncertainty that I depart from the radical approaches concerned with questions about ideology that I referred to earlier. Here again my political concern with understanding behaviour needs to be separated from more normative questions where actors' 'real' interests are important. I accept the position that interests are not simply given and are partly the outcome of contest over interpretations of reality (and therefore partly determined by power). However, in the context of the thesis I tend to accept actors' own perceptions of their interests without problematising them. I am largely agnostic about whether they are 'right' about which kinds of economic regulation will best serve their interests and leave that for the reader to decide – although it is obviously impossible to be entirely objective and my own views will probably become apparent.

What I do have to assume for the study to have some predictive power is that actors are broadly rational within the constraints of uncertainty – this of course is also a necessary assumption of Beetham's work since otherwise it would be impossible to construct *reasons* for obedience from actors' beliefs. If this were not so, it would be impossible to make any judgements about what exactly it was that was making legitimating arguments more or less persuasive in particular circumstances. At the very least it is important to recognise that legitimation is only possible where legitimating arguments are broadly credible, there are therefore practical limits on what legitimation can do without making real compromises over interests. There are clearly problems with making judgements about credibility to particular actors but, particularly where the audience for IMF legitimacy claims is largely one of elite technocrats, they are not insurmountable.

Overall, then, there are two central factors that make legitimacy a useful concept for exploring international institutions like the IMF. Firstly, the fact that the Fund has only limited coercive resources of its own and has to rely, at least in part, on the incentives provided by other actors to secure implementation means that persuasion (rather than coercion) is important and that the relationship between those inside the institution and those more indirectly involved cannot easily be ignored. Secondly, since different actors' precise interests and power resources are both unclear because of the technical complexities of economic causation, issues about how interests are defined and what kinds of power in fact exist are important objects of study. It is that uncertainty that provides space for various forms of legitimation: ways of reassuring actors, in the face of uncertainty, that their interests are being respected.

1.2 Outline of the argument

How are these concerns with legitimacy to be converted into a practical piece of political analysis? The overview provided at the beginning of this Chapter suggested that the IMF's role in the Asian crisis had triggered a crisis of IMF legitimacy. That is significant politically for the reasons I discussed in the previous section. Legitimacy provides actors with reasons for complying with institutional policy. If those reasons are logically weak, political challenge is likely, though whether it

materialises will depend on more strategic calculations. Challenges to legitimacy have the potential to force institutional reform, but, in keeping with my pragmatic political conception of legitimacy, only if they trigger sufficient levels of political mobilisation against key audiences.

Where those kinds of political challenge do arise, an understanding of the causes of political challenge in terms of legitimacy problems will provide suggestions for effective institutional reforms.

Who exactly 'key audiences' are in the case of the Fund is itself currently an unsettled question because of debates about the growing importance of 'civil society engagement'. Likely candidates though are the officials who represent states within the IMF, those in charge of negotiating conditional programmes in borrower countries, and sectors of domestic populations that are in a position to politically influence those two sets of officials. The relative importance of these different actors for IMF legitimacy is something the thesis aims to investigate and is discussed, particularly, in Chapter 9. It will depend on the resources that different actors can mobilise in order to damage the IMF's ability to achieve its aims and purposes.

We are now in a position to understand how the three questions I have set out to answer fit together. If the IMF suffered a crisis of legitimacy, it would be reasonable to expect significant pressure for change as a result. However, in the event reforms have been fairly modest. The question, then, is whether that was because the Fund's legitimacy crisis was a case of 'sound and fury signifying nothing' (Shakespeare, 1606) or whether the mismatch suggests that the Fund's legitimacy problems have not yet been resolved. Answering that question will tell us a good deal about the politics of Fund decision-making.

The starting point for the investigation must be to ask what it was that turned the IMF's performance difficulties in Asia into a broader crisis of legitimacy. Why did criticism erupt in response to those particular programmes at that particular time? Part of the explanation is that the Asian crises were particularly large and took place in high profile countries, threatening systemic stability, but there is more to it than that. To understand exactly what was at stake we need to start by looking more closely at the basis of pre-existing Fund legitimacy claims: the relationship between the Fund's avowed purpose, its institutional authority, its legal structures and evidence of formal consent.

I argue that the significance of the Asian crisis was its effect on pre-existing problems with the relationship between the Fund's role and its institutional structures. Essentially the problem relates to the balance between political and technical authority as the Fund's role has evolved in the face of changes in the international political economy.

When the Fund was set up at the end of the Second World War, it involved a negotiation between states about inter-state economic relationships. The Fund was to preside over a relatively tightly defined set of reciprocal legal obligations binding on all states. Within that framework there was some room for discretion, which was to be exercised on a technical basis by economic experts

representing countries in proportion to country economic significance. The Fund's authority was to be based on a legal framework benefiting from state consent, technical expertise within the Executive Board and limited claims to be a representative institution.

I start the thesis (Chapter 2) by reviewing the logic behind this initial account of Fund legitimacy in terms of the four aspects of legitimacy claims I explored above (page 7). The historical account is important partly because public statements the Fund issues to justify its legitimacy continue to emphasise historical continuity. It is also helpful because the Fund's institutional structures have remained largely unchanged as its role has evolved and the changing relationship between the two goes a long way to explaining the Fund's current difficulties. The approach is to use the Fund's own legitimating accounts set out on the Fund website, in speeches and policy documents as an initial point of comparison against which to evaluate the adequacy of Fund legitimacy on the basis of current performance. Obviously it should be expected that these accounts provide a somewhat rose tinted picture but they do provide a set of public criteria against which the Fund presumably expects to be judged. The further reality diverges from the justifications the Fund has been able to come up with the more likely it is that problems will emerge.

While the Fund's institutions demonstrate continuity, what has changed over time (as I show in Chapter 3) is that, with the collapse of the Bretton Woods exchange rate system and the rise of capital flows in the 1970s, the Fund's global regulatory role has declined, its symmetrical nature has been⁹ undermined, Executive Board discretion in relation to conditionality has greatly expanded.

In short, the Fund's role in developing countries has expanded as its political authority has become more problematic. During the 1980s, that role concentrated on promoting a strongly market-based agenda on the strength of a fairly widespread economic consensus. Essentially, Fund interventions were far more reliant on justifications based on technical authority. Difficulties with that market-based agenda and a growing willingness to question domestic political arrangements in an international context, both partly a result of the end of the Cold War, changed this agenda during the 1990s. The Fund became increasingly involved in institutional issues and 'good governance'.

That new institutional agenda made the Fund's policies more intrusive at a domestic level, raising problems for implementation and making it more difficult to separate the economic aspects of Fund policy from their social and political effects. The solution, in response to a variety of political pressures, has been to pay more attention to the political viability of Fund programmes leading to involvement with more political aspects of the good governance agenda and a willingness to 'engage' with 'civil society'.

Prior to the crisis, then, the IMF's authority amongst states had increasingly come to be based on technical authority rather than appropriate political accountability or consent to a legal framework. The promise was essentially that the Fund would mobilise private capital inflows in return for

⁹ Previously all states were subject to Fund discipline, all lent money to the common pool and expected to borrow. Since the 1970s the membership has split into lenders who are weakly disciplined by the Fund and borrowers who suffer more extensive interventions.

policy change in developing countries. For developed countries the bargain was one of providing accompanying financial assistance, in the form of loans to borrower countries, in return for a more stable environment for overseas trade and investment. At the same time, below the level of the state, the Fund's interventions were pushing in a more political direction in an attempt to secure programme implementation.

The Asian crisis was significant because it provided new information about the nature of these bargains and triggered political opposition at both domestic and international levels. It raised a number of important questions and provided some empirical basis for the answers.

What exactly did the Fund's new role, primarily involved with enhancing market confidence to 'catalyse' finance, entail? Given the political impact of the new measures, was the Fund an appropriate institution to evaluate the balance between economic imperatives and their social and political effects? Was its technical judgement just that or was it in fact marred by political bias given the Fund's institutional makeup? Was its technical judgement, in any case, reliable? If the IMF was to be involved in a political agenda, shouldn't that agenda also include politically progressive measures? Essentially, what were the costs and benefits to states of the Fund's new role under capital account openness?

Secondly, given the Fund's emergent contacts with civil society and increasing overlap between the role of the Fund and Bank, what exactly was the balance to be between different actors within the new multi-level framework of Fund governance? Who would be in charge in which circumstances (the Fund, the Bank, states, civil society (and which parts of it), the financial markets, bilateral lenders, powerful states)? What would the political consequences of that be? In what circumstances would it trigger resistance and from whom? What does that suggest about the politics of Fund policy-making, the need for reform and the future prospects for Fund legitimacy?

Chapters 4-8 explore the answers to these questions on the basis of a general overview (Chapter 4) and four case studies. The case studies are: two countries that accepted Fund programmes (Korea and Indonesia in Chapters 5 and 6 respectively); Malaysia (Chapter 7) which refused to go to the Fund, adopted an alternative strategy for crisis resolution based on capital controls, and raised very public challenges to Fund legitimacy; and the United States (Chapter 8) as the most powerful creditor country and the one in which debate was most heated and public.

Chapter 9 draws together the implications of the case studies and relates them to the post crisis reform process so as to answer the three questions with which the thesis began. Chapter 10 concludes by drawing together the most important lessons.

I argue that the crisis threatened the Fund's pre-existing legitimacy claims because the operation of financial markets in Asia cast serious doubts over the argument that such flows were automatically welfare enhancing. If the claim that free capital markets enhanced global welfare was increasingly untenable, an IMF role conceived of as enhancing market confidence could no longer be seen as

politically neutral. That immediately raised wider issues about Fund authority over developing country states.

The domestic politics of implementation also raised issues about the political nature of the Fund's institutional agenda for both state and non-state actors. Essentially civil society engagement was domestically popular to the extent that it helped to undermine authoritarianism and state intervention in the markets to assist powerful big business interests. However, the IMF's wish to replace that authoritarian system of political economy with a neoliberal minimal state was far less popular, though how much so depended on the social structure of the relevant society and the nature of pre-existing state intervention.

The IMF's role, then was highly political at both domestic and international levels. The lack of clarity over the nature of civil society engagement and the interests that were in practice taken into account when formulating IMF programmes left the Fund's political authority looking decidedly inadequate. Blurred lines of accountability made it difficult for different actors to tell who the Fund was in fact listening to and on what basis it was making decisions. Worse still, civil society engagement, designed to enhance the prospects for implementation at a domestic level, threatened to undermine the IMF's legitimacy with states while the politics of implementation suggested that state cooperation was in fact the most crucial factor in securing programme implementation. In any case, civil society accommodation seemed to take place within relatively narrow boundaries determined by the Fund's wider institutional framework in which developed country finance ministries were dominant. Without reforming that framework there were limits to what could be achieved through more intensive political engagement at a domestic level.

Nonetheless because of the politics of the interests involved (which I unpack in more detail in Chapter 9), post-crisis reforms have continued to concentrate on enhancing the Fund's technical authority in the interests of securing continuing capital market openness. They have not addressed increasing uncertainty about the nature of the relationships between an expanding network of actors involved in Fund decision making. They also fail to deal with the need to reassert political control over the financial markets, at least in developing countries.

I argue that this reflects a mismatch between the incentives that the Fund's institutional structures create for listening to different audiences and the audiences it needs to listen to if its role is to remain viable. Particularly problematic is the dominance of personnel from an economics background who are not intellectually well equipped to deal with the political problems that result. There is also a strong feeling that, pragmatically, trying to fundamentally renegotiate the political settlements involved will be too difficult. Reforms therefore tend to involve informal policy shifts, despite the fact that, based on my analysis, the fundamental problem with the Fund's institutional structures is too much informality and unclear (and inappropriate) lines of accountability. Political obstacles to change, though, are unlikely to be overcome without the impetus of more major crises or greater political unrest.

1.3 Scope and sources

Having reviewed the broad outline of the thesis, I want to spend some time setting out how it fits with existing literature. I do not aim to conduct a full 'literature review' as the pre-existing work is cited where appropriate in the course of the argument. However, it seems appropriate to provide some indication of what the thesis aims to achieve, what is covered elsewhere in the literature and what remains to be done. I will also use this section to provide an overview and justification of the sources I have used in the research the thesis draws on.

Scope

The thesis aims, primarily, to provide new insights into the politics of the IMF. There is already an extensive literature on the Asian crisis and, although my accounts of country experience pay more attention to the political aspects than much of the pre-existing work, I am not primarily interested in the crisis itself. I am more interested in what the crisis experience says about the nature of the IMF's role in middle-income countries at the turn of the millennium.

It is important to note that the thesis concentrates on middle-income countries rather than aiming to provide a comprehensive picture of the Fund's role in developing countries. Issues surrounding the HIPC (Highly Indebted Poor Countries) countries and the new PRGF (Poverty Reduction and Growth Facility) overlap at various points but, on the whole, are significantly different. Some of the scepticism that will emerge about the value of NGO participation, for instance, is less appropriate in the HIPC context. The power relationships between low-income countries and the Fund are also, sadly, likely to be even more problematic than those of relatively powerful middle-income countries such as those in Asia.

Nonetheless, the paucity of existing literature on the politics of Fund policy-making means that the politics of relationships with middle-income countries already raise more than enough important issues for one thesis.

there are remarkably few studies on the politics of Fund decision-making, perhaps because of the economic nature of the IMF's role. There are a wide range of excellent studies of the economics of conditionality (Edwards, 1989; Killick, 1984; Killick, 1995; Williamson, 1983). Some radical writers have pointed to the political *effects* of Fund programmes (Korner et al., 1986; Pastor, 1987; Payer, 1977).

When it comes to the causal factors that influence Fund policy in developing countries the literature is much thinner and rarely cited. There are three important studies of the politics of conditionality negotiations (Bartilow, 1998; Martin, 1991; Stiles, 1991) but none of them address the Fund's new governance conditionality. When it comes to the overall shape of Fund policy, the Fund's official histories and other books published by the Fund are helpful (De Vries, 1976; De Vries, 1985; De Vries, 1987; Horsefield, 1969; James, 1996) but are obviously not written from a particularly critical point of view. Ferguson (1988) is good on the events of the 1970s but, by now, rather out of date.

In any case there is no study that attempts to link these two aspects together, showing how conditionality fits within a wider context of Fund policy and how that context, in turn, is affected by the experience of particular Fund programmes.

Putting conditionality in the context of the Fund's wider role is important for two reasons. Firstly, that has always been the way the Fund has tried to justify it – conditionality is portrayed as a subset of the wider international obligations countries enter into when they join the institution. Secondly, looking simply at the negotiations involved in particular countries fails to emphasize the issues that are *not* up for negotiation – the wider system of obligations that are, to some extent, determined by the Fund's leading shareholders but that are kept off the conditionality agenda despite the way in which they provide the context in which conditionality can be justified as 'technical'. Although I concentrate on relationships with developing countries, then, I do also briefly explore the kind of territory covered by Pauly's (1997) work on surveillance amongst industrial countries but again I do not aim to add anything to the existing literature on those issues.

It is perhaps also important to note that the thesis does not aim to make any particular theoretical contribution to debates in the international relations literature. I sketched some of the relationships between my conception of legitimacy and pre-existing IR theory in section 1.1.

A combination of expanding institutional mandates for the IFIs and the rise of an increasingly vocal antiglobalisation movement has made issues around the legitimacy of international organisations an increasingly prominent issue but literature around legitimacy is only beginning to emerge in IR (Coicaud & Heiskanen, 2001; Hurd, 1999). That is partly because of the dominance of rational choice theorising. If actors' preferences are immutable and largely outside the realm of enquiry, it is difficult to understand the importance of persuasion in a context of imperfect information. A thorough discussion of these issues would take me too far from my primary purpose and is best left for another context.

In any case, one of the lessons I wish to draw from the thesis is the importance of particular and local factors for the kinds of economic issues the Fund is increasingly dealing with. IR theory is usually concerned with attempting to extract far more general laws of international behaviour and, to the extent that I think that is possible at all, I believe it would need to be done on the basis of a wider comparative study that would, again, dilute the messages that can be provided about the IMF.

Overall, then, the thesis aims to provide new insights about the politics of IMF policy-making in relation to middle-income countries. It does so through an examination of the threats to IMF legitimacy that resulted from the Asian crisis. That provides useful insights into how we should think about IMF reform in a way that pays appropriate attention not just to inter-state politics but also the politics of programme implementation and popular resistance, while acknowledging the limits that power relationships in the international system place on the prospects for radical change.

Sources

Legitimacy is fundamentally a matter of *public* justification. That is particularly so for justifications directed at actors outside the Fund's institutions. Even within them, though, there are few opportunities for developed and developing countries to sit around a table and discuss strategic policy issues with each other in private: that is why there has been so much enthusiasm from those invited to become involved in the G20 process, despite its limitations (Mohammed, 2001b). The sheer number of actors involved in Board of Governors¹⁰ meetings makes more intense communication difficult. The thesis therefore relies heavily on public documents: speeches, policy papers, public summaries of discussions and defences of positions published in the press or on the IMF website and these generally provide sufficient information for my purposes. The volume of such documents now published by the Fund is enormous making research much easier than it has been in the past.

I also conducted a small number of interviews with Fund insiders in Washington DC in autumn 2000. The interviews with developing country representatives were largely helpful in exploring the issues that *weren't* raised in public debate for strategic reasons. I also spoke to Fund External Affairs to get a perspective on their broader communications strategy as opposed to positions on specific issues. On the whole, though, interviews did not provide a great deal of information that wasn't already publicly available and merely confirmed perspectives emerging from published documents.

The case study chapters are primarily interested in the reception of Fund policies amongst outsiders: the non-financial arms of governments and wider society in both borrower and lender countries. Since I am concerned with 'key audiences' – those that are able to influence the implementation of Fund programmes, the policy positions adopted by elites within the institution, or the prospects for continued financing – it is not necessary to have detailed information on every aspect of 'public opinion'. Rather, what matters is the kind of opposition that features in public debate or is expressed in high profile civil unrest and protest. The case studies therefore rely on government speeches and extensive searches of the local and international English language press.

In all three Asian case study countries, there are English language newspapers that are widely read by elites and policymakers. Their *interpretation* of events needs to be read with a certain amount of care, as does the international financial press. The Asian papers tend to be written for prosperous elite audiences. The *Jakarta Post* in particular is also seen as a 'Christian' newspaper by many Indonesians. However, where the Asian popular press had significantly different views on issues these were usually referred to in the mainstream press, if only to provide a refutation. Any concern that my lack of linguistic competence has coloured the analysis can also be reduced by comparing my interpretations with an extensive secondary literature on each country written by authors without my linguistic handicaps.

In Western countries, the perception of events as reported in newspapers such as the *Financial Times*, *New York Times*, *Washington Post* and *Wall Street Journal* is also, obviously written from a

¹⁰ The Fund's highest decision-making body – see Figure 2-2 on page 25.

particular point of view. Nonetheless, it is often only the financial press that reports on events in Asia in any detail and these will be the sources that many policymakers use when formulating opinions on Fund policy¹¹. My principal lender country case study, the United States, as well as being the Fund's most influential shareholder, has a particularly open political system and transcripts of all Congressional committee meetings are available on Congressional websites. I make extensive use of these to analyse the debates that took place within US political institutions. I also interviewed key policymakers in Washington: Congressmen, Congressional staff and key NGO activists.

The only real limitation to the research is a lack of detailed information on the positions of developing and developed country officials from countries not used as case studies. Here, of course, there are limits to how much any one study can do. The approach I adopt is to build on general accounts of the negotiation process provided by informed observers combined with an analysis of the kinds of factors that influenced opinion in my case study countries to get a general conception of the kinds of factors influencing differences of opinion.

¹¹ That is certainly as far as legislatures are concerned. That was evident in the kinds of articles that Congressmen asked to have added to the record. It was also confirmed by interviews with Congressional staff and officials. Even figures in the Executive told me that they principally relied on media op-eds and journals like Foreign Policy and Foreign Affairs.

2 IMF legitimacy: core principles

In the Introduction, I argued that we could only understand the implications of the Asian crisis for IMF legitimacy in the context of a broader understanding of the ways the IMF had attempted to establish its legitimacy in the past. In this Chapter, I will set out and analyse the logic of the IMF's original legitimacy claims on the basis of Beetham's account of the form that such claims usually take (see page 7 above).

This original account is important because IMF speeches and documents continue to stress the continuity of the Fund's role over time. They argue that, although the institution has evolved, its core role has remained constant and the fundamental reasons why states should comply with Fund prescriptions remain unchanged. Whether that is an entirely defensible position is something I will debate throughout the rest of the thesis and particularly in Chapter 3. However, to anticipate a little, I will conclude that, since the IMF's institutions have remained largely unchanged over time, the fundamental logic of the IMF's early legitimacy claims remains relevant. Historical developments are important in changing the relationship between these institutional continuities and the Fund's contemporary role rather than in providing significantly novel forms of institutional justification. It is therefore important to investigate in some depth the precise nature of the Fund's original authority claims.

I begin by setting out a brief overview of the Fund's legitimacy claims (section 2.1). This overview is based on IMF publications, speeches and web-based documents. It obviously provides a somewhat rose-tinted picture of the way the IMF operates. It would be unrealistic to expect actual performance to correspond precisely to the account set out by the Fund itself. However, that picture is important because it embodies a set of public criteria against which the Fund presumably expects to be judged. The *degree* to which practice diverges from that picture will be significant in indicating the potential for political opposition and dissent to emerge. As I explained in the introduction, legitimating arguments need to be broadly credible if they are to be effective. If an

institution can only justify itself using arguments that have lost all credibility it has significant legitimacy problems. Which issues will lead to political problems in practice is an empirical question discussed in the case studies but an analysis of the logic of such arguments will provide a starting point for an understanding of issues that are in fact raised in practice.

The second part of the chapter (section 2.2) goes on to analyse the IMF account, exploring its logic and the boundaries that logic suggests to legitimate Fund action. I argued in the introduction that legitimating arguments needed to establish that: the limits to freedom that an institution imposed were compensated for by the good it served; and that its legal structure and institutions should give relevant actors confidence that it would serve this purpose and no other. Sections 2.2.1 and 2.2.2 look at the way these two arguments are made by the IMF. In the context of relationships between states, 'freedom' is closely related to the idea of sovereignty and section 2.2.1 concentrates on the relationship between the IMF's role and ideas of state sovereignty. Section 2.2.2 then looks at the ways in which the IMF's institutional framework is used to ensure that restrictions on state action are justified on the basis of consent, technocratic authority, reciprocity and representation.

Between them these sections provide a fuller explanation of the logic of the IMF's legitimating arguments and suggest some of their limits. In particular they stress that the IMF relies on a combination of technical authority and authority based on state consent. The overall legal framework within which the Fund operates is legitimated by state consent but, because of the nature of Executive Board decision-making, the discretion the Board exercises must rely heavily on technocratic authority. The balance between decisions made by the Board and those consented to by all states on the basis of equality is therefore highly significant. How appropriate that balance is will depend on the extent to which the kinds of decisions the Executive Board makes can be effectively justified in terms of technocratic economic calculation.

Finally, in the light of that discussion of the relationship between role and institutions, I bring the abstract analysis of the majority of the chapter slightly closer to practical issues in section 2.3 by exploring the ways in which the formulation of conditionality (the central interest of the thesis) relates to the overall logic of IMF legitimacy claims. Here again the relationship between voluntary state acceptance of programmes and Executive Board veto is important for Fund legitimacy.

2.1 The IMF's legitimacy claims: overview

2.1.1 Purpose

Fund staff argue that the IMF's role must be understood as part of the response to the breakdown of the inter-war Gold Standard and the Great Depression that followed. The key lesson learnt was that the maintenance of an open international economy required international cooperation around

an agreed code of economic conduct¹. When states had attempted to pursue their own economic interests at the expense of other states, the result was a breakdown of the international economic system that was beneficial to none. The core of the IMF's role was (and is) to provide a forum for that economic cooperation in the monetary sphere based around a code of conduct agreed by the membership. The system of free payments on current account that this cooperation would promote was a necessary adjunct to the system of free trade to be promoted by the Fund's sister organisation².

This role is at the heart of the Fund's purposes.

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

Its central role is to watch over the economies of its members to ensure that their economic policies conform to the code of conduct. Its unique role is as the only institution with a (more or less) universal membership that can impress on member states the interests of the global economic community as a whole in monetary matters (Guitian, 1992).

If one of the lessons of the Great Depression was that cooperation was required to prevent system breakdown, another came from the causes of that system breakdown. The Fund's architects realised that there were risks attached to the maintenance of an open economy. The temptations to resort to protectionist and beggar-thy-neighbour policies were particularly acute for countries forced to pursue deflationary policies to adjust to balance of payments deficits. Surveillance would reduce the risks to some extent but a crucial part of the Fund's purposes was to provide greater incentives for maintaining a system of current account openness.

Part of the solution was to allow greater exchange rate flexibility under IMF supervision so that adjustment could take place partly by devaluation rather than deflation. The other part was to:

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

¹ There are a number of 'lessons' from the Great Depression referred to in this section. There is still considerable dispute over the causes of the Depression (compare Freidman & Schwartz, 1963; Kindleberger, 1973; Temin, 1989 and Eichengreen, 1992). However, with the exception of the dangers of speculative capital flows (Freidman & Schwartz, 1963) there is broad acceptance of the major 'lessons' which appear in IMF accounts. On the need for economic cooperation see (Eichengreen, 1998). On the unacceptable costs of adjustment under the Gold Standard see (Ruggie, 1983) and (Dell, 1981). Burley (1993) is also interesting on the idea that the Bretton Woods institutions were an attempt to project the New Deal into the international sphere.

² Initially intended to be the stillborn ITO (see (Gardner, 1980)) but in practice the GATT and now the WTO

The IMF would provide finance as a sort of insurance policy for members so that they would maintain an open current account³ in 'normal' times in the knowledge that they could borrow funds to ease adjustment to any balance of payments deficits that might arise.

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

In other words, surveillance conditionality and financing are all interrelated parts of the Fund's overall purpose of enforcing the code of conduct (see Figure 2-1 for a diagrammatic representation). All members are obliged to observe the code of conduct and this obligation is enforced by the surveillance function.

Surveillance should minimize the occurrence of disequilibria. However, even effective surveillance will be unable to prevent the occasional need to adjust. Deficit states will need to adjust in ways that do not breach the code of conduct (hence conditionality) but are provided with finance to assist them in doing so.

2.1.2 Procedure and authority

Now that we have a picture of the tasks that the Fund is supposed to perform we are in a position to examine the *way* it operates. It should be possible to show that it is qualified to perform those tasks; that there are procedures in place to ensure that it does not use its power to pursue other purposes; and that it performs them in an appropriate fashion.

There are three overlapping types of justification that appear in Fund accounts. The first is a claim to be predominantly a technocratic economic institution making impartial decisions on the basis of economic expertise. The second is the legal one that Fund activities are carried out in accordance with the Articles of Agreement and are governed by the rule of law. The third is a broader claim that the Fund is a representative institution ultimately controlled by the wishes of its member governments.

The general principles and the parts of the code of conduct contained in the Articles of Agreement are primarily justified on the basis of consent and the rule of law. They have been accepted by the

³ It is important to note that there was never any similar obligation for capital account transactions and, indeed, the IMF was designed with the idea that capital controls were a necessary and desirable feature of the international economy. As we will see in chapter 3, this assumption has subsequently changed significantly.

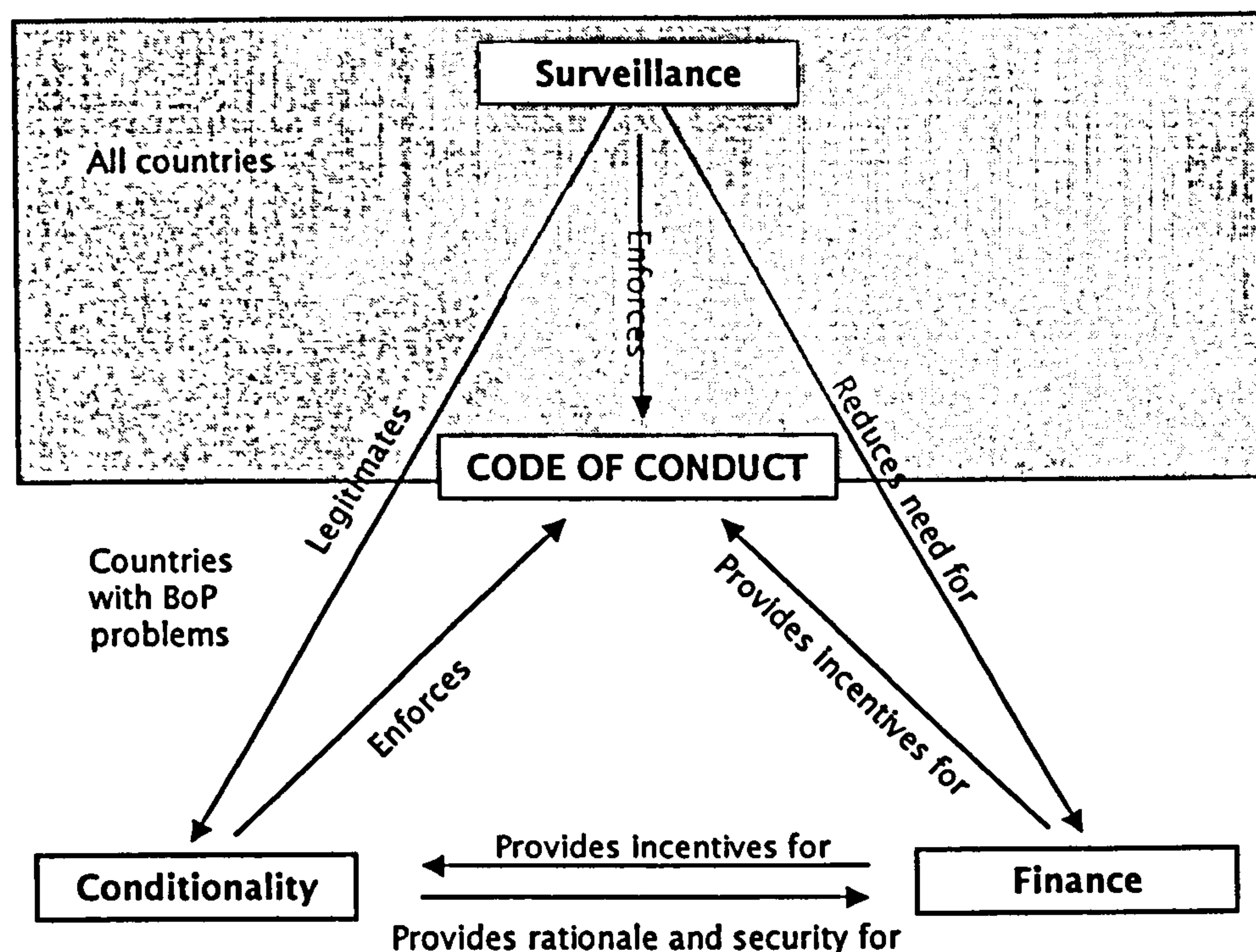


Figure 2-1: The IMF's role

membership on joining the IMF which is a voluntary act making them a legitimate part of international law. They also provide a set of rules that are equally binding on all member states and are applied uniformly to those states. More fundamentally, they are rational technical principles that will ensure the efficient functioning of the global economy, which explains states' willingness to sign up to them in the first place.

Amendments to the code of conduct, decisions on general policy, and general oversight of the IMF's operations are then justified by the fact that they take place within that legal framework, are largely technical decisions and are overseen by representative institutions:

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

There are two representative structures within the IMF (see Figure 2-2). The most senior body is the Board of Governors, made up of representatives (usually the minister of finance or central bank governor) from each of the Fund's member countries. The Board is advised by the International Monetary and Financial Committee (a smaller group of 24 ministers – one representative for each Executive Director) and the Development Committee (which has similar membership, advises on developing country issues and is a joint committee with the World Bank).

The Board of Governors hold annual meetings in which they exercise oversight of Fund policy at a very general level. The advisory committees are essentially a response to the difficulty of carrying

out meaningful discussion in a body with 192 members such as the Board. Most discussion takes place within the IMFC and IMFC proposals are rarely significantly modified by the Board of Governors

Day to day monitoring and immediate policy decisions are then delegated to the Executive Board consisting of 24 Executive Directors. The Fund's five largest shareholders (the US, Germany, Japan, UK and France) have an Executive Director each. Another three Executive Directors represent individual countries on a rotating basis (currently China, Russia and Saudi Arabia) while the remainder of the Executive Directors are 'elected' by a group of countries. Countries are grouped broadly by geographical region. The arrangements for selecting representatives vary between different groups. In some, one country is clearly more powerful than the others and always appoints the Executive Director, while in others appointments rotate. The existence of Alternate Executive Directors and support staff facilitates the representation of a broader range of countries⁴. Executive Directors are all drawn from financial ministries or central banks providing them with technical authority based on their expertise in economics. Part of their role is to represent their constituent governments but they are also officers of the Fund and paid from Fund resources helping them to take an objective view of the global economic welfare.

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

Where voting takes place in the Boards, votes are allocated in proportion to the amount that each country contributes to the Fund (its 'quota'). These quotas, in turn, are determined by a complex formula intended to represent a country's significance in the global economy⁵. This system of voting is appropriate, it is argued, since it means that those countries that contribute most to the institution and which have the greatest responsibilities for the maintenance of global monetary stability also have the most control. These responsibilities are demonstrated in the practice of surveillance where smaller countries' policies are merely required to be compatible with global economic conditions while larger countries are also required to take account of the effect their policies will have on the system as a whole (Guitian, 1992).

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

⁴ Lister (1984) and author interviews with developing country Executive Board members.

⁵ For discussions see (IMF, 2000c; Lister, 1984; Mikesell, 1994)

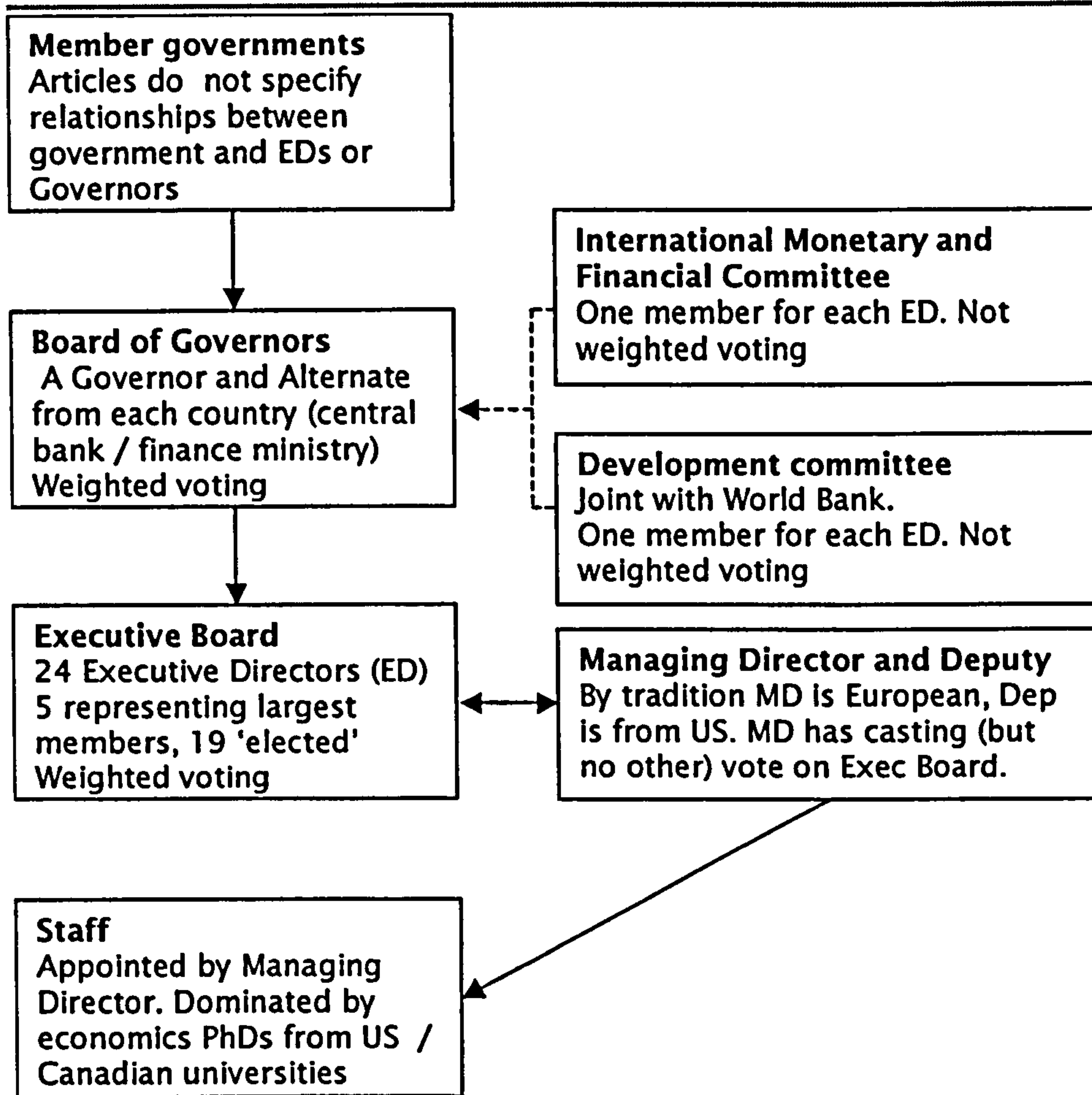


Figure 2-2: IMF decision-making bodies

The task of applying the code of conduct in the context of the Fund's surveillance and conditional lending activities falls to the staff in collaboration with key officials of the member government concerned. The IMF likes to claim that the measures incorporated in the letter of intent⁶ are chosen by the government concerned (Driscoll, 1998). The staff's job is to assist in their selection and to make a judgement as to whether they will produce a satisfactory adjustment within the time scale allowed for the programme.

The Fund is keen to emphasize that the vast majority of decisions are purely technical ones appropriately dealt with by the highly qualified Fund staff (Polak, 1991; Southard, 1979). Where there is a need to make judgements, the staff are guided by the principle of equal treatment given the circumstances of the country concerned.

The Executive Board closely monitors staff decisions and Executive Board reviews of previous programmes form an important body of precedent. Once programmes have been formulated by a

⁶ A document, signed by appropriate domestic authorities, outlining the policies that will be adopted in exchange for funding

staff mission sent to the country concerned, they are moderated against other programmes by the Policy Development and Review Department for equality and consistency. They are then submitted via the Managing Director to the Executive Board for approval. The Executive Board almost always agrees programmes since it would be impractical for a staff mission to return to a country to re-negotiate conditions. However, if the Board is unhappy about a programme it will attach a memorandum to a letter of intent to that effect for the staff's future guidance (Stiles, 1991).

The overall picture is one of a technocratic institution operating within a broad legal framework set out (quasi) democratically by its membership. Within these broad parameters, surveillance and the determination of conditionality are largely technical exercises. They are therefore entrusted to a technically qualified staff of experts. General oversight is provided by *ex post* accountability to the Executive Board.

2.1.3 Legality

IMF business is regulated by the Articles of Agreement. All countries consent to their terms when they agree to join the institution. Membership is voluntary and countries are free to leave at any time. The Articles set out members' central obligations, the purposes of the IMF and the procedures and practices for decision-making within the organisation. Additional rules and guidelines can be formulated over time through decisions of the Executive Board and Board of Governors. The legal framework leaves considerable room for discretion but this is necessary given the complexity of the economic issues involved and the importance of tailoring policy to the specific circumstances of the countries concerned (Guitian, 1992).

2.1.4 Consent

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

2.2 Analysis

How convincing is this account of IMF legitimacy? Ultimately, that is a question that can only be answered for particular audiences at particular times in particular places. Anything like a definitive answer will have to wait until the end of the thesis. However, I argued that, to acknowledge the particularity of legitimacy is not to divorce it entirely from reason. Broad credibility can be assessed by examining the logical strengths and weaknesses of the claims made, even if final judgements need to be made in the light of more empirical evidence.

This section will therefore explore the logic of the IMF's authority claims at quite a fundamental level. Understanding how those claims actually work will also clarify their limitations giving us the

underlying logical basis for later debates about IMF legitimacy in more specific contexts. It will help us to see what it would be necessary to believe in order to find the IMF legitimate and therefore to understand some of the reasons behind dissent when we move towards more practical considerations in the rest of the thesis.

As I showed in my discussion of legitimacy and power in Chapter 1, the essence of legitimacy arguments is the relationship between the role institutional power claims to serve and the nature of the restraints and safeguards in place to ensure that it does so. The analysis begins with an investigation of the relationship between the goals the IMF claims to serve and the restrictions it imposes on state freedom. These kinds of arguments are usually made in relation to the idea of sovereignty and the analysis follows that pattern, beginning with a discussion of the concept of sovereignty itself. Section 2.2.2 goes on to explore the adequacy of the procedures and authority structures that the IMF claims ensure it does operate in accordance with those purposes.

2.2.1 IMF power and purpose: sovereignty and counterfactuals

In the international realm, a state's freedom of action is traditionally referred to as its sovereignty. At its most fundamental, this is a claim that there should be one final site of political decision making for each territorial unit – the state. That state should therefore have exclusive jurisdiction over domestic matters and be entitled to act as the sole international representative of its citizens.

Unfortunately, sovereignty is a complex concept and the word is often used for different purposes by different authors. For my purposes, it is important to distinguish between a state's legal sovereignty (the issues over which it could technically legislate without international interference) and its practical efficacy (the goals that it could realistically expect to achieve). It is also important to try and make a distinction between issues that are *prima facie* domestic – and therefore fall within a state's exclusive jurisdiction unless it negotiates an agreement that says otherwise – and those which are always international and therefore can only be regulated by agreements between states.

I wish to argue that, in terms of my broad conception of legitimacy, it is important to understand what a state has given up by agreeing to be a member of the IMF. That involves identifying its *prima facie* legal sovereignty and its likely practical efficacy in the event that it had retained that *prima facie* sovereignty.

These are in fact difficult tasks because there is no obvious counterfactual situation to use as a comparison. Nonetheless, this section looks at the historical evidence of the 1890s and 1930s to provide some idea of the relationship between the IMF's purposes and the likely consequences of a *laissez faire* attitude to international monetary policy. It concludes that states have agreed to place greater restrictions on their legal jurisdictions than they did in the past but that the differences are less obvious in terms of their practical efficacy. The IMF's purpose is potentially justifiable but the way in which it actually carries out its functions will determine whether it turns out to be legitimate in practice.

Sovereignty

The concept of sovereignty was developed gradually as part of a process of social and political change in early modern Europe. It involved a concentration of political power at the level of the territorial state, against the power of aristocracy below the level of the state and against the power of the Church and Holy Roman Empire above the level of the state (Hinsley, 1986; Spruyt, 1994).

At the domestic level, this concentration of power was always justified on the basis that there was a need for a single institution that could act as the ultimate arbiter of political conflicts within a particular territory and which was endowed with the coercive resources to enforce those judgements (Hinsley, 1986; Hobbes, 1991). It was essential if the state was to be able to provide the security that its subjects expected of it (Bodin, 1606; Hobbes, 1991)

At the same time, both the logic of the justification for unified domestic sovereignty (Hinsley, 1986), and the practical advent of increasingly frequent interactions between states (Spruyt, 1994; Thomson, 1994) required some recognition of the claims and interests of other sovereign states. While claims to domestic power implied a narrow striving to maximise a state's freedom of action on behalf of the interests of its citizens, the imperatives of an increasingly international world trading system required compromise with other states in the interests of mutual security (Thomson, 1994) or prosperity (Spruyt, 1994). In particular (given the potential for the spread of religious conflict through Europe) states agreed that they would negotiate international agreements with each other without becoming involved in each other's domestic affairs.

Of course, the concept of sovereignty has not stood still since then in either its domestic or international manifestations. Internationally, the qualifications for sovereign recognition have varied over time. In the present context it is significant that the formation of the IMF coincided with an unprecedentedly generous definition. Not only were no questions asked about a state's positive ability to govern and defend its population, but additionally there was (only partly successful) pressure to extend states' formal equality (in the sense that they had to deal with each other and were free to contract with each other without being formally subject to any higher authority) to a more substantive equality under which states had a right to equal representation in international fora (Hinsley, 1986; Jackson, 1990). To some extent, the maintenance of the sovereignty regime has always been a collective project by states to enhance their internal and external power through international support. However, the post-war multilateral institutions with their legal structures, formal procedures and recognition of all states took this process to another level⁷.

Domestically, the principle debates have concerned the related questions of the extent to which sovereignty must be constituted as *popular* sovereignty and of the legal limits that might need to be placed on sovereign power. Although the idea of popular sovereignty is theoretically accepted almost everywhere, in practice it is ultimately incompatible with the idea of a need for a final arbiter

⁷ On the novelty of the post war institutions see (Ruggie, 1993) and particularly (Burley, 1993)

that forms such an important part of the concept of sovereignty⁸. For liberals popular sovereignty also threatens the wish to protect private property from the reach of the state. *Popular* sovereignty has therefore tended to be diluted by the introduction of representative institutions and the maintenance of a sovereign state, albeit one that is subject to some form of popular control. State power, even when subjected to popular control, has tended to be subjected to the rule of law and to various kinds of constitutional limitation to avoid the tyranny of the majority.

Although this thesis is largely about international relations, the domestic debate is important because, with the advent of popular sovereignty, one of the key claims to the right to sovereign self-determination springs from the republican or perhaps communitarian idea that the sovereign state articulates the will of a particular community with its own right to self-determination. Particularly since the Enlightenment, there has been distinct scepticism about the ability to articulate any absolute conception of the human good leaving most questions of appropriate 'ends' to be decided through debate, compromise, and political struggle within particular communities. Indeed liberal attempts to put constitutional limits on state power are precisely designed to limit the kinds of ends that the state might attempt to aim at. The authority for such goods as are articulated is then based on their articulation by the sovereign power at the end of such debates and struggles – their status as the outcome of political struggle within a community, a nation state. This kind of authority claim therefore adds additional weight to the claim to sovereign autonomy, something that needs to be overcome if an international institution is to successfully claim authority over such a collectivity⁹.

Nonetheless, none of that subsequent debate alters the fundamental conclusion that state sovereignty is based on the mutually accepted principle that, for reasons of national and international security and prosperity, there must be one final arbiter of political conflicts within each territory. It involves asserting:

1. a claim to be the single representative of a subject population authorised to negotiate *international* agreements on their behalf; and
2. a claim to a right to non-interference in *domestic* affairs except with sovereign consent in return for extending the same courtesy to other states.

⁸ I do not wish to imply that Hobbes' theory, for example, is incompatible with democracy. There is no reason why Hobbes' sovereign should not be democratically accountable (although that might be problematic given Hobbes' epistemological convictions). The point I am making is that, in the absence of universal agreement, there is a need for some procedure for making a final decision between competing interests and points of view. The problem is most obvious for theories like Rousseau's that conceive of a 'collective will'. Representative institutions and a modern bureaucracy are the common contemporary solution to this problem.

⁹ This discussion is fairly condensed but I hope not particularly controversial. On the idea that goods are defined by and within a particular context see for example (MacIntyre, 1985), though of course MacIntyre is no great supporter of the 'compromise' and 'political struggle' that tend to be involved in determining the 'good' in contemporary societies. A similar position underlies a range of modern ethical theory based around the idea of some form of idealised human agreement as the basis of ethics (Habermas, 1987; Rawls, 1972) though other authors (notably Habermas) are more optimistic than me about the scale over which this sort of inclusive dialogue might take place. My account of the relationship between sovereignty, popular sovereignty and constitutionalism is based largely on (Hinsley, 1986, 144-157) and (Fontana, 1994). The point about the influence of popular sovereignty on international authority is my own – for support see the discussion in Chapter 3 (see also Woods, 1999).

Economics and the national/international boundary

This is still the basic principle enshrined in international law.

The principal corollaries of the sovereignty and equality of states are (1) a jurisdiction, *prima facie* exclusive, over a territory and the permanent population living there; (2) a duty of non-intervention in the area of exclusive jurisdiction of other states; (3) the dependence of obligations arising from customary law and treaties on the consent of the obligor (Brownlie, 1998, 289)

Of course, in practice the principle of non-interference has always been something of an uneasy compromise. As realist writers are keen to remind us, states are far from equal in terms of material and ideological resources. There is no overarching authority to enforce compliance with such principles and they are sometimes breached (Krasner, 2000). However, breaches occur against a background of general compliance (Hurd, 1999) and the basic principles of international law are at least universally acknowledged¹⁰.

In any case the principle itself is quite limited. States have a *prima facie* exclusive jurisdiction in the domestic realm but the actual boundaries of this 'reserved domain' are constantly being re-written by international law. For international lawyers, the reserved domain is simply

the domain of state activities where the jurisdiction of the state is not bound by international law and varies according to its development (Brownlie, 1998)

Indeed, if we were interested in IMF legitimacy from a purely legal point of view this legal demarcation of jurisdictional boundaries would be sufficient. It would be clear that IMF power was unproblematic because both IMF membership and the acceptance of conditional finance are, as we have seen, voluntary activities. They are legal agreements ratified by the consent of sovereign states.

However, given that my conception of legitimacy is broader than that and is concerned with the ways in which rules can be *justified*, we need to look a little deeper. It is obviously important that states *can* decide to limit their own freedom of action in the interests of a broader good. So the international court of justice

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

What is important is to establish what exactly has been given up and what has been gained when they decide to do so.

¹⁰ Realist writers are keen to stress the disadvantages of the sovereignty regime in restricting states' foreign policy freedom. Other writers have pointed to the advantages. To the extent that a system of sovereign states becomes institutionalised, demonstration effects and mutual recognition can boost states' domestic legitimacy (Beetham, 1991; Jackson, 1990). More importantly for strong states, there are clear advantages in the existence of a single entity capable of contracting and treaty making on behalf of the population of a given territory - as demonstrated by the difficulties in making meaningful trade arrangements with the Hansa league (Spruyt, 1994). The system can also facilitate arrangements for the maintenance of international security (eg. Eliminating maritime piracy Thomson, 1994).

The arguments then are still ultimately about the extent to which the restrictions imposed on states' freedom of action by the IMF are justified in the interests of serving its wider purpose. The point about raising these issues as questions about *sovereignty* though is to make a point about the extent of those restrictions. It is to assert the principle that decisions made at the level of the sovereign state are fundamental, for the reasons I discussed in the conceptual section above. The benchmark position is a state's exclusive jurisdiction over its domestic affairs. Any modification of this jurisdiction is something that must be negotiated – it cannot legally be taken away by force and the assumption in the event of doubt is that an agreement does not do so (Brownlie, 1998). Since macroeconomic issues are (so the argument goes) domestic issues, the point of comparison for the relative benefits of institutional membership becomes that of a nation state free to make its own decisions and the IMF's mandate must be interpreted so as to minimize derogation from this principle.

Apart from the importance of the fact that states can be seen to consent to IMF authority (see p36 below), there are two principle lines of attack on this argument about sovereignty both of which in fact have similar implications. The first is to question the extent to which macroeconomic policies really are domestic policies (and therefore *prima facie* immune from international regulation). The second is to point out that any reasonable assessment of what is being given up by this abandonment of sovereignty (if such it is) must also take into account the full consequences of each state's wish to continue to order its macroeconomic affairs as it sees fit. Effectively both claims revolve around the importance of identifying the correct counterfactual to acceptance of IMF authority and compliance with its prescriptions – the implication being that the IMF's intrusions are inevitable in the face of states' commitments to mutual prosperity.

Sovereignty and the monetary system before the IMF

Appropriate counterfactuals are notoriously difficult to identify and are always ultimately a matter of contestable judgement (Hawthorn, 1991). However, the obvious place to look for what evidence does exist is the history of the pre-war global economy, particularly as we are invited to do so by the IMF's own legitimating account that focuses on the experience of the Great Depression.

On the one hand, it is clear that macroeconomic policy did historically fall within the formal domestic legal jurisdiction of sovereign states. The Gold Standard system that emerged in the 1870s was the outcome of the individual choices of a series of different governments – albeit to a greater or lesser degree under the influence of British financial hegemony¹¹

That is not to say that there wasn't a high level of informal international coordination and even cooperation. Central Banks tended to follow the lead of the Bank of England in setting overall levels of discount rates (and therefore economic activity). In times of crisis central banks were even willing to lend reserves to their international counterparts. However, there were no international agreements institutionalising a requirement for them to do so.

¹¹ Except where indicated otherwise, this section relies heavily on (Eichengreen, 1998)

On the other hand it was a system built on a strong political commitment¹². This was particularly clearly demonstrated in the inter-war years when commitment began to break down. It was a commitment to the importance of currency stability over the importance of domestic economic growth or unemployment, at least in the final instance. In a sense it was an internationalist commitment (in that it valued international economic relations over domestic considerations). More importantly, it reflected the lack of representation of the working classes that existed before the extension of suffrage and growth of labour parties in the early 20th century¹³ (Ruggie, 1983).

The economic instability of the interwar years was, of course, driven by a complex range of factors that are still not well understood. A key part of the breakdown, however, was a growing feeling that governments could not be absolutely relied upon to put the goal of exchange rate stability above all others. In the past, when countries appeared to be suffering from balance of payments problems, finance would flow in anticipating the inevitable rise in central bank discount rates thereby moderating the need for such rises. A combination of floating exchange rates, greater financial speculation and greater uncertainty over the adjustment process as a result of political pressure undermined this mechanism and made adjustment considerably more difficult¹⁴.

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

For defenders of the IMF the point is clear. The maintenance of a functioning international economy has always relied on international political coordination – either explicit or implicit. The lesson of the Great Depression was that, once the international political commitment to currency stability over domestic politics had evaporated, the growing complexity of the compromises involved in the maintenance of a global monetary system required some kind of institutionalised cooperation to reduce the risk of another system breakdown (Ruggie, 1983).

Although it may have been possible to run the system without any restrictions on nominal sovereignty during the Gold Standard period, that was only because, in practice, states could be

¹² Contrary to the nostalgia that some liberals still feel for what they believe was a golden age characterised by an apolitical, 'natural' self-regulating global economy.

¹³ And perhaps the lack of any formal economic theory linking deflation with unemployment (Eichengreen, 1998) (though the absence of such a theory was probably not unrelated to the limited political influence of the working class).

¹⁴ Whether the blame should lie with speculators (Nurske, 1944) or with governments for providing them with opportunities (Freidman, 1953) remains a matter of dispute

relied upon to restrict themselves to particular kinds of action. They were politically committed to deflationary adjustment. Once this ceased to be the case, there was no real choice but to institutionalise new commitments moderated to reflect the new political reality.

Developing countries, adjustment and debt

While this is the standard story about the operation of the Gold Standard prior to the Great Depression, it is based very largely on the experience of countries at the centre of the system in Western Europe and to a lesser extent the United States. Independent countries at the periphery – particularly those in Latin America¹⁵ – never benefited from Gold Standard international cooperation or the ‘automatic’ adjustment system.

Robert Triffin argues that adjustment in Europe in fact took place to a large degree through adjustments in capital flows from the centre to the periphery rather than through adjustments in national prices and wages. Central bank discount rate changes in Europe could have significant effects on these flows but capital importing countries had far less control and therefore found adjustment more difficult. They tended to experience pro-cyclical flows that would boom when European economies were strong (and export prices high) and dry up when export prices fell as growth slowed in Europe and capital was repatriated.

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

This relationship helps to explain the fact that, although adjustment under the Gold Standard was theoretically deflationary, it was only after the collapse of the Gold Standard in the 1920s that significant wage and price declines actually took place in developed countries (Triffin, 1964, p4).

How were the periodic crises that resulted in developing countries dealt with? The answer depended on the size and cause of the debt crisis; the strategic position of the debtor country; the type of finance involved and the broader macroeconomic environment of the time.

At the most notorious extreme were late 19th century British interventions in Egypt and Turkey where debt problems were used as an excuse for virtual colonisation but these are very much the exception rather than the rule¹⁶.

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

¹⁵ Conditions in the colonies were different again with domestic monetary policy often directly subordinated to the interests of the colonial monetary authorities - see particularly (De Cecco, 1974). I concentrate on Latin America here because the analogies with ‘independent’ developing countries today are clearly closer.

¹⁶ Lipson, in similar vein, argues that gunboat diplomacy in Latin America was usually in response to some more serious issue such as breaches of international law in the way that creditors were treated (Lipson, 1989)

As Palmerston put in the 1840s

the British Government has considered that losses of imprudent men who have placed mistaken faith in the good faith of foreign Governments would prove a salutary warning to others (Lipson, 1989, 195)

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

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

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

It is difficult to come to easy generalisations as to the treatment of debt problems prior to the creation of the IMF since the general economic climate, the type of debt, and the political nature of the relationships involved all had an influence. What is clear though is that the decision was (almost always) made by a free sovereign state on the basis of its preferred relationships to creditors and the financial markets at large rather than in relation to any set of politically agreed rules or negotiations between states.

Conclusions

In legal terms it is clear that countries retained a broader jurisdiction over their monetary affairs before the IMF was created. On the other hand, the imperatives of the global economy still placed considerable restrictions on what they were able to do in practice.

The IMF was created largely in response to a political change in which industrial country governments began to play a more ambitious role in economic regulation in ways that complicated international economic cooperation. It was designed to support those more ambitious, socially

directed state interventions in the economy by instituting some political control over international financial markets.

Developing countries always had less control over their economic environment and were subject to greater restrictions. In particular they were unable to avoid periodic defaults involving painful economic retrenchment or negotiation with external creditors. The choices they made, though, were clearly choices about their desired continuing relationship with external capital markets weighted against various kinds of domestic cost. The relationships were by and large with the international economy and private markets rather than with other states.

Again the picture is one of little inter-government interference in the workings of the market and therefore a wide conception of sovereignty. On the other hand, there was only very limited real freedom of government action and the overall position was far from satisfactory.

The IMF has institutionalised what were previously haphazard relationships. In a sense, at least in developed countries, this is a response to efforts to *increase* government power over the economy, broadening the scope of domestic sovereignty in response to growing demands on state performance pressed from below. However, this could only be achieved through a cooperative effort: by pooling sovereignty in an international context.

What the effects of this have been on individual governments cannot be determined without a far more detailed investigation of the IMF's exact powers and their effects on different countries in different contexts. Generally, though, it is difficult to argue that states have collectively become less powerful as a result of the creation of the IMF. The degree of institutionalisation of the arrangements set up at the end of the Second World War, with their clearly defined multilateral legal obligations and guarantees of representation for new nations reflected a new respect for the sovereignty of weaker states (Jackson, 1990) and were a new departure in international regulation (Burley, 1993) (Ruggie, 1993). Nonetheless, as we have already seen, although there was respect for sovereign equality (reflected particularly in the fact that 14% of the votes in the IMF were distributed equally amongst member countries before quotas came into play) it was tempered by considerations of differential national power.

There remains, therefore, considerable room to question the extent to which particular restrictions on the actions of *individual* states are in fact necessary to accomplish the IMF's general purpose. The issue is not whether states could control their economic environment without some kind of international agreement, it is about the extent to which the agreement that does exist provides them with a good deal relative to possible alternatives. The historical practices reviewed in this section give some idea of what those alternatives might be and therefore provide important background for the rest of this chapter and Chapter 3. At the same time, the world is simply different now and any assessment of their relevance will have to take account of these changes.

I will return to the question of sovereignty in Chapter 3 and Chapter 9, in the meantime I will move on to a review of the way the IMF does in fact operate and particularly the safeguards that are in

place to ensure that it provides states with the maximum economic benefits at a minimum economic and political cost.

2.2.2 Institutions and authority

In the previous section, I argued that there was a strong argument for some kind of institution to provide a forum for the international monetary co-operation that the IMF regards as its principal purpose. The question that remains is whether the institution that has been created embodies rules and decision-making procedures that are appropriate to ensure that it does in fact serve this purpose and no other. Do the IMF's decision-making bodies have sufficient authority to give member states confidence that the institution does indeed serve their common interests? Do the institutional rules circumscribe this authority in a way that prevents IMF power from being used for non-sanctioned purposes?

In the section that follows, I will examine the logic behind the legal restraints and decision-making procedures embodied in the IMF. As in the previous section, I will concentrate on the unchanging core of IMF justifications. I will look critically at these arguments and suggest their limits - what it is necessary to believe in order to find them convincing.

Overview

IMF accounts suggest three different ways in which the Fund's institutional structure ensures that IMF power is only used for its allotted purpose. Most fundamentally, the IMF acts within a legal framework which, as we saw above, is set out transparently in the IMF's Articles of Agreement and is consented to by all member states on joining the institution. Secondly, the majority of decisions taken by the Executive Board within that legal framework can be characterised as technical objective decisions. Thirdly, the Executive Board is a representative institution. Although, for political reasons and because of the differing responsibilities of different actors within the global system, that representation is unequal, it nonetheless provides some political oversight of the technical decision making process. At the margins, the Board of Governors is also in a position to exercise periodic oversight and to control the general direction of the institution.

The legal framework and consent

The idea of a rule-bound framework has two potential advantages for institutional legitimacy. Firstly, there is the procedural point that clearly established rules and limits to conduct mean that the boundaries of institutional power are set out so that members can make an informed choice about whether or not to join the institution. A set of transparent criteria are established so that any breach of this overarching framework can be challenged in legal terms. At first sight, at least, if members consent freely to join the institution and are able to leave at any time, it is reasonable to assume that any actions that do not breach the rules are legitimate.

Secondly, there is the stronger claim that a multilateral legal framework can restrain abuses of power because even those with greatest influence over IMF policy will themselves be subject to the law. If all countries are likely to suffer from balance of payments problems, a rules based framework accepted by all is likely to be reasonably fair.

The advantages of transparent rules in delimiting the boundaries of legitimate institutional conduct are undeniable and the important consequences a breach of the IMF's legal framework are likely to have for legitimacy should not be underestimated. However, there are some reasons to doubt how far compliance with a legal framework can go, on its own, in ensuring institutional legitimacy.

Taking the stronger claim first, reciprocal obligations embodied in rules will only provide restraints on the powerful to the extent that countries will all be equally likely to find themselves in the situations that the rules are designed to deal with¹⁷. Otherwise there is nothing to stop carefully framed rules from becoming instruments of exploitation, apart, of course, from the political consequences of legal transparency¹⁸. There is the potential for rules to embody a fair system of mutual obligations but there is no good reason to assume that they must do so – in other words reciprocity is perhaps best thought of as a question about the Fund's allotted role and about Fund performance rather than one about the presence or absence of a legal framework.

The weaker claim, about a transparent framework that all members have consented to on joining the institution is more convincing but problems remain. These problems spring from the need to strike a balance between rules and discretion that is an issue with all legal systems. They are ultimately problems to do with uncertainty about the future – about what exactly it is that has been agreed to. If rules are insufficiently specified, consent to the rules will still leave considerable scope for doubt and dissent about the way discretion is exercised and therefore the policies that are adopted in particular circumstances. On the other hand, if rules are set out in great detail they may be unable to adapt to unexpected situations and issues of interpretation will be problematic. Here consent leaves room for doubt about whether the rules will be either adequate or sufficiently flexible to deal with future contingencies.

In practice, the IMF framework always left room for some discretion and, as we will see in Chapter 3, discretionary decision-making has become more important over time. Now, at one level, since the IMF's Articles of Agreement include procedural rules about how future decisions are to be made (establishing new rules), it is possible to argue that the decision to join the IMF includes an acceptance of future judgements made within its institutional framework. Agreement to become a member includes agreement about the legitimacy of the IMF's decision-making framework and so all IMF rules are equally binding. In practical terms, though, this is clearly inadequate. The way the decision-making body works in practice is bound to be an issue, hence the importance of the multi-faceted conception of legitimacy I set out in Chapter 1.

The balance between rules and discretion and between fundamental rules and those created later through the Executive Board will also influence IMF legitimacy. The more the system shifts from rules to discretion, the more weight will be placed on the decision-making structures that I review

¹⁷ The arguments here should be familiar. The idea of the rule of law is closely related to Kantian ethics. The necessity for all actors to feel reasonably likely to be affected by any rules made is the intuition driving Rawls' introduction of the concept of a 'veil of ignorance' (Rawls, 1972)

¹⁸ If rules are set out clearly and publicly, it is easier to raise political challenges to those that are difficult to justify on normative grounds than it is to challenge obscure and ill-specified procedures.

in the next sub-section and the less on original consent. Likewise, the extent to which the Executive Board is able to re-write the IMF's legal mandate (the extent to which rules are made by the Board rather than through inter-state negotiations) will also be important because Board decisions are made on the basis of weighted voting rather than sovereign equality.

Having said all that, there remains an important difference between an international institution such as the IMF and legal systems operating within states. The IMF's member states are free to join and free to leave the institution at any time. Not only do they initially consent to membership, they also exercise continuing consent by remaining members over time. In other words, arguably, continuing state consent to the IMF regime provides a continuing ratification of the decisions and procedures that flow from the IMF's legal framework. The importance of consent and therefore the assumption that international institutions must be welfare improving is at the heart of many liberal institutionalist accounts of international organisations (Keohane, 1984).

However, there are also reasons to doubt how much consent really tells us. In a recent book on international institutions, Gruber has pointed to the importance of what he calls 'go it alone' power (Gruber, 2000). Gruber's argument is essentially one about identifying the correct counterfactual to institutional membership. He points out that, once it is clear that two or more states will set up an institution, the range of choices open to additional countries has already been altered. They are no longer choosing between negotiating an institutional bargain and retaining the status quo – they must now choose between joining the *particular* institution proposed and remaining on the sidelines while other countries cooperate within the newly established framework.

In the context of the IMF, the point is that most prospective members were not present at the original Bretton Woods negotiations and had little influence on the way they were conducted. The choice they were presented with was acceptance of the entire IMF institutional package or acceptance of none of it. Overall, the position is unchanged in relation to legitimacy – consent implies that the IMF framework as a whole is perceived as better than the alternative of non-membership. However, the crucial point is that the institution must be accepted as a package and from a limited range of possible alternatives: consent need not imply wholehearted enthusiasm, it may merely reflect a grudging acceptance of the best of a bad set of choices.

Overall, the existence of a legal framework benefiting from the formal consent of all member states is an important base line for IMF legitimacy. There is no denying that states are free to leave and that they choose not to do so. Nonetheless, as Gruber points out, consent is exercised within a set of choices created in the context of the current international financial system.

As IMF programmes become more extensive or more difficult to monitor, the quality of cooperation members are willing to offer will also be important. Formal consent may not be enough for the institution to achieve its aims: states will need to be prepared to make genuine efforts to implement programmes rather than merely paying lip service. After a certain point, then,

consent like legitimacy is a matter of degree so additional factors providing incentives for compliance with IMF policy will also be important.

Technocracy, representation and accountability

When it comes to decision-making, the IMF's legitimating arguments are heavily reliant on the idea that the IMF is a 'technical' rather than a 'political' institution. Decisions are officially made from an objective point of view aimed at maximising economic welfare within the confines of the IMF's legal mandate.

At one level the logic here is very simple. The claim is that the causal laws enshrined in the science of economics mean that if the desired goal is x , the appropriate policy is y . The goals have been defined by state consent and are set out in the Articles of Agreement. Once those goals are accepted there is really very little choice about appropriate policy, it is merely a reflection of what is actually possible.

However, in practice the dominance of utilitarian thought within economics means that various kinds of utilitarian justifications tend to creep into the authority claims the Fund makes. The advantages ascribed to utilitarian thought are therefore also part of the 'technical' self-description. Particularly important is the idea that utility is objective and 'democratic' because it is about maximising aggregate welfare without making distinctions between particular people – each person's utility counts once and only once. That is clearly an attractive argument for an international institution to make if it wishes to be able to overcome 'national' interests in certain circumstances but, as I will argue below, it is not a position that is defensible in the same technical terms.

A prominent discussion on the appropriate management of capital account crises illustrates the way this kind of thinking works in practice. Giannini is discussing possible arrangements for dealing with a rapid outflow of capital – options range from attempting to entice funds back through market incentives to administrative restrictions on the repatriation of capital or debt cancellation (an issue discussed in more depth in section 4.1.2 below)

The issue is often broached as one of achieving "a more equitable burden –sharing"...When resources have been misallocated, the question of who was responsible in the first place is of little economic relevance. What matters is that the misallocation be dealt with in the least costly way...the issue of moral hazard¹⁹ is logically distinct from that of ensuring equitable burden sharing. The real issue is whether by involving the private sector, the overall costs associated with foreign-exchange crises can be reduced (Giannini, 1999, 37-8)

Important here is the idea that short-term concerns with the justice of the arrangements in relation to particular actors detract from more important questions about the long-term causal consequences of the policies adopted. Achieving justice can be a pyrrhic victory when it ultimately makes everyone worse off. Technical expertise is important in identifying the likely longer-term implications of particular policies. There is also a deliberate stress on the extent to which many problems simply *are* coordination problems. So, in the current context, measures aimed to ensure

¹⁹ The sometimes inappropriate incentive effects of various methods of crisis resolution

that private lenders are 'punished' for their mistaken investment decisions may merely prevent future lending, making everyone worse off. A utilitarian stress on the medium or long-term consequences of actions can focus attention on mutual gains rather than short-term distributional questions.

This translates more generally into a reminder that:

what are the best arrangements to make about property if the state is to be as well constituted as it is possible to make it...is as much a question about the probable consequences of human actions as it is about the rational justification of particular evaluative beliefs or aspirations (Dunn, 1996, 123-4)

This kind of 'sum welfare consequentialist' reasoning (Sen, 1987) has always been at the heart of economics but its attractions in the context of an international institution should also be clear. The salience of subjective issues that could lead to conflict (questions about justice or distribution) is minimized and emphasis is placed on pragmatic, objectively determined, mutually beneficial, solutions to the problems at hand based on the empirical evidence. The resonance of this kind of reasoning with neo-institutionalist perspectives in IR (Keohane, 1984) should be readily apparent. From the point of view of legitimacy, actors that object to the decisions made can be dismissed as either misguided or self-seeking, narrow minded and therefore anti-democratic²⁰.

Technical representation

Not only does this technical self-perception inform IMF justifications for particular policies. It also lies behind the choices that have been made about the IMF's decision-making structures.

The key decision making body in the IMF is the Executive Board. Although it is formally subject to the Board of Governors, in practice a forum of 192 representatives is too unwieldy for effective decision-making and many quite high-level policy decisions are made by the Executive Board²¹.

In my discussion of IMF institutional arrangements earlier in this chapter I pointed out that EDs must be economists and that most Executive Directors represent more than one country. A review of the debates surrounding Bretton Woods suggests that this was part of a deliberate strategy in keeping with the technical utilitarian notion of IMF decision-making. It was clearly necessary that states should feel they had input into and control over institutional decisions. However, at the same time, the Fund's architects were anxious to ensure that Directors would identify as much with the institution as with their own country.

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

According to Lister (in an account that bears the stamp of extensive conversations with Fund staff) part of the Executive Directors' job is to

²⁰ See, particularly, the discussion of 'good governance' in Chapters 3 and 9.

²¹ The IMFC's role as a site for pre-agreeing issues of policy has been increasing since its role was formalised in the aftermath of the Asian crisis. To assist with that process the IMFC now meets in advance of Board of Governors' meetings.

keep the IMF from becoming [a] forum for political battles unconnected with [its] technical functions. Upon such persons falls the task of persuading their governments that the organizations to which they happen to be attached should be shielded from the damage that political partisanship always entails (Lister, 1984, 198)

The idea of full time Directors at an institutional headquarters was a deliberate strategy to encourage some geographical distance between Executive Directors and their political masters. Keynes was deeply upset when the decision was made to have Fund headquarters in the political capital of Washington rather than the financial capital New York as he felt the Fund would be taken over by politicians (Gardner, 1980).

Weighted voting and consensus decision-making, too, can be seen as part of a strategy stressing representation rather than accountability. The idea is to produce a unified institutional perspective on issues, avoiding controversy. Consensus decision-making and limited publication of Executive Board minutes enables the IMF to present a united front to the outside world. Weighted voting determines the contribution that different country representatives will then be able to make in arriving at that institutional position. Those countries with the largest stake in the global economy and the largest financial stake in the Fund are given the greatest say in decisions arrived at. The model is very much that of a corporation²².

Just as the idea of technical decision-making is particularly attractive in the context of an international organisation, this technical conception of directors' role also has advantages. Rather than having to agree some form of political authority above the level of the nation state, technical decisions can be portrayed simply as correct interpretations of economic reality.

Limitations to technical utilitarian decision-making

How persuasive is this technical conception of the Executive Board likely to be?

The idea that, given a particular set of goals sanctioned by state consent, technical considerations will place limits on the possible policies countries can carry out is uncontroversial. It may also be true in many cases that a better understanding of the economic consequences of various measures over the medium-term will have a profound impact on assessments of appropriate courses of action. The formal models of welfare economics can contribute to decision-making by clarifying the issues at stake, contributing to constructive debate and delineating the range of available possibilities (Hahn, 1982). Problems arise, however, when it becomes difficult to separate ends from means or when the ethical content of particular kinds of utilitarianism is consciously or unconsciously incorporated into the supposedly technical decision-making process.

Perhaps the most problematic issue here is the utilitarian conception of the human good as entailing the maximisation of a number of *individual* goods. This individualistic conception makes it difficult to incorporate values like freedom, equity (Sen, 1987; Sen & Williams, 1982) or the importance of maintaining a political community (Taylor, 1982) into utilitarian calculations. It is not necessarily impossible to do so in the context of a very inclusive concept of utility but such

²² Indeed the Articles of Agreement bear a marked resemblance to the articles of association of a UK company.

considerations are certainly unlikely to be reflected in the ways utility is normally used in economic calculations (O'Neill, 1998; Sen, 1987).

Economic welfare is a very important value in the modern world but it is evidently not exhaustive. One answer is to say that the IMF is an economic institution and that there are other institutions or parts of government that are responsible for taking into account different sorts of concerns. The problem is that policy-making cannot always be split up in this way. Economic decisions have spill-overs into other areas of social life. Once they have been made various social avenues are already closed off and other kinds of decisions made by other bodies cannot compensate.

The wider Executive Board discretion becomes the more likely it is that there will in fact be a need to make choices that are hard to see as purely technical. Even without the non-economic consequences of economic decisions, if economic theory cannot specify a single appropriate course of action some kind of non-technical choice will have to be made. The Executive Board (or whoever else makes the decision) will effectively be choosing between sub-goals with different probable outcomes and therefore inevitably be making decisions about ends as well as means even if it does not intend to do so.

The second issue is the extent to which utilitarian ethical concepts translate into politically persuasive arguments. Firstly, to re-emphasise the point about political community, arguments of the form 'everyone in the aggregate will be better off if we do x' may not be particularly persuasive where there are losers as well as winners. If the differences are marginal or the distribution of gains and losses are uncertain such arguments may remain broadly attractive but the extent to which people are willing to take the risk of being a 'loser' will depend on their relationship with the 'winners'. As J.S. Mill put it, members of a nation 'cooperate with each other more willingly than with other people' (Mill, 1993, 391). Problems that are pure coordination problems will be more easily dealt with than those in which there is a distributional element. People who identify with one another will be more willing to make sacrifices in the interests of the common good.

Even if, theoretically, we accept the force of arguments proceeding from particular ends through technical calculation to appropriate policy, there remain issues about who is to make the calculations and how we are to be sure that they have been made correctly. This is absolutely key when we come to think about accountability. In situations where goals are clear and it is reasonable to hold people accountable for their success in achieving those goals, non-transparent decision-making methods of the kind enshrined in the Executive Board are not problematic. That is why, arguably, central bank independence need not concern us over much or why corporate accountability to shareholders need not involve continuous oversight. If inflation stays low, or investors achieve good returns, everyone is happy. If not a new set of directors are appointed or shares are sold.

As decisions become more difficult and complex, and as the institution involved can only control a small part of its environment (failure may be due to poor policy or external factors) the quality of

the *policies* chosen and the reasons for their choice become the basis for evaluation as much as outcomes. A powerful consensus amongst economists may help to boost technical credentials. The more difficult it becomes to assess performance though and the more public disagreement there is amongst economists the more we need to know *why* particular policies were chosen and, because technical uncertainty easily slips into ethical decision-making, the more 'political' such choices are likely to become. I will suggest later that, because of the economic training received by IMF staff, there is a marked tendency to overcome such difficulties by relying on some conception of utilitarianism without necessarily realising that this is itself a political choice

Overall, technical Executive Board decision-making is most likely to be appropriate where: problems are largely coordination problems enabling mutual gains; there is a high level of technical consensus about the likely outcomes of policy; and policy issues do not have spill-over effects on other issues that are not appropriately dealt with by utilitarian economic calculation.

How much the IMF's legal mandate and decision-making structures do ensure that these conditions are satisfied in practice is an empirical question. Generally speaking, though, the wider and less tightly defined the IMF's mandate becomes, the more important it will be that Executive Board expertise is properly scrutinised to ensure that experts are really setting out genuine limits to practical possibilities rather than, through conscious or unconscious bias, ruling out courses of action without proper public debate.

The more complex the decisions concerned, the greater responsibility on experts to explain and justify the choices made. As a prominent economist has put it:

If there's one thing I've learned in government, it's that openness is most essential in those realms where expertise seems to matter most (Stiglitz, 2000)²³

If the IMF is to secure its political legitimacy, its institutional structure must ensure that this kind of debate takes place in a way that provides adequate and appropriate opportunities for the consideration of issues that cannot be resolved through utilitarian calculation. A more obvious way to settle this type of dispute is through democratic forms of debate and struggle of the kind that I argued were at least supposed to take place within sovereign states, particularly where they had a good claim to embody some form of popular sovereignty (page 29 above) suggesting that technical authority will be susceptible to significant challenge under these circumstances. This is particularly important because economic justifications are so central to IMF thinking, particularly given the economic training of both the staff and Board members. There is a danger that this kind of personnel will be insufficiently sensitive to other forms of ethical and political justification.

Representation and accountability

The IMF is not solely reliant on technical utilitarian authority. It was also set up to act as an intergovernmental institution. The idea here is that the IMF is a tool used by states to further their

²³ For more fundamental concerns about the danger that greater understanding of causal relationships can lead to experts exercising inappropriate power at the expense of individual liberty see (Adorno & Horkheimer, 1997; Foucault, 1980)

collective purposes and embodies a bargain between those states. Since the Fund regulates the international monetary system it should be responsible to states in proportion to their stake in decisions affecting that system. That is the justification for weighted voting.

There are two issues here, the first concerns the extent to which weights adequately represent 'stakes' in Fund decision-making and the second concerns the relationship between states and their populations.

The idea that voting weights should be apportioned in terms of stakes in the global economy makes most sense if we think in terms of a coordination problem where the IMF simply provides benefits without imposing costs. It makes sense for authority based on expertise to be supplemented by giving EDs additional authority on the basis that they represent particular states, hold those states' interests in mind and are accountable to them. That can, potentially, compensate for the narrowness of purely utilitarian decision-making albeit at the risk that decisions will be, in some way, 'politicised'. It will also imply that states have an incentive to hold their EDs to account for incompetence if not necessarily for exceeding their powers. Those with the greatest potential to gain should logically have the greatest say in decision-making since that provides a sensible incentive structure to maximise institutional success. As decisions diverge from the mutually beneficial ideal, though, the voting system becomes more problematic.

Underlying that vision is the idea that the task involved is one of maximisation and that decisions made are somehow a sum of the views of those participating. That may be the case where the decision to be made relates to a choice from a range of different possibilities in which compromise can be struck between the views of different parties (the appropriate level for a countries' exchange rate for example - one could imagine a decision being made on the basis of a weighted average of EDs preferences).

However, not all decisions are of this type. So, for example, decisions that are about binary choices may produce a situation that looks more like the view of the majority being imposed on the minority. If alliances vary on different issues so that those in the minority on some decisions can expect to be the majority in others this may not be problematic but where cleavages are relatively permanent and weighted voting ensures the dominance of a narrow minority of the powerful there is clearly the potential for problems. These problems will, again, be far less acute when the issues decided on can largely be construed as part of the resolution of coordination problems but will be more problematic when questions of distribution become significant.

In theory, consensus decision-making could also moderate these difficulties by putting increased pressure on the powerful to secure the support of the weak through compromise and bargaining. It may be that the voluntary nature of IMF membership and conditionality also exerts a similar pressure. However, research on the practice of 'consensus' decision-making suggests that there are difficulties. Discussions take place with actual voting positions in mind and 'consensus' in practice means the clear likelihood that a vote would be passed if one were taken (Bichsel, 1994). Since no

votes are actually taken and the minutes of Board meetings are deliberately silent on the views of particular directors it is very difficult for outsiders to determine how decisions have actually been made.

This is clearly an issue when it comes to ED's accountability. Where EDs are responsible to one government and the decisions taken by them are legitimately seen as decisions of the Treasury ministry of the country concerned, the idea of EDs as representatives is relatively satisfactory. Home ministries can give EDs instructions and ask for reports of their activities and there will only be a need for a limited degree of trust in the representative concerned. When EDs represent a wider range of countries (as many of them do), though, consensus decision-making becomes far more difficult as governments cannot tell what is being done in their names. Similarly, where the issues debated are of wider interest and affect sections of domestic populations, the picture again becomes less satisfactory. Accountability is impossible without some level of transparency and some kind of sanction for inappropriate performance. In practice transparency is limited and the chain of representation from citizen to IMF begins to look very long (citizen-legislature-Finance Minister-Executive Director-Executive Board-Fund staff).

All these potential difficulties suggest that the kinds of decisions that the IMF is making will be very important. The IMF decision-making structure seems to be designed with a particular kind of decision in mind: technical questions about maximising economic welfare through solving a coordination problem.

Despite these concerns, it may still be possible to argue that institutional structures should reflect real world power, particularly in an institution that has little coercive might of its own and is therefore reliant on consensus. Indeed at least one commentator commends the IMF decision-making model on precisely these grounds. In comparison to the frequent paralysis of the UN, it is a system 'that the IMF has been using relatively successfully in generating viable collective action' over a period of more than 50 years (Lister, 1984, 8). However, this looks like a justification based more on power than legitimacy. Power is moderated to the extent that it is exercised publicly through an international institution on the basis of 'consensual' decision-making but it is less clear that states' relative say in the institution can be justified in any way that is more directly related to the purpose the IMF is supposed to serve.

2.2.3 Conclusions

In section 2.2.1, I argued that IMF legitimacy was based on a claim to advance state interests by providing cooperative arrangements for managing the international economy. States needed to agree to restrict their own autonomy in the interests of making longer-term gains through greater system stability. Better international monetary coordination could enable them to undertake more sophisticated interventions at a domestic level, furthering their economic interests and securing their domestic legitimacy.

The question was whether the Fund would, in practice, provide benefits to all states involved or only to some of them. That is obviously ultimately a question about performance but, in the economic sphere, performance will often be difficult to assess. Over a long period of time, it is also reasonable to expect institutional performance to be weak from time to time for purely innocent reasons. That is where institutions are important. They can provide additional reasons to believe that institutional performance is directed towards institutional goals, they increase an institution's resilience to occasional performance problems.

How much support do the IMF's institutions provide in that respect? In section 2.2.2 we saw that the IMF's legal and institutional arrangements provided three kinds of assurances. States were given the opportunity to consent to the legal arrangements governing the Fund's operation. Within those legal arrangements, decisions would be made on the basis of technical economic expertise rather than more subjective political criteria. Finally, the decision-makers were also to be representatives of individual states and were therefore in a position to protect their interests.

Those justifications had some potential but were likely to be more convincing under certain conditions than others. Technical decision-making was best suited to resolving coordination problems within a relatively tightly defined mandate, particularly in a context of reasonable consensus within the economics profession. The IMF's representative credentials were reasonably well suited to supporting that kind of decision but were problematic for anything more demanding because of weighted-voting, limited transparency, and a long chain of representation from citizen to Executive Director. In short the more independent and international aspects of IMF decision-making were the most fragile. If decisions were kept within reasonably tight parameters, and if there were few permanent cleavages within the membership they were capable of justifying some functions but only within fairly narrow boundaries.

State consent to a legal framework looked, at first sight, like a stronger justification. At their best, legal rules could ensure equal treatment between countries. Even at their worst, they ensured that states had consented to the obligations the Fund imposed. That could, potentially, help to ensure that the conditions required for the IMF's technical authority would be met. States would presumably ensure that legal restrictions on the Fund's role would ensure that only issues that states were comfortable delegating to the Executive Board would in fact be determined there. That should provide reassurance where there are concerns about non-technical issues being incorporated into Executive Board decisions.

Unfortunately, I also suggested that consent need not be freely given since states are always acting within a set of complex political and economic constraints. The fact that IMF membership is better than leaving the Fund need not imply that the institution is satisfactory, merely that it is better than the available alternatives. There was also a noticeable coercive element to conditionality that could result in acceptance of conditions because of power rather than legitimacy.

Overall, then, IMF institutions will provide the best support for broader IMF claims where states are able to pre-agree a relatively narrow framework for IMF operation that leaves little room for Executive Board discretion. Nonetheless there is scope for discretion to be exercised where the decisions made appear equally binding on all countries or where there are strong technical justifications available. Beyond that, claims to sovereign self-determination will be hard to overcome unless restraints are clearly welfare enhancing for all states over time (unless performance is manifestly good). The extent to which governments are seen to take part in decisions about their own policies will therefore be very important. Overall performance on the one hand and the balance between state consent and Executive Board discretion on the other will be highly significant for IMF legitimacy.

2.3 The framework in practice: formulating conditionality

Since the thesis is primarily concerned with conditionality, it is important to see how this balance between state consent and Executive Board discretion is struck in practice when conditionality is formulated. That discussion will also bring the very general, theoretical discussions of the previous sections closer to practical concerns, preparing the discussion for the more empirical discussions of the rest of the thesis.

We saw, in section 2.1, that conditionality is supposed to be designed to ensure that adjustment takes place in a way that safeguards the IMF's resources and avoids breaching the IMF's 'code of conduct'. According to IMF accounts, conditionality is primarily determined by the borrower country but with staff collaboration and Executive Board oversight to ensure that programmes are acceptable. The importance of government involvement potentially adds additional security to the justifications we have already examined. The country remains free to determine its policies within constraints imposed by the Executive Board. It is only those constraints, rather than the programme as a whole, that need to fit within the limitations I suggested in the previous section. How confident can we be in practice that this is in fact the case?

In practical terms, the process begins when a country decides to approach the IMF for a loan. The Area department staff in Washington prepare a draft letter of intent based on information to hand, particularly that obtained as part of recent Fund surveillance. A staff mission, usually headed by a senior member of the relevant area department then goes to the country concerned to gather further information and negotiate a programme with government personnel – usually drawn from the finance ministry or central bank. Once negotiations are complete, the mission returns to Washington. The programme is then moderated by members of the IMF's functional departments and submitted to the Executive Board for approval.

In terms of legitimacy, the procedure seems to rely on a combination of technical decision-making (in that it is primarily the staff that decide) combined with a more political element of state consent (since the recipient government is involved). On the basis of the discussion in section 2.2, the most

interesting issues will relate to the balance between government and staff input and the degree to which the staff are subject to Executive Board oversight or legal restrictions.

The IMF is keen to emphasise government freedom in programme specification:

We don't impose conditions on governments. If a program were to be imposed from outside, its chances to be fulfilled, to be implemented, would be minimal. For a program to have its chances, it has to be seen as really the program of the country, elaborated by the country (Camdessus, 1993 quoted in Woods, 2000b)

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

What research there is on the question suggests that Camdessus is overstating his case. It is clear that countries are able to influence the nature of programmes to varying degrees depending, amongst other things, on: their strategic importance to the IMF's major shareholders (particularly right wing regimes such as Mobutu's Zaire during the Cold War), their economic significance, the scale of their difficulties and the nature of the processes required to obtain domestic ratification of programmes (Bartilow, 1998; Stiles, 1991)

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

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

Obviously some IMF restrictions would be expected on programme content – the IMF's role is to encourage states to exercise their economic sovereignty in ways that do not conflict with the core values the Fund was set up to promote. However, restrictions on policy should be confined to those consonant with the IMF's broader purposes as interpreted by the Executive Board. Within those restraints staff should presumably be flexible. I am not intending to evaluate the IMF's actual procedures in any detail in this Chapter – that will be done in Chapters 5-10. The point here, though, is that country 'consent' again does not seem to be enough to ensure the legitimacy of conditionality. It is not difficult to understand why, since any country asking the IMF for funds is already in a state of crisis.

Leaving aside questions of staff over-zealousness for now, the second set of issues concern what exactly does determine staff positions in conditionality negotiations. According to IMF rhetoric,

staff make technical decisions on the basis of country obligations under the code of conduct and of the need to preserve Fund resources.

In formal terms, the legal framework for conditionality has always been rather limited, making it difficult to determine what exactly the 'code of conduct' entails in this context. The only publicly available guidance comes from the Articles of Agreement and a very general set of guidelines on conditionality promulgated in 1979. Even these have not, in fact, been followed. At the time of writing the IMF was in the process of a major review of its conditionality. One of the background papers for that review clearly acknowledges that, at least since the late 1980s, the Board has largely ignored the section of the guidelines outlawing structural conditionality except in exceptional circumstances (IMF, 2001c).

Informally, though, it is clear that staff have a very good idea of what the Board expects to see in programmes. A large number of research papers and policy reviews published by the IMF and academic observers mean that it is also now possible for outsiders to get an idea of Board positions, though this was not so for much of the Fund's existence. The lack of formal legal guidelines is therefore most relevant in pointing up the extent to which power has been delegated to the Executive Board. However, Board decisions are merely indicative of past member preferences. They do not provide any kind of legally binding precedent for future decisions. If the Board changes its mind it can simply ratify a contradictory programme.

Executive Board opinions therefore remain extremely important but they appear only to be incorporated at a late stage of negotiation. In practice this is not too problematic for Board authority since staff are very anxious to avoid Executive Board censure and their decisions are made in the light of past Executive Board decisions.

In fact, those familiar with the IMF tend to stress the Executive Board's tight control over policy and the institutional culture that emphasises the presentation of a common point of view to the outside world. My own discussions with IMF staff confirmed Stiles' earlier finding that many issues would simply never find their way into programmes because staff felt they were unlikely to be accepted by the Board (Stiles, 1991). The ESAF evaluation provides similar indications:

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

In other words, it is possible that *ex post* review by the Executive Board actually encourages negotiators to be less flexible than they might otherwise be since staff are not in a sufficiently powerful position to exercise discretion without Executive Board sanction.

In highly political or high profile situations, this difficulty is ameliorated by greater high-level contact during the negotiation process. So, for example, in the Asian context, US Executive Director Karen Lissakers told a Congressional committee that:

in all of these programs there has been a fair amount of input from the Executive Board and various member governments including the US Government in consultation with management

and senior staff. We try to stay in close touch to monitor the status of the negotiations and to secure inclusion of various policy measures that we thought were vital (House Banking Oversight Subcommittee, 1998)

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

On the other hand, this political intervention takes place through largely informal channels further questioning the authority of the Executive Board as a whole. This is particularly important if we are concerned about the Executive Board's ability to impose strategic direction on IMF deliberations. Approval or disapproval of programmes is essentially a reactive activity raising the possibility that Board deliberations will tend to have a conservative bias. Rather than deciding on solutions to new policy problems through Executive Board debate, staff will presumably consult informally with the Managing Director and particularly interested EDs to produce a programme. The Board as a whole will then be under some pressure to agree it in broad terms when it comes up for review since to do otherwise would undermine the institution's credibility. Changing course will then involve a considerable degree of self-criticism of a kind that could potentially have been avoided if discussions had taken place in advance.

Internal decision-making processes remain slightly mysterious. Although the Fund is more open than it was in the past, few researchers have had sufficient access to dissect relationships within the Fund and the terrain is in any case sufficiently political and controversial to make interview evidence difficult to interpret. However, the account given here fits all the available evidence and has the advantage of explaining the two strands of argument that emerge from the available literature: one stressing IMF inflexibility and conformity and the other stressing limited Executive Board control²⁴.

Of course, Executive Board ratification does eventually take place though and presumably *ad hoc* decisions made in formulating programmes will be made with this in mind. So, to the extent that they are able to impose their views, what can we expect Executive Directors to be trying to do? What incentives do EDs face and do those incentives encourage confidence in the kinds of restrictions that the IMF will impose on national policies?

IMF accounts emphasize the common interest countries have in a smoothly functioning international monetary system and to that extent we might expect Executive Board discussions to be based on the technical economic opinions of EDs. We can expect general preferences for an open international economy to secure access to export markets and either to secure or facilitate investment balanced by the wish for countries to maintain their own national autonomy. However, at the same time, EDs will also have narrower interests.

²⁴ This apparent contradiction is particularly apparent in the best discussions of appropriate IMF reform (such as De Gregorio et al., 1999 and Woods, 2000b). Stiles, 1991, Martin, 1991 and IMF, 1998 are also helpful.

The most obvious here is the interest the borrower country has in limiting the costs of adjustment. Those costs will be determined in the context of the borrower government's interests and may be political as much as economic but clearly more finance will be better than less finance and fewer conditions will be usually be better than more.

Borrower countries have the ability to refuse conditionality but only at the cost of not receiving financial assistance. Within Executive Board discussions this may leave them in a very weak position indeed. Having decided to accept the program, they need to convince the other Executive Directors that they are keen to implement it to ensure that funding is eventually provided. They are not, therefore, in a position to raise public objections to aspects of the programme that they would have preferred to avoid²⁵ and are under strong pressure either to accept it in its entirety or reject it. This may be particularly relevant where they are hoping to attract additional bilateral financing from other countries whose representatives will be present at Executive Board discussions. That suggests that the Executive Board may receive little negative feedback from borrowers but, if it is doing its job correctly, that may not be inappropriate since borrowers can hardly be expected to take an objective long-term view in the midst of a crisis.

More reliable are other countries that expect to borrow in the near future. They should have incentives to raise objections to conditions in an attempt to prevent similar conditions being imposed on them in any future programme. At the same time, the desire to maintain the benefits of the international economy, particularly access to export markets, and to guarantee Fund resources will suggest sympathy for conditionality which may offset concerns about being subjected to similar conditionality. Potential borrowers should have appropriate incentives to weigh up the benefits of internationalism against preferences for autonomy creating a balanced approach that keeps IMF restraints within suitable boundaries.

Of course it is possible that countries will simply have different preferences about the relative importance of an open economy versus policy autonomy. As long as those preferences are broadly distributed that should not present a significant problem, particularly in a context where weighted voting ensures that those with potentially the most to gain have the largest say.

However, other less appropriate political motives may come into play. Countries may wish to present an internationalist laissez-faire image for short term commercial reasons or have incentives related to the potential for upsetting important political allies (or potential enemies). The final outcome may therefore depend on a complex range of factors but countries that are either in a very strong position (no particular concerns about the consequences of speaking out) or a very weak position (expecting to be the next borrower) may have most incentive to object to policies that they would not like to have to implement themselves.

²⁵ Interviews with developing country Executive Board members and other developing country officials confirm this point.

Finally, and most potentially problematic, any country that does not expect to borrow will not have the same incentives for restraint. Countries in this position will therefore have incentives to push for as much market access as possible with the minimal amount of committed finance.

The number of countries in this position will therefore be highly significant for IMF legitimacy since it will have an important effect on the incentives present in Executive Board discussions. However, even here restraints remain. Conditionality does remain voluntary and even quite large amounts of finance will not compensate for policies that are obviously well beyond the IMF's mandate. In other words the need to maintain IMF legitimacy will itself suggest the need for restraint even for these countries since, without the IMF structure, they would have no formal means to pursue their foreign policy goals.

2.4 Conclusions

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

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

The IMF's role, then, was originally to be one of *global* regulation of the international financial system in the interest of enhancing states' ability to fulfil their social and political obligations, whilst continuing to enjoy as many of the benefits provided by an open international economy as possible. In a sense, the Fund was charged with legitimating the international economic system by providing states with incentives to stay internationally engaged. It is also important to note that the Fund was designed to be a global regulatory institution as well as simply a provider of a kind of financial

insurance. The way that regulatory role was originally constituted left the Fund with a relatively tightly defined mandate that could be portrayed as embodying a series of reciprocal obligations, the majority of which were agreed to by states on joining the institution.

The Fund's institutions were designed with a very particular role in mind. Outside that role, the legal and institutional guarantees enshrined in the Articles of Agreement begin to look problematic. The content of the IMF's legal framework in practice will be important in determining the balance between state consent and Executive Board authority which is more problematic (at least in non-technical areas) because of weighted voting and limited transparency. The wider the Fund's discretion becomes and the less secure its technical underpinnings the more problematic legitimacy will become.

Given the doubts about this framework, it is important that the balance between state and IMF input in conditionality can be properly assessed so that state responsibility for particular programmes can bolster IMF credibility. It is only the *restraints* on state activity imposed by the Fund, rather than everything a country does in response to crisis, that need to be legitimated. If the balance between Fund authority and state consent is blurred that could create difficulties for the Fund's legitimacy.

Finally, I have also argued that even the Fund's most fundamental justification based on continuing state consent is less secure than it might look at first sight. In normative if not legal terms, state consent is only helpful to the extent that it is made from a genuine set of choices. Once the Fund has been set up, at least, states are left with the choice of accepting or rejecting the institution in its entirety. Negotiating specific provisions is not an option. That may significantly reduce the benefits that consent can contribute in terms of legitimacy.

Of course, none of these failings are *necessarily* drastic. If performance is adequate there is no strong reason to question IMF legitimacy. However, where performance is wanting there is the potential for difficulties to arise. More importantly the specific weaknesses of IMF authority claims will mean that some kinds of performance failure will be more significant for IMF legitimacy than others as they will feed into weak points in the IMF's justifications. The resilience institutional structures can potentially provide for institutional legitimacy may then go into reverse as institutional weaknesses re-enforce questions about performance.

3 From Bretton Woods to the 1990s

In the previous chapter, I argued that the IMF portrays itself as an institution charged with resolving what is largely a technical problem of coordination. The maintenance of the international monetary economy is in the interests of all states but it requires some degree of inter-state cooperation. The experience of the inter-war years drove home the importance of institutionalising this coordination and of providing some form of political control over the operation of international finance. That, in turn, was the driving force behind the creation of the IMF.

In this chapter I want to explore the role the IMF actually carried out shortly after it was set up and the way it has evolved since then. I can then assess the extent to which the vision of technical coordination within a relatively narrow legal framework underlying justifications for the Fund's institutions provides an accurate portrayal of its operations in practice and whether its operation continues to provide the promised benefits in terms of state economic management. Exploring the changes that have taken place in the IMF's role over time and the factors driving those changes will help us to propose some reasons why, by the late 1990s, the IMF had become vulnerable to the crisis of legitimacy that took place after the Asian financial crisis.

In the Introduction, I argued that legitimacy changes are likely to be either the result of changes in the way an institution operates that undermine its legitimating claims or of changes in public norms that affect the extent to which previous justifications are acceptable. This chapter will review major changes in both the IMF's role and in relevant public norms such as those relating to sovereignty and to the importance of markets for development.

The chapter begins with a simple explanation of international monetary economics to give an idea of what a technical coordinator of the international monetary system might look like. It goes on, in section 3.2, to explore the extent to which this ideal was embodied in the original Bretton Woods system. I then review the major changes that took place within the Fund in the 1970s and 1980s in section 3.3 and some of the ways that the Fund has both extended and tried to re-legitimate those changes in the 1990s in section 3.4.

The overall argument is that changes in the IMF's role over time have tended to polarise the institution into debtors and creditors. The IMF has, perhaps unsurprisingly, never been best seen as

a purely apolitical technical institution. What is important though is the extent to which that position has become increasingly untenable over time. Since the collapse of the Bretton Woods system of fixed exchange rates, greater discretion in monetary management has actually resulted in a far broader role for the IMF. However, its enforcement powers have been limited to borrower countries. Its enforceable policies - those involved in conditionality - have broadened into areas that are more difficult than ever to justify in purely technical terms. These same developments have made its representative structures less appropriate than they were before.

There have been some modest compensations though. Increased capital flows and integration into the global economy may (arguably) mean that the IMF can provide greater benefits to some middle-income countries than it could before. There have also been tentative moves to give the IMF a wider, more democratic appeal both in terms of the types of policies it adopts and in terms of its openness to outside influences. The question for the rest of the thesis is whether these compensations are effective enough to counteract the problems.

3.1 The political economy of monetary coordination and the Bretton Woods system

Monetary policy

In simple terms,¹ the purpose of money in an economy is to provide a convenient means of exchange between a wide variety of goods of different types in different quantities without having to resort to barter. It is a master commodity that can be exchanged for all others. But, like any commodity, its value depends on the laws of supply and demand. Extra money in circulation (an increase in supply) will, in the long-term, result in a reduction in what can be bought for each unit of currency (a decline in demand). In theory this should mean that monetary systems are self-adjusting. So, for example, there is no point in the mercantilist attempt to collect large quantities of money within national borders because the result will be an increase in national prices and an automatic compensatory outflow of money (Hume, 1752).

In fact, because price adjustments of this type can be difficult for market participants to detect, and because they may be slow or 'sticky', the amount of money in circulation in a particular context can have important (though complex) effects on economic output. Decreasing liquidity impairs economic growth and causes unemployment. Increasing liquidity causes inflation, which leads to uncertainty about future price levels discouraging investment and economic activity, and may also result in unemployment. Inflation and deflation also have complex distributional effects between savers and borrowers, those on fixed incomes and those with better economic bargaining power, wage earners and profit earners.

¹ The issues in fact cover most of modern macro-economic theory. The interested reader might wish to consult one of the standard text books. Mankiw (1999) is good on domestic policy. For international implications the best introduction is probably (Krugman & Obstfeld, 1997)

For these reasons, countries wish to maintain control of their monetary policy. However, in a world of freely exchanged currencies, changes in monetary policy in one country can have spill-over effects in other countries.

One important international example involves the relationship between exchange rates and a country's current account balance. If a country devalues its currency, it can buy less foreign goods per unit domestic currency and other countries can buy more of its goods per unit of their currency. The result is a short-term increase in exports and decrease in imports – at least until domestic prices adjust to compensate.

This adjustment affects other countries, as they find themselves importing more goods and exporting fewer goods. As we saw in the previous chapter, a series of competitive devaluations as countries attempted to boost their own exports at the expense of competitors is widely viewed as one cause of the Great Depression.

The point of international monetary coordination is to try to ensure that countries take into account the effects of their monetary policies on other countries. This is important because it will enhance overall economic efficiency. More importantly, too much disruption caused by the policies of others may make countries decide to reduce their interaction with the outside world, disrupting the system of global free trade.

In terms of the technical economic conception of the IMF, the overall level of liquidity in the system and the way that liquidity is distributed between countries should be designed to maximize the efficiency with which economic resources are being used. This can be done by controlling overall levels of liquidity; regulating exchange rate policies; and making rules determining which countries should adjust their monetary policies and how that adjustment is to take place.

In simple terms, when countries have large quantities of money sitting unproductively in bank vaults or if other resources are not being used productively (there is high unemployment or large parts of domestic productive sectors are running below full capacity) they should pursue a more expansionary monetary policy. On the other hand, countries that are importing more than they can produce or suffering from inflation should be encouraged to pursue contractionary measures.

Disputes arise because adjustment is always costly, at least in the short term. Equally, the 'correct' monetary policy for a country is always partly uncertain. It depends, amongst other things, on the relative importance attached to growth and employment on the one hand and monetary stability on the other. Those preferences, in turn, reflect differences of technical opinion over likely effects of changes in liquidity. Additionally, since there can only be one level of global liquidity, it is likely that this will be more appropriate for some countries than others.

Negotiating the Bretton Woods system

For Keynes, part of the problem with the Gold Standard was that it had a deflationary bias because liquidity was determined by the rate at which new gold deposits were discovered and because it was deficit countries that were required to adjust.

It has been an inherent characteristic... [of the system] that it throws the main burden of adjustment on the country which is in the *debtor* position... thus it has been an inherent characteristic of the automatic international metallic currency (apart from special circumstances) to force adjustments in the direction most disruptive of social order, and to throw the burden on countries least able to support it, making the poor poorer (Moggridge, 1992, Vol 25, 27,29)

At the time of the Bretton Woods negotiations, it was clear that the United States would be a creditor country for the foreseeable future and that European countries would be debtors. Much of the argument therefore revolved around the extent to which creditors as well as debtors would be made to adjust. Keynes, partly because of technical and political preferences, and partly as representative of a debtor nation, wanted a symmetrical adjustment system in which both debtors and creditors had incentives to adjust (Gardner, 1980).

The Americans, on the other hand, were only willing to ensure that debtor adjustment would be facilitated by providing what Cooper later described as a 'double screen' to cushion domestic economies from balance of payments problems (Cooper, 1975). The Fund would allow countries to devalue their exchange rates in the event of a 'fundamental disequilibrium' and, as we saw in the previous chapter, provide funds to ease adjustment in the event of balance of payments problems. Keynes attempted a rearguard action by introducing a 'scarce currency clause' which provided that, where 'demand for a member's currency seriously threatens the Fund's ability to supply that currency' other countries could institute exchange controls against it (Gardner, 1980). In practice it was never successfully invoked (James, 1996).

Once the provision of funding to ease adjustment had been agreed, there was a further dispute over how far the IMF (or more accurately the creditor countries) would be able to control the way in which resources should be used. Keynes had believed in automatic access to IMF resources, subject to minimal constraints to ensure that money was not frittered away for consumption. On the other hand, White had assured the US Congress that they would retain control over the way Funds were used. The wording of the Articles of Agreement left the situation ambiguous.

The US Executive Director, conscious of White's assurances to Congress, and restrained from approving unconditional lending by the laws passed to approve the Bretton Woods system, insisted that the IMF should impose conditions. The Europeans, on the other hand, were concerned that they would be forced to adopt US Treasury policy. Conditionality would increase the IMF's discretion and 'politicise' it. By the early 1950s, the result was a stalemate in which the Europeans would not accept conditions and the US would not allow the Fund to lend (Dell, 1981; Horsefield, 1969).

Eventually a compromise was adopted, under which the first 25% of a country's quota could be drawn automatically but further drawings would be subject to increasing conditionality. Repayment had to be made within 3 years (Gardner, 1980; Horsefield, 1969). What Keynes conceived of as primarily an additional source of liquidity had become much more closely linked to the adjustment mechanism. In practice, in the name of maintaining Fund resources, countries were only allowed to

borrow if they could demonstrate commitment to policies designed to solve their balance of payments problems.

3.2 The IMF's role in the Bretton Woods era

3.2.1 The code of conduct, symmetry and liquidity

During the Bretton Woods period, the Fund had a good claim to be regulating the monetary system from a global perspective. Exchange rates were fixed to the dollar, with the dollar tied to gold. The fixed exchange rate system provided a clear rules-based constraint over all countries² policy in a context where the inter-war experience had meant the Fund's architects were suspicious of international capital flows and encouraged countries to maintain capital controls.

Many high-level policy issues where the Fund exercised discretion also had clear global scope. The central issue concerned the overall level of liquidity. With all currencies tied to the dollar, US monetary policy played a key role in regulating global liquidity. In the early years, the vast need for liquidity in a Europe engaged in post-war reconstruction meant that there was widespread enthusiasm for loose US monetary policy and direct transfers in the form of Marshall Plan aid. This eased the freeing of exchange controls on current account in Europe which was a key achievement of the 1960s (and incidentally protected European countries from conditionality to some degree).

Over time, though, this became problematic, since dollars were supposed to remain convertible into gold. The more dollar supply outstripped that of gold the less confidence there was likely to be in the system as a whole.

During the 1960s, a number of measures were put in place to protect the dollar. Along with various types of central bank cooperation (Eichengreen, 1998), the G10 set up a special line of credit, the General Agreements to Borrow (GAB) in case the Fund's supply of dollars proved insufficient. Potentially more significantly, the IMF created a system for producing its own currency – SDRs (or Special Drawing Rights) which were a truly international currency that could be produced more symmetrically than the dollar.

Negotiations over the SDR and GAB reflected a shift in the balance of power between the US and Europe. Europeans were increasingly concerned over what De Gaulle was to call the 'exorbitant privilege' the US enjoyed to print money³. Transformed into creditor countries, it was the Europeans' turn to fight for control rather than automaticity in the provision of liquidity through the GAB. The IMF's managing director, Jacobson, had to remind them that they too might need its resources in the future. The Fund was also struggling to ensure that negotiations continued under its auspices and that the benefits of the GAB were extended to developing countries (Ferguson, 1988). In the end, the GAB could only be organised on the principle that even when the Fund had

² Though the constraint was often avoided in practice – devaluations were frequently presented to the Board as a *fait accompli* (James, 1996)

³ These concerns were partly fuelled by increasing US multinational investment in Europe

approved the use of resources, the G-10 had a further veto: a clear setback for the principle of universality. Disquiet over G-10 dominance led to developing country attempts at organisation through the formation of G-24 and the UNCTAD (Ferguson, 1988; James, 1996).

In negotiations over the the Europeans again asserted their dominance by requiring an 85% vote in the Fund before issuing SDRs, giving them a veto. There were further moves to conduct these negotiations within the OECD or G10 and to distribute liquidity only to the industrial nations. However, the US favoured the Fund, since developing country support for the SDR would provide expansionist allies against the Europeans. The SDR was kept within the IMF but developing country attempts to provide a 'link' between SDR distribution and development were unsuccessful, with SDRs distributed in proportion to IMF quotas (Ferguson, 1988).

Ultimately, there were limits to cooperation in support of the dollar. The gradual re-emergence of capital flows was making industrial country adjustment increasingly difficult. Disputes between a debtor US and creditor Germany in the mid 1960s resulted in two reluctant German revaluations (the only forced revaluations in the whole Bretton Woods period). However, dollars continued to flow out of the US. The last straw was a massive capital flight from the US to Germany and Japan in 1971 combined with a US refusal to acknowledge any responsibility ('it's our currency but it's your problem' as Connolly famously put it). It became clear that cooperation was not merely delaying American adjustment but allowing the Americans to avoid it completely.

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

3.2.2 Adjustment and conditionality

In contrast with questions about overall liquidity, conditionality was far less controversial during this period than it was to become later.

Balance of payments adjustment in theory

In simple terms⁴, a country that has a balance of payments deficit has two choices – it can attempt to reduce demand (spend less) or to increase supply (produce more). Demand side measures (essentially credit ceilings and fiscal constraints) work more quickly and are more certain to eliminate deficits, at least in the short term. They are also more clearly within government control⁵ and leave governments some freedom in determining how the costs of adjustment will be distributed (Polak 1991). On the other hand they are more likely to be damaging to the domestic economy and to induce recession.

Supply side measures are aimed at increasing earnings rather than reducing spending. This would appear preferable. However, they are also more uncertain. There is more argument about which measures are likely to be most effective in achieving these results and production is less likely to be

⁴ For an excellent and readable review of IMF conditionality see (Killick, 1995). For the classic technical critique of the IMF approach see (Edwards, 1989)

⁵ Although not necessarily with the precision that IMF quantified performance targets might suggest (see Killick 1995 chapter 4)

within government control. Perhaps more importantly, many of the measures concerned involve removing subsidies and privileges from particular groups that may be politically powerful (particularly the urban working class). Finally, the effects of supply side measures are likely to be slower to materialise.

The balance between the two types of measure may be determined by a number of factors. In terms of economic theory, it can be argued that a deficit that is produced by over-expansive domestic macro-economic policy should be corrected by demand side measures. A structurally caused deficit (e.g. resulting from declines in commodity prices or terms of trade shocks) should be financed if it will correct itself, or resolved by more structural measures if it will not (Bird 1984).

In more practical terms it may be that the availability of finance is the central constraint. Where there is limited finance and time is short, it will be essential to adopt demand compression policies to remove the deficit, as this works more quickly. Where more finance (and therefore time) is available, supply side measures become possible. Borrowed money must be repaid, though, and it is imperative that supply side measures are effective and that finance is used productively or problems may reappear in a worse form later.

Balance of payments adjustment during the Bretton Woods period

During the 1950s, the combination of limited private finance and the discipline of the par value system meant countries could only run up limited deficits before being forced to go to the Fund. Since problems were relatively small, IMF conditionality was largely confined to demand side measures.

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

Although these measures were not entirely popular⁶, they were relatively straightforward, with little room for IMF discretion (Guitian, 1992) and left considerable scope for government choice in the details of implementation. IMF staff look back on this era as a time when relationships with developing country governments were, by and large, positive (Finch, 1989).

A review of developing country representatives' statements at annual meetings reveals little general concern with conditionality, although there were some issues about the extent to which conditionality was equally applied (Ferguson, 1988). The disputes about overall levels of liquidity discussed in section 3.2.1 were far more significant.

3.2.3 Conclusions

The agreement negotiated at Bretton Woods that operated from 1944 to 1971 clearly cannot be defended as a purely technically driven system. The power of those with resources (surplus countries) over those without (deficit countries) has continued to mean that the question of who

⁶ As early as the 1950s Prebisch had developed his structuralist critique of the orthodox economics favoured by the IMF. It was not until the late 1960s, however, that academic criticisms of the IMF as acting against the interests of developing countries began to appear (See for example Krasner, 1968)

adjusts is determined by criteria that are more political than economic. Continuous disputes between debtor and creditor countries as the relative economic power of different nations fluctuates make this clear.

Indeed the existence of the Fund was partly a response to political imperatives. White, in particular, was heavily influenced by the liberal views of Secretary of State Cordell Hull who believed that 'unhampered trade dovetailed with peace; high tariffs, trade barriers, and unfair economic competition with war'⁷.

These concerns with global stability, particularly after the beginning of the Cold War in the late 1940s, facilitated international economic cooperation. The most significant example being the Marshall Plan, which largely replaced the use of Fund resources in the early period (again emphasising European countries' reluctance to be subject to the conditionality regime). Disputes over who would meet the costs of US Cold War priorities in Vietnam were one of the factors behind the disputes that led to the breakdown of the system in the early 1970s.

On the other hand, although rules for adjustment were partly determined by power considerations, they were institutionalised in a way that made adjustment easier than under the Gold Standard. Countries had an internationally sanctioned right to devalue their currencies, albeit with the need for international consent. They also had a right to finance to facilitate that process. Finance was limited and came attached to conditions that required demand side, deflationary adjustment. Once that principle was accepted, however, the precise content of conditionality could be determined by criteria that could credibly be viewed as largely technically determined.

Finally, although some countries were clearly more likely to find themselves borrowing from the Fund, it was also clear that, over the longer term, all countries were at least potential borrowers. Although the adjustment mechanism was, as always, biased in favour of creditors, the fact that all countries were potential debtors could be expected to have a moderating influence on the way conditional financing operated.

Overall, the IMF's self-perception as a technical institution presiding over a symmetrical set of mutual obligations embodied in a rules based code of conduct, though not wholly accurate, provided a broadly credible description of its operation in this period. The most obvious deviation from technical rationality, political considerations about overall levels of liquidity (indirectly, about who should adjust), were resolved through the IMF's more politically accountable institutions – the Board of Governors and the Executive Board. More obviously technical matters – the determination of conditionality – were carried out by Fund staff.

⁷ Hull's memoirs quoted in Gardner, 1980, 9

3.3 After Bretton Woods: the 1970s and 1980s

3.3.1 Surveillance and symmetry

Under the system of flexible exchange rates that emerged in the 1970s, the obligation to maintain a fixed parity was replaced by a less specific obligation to 'collaborate with the Fund and other members to assure orderly exchange arrangements and to promote a stable system of exchange rates' under the IMF's 'firm surveillance' (Art IV s1, s.3). The IMF became interested in any aspects of a member's policy that might influence the exchange rate (Guitian, 1992; Pauly, 1997). On the other hand, given the greater freedom involved, it became less clear when the limits of acceptable policy had been reached, undermining IMF discipline.

As Guitian (1992, 11) puts it:

In contrast with the Bretton Woods regime, under which nations agreed with the constraint and the international community administered the discretion, the current system puts into effect exactly the opposite framework: members have underwritten the predominance of discretion, while the international community is left with the task of administering the constraints to which this discretion is made subject.

The practical consequence was that it became even more difficult for the IMF to exert discipline on the policies of industrial countries. This didn't mean that they were free to do as they pleased. Increasing interdependence (particularly as a result of the growth in capital flows) meant that occasional policy coordination was essential but this usually took place within the auspices of the G7 or the OECD, with the Fund's role mainly reduced to the provision of information (Guitian, 1992; IMF, 1999a; Pauly, 1997)

The other key development also sprang from the growth in capital flows. After the first oil crisis, increased availability of finance in the Euromarkets meant that industrial countries could finance their balance of payment deficits without recourse to the Fund (the last loans to industrial countries were those to the UK & Italy in 1976). The effect was to undermine the Fund's role in regulating liquidity and further emphasize the separation of the Fund membership into more or less permanent groups of creditor and debtor countries with the middle-income countries alternating between the two depending on their creditworthiness at the time.

3.3.2 Adjustment and conditionality

Policy content

The oil crisis also affected the size and nature of balance of payment problems. Balance of payments difficulties for oil importing countries were on a far larger scale than those experienced before.

Initially the response was to finance these deficits, since they were clearly the result of structural problems rather than over expansive macro-economic policy. For middle-income countries this usually involved increased borrowings on private capital markets (particularly in the form of syndicated commercial bank loans).

For lower income countries, who were not so creditworthy, it involved going to the IMF but at this stage the Fund too was relatively supportive of attempts to finance deficits. It adopted two low conditionality facilities and the Extended Fund Facility that allowed for longer-term programmes (De Vries, 1987). On the other hand, conditionality was already beginning to expand during this period to include more specific conditions on fiscal matters such as the removal of food subsidies.

By 1976, attitudes in the industrial countries were beginning to harden and combating inflation became a major concern. It became more difficult to secure finance. Pressure from the industrial countries and a change of heart from the managing director resulted in a considerable tightening of conditionality (De Vries, 1987). The result was a noticeable loss of Fund legitimacy as an increasingly powerful and relatively united developing country group (Ferguson, 1988) protested publicly⁸ and increasingly sought funding outside the IMF (De Vries, 1987). The central criticisms are by now familiar from the literature on adjustment. Economically, they were that conditionality:

- (a) involved making too many policy changes in too short a time
- (b) was too heavily geared to deflationary demand restraint, harming growth and resulting in political unrest
- (c) was too heavily based on monetary targets which suggested monetarist thinking and which were not sufficiently tailored to individual country circumstances
- (d) tended to have regressive distributional consequences
- (e) concentrated on exchange rate depreciation which was ineffective (as the inflationary response outstripped the effects of incentives to increase supply) and would work better with trade controls (to encourage raw material imports rather than luxury goods) which the Fund would not allow⁹

Politically it was argued that the measures were ideologically anti-socialist because of their distributional impact and because of their stress on the reduction of state control in the economy¹⁰. It was also suggested that there was favouritism in the application of conditionality with industrial countries and their Cold War allies receiving more lenient treatment.

The controversy forced the IMF to conduct a limited (De Vries, 1987; Ferguson, 1988) review of its lending procedures. The result was the 1979 *Guidelines on Conditionality*, the only broad policy statement on the appropriate contents of conditionality produced before 2001. These guidelines included a number of provisions designed to ensure that countries' preferences would be respected

⁸ A representative selection of criticism from this period is contained in Development Dialogue No.2 1980 – See particularly (Nyrere, 1980) and (Arusha Initiative, 1980)

⁹ The list is taken from (De Vries, 1985) but the same criticisms can be found in other reviews (eg. Bird, 1984, Williamson, 1983)

¹⁰ The impact of IMF programmes on the poor is a consistent theme in critical appraisals of the Fund's role, see(Pastor, 1987)

and that conditionality would be kept to a minimum. There was also some evidence of a relaxation of conditionality over the next few years (De Vries, 1987). However, developing country strength was short lived¹¹ and, as we will see, the guidelines ultimately had little influence on the development of conditionality.

The second oil shock in 1979 was met with attempts at adjustment rather than financing. The result was a combination of high interest rates which raised borrowing costs, and recession in industrial country export markets. The eventual consequence was the outbreak of the debt crisis in 1982 and balance of payments problems of a magnitude which dwarfed even those of the mid-1970s.

Not only were the problems on a different scale, they were of a different nature. They resulted in the IMF becoming more involved with debt rescheduling. In the late 1970s first the Paris Club and later the commercial banks began to rediscover that, like the League of Nations in the 1920s and 1930s (Pauly, 1997), the IMF could perform a useful role in renegotiations of sovereign debt. The central difficulty with sovereign debt is what economists describe as the 'willingness to pay' problem. A sovereign debtor's ability to service debt will depend on the economic and fiscal policies it adopts. It is politically difficult for groups of banks or even official creditors to dictate policy to a sovereign state. On the other hand, without some assurances it is difficult to have confidence in repayment. The solution was to involve the IMF. This would result in greater creditor confidence and, therefore, a better deal for the country concerned (Finch, 1989).

This arrangement was satisfactory while it was reasonably likely that debts would be repaid. When, later in the 1970s, debts expanded to the point where they were clearly unsustainable, things became more difficult. When the debt crisis first struck in Mexico in 1982, the problem was so large that the banks themselves were under threat. The IMF said that it would refuse to lend (and therefore apply its strict conditionality to Mexico) unless the banks could come up with a large enough financing package to make the programme viable. Since the banks too were in danger of collapse if the package failed, funding materialised (Kraft, 1984). Mexico gained additional funding while the banks gained the assurance of conditionality.

The problems came later when the banks were no longer under threat of bankruptcy if the programme proved unsuccessful. They began to use the IMF's insistence on adequate funding to press for tighter conditionality and greater concessions from debtors (Finch, 1989).

Given the size of the debt overhang it became difficult to justify conditionality as a statement of the policies required to overcome balance of payments difficulties, since this was not a realistic goal. It looked more like an attempt by the banks to recoup as much as possible without having to reschedule their loans or for aid agencies to maximize aid effectiveness (Finch, 1989). Although not a purely zero-sum game (since lenders still had an incentive to value long term growth for its effects on repayment), there clearly was a relationship between how much repayment the IMF could

¹¹ So much so that by 1990, Polak's review of the 1979 conditionality guidelines concluded 'these restraining provisions have not prevented the intensification of conditionality in every direction that the guidelines attempted to block' (Polak, 1991, 53-54)

squeeze from a borrower country and how much debt needed to be written down or rescheduled. It also became more difficult to see the IMF's role as part of *global* regulation of the international economy. The IMF was acting rather as an intermediary between particular groups of debtors and creditors in the context of crisis management.

As far as the development of conditionality is concerned, this massive increase in the size of balance of payments problems without any appreciable increase in available funding also led to a change of direction. The IMF's traditional policies of demand compression were no longer viable and, with increasing collaboration with the World Bank (Polak, 1994), the IMF began to become much more interested in supply side measures, since the problems involved could only be resolved through increasing production as well as shrinking demand. It is important to note, however, that supply side measures were *in addition* to demand side measures rather than a replacement for them (Killick, 1984; Killick, 1995).

I have already pointed out that, although supply side measures are theoretically a more desirable way to resolve balance of payments problems, the choice of particular measures is more controversial than it is for demand side measures. They also tend to be more intrusive and to have more direct political consequences. The measures included in IMF programmes were heavily influenced by the new free market development orthodoxy that emerged in tandem with the rise of the New Right in the UK & US (Toye, 1993).

They tended to emphasize the withdrawal of the state from the economy (in the form of the removal of price controls, privatisation, the decontrol of interest rates) and the importance of export orientation (Killick et al., 1998). There is obviously scope for choice amongst measures adopted to promote production and, as critics were keen to point out, there are alternative strategies available¹² to those adopted by the IMF.

Later in the period, growing NGO criticism of structural adjustment and concerns at the adverse effects of conditionality on political stability led to additional, less market based, extensions to conditionality. Until the late 1980s, the IMF argued that its mandate was to set macroeconomic targets but it was for governments to decide how those targets would be met. Whether the government cut back on military expenditure or health care was none of the IMF's business (Nowzad, 1982).

However, the resulting perception was that the IMF encouraged cuts in expenditure on the poorest, leading to extensive public criticism. By the end of the 1980s, an increased focus on social safety nets was apparent and the IMF had begun, in a few cases, to question levels of military expenditure in borrowing countries (Polak, 1991). How significant these changes were is somewhat questionable. There is no doubt that there was some shift in both policy and presentation. Left wing critics maintain that the changes were cosmetic while some at the IMF even describe them as revolutionary (Polak, 1991)

¹² For example the idea of the 'developmental state' discussed in Chapters 4 and 5 below

Institutional changes

This expansion in the size of balance of payments problems and the scope of conditionality was not matched by increased finance. Fund resources have been declining steadily in proportion to the volume of world trade¹³ (Bird, 1995; Dell, 1981) tipping the *financing/conditionality* balance further towards conditionality.

The IMF's decision-making structures remained broadly unchanged. The number of developing country members and their economic significance expanded over the period so that developing countries as a group had a larger share of the votes and more Executive Directors by the end of the period (Ferguson, 1988; Krasner, 1985). Viewed individually, though, many developing countries found their voting shares decline. That was because, when the IMF was set up, each country was allocated an equal number of 'basic votes' to reflect the principle of sovereign equality as well as the votes they received in proportion to their quotas. Over time basic votes have remained constant while quotas have increased substantially to the detriment of smaller states – they were originally 14% of total voting rights and are now less than 3% (Gerster, 1993a; Lister, 1984; Woods, 2000a; Woods, 2000b).

The number of IMF decisions requiring special majorities also increased during the period as compromises on quota changes were struck by providing the losers with vetos over particular types of decision (Gerster, 1993a; Lister, 1984; Woods, 2000a)

3.3.3 Summary

Over this period, the most important decisions made by the IMF began to relate to conditional adjustment rather than to questions about overall liquidity. The scope of conditionality expanded significantly while the IMF's leverage over non-borrowing countries declined.

For critics, the main concern over the new structural measures included in IMF programmes was that they were essentially *additions* to the standard programmes resulting from a gap between the size of balance of payments problems and the amount of available finance (De Vries, 1987; Killick, 1984; Killick, 1995). They did not indicate a new more growth-friendly turn but did indicate a broadening of conditionality. Given the difficulties of justifying supply side measures in purely economic terms, the result was a clear danger of political favouritism. The influence of Cold War strategic purposes on IMF lending during this period did little to reassure¹⁴.

At the same time the availability of private finance meant that some countries could be virtually certain that they would no longer need to use the IMF's financial facilities. These were also the countries that had the largest influence over IMF decision-making. The IMF's voting structure was not reformed to reflect the increased obligations placed on developing countries. It continued to be

¹³ Much of the increase in finance that did take place was in the form of IMF contingent borrowing under the general agreements to borrow. These funds were subject to a 'double-lock' so that the G10 countries contributing the funds could veto IMF decisions to lend, further undermining the cooperative nature of the Fund.

¹⁴ The most commonly cited examples in this respect are Zaire, Egypt, Sudan and Argentina see also (Bartilow, 1998; Finch, 1989; Polak, 1991; Stiles, 1991)

based on the amount of finance contributed and a country's overall power within the global economic system.

Increasing involvement with debt and capital account issues created a new role for the Fund and a new relationship between it and the financial markets. During the Bretton Woods era, the finance that accompanied adjustment programmes came entirely from IMF resources. Negotiations took place solely between the borrower country and the IMF as representative of the membership as a whole.

Once adjustment also began to involve debt renegotiation, mobilising finance became a more strategic exercise. It involved a power struggle between banks' wish to maximise their returns and developing countries' desire for a pain-free adjustment with the IMF in a position to influence (though not control) the outcome. Fund resources themselves were a crucial part of the bargain. There was a danger that they were being used to pay overseas creditors rather than fund domestic adjustment – a problem acknowledged by those generally supportive of the Fund (Polak, 1991).

Again there was some common interest – if the banks pressed too hard for deflationary responses the long-term prospects for debt service would be poor. However, it was also far from a purely positive sum game and the IMF's position as mediator was potentially problematic – it raised questions about whether the IMF had been overly generous to either creditors or debtors. The IMF's limited direct control over the markets made the role particularly difficult and the fact that the majority of lenders were based within the Fund's controlling major shareholder countries raised questions about its impartiality.

3.3.4 Characterising the changes

The IMF tends to stress the ways in which the changes that took place over this period were responses to changing economic circumstances and developments in economic theory. Critics, on the other hand, point to changes in the balance of power between developing and developed countries and variations in the ideological dispositions of the IMF's largest shareholders.

Economic explanations

From an economic point of view, changes were firstly responses to the changing state of the global economy (De Vries, 1987). Guitian (1992) draws a parallel between the greater scope of surveillance resulting from the demise of the par value system and the expansion of the range of conditionality that was also required as a result of greater country flexibility. De Vries emphasises the importance of increasingly large balance of payments problems in the face of tight financing constraints in driving the shift to supply side measures (De Vries, 1987).

Changes can also be seen as a response to changing perspectives amongst economists and to some of the issues raised by the IMF's critics. The decision to press for more adjustment to the second oil shock was part of a growing recognition amongst economists that inflation was a key problem for the world economy. The inclusion of supply side measures was part of a move to include

economic growth as a specific objective of IMF programmes in response to some of the criticisms of the late 1970s.

A powerful argument for conditionality to include growth as a direct objective is that without such an approach medium-term viability (and the revolving character of Fund resources) may be elusive (IMF, 2001c)

The greater detail on fiscal provisions can be justified as an attempt to ensure that government expenditure cuts are directed towards greater efficiency rather than to declining investment (Polak, 1991) In the IMF's terms there has been a greater focus on the 'sustainability and quality' of fiscal adjustment (IMF, 2001c).

The market oriented nature of the measures included in structural adjustment programmes can be seen as a reaction to what was generally recognised (at least by the late 1970s) as the failure of import substituting industrialisation in Latin America. It was a response to the new 'Washington consensus' amongst the economics profession at large – a counter revolution against the Keynesian inspired excesses of the 1970s¹⁵.

Later, IMF experience with low income countries and transition economies whose problems were largely structural in origin enhanced the focus on supply side measures (IMF, 2001c).

Political explanations

Others argue that this purely economic explanation ignores the influence of clear changes in the balance of power between developed and developing countries during this period and of the differing ideological preferences of the IMF's main shareholders.

The first oil shock in the early 1970s resulted in growing economic power of oil exporting countries. The availability of finance on the international capital markets also meant that some oil importing countries had the opportunity to obtain their funds elsewhere. This meant that they could, and did, use this to put pressure on the Fund to make its resources more attractive (De Vries, 1985). Developing countries' ability to use Cold War strategic concerns to press for resources and the fact that US post-war dominance was being replaced by a more balanced relationship in which Europe and Japan also needed to be considered all contributed to developing country strength. The result was a period in which developing countries were increasingly assertive in international politics.

In an influential book based primarily on the experience of this period, Robert Jackson argues that developing countries were pressing to extend the changes that had taken place in the international sovereignty regime as part of the process of decolonisation (Jackson, 1990).

During the period of classical liberalism in the 19th century, sovereignty was largely the result of positive criteria. States became recognised on the basis that they were there – that they were sufficiently organised and powerful to demand recognition from their fellow states. Arguably, some

¹⁵ On the 'Washington consensus' see (Williamson, 1983). On the importance of Latin American experience in shaping that consensus see (Stiglitz, 1998a). The characterisation of these events as a counter-revolution follows the critical account provided in (Toye, 1993).

degree of 'civility' such as the possession of a constitution was also a key factor. States that failed to achieve these standards were either ignored – not made party to international treaties – or were absorbed as various kinds of colony or protectorate.

During the process of decolonisation, this positive requirement was replaced by a negative assumption of the right to self-determination for all peoples. Sovereignty moved along a continuum towards a normative requirement of recognition and away from a positive requirement of self-help and self-assertion¹⁶.

From this incontestable right to self-determination enshrined in the UN Charter, some Third World jurists in the 1970s attempted to extrapolate a 'right to development'.

The right to development flows from this right to self-determination and is of the same kind. For it is pointless to acknowledge self-determination as an overriding and pre-emptory principle if we do not simultaneously acknowledge a right to development for the people which has determined its own future. Mohammed Bedjaou cited in (Jackson, 1990)

For Jackson,

the result is a dual system of international legitimacy and legality. This is revealed in the concurrent practice of acknowledging the special claims of marginal Third World governments to preferential and non-reciprocal assistance while respecting a universal and reciprocal right of non-intervention. States should extend active assistance while respecting a universal and strict respect for the sovereign equality of states and free of any conditions derogating from that sovereignty.

In similar vein, Krasner argued that developing countries in the 1970s adopted strategies designed:

to limit the market power of the North by enhancing the sovereign prerogatives of the South, either through universal international organisations in which each nation has a single vote, or by widening the scope of activities exclusively subject to the unilateral sovereign will of individual developing states. (Krasner, 1985, 7)

The aim was to use political criteria – the right to sovereign self-determination and the equality of all peoples – to claim the right to a transfer of resources without undermining the sovereign right to non-interference in domestic affairs. Developing countries tried to use the idea of a right to development to argue that resource transfers such as IMF finance were closer to a right (and so should be condition free) than to a commercial transaction (where the historical experience reviewed at the beginning of chapter two would suggest quite intrusive conditions were the norm).

Calls for a New International Economic Order were heard throughout UN institutions in the 1970s. Success in the IMF was modest – though the relatively generous response to the first oil shock and success in forcing a review of conditionality in 1979 are indicative of developing country strength (Krasner, 1985). However, the period in which these efforts looked likely to have a significant impact were short lived.

Rather than disengaging from international institutions (as Krasner predicted) developed countries were able to reassert control in the 1980s. As we have seen, this was in part a result of the impact

¹⁶ See also Hawthorn, 1994; Krasner, 1985

that the developed countries' response to the second oil shock had on what were, at least in retrospect, highly vulnerable developing country finances. Under these circumstances, the trend towards a loss of control of the international financial institutions could begin to be reversed.

Unprecedentedly large balance of payments problems, the need for debt rescheduling and the fact that the debt crisis took place in a context of developed country recession, exacerbating industrial countries' reluctance to agree transfers, had two consequences. Most obviously it meant that developing countries found themselves back in a far weaker position as market access disappeared. In addition the size of the financing gap meant that the response to the debt crisis involved far more coordination of lending than had taken place before. The IMF's new role as coordinator of the rescue gradually transformed it into the gatekeeper to finance from the World Bank, bilateral donors (who were in turn increasingly coordinated through bodies such as the OECD's Development Assistance Committee) and arguably for the financial markets¹⁷. This clearly added leverage to IMF power at a time when developing countries were in no position to argue about the terms on which lending was provided.

The way that new-found power was exercised was heavily influenced by the neo-liberal policies of the Thatcher and Reagan governments. A consensus on the overriding importance of free markets made it easier to legitimate interventions in developing countries that would previously have been seen as unacceptable.

Conclusions

The changes were, of course, a combination of political and economic factors. Changes in IMF policy were economic adaptations to the world the Fund found itself dealing with but that world was in part a political creation. It would be wrong to portray the changes as entirely controlled by all-powerful developed countries. Apart from anything else, that would underestimate increasing dissatisfaction about aspects of state-led development within developing countries (Boughton, 2001). Nonetheless, it is difficult to deny that changes in the Fund's role were partly driven by the shifting balance of power, a fact that must undermine any claim that the IMF is a purely technocratic consensual institution. To talk about 'larger financing gaps' as though they were purely natural developments is disingenuous given that the amount of finance available to the IMF and through bilateral contributions (though not so clearly through the financial markets) is politically determined largely by developed country choices.

3.4 The 1990s market confidence and good governance

Two key changes took place during the 1990s, one largely economic and the other largely political. The first was a resurgence of capital flows in a context of international moves towards financial deregulation and the second was the end of the Cold War.

¹⁷ The link between IMF programmes and inflows of private capital is discussed below.

The IMF's role in Eastern Europe is largely beyond the scope of this thesis. For our purposes it is sufficient to note that IMF staff were heavily involved in technical assistance and structural interventions to create market economies in the post-communist countries and that this reinforced the IMF's pre-existing tendency to become involved in structural policies (IMF, 2001c; James, 1998). However, a more relevant consequence in the context of the Asian crisis is a growing willingness for bilateral and multilateral institutions to become involved in issues of 'good governance'.

These changes in policy have also been reflected in gradual institutional adaptation towards an operating style more in keeping with the liberal international norms of the 1990s.

3.4.1 Capital flows, market confidence and the 'catalytic effect'

By the 1990s capital flows to developing (principally middle-income) countries were, again, expanding rapidly. Between 1988 and 1995, total net LDC external funding increased from US\$37 billion to US\$235.8 billion of which US\$90 billion was direct investment and US\$100.2 'other' (IMF, 1989; IMF, 1996). This began to provide a further justification for IMF conditionality that was distinctively different from its original purpose as bridging finance for current account balance of payments problems.

Since the value of financial assets is heavily dependent on expectations about their future value, market confidence can have a large impact on asset values, capital inflows and therefore a country's balance of payments. For some time now¹⁸, the IMF has been arguing that IMF conditionality can enhance market confidence and have a 'catalytic effect', inducing capital inflows (Dhonte, 1997; Masson & Mussa, 1995).

The idea is that IMF conditionality can provide a sort of commitment technology to enhance confidence in a governments' willingness to follow through on announced policy changes¹⁹. The negotiation process can provide the IMF with superior information about a country's commitment to economic reform than is available to the markets. The fact that the IMF is willing to commit finance in support of a programme, and the fact that the country stands to lose that finance if its adjustment effort falters, means that conditionality can provide valuable assurances to official lenders and the markets. The IMF's objectivity and superior technical knowledge may add additional credibility.

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

¹⁸ Dhonte argues that this began with the IMF's role in encouraging concerted lending during the debt crisis. It is therefore a trend that began with the IMF's growing involvement in debt issues reviewed in the previous section.

¹⁹ A loose analogy is the widespread view that central bank independence can reassure the markets that monetary stability will not be sacrificed to short-term political gain. Once this becomes the expectation, measures that are taken to fight inflation will in fact be more effective than they would be if taken by government because they will not trigger speculative tests of government resolution.

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

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

If it is also to enhance credibility with private markets it must make a:

judgement not only on the technical aspects of the policies, but also on the policy-makers' determination to sustain them. The Fund puts its own credibility at risk in vouching for this determination, most visibly by the commitment of its own resources...Markets do not, obviously, take Fund assurances at face value; but program conditionality can nevertheless help the member signal its determination to act in a restrained manner (Dhonte, 1997, 8).

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

it is not only necessary to rely on a core team of national coordinators; in many cases, there must also be a strengthening of the whole civil administration, in particular the judiciary. An efficient civil service, backed up by a competent judiciary, is necessary for the solution of the authorities' time consistency problems and for the establishment of the rule of law, and thus for the creation of an economically secure environment. In this specific sense, "good" governance is an integral component of Fund programmes (Dhonte, 1997, 11-12).

In fact, once market confidence becomes the crucial determinant of balance of payments viability because of its effects on the capital account, the range of policies that may have an influence on the exchange rate is vastly expanded. In a sense this is merely to underscore the significance of capital market opening, welcomed by some as ensuring that governments will be subjected to 'market discipline' and deeply unpopular with others as government goals become more subordinated to 'market sentiment'.

3.4.2 Good governance

The IMF's new interest in questions about the predictability and certainty of policy was in part a response to the relationship between market confidence and capital flows. However, that development was only a small part of a far wider agenda.

In technical terms, this new agenda reflected another period of 'learning' within the economics profession. As we saw in the previous section, the increased focus on structural conditionality in the 1980s was accompanied by a political focus on the benefits of markets over states. Limited government was a central plank of approaches to development economics and, therefore, of IMF conditionality.

The Washington consensus held that good economic performance required liberalized trade, macroeconomic stability and getting prices right. Once the government dealt with these issues

– essentially once the government ‘got out of the way’ – private markets would allocate resources efficiently and generate robust growth. (Stiglitz, 1998a, 1)

In the late 1980s, though, it was possible to observe another shift in emphasis within the IFIs. The World Bank’s experience with structural adjustment in Africa had made it increasingly conscious of the importance of government for development (World Bank, 1989).

The contrast between East Asian and Latin American development was also important. Much of the Washington consensus was a reaction to Latin American experiences (Stiglitz, 1998a). Initially economists had argued that East Asia had ‘got it right’ by its focus on export promotion rather than import substitution and by its less state centred approach to development (Krueger, 1979). In the early 1990s a concerted academic attack was launched on the second half of this view, pointing out the extent of state intervention in fostering growth, particularly in the North East Asian NICs²⁰. Under pressure from the Japanese, the World Bank produced a grudging and somewhat half-hearted acknowledgement of the importance of state policy for East Asian development in 1993 (World Bank, 1993), paving the way for its increasing interest in the state in the late 1990s.

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

Although questions about the way government institutions operate clearly have the potential to be highly political, the Articles of Agreement of the IMF and World Bank prevent them from becoming involved in political issues²¹ so their approach has tended to be couched in technical terms. Indeed World Bank president James Wolfensohn is apparently particularly proud of the ways in which he has been able to redefine issues that were previously thought of as political, such as corruption, as technical issues affecting growth and macroeconomic balance (Hawthorn, 1999).

The IMF was slower to become explicitly involved in governance than the World Bank. The first official mention came in the Interim Committee’s Autumn 1996 declaration *Partnership for Sustainable Growth* which argued that ‘promoting good governance in all its aspects including ensuring the rule of law, improving the efficiency and accountability of the public sector, and tackling corruption’ was an essential part of a framework in which economies could prosper. This triggered Executive Board discussions leading to the publication of the IMF’s governance guidelines in August 1997 (IMF, 1997a).

²⁰ For the debate on the ‘developmental state’ see (Amsden, 1990; Wade, 1990) and the case study discussions in Part 2 of this thesis – particularly chapter 5 on South Korea

²¹ The IMF, for example, is required to ‘respect the domestic social and political policies of its members’ (Article IV Section 3 (b))

The guidelines acknowledge²² that 'it is difficult to separate economic aspects of governance from political aspects'. They try to deal with this issue by concentrating on 'economic' issues and explicitly stipulating that 'the IMF's judgements should not be influenced by the nature of a political regime of a country nor should it interfere in the domestic or foreign politics of any member.' (7)

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

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

In fact it should not be surprising that this separation can be difficult to maintain. In parallel with the IFI's development of a 'technical' interest in 'good governance', these issues had been playing a more important and far more explicitly political role in the agenda of bilateral donors since 1989.

There were a number of reasons for this renewed focus on the importance of state institutions in development. The fact that bilateral donors began announcing the new agenda in 1990, just after the collapse of the Eastern Block, is no accident. Douglas Hurd gave a speech in 1990 calling for 'good government' and political pluralism. Later in the month Mitterand declared to the biennial French-African summit that 'France will link its financial efforts to the efforts made towards liberty'. By the mid 1990s, this political aid agenda had been adopted by almost all the bilateral donors and the OECD Development Assistance Committee (DAC)²³.

This was not only a simple reflection of the kind of post Cold War liberal triumphalism exemplified by Fukuyama's *The End of History*. The end of the Cold War had created a new environment for foreign aid. In the past, Cold War priorities had provided a security justification for extending aid budgets but the competition for influence that was involved had placed restrictions on what could be done as part of the aid process. After 1989, 'Western governments felt freer than before to

²² The quotations that follow are all from (IMF, 1997a). The numbers in brackets indicate the paragraph numbers in that document.

²³ For an extended review of this process and a comparative analysis of the policies adopted by bilateral donors see (Crawford, 2001)

pursue basic political concerns vis-à-vis the governments of the South' (Stokke, 1995, p9). At the same time, appeals to democracy and human rights could be used to bolster flagging public support for aid budgets once more direct security justifications had disappeared (Lancaster, 1993).

This was particularly clear in the rhetoric²⁴ of Clinton foreign policy. An article published by Secretary for Defence Strobe Talbott in the run up to the 1996 presidential elections is a prime example:

As president, [Clinton] has ... [made] support for democracy a priority of his administration's diplomacy in Latin America, Asia, Africa, Central Europe, and the former Soviet Union (p47)... This conviction reflects the political realities on the home front of US foreign policy... The American people want their country's foreign policy rooted in idealpolitik as well as realpolitik. (p49) ... To sustain the support of the American public for international leadership, American foreign policy must continue to be based on the nature of our society and on our character as a people as well as on our interests as a state. (p63) (Talbott, 1996)

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

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

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

3.4.3 Institutional change

As early as 1994, Peter Burnell suggested that the IFI's new enthusiasm for good governance should be reflected in their own operations (Burnell, 1994). Although change has been limited, the second half of the 1990s have shown a shift in focus. This change has had two aspects: a greater focus on the importance of 'ownership' and more transparency about IMF operations.

Ownership

A growing body of academic and internal research was pointing to problems with implementation in IMF programmes. So, for example, Tony Killick at the ODI in London had noticed, while carrying out different research, that breakdown of programmes (an indicator of serious non-implementation) was running at over 60% in the early 1990s (Killick, 1995). He and his colleagues went on to suggest, using insights from agency theory, that the fact that it was difficult to enforce

²⁴ In reality, the distribution of funds between countries did not provide much evidence of a change in priorities in the US (Hook, 1998) or indeed in Europe (Olsen, 1998). Strategic and economic concerns remained priorities.

conditions that governments really were strongly opposed to was hardly surprising given the relative costs that the IMF and domestic populations were able to inflict on decision makers. This was particularly problematic given that there is considerable evidence of IMF reluctance to use the sanction it does have at its disposal – refusal to disburse further funds²⁵ (Killick et al., 1998).

The IMF too was aware of the difficulties. The Policy and Review Department had observed that ‘a substantial proportion of program interruptions are attributable to policy disagreements between governments and Fund staff’ (cited in IMF, 1998, 21) and the ESAF evaluation carried out in 1998 (IMF, 1998) was asked to offer a particular focus on ownership.

These concerns about the effectiveness of conditionality, combined with a growing recognition of the possible benefits of participatory development on small scale projects lead to a greater focus on the importance of ‘ownership’ or ‘partnership’ at the IMF and a wide range of other development institutions. This new focus, of course, also had a certain resonance with the growing international importance of democratic norms.

Though the principles are widely acknowledged, they have been more difficult to realise in practice. At the IMF there clearly have been moves to widen the audiences that the IMF contacts in borrower countries. Under Camdessus’ leadership the IMF began to reach out to labour unions in recipient countries²⁶. Fund staff more generally are far more likely to talk about ownership and there have clearly been changes to the operation of staff missions from the traditional model in which negotiations took place largely within finance ministries²⁷.

For some this is still largely a matter of ensuring government support – ‘if governments don’t have a solid base of support for an IMF-sponsored programme, it won’t work’ – but for others it also includes the need for ‘a broad-based social consensus’ behind programmes²⁸.

To date the principal practical manifestation of this change has been a broadening of the contacts between IMF missions and broader sectors of the domestic population. Mission leaders have increasingly had contacts with non-core ministries (i.e. other than the central bank, the Ministry of Finance and its associated agencies such as planning ministries or State Owned Enterprise ministries). In some cases they have also spoken to business, labour and NGO groupings.

Questions remained, however, over the extent to which these consultations would constitute a genuine input into the policy process rather than merely an attempt to explain and justify the IMF’s views to a wider audience.

²⁵ The results of this research were communicated to the IMF at high level seminars in Washington (Killick et al., 1998)

²⁶ Management issued instructions to resident representatives in 1995 to cooperate with the ILO and foster links with local unions. (O’Brien et al., 2000).

²⁷ See for example IMF 1998

²⁸ Quotes are from interviews with Jan Arte Scholte in 1996 cited in O’Brien et al., 2000, 187

Transparency

The other main development involves an opening to a wider audience at the level of scrutiny over general policy in the form of greater transparency about Fund operations.

Some Washington based NGOs²⁹ had been campaigning for greater transparency at the IMF since at least the early 1990s. When the Mexican crisis struck in 1994, strong opposition in the US Congress to the way the crisis was dealt with³⁰ triggered pressure towards more openness as a condition for providing the \$100 million the IMF that was required to replenish ESAF in the same year. This pressure towards transparency was particularly difficult to ignore when the IMF's response to the crisis was to press for more fiscal and financial transparency in developing countries.

The result has been a release of a great deal of information on the content of IMF conditionality that had previously been confidential. Since 1994, the Fund has issued press releases concerning the approval of stand-by credits including a summary of the conditions involved. In 1990 Argentina began to publish its letters of intent and other countries have increasingly followed suit. Since 1996 a number of ESAF policy framework papers have also been published. 'Public information notices' summarising some key Executive Board decisions and a wider range of staff papers have also become available on the IMF's website.

3.4.4 Conclusions

During this period, the IMF's role in developing countries continued to expand but, more than in the 1970s and 1980s, the IMF also began to look for new ways to justify that expanded role.

The IMF's role in regulating capital account transactions that started with its role in debt rescheduling, particularly after Mexico's crisis in 1982, became more explicit in the 1990s. The idea that the IMF could help to support capital account balance by enhancing market confidence in turn provided a justification for intervention in an ever wider range of policies and began to create a far more explicit link between the IMF and the private financial markets.

The increasing separation between developing and developed country interests that took place during the 1980s, combined with longer running programmes and a move to supply side measures had already begun to make the IMF look like a development institution rather than a global regulator. The added adoption of 'good governance' in the 1990s and the trends towards an increased focus on poverty and social welfare that began in the late 1980s and became more prominent during the 1990s reinforced this perception.

This meshed well with the changing rationale for foreign spending in the wake of the Cold War. At least at the level of rhetoric, there was a return to a more humanitarian conception of aid and public evaluations of government aid budgets reflected this.

²⁹ Particularly Friends of the Earth – US, Centre for Concern and the Bretton Woods Project (O'Brien et al., 2000, 183).

³⁰ For more details see Chapter 8 below

The 'third wave' of democratisation and the IMF's moves towards greater openness and accountability to an emergent global civil society began to dissolve the contradiction that Jackson described in developing countries' claims to sovereignty during the 1970s. In a world that was increasingly seen as constituting a liberal global order, states found it more difficult to use arguments about sovereignty to obtain international resources unless they could at least argue that those resources had a reasonable chance of improving the livelihoods of their populations. That this change should be seen as part of a broad change in international norms, rather than merely an extension of IFI conditionality, is apparent in concurrent changes in the international security and human rights regime authorising foreign military intervention in defence of human rights (Mayall, 1996).

Nonetheless institutional change at the IMF remained modest and questions remained about to whom the institution should and would become more accountable – those questions will form a key part of the discussions in the rest of the thesis.

3.5 IMF evolution and legitimacy

There are both continuities and differences between the Bretton Woods conception of the Fund and the institution as it exists today. The IMF has never been best characterised as a purely apolitical technocratic institution – most obviously the extent to which creditor countries meet the costs of adjustment has always been the result of power struggles. This shouldn't surprise us too much. As I argued at the beginning of chapter two, legitimating accounts are always somewhat self-serving.

What is important is the *degree* to which that account is credible, and particularly the way its credibility has changed over time. The evidence I have reviewed in this chapter suggests that a number of developments have seriously weakened technocratic claims and undermined the reciprocal relationships that originally underpinned Fund legitimacy claims. On the other hand changing international norms (particularly in terms of conceptions of sovereignty and attitudes to the market) and a gradual move to enhance the IMF's representative legitimacy have provided modest compensations.

The collapse of symmetry

The Fund never embodied a completely rational, neutral and symmetrical set of obligations. Power considerations were always present. Debtor countries have always been in a weaker position and strategic considerations have determined how well they are to be treated. European countries have been more successful throughout than developing countries in avoiding conditionality.

Nonetheless, the IMF as originally conceived did embody a series of reciprocal obligations, at least to some degree. All countries could be expected to borrow from the IMF. Even the Europeans had to accept conditionality from time to time. All countries (with the possible exception of the United States) were also subject to some IMF discipline even when they were not borrowing.

The changes that began in the early 1970s greatly undermined this symmetry, as many internal and external commentators have noted (Guitian, 1992; Polak, 1991). This has had quite fundamental effects on the incentives facing different participants in the organisation. Two clear examples relate to the tendency towards debtor adjustment and debates over appropriate levels of IMF financing.

When early critics pointed to the tendency for the IMF, too, to press adjustment on debtors rather than creditors (Dell, 1981) the IMF could point to the system of reciprocal obligations within which conditional adjustment was embedded.

By the 1990s this argument was becoming particularly hard to sustain. So, for example, Guitian's classic 1992 defense of the Fund argues that the IMF should concentrate on each individual country's obligations

the IMF looks at 'the soundness of a country's balance of payments, or to put it differently, of the country's skill in keeping within the budget constraint it faces' (Guitian, 1992, 15).

When the surveillance process is working properly, the cumulative effect of each nation's policies will be a global economic equilibrium. However, he is forced to admit that, under contemporary conditions, surveillance simply *doesn't* work effectively as there are no effective restraints on creditor countries. In a context where countries no longer fluctuate between debtor and creditor position at the IMF, this change clearly has difficult political consequences.

More honest was an earlier Fund defence that simply accepted the injustice but challenged the IMF's critics to come up with a politically feasible alternative (Nowzad, 1982). This focus on an appropriate counterfactual is more credible but it seriously undermines the IMF's claims to provide objective support for a global liberal economy in the interests of all – it is an argument more in the language of power than of legitimacy.

The issue of creditor adjustment was always going to be problematic but even issues that might have been resolved more amicably in the past such as levels of Fund finance have the potential to be far more problematic following the decline of symmetry. In the past, all countries could expect to borrow from the Fund so IMF resources could be genuinely regarded as a common revolving fund (Kenen, 1986). Even then, greater developing country vulnerability to commodity price shocks and the fact that quotas were linked to voting rights meant that a quota increase would have the greatest adverse effects on those most able to oppose it implying some downward bias.

However, once some countries began to perceive themselves as lenders and others as borrowers the problems were greatly exacerbated. To the extent that financed adjustment can promote common goals – a rapid return to growth and therefore re-emergence as a trading partner in the global economy – there are still incentives to provide finance. However, there is an inevitable tendency to see finance as a down payment on policy reform rather than a mutual insurance policy under conditions designed to promote common goals. Since finance will only be used to promote reform in one group of countries there is bound to be a suspicion that, while some reform is in

everyone's interest, other proposals may be designed to benefit the interests of finance providers against those of finance consumers.

The decline of a global vision

Closely related is the decline of a clear role for the IMF as a global regulator. The move to floating exchange rates has meant that the IMF no longer has a role in setting clear global rules or in monitoring international liquidity. It concentrates far more on the monitoring of individual country policies in the context of both surveillance and conditionality. Worse still, in practice surveillance has little influence on developed countries who negotiate monetary arrangements with each other in the context of the G-10 or OECD. They use the Fund more as a way to negotiate their relationships with developing countries

The Fund is at pains to stress its continuing role as a central site for international negotiations and the provision of information on an international scale. The Fund's two flagship annual publications – *World Economic Outlook* and *International Capital Markets* - are significant here but even they contain little genuinely regional or global analysis. Indeed the recent external evaluation reports on surveillance and research commissioned by the Fund have pointed to this issue (IMF, 1999a; IMF, 2000a). At any rate, a role as global information provider is very different to one charged with global regulation, particularly as a key part of the Fund's role was to provide political control over the markets so as to reduce the need for adjustment, as well as merely providing finance and advice to ease adjustment when it became necessary.

Expanded conditionality

The very core of the logic of conditional finance also remains in place. The Fund mobilises finance to ease adjustment and, in return, imposes conditions on borrowers to ensure adjustment takes place without breaching international obligations.

What has changed is that conditionality has clearly become far more extensive than it was intended to be when the Fund was set up (if it was intended to exist at all). As it has been extended, it has come to address issues that are far more significant for domestic politics. In the 1980s this agenda was largely to do with economic liberalisation and rolling back the state. In the 1990s it has begun to embrace transparency, accountability, judicial institutions, and dismantling industrial policy. It has also evolved to deal with longer-term policy in developing countries, attempting to pursue structural measures to boost production.

The IMF has tried to legitimate this change largely by portraying conditionality as a residual category – what is left once surveillance and the availability of finance have been dealt with (Guitian, 1992). If we are prepared to bracket those issues, the IMF's arguments that changes in its scope have been driven by technical changes and developments in economic knowledge look a little more credible though they still rely on a conception of economics as objective science that is highly questionable.

However, these attempts to confine debate can plainly be seen as a strategy to restrict the issues that are on the agenda when conditionality is being discussed or negotiated. It is designed to

displace controversy rather than to deal with it. In doing so signals are sent out about the hierarchy of decisions involved with some issues more willingly discussed than others. Lowest level and easiest to change are arguments about the content of conditionality conceived within the narrow context in which the Fund portrays it, then comes the availability of private and public finance and finally the overall framework of the global economy.

Even if we do bracket larger issues, though, and accept that conditionality's *development* has been a technical matter it is clearly increasingly difficult to justify its *content* as technically determined as the agenda of potential conditions grows ever wider. That has highly problematic implications for the Executive Board's technocratic authority.

More intrusive conditionality is also more likely to mobilise domestic political groups since it will have direct effects on a wider range of individuals. This in turn makes it far clearer that negotiating conditionality must be seen as a 'two-level game' (Putnam, 1988) in which government negotiators (and therefore IMF staff) have to pay more attention to how programmes will play with domestic audiences.

If we don't 'bracket' the more fundamental issues, though, we again see the importance of declining symmetry for IMF legitimacy. Conditionality used to be justified in part by its status as one part of a broader reciprocal rules based framework designed to reduce the potential costs of engagement with the international economy and provide incentives for continuing engagement. With the declining influence of surveillance in developed countries, and the Fund's difficulties in pointing to a truly global vision, the separation between debates about the content of conditionality and about much broader issues in global monetary regulation becomes more difficult to maintain. Those debates are *not* going on elsewhere and, therefore, a key part of the justification for conditionality (the conditions countries are obliged to adjust to) is not up for debate. Without justifications based on the rule of law or consent, the Executive Board therefore needs to carry far greater authority.

From current account to capital account

Underlying many of these changes has been a gradual shift from an exclusive interest in current account issues and towards an interest in capital account issues: effectively a reduction in the extent of political control over the international economy as a whole. The rise in privately financed sovereign debt was a key factor in undermining symmetry, producing larger crises, and justifying expanded conditionality.

The shift towards private funding also diminished IMF control over balance of payments financing and, gradually, over the content of conditionality as the Fund began to need to enter into complex strategic relationship with the markets over the contributions that would be made towards resolving balance of payments crises. It was no longer in complete control of the relationship between conditions included and funds provided. In a way it is therefore possible to read all the changes that took place between Bretton Woods and the Asian crisis as consequences of a gradual shift towards capital account openness.

By the mid-1990s, under pressure from the G7 (and particularly the US (see Chapter 8)) capital account liberalisation appeared to have become an implicit Fund goal. In that context it is important to note that the original assumptions underlying the Bretton Woods agreements included a strong expectation that international capital flows would be regulated.

In fact the IMF's involvement in capital account crises was deliberately outlawed by Article VI of the Fund's Articles of Agreement which prevents the Fund from providing resources to a country experiencing a 'large or sustained outflow of capital'. Polak argues that this issue was dealt with in Asia as it had been in the past using 'fancy legal footwork' arguing that more generally,

When the membership has agreed that the Fund should perform a new task ... the Fund has usually found a way to do so without recourse to amendment (Polak, 1998, 49)

The footwork required to justify intervention in Mexico and Asia was particularly fancy³¹ and even Polak acknowledges that some formalisation of the new position would be desirable. Giannini argues more forcefully that:

Rule-bending is a common practice in real-world institutions and can even be viewed as healthy to the extent that it is a response to a new challenge...[but]...if it is protracted or applied to a core, rather than to marginal functions, it risks putting the legitimacy of the rule bending institution at great peril (Giannini, 1999, 23).

As Polak's discussion makes clear, the IMF has dealt with this issue on the strength of member consent. However, that consent is only exercised within the context of the IMF's weighted voting decision-making structures which offer weaker veto options to weaker states (and to various sanctioning institutions at domestic level) than the formal procedures for amending the Articles.

Finally it is worth pointing out that developing countries have yet to make any explicit legal undertakings to maintain capital (as opposed to current) account openness, something that will be significant when we come to look at the Asian crisis in Chapter 4.

Changing public international norms and new justifications?

Although the picture presented so far looks very negative for IMF legitimacy, there have also been developments that may make conditionality more acceptable, at least for some players in developing countries.

The IMF's claim that developing countries have begun voluntarily to adopt more market-based policies has some credibility (Boughton, 2001). The reasons for this change are the cause of much speculation and are not well understood (Bierkersteker, 1992; Stallings, 1992). Possible factors include:

- a reaction to the failures of earlier state led policies (particularly those in Africa and Latin America),
- a growing recognition of the potential benefits of trade and foreign investment - a conversion to economic orthodoxy. That may be under the influence of overseas education

³¹ See (Giannini, 1999) for a discussion

or the hegemonic research output of the IMF and World Bank but it will also have been influenced by the renewed availability of private finance in the 1990s,

- an acceptance that the balance of power in the contemporary international economy simply leaves little choice but to adopt the new market friendly measures.

For countries that have access to capital markets, the resurgence of global finance in the 1990s clearly does provide incentives towards more orthodox macroeconomic policy in the same way that the promise of future finance facilitated debt negotiations in the 1890s (see section 2.2.1 above). For these countries IMF arguments about credibility and a potential 'catalytic effect' have clear attractions, at least in theory.

In practice questions remain about the extent to which IMF policies actually do enhance market confidence and induce capital inflows: something I will discuss further in Chapter 4. However, increased economic internationalisation and a growing developing country conversion to more orthodox economics are clearly significant trends that could theoretically make the IMF's task easier.

The second new set of justifications, those relating to good governance, are more unambiguously political. From a developed country point of view their logic is clear. If the IMF has long term involvement in countries designed to promote growth, it is difficult to regard it as anything other than a development institution – even though that is still emphatically not the official position at the Fund or at least some of its major shareholders³². As a post Cold War development institution its legitimation must be humanitarian and it is therefore logical to include a concern with poverty and governance issues – particularly to the extent that these issues too can be redefined as mere technical requirements for development.

In developing countries, a focus on potentially popular issues such as democracy, human rights and poverty reduction may also reduce some sources of popular resistance to the Fund, helping it to overcome its old *dependencia* image as the promoter of foreign capital at the expense of domestic welfare (Payer, 1977). This was an image that the Fund sometimes allowed states to perpetuate through scapegoating strategies in which the IMF was blamed for unpopular policies favoured by domestic governments. This may be particularly important as more extensive programmes with more direct effect on domestic populations become more common. A new focus on 'ownership' then both reflects new international norms and the need to legitimate a broader agenda.

The new agenda also reflects a significant change in the international sovereignty regime. We saw above that Jackson identified a shift in the Post War era towards states that were preserved internationally for moral (self determination) and strategic (Cold War) reasons despite limited domestic legitimacy (see page 69 above). During the 1990s, that shift began to be challenged. In the

³² So, for example, both the US Treasury and USAID confirm that USAID have no involvement in determining IMF policy because the Fund is 'not a development institution' (personal communications, October 2000). In contrast, DFID has clearly had a significant input into UK policy during Gordon Brown's chairmanship of the IMFC

new liberal world order, states are to be held responsible by 'the international community' for the interests of their domestic populations.

This, of course, has profound implications for the legitimacy of international institutions such as the IMF. In this Chapter and Chapter 2 I have talked, predominantly, about states as unitary actors. One consequence of the new agenda is that it is no longer practical to do so. This is a complex issue and will receive more discussion in Chapter 4.

3.6 IMF legitimacy in the mid-1990s

The core of the Fund's role has remained constant over time and retains considerable potential attractions. It continues to provide an international forum for negotiation, exchange of information and regulation relating to the international monetary system in the interests of promoting openness. Conditionality has the potential to ease adjustment, mobilising considerable resources for developing countries.

However, within that broad framework the Fund's role has been significantly reinterpreted. The 'code of conduct' in support of openness has become much more flexible and that flexibility seems to have been particularly beneficial for developed countries: essentially there is less control over financial markets implying a greater need for adjustment to market behaviour. As a consequence, the Executive Board has taken on a much more extensive and controversial role in developing countries and that role is less easily tied into a more fundamental set of rules enshrined in law.

Relationships around finance, too, have become less symmetrical. Only some countries now expect to have to borrow from the Fund. Others are merely lenders and this will inevitably affect attitudes towards the institution³³. Equally, the Fund now has a far more marginal position in providing finance. Private markets have become more important and the Fund has entered into a difficult strategic role with those markets. It hopes to catalyse lending but has sometimes been accused of serving the interests of private markets rather than those of states. By allowing the genie of private capital back out of the bottle, states have made a significant dent in the post war idea of embedded liberalism which was one of the principal inspirations behind establishing the Fund.

On the other hand, large capital flows to developing countries are potentially very attractive and their rise also provides new incentives for agreeing conditionality, at least if crises are not too frequent and the 'catalytic effect' materialises in practice.

The more extensive and more political agenda that the IMF seems to feel is required for conditionality under contemporary conditions provides additional challenges. It raises questions about the Executive Board's technical competence and an additional set of issues about consent of actors below the level of the state that I will look at more thoroughly in Chapter 4. On the other hand, emerging international norms around the ideas of democracy and human rights may have

³³ See also section 2.2.2 above

facilitated political interventions. Some aspects of the good governance agenda adopted by the IMF also have the potential to make the IMF appear more attractive to non-government groups in both developed and developing countries.

The rest of the thesis will explore political responses to the balance between the costs and benefits of the changes that have taken place. First, though, I want to re-incorporate these complex changes explicitly into the original account of IMF legitimacy I gave in Chapter 2 so as to clarify the links between this part of the thesis and the case study discussions that follow.

Purpose and performance

IMF conditionality has largely been divorced from the framework of reciprocal obligations that originally underpinned the Bretton Woods agreements. International political control over the financial markets in the interests of state economic management for social and developmental purposes has become far more limited. On the other hand, common interests still exist. The basic coordination problem where most states want most *other* states to maintain economic openness remains and provides a justification for institutional restraints. The obligations to current account openness remain in place in the background – they are just less visible as current account openness has become more widely accepted. Conditionality still promises finance in return for policy change, offering the potential for mutual benefits. What has changed is that the connections between these two aspects of the Fund's role have become less secure as symmetry has declined.

Conditionality increasingly looks like a bargain between states with some common and some opposed interests, rather than part of a broader framework of mutually beneficial reciprocal obligations. Developing countries still wish to attract foreign investment and ensure that 'emerging markets' remain attractive investment locations for developed country financial institutions. Policies that encourage the smooth functioning of financial markets and investment are therefore mutually beneficial. The difficulties concern potential conflicts of interest between the wishes of the providers and recipients of investment. What are the costs of market-friendly policies, what are the benefits and how much freedom should developing countries be granted to choose where to strike a balance? Worse still, there is a danger that developed countries will press for policies to be included in conditionality that serve ends other than simply continuing market access – particularly as the IMF comes to be seen as a 'development' institution and as its funding comes under closer political scrutiny in developed countries.

Performance is increasingly likely to be assessed differently by different states. Countries that do not expect to borrow from the Fund will be interested in the extent to which they get value for money (policy change per dollar) without triggering too much developing country animosity. Some actors will also be assessing the results in terms of *development* goals which are far broader than the IMF's original mandate. Borrower countries, perspectives will remain more similar to those I set out towards the end of Chapter 2 (page 51). However, they will realise that developed country interests have changed and may therefore be more sceptical about what is included in conditionality. They will also have less good reason to see conditionality as an attempt to support

the obligations *all* countries take on when participating in the international monetary system and more reason to see it as a set of costs imposed by developed countries. The question is whether the flows of finance mobilised by the Fund are sufficient to compensate for those costs.

Legality

The issues here have been covered on page 82 above. The Fund's legal framework is looking increasingly weak and considerable efforts have been made to push decision-making through the Executive Board using weighted voting. The balance between individual state consent and weighted decision-making has shifted toward the latter.

Procedure and authority

The collapse of symmetry and expansion of conditionality has placed far greater weight on Executive Board authority but Executive Board decision-making has not adapted to help meet the changes.

Voting rights at the IMF are still determined on the basis of overall economic and political power, despite the fact that stakes different countries have in the way the institution operates have changed significantly (Woods, 1998; Woods, 2000b). Although the developed countries still contribute most finance and have the largest stake in the global economy, it is by no means clear that they are most affected by the Fund's decisions.

The Fund would find it difficult (though perhaps not impossible) to operate without the resources developed countries provide. However, since its primary regulatory function is now in developing countries, it is equally clear that it cannot continue to perform a useful function without developing country cooperation. The decline in symmetry and reciprocity makes this more serious still. Now that developed countries are unlikely to borrow the restraints provided by the 'rule of law' cannot be expected to operate to limit conditionality and in the absence of mutual benefits, there are fewer good reasons to expect adequate funding.

At the same time, the Executive Board's technical credentials are less well suited to the decisions it is asked to make. I explored the logic of technocratic authority in Chapter 2. I stressed the need for narrow and clearly articulated goals for technocrats to aim at. Obviously, the decline of the legal framework has been problematic in that respect. Instead, during the 1980s, the Fund was increasingly reliant on the political and economic rise of market-oriented policies reflected in the Washington consensus (Boughton, 2001; Polak, 1991). The rise of capital flows in the 1990s may have prolonged this policy convergence.

However, if the IMF is right about the far wider range of policies that are brought into play under its new functions, there is room for considerable technical and political uncertainty about appropriate policy. There has been a marked tendency to substitute utilitarian conceptions of welfare for state agreed goals (something I will discuss further in the rest of the thesis). Of course, claims about welfare were always one of the means that were used to *persuade* states that they should offer consent but they were not the only consideration. States would presumably weigh concerns

about economic welfare with other values before agreeing to an expanded Fund role. That opportunity has only been offered within the context of weighted voting in the Executive Board. I also argued that technical legitimacy is distinctly fragile where it is unsupported by institutional structures that ensure mistakes in determining policy are genuine mistakes rather than political opportunism. It is that reassurance which current arrangements fail to supply.

The compensatory reforms in this area, prior to the Asian crisis, were distinctly modest. The Fund had begun to release more data, making external assessments easier but not paving the way for any external accountability except within the context of domestic political systems. There was also a move to consult broader groups of people than the Fund's traditional focus on finance ministry and central bank personnel. These moves represent a gradual recognition of the need for some kind of broader representation but they were tentative moves and their import was difficult to assess prior to the crisis.

IMF authority will therefore be based largely on the effectiveness of past performance rather than on institutional reassurances.

Consent

In terms of consent, the limited legal framework and enhanced Executive Board discretion mean that consent to the particular programme that comes out of negotiations will be particularly important in demonstrating continuing commitment to the IMF.

In the context of increasingly prominent democratic rhetoric at an international level and more intrusive IMF programmes there may also be concerns that consent by state personnel is no longer sufficient for IMF legitimacy.

This will, of course, depend on the domestic legitimacy of the state the IMF is trying to deal with and the extent to which that state is willing to work actively to legitimate the programme. There are also important questions about the extent to which it is legitimate for states to delegate negotiating authority to the financial personnel who usually negotiate IMF programmes or whether that has too great an effect on the balance of power within the domestic political system.

In a context of increasing concern about IMF legitimacy it will also be important to use the case studies to assess the quality of consent achieved. The kind of formal submission to IMF authority Beetham talks about (see Chapter 1) is an important baseline but evidence of compliance or public resistance to the programmes will also be important in assessing IMF legitimacy.

4 IMF legitimacy and the Asian crisis: introducing the case studies

In Chapter 1, I argued that the Asian crisis became a crisis of IMF legitimacy because of its implications for wider pre-existing debates about the future of the Fund. I spent the rest of Chapters 2 & 3 exploring the logic of the IMF's legitimacy claims and the ways in which that logic had been affected by the Fund's historical evolution so that we could understand those debates. We are now in a position to return to an investigation of the Asian crisis itself and a discussion of its implications for IMF legitimacy.

The Asian crisis was significant for many reasons. Most fundamentally, although there had been an emerging market capital account crisis before in Mexico in 1994, that crisis had been partly the result of government overspending (a current account issue) and, in any case, was dismissed by most economists as a one off event. The Asian crisis proved beyond doubt that Mexico would not be one of a kind and confirmed that such capital account crises could take place even when macroeconomic fundamentals remained sound. It therefore triggered debates about an ongoing role for the Fund in managing capital account crises and a related debate about the costs of such crises (and of capital account openness more generally). It was also the first major opportunity to apply the IMF's new guidelines on good governance, published in 1997.

The crisis therefore provided a good testing ground for the issues I raised at the end of the last chapter: whether the potential benefits of the IMF's new roles in capital account regulation and social issues outweigh their disadvantages in terms of legitimacy and authority for particular actors. The fact that the crisis took place in countries with economic and strategic significance makes for particularly useful case studies. The Asian countries were in a good position to bargain with the Fund and should have been able to secure less rather than more intrusive programmes – problems in Asia would therefore indicate difficulties with the entire IMF approach. Their importance also

meant that the issues were the subject of public debate both in Asia and elsewhere providing good quality evidence of the positions important actors took on controversial issues.

The discussion so far has concentrated on general arguments about the relationships between states and the logic of IMF authority claims from various possible state perspectives. The first part of this chapter (section 4.1) will begin to move the thesis towards more empirical questions by introducing the specific technical controversy surrounding the Asian crisis, though still at a fairly abstract level. That will provide a useful theoretical background for the four case studies that follow (South Korea, Indonesia, Malaysia and the United States in Chapters 5-8 respectively), setting out the core debates with some of their implications for IMF legitimacy, and minimising the need to repeat arguments that recur in different contexts.

As with the more general arguments about legitimacy raised in the previous chapters, the technical questions remain contested. There is universal agreement that the economies concerned did not respond well to the IMF programmes but the reasons for that remain controversial and different interpretations have very different implications for IMF legitimacy. For some, the crisis demonstrated an important market failure, which draws into question the current policy of a hands off attitude to the regulation of international financial markets. For others it demonstrated the inappropriate nature of politically motivated *intervention* by states in domestic economic management, suggesting a need for greater Fund promoted 'technical' regulation.

In terms of the IMF's *political* legitimacy, the technical debates surrounding the crisis are unsettled and are therefore not by any means decisive in themselves. What will ultimately make them important is the kind of political support that can be mobilised behind the different interpretations. That is the connection between the theoretical discussions up to this point and the case studies that follow. Section 4.2 links theoretical discussion of the crisis to specific questions about the political reception of the crisis that will be addressed in the case studies which seek to combine technical and normative arguments with political analysis about the reception of Fund programmes and the sources of political opposition.

When I introduced my conception of legitimacy at the beginning of the thesis, I argued that legitimating arguments needed to be assessed in terms of their credibility for particular actors at particular times and in particular places but, so far, I have left the question of who those actors might be in the IMF context ambiguous. The discussion in the first part of the thesis was based on the IMF's original accounts and therefore tended to follow the original inter-governmental conception of the Fund in which states are the relevant actors. However, towards the end of Chapter 3, I began to suggest that issues such as good governance and problems with non-implementation were making other domestic actors increasingly significant. By the end of section 4.2 it will be clear that this is the case and that it raises important issues for the nature of IMF legitimacy.

In section 4.3 I therefore start to extend the discussion to look at the three-way relationship between domestic groups, their states, and the IMF. That discussion indicates a further set of questions about the institutional politics of programme negotiation and implementation, particularly in the light of increasing IMF interactions with ‘civil society’, that form the second set of issues to be addressed in the case studies. The chapter concludes with a brief summary of the agenda for the remainder of this part of the thesis.

4.1 The Asian crisis

As I showed in Chapter 1, the IMF’s response to the crisis proved highly controversial. It is helpful to see the technical controversy in terms of two overall issues. The first concerns the extent to which the IMF made appropriate choices about how the costs of the crisis were apportioned between foreign private lenders, Asian private borrowers, Asian governments (and therefore Asian tax payers) and foreign governments (through IMF contributions). This is a question about the relative advantages of market-based and administrative measures in resolving capital account crises.

The second concerns the extent to which structural measures in the Fund programmes, designed (broadly) to address questions of banking supervision and good governance, were necessary for or helpful in resolving the crisis. There was also a third controversy over the IMF’s chosen macro-economic remedy but, in many ways, this choice was determined by the IMF’s solution to the first set of issues.

These controversies are, at one level, technical issues about IMF performance. However, the issues turn out to be highly controversial in ways that raise important questions about IMF legitimacy. They raise issues about the potential financial costs of capital account openness and also about the kinds of policy that are in fact necessary to support openness. Indirectly, that also raises questions about who is to have the right to decide how the costs are to be distributed and even whether they are worthwhile. In short they have an impact on all of the aspects of legitimacy that I analysed in the first two chapters.

Debates about the appropriate solution to a crisis are often about understanding what caused the problems in the first place. This was certainly true of the Asian crisis. In particular the discussion is, at least implicitly, about apportioning blame – were financial markets acting irrationally and in need of better regulation, were the problems driven by Asian or international financial institutions, how much were Asian governments to blame? What, therefore should be done to resolve the crisis and who should pay?

This section, then, will begin by reviewing the debates about crisis causation to provide a better understanding of the reasons and interests behind the controversy about IMF crisis resolution. That will set the stage for a discussion, in section 4.2, of the significance of the issues and the questions that need to be answered by the case studies.

4.1.1 Crisis causation

The crisis essentially involved a massive withdrawal of capital from the Asian economies. Radelet & Sachs' early estimate was that the difference between peak capital inflows and peak capital outflows to the five most affected countries was US\$105 billion in 1997 or 9.5% of their combined GDP (Radelet & Sachs, 1998b). These massive outflows of capital resulted in massive exchange rate devaluations, stock market collapse and widespread insolvency of banks and corporations¹.

All commentators agree that there were some rational economic reasons for investment to flow into Asia in the early 1990s and to leave again in the late 1990s. In particular, a weak dollar relative to the yen in the early 1990s boosted Asian exports to Japan at a time when interest rates in Asia were far higher than they were in most industrialised countries. In the late 1990s, the exchange rate position was reversed and interest rates in industrial countries rose as their economies strengthened. Rising wage costs relative to productivity and increased competition from China and Mexico in the late 1990s were also factors in making the crisis economies less competitive² (IMF, 1997e; World Bank, 1998a).

However, these events were not dramatic and all commentators agree that they are insufficient to account for the huge swings in capital flows that took place during the crisis³. The additional factors that explain this situation are the subject of some controversy.

Poor banking regulation

What is clear in retrospect is that, at the time of the crisis, the banking systems in the affected countries were in a highly vulnerable position. Asian banks had large amounts of short-term foreign debt⁴ which they were lending on to fund longer term domestic projects. Much of this debt was not hedged against exchange rate shifts.

To make matters worse, Asian banks' risk management practices were often suspect. There was a tendency to rely on the collateral provided on loans without any supplementary assessment of likely income stream (Corsetti et al., 1998; World Bank, 1998a). This was particularly problematic as high savings rates and weakly developed equity markets meant that corporate finance was much more debt based than it is in most developed countries⁵. The collateral often consisted of financial assets such as shares (particularly in Malaysia) or property (in Thailand) adding to vulnerabilities.

¹ Exchange rate movements for the case study countries can be found at Figure 5-1, Figure 6-1, and Figure 7-1 on pages 137, 175, and 213 respectively

² Export growth in Korea declined from 30% in 1995 to 4% in 1996. In Thailand the figures were 20% to – 1% (Radelet & Sachs, 1998a)

³ For a cross section of opinion that concurs on this point see (Corsetti et al., 1998; IMF, 1997e; Radelet & Sachs, 1998a; Wade & Veneroso, 1998a)

⁴ BIS data suggests that short-term debts exceeded reserves in all three countries (ratios of 213% in Korea, 181% in Indonesia and 169% in Thailand). Bank's foreign assets also exceeded their domestic assets by 297% in Korea, 1103% in Thailand and 424% in Indonesia (Corsetti et al., 1998).

⁵ Estimates vary. (Corsetti et al., 1998) put the average debt-equity ratio for the top 30 top *Chaebol* at 333%. In (Lane et al., 1999) the figure for Korea is 395% and for Thailand 450%. The equivalent figure for the US is around 100%. It is also important to note that while high debt equity ratios appear perverse in a context of free capital

The resulting levels of short-term foreign denominated debt, often lent on for high risk domestic projects, left countries vulnerable to a rapid withdrawal of capital broadly analogous to a domestic bank run (Diamond & Dybvig, 1983; Radelet & Sachs, 1998b). Inadequate bankruptcy legislation in crisis countries exacerbated the problems. Uncertainty over creditor priority meant that there were incentives to attempt to grab assets before they could disappear.

While this much is clear, a number of key questions remain controversial. For such large flows of capital to take place, financial assets must either have been over-valued before the crisis or, alternatively, the crisis must have involved a panic resulting in an unnecessary and in some sense irrational withdrawal of capital. If assets were over-valued prior to the crisis we are left wondering what led to that over-valuation and why investors were unable to spot it.

The empirical evidence does provide some indications that assets were over valued in Korea and Thailand but very little in Indonesia (Radelet & Sachs, 1998a). These indicators include boom and bust patterns in stock markets and property prices (Thailand), declining returns on capital (Korea and Thailand) and high levels of non-performing loans (all three countries, though levels were declining in Indonesia).

Government policy

How did this over-investment and asset over-valuation come about? A combination of factors seems to have been involved. Korea and Thailand had recently liberalised their financial sectors. Past experience suggests that financial liberalisation often results in a temporary sharp inflow of capital (Palma, 1998) (McKinnon & Pill, 1996).

Government policy had also encouraged short-term borrowing. For political reasons, Korean liberalisation had favoured short-term rather than long-term borrowing (Chang et al., 1998). The Thai government had set up the Bangkok International Banking Facility in 1993 which involved a series of incentives designed to encourage Thai banks to raise money from non-residents and lend it on to other non-residents (Council on Foreign Relations, 2000). In practice the interest rate differentials between foreign and domestic loans meant that foreign borrowing was lent on domestically at high profits. Even if exchange rate risk had been taken into account, borrowing abroad was still cheaper than domestic loans (World Bank, 1998a).

Public government commitments to exchange rate pegs also encouraged banks to disregard exchange rate risk. The combination of fixed exchange rates and liberalised capital accounts also left countries unable to use interest rates to cool the domestic economy⁶. In any case, the high debt nature of Asian corporate finance would have made governments reluctant to raise interest rates.

flows, form a key part of the logic of the 'developmental state' system in East Asia and appear far less 'irrational' in that context - see (Rajan & Zingales, 1998; Singh, 1998) and Chapter 5 below

⁶ In technical terms, the Mundell-Flemming model showed long ago that countries can only ever have two out of three of fixed exchange rates, free capital flows and domestic control over monetary policy - see for example (Krugman & Obstfeld, 1997).

Even so, markets should have recognised what was going on. Even if Asian banks were poorly controlled and regulated, international lenders should have become concerned with asset mismatches and over-valuations.

At this point competing explanations all rely on some kind of market failure. The most market friendly explanations concentrate on lack of transparency and information shortages while the least market friendly argue that cycles of 'mania, panic and crash' (Kindleberger, 1978) are a persistent feature of financial markets. In between come explanations emphasizing various kinds of 'cronyism' and 'moral hazard'. These different explanations are difficult to separate on the basis of available data but choosing between them is important because different accounts of crisis causation support different approaches to crisis resolution.

Lack of transparency

For those who remain confident in the markets, 'external shocks revealed weaknesses in the Thai economy that until then had been masked by the rapid pace of economic growth and the weakness of the US dollar to which the Thai currency, the Baht, was pegged' (Fischer, 1998a)⁷. In other words it was only when growth slowed and the Thai stock market began to collapse that the weaknesses became visible. Previously, 'lack of transparency delayed public realization of the scale of the problems' (IMF, 1997e, 10)

The argument is perhaps strongest in Thailand. Current account deficits were regarded as sustainable in the context of high growth and low consumption. It was only when property prices began to fall and the insolvency of a large non-bank financial institution – Finance One – alerted investors to the links between the property and finance sectors that borrowers realised there was a problem and began to reduce exposure.

In Korea, occult *chaebol* accounting practices and complex systems of cross guarantees between subsidiaries may also have made it difficult to tell how serious debt problems actually were. Three high profile corporate bankruptcies in early 1997 (Hanbo Steel, Sammi Steel and Kia motors) may have begun to change perceptions and terms of trade shocks resulting from regional currency devaluations as the crisis spread later in the year were then sufficient to trigger the crisis. On the other hand, these financing patterns were well documented at least in general terms (Woo, 1991).

Figures on corporate debt were also difficult to obtain. This was particularly significant in Indonesia where the majority of foreign borrowing had been carried out directly by the corporate sector. Official figures on non-performing loans were also highly unreliable with, for example, analysts estimating that the true figure for Korea was 10-20 times greater than the 0.8% government estimate.

Finally, unreported off balance sheet transactions conducted in 1997 by the Thai and Korean central banks disguised the extent to which they had run down their reserves in attempting to protect their pegged exchange rates in the immediate run up to the crisis.

⁷ (Corsetti et al., 1998) and (World Bank, 1998a) discuss the situation in similar terms

However, there was also a good deal of data available that revealed considerable problems if the markets had taken the time to look for it. The IMF points out that its 1996 World Economic Outlook had warned of growing vulnerability to changes in investor sentiment, excessive narrowing of risk premiums for emerging markets and the dangers of fundamental weaknesses in financial sectors (IMF, 1997e, 40). As Wade (1998) points out, investors need only have read the first sentences of the January 1996 BIS report to be alerted to the problems:

Claims on Asian countries continued to expand at a brisk pace in the first half of 1995...The predominance of primarily short-term inter-bank funds helped to push the proportion of the 'up to and including one year' maturity band in outstanding claims in the region to 64% at mid 1995.

And in June 1996 the report argued that the volume of flows to emerging markets was adding to:

Concerns related to the sustainability of the rallies seen in securities markets, the instability of short-term bank flows, and the spreading of the market tiering faced by Japanese banks to a broader spectrum of participants.

(Akyuz, 1998) notes that UNCTAD had also issued warnings of slowing growth in Thailand and Indonesia, though not Korea.

The task force of eminent economists put together by the Council on Foreign Relations sums up what is probably closest to a consensus position:

None of this is to say that lack of information was the key factor in the Asian crisis. Faulty analysis and plain euphoria probably were more important.(Council on Foreign Relations, 2000)

Others go further with (Stiglitz, 1998b) arguing that 'Most of this debate has just been blame shifting' and (Wade, 1998) claiming that investors didn't wish to see the evidence that recently liberalised financial systems were functioning incorrectly.

Mania panic and crash

Other writers have suggested that the crisis demonstrates deeper problems with the operation of financial markets. At the root of the problem is the fact that the valuation of financial assets is, at least in part, determined by estimations of the future income stream that they will provide. Keynes famously described the result as like a beauty contest where contestants were to be judged, not by their attractiveness, but by how attractive each judge thought they would be to the other judges. Under these circumstances, asset prices rise partly because market participants expect them to rise further in the future. Expectations lead to greater demand which push up prices further confirming the initial optimism. Eventually, however, prices reach a point where the fact that they are over inflated can no longer be doubted and collapse rapidly. There are a number of different economic models based on this broad principle⁸ but the general pattern of 'mania, panic and crash' remains and has recurred throughout history (Kindleberger, 1978).

⁸ In relation to the Asian crisis, compare (Griffith-Jones et al., 1998; Kregel, 1998a; Wyplosz, 1998 and Akyuz, 1998)

There are two of these models that are special cases and which require some further investigation. They are important because one, the bank run model (Radelet & Sachs, 1998a), suggests that the major problem was capital withdrawal, which could imply, at its most extreme, that there was nothing fundamentally wrong with the Asian economies at all. Alternatively, the other, the moral hazard model (Krugman, 1998b), argues that the problem was one of moral hazard caused by government interference in the markets before the crisis which could imply that markets were acting entirely rationally.

The bank run model

I have already briefly discussed the bank run model in the section on banking supervision above. In more detail, the argument is that banks (or in the current context whole economies) involved in converting short-term funds into long-term projects are always in a vulnerable position. In the normal run of events, the better returns that can be achieved by the long-term projects ensure that sufficient incentives can be provided for the short-term loans to be rolled over. However, if market confidence in the institution (or economy) concerned should falter enough for some investors to withdraw their capital, it becomes rational for all other investors to do so too. This is because the long-term projects will cease to be viable if they are not fully funded.

What is important about this model is that a crisis can occur even when there is no good overall reason for it to do so. Market panic can become a self-fulfilling prophecy. Taken to its limit, this model might imply that the Asian financial crisis was an entirely unnecessary event caused by a collective action problem.

Moral hazard and crony capitalism

The moral hazard argument provides an alternative explanation that concentrates on over investment in the run up to the crisis. Krugman (1998b) argues that a number of factors led investors to believe that they would reap the full rewards of successful investments without having to pay the costs if things went wrong.

High debt-equity ratios and an absence of effective bankruptcy legislation might be enough on their own to have this effect. More importantly, Krugman argues that there were reasons for the markets to believe that failing firms would be bailed out. In particular he cites close business-government relationships, banks that are 'too big to fail' and the possibility that the IMF would bail out foreign creditors as it had during the Mexican peso crisis. These factors all provided incentives for investors to invest without taking sufficient account of the risks resulting in a build up of excess capital in the economies concerned. A crisis occurred when it became clear that such assistance was not ultimately going to materialise.

Taken to its limit this approach could imply that the crisis merely corrected a set of over valuations encouraged by faulty incentive structures in the Asian economies concerned. It wasn't that the markets judged wrongly, rather they acted in the expectation that they would gain while prices went up and be bailed out when they went down.

Choosing between the models and assigning responsibility for the crisis

Each model has different implications in assigning responsibility for the crisis. That is obviously important politically when it comes to justifying the costs that are imposed on different parties in the process of crisis resolution.

Unfortunately, the various models are difficult to separate on the basis of the (often disputed) evidence. In any case they are not mutually incompatible. Moral hazard could have supplied some of the reason for over inflated asset prices with simple 'mania' supplying the rest. The dramatic collapse of prices after the crisis could have involved some rational adjustment and some panic induced overshooting.

The strongest supporting evidence for the moral hazard model comes from Thailand. Right up until late June, the government had promised that it would not devalue the Baht and the Thai central bank's Financial Institutions Development Fund had been pouring liquidity into Thailand's troubled finance companies. A shift in Thai investment away from productive sectors and into real estate and other financial assets may have provided a further indication. The crisis was precipitated by the failure of Finance One which might have indicated to the markets that no more bail outs would be forthcoming.

Some analysts have argued that a history of heavy government support for the Korean chaebol may have raised similar expectations. Chang et al (1998) disagree, pointing out that recent government support for *chaebol* subsidiaries had always been accompanied by a change of management and that three large groups had been allowed to fail between 1990 and 1996. However, examples of corrupt relationships between Hanbo Steel and figures with high-level connections in the Korean government (see chapter 5) may have sent inappropriate messages, particularly to overseas investors.

The argument is very difficult to sustain in Indonesia because the majority of the debt was to the corporate sector. Some companies clearly did have some kind of political guarantees because of corrupt relationships with the Suharto family (see chapter 6 below) but it is difficult to argue that many were in this position (McLeod, 1998; Radelet & Sachs, 1998a).

Even if investors were not consciously investing in the hope that they could rely on government guarantees, many official accounts of the crisis argue that Asian bank lending had been less efficient than it should have been because non-market factors had entered into lending decisions. There was insufficient market discipline exercised in financial markets. Government involvement in financial markets (everywhere) and banks that with high concentrations of loans extended to individual companies (especially in Korea) could have been put under pressure to 'gamble for redemption', continuing to lend to companies that were in trouble in the hope that more money would promote a recovery (Greenspan, 1998a; IMF, 1997e; World Bank, 1998a; Yellen, 1998).

Those favouring bank runs, on the other hand, point out that the markets were not behaving as though they knew there was a risk but expected to be bailed out. Based on evidence from the rating

agencies and on interest rate spreads, they were behaving more as though they did not foresee significant problems. They add that government interference in markets and many of the other problems cited as 'causes' of the crisis had been well known to all market actors for years before the crisis took place (Radelet & Sachs, 1998a; Radelet & Sachs, 1998b). Perhaps more importantly, few would deny that the 'correction' of asset prices that took place was way beyond anything reasonably justifiable, a point made by Krugman himself in a later article (Krugman, 1998a). What is more controversial is the extent to which the correct conclusion to draw is that there weren't really any major problems in the first place. Few would go this far but opinion differs greatly on how serious the problems actually were.

Summary

Overall, it is difficult to come to firm conclusions about the causes of the crisis. Most economists would accept that all the models have some potential validity. They would differ in the emphasis given to different factors. In particular, some are more inclined to blame market failures while others are more inclined to blame government failures. Within the market failure camp there is also room for disagreement over whether failures were to do with the actions of Asian or foreign investors.

In terms of IMF legitimacy, it is important to acknowledge that there was genuine uncertainty in the economics profession about appropriate courses of action. The IMF was forced to make a swift decision on the basis of the limited information available at the time. On the other hand it is also clear that there were a number of alternative approaches that could have been taken on the basis of that available information. In practice IMF accounts tend to emphasize domestic causation with some limited acknowledgement of global factors while the G24 have taken the opposite position. It is important to consider the possible political and economic reasons for the particular choices that were made.

4.1.2 Debating the IMF response

Despite controversies over aspects of causation, it is clear that once the crisis was set in motion it took the form of a cycle of declining confidence inducing asset withdrawals which induced further declines in confidence. To halt the crisis, this cycle had to be broken so that capital would begin returning to the economies concerned.

The IMF's solution was initially a largely market based one in which interest rates were raised to provide incentives for the return of foreign capital, money was lent to improve the prospects for debt repayment and various micro-economic policies were implemented to restore investor confidence. Fiscal policy was also tightened to cover the costs of increased debt service and financial sector restructuring (Fischer, 1998a; IMF, 1997e). Each part of this solution was controversial.

Macroeconomic policy

High interest rates are the traditional remedy for balance of payments crises as they slow down the economy, dampening demand for imports and thereby easing balance of payments constraints. The

Asian crisis was primarily a *capital account* crisis but it did leave countries with related current account cash flow problems that needed to be resolved. More importantly high interest rates can also be justified on the grounds that they make holding domestic currency more attractive and therefore help to strengthen the exchange rate.

In the context of a capital account crisis, however, they may have ambiguous effects. High interest rates exacerbate the problems with corporate debt that are a key part of the downward cycle. This in turn has an impact on the banking sector as non-performing loans decrease cash flow in a context where exchange rate devaluations have already put banks under pressure in repaying their own foreign currency debts⁹. The argument here is that the credit risk effects of increased interest rates outweigh the incentives that they provide (Kregel, 1998a; Kregel, 1998b; Radelet & Sachs, 1998a; Stiglitz, 2000). If lending is often denominated in foreign currencies, as it had been in Asia, there are additional questions about how effective changes in *domestic* interest rates will be in encouraging capital flows when interest rates are more likely to be based on international rates.

On the other hand, the IMF has been unrepentant, arguing that without raising interest rates exchange rates would have continued to fall which would have had largely the same effect (Lane et al., 1999).

The fiscal policy element has come in for even more stringent criticism. If the problem was one of government overspending, there might have been some justification for fiscal retrenchment. In a capital account context, though, the result would simply be a recessionary economic slow down that would impair the chances of debt service without producing significant benefits. Stiglitz (2000) argues that:

Quite frankly, a student who turned in the IMF's answer to the test question "What should be the fiscal stance of Thailand, facing an economic downturn?" would have gotten an F.

The IMF later acknowledged that its policy had been a mistake and began to ease the fiscal elements of its programmes in early 1998 (Boorman, 1998; Lane et al., 1999).

Underlying these technical questions are some political considerations. Imposing tight fiscal policy could be seen as an attempt to ensure that the crisis countries kept as much money as possible back for debt service – the debate is therefore partly about who pays for the crisis. Some early comments by IMF staff suggest that attempts to please the Executive Board in this way were a consideration (see comments by Mussa in (Chote, 1998)) though Executive Board members have argued that the staff were responsible (Stiglitz, 2000). One possible explanation is that staff were acting on what they *thought* were Executive Board preferences and the Executive Board were accepting what they *thought* were staff technical judgments (see the discussion on page 50 above).

Most economists agree that the interest rate decision was probably unavoidable if market measures were going to encourage the return of capital. As we will see later though, this market-based strategy itself has been the subject of considerable controversy.

⁹ See especially (Kregel, 1998a)

Micro-economic interventions and restoring confidence

The Fund argues that the microeconomic parts of its programmes were necessary: because they addressed problems that had been a key cause of the crisis; and / or because they were required to boost investor confidence and secure capital inflows; or in the interests of good governance.

Obviously the IMF's understanding of the causes of the crisis will be crucial here in determining the appropriate measures. While all the elements of crisis causation discussed above feature in the IMF's interpretation to some degree, the emphasis is on government policy, moral hazard and lack of transparency - in keeping with the IMF's traditional faith in markets and very much in line with the guidelines on good governance reviewed in chapter 3¹⁰.

The key domestic factors that led to the present difficulties appear to have been first the failure to dampen overheating pressures...,second the maintenance for too long of pegged exchange rates...,third lax prudential rules and financial oversight.....(IMF, 1997e, 40).

Which is not, of course, to say that the Fund account implies markets were acting perfectly.

... although the roots of the current difficulties lie mainly in the countries most affected developments in the advanced economies and global financial markets contributed considerably to the build-up of the imbalances that eventually led to the crisis..(IMF, 1997e, 40).

and

the amount of exchange rate adjustment that has taken place far exceeds any reasonable estimate of what might have been required to correct the initial [currency] overvaluation[s]...In this respect, markets overreacted (Fischer, 1998a).

Still, ultimately the IMF concluded that

The main responsibility for taking appropriate measures lies with the countries concerned (IMF, 1997e, 41).

Specifically, financial sector problems included:

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

In Korea central problems were high debt-equity ratios. *Chaebol* in trouble had been helped to stay afloat by 'unwise further extensions of credit, often at the behest of the government' (IMF, 1997e, 12). In Thailand the key problem was over exposure to the property market and foreign currency. In Indonesia it was a combination of finance – excess foreign exposure with high levels of non-performing loans - and anticompetitive practices – 'trade restrictions, import monopolies and regulations' (IMF, 1997e). More generally, Fund accounts tended to talk of lax market discipline meaning that, for various reasons, there were insufficient incentives for the efficient allocation of capital. The picture is one of over-investment caused by moral hazard and various kinds of poor regulation that reduced the incentives for proper credit assessment and market discipline.

¹⁰ See for example (Fischer & Griffith-Jones, 1998). On the good governance guidelines see page 74

The response was to implement a series of reforms designed to reduce the role of the state in the economy of each of the countries concerned in an attempt to enhance competition and market discipline. Other measures were also introduced to 'improve' the legal framework for the relevant economies by insulating the economy from state interference, making it easier for investors to monitor short-term performance and improving bankruptcy provisions so it would be easier to let inefficient firms fail. These reforms included increasing corporate transparency and accounting requirements; improving banking regulation, extending bankruptcy regulation and enhancing central bank independence. In some countries they also involved new competition laws and consumer protection regulation.

Criticisms of the microeconomic parts of the IMF programmes spring from two questions. The first one relates to causation. Were the structural factors identified by the IMF:

- (a) actually *causes* of the crisis;
- (b) merely problems with the relevant economies that needed to be fixed at some point;
or
- (c) not problems at all?

Secondly, was it addressing those structural issues necessary and / or sufficient to solve the crisis?

The two questions are closely related but actually independent. Even if structural problems weren't a cause of the crisis, they might still need to be resolved to restore market confidence if the markets *believed* they were a cause of the crisis, regardless of the truth of the matter. Alternatively, whether they were a cause of the crisis or not, their resolution might not be sufficient (or even necessary) to resolve the crisis – particularly if another approach (such as a debt moratorium or capital controls) were possible.

Since IMF advice is supposed to allow countries maximum flexibility within the constraints of the 'code of conduct', and since (as we will see later) the issues are highly political, the answers are obviously important for IMF legitimacy. If the structural reforms weren't technically necessary did they represent an improper use of Fund power to serve the purposes of its leading shareholders, indicating political bias? If they were necessary because of market sentiment but not for any more fundamental reason (if the markets had 'got it wrong' in some way) what did that say about capital account openness and the role of the Fund? In either case, were the domestic political implications of the reforms properly considered?

I will start off with a critique of the rationale behind preventing state intervention in the markets, since this is central to technical justifications of the structural policies, and go on to explore the question of the Fund's role in enhancing market confidence.

What are the justifications for the IMF's structural interventions?

As we have seen the micro-economic sections of IMF programmes in Korea, Indonesia and Thailand concentrated on altering the relationship between the state and business to eliminate state

intervention in credit markets (particularly in Korea) and to reduce both internal and external barriers to trade (particularly in Indonesia). They were attacks on various kinds of 'industrial policy'.

There are two arguments behind Fund scepticism about industrial policy. Firstly, as we have seen there is an argument based on economic efficiency, which suggests that state protection and intervention in credit markets (the creation of 'rents') channels capital to un-productive uses undermining the overall efficiency of the economy and harming growth. In addition, the wish to secure these rents provides incentives for companies to spend resources in attempting to capture them involving anything from presentations and lobbying to outright corruption where state officials and businesses conspire to divide up resources between them¹¹.

These twin economic and normative justifications are combined in the IMF's concern for good governance. As we saw in Chapter 3, part of the governance agenda involves

limit[ing] the scope for ad hoc decision making [and] rent seeking...[through] liberalization of exchange, trade and price systems and the elimination of direct credit allocation (IMF, 1997a).

The arguments have historically been based around state-market relationships. In the Asian context, firm-bank relationships are also important. Firms and banks were tied together in a long term and interdependent relationship very different from the Anglo-Saxon arms-length model. Under the Anglo-Saxon system, equity finance is more important and firm-bank relationships are conducted at arm's length on the basis of strict rules on the disclosure of information. In Asia, where the majority of finance is debt finance, capital costs are constant regardless of the state of the economy and banks have large exposures to individual firms. Those exposures provide incentives to support companies in time of need in return for asking for greater returns in times of surplus – the relationship takes place over longer time horizons. Loans become a form of quasi-equity and banks have far more influence over their debtors. There are clear analogies with the efficiency and corruption criticisms of rent-seeking. Banks are working on 'non-market' criteria limiting incentives towards static efficiency and raising the possibility of relationship lending (perhaps on the basis of bribery).

While very much the orthodoxy in the international institutions, particularly since the neo-liberal turn in the early 1980s, these arguments are far from unassailable even from relatively main-stream economic perspectives. Since the critique is less frequently set out, it is worth providing a fairly thorough (if still brief) discussion.

In terms of direct effects on efficiency, critics acknowledge that industrial policy may be inefficient in the short-term but point out that real world economies differ very significantly from the neo-classical paradigm.

The static models of neo-classical theory take no account of the role of information and innovation in fostering growth over the longer term. Unfortunately, it is difficult for particular businesses to capture the full benefits gained from discovering (or in developing countries, acquiring, adapting

¹¹ Two of the classic accounts are (Krueger, 1974) and (Posner, 1975)

and implementing) new techniques since knowledge can easily be copied and transferred. In any case the returns will only materialise over the longer term. Where 'market discipline' is operating by threatening the withdrawal of capital if short-term returns are less than optimal, investment in technological upgrading may never take place. This is acknowledged in industrial countries, for example, by the practice of granting patents to innovators, giving them breathing space to market products and producing an immediate asset to calm investors (Khan & Jomo, 2000). Some Western economists have also questioned the short-term bias in equity-based systems of finance (Hutton, 1995; Porter, 1992).

Industrial policy is a sort of *ex ante* version of these 'Schumpeterian rents'. Governments provide entrepreneurs with various incentives for innovation such as tariff protection, tax breaks or subsidised credit. In a broadly analogous way, relationship banking can also be used to extend investment horizons.

If implemented correctly such policy can help to overcome investors' reluctance to take on the risk and illiquidity involved in investment in industrial upgrading. (Chang, 1999; Khan & Jomo, 2000; Vartianen, 1999). There are a number of ways of achieving this in practice. The most widely cited model is the idea of the 'developmental state' originally used to describe Japan (Johnson, 1982) but also highly relevant for Korea (Amsden, 1990) which I will look at in more detail in Chapter 5. For now it is enough to point out that both government policy (Amsden, 1990) and the relationships between corporations and banks (Singh, 1998; Woo, 1991), criticised by the IMF in Korea, were part of a deliberate state strategy to reduce the influence of certain forms of market discipline in the interests of longer term manufacturing investment.

Although creating rents *may* create inefficiency and encourage corruption, there is no reason to assume that it *will* do so. At the same time certain kinds of appropriately administered rent creation can be enormously effective in accelerating technological upgrading. If rents are administered by bureaucrats with sufficient skill and integrity, rent-seeking and corruption can be minimised.

Of course, it would be wrong to suggest that rent seeking is never a problem. The costs in terms of corruption will vary depending on the political and economic circumstances in each country (Khan & Jomo, 2000). In some cases (eg. South Asia) decentralised political systems have made corruption so pervasive that it has undermined any attempt at industrial policy. In Malaysia, on the other hand, the institutionalisation and centralisation of transfers has reduced the scope for informal influence. The costs and benefits may also vary over time. The strategy of picking sectors to subsidise is always a risky one requiring high levels of bureaucratic competence and independence. As industrialisation progresses, and a country reaches the limits of 'learning' and embarks on innovation, it may become more difficult. It may become necessary to shift from state industrial policy to a more orthodox system based on patent protection.

In any case, arguably even quite large sums spent on rent seeking may pale beside the social benefits produced in the form of broad based economic growth where rents are used skilfully to promote

technological change. For many, Korea has been the paradigm developing country case of this sort of strategy. The point is that the benefits as well as the costs should enter into the assessment.

These technical arguments in favour of rent seeking are the strongest reason for questioning the neoliberal rent seeking paradigm but even other varieties of rent creation and resource distribution may not be wholly destructive. Economies of scale and scope, as well as short time horizons, may be significant barriers to industrialisation. It may therefore be necessary for resources to be channelled to a limited segment of society to create a class with sufficient capital to get industrialisation under way. This process took place in Europe too (for example in the form of the enclosure acts in the UK) albeit usually over a far longer time scale and in conditions where domestic populations were less able to offer resistance.

During either process (capital concentration or industry promotion), political considerations will be key in determining the distribution of resources. The state must try to channel resources to situations in which they will be used productively but it will also have to buy off powerful political opposition and may need to use resource transfers to secure political stability. Indeed in some cases, securing broad political and social harmony may itself be an important part of the development process (Khan & Jomo, 2000). In Southeast Asia (particularly, for our purposes Indonesia and Malaysia) there have been attempts at fostering industrialisation through state intervention but these have been less significant than attempts to redistribute resources to encourage greater ethnic harmony (Malaysia) or political stability (Indonesia). If rent creation is an essential part of development, some injustice in resource allocation may be unavoidable, even if that is difficult to accept from a neo-liberal ideological perspective¹².

In short, rent distribution can cover a wide spectrum from the kleptocratic economic 'management' of Mobutu's Zaire to the kinds of interventions undertaken by the Korean government that, for many, can be characterised as quite legitimate economic management tools. There is room for considerable dispute about the point at which policies cross the line into 'corruption'. From this perspective the IMF's good governance guidelines tend to gloss over the distinctions by treating all state discretion as a potential source of corruption.

In the Asian context this is particularly important because the crisis countries have been at the centre of a debate over the appropriate role of the state in development that has been raging since the late 1970s. I have already reviewed the progression of Bretton Woods thinking from the market friendly early 1980s to a growing recognition of the state in the late 1990s (section 3.4.2 above). As we will see in more detail in the case studies, the nature of IMF interventions in the crisis reopens this debate again with the Fund account suggesting state intervention is to blame for the crisis while

¹² The *creation* of a market economy may be rather different from its maintenance. For a reading of fluctuations in modernisation theory along these lines see (Cammack, 1997). This ambiguity is reflected in fluctuations in the literature on corruption which is sometimes more willing to accept corruption and sometimes less so (Szeftel, 1998).

critical economists see too *much* liberalisation during the 1980s with insufficient attention to appropriate regulation as the cause of the problems.

According to this perspective, the point is that the rent seeking paradigm has tended to underestimate the costs involved in and preconditions for a functioning market economy, reflecting a liberal tendency to see markets as 'natural'. The growing awareness of the need for government regulation reflected in the rise of good governance during the 1990s is an important corrective. Economists are more likely to accept that both states *and* markets are necessary for an economy to function. Still, there remains a tendency to overlook the extent to which liberal economies require particular kinds of *political* underpinnings (Fine, 2000; Robison & Rosser, 2000). There is also little recognition of the costs of (for example) effective banking supervision, data collection (to enhance transparency), a technically competent legal system and the recourse to law more generally¹³. In this context relationship banking, in particular, may be seen as an appropriate 'second best' option on these grounds alone¹⁴. The point is that there is a need to compare the real world of liberal markets with the real world of rent driven systems in the context of what is politically possible.

Finally, it should be clear that the issues are not simply economic. They relate to questions about the available strategies for political management, the balance of power between the state and business, inter-ethnic wealth distribution and social choices between faster growth and greater fairness in resource allocation. The IMF programmes therefore had very significant political and social consequences, underlining my assertion that the IMF's expanded role was moving it into areas where domestic consent and domestic cooperation would become increasingly significant .

I have suggested that the mechanisms for and purposes behind rent distribution vary from country to country. Although the issue of rents was central to debates about all three of my Asian case study countries, the strength of the arguments needs to be assessed in relation to the political economy of particular countries. Understanding the relevant domestic issues will have to wait for the case studies.

In more general terms, though, criticisms of the rent seeking approach overlap with debates over the moral hazard versus market panic conceptions of crisis causation. The moral hazard and rent-seeking interpretations are necessary partners, while the bank run model would tend to reduce the salience of the rent-seeking issue. At the same time in an international context, the developmental state concept in Korea and Japan has been the long standing object of Congressional animosity as the system is believed to create barriers to foreign trade and investment, adding an overtly political angle to the debate (see, particularly, Chapter 8).

¹³ On the costs of the preconditions for economic openness see (Rodrik, 2001a).

¹⁴ Mick Moore has pointed to the far lower legal costs of doing business in Japan where recourse to the courts is far less frequent (Moore, 1993)

Market confidence and the catalytic effect

I reviewed the Fund's arguments about market confidence and the catalytic effect briefly above (section 3.4.1 on page 71). There are actually strong and weak versions of arguments about the relationship between IMF involvement and market confidence.

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

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

Finally, even the weak version will only be successful if Fund policies are actually likely to achieve results that foreign investors are looking for. Here Bird points out that different types of investors will have different requirements. High interest rates will attract currency traders and inter-bank loans (though since many such loans are denominated in LIBOR their effects may be limited) but may repel FDI since they have the potential to induce recession¹⁵.

In other words the catalytic effect is likely to be most successful where the Fund's self-image proves an accurate description of what is going on: where its policies are better than those a country would suggest and where conditionality is genuinely owned. That suggests that enhancing IMF legitimacy may be able to start a virtuous cycle of greater ownership and improved performance.

In the context of the Asian crisis, these criticisms were raised informally by Jeffrey Sachs who argued that the arrival of the IMF gives all the comfort of seeing an ambulance outside one's door (Radelet & Sachs, 1998a, 33). Sachs added another plank to the argument by suggesting that where market confidence is key, including large numbers of issues in a Fund programme may create problems that did not exist before. Once the Fund has told the markets these issues need to be

¹⁵ Bird has attempted empirical tests to evaluate the catalytic effect. He found different types of effect with different sources of finance. Fund approval did have a modest effect on public sector finance but there was no evidence of a positive effect on private finance (Bird & Rowlands, 1997)

resolved, the markets will not be satisfied until they have been regardless of whether they caused any objective problems. The longer the programme the more bad news is given to the markets. The IMF was 'screaming fire in the theatre' (Sachs, 1998).

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

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

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

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

Lender of last resort, international bankruptcy and moral hazard

Perhaps the most fundamental issue is the Fund's overall strategy for dealing with capital account crises. If, as most commentators agree, the best analogy for understanding the crisis is with some kind of systemic bank failure, what were the available options?

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

If, however, market confidence does not return, the lender of last resort role becomes very problematic. If the situation ultimately ends in bankruptcy, then the liquidity injection will have been transferred to banking system creditors who should in fact have incurred heavier losses than

they did. A lender of last resort operation becomes a 'bail-out'. Creditors escape the consequences of their risky sovereign lending and the government is left with even higher debt owed to the IMF instead of private creditors.

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

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

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

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

The political controversy over the Asian crisis springs from the different distributional implications of these various possible approaches. The lender of last resort approach is always costless to creditors and either relatively costless or extremely expensive to crisis countries depending on the outcome. The more administrative measures are all cheaper for the crisis country in the short term and more expensive for foreign creditors but may impair future market access, costing crisis countries more over the longer term.

As Ginanini points out the lender of last resort role creates:

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

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

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

The counterfactual problems involved in assessing the likely consequences of different courses of action mean that this issue, like the others, remains contested¹⁶.

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

4.2 Issues for the case studies

What is the significance of all this and what issues does it raise for the case studies?

We have seen that the Asian crisis raised a number of technical controversies which are connected with concerns about the Fund's role and which have a significant political impact.

The IMF's overall strategy involving a market based rather than administrative solution to the crisis demonstrated faith in the international capital markets. It suggested a diagnosis of the crisis that blamed domestic policy rather than international investors. It would be costly in the short-term for

¹⁶ The historical experience is in any case mixed. There seem to have been few lasting penalties for non-payment in the aftermath of the Great Depression but then default was relatively widespread. Renegotiating bond contracts was nonetheless a very lengthy process leading to considerable uncertainty (Eichengreen & Portes, 1989; Jorgensen & Sachs, 1989)

the domestic government, though over the long-term it might be beneficial in demonstrating a commitment to debt repayment. Nonetheless, the approach raised questions about institutional bias in favour of the Fund's major shareholders and a more general tendency to be suspicious of states.

The macroeconomic issues are closely related. Again they can be interpreted as attempts to favour foreign rather than domestic interests. High interest rates would attract foreign investment at the expense of the domestic real economy. Tight fiscal policy would maximise the chances of government assistance in debt repayment and reduce the need for debt rescheduling. On the other hand monetary policy, at least, seems to have been largely inevitable once a market-based strategy had been chosen.

Finally, the IMF's structural measures were highly controversial. There were questions about whether such extensive measures really had a chance of restoring market confidence or were even necessary. More importantly that raised issues about the extent to which Fund policies could be justified economically and about whether the IMF was taking sufficient and unbiased account of their social and political consequences. At a more practical level that led to the concerns that I aired in Chapter 1, that the IMF was moving into overly political territory and that the programmes would lead to significant popular domestic discontent.

The most immediate questions raised for the case studies are empirical and technical issues about IMF performance. Why was the crisis so costly? Was that because the IMF's market based, market confidence approach was misguided? If so, was that because it was wrong about what would boost market confidence, or because the markets were acting irrationally? If, as I have argued, assessing rent creation is a complex business involving economic and social considerations, how should one make that assessment in the crisis countries?

At a fairly abstract level, it should already be apparent that these issues have implications for IMF legitimacy. Most fundamentally, if IMF performance was poor does that threaten Fund claims to exercise an internationally valuable role in capital account regulation? Should the new aim of capital account convertibility be formally adopted? Alternatively, would that role have been more viable if an alternative approach had been adopted – particularly one that involved a more administrative approach to crisis resolution?

If it was the IMF approach that was wrong, *why* was it wrong and what does that say about the IMF's institutional structures? There seem to be particular grounds for concern about the IMF's technical legitimacy given the increasingly political consequences of Fund interventions but what exactly was the problem? Were IMF policies broadly correct but difficult to implement domestically given the additional actors that have become involved in programme implementation? In that case, should the Fund be reforming its institutional structures in a way that would provide it with greater popular domestic legitimacy in borrower countries? Would clearer state consent help that process? Is there a need to re-establish a transparent legal framework to provide greater legitimacy for problematic policies? Alternatively were IMF policies fundamentally flawed? If so does it need

better technical input or is the problem one of political bias? Again could institutional changes resolve those difficulties?

Since we are concerned with *political* legitimacy though, what is most important is the way that these debates feed into actual political pressure for IMF reform and it is here that the case studies are particularly significant.

There are likely to be two sources of such pressure. Most immediately, if IMF programmes are not in fact implemented that will suggest that states are not being provided with sufficient reasons for compliance – or that the IMF is attempting a role that is too ambitious. All states will have an interest in taking note of non-implementation. For borrower countries there will be concerns that borrower states may have good reasons for non-implementation or that, where market confidence is important, programmes that cannot be implemented will be very costly. For lender states the point of the IMF is largely to secure policy change. Non-implementation implies that it is not performing its allotted role.

Secondly, regardless of implementation, if other countries not immediately involved in the crisis are concerned about IMF policy they may offer dissent in the IMF's two Boards either over the specifics of the programme or in relation to the appropriate course of future Fund policy.

That suggests that we need to look at a variety of different countries. We need to investigate at least one crisis country that accepted an IMF programme. In fact I have chosen two so that a comparative approach can be adopted. Korea was the most successful programme and was also significant because, prior to the crisis, it was regarded as the purest example of a 'developmental state' making the IMF's technical arguments about structural policies particularly controversial. Indonesia was the least successful programme and the country in which issues of corruption (the other strand of the rent-seeking arguments reviewed in section 00) were most significant.

We also need to look at onlooker countries that might raise issues at the Fund's two Boards. Here I have chosen one borrower country, Malaysia, and one lender country, the United States. Malaysia is important, partly because Mahathir articulated the most public criticism of IMF policy and partly because Malaysia was faced by a similar crisis but adopted a very different solution. It implemented capital controls. The Malaysian case can therefore provide us with both a case study of the reasons why some borrower countries objected to Fund programmes and a potential counterfactual.

The United States is important partly because of its enormous influence in the Fund. Additionally, it was the lender country in which there was most public debate about IMF interventions making an analysis of the politics of lender country relationships with the Fund much simpler to carry out.

I now turn to an examination of the exact issues that the case studies need to address. The issues will be easier to understand if we begin with questions about the kind of dissent that might be raised by onlooker countries.

4.2.1 Issues for onlooker countries

Malaysia

For borrower countries like Malaysia, which we will look at in Chapter 7, the issues are about how costly IMF interventions appeared to be and what should be done about that.

That raises a set of questions about Malaysian interests. Would IMF policies that were politically problematic in crisis countries be difficult to implement for Malaysia? Given what went on in the crisis countries, how much flexibility could Malaysia expect from the IMF under what circumstances? What does performance in Asia therefore imply about the political and economic costs of capital account openness for Malaysia? What are the politically feasible alternatives?

From those questions about interests, more strategic political questions follow on which emphasise the link between interests and legitimacy. How much support can Malaysia expect from others if it raises objections? What are the costs of raising objections in terms of market perceptions and Malaysia's relationships with political allies?

Legitimacy is important here because the more convincing IMF justifications are, the more difficult it will be to muster political support. The IMF is intended to resolve a coordination problem. That will inevitably impose occasional costs on states. Narrow self-interested arguments that simply reject those costs to the detriment of the entire international community are not only less likely to capture the moral high ground, they are also less likely to attract broad international political support. Arguments about the relationship between IMF policy and the interests of large groups of states though – arguments that attack IMF legitimacy – are more likely to be successful. Questions about the relationship between IMF interventions in crisis countries and the IMF's broader legitimacy claims will therefore be particularly significant. This is where perceptions of the crisis countries are important. How can evidence in crisis countries be used to support broader questions about Fund legitimacy that have the chance of attracting political support to push for reform?

The Malaysian case study will be about analysing the objections Mahathir raised to IMF interventions in Asia. However, it will also need to look at the reasons behind those objections, partly to understand the politics of IMF intervention but also because those reasons will have implications for Mahathir's credibility and for his ability to mobilise broader support. The domestic impulses behind Mahathir's decision to adopt capital controls will suggest circumstances in which other countries will be tempted to object to IMF policy. They will also provide valuable information about what made Mahathir's opposition more or less credible. Was it purely self-seeking and anti-social – a rejection of the IMF's aims of economic cooperation – or did it raise genuine issues about the balance between state autonomy and the benefits of economic cooperation that were of interest to other countries?

Differences with the IMF approach, of course, revolve around Mahathir's decision to adopt capital controls. The analysis of the politics of that decision will also be independently relevant to other

countries' evaluation of IMF policy in Asia since they provide a potential counterfactual to IMF policies for crisis resolution.

The United States

For lenders like the United States, which we will look at in Chapter 8, the questions will be slightly different. Three issues are key. How much pressure did the crisis place on Fund (and therefore US) resources? What were the consequences of IMF intervention in the form of desirable policy change? How much political resentment was triggered and what will the effects be in terms of future IMF efficacy and political relationships with affected countries?

Arguments about the cost issues and policy change issues will be directly relevant in assessing crisis performance and justifying Fund involvement to domestic audiences. Issues about political resentment and therefore IMF legitimacy will be less immediate but will become increasingly important as challenges appear from borrower countries (such as Malaysia). Here the difficulty will be in marshalling justifications for *maintaining* desirable aspects of the Fund's role (from a US point of view) that can expect to have a broader international appeal despite concerns about performance. Again, interpretations of crisis country experience are important at this point.

The central questions for the US case study are about the way the balance is struck between these self-interested national and more strategic international considerations. As the IMF has become more visible in American politics there are important issues about the way these considerations are resolved through US political institutions. Who decides where the balance is struck? Which groups are involved? How much democratic control is there over the outcomes and what might we expect to happen if that democratic control was enhanced?

4.2.2 Issues in crisis countries

Korea and Indonesia, the crisis countries, are likely to find it more difficult to take part in these international debates. Firstly, their need for finance makes them deeply reliant on IMF assistance and on market confidence that programmes will be implemented. They are not in a good position to offer public resistance (see the discussion in section 2.3 above). Secondly, the IMF is supposed to place some restraints on state freedom and arguments about that from countries in the process of borrowing will look self-interested undermining their broader credibility.

Nonetheless, crisis country experience is important in those debates because we saw that later arguments raised by outsiders are based on perceptions of crisis country experiences and those arguments will rely on evidence from those experiences.

There is obviously room for divergent interpretations of what actually went on in the two case study countries. I will attempt to provide a relatively balanced account that enables one to understand the basis of those different interpretations. I attempt to indicate where evidence is controversial and to make it clear when I am putting forward a disputed point of view. I also indicate points where it is likely that outside perceptions may have differed from what, on the basis of later information, seems in fact to have been the case. This is obviously a difficult enterprise in

such contested territory and readers will inevitably disagree from time to time. My account should at least be sufficient to provide the basis for an assessment of the evidence that can be marshalled in support of the debates that arise in the context of the onlooker country case studies (Chapters 7 & 8) and my broader review of the politics of IMF reform (Chapter 9) even if many will ultimately feel that my account is biased towards or against the IMF.

I have three particular concerns in the crisis case studies. I will: summarise the evidence relevant to the technical debates about IMF performance as it arises in the two countries; explore the politics of negotiation and implementation of the programmes; and draw conclusions about the nature of IMF interventions in the context of the political economy of the countries concerned.

The rationale and issues surrounding the first concern need no further elaboration. My concern with the nature of IMF interventions relates principally to the structural part of the IMF programmes and has obvious connections with legitimacy. I set up an opposition between technical and political aspects of decision-making in Chapter 2 that has implications for IMF authority. One of the key questions for the Indonesian and Korean case studies, that will then be significant in the debates reviewed in Chapters 7, 8 & 9, concerns the relationship between these kinds of decisions in the context of IMF structural policies. To what extent are technical understandings of what went on adequate? What sort of political issues were involved? And what are the implications of that for IMF legitimacy, particularly in terms of the decision-making process?

The politics of negotiation again relate to institutional questions discussed in Part One. How much were the programmes prepared by the government and how much were they imposed by the IMF? What does that tell us about the IMF's interpretation of its 'code of conduct' at the turn of the millennium? Equally importantly, how much of that negotiation process was visible from outside and how did transparency (or lack of it) influence domestic and international perceptions?

Secondly there are related issues about implementing programmes once they have been agreed. Which groups were enthusiastic about which aspects of the programmes? Where was dissent offered and why? To what extent was such dissent able to influence implementation?

Those questions clearly overlap with debates about the nature of IMF conditionality. What kinds of interest were at stake? They are also important in their own right. If IMF legitimacy is important because of its influence on programme implementation, understanding the implementation process in particular countries is clearly highly significant for any assessment.

Particularly important, given the issues raised in Chapters 2 & 3 are questions about the groups that turn out to have an influence on implementation either directly or indirectly through their influence on the broader political process. The growing importance of domestic politics both for implementation and in oversight of lender country policies was a theme that began to emerge at the end of Chapter 3. Since the discussion of IMF legitimacy so far has tended to be carried out in terms of state interests, the final remaining task before the case studies is to explore some of the

theoretical implications of this development for the nature of IMF politics to provide a framework for analysis of these issues in the case studies.

4.3 The importance of domestic populations

The discussion in section 4.2 began to suggest the importance of domestic politics in arguments about IMF legitimacy. Discussions in Chapter 3 suggested some of the historical and theoretical reasons why this was likely to be the case. In particular Fund policy has become more wide-ranging and, since the Cold War, the boundaries between domestic and international politics have become less well defined.

Domestic interests are in a position to influence programme negotiation and implementation in borrower countries and, since the rise of structural adjustment in the 1980s, political economists (often with IFI or OECD support) have been studying the politics of programme implementation (Haggard & Kaufman, 1992; Haggard et al., 1995; Killick et al., 1998; Williamson, 1984).

In lender countries there are significant questions about the extent to which non-financial arms of government and civil society are able to influence Fund policy. Reluctance to accept strategic justifications for aid in developed countries and the rise of NGOs since the 1980s has also meant increasing public scrutiny over developed country policies towards the IMF. This has led to a complex set of questions about who should be able to hold the IMF to account and who is able to do so in practice.

So far I have tended to talk about the IMF in terms of relationships between states and the Fund. That is in keeping with the way the original institution was set up. It should be clear that this narrow focus is no longer entirely adequate. In this section, I want to expand it to include domestic interests as an additional axis of influence. How significant domestic voices are in fact is something that will be looked at empirically in the course of the case studies. However, it is useful to have an analytical framework through which to carry out that discussion and providing such a framework is the purpose of this section.

4.3.1 The old model

Interactions with the IMF have always been, using Robert Putnam's familiar terminology, a 'two-level game' in which what finance ministers were prepared to negotiate depended on their domestic 'win set' – the set of policies that could be successfully implemented without provoking an unacceptable level of domestic opposition. The position of negotiators was special, in that it was always possible for them to veto arrangements that were within the domestic win set but that conflicted with their own priorities, but they remained ultimately subject to the constraints of domestic politics (Putnam, 1988). In keeping with the post-war sovereignty regime, the extent to which negotiators' preferences were compelled to conform to the popular will would depend purely on the nature of those *domestic* politics.

An account of programme negotiation in Houphouet-Boigny's Cote D'Ivoire is typical of standard procedures:

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

Other countries did operate alternative procedures so that in Haiti, for example, IMF programmes could not be implemented without legislative consent but this is purely a domestic arrangement. Similarly, in the United States, Congress has retained a veto power over any attempt to increase Fund resources or change the Articles of Agreement. In the UK, in contrast, there is no need for such parliamentary consent, though the Treasury Select Committee does periodically review UK policy towards the Fund¹⁷.

Different policies and decision-making procedures are likely to arouse different levels of domestic interest. In the past, the secrecy with which the IMF conducted its business and the relatively high level technical decisions that it presided over – issues that were implemented by central government with little obvious effect on populations – limited domestic influences, giving ministers considerable room to manoeuvre.

Under those circumstances, it was possible for internationally minded governments to make deals amongst themselves and then legitimate them to domestic populations in the way that they saw fit. Particularly important was the well-known scapegoating strategy where government ministers would negotiate austerity programmes that they knew were necessary but unpopular domestically. They would then portray programmes as an IMF imposition – using the Fund as a scapegoat. This was not an ideal strategy for governments because they were forced to appear ineffective in pressing their domestic population's goals internationally. Given that, as we saw in chapter 2, domestic sovereignty is partly legitimated on the basis of efficacy – on the ability it gives governments to serve the interests of their populations – this is clearly undesirable. However, if the government is seen to protest in a sufficiently public and robust fashion the worst domestic effects may be ameliorated.

For many authors this scapegoating function has been a key part of the IMF's (unofficial) purpose. For Louis Pauly, for example, the fundamental problem that the IMF is designed to deal with is that:

Citizens continue to hold their own states responsible for the effects of capital market integration. The integration project is, however, an interstate project...Multilateral surveillance is based on the principle that states are *accountable* to one another for the external implications of their internal policy decisions...[it] is not based on the principle that states are *responsible* to one another...they remain responsible only to their citizens (Pauly, 1997, 141).

Pauly, who is largely interested in Fund surveillance in developed countries, produces a vision in which state leaders appreciate that sacrifices need to be made in the interests of a more integrated

¹⁷ For some now slightly out of date information about other jurisdictions see (Gerster, 1993b).

global economy but that they find it difficult to explain this to their populations. The IMF, rather than an instrument of global governance, is largely a 'buffer' between states and global markets. It allows states to make the necessary compromises while obscuring the political nature of the choices that have been made. So in describing the US role in the 1994 Mexican crisis, Pauly argues that:

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

The problem of course is that over the longer term, and particularly when more public cooperation is required to implement more extensive conditionality, this strategy undermines the effectiveness of the IMF¹⁸. It is only an effective strategy where IMF involvement is expected to be occasional and short-lived and where it is unlikely to mobilise a broad strand of domestic opinion. Even then, the effect over the longer-term can be to build up cumulative international resentment, particularly in an era of increased cross border information flows¹⁹. Greater global communications and the importance of 'market confidence' in an environment of free capital flows may, in any case, make it more difficult to portray different messages to different audiences, telling overseas investors one thing and domestic audiences another.

The difficulty of implementing expanded conditionality in developing countries and greater post-Cold War scrutiny of aid budgets in the developed world (see Chapter 3) have made the strategy particularly difficult. In an international context where liberal norms are increasingly important, at least at the level of rhetoric, strategies deliberately relying on limited transparency are increasingly problematic.

There is also a risk for the IMF that scapegoating strategies may not really form part of a good faith attempt to implement agreements made internationally. Governments (particularly those that do not require election) may also have an incentive to deliberately whip up some level of popular opposition. This is because a narrower domestic win set means a stronger negotiating position (Putnam, 1988). If it can clearly be demonstrated that the IMF's preferred policies will result in riots, it is easier to put pressure on the Fund and other donors to come up with more resources to ease the pain - a strategy that Stiles argues has been deliberately used in Latin America (Stiles, 1991).

As I indicated in Chapter 3, evidence on programme implementation collected during the 1990s suggested that the politics of implementation was not simply an academic issue. The Fund has therefore become increasingly concerned with the question of broader 'ownership' of programmes, underscoring the limitations of conditionality as a means of coercion (Killick et al., 1998).

¹⁸ I should perhaps point out that this is not exactly a criticism of Pauly who is primarily interested in the relationships between industrial countries where IMF coordination generally occurs over less intrusive issues such as exchange rate alignments. In the context of good governance Pauly is considerably more sceptical (Pauly, 1999).

¹⁹ See also (Woods, 1999) for an argument that, while having potential drawbacks in short term efficiency, greater attention to accountability, transparency, shared decision-making etc. (as opposed to mere obfuscation) is essential for the longer-term legitimacy of international institutions.

4.3.2 Towards a new model

A combination of concerns with programme ownership, the increasing importance of 'good governance' in the aid rhetoric of developed countries, and a growing conviction about the compatibility of free markets and liberal democracy provide the inspiration behind an emergent new model designed to address these concerns.

I have already discussed the way in which good governance has been incorporated into the IMF's role as both a technical and a political device (section 3.4.2). The idea is that democratic (or at least 'good') government and free markets are mutually supportive. Transparent, (sometimes even democratic) decision-making procedures based on the rule of law provide a more predictable institutional environment for economic growth. Anti-corruption measures and attempts to limit the role of the state in allocating resources are also 'democratic' in the utilitarian sense that they prevent the capture of economic policy making by the politically (or economically) powerful at the expense of everyone else.

Implicitly at least it appears that there is an assumption that any effectively functioning democracy will endorse traditional IMF market-friendly policies. Overall, the existence of democracy and the rule of law will not only have direct domestic benefits but will also reassure the markets that policy will be implemented predictably and in a way that ensures free competition without discriminating between domestic and foreign investors²⁰.

The problem is that many states are not in fact democracies and, in any case, populations are not always sufficiently expert to understand the long-term implications of IMF policies. Populations, even in democracies, cannot therefore be relied upon to ensure that the IMF's correct policies will be implemented. The solution is to try and forge links with a wider range of groups so that the IMF is no longer so reliant on borrower country states for its legitimation and has a chance to explain its policy preferences more directly to 'civil society'.

Interactions with a wider range of government agencies will compensate for any shortages of expertise that have become important in the context of the IMF's expanded mandate. Consultation with NGOs will help the IMF to take into account the interests of those who are not well represented by government – again compensating for the limited information provided by government personnel. At the same time these wider contacts will provide the IMF with greater opportunities for explaining its policies thereby providing it with greater public support. Greater consultation appears to be about a better exchange of information to ensure that technical calculations of economic welfare are better informed and are then better explained to those who must implement them.

²⁰ For an extended argument to the effect that new found enthusiasm for democracy in the 1990s was largely a by product of a new found faith in capitalism see (Cammack, 1997).

These more democratic procedures will also provide reassurance to concerned publics in developed countries that the IMF is not merely using their taxes to further security interests and those of big business.

IMF resident representatives are therefore expected to make wider contacts with 'civil society' and particularly the labour movement²¹ and presumably to take account of their views when advising negotiating missions. The IMF is also to work more closely with the World Bank to ensure that the institutions' advice is compatible and that adequate social safety nets are in place. This need to be concerned with broader audiences obviously makes the negotiation process considerably more complex (see Figure 4-1).

The central problem with all this is the underlying assumption that the IMF's policy prescriptions *are* in everyone's interests and that any derogation from them is likely to be the result of taking a narrow politically biased view rather than a broader, objective technical one. Looking back to my discussion of technical authority in section 2.2.2, strong utilitarian type arguments have come into play that are difficult to see as simply technical decisions about meeting pre-agreed international aims.

If that utilitarian view was acceptable, and the problems involved were largely problems of information and understanding, the IMF's new approach would be appropriate. What the new procedures leave less clear are questions about how disagreements and conflicts are to be resolved where there is doubt about the adequacy of the IMF's technical judgement. Here the sheer multiplicity of actors involved in IMF decision-making immediately raises concerns (see Figure 4-1). The probability of forging consensus between such a wide range of actors is very slim raising important questions about whose interests are to prevail in the event of conflict.

4.3.3 Questioning the new model: multi-level governance and three visions of the 'new' IMF

The academic literature on multi-level governance (MLG) is helpful when it comes to thinking about the relationships involved.

Based on the experience of the European Union, theorists have described a concept of multi-level governance which points to: the emergence of institutions with flexible jurisdictions based round particular issues rather than particular territories; the increasing importance of non-state actors; and a move from hierarchical rules-based systems of power centred on the nation state towards less formal negotiated arrangements (Hooghe & Marks, 2001; White, 2002).

²¹ The Fund issued specific instructions to this effect in 1995. These developments are discussed more fully in (IMF, 2001b)

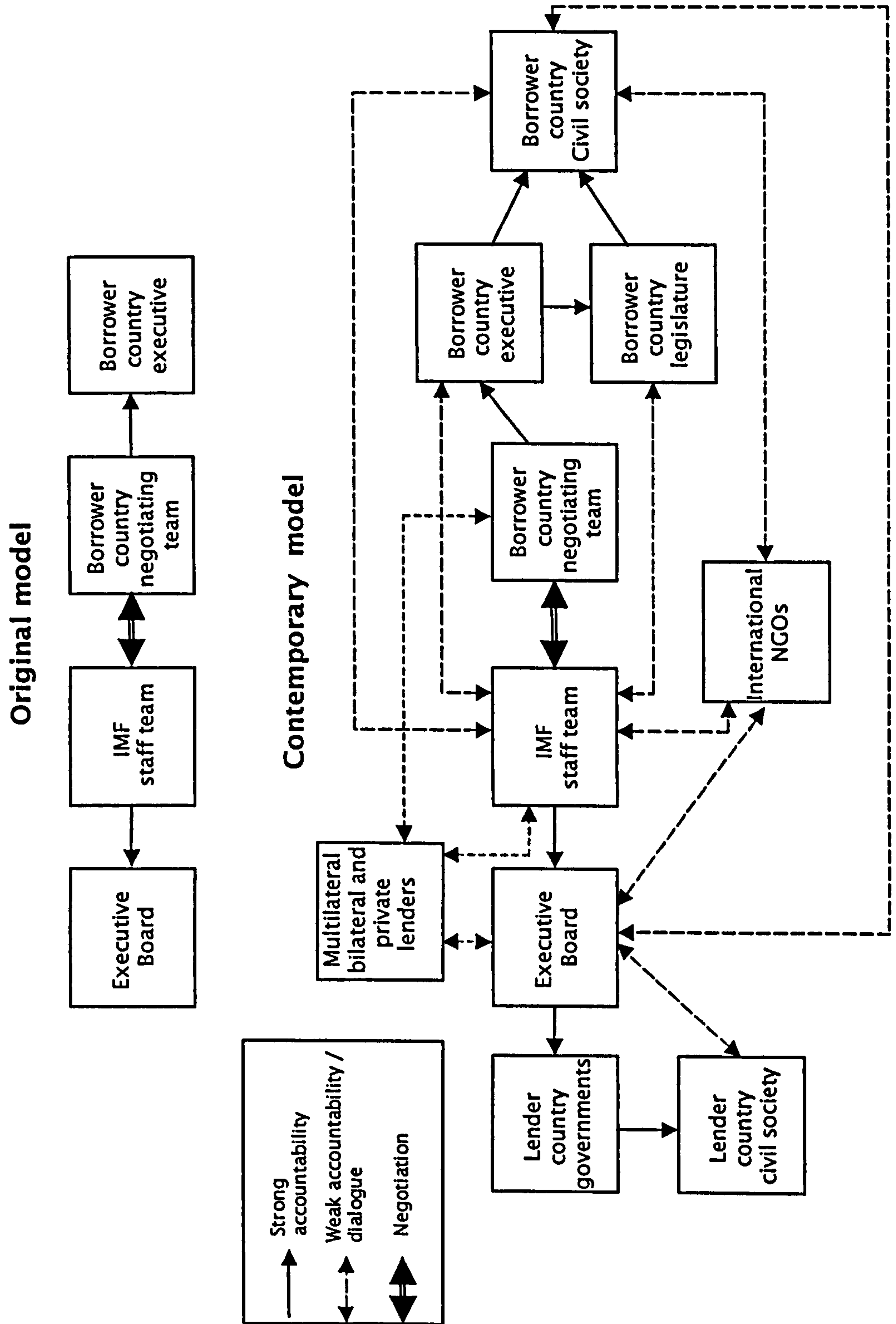


Figure 4-1 Old and new model negotiations

The parallels with the IMF should be clear. We have already explored the flexible, functional nature of the IMF's jurisdiction. The rise of market confidence and moves towards greater engagement with civil society have begun to involve a far wider range of actors in IMF decision-making and the precise nature of the relationships remains unclear (Figure 4-1).

For some, particularly with a political economy background, there has been considerable enthusiasm for the more fluid arrangements involved in multi-level systems. The focus is on flexibility and inclusiveness. A wider range of actors operating within a less rigid framework provides the opportunity for a more effective decision-making process as more stakeholders are involved. Working through negotiations rather than rules assists in producing flexible solutions to the problems thrown up by a rapidly changing world.

However, there are also doubts. Most saliently, Peters & Pierre argue that

multi-level governance appears incapable of providing clear predictions or even explanations (other than the most general) of outcomes in the governance process...It is very nice to say that a range of actors were involved and negotiated a solution but we would argue that a more definitive set of predictions are needed (Peters & Pierre, 2001).

The danger of multi-level institutional arrangements is that they blur lines of accountability and impair decision-making transparency. If it is important to know *why* decisions were made and evaluation is complex, these kinds of institutions can leave outsiders feeling powerless when it comes to holding them to account.

In terms of the Fund, then the question is how exactly civil society is to be involved and whether there will be clear guidelines to avoid these difficulties. Will direct civil society-Fund interactions threaten the power of sovereign states? If civil society wishes to protest particular measures will it know who to hold to account: the Fund, the World Bank or domestic governments?

At the moment, Fund strategy for civil society engagement does not seem to be clearly established: the Board has yet to articulate clear objectives for greater involvement with civil society (Scholte, 1998). Documents that do address the issue tend to concentrate on exchange of information:

we value our interchanges with civil society. These contacts have enhanced the effectiveness of our programmes and contributed to an effort in many places to encourage democratic governance. At an international level they can push sound macro-economic and structural policies...At the grassroots they can mobilise civil society to have a voice in economic policy debates, monitor government programmes, help explain the benefits and costs of various policy options and offer first-hand experience and expertise (Camdessus, 2000a)²².

The idea appears to be that civil society can help to bring issues to the Fund's attention and that the Fund can use contact with civil society to explain its policies better. In particular civil society would seem to offer a counter-weight to economists' continuing concerns about 'vested interests'. Exactly what the expected political consequences are though is (perhaps unsurprisingly) left unclear. How will this new information affect decision-making?

²² In similar vein see (Larsen, 2001)

I want to suggest that these kinds of statements and the IMF's current practices suggest three possible idealised visions with three very different conceptions of the basis for Fund authority and of the actual nature of the multi-level relationships involved.

The first option is basically business as usual but with an expanded conception of the decisions that can be regarded as technical utilitarian calculations designed to resolve coordination problems between states and with better communication of the resulting policies.

I have already mentioned this attempt to expand the scope of what is to be considered 'technical' in relation to corruption but that is only one part of a wider trend in which a broader range of issues, particularly questions about political institutions, social capital and corporate governance, have begun to be incorporated into the practice of economics. In the context of development, the best-known statement is Stiglitz's argument for a 'post-Washington consensus' (Stiglitz, 1998a). Stiglitz himself is clearly aware of the dangers of viewing this as a purely technical matter to be determined by economists (Stiglitz, 2000) but it is not clear that his caution is universal (Fine, 2000).

The purpose of greater openness to and consultation with civil society in this vision is largely to provide an opportunity to explain why these policies are the appropriate ones in particular circumstances in the hope that civil society understanding will lead to public acceptance. Contacts may also provide information to the Fund and assist with *ex post* evaluation. It is largely, then, an exercise in persuasion.

The underlying vision of IMF authority remains heavily technocratic and the problem to be overcome by engagement is that the political process harms the IMF's ability to get the technical message across, or perhaps to a lesser extent to gather the appropriate information for technical decision-making.

A second approach is to extend this business as usual approach by taking more account of the preferences of new actors. Here the IMF's calculations begin to involve a greater degree of explicitly political calculation in evaluating the likely reactions of domestic groups. The IMF's wider agenda, particularly poverty reduction and good governance, may provide it with more scope to produce packages with something for everyone aiding domestic implementation. This is essentially a 'two-level game' approach where states remain in charge but the IMF is more willing to work with them (or even assist them in political management) in the interests of policy implementation.

The involvement of more actors increases the flow of information both in and out of the Fund. Greater transparency should result in more confidence that IMF decision-making is genuinely designed to serve Fund purposes and isn't captured by other agendas. This second approach puts considerable pressure on the accountability aspects of Executive Board decision-making. Decisions are now less purely technical and involve explicit bargaining and trade offs between the 'international interest' and what is politically feasible in borrower countries. It also puts a lot of pressure on state cooperation, expecting governments to have a good idea of their domestic political situation and working honestly with the Fund to achieve programme implementation.

The third approach puts even more emphasis on the role of civil society. In this vision, the Fund is to work primarily on behalf of domestic populations. If states are unwilling to do so, the Fund should be willing to put pressure on them from below. It should specify programmes that will serve the interests of domestic populations with the expectation that popular pressure will mobilise around those programmes forcing states to implement programmes even where they attack the interests of powerful elite supporters. Here the IMF's technical decisions concern the welfare of civil society groups and its goal is, effectively, to maximise welfare within countries as well as in their interactions. Civil society groups are charged with identifying the 'national interest' and applying pressure to ensure that it is realised in cooperation with the IMF against the state.

The three visions clearly overlap. At least in the light of the Fund's original institutional relationships, some version of the second approach would seem to be the most promising. The question is how much of the first and third visions will be incorporated into Fund policy-making in practice. In interactions between the Fund, civil society and states, how much is technical authority (or perhaps the will of the markets) to be the determining factor and, where the Fund's technical view is unacceptable to states, civil society, or both, whose view is to prevail? What effect will that have on IMF legitimacy to different groups of actors?

Those questions about the nature of the system of multi-level governance centred on the IMF are the second set of issues to be explored through the empirical evidence of the case studies.

4.4 Conclusions: the agenda for Chapters 5-8

The debate about the Asian crisis fundamentally springs from questions about Fund performance, market failure and Fund technical authority. That was particularly significant because of the historical context in which it took place. As we saw in Chapters 2 & 3, prior to the crisis, the Fund's regime was increasingly moving in a direction of limited political control over financial crisis and of authority that was based on the technical ability to prescribe policies that would mobilise capital flows.

Normatively, if there were growing doubts amongst economists about the Fund's technical authority and if the rationality of markets were to be doubted, what reasons did developing countries have to comply with Fund policy? That was particularly problematic since the alternative interpretations of Fund intervention in Asia raised by reputable economists also suggested considerable political bias in Fund operations. A market-based approach to crisis favoured foreign creditors over Asian economies. High interest rates threatened to allow fire-sales to foreigners. Tight fiscal policy was designed to ensure repayment of the IMF at the expense of the domestic poor. On the other hand, though raised very publicly, these critical perspectives were not universally accepted. There was an alternative point of view that was much more sanguine about IMF intervention and only implied the need for moderate reform.

Politically, then, the question is whether these kinds of doubts would trigger increasing state resistance in the form of higher levels of non-implementation and protest within the Fund's institutional structures?

Additionally, the Fund's new role involving issues of good governance meant that interactions at the domestic level would become more important in developing countries. The Fund regime was moving closer to the kind of system described by theorists of 'multi-level governance'. From a Fund point of view, that raised issues about how to assist in securing domestic implementation but they were complicated by questions about whether it was states or citizens that were most likely to object to Fund policy and how such objections should be dealt with. From a citizen point of view, the Fund's interventions were becoming increasingly significant and complex. How much of what was being done in the Fund's name was actually imposed by the Fund and how much by the domestic government? Who should be held to account and what was to be done where the Fund or states proved unresponsive? In short, how would the Fund's new agenda be regarded domestically and what messages would the politics of implementation send out about Fund legitimacy.

In summary, the case studies aim to address four sets of issues. Firstly, they explore any additional evidence concerning the technical debates surrounding the crisis. Secondly, they ask how political the Fund interventions were. Thirdly they explore the politics of implementation to try and determine the balance of authority exercised by states, the Fund, the markets and civil society. In particular it will be important to investigate forms of resistance to the Fund framework to determine whether they are challenging to Fund legitimacy and, if so, to suggest options for re-establishing Fund legitimacy. Finally, it will be important to look at reactions outside the crisis countries to assess the political prospects for Fund reform.

In short the case studies will link together the issues about the normative persuasiveness of Fund authority claims and the politics of challenge to legitimacy.

5 South Korea

This chapter, like the one that follows, is concerned with the three sets of domestic case study issues outlined in Chapter 4. I am interested in: empirical evidence that sheds light on the technical controversies set out in section 4.1; information about the nature of IMF interventions, particularly the balance between their economic and non-economic effects; and information about the politics of negotiation and legitimation, particularly in relation to the three visions of the IMF that I explored in section 4.3.

The economic and political impact of the IMF programmes needs to be assessed in relation to the pre-existing political economy in the crisis countries. Given the nature of IMF structural policies, the historical relationship between the state and the economy is particularly crucial and I begin the chapter with a brief review of the role of the state in development. I then go on to provide a short chronological account of the crisis that serves as the basis for subsequent discussions.

The first task concrete task is to explore how the technical debates I reviewed in section 4.1 are relevant to the Korean context and to see what the Korean experience has to contribute to them.

I then go on to look at the politics of the crisis, firstly by identifying interests that could expect to gain or lose from the IMF programme. I use that analysis to analyse and explain the process of programme negotiation and implementation. Looking at negotiation and implementation in terms of underlying interests helps to clarify what kind of interests are involved – addressing questions about the nature of IMF intervention. The negotiations themselves then provide information that is helpful in evaluating the implications of the crisis for arguments about the contribution of IMF institutions to IMF legitimacy. The conclusion to the chapter draws together the various lessons.

What we find is that the IMF programme in Korea came in for trenchant criticism from academic economists and the international financial press. In the end, though, it was largely accepted by the Korean people.

Criticism came from enthusiasts of the 'developmental state' who felt, correctly, that the IMF was attempting to destroy and discredit the very system of political economy that they believed had been responsible for Korea's phenomenal economic growth since the 1960s. Others, on the other hand, saw this as a positive development. They felt the developmental state had outlived any usefulness it may have had in the past. In other words, international debate revolved around the controversies over rent-seeking and the role of the state that I reviewed in section 4.1.2

Domestic acceptance, despite technical controversy, is best understood as the result of political factors. The IMF programme was highly compatible with Kim Dae Jung's agenda to 'democratise' the Korean economy by breaking the relationship between state and big business that he saw as a key factor behind post-War Korean authoritarianism. Although he had reservations about other aspects of the programme (high interest rates and unnecessary foreign opening), he seems to have decided that it offered a unique opportunity for undermining the power of the Korean *chaebol*.

Once converted to the programme his considerable political skills and credibility, particularly with labour, were harnessed to ensure the programme's acceptance by the population at large.

In terms of my three visions of Fund engagement with civil society (page 119), the results initially look positive for the second vision: limited IMF responsiveness to the domestic political situation as articulated by domestic civil society. On closer inspection, though, there is also some room for concern. The IMF and Korean government seem to have had quite different motivations for the reforms suggesting a happy coincidence more than the result of IMF flexibility. The United States had a third agenda and appeared to exercise more influence than should have been possible in terms of IMF multilateral rhetoric. In short, the sceptical could still argue that performance may have been relatively successful but it seems to have been so despite, rather than because of, the nature of Fund institutional arrangements.

5.1 The state and development in South Korea

The case studies in this part of the thesis are concerned with the way IMF programmes were received in practice. It is therefore important to review the systems of political economy that IMF programmes were designed to change so we can see how IMF interventions interact with previous economic and political debates within the countries concerned.

Most issues around post-War Korean economic policy are best understood in terms of the set of institutions compromising what has come to be called the 'developmental state'. That is either because they were designed to create or maintain those institutions or because they represent attempts to dismantle them.

As we saw in Chapter 4, the structural aspects of the IMF programme were designed to dismantle what was left of that system in order to foster good governance and eliminate 'rent-seeking'. The issues raised about the economic and political advantages and disadvantages of those kinds of rent

creation (inefficiency versus a long-term view, corruption versus stability and control) in Chapter 4 are all significant in the Korean context.

The discussion that follows is designed to explore the political and historical reasons behind the positions various Korean actors ultimately took on the future of the developmental state and the IMF programme more generally. That will involve reviewing the claims made on behalf of the developmental state; its political underpinnings and political consequences; and a series of attempts to reform it, culminating in Kim Young Sam's *segye-hwa* policy at the eve of the crisis.

5.1.1 The concept of the developmental state

A key factor in the controversy over IMF intervention in Korea springs from Korea's categorisation as perhaps the paradigm case of an East Asian 'developmental state'. Explanations for Korea's phenomenal post-War growth are the subject of considerable controversy focussed on the precise role played by the Korean state in promoting that growth.

There is widespread agreement that the state was responsible for ensuring macro-economic stability and encouraging an export-led growth strategy. Indeed, in the 1970s and 1980s, a number of neo-liberal commentators saw these as the primary reasons for Korea's success (in contrast with Latin American attempts at ISI).

The developmental state literature, however, argues that the Korean state went much further, deliberately encouraging economic upgrading, initially through pressurising firms to enter new industries and later by facilitating the drive to technologies identified by business (Amsden, 1990). Others argue that it is more accurate merely to point to the state's attempts to boost companies' profits artificially in domestic markets so as to ensure resources for investment (the 'profit-investment nexus') and to prevent conspicuous consumption and speculative investment to insure that these super-profits were re-invested for productive purposes (the 'export-investment nexus') (Akyuz et al., 1998). At any rate, the 1980s minimalist conception is now very much a minority opinion and most accounts point to the influence of some form of the rent distributions strategy I explored in Chapter 4 (Rodrik, 1995; World Bank, 1993).

The Korean government deliberately encouraged the creation of a limited number of large conglomerates (the *chaebol*) who were encouraged to compete with each other in the context of a highly protected and very profitable domestic market. Competition was to be on the basis of quality, distribution and market share rather than price (Amsden, 1990; Singh, 1998). In addition to the domestic carrots offered (tariff protection, limited competition, subsidised credit), the government also applied a stick of forced export quotas. Companies were encouraged to take part in continuous technical upgrading of export production and, if they failed to meet targets, faced the threat of withdrawals of subsidised credit or tax investigations (Amsden, 1990; Woo, 1991). Government discipline and the need to compete internationally provided incentives to improve efficiency avoiding the potential anti-competitive consequences of a pure ISI strategy.

The banking system was an important part of the set up. It worked on very much the pattern I described in Chapter 4 (section 4.1.2) though early on the government directly controlled bank lending decisions enhancing the relationship between classic rent-seeking arguments and those based on market discipline. Later on government influence was reduced but didn't disappear entirely.

Less visible in the literature, but also important, was the state's willingness to keep industry competitive by disciplining labour and its ability to justify concentrating resources on the *chaebol* at the expense of a wider range of potential capitalists.

5.1.2 The politics of the developmental state

The level of political and bureaucratic management of the economy required for this kind of developmental strategy is clearly highly demanding on the state, raising questions about the political pre-requisites of the system. The symbiotic relationship between state and business also has significant political consequences in terms of the sort of society it implies.

Political pre-requisites

To carry out the developmental tasks I have identified, the state needed to be: highly competent; committed to technological upgrading; and able to insulate itself from both the danger of elite capture and of popular pressure (Evans, 1995).

A complex array of factors account for the Korean state's satisfaction of these requirements.

Chalmers Johnson has argued that:

The successful capitalist developmental states have been quasi-revolutionary regimes, in which whatever legitimacy their rulers possessed did not come from external sanctification or some formal rules whereby they gained office but from the overarching social projects their societies endorsed and they carried out (Johnson, 1999, 52)

The project of technological upgrading in Korea was driven by the twin nationalist aims of avoiding renewed subordination to Japan and defence against the communist North. The threat from the North secured huge US aid transfers in the 1950s. The US aim was to promote a liberal free market Korea in a subordinate role as supplier of primary products to Japan and consumer of more technologically sophisticated Japanese goods (Cumings, 1998). Rhee subverted this goal, channelling US aid to a select band of proto-capitalist political supporters. USAID disapproved but security considerations overrode any anxieties (Amsden, 1990; Haggard & Moon, 1993; Oh, 1999).

Even at this stage, the Korean bourgeoisie¹ was effectively a creation of the state. Korean capitalist development was a state led project owing its inspiration to List and Hegel, rather than a project led by an independent middle-class rebelling against traditional authority and drawing its inspiration from Locke and Adam Smith (Cumings, 1998; Kohli, 1999). That dependence on the state was a

¹ In this section I use bourgeoisie to indicate the capital owning class (particularly *chaebol*/owners and senior managers) and 'middle-class' to indicate a rather looser notion of the relatively well off (white collar workers, professionals, medium-sized business owners etc.)

key facilitating condition for the state's ability to maintain its independence from capture by particular business interests.

The most dramatic illustration of this dependency came with Park's early determination to demonstrate to the Korean bourgeoisie that it owed its past and future existence to the Korean state. Laws passed by the ill-fated Chang Myon administration to deal with illicit wealth accumulation under Rhee were used to nationalise the banking system through confiscation. Korea's leading businessmen were then summoned by Park and offered exemption from further prosecution in return for a pledge to cooperate with his developmental projects (Haggard, 1990; Haggard & Moon, 1993). Later, the combination of high corporate debt-equity ratios and government controlled credit allocation were used to perpetuate the dependent relationship (Woo, 1991).

A key inspiration for the state's power and economic competence was the Japanese experience itself. Park was an explicit admirer of the Japanese state of the Meiji restoration era (Amsden, 1990; Cumings, 1984; Kohli, 1999) and, on coming to power, quickly went about dismantling the chaotic bureaucracy inherited from Rhee, replacing it using military organised technocratic selection procedures (Moon & Kim, 1996). He also concentrated state, and particularly economic, power in an imperial presidency with direct control over the powerful Economic Planning Board (EPB) based in the Blue House (Cheng et al., 1999). The system was authoritarian, dominated by the Executive and based on results-oriented administrative discretion rather than process-oriented administration under the rule of law – a pattern that persists to the present day (Woo-Cummings, 1999).

Park's developmental state acquired what social legitimation it had through an appeal to the twin ideologies of anti-communism and nationalist industrialisation (Choi, 1993b). He promised a wider distribution of the fruits of development than had taken place under Rhee and a more stable political system than that of Chang Myon's democratic republic. Building on the US sanctioned land reform, Park channelled significant resources to the countryside (the most likely site of political resistance) (Choi, 1993b; Moon & Kim, 1996). He encouraged the *chaebol* to pay reasonable wages and provide employee welfare but also helped them control any more significant labour demands through the threat of repression exercised by the ubiquitous KCIA in the name of anti-communism (Choi, 1993b). The middle-classes were expected to value political stability and the potential gains springing from rapid economic growth.

Political consequences

The political underpinnings of the developmental state also had significant political consequences that remain important to the present day.

Most obviously, what was created was an authoritarian state in close alliance with big business. The state was successful in avoiding capture by individual *chaebol* but, the more successful the developmental project became, the more difficult it was for the state to keep control of the *chaebol* collectively (Amsden, 1990). At the same time, powerful business support for a state clearly

committed to its interests made it difficult for any social group to mount effective opposition to the state-*chaebol* alliance (Choi, 1993b).

As industrial transformation began to make urban labour and the non-*chaebol* owning middle class more politically significant than Park's traditional agricultural supporters, political strains mounted. Labour and student unrest has been a persistent feature of Korean political culture² that even extreme repression was unable to stifle completely (Choi, 1993a; Cumings, 1997). However, anti-communism and a preference for political (and therefore economic) stability meant that the largely conservative Korean middle-class was often reluctant to join with more radical student and labour protest, preventing a broad-based popular alliance (Choi, 1993b).

Indeed, the fact that the bourgeoisie was largely a creature of the state meant that the kind of middle-class opposition to the state expected by much Anglophone political theory was slow to emerge. It was a long time before any considerable economic power base could emerge that was independent from the state. The *chaebol* owning bourgeoisie, rather than legitimating itself on the basis of freedom and equality of opportunity, tended to claim that it was an essential part of the national developmentalist project. This is one reason behind the 'profit-investment nexus' side of Korean political management. There has been a marked unwillingness to celebrate the profit motive in Korean society. Eckert argues that Korean business still constitutes a 'class in search of hegemony' pointing to the way Korean leaders continue to blame economic downturns on conspicuous consumption and the tendency for Korean companies to produce executive hagiographies stressing their company chairman's commitment to the national good (Eckert, 1993). Nonetheless, the *chaebol* do perform important and valuable functions within Korean society in addition to their material and ideological support for the state. They are clearly the most technologically and economically dynamic section of the Korean economy. They are also large employers and carry out an important welfare function.

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

5.1.3 Attempts to reform the developmental state in the 1980s³

As political opposition to the authoritarian state-*chaebol* alliance grew with the social changes resulting from Korean industrialisation, economic criticisms of the system also began to be articulated. Critics claimed that the high debt nature of Korean corporate finance left *chaebol* vulnerable to small interest rate changes during economic downturns. Indeed the government was frequently called on to bail them out, most dramatically by cancelling all debt to the unofficial 'curb

² Even Park was unable to silence student demands for 'democracy, higher wages, egalitarianism, eradication of poverty, and protection of the small scale firm' (Amsden, 1990, 148).

³ This section is heavily condensed, the best source on legislative attempts at reform is (Lee, 1997).

market' after a downturn in 1971. Arguably it was the economic consequences of one such episode that eventually brought down the Park regime in 1979.

The sheer economic might of the *chaebol* was also criticised. They monopolised credit preventing the emergence of a more egalitarian (particularly as most *chaebol* remained family owned, so economic concentration in a few firms also implied concentration of wealth) and entrepreneurial small business sector. There was also a suspicion that *chaebol* size and business diversification owed more to the political imperatives of obtaining government patronage than it did to any economic rationale.

The history of the developmental state after Park is therefore one of repeated, and often unsuccessful, attempts at reform. Chun Doo-Hwan (1979-1987) seized power after Park through a military coup. He engaged in a fairly orthodox structural adjustment plan to try and deal with the excesses of the heavy industry push that characterised later economic policy under Park (Haggard & Moon, 1993). US pressure for trade and financial sector liberalisation was also a significant factor (Mo & Myers, 1993). However, for reasons explored below, structural reforms were ultimately only partial.

Although these policies might have been expected to produce benefits for the middle-class, by this time opposition was largely *political* in nature reacting against military authoritarianism. As early as 1980, the military had to put down a virtual rebellion in Kwangju using live ammunition and killing at least 200 people. Korean students finally succeeded in uniting with an increasingly militant labour union and, crucially, also obtained broader middle-class and professional support in the interests of freedom and democracy forcing elections in 1987 (Oh, 1999).

Roh Tae-Woo (1987-1992) inherited a relatively healthy economy but political opening quickly led to difficulties. The recently liberated labour unions used their freedom to push for rapid wage rises to make up for past injustices and business responded by talking up fears of recession in the late 1980s, successfully recreating the traditional split between the conservative middle-class and more radical student and labour activists.

Like Chun before him, Roh too seems to have intended to reform the state-*chaebol* relationship. He put pressure on *chaebol* to dispose of investment assets (particularly land, long a bone of contention in an increasingly crowded Korea) and to diversify ownership through equity offerings. He added further reforms to Chun's competition and investment regulations and attempted to use them to press for a reduction in *chaebol* internal diversification. Like Chun, he also introduced measures to prevent *chaebol* abuse of sub-contractors and to promote small businesses (through SME lending quotas imposed on the banks).

However, like Chun he too was caught on the horns of a dilemma. Attempts at reducing *chaebol* domination through liberalisation (particularly under foreign pressure) often in fact resulted in further economic concentration as the *chaebol* were best placed to profit. So, for example, privatisation of banks ran the risk that they would be bought by *chaebol* who could then take direct

control of credit allocation. The tendency was then to resort to legislation which proved difficult to enforce given the *chaebol's* mammoth political influence.

The result was a regulatory albatross that, in the end, did not achieve its purpose...almost all major reforms of the last two decades...not only moved at a snail's pace, but went hand in hand with proliferation of more regulations to obtain an economically desirable outcome. And few of the measures really worked (Woo-Cummings, 1999, 126).

Politically, a more liberal political climate under Roh not only gave labour greater opportunities for self-expression. It began to erode the taboo on middle-class conspicuous consumption. It was also clear that money politics was either becoming more important as democratic political parties started to compete for funds or was merely harder to conceal with the rise of democracy. Overall, observers started describing Korea as the 'golf republic' (Cotton & Van Leest, 1996) something that Kim Young-sam, Roh's successor, was keen to react against

5.1.4 Kim Young-sam and the background to the crisis

Kim Young-sam came to power in 1992 on the basis of a 'grand conservative coalition' in which Kim, long considered a radical critic of the ruling party, joined forces with it and Kim Jong-pil's conservative New Democratic Republican Party. On the left of the coalition, and having received little support from his conservative 'allies' prior to election, Kim began his term with an attack on the corruption of old-style Korean politics. He released political prisoners, dismantled notoriously powerful political organisations within the military, instituted a 'real name' system for finance and real estate transactions, voluntarily declared all his assets and persuaded his ministers to do likewise, and promised to live frugally and not profit from his office. He also took some steps to institutionalise appropriate political behaviour by passing new electoral laws that seemed to have more coercive bite than those of the past (Haggard, 2000).

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

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

- Deconcentration first – domestic reform of the *chaebol* and measures aimed at encouraging SMEs could be carried out in conjunction with selective external opening so that domestic firms could adjust over time without the risk of external shocks.

- External opening first – particularly given US pressure, an attractive path would be to encourage domestic competitiveness through external competition. It would also force a transition from state direction to market regulation, again gradually reforming the *chaebol*
- Democratisation first – social goals should take priority over growth, at least for a limited period. An increase in welfare spending, redistribution of income from capital to labour and focus on social inclusion. Particularly important would be reforming the system of industrial relations to create less adversarial relationships (Gills & Gills, 2000).

Kim Young-sam appears to have been attracted to all three options for different reasons. His early moves (real name system and anticorruption) suggested a deconcentration and democratisation first approach. He also pursued further attempts at regulating the usual *chaebol* abuses: a focus on core businesses was encouraged, limits were placed on holdings in private banks, limits on the expansion of subsidiaries, attempts to separate ownership and management through limits on family equity holdings and restrictions on cross payment guarantees⁴. However, after this first round of reforms, the *chaebol* began to assert themselves. Investment rates in Korea fell, overseas branches were set up instead and growth faltered as a result.

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

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

Of course, in practice in statements about *segye-hwa*

Some purposes are thought to be better left unheralded, and some may be put in mostly as decoration (Bobrow & Na, 1999).

In keeping with the gradual political shift towards the interests of the *chaebol* and an external opening strategy, highest priorities were trade and financial liberalisation which meshed well with the new enthusiasm for multilateralism in the OECD and WTO.

⁴ Various techniques of corporate finance were used by the *chaebol* to maximise control over companies for a minimum capital stake. Subsidiaries would own each others' shares and would guarantee each others' liabilities making it easier to raise finance but also causing vulnerabilities as the failure of one firm could bring down the whole group

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

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

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

5.1.5 Conclusions

There is little doubt that in their heyday the *chaebol* made a huge contribution to Korean prosperity. By the 1980s, though, increasing international pressure and domestic discontent over state-*chaebol* relationships was creating a social consensus around reforming state-business relationships. At a popular level, this seems to have been driven by political and distributional concerns while policymakers were concerned about economic inefficiencies.

The problem was that *chaebol* economic dominance made it difficult to change the situation through liberalising legislation since any liberalisation merely gave the *chaebol* greater room to manoeuvre. Their political power was also growing allowing them to oppose any legislation that would have a serious impact on their market dominance. Particularly important was their ability to provide financial resources that could be used to maintain political support through patronage and, after a democratic transition, for campaign funding. However, they were also key employers and, because of the nature of the employment relationship, a central welfare provider.

At the same time popular discontent with the *chaebol* was growing and the *chaebol* themselves were becoming increasingly critical of the returns they were getting for their financial support to

politicians⁵. Overall the state-*chaebol* relationship was increasingly becoming one of both mutual dependency and mutual animosity.

International consensus around neo-liberal policies, together with a certain domestic political logic seems to have encouraged Kim Young-sam to see liberalisation and internationalisation as the solution to this impasse. As we will see in the second part of the chapter, the problem was that, in keeping with the weaknesses of the neoliberal paradigm itself, he underestimated the importance of the legal, institutional and political underpinnings of a market economy with disastrous consequences for the Korean economy.

IMF structural policies, aimed at dismantling the state-*chaebol* alliance, fed into pre-existing political controversy in Korea.

That controversy was partly about economic views: were the *chaebol* becoming increasingly inefficient, relying more on patronage and less on technical expertise than in the past? Should Korea therefore embrace international trends towards 'flexible specialisation': smaller, leaner more flexible firms competing in high technology sectors? Or would that destroy the Korean giants that were so important to Korean export performance?

It was also deeply political. Were the *chaebol* responsible for increasing wealth differentials? Was 'real' democracy possible in Korea without attacking the *chaebol*? Would attacking the *chaebol* put a stop to money politics? Who would gain and lose as part of the reform process?

5.2 The Crisis in Korea

Korea experienced a surge in investment between 1994 and 1996 driven by: the exchange rate factors described in Chapter 4, impending OECD membership, and particularly by related efforts at financial liberalisation. Unlike previous investment surges, this one was fuelled by foreign rather than domestic debt.

During 1996 Korea began to experience a marked deterioration in its terms of trade (about 12% (Balino & Ubide, 1999)) due to the reversed trend in the yen-dollar exchange rate and a collapse in key export prices, noticeably semi-conductors and steel. The inevitable current account deficit was largely funded by short-term capital inflows.

This did not initially raise significant concerns since:

Internal macro-economic fundamentals, such as GDP growth, the fiscal position, CPI inflation, and interest and exchange rate stability indicated strength. (Balino & Ubide, 1999, 6)

Kim's response demonstrated his increasing political dependence on the *chaebol* and a political preference for growth oriented policies. Rather than reducing investment, or allowing the exchange rate to decline, Kim pushed ahead with legislation to increase labour market flexibility. He set up a

⁵ This was most clearly demonstrated by Chung Ju-yong of the Hyundai group's decision to stand in the 1992 presidential elections

presidential 'Commission on Labour-Management Reforms' with representatives of government, business and NGOs. Employers wanted to make it easier to fire workers, to introduce substitutes and stop pay during strikes and to adjust working hours at will. The unions wanted greater political rights, legalisation of multiple unions and greater bargaining power for public sector workers, particularly teachers.

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

By early 1997, it became clear that slowing exports were having serious cash flow consequences for highly leveraged medium sized *chaebol*. The first to fail was Hanbo steel on 23rd January 1997. It later emerged that large-scale corruption had been involved in lending decisions involving Kim Young-sam's son (amongst others). The government nationalised Hanbo and the management were dismissed. The Hanbo crisis was hugely significant politically, particularly given Kim Young-sam's self-promotion as a frugal President fighting corruption partly by personal example. From this point on, Kim was something of a lame duck and increasingly attempted to distance himself from Lee Hoi-chang – the ruling New Korea Party candidate for the upcoming presidential elections. Economically, it raised questions:

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

but was still generally regarded as an isolated incident.

When two further *chaebol*, Sammi Steel and Jinro, went bankrupt in March and April respectively, a more concerted response was called for. Concerned that knock on effects throughout the economy might damage the banking system, the government arranged an anti-bankruptcy pact, announced on 18th April, under which major banks would continue lending to troubled companies. The banks would in turn receive support from the 'Korea Asset Management Corporation' (KAMC) set up by the government for this purpose.

Market reaction was largely positive in the short term. Some suggested Jinro should have received harsher treatment (it was bailed out by the KAMC on the basis of management personal guarantees of new debt and some concessions on restructuring) but most feared the knock on effect on other *chaebol*. Externally, the international rating agencies started to downgrade credit ratings on major Korean banks citing directed lending, over regulation, too many financial institutions and concerns over bad loans (Economist Intelligence Unit, 1997b, 32).

At a popular level, pre-existing anti-luxury and 'buy Korean' campaigns began to become more prominent around this time, privately run but with the cooperation and even enthusiasm of some bureaucrats (*FT* 6th October 1997) The nationalistic element in this was, if anything, encouraged by EU efforts to raise complaints over the issue at the WTO.

By the middle of the year, concern over the fragility of the Korean banking system was mounting although there was still no suggestion of imminent crisis. Doubts were moderated to some extent by the fact that the government was clearly aware of the problems and a Financial Reform Commission was working on a reorganisation of the regulatory system.

The proposal was to consolidate supervision of banks, securities and insurance within a single body – the Financial Supervisory Commission reporting to the Prime Minister. However there were political difficulties with the proposals. The Bank of Korea (BOK), which has traditionally been subordinated to the Ministry of Finance (and now MOFE) was resentful of its proposed loss of regulatory capacity and strongly opposed the reforms. BOK control over monetary policy would be strengthened in return but would still be subordinate to MOFE's ability to set the overall thrust of macro-economic policy and BOK staff regarded this as little consolation.

Meanwhile, the first big test of the anti-bankruptcy pact occurred when Kia found itself in difficulties in late June. The government was inclined to let Kia fail but the issue rapidly became politicised. There is a history of conflict between Kia and Samsung over entry into the automobile industry (Oh, 1999). Kia has a large factory in Cholla province and Kang Kyong-shik the minister in charge of making the final decision was closely connected with Samsung (based in Kim Young-sam's Kyangsong province)⁶. Kia executives used this to whip up political opposition to the closure and the issue dragged on until October 22nd, creating considerable uncertainty in the markets and a steady decline in stock prices and the exchange rate. The final decision was to nationalise Kia.

⁶ Regionalism has had an increasingly important influence on Korean politics with conservative Presidents Chun, Roh and Kim Young-sam all coming from Kyangsong Province. Regional affiliation is by far the most important determinant of voting behaviour everywhere outside Seoul, where the only competition on issues takes place (Oh, 1999).

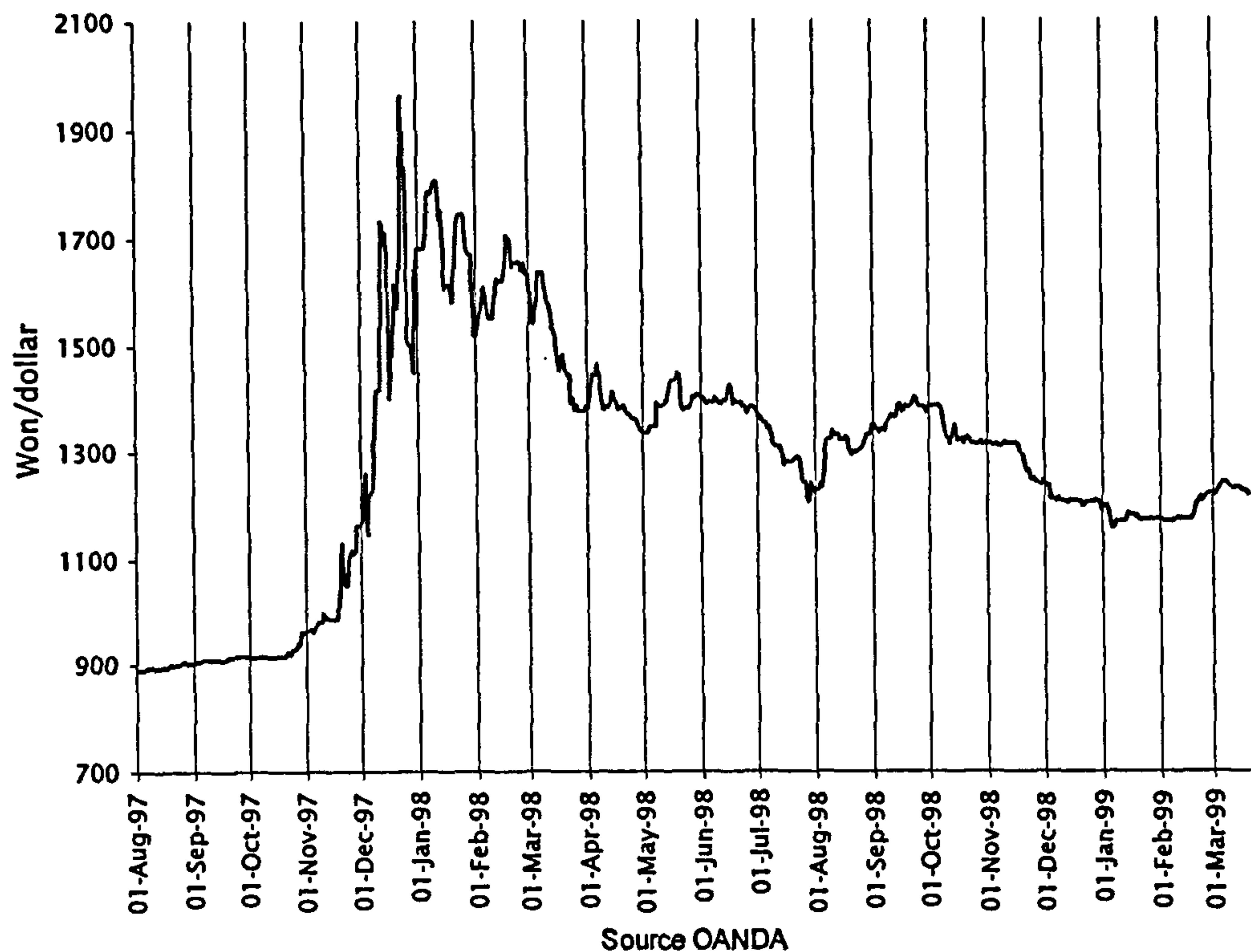


Figure 5-1 Won-dollar exchange rate

Market reaction was hugely negative (see Figure 5-1). The Financial Times' view is representative⁷:

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

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

Shortly afterwards, the final straw came when parliament failed to ratify the financial reform bill in mid-November. By now, market analysts were saying that Korea had no choice but to go to the IMF (*FT* 19th November 1997). A final attempt was made to calm the markets by announcing a package of consolidating bank mergers and greater foreign access to the Korean bond market but it

⁷ A survey of 100 foreign investors carried out by the Korea National Economic Institute at around this time found that poor management of Korean companies, and government rescue of troubled conglomerates instead of allowing them to go bankrupt were key reported reasons for withdrawal from Korea (cited in *FT* 19th November 1997)

had little impact. In fact, IMF managing director Michel Camdessus had already been smuggled into Seoul for preliminary consultations on the 16th. Negotiations were formally announced on 23rd November and the first programme was announced on 5th December.

The first programme was broadly welcomed by the markets and triggered a brief rally in the exchange rate but enthusiasm was short lived (see Figure 5-1 on page 137). Domestic popular reactions were highly negative. Opposition politicians and union leaders raised public criticisms of the programme and there was some highly negative press coverage. Despite public commitments to the IMF programme eventually extracted from the presidential candidates by Kim Young-sam on 12th December, analysts began to question Korean political commitment and the political feasibility of reform:

Its like walking through the looking glass...there is a frightening disconnection between how Koreans and foreigners see the situation (a 'US analyst' quoted in *FT* 12th December 1997)

nobody has any confidence that the politicians are going to be able to deliver [the IMF programme] (Chris Tinker of ING Barings in Hong Kong, quoted in *FT* 12th December 1997).

Given the history of unsuccessful attempts at *chaebol* reform, the markets were nervous that the IMF programme contained no concrete deadlines. Worse still, IMF pressure forced the central bank to issue a statement outlining the true position of its reserves. Figures up to that point had ignored extensive forward contracts in the currency markets and the true position was that Korea was virtually bankrupt.

In the end the Won's fall was only halted on Christmas Eve after US and European officials managed to persuade international banks to roll over short-term credits in return for the extension of Korean government guarantees on all domestic debt bank debt (again, see Figure 5-1 on page 137). A more permanent solution was arrived at after tough negotiations between the banks and the Korean authorities. Morgan Stanley had proposed a 'market based' solution in which the Korean government would issue a series of bonds that banks would bid for, expecting interest rates to be in the region of an exploitative 7% above US Treasury bonds. Eventually the Korean government, advised by Goldman Sachs, agreed floating rates of 2.25%, 2.5% and 2.75% above LIBOR for one, two and three year loans guaranteed by the Korean government⁸ (Callaghy, 2000).

The exchange rate then began to recover gradually and attention turned from crisis to recovery.

5.3 The economics of the crisis: theory and evidence

I provided an overview of debates surrounding the Asian crisis in Chapter 4 which suggested that the issues were both technical and political. It also discussed the technical arguments in fairly abstract terms. Before looking at the political aspects of the debates in section 5.4, it is important to review the technical arguments developed in the Korean context and to review the evidence the

⁸ See the joint press release by the Government of Korea and the Creditor Banks Negotiating in New York issued 28th January 1998, reprinted in (Sohn & Yang, 1998)

crisis provided to support different points of view. We can then see how different technical perspectives interacted with political interests (section 5.4.1) to structure the process of negotiation and policy implementation (section 5.4.2).

5.3.1 The IMF Response

The IMF programme announced on 5th December followed the broad parameters I described in Chapter 4: tight monetary and fiscal policy to support the exchange rate and induce capital inflows; structural reforms of the corporate and banking sectors; trade and capital account liberalisation; and social safety net provisions. However, the structural aspects were particularly tailored to the Korean situation

Structural reforms

IMF documents make it very clear that the Fund saw structural problems as the key to the crisis in Korea (Balino & Ubide, 1999; Borezstein & Lee, 1999; IMF, 2000d; IMF Asia and Pacific Department & Gobat, 1998). Limited market discipline within Korea meant that there were insufficient incentives to ensure the efficient allocation of capital. Historically, banks had largely been a channel through which the state provided capital to the *chaebol*. There had been some limited financial liberalisation and the government had reduced its influence over the banking sector. However, a combination of factors conspired to limit market influence over credit allocation.

Concentrated family ownership, occult *chaebol* accounting practices and an absence of independent board directors meant that it was difficult for shareholders to control management. A limited equity market, a lack of institutional investors and regulations preventing mergers and acquisitions further reduced the scope for shareholder discipline. Nonetheless, implicit government guarantees to support the *chaebol*, together with their sheer size and market dominance meant that they continued to receive large amounts of bank credit. Poor prudential regulation and the importance of relationships in compensating for limited transparency resulted in bank portfolios that were heavily weighted towards particular *chaebol* making it hard for banks to exert market discipline. In any case the history of state interference meant that credit control expertise was in very short supply – loans were often made on the basis of collateral rather than cash flow predictions.

The overall result was highly leveraged, low profit conglomerates that starved the rest of the economy of credit and whose inefficient management faced few market incentives to improve performance. The economic downturn in 1996 gradually brought these issues to light as a series of high profile bankruptcies began to put pressure on the highly exposed banking system.

The solution was to reintroduce market discipline. The programme therefore promised to⁹:

- limit the scope for *chaebol* owners to control large numbers of companies with limited equity stakes by outlawing cross shareholdings and cross guarantees

⁹ For the sake of simplicity I have provided a single account of programme contents. I review some indicators of variation between programmes in the section on the politics of the crisis below. Transcripts of all the programmes are reproduced in (Sohn & Yang, 1998)

- make the *chaebol* more transparent by instituting consolidated audited accounts
- improve competition by removing limits on foreign equity ownership and by permitting mergers and acquisitions
- enhance banks' prudential regulation by placing all banks under the supervision of a single Financial Supervisory Commission and implementing Basel core principles
- open the banking sector to foreign competition
- secure central bank independence.

Overall it was clear that the intention was to remove any possibility of government interference in capital markets and to undermine the traditional system of relationship banking. Officially, then, this intervention was largely about the technical, efficiency aspects of rent-seeking but in the context of the Korean political economy, it also had implications relating to the more political issue of corruption.

The evidence in support was largely low *chaebol* profitability, particularly in the run up to the crisis (Boresztein & Lee, 1999).

Macro-economic policy

Macro-economic policy was apparently designed simply to support these reforms:

Financial sector restructuring, rather than macro-economic stabilisation, is at the core of the IMF programmes (Fischer in *FT* 17th December 1997).

High interest rates would combine with structural reforms to revive market confidence in the returns to investment in Korea and trigger capital inflows. Fiscal tightening was designed to show government commitment and to cover the expected costs of financial sector restructuring.

After February, the IMF began to press the government to institute greater fiscal stimulus and permitted a gradual reduction of interest rates as it became clear that Korea would suffer a far greater recession than initial IMF estimates had suggested.

Market opening

Capital market opening was required to facilitate the capital inflows Korea would require for recovery. It would also remove the temptation for future government interference in the capital markets and, through the entry of more sophisticated foreign banks, enhance market discipline in the Korea economy.

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

Labour market reform

Foreign investors would be reluctant to invest in Korean companies unless they could be sure that it would be possible to lay off excess workers. At the same time, social considerations (and the

militancy of the Korean unions) meant that it was important to establish a social safety net for those who would lose their jobs.

5.3.2 Economic critique

Causation - moral hazard or inappropriate liberalisation?

The central moral hazard versus irrational market panic debate manifests itself in Korea as an argument about the extent to which *chaebol* over-investment is best seen as a result of moral hazard, foreign investor ignorance or of faulty financial liberalisation under the Kim Young-sam regime.

For those (like the IMF) who favour moral hazard¹⁰, low *chaebol* profitability and high borrowing are best explained by non-market lending practices. Directed lending in the past and more recent corruption, (Hanbo being the prime example), together with strongly held perceptions that the government would not let *chaebol* fail explain what otherwise look like incredibly lax lending procedures by domestic and foreign firms alike. Rent creation and lax market discipline are at the root of the crisis.

For others, the 'market discipline' discourse tends to reflect a total inability to understand the logic of the developmental state model. Assessments of *chaebol* profitability compare shareholder returns for *chaebol* and Western companies. This is simply not a comparison of like with like. If loans are to be seen as quasi-equity, the correct comparison is a combination of interest payments and profits (as more traditionally defined). Here the contrast is far less stark¹¹ (Chang, 1998; Wade & Venerosso, 1998a).

It is also important to take a long-term perspective in which investment is not purely assessed in terms of static profitability but also in terms of longer-term growth. This has always been the key benefit of the developmental state model and is a factor that does not appear to be considered by those who favour the IMF approach.

For critics the problem was that Kim Young-sam's *segye-hwa* drive had undermined state control over the *chaebol* and market liberalisation had merely boosted their power. The results, overcapacity as managed competition is abandoned financed by a short-term borrowing binge, merely demonstrate the extent to which markets cannot be trusted to allocate capital rationally and therefore to which the developmental state was responsible for Korea's past success (Wade & Venerosso, 1998a; Wade & Venerosso, 1998b; Weiss, 1998).

An intermediate view which emerges from some of the later literature on the crisis is that Korea was clearly in a state of transition *before* the crisis (see section 5.1.4 above). The developmental state had few remaining supporters. The question was one of managing the transition appropriately. Here blame still attaches to the pace and nature of financial liberalisation but there is also an

¹⁰ Corsetti et al. (1998) are supportive of the IMF here, as more generally. Their views are also shared by some Korean specialists.

¹¹ Here, as in many other important issues in the Asian crisis, there seems to be a marked discrepancy between different economists' figures – compare (Chang et al., 1998) with (Borestein & Lee, 1999).

acceptance that the developmental state is incompatible with full engagement in the international economy and that the choice to abandon it had already been made.

The problem was that the Korean state and financial system were not capable of managing the transition effectively. A combination of domestic political factors (*chaebol* political dominance) and an international neoliberal orthodoxy that had a tendency to see liberalisation as a good in itself meant that the state failed to provide the legal and regulatory frameworks that were required for a transition to a more liberal economy (Lee & Kim, 2000). Kim era reforms:

accelerated the kinds of deregulation demanded by the *chaebol* without promoting real competition and efficiency (Kang, 2000).

Were structural reforms necessary? Could the IMF restore market confidence?

Another debate reviewed in Chapter 4 concerned whether capital should be enticed back through market incentives and confidence enhancing structural reforms or whether some kind of work-out procedure was important.

I pointed out that this was largely debated as a question about crisis causation with those blaming moral hazard for the crisis preferring market resolution and those blaming panic being more open to work-outs. Macro-economic preferences, at least in terms of monetary policy, were then largely determined by the resulting choice. However, these distinctions could easily be blurred. A panic which began as a result of moral hazard might still overshoot and call for more drastic means of control. At the same time, even if structural weaknesses were not a *cause* of the crisis, once perceptions had taken hold they might have to be addressed to resolve it.

The account of the crisis in section 5.2 suggests that the markets *were* concerned about market discipline in the run up to the crisis. On the other hand responses to the IMF package were less than euphoric. There are several possible interpretations.

One is that market discipline was only a minor factor – it was an issue but did not *cause* the crisis – in which case the IMF diagnosis was plain wrong.

Alternatively there may have been insufficient evidence of government commitment to the programme – after all Kim Young-sam was having significant difficulties in getting legislation through and the situation improved once Kim Dae-jung took power. Here one can either conclude (supporting the IMF) that the government should have tried harder or (along the lines of Bird's critique – section 4.1.2 above) that government commitment could only be demonstrated over time making a swift return of confidence highly unlikely (and therefore undermining the Fund's market based strategy).

Finally even if one accepts the strong IMF position, it is still possible to argue that the structural measures were wrong if the markets' diagnosis of what was best for the economies concerned was itself flawed. Declining returns on investment may have reflected a loss of government control and market failure rather than a lack of competitive market discipline. In which case, again, relying on market sentiment would be a harmful strategy.

These arguments have particular significance in Korea because of the ‘concerted’ roll over of short-term credits that took place on December 24th. It was only after the roll-over that the exchange rate began to stabilise. Media and academic comment saw this as a significant deviation from previous US and IMF strategy. For IMF enthusiasts the roll-over was necessary because of poor government implementation and its success was helped by Kim Dae-jung’s election. For detractors it was an inevitable result of flawed programme design or simply an over optimistic assessment of the IMF’s ability to enhance market confidence. If the latter was the correct view, criticism of high interest rates and tight money naturally followed on and there were powerful implications for the appropriate strategy to deal with future crises.

Further liberalisation?

Finally, questions were raised about whether the capital and trade liberalisation measures served any purpose in the context of the programme (I have indicated IMF justifications above) or whether they were merely designed to ensure lender country support by providing market access – particularly given a long history of US pressure for market liberalisation in Korea (see chapter 8 below). To the extent that justifications for them looked weak, the stigma of political bias might also have an impact on the debate about market discipline.

5.3.3 Summary

The evidence fails to distinguish decisively between the different technical approaches. There were problems with returns on investment in the Korean economy prior to the crisis and the markets were worried about market discipline. On the other hand markets did not respond positively to the IMF programme and it is arguable that investment decline was due to insufficient government control. It remains possible to make arguments for or against the IMF programme. The question is how much political support the different arguments were able to attract and how that influenced negotiation and implementation of the IMF programme.

5.4 The politics of the crisis

Having reviewed some of the technical arguments about crisis causation and IMF policy, we need to look at the various economic, social and political interests that would have been served by the different measures on offer to uncover potential support for and opposition to the IMF programme.

5.4.1 Issues and interests

Corporate sector reform

Given the history of attempts to reform the *chaebol* reviewed in section 5.1, it should be no surprise that the parts of the IMF programme designed to reduce the power of the *chaebol* were popular with large sections of the Korean population. Data from a large-scale survey conducted in 1998 (Figure 5-2) indicates that *chaebol*-government relationships were by far the most popular explanation for the crisis (Shin & Rose, 1998).

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

He was labelled as an anti-business leftist when in fact he has always been closer to a classic free marketer with a preference for small and medium sized enterprises engaged in competition (Kim, 1985)¹². The confusion came from the fact that, by Korean standards, his criticism of state control of the economy made him a radical. Since concern with state intervention in the market extended to state repression of the labour market, it was politically convenient for incumbent Presidents to label him a communist.

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

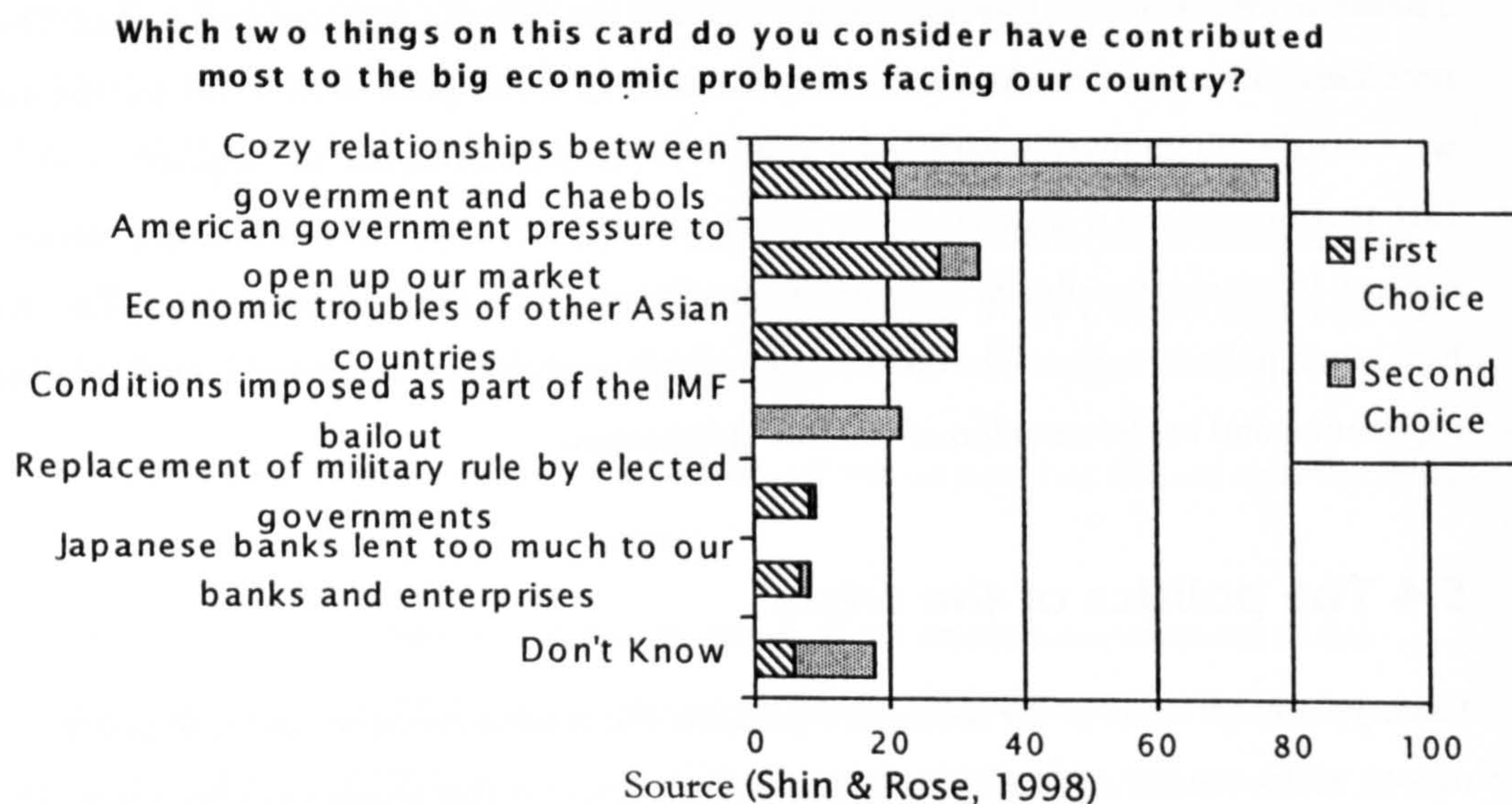


Figure 5-2 - Opinion poll on crisis causation

While popular opinion in Korea was in favour of restricting the *chaebol*, there were a number of countervailing interests. The Ministry of Finance and Economy stands to lose considerable

¹² Some of the more astute foreign press commentary did realise this. The *Financial Times* and *Economist Intelligence Unit* reports both argued that a better comparison in some ways was with Margaret Thatcher rather than a radical union leader.

influence in a thoroughly deregulated economy¹³ and civil servants were, in any case, threatened by crisis induced government cut backs. The *chaebol* themselves, organised as the Federation of Korean Industries (FKI) were inevitably going to offer resistance. Finally, workers employed by the *chaebol* were in an ambiguous position. Extensive restructuring would inevitably mean job losses even if it ultimately suggested a weaker relationship between employers and government.

Market opening

As we have seen, financial sector liberalisation was the area of *segye-hwa* reform that received strongest *chaebol* support as it enabled them to free themselves from state control over credit allocation. However, broader market opening was more problematic given a history of protection for domestic industry. There was therefore a reformist strand within the Korean bureaucracy that had long favoured greater market opening with the expectation that it would force the *chaebol* to downsize or at least subject them to greater competition (Gills & Gills, 2000; Matthews, 1998).

In terms of the general public though, there were also important issues of national identity. The ideology of the developmental state has always been one of revolutionary developmental *nationalism*. The state-*chaebol* relationship was justified as a way to ensure national strength guarding Korea's independence from the North and Japan. To some extent Kim Young-sam's espousal of successful globalisation as the mark of a strong nation in the new millennium had counteracted these views but the process was by no means complete.

From the beginning it was clear that selling off considerable chunks of the Korean economy to foreigners was a deliberate intent of the programme (albeit in response to post-crisis capital shortages and in an effort to protect Korean jobs and economic growth). In an atmosphere in which asset values were deeply uncertain it is not surprising that there were real concerns that Korean assets would be sold to foreigners at knock down prices.

Labour issues

Unemployment was, to some extent, an inevitable feature of the crisis. Labour was willing to accept job losses but wanted assurances that outstanding issues about political exclusion would be dealt with, that there would be a social safety net, that employers would suffer too and that efforts would be made to avoid job losses. It is important to note, however, that unionisation in Korea is still very low and there is a tendency for Korean unions to speak, largely, for *chaebol* employees rather than for the labour force more broadly.

Macro economic policy and debt roll-overs

I addressed the national / international dimensions of the various options for crisis resolution from debt moratoria and repudiation at one extreme to complete government foreign bailouts of foreign investors at the other in Chapter 4. The initial IMF programme adopted a market-based approach. The second programme on Christmas Eve, though, included some concerted lending in return for a government guarantee. How hard (if at all) Korea had originally pressed for this solution in the first

¹³ As far back as 1993, there were bureaucratic disputes about the pace and extent of liberalisation between a free market EPB and a protectionist MOF and BOK (Gills & Gills, 2000) Although the MOF and EPB were merged by Kim Young-sam, internal rivalries persisted.

round of negotiations is unclear and the precise politics of negotiations on this issue are unknown though there are some broad indications which I will look at more thoroughly when we return to a more international perspective in Chapter 9.

What is more important in the context of this chapter, which focuses on domestic debates, are the narrower choices made about:

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

and the way those choices were justified and received domestically.

The potential advantages of tight money were that it would encourage a swifter return to market access and provide banks with stronger incentives to force through corporate sector restructuring – limiting further waste of resources on trying to rehabilitate ailing corporate interests.

The disadvantage was that it would produce a deeper recession, greater corporate bankruptcies, more unemployment and generally have a more adverse impact on the poor.

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

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

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

Summary

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

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

For the rest of Korean society, there was political enthusiasm for reducing *chaebol* dominance, particularly if that put a brake on money politics. However, that enthusiasm was tempered by economic nationalism and a reluctance to see the *chaebol* sold to foreigners at knock down prices. The overall effects on the economy would also be important but the extent to which the average Korean felt qualified to judge is doubtful¹⁴. Preferences are likely to have been determined principally by the extent to which other aspects of politicians' programmes were capable of ensuring trust in economic claims.

Overall there was the potential to mobilise popular support for the programme but there were also significant obstacles.

5.4.2 Negotiation and legitimation

If there were interests both supporting and opposing different aspects of the IMF programme, how was the final programme determined? What was freely negotiated and what was largely imposed by the IMF? How was the deal that was agreed on justified to the Korean population? Does that suggest that there are limits to what the IMF can legitimately achieve and if so what is the nature of those limits?

Negotiations and initial reactions

Negotiations between IMF staff missions and government teams go on behind closed doors but the level of media attention on the Korean crisis means that press reports do provide some assistance. There were indications that negotiations did not involve a total meeting of minds. They took several weeks and one 'Western diplomat' told the *Financial Times* that 'these are adversarial negotiations. Korea has no concept of a win win outcome' (*FT* 2nd December 1997). The IMF accused the Korean government of releasing details to the press in an attempt to whip up public opposition to the programme while the government retaliated by claiming that the IMF mission under Hubert Neiss had made agreements only to have them overruled by Camdessus (*FT* 3rd December 1997).

Camdessus' involvement may reflect increasing political pressure from the United States. More generally there is clear evidence of extensive US involvement in the negotiations. According to Bruce Cumings, 'even mainstream pundits found the International Monetary Fund to be the mere creature of US Treasury Secretary Robert Rubin and Deputy Secretary Summers' (Cumings, 1998, 52). It is certainly clear that high level US officials including Summers went to Seoul at the same

¹⁴ The Korea barometer survey was modified when pilots suggested (unsurprisingly) that many Koreans didn't feel qualified to answer the more technical questions about the crisis (Shin & Rose, 1998).

time as the IMF mission and that Rubin personally held up negotiations for 10 hours while insisting on new accountancy standards¹⁵ (*New York Times (NYT)* 8th December 1997, Cumings, 1998, 53; Mathews, 1998). Academic writers were quick to point out the extent to which the IMF programme conformed with a long term US agenda to open Korea markets and undermine the developmental state (see chapter 8 for more details).

In terms of public statements by Korean politicians, considerable reservations were expressed about certain aspects of the programme. Opposition candidate Kim Dae Jung, perhaps opportunistically, declared 5th December a day of 'national humiliation' but all three candidates suggested that they would like to renegotiate aspects of the deal. Lee Hoi Chang, the ruling GNP candidate said the IMF was behaving like an 'economic conqueror'. All three presidential candidates conceded that corporate restructuring was necessary but, while Lee was in favour of foreign opening, Kim and Rhee both felt that further capital account liberalisation was inappropriate. They were unanimously critical of the IMF's fiscal and macro policy prescriptions and their likely impact on growth (*Business Korea (BK)* Vol.14 No.12).

Mathews suggests that there were three overlapping agendas in the negotiations. The IMF's calls for tight monetary and fiscal policy were largely non-negotiable. A second US agenda was focused on securing greater US market access in Korea, particularly capital account opening, access for foreign banks and related measures to improve corporate accounting. According to Mathews' contacts in the Korean Ministry of Finance, the Koreans traded concession on this agenda (after all, as we have seen, there were elements in Korea that largely supported it) for the inclusion of an agenda of their own: the labour market flexibility and corporate governance reform that successive Korean administrations had been attempting to implement for years (Mathews, 1998).

Mathews probably underestimates the IMF's own preference for a broader agenda. Although much of the package was, as he points out, atypical of past programmes, it did correspond well with the recently adopted good governance agenda and with the measures already implemented elsewhere in Asia. The details of which exact parts of the structural reforms were supported or resented by the government also remain unclear. The overall point, though, still stands: the Korean government was probably unhappy with the macro aspects of the programme and with some elements of structural reforms but it was also willing to use the IMF and US as scapegoats for other aspects of the structural agenda that it supported.

Negotiations with the IMF are important for the IMF's legitimacy with implementing governments but its popular legitimacy in Korea and elsewhere is also dependent on the impressions that these negotiations left with broader publics.

Here initial signs were not good. As I have already indicated, Korean politicians voiced public discontent. More worryingly, there was considerable negative media coverage and anecdotal

¹⁵ Cumings claims that 'sources in Washington' admitted that several reforms had been specifically demanded by US Treasury officials. Later, US officials trying to persuade Congress to renew quotas reinforced this impression – see chapter 8 below.

impressions suggested that Koreans, if not blaming the crisis on foreigners, at least felt that it was being exploited by them. A newspaper editorial of the time is typical:

A senior US Treasury official backhandedly manipulated IMF negotiations to push for market opening while Japan used financial aid as a weapon to prop open the [Korean] domestic market for their goods (*Dong a Ilbo* 3rd December 1997)¹⁶.

This point of view was unsurprisingly particularly popular with the *chaebol's* trade association, the FKI (*Korea Herald* 4th December, 5th December).

At the same time, Korean union leaders, aware of the likely implications for jobs, also issued warnings - 'it is the workers, not the government officials who will have to bear the brunt of the IMF measures' (KCTU leader Yoon Young-mo cited in *FT* 8th December 1997) and the *Financial Times* talked darkly of social and political unrest.

However, this was never the only response. Even in December, according to *Business Korea*, 'many Koreans are positive about the package' as it could have encouraging effects on Korea's international competitiveness. For others 'it seems like Korea has been seen by some as an untrustworthy country in international society and it is believed that many Koreans are ashamed of such a reputation' (*BK* Vol14 No.12). The question was whether enough Koreans could be won round to this point of view.

Kim Dae Jung's conversion

The most important convert was Kim Dae Jung himself. His initial opposition to the IMF programme seems to have helped his election campaign (*FT* 11th December 1997, 20th December 1997), though other factors were probably more important¹⁷.

Under (strongly resented) pressure from the IMF Kim Young-sam called a meeting of the presidential candidates on 12th December (before the elections) at which he persuaded them to put their support behind the IMF programme.

What went on at that meeting is unknown. However, given the lack of transparency about the actual position of the Bank of Korea at this point and Kim's later claims to have been 'flabbergasted' at the scale of the problems he inherited, it seems likely that it was largely concerned with conveying the seriousness of Korea's position.

By the time Kim had won the election it is clear that he was, publicly at least, an enthusiastic supporter of the programme.

Legitimation and forging consensus

With Kim behind the reforms, the central question was whether he would be able to forge a sufficient social consensus to drive them through. In the end he did so through a combination of:

¹⁶ See also *Business Korea* Vol 14 No 12, *FT* 8th December 1997, 12th December 1997, *Korea Herald* 4th and 5th December

¹⁷ For example, forging an alliance with Kim Jong Pil to widen his regional support, Kim Young-sam's involvement in the Hanbo scandal and minor incidents that tarnished Lee Hoi-chang's 'Mr Clean' image see (Economist Intelligence Unit, 1997a; Economist Intelligence Unit, 1997c)

public speeches harnessing Korean nationalism and emphasizing the connection between reform and democracy; a tripartite negotiation with the most powerful sources of social opposition; and some side payments to affected parties.

Early market and diplomatic assessments were largely negative with outsiders suspicious of his 'populist' credentials:

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

In fact, this proved to be Kim's chief asset. His popularity with labour gave him far greater credibility than any previous Korean leader, all of whom were tarnished by relationships with the *chaebol*. This popular trust, combined with the weak political position of the *chaebol* who were increasingly blamed for the crisis enabled him to set up a tripartite commission comprising representatives of labour, industry and the government.

By the time the commission met on 15th January Kim had already succeeded in forcing the previously stalled financial supervision regulations through the national assembly. He had also summoned chairmen of the top 5 *chaebol* to agree '5 principles of corporate restructuring' (the next 30 *chaebol* were then summoned in early February). This gave Kim credibility in brokering a deal in which labour would accept lay-offs and reductions in wages and working hours in return for assurances that the government would vigorously prosecute any illegal labour practices by business and press for further corporate restructuring.

In more detail, the agreement contained the following provisions:

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

Equally interesting, though, is the language of the Commission's announcements. Its full name was the 'Tripartite Commission on Fair Burden Sharing' and that was very much the spin put on the announcement. It argued that the crisis sprung from a failure to adapt to the 'new economic environment' and that

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

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

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

It is clear, then, that some effort had been made to meet the criticism that labour made throughout - that it was being asked to pay the price of management and government mistakes.

Having dealt with the strongest centres of likely opposition (labour and the *chaebol*) it became important to convince the wider general public. Again, the Tripartite Commission statements provide indicators of government strategy. The crisis was portrayed as the result of a failure to adapt to the new international economy and as an opportunity for 'a second economic leap'.

We understand that we must bear painful burdens, which we have never experienced previously. Nevertheless, if we cooperate and share the hardships resulting from these difficult times, we believe that we can overcome the upcoming challenges and create another "Miracle of the Han River" (Tripartite Commission, 1998, 165).

This was also very much the language used in Kim's other speeches. There are interesting echoes of some of the characteristics of the ideology of Korean capital that I noted in the historical section at the beginning of this chapter. There is a focus on resolving the crisis through hard work centred on reasserting national pride – even clearer in the conclusion to the statement:

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

While of dubious economic value, this sort of rhetoric clearly struck a chord in the Korean people. A Korea Development Institute survey found that 38% of Koreans saw a 'nation wide frugality campaign' as the best way to raise confidence in the Korean economy in the international financial markets (official press release 16th January 1998 – reproduced in Sohn & Yang, 1998). By mid 1998 the *Financial Times* argued that Korea was dealing with the crisis by national mobilisation resembling a war economy (*FT* 35th February 1998). Koreans had donated a staggering US\$2 billion dollars in gold to replenish central bank reserves and a sense of national pride was returning.

The question was whether, through the kinds of rhetoric used in Kim Young-sam's *segye-hwa* drive, this nationalism could be harnessed to an open economy Korea in a globalised world in the same way that it had been in building an industrialised 'Hermit Kingdom'.

The second major theme in Kim's other speeches was the relationship between economic restructuring and democracy. His inauguration speech blames the crisis on democratic deficits springing from the collusion between politics and business and concludes that 'political reform must precede everything else'... 'we can overcome today's crisis by practising democracy and a market economy in parallel' (Sohn & Yang, 1998).

A further strategy was to ensure that government money was used to protect important political constituencies that had been adversely affected by the crisis

I have already referred to government spending on social safety nets¹⁸. This was particularly important for semi-skilled workers in smaller enterprises since the far more powerful *chaebol* unions managed to contain the majority of job losses in larger firms. These lower paid workers are amongst the poorest people in Korea and constituted the overwhelming majority of unemployment which peaked at around 9% in February 1999.

Historically, welfare in Korea was provided through very low unemployment (around 2%), family support mechanisms and the lifetime welfare and employment system provided by the *chaebol*. Urbanisation in Korea, an ageing population and *chaebol* pressure for more flexible labour markets was beginning to undermine this compromise before the crisis set in. Unemployment has stabilised at around 4% - double the pre-crisis levels.

Kim's response was limited, reflecting a widespread concern in Asia about the dangers of adopting a Western style welfare state given its inevitable negative consequences for recently emerged internationally competitive businesses. Nonetheless, it did involve some long lasting changes – particularly an extension of the unemployment insurance to all firms with 5 or more employees. Temporary relief was also provided in the form of workfare programmes and a 'temporary livelihood programme'.

The second group the government was anxious to protect were small and medium sized enterprises. As I explained earlier, smaller businesses were particularly badly affected by the credit crunch resulting from high interest rates (Economist Intelligence Unit, 1998a). They were also Kim's key political constituency and the government made special efforts to channel funds in their direction. Loans were rolled over twice and a variety of SME support funds (credit insurance, central bank credit line, funding for trade finance and four SME restructuring funds) were introduced (Haggard, 2000, 155-6).

Finally, Kim made a conscious effort to secure foreign support – both to encourage reinvestment and to provide support and a scapegoat for reform. The IMF fulfilled both roles. Camdessus' reassurance that 'the workers will not be alone in paying the price' delivered publicly and to union leaders in private was apparently a key factor in bringing unions to the Tripartite Commission (FT 14th January 1998) while, at the same time:

the international financial institutions could run political interference for the new regime: every unpopular policy and outcome could be blamed on the IMF (Woo-Cummings, 1999).

Particularly significant was Kim's tour of the United States winning him much praise in the international financial press:

¹⁸ The section on safety nets relies heavily on the relevant chapter of (Haggard, 2000)

No South Korean leader has ever told his people so many uncomfortable home truths, let alone made as much of an impression overseas as Mr Kim (Economist Intelligence Unit, 1998c).

Overall, then Kim portrayed the reform agenda as one in which: big business will be forced to become more transparent while gaining greater autonomy from government; small business will be encouraged as the backbone of the new economy; labour will accept the costs of lay offs in return for greater political representation, expanded social safety nets and more democratic enterprise relations; the Korean people will accept temporary hardship in the interests of creating a nation with the national image, competitiveness and globalised culture to compete in the 21st century world order; and foreign investment will be encouraged for the sake of competitiveness, offset by expanded exports to maintain national wealth¹⁹.

5.5 Results: legitimacy and implementation

How successful was the strategy? And did that translate into implementation?

The initial public dissent described above was certainly moderated as time went by.

Public anger has died down and Koreans are beginning to take a cool look at their economic problems (*FT* 18th December 1997).

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

On the other hand pockets of dissent remained. If the overall emphasis on breaking up the *chaebol*-government relationship was popular, there was less enthusiasm for the IMF's proposed mechanisms for doing so – preventing government bail outs of the *chaebol* and attempting to introduce market discipline through foreign entry. It is noticeable that, in the survey on crisis causation reviewed earlier (Figure 5-2) US pressure for market opening was a very popular first choice for crisis causation. In terms of crisis resolution, the same survey found that government subsidies were the second most popular solution to the crisis, considerably ahead of market liberalisation.

This was reflected in Kim's approach to corporate restructuring. Although the official position was that the government has

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

in practice, there was a great deal of government intervention in the restructuring process. The new FSC set up under the legislation passed in December and responsible to the Prime Minister's office

¹⁹ See speeches reproduced in (Sohn & Yang, 1998)

had overall responsibility for restructuring and, despite rhetoric to the contrary, remained heavily involved.

Government intervention was clearest in Kim's enthusiasm for the 'big deals' which were designed to force the 5 largest *chaebol* to concentrate on core businesses through exchanges of non-core subsidiaries. *Chaebol* were also encouraged to submit plans for eliminating cross guarantees and reducing debt-equity ratios to below 200%.

This process was deeply confrontational with sharp differences over appropriate asset valuations. A public relations battle between the *chaebol* and the Blue House raged throughout 1998. The government accused the *chaebol* of obstruction. It threatened to encourage banks to withdraw credit from miscreant *chaebol* and implemented a far tighter monitoring system in 1999 – undermining any claims that the process was a product of informal dialogue. The *chaebol* meanwhile encouraged nationalist rhetoric (concerned about the possibility that foreign takeovers of banks would lead to tougher debt negotiations (Haggard, 2000)) and made it clear to the government how important they were for the overall Korean economy. Much debt restructuring actually took place through accounting manoeuvres involving re-writing asset valuations on balance sheets rather than debt write-downs or asset sales.

For the second tier *chaebol*, Korean banks were entrusted with the responsibility for organising debt workouts and corporate restructuring. This looks closer to the IMF's preferred strategy of creditor discipline (Balino & Ubide, 1999) but even here the FSC exercised tight oversight of the process. So, for example, the first list of 20 'target companies' prepared by the banks was sent back to them by the FSC who asked for a longer list (eventually 55 companies) (Economist Intelligence Unit, 1998b). Foreign purchases were relatively disappointing and much of the restructuring involved interest rate reductions more reminiscent of the traditional Asian banking model (Haggard, 2000; Singh, 1998)

Over all, significant changes took place, particularly in enhancing transparency and restructuring bank and corporate debt. Indeed Korea's resolution of these issues was the swiftest in the region (Callaghy, 2000; Haggard, 2000). At the same time, the government's approach was highly interventionary invoking criticism from the IMF academic commentators:

Kim Dae Jung has preferred informal procedures to formal ones...as an arena for negotiations and consensus building and negotiation, instead of the formal legislative body (Moon & Mo, 2000).

The persistent government presence in the reform process is important because it suggests a significant gap between the mechanics of the reform process and the IMF's vision of the way a market economy functions. The whole rationale behind the IMF programme was to introduce *market* discipline. The important role of the state in pushing market reform both emphasises the political aspects of the reform programme and leads to questions about the extent to which the Asian model has actually been transformed. Policy-making continues to demonstrate considerable continuity with the past.

There was also continuing resistance from the labour movement, particularly as job losses began to spread from SMEs to larger businesses in 1998. The most high profile dispute resulted in a prolonged strike at Hyundai in the summer of 1998. At the height of the action workers occupied a closed plant in Ulsan and riot police were about to go in when MPs intervened. They negotiated a settlement which cut planned redundancies from 1,500 to 277 (mostly female cafeteria staff) (Economist Intelligence Unit, 1998a). The KCTU also attempted to stage a 'general strike' in June 1998, though they only achieved rather limited support. Both unions walked out of ongoing Tripartite Commission talks in summer 1998 and again in February 1999.

The record of implementation, as far as the structural aspects of the programme are concerned, was mixed. Trade and capital account liberalisation went through relatively easily. However, labour resistance and *chaebol* evasion have limited the extent of corporate restructuring. There have been significant changes but *chaebol* efforts to revalue assets and debt rescheduling have reduced the need for cuts in capacity, downsizing and asset sales, potentially storing up trouble for the future (Moon & Mo, 2000). Both market minded outsiders and the IMF regard the reform process as incomplete.

It may be that it will merely take more time. However, there are also signs that in the aftermath of the crisis, reform fatigue is setting in with resistance growing particularly to further divestment to foreign businesses. So, for example just over half the Korean population polled were against General Motors' take-over of Daewoo (Economist Intelligence Unit, 2000b). During the April general elections the opposition Grand National Party campaigned (only partly successfully) on the basis that Kim Dae-jung was transferring wealth to foreigners and that liberalisation measures should be put on hold or reversed. A late 1999 article by Kenichi Ohmae (of *Borderless World* fame) accusing Kim Dae-jung of being an American puppet and abandoning Asian capitalism also circulated widely to popular acclaim (Moon & Mo, 2000).

Incomplete reforms have two potential long-term implications for IMF legitimacy. If the Korean economy recovers successfully without being fully reformed, developing countries may question the extent to which the micro-economic aspects of the IMF programme were necessary in the first place. At the same time, developed country interests will have questions about IMF effectiveness, particularly, but not only, if another crisis follows.

5.6 Conclusions

Returning to the three sets of questions the case study set out to address, what have we learnt? How strong were the technical justifications for IMF interventions, what were their political consequences, and what did the politics of implementation suggest about the emerging framework of multi-level governance of which the IMF is a part?

The economic evidence is not sufficiently compelling to force acceptance of any particular point of view on crisis causation and appropriate solutions although it is informative. Most interesting on the one hand is evidence supporting the relationship between IMF structural policies and market

confidence in that international financial analysts were evidently concerned about 'market discipline'. On the other hand confidence did not respond well to the first programme (undermining the strong catalytic effect argument). It was the December debt roll-over that improved the Korean exchange rate.

That raises doubts about the IMF's preference for market-based solutions to crisis but tells us little about the advantages or otherwise of the IMF's structural policies. The markets may have been suspicious about implementation (leaving the weak catalytic effect argument unproven). In any case market opinion need not necessarily have been *right*. The whole point of the developmental state was to reduce financial market pressure over the short-term and it is still possible to argue that the correct response is to question capital account liberalisation in Korea rather than press for more.

Even in terms of the debt roll-over, the counterfactual question remains. Would a more concerted approach have been better in October? Even if it had been, would it have had negative knock on effects in other emerging markets?

If the technical credentials of the IMF approach are in doubt what was its domestic political content? IMF structural policies need to be seen in the context of pre-existing debates about Korean political economy. There was considerable opposition to the *chaebol* on both economic and political grounds. The corruption revelations that took place during Kim Young-sam's presidency had created deep discontent about authoritarian money politics and the *chaebol* were seen as part of that system. Aspects of the IMF's good governance policies therefore had significant domestic resonance.

On the other hand, the situation was more complex. The *chaebol* played a crucial role in the Korean economy and, despite their inefficiencies, remained dominant in Korean production and as key employers. If liberalisation meant fire sales to foreign companies that would offend Korean nationalist sentiment. For other groups, labour and small business, the idea of limiting *chaebol* power was attractive but the IMF's methods (involving job losses and high interest rates) would be unpalatable, raising greater opposition as time went by.

Although IMF policies are about economic issues, then, and differing opinions about the relative efficiency of the *chaebol* were a central part of the debate, they also had an impact on a wider range of issues. The debates in Korea were also about political issues such as: the link between state-*chaebol* relationships and political power; the nature of the employment experience in Korea; the balance between short and long-term investment preferences; the appropriate role for foreign business in the Korean economy and appropriate forms of social welfare.

These kinds of issues could be expected to divide the Korean public. The *chaebol* would clearly be opposed to them but for many Koreans the costs and benefits were harder to determine. What then swung the balance in favour of broad popular support for the programmes?

The first point is the importance of state consent. Kim Dae Jung's support for the programme was invaluable in securing implementation. That support, in turn, seems to have been built by a

combination of pre-existing political purpose (ideological objection to the state-business alliance and limited access to the benefits) and persuasion from pro-reform bureaucrats. Although, as we will see, the Fund's willingness to consult with a broader range of actors provided valuable assistance, its credibility with financial bureaucrats was clearly crucial.

Once Kim had decided to support the programme, a combination of astute political management and IMF assistance on social issues seems to have been key to making the most of potential support. In terms of concrete compromises, he made sure that labour got something out of the crisis. In terms of presentation, Kim's Tripartite Commission, and the support it was given by the IMF, helped to create the impression that labour's voice was being heard, even if the majority of demands were not met. He also managed a successful appeal to important Korean political values: democracy, nationalism (adapted in this context to take the form of frugality and enthusiasm for a strong Korea in the era of globalisation) and clean government.

In terms of the three visions for IMF engagement in domestic politics that I discussed in Chapter 4, the situation provides some initial support for the second approach in which the IMF is reasonably flexible about working with the authorities to secure the political legitimacy of the programme.

On the other hand, despite a political environment that was predisposed to reform and considerable state support, the reform process did not go entirely to the IMF's plan. Bureaucrats involved in economic administration and *chaebol* owners remained powerful forces with interests in opposing change. Labour, with its mixed interests in *chaebol* downsizing and a habitually conservative Korean middle-class then had the potential at least to be won over by playing off the dangers of foreign take-over and the ill effects of high interest rates against the potential benefits of democracy and clean government.

In a democracy, it is not only politicians who can use appeals to technical arguments and political values to harness support. The *chaebol* in particular actively harnessed critical economic arguments (market panic, recessionary macroeconomic policy, etc.) to their cause, particularly in relation to high interest rates. They were also able to point to question marks over American (and Japanese) interference in the negotiation process. As we saw, there were some justifications for those queries and partial use of the scapegoating strategy helped to obscure the true position opening the opportunity for opposition groups to attack elements of the strategy that were in fact government policy. There is some evidence that these strategies had at least limited success in mobilising wider dissent at least as time went by.

That dissent showed up in state calls for lower interest rates, an interventionary rather than market-based approach to debt restructuring and, eventually, in limits to the overall reform process.

What do the politics of implementation tell us then about the relationships between the IMF, the Korean state, and Korean civil society: about multi-level governance within the Fund framework?

For many observers questions about authority need not concern us too much in the Korean context. After all, the Korean government clearly was behind the reform process. If that was a

mistake, at least it was a democratically sanctioned one. That is essentially a point about the balance between state and IMF decision-making. The IMF does not seem, at least initially, to have had a huge impact on the political process.

However, from the point of view of a future potential borrower, or from a committed domestic opponent of the reforms difficulties remain. If the policies *were* wrong, IMF intervention remains problematic in that it could be expected to have effects on the political choices made by ordinary Koreans: providing external expert authority for the need to promote a particular liberal vision of economic management.

That is particularly problematic as a relatively coherent alternative technical position on appropriate remedies for the crisis was articulated both internationally and by sections of Korean 'civil society'. It was not by any means certain that the IMF approach was wrong but the existence of a widely held alternative view does suggest that the ultimate decision about policy must have been made on criteria that could not be completely specified in economic terms, raising questions about what those criteria were. That is particularly significant for states' perceptions of Executive Board technocratic authority given the important domestic and international political consequences of the programme.

Although Kim seemed enthusiastic, lack of transparency surrounding negotiations, extensive US involvement in the negotiation process and similarities between the programme in Korea and the IMF's programmes elsewhere suggest, at the very least, that the fortunate outcome owes more to a convergence of views than to a high level of IMF flexibility. In fact a key problem in assessing the precise nature of IMF interventions is that no-one does know exactly what went on in negotiations. There is at least some evidence that the 'scapegoating' strategy is not wholly dead. Certainly, various political actors in Korea were still able to use the potential for that kind of dynamic to attack the IMF programme.

It is fair to conclude, though, that the 'second vision' approach did involve the IMF in some flexibility about domestic political issues. On the other hand, that flexibility was limited and took place within relatively narrow pre-determined boundaries (a largely market confidence based approach and structural reforms in the interests of market discipline). Is the IMF's democratic rhetoric vindicated, then, or is good governance more a matter of assisting the state in political manipulation?

Here the role of 'civil society engagement' is interesting. Kim's legitimating strategy suggests that the details of technical arguments are less important in convincing domestic groups than more concrete political benefits. Good governance policies then have the potential to be used to win over popular support. However, that is a very different thing from a programme that is proposed and owned by civil society.

Overall, the Korean state was only given limited room to manoeuvre within IMF preferences that had significant political consequences and clearly corresponded closely with the wishes of the

Fund's leading shareholders (especially the United States). Civil society engagement was closer to the top down management of potential dissent than it was to some process of genuinely participatory decision-making and involved choosing between different elements of non-state organisations in Korea. In the context of Korean democracy, a consideration of state enthusiasm for the overall IMF project and an emergent social consensus against the *chaebol* led to a reasonably legitimate programme. The question is whether the limited concessions the Fund made to domestic interests in Korea will be enough to secure implementation in a more difficult environment such as Indonesia.

The IMF's more formal institutional framework places significant limits on the scope for flexibility in response to demands made by borrower country civil society. Pragmatically, it is also clear that state consent is very important in securing programme implementation and can be crucial in managing what civil society opposition does materialise. In Korea the state was very much behind the IMF programme and that was partly a reflection of pre-existing social and political factors that favoured a shift in the direction of the kind of liberal economic management the Fund prefers. Even so, the need for significant state involvement in pressing that move unnerved the Fund and served to emphasise the extent to which liberal economic systems are political creations rather than natural self-regulating technical systems. It may also have sent worrying messages to less sympathetic states about the Fund's willingness to involve itself in domestic political issues in an attempt to secure its policy preferences: about the increasingly blurred boundaries between economics and politics.

6 Indonesia

This chapter broadly follows the pattern of the Korean Chapter. It aims to answer the same three sets of questions. The major difference is that Suharto was very reluctant to implement the Indonesian programme. Implementation was poor, recovery is still uncertain 5 years on and the crisis triggered a political crisis and very serious social unrest. If the programme in Korea was, with some reservations, a success it is hard to avoid the conclusion that the programme in Indonesia was a failure. Much of what needs to be explained, therefore, is what prevented implementation and what the alternatives might have been, rather than the factors that supported IMF implementation.

I begin the chapter in the same way, with an overview of the historical background, designed to assess the nature of state-business relationships in Indonesia, a chronological overview and a review of the evidence on technical issues.

The section on the politics of the crisis, though, takes a different format. In Korea I concentrated on how state support was obtained and how the political elite then managed to convert that into popular acceptance. In Indonesia state support did not materialise until much later. The questions then concern: why that was the case; the extent to which the New Order state was acting in the interests of the domestic population; and, given programme failure, what the alternatives might have been. I start with an explanation of Suharto's actions and then attempt to assess the consequences of Suharto-IMF struggle over Fund legitimacy. What did the struggle tell us about the nature of IMF intervention and about the IMF's emerging role?

IMF interventions were ultimately very radical, calling for a wholesale transformation of the Indonesian economy. For some that was necessary and inevitable. For others it was a reflection of IMF over ambition. For a wide range of observers, it was certainly very difficult to see IMF interventions as purely economic. The problem springs from the very large gap between pre-crisis Indonesian political economy and the Fund's idealised liberal vision. For enthusiasts a move towards that vision must be a good thing. For opponents, a more pragmatic assessment is required of the realistic political possibilities in the Indonesian context.

The last section of the chapter looks at reforms after Suharto's fall to provide some information on what such prospects were. That is obviously an exercise that is only possible with the benefit of hindsight. Its implications for what the IMF should have done in 1997 are unclear. On the other hand the discussion is important for subsequent debates on IMF reform.

I argue that the IMF was faced with genuinely difficult choices in Indonesia. The programme it attempted to impose on Suharto was never going to achieve his full support. A more pragmatic programme, though, risked making it look like the Fund was soft on corruption and authoritarianism (bailing out a dictator). Non-implementation meant that the Fund could claim it was Suharto's intransigence, rather than IMF technical failure, that was primarily responsible for the crisis. On the other hand, that also draws attention to the extent to which IMF policies conflicted with domestic political preferences. The fact that the programme proved very difficult to implement even when Suharto had left suggests that lack of 'political will' was by no means the only problem. The Indonesian case, then, raises very difficult issues but it is hard to ignore the fact that many of them are fundamentally *political* rather than technical in nature.

6.1 The state and development in Indonesia

The Indonesian nation was formed from a collection of territories encompassing large geographical, historical, cultural, ethnic and religious variations. It also inherited a distribution of wealth and opportunity that was skewed towards European and Chinese ethnic groups¹. Much of Indonesia's political history has involved a gradual concentration of political power legitimised by the difficulties of forging national unity.

A key official economic goal has been the advancement of *pribumi*² economic interests through industrial upgrading with microeconomic policy, in particular, harnessed to the goal of nation building since independence. That policy has taken the form of more or less genuine attempts at industrial policy as well as direct measures to channel resources to *pribumi* and to those whose support was required to maintain the political status quo with the three goals often merging into one another. It does not, by any means, correspond to the 'developmental state' model. On the other hand, since the collapse of the chaotic Sukarno regime in the mid-1960s macroeconomic policy has been fairly orthodox and Indonesian growth has been impressive.

IMF attempts to reduce state intervention in the Indonesian economy are more easily justified in economic terms, though even here they have some weaknesses so the nature of Indonesian economic management still needs to be examined. More importantly, though, they were designed to

¹ Historically, political control over labour, rather than economic control over land had been the key to wealth and status in Java (Tarling, 1992). *Pribumi* were therefore incorporated into the colonial state, if at all, as civil servants rather than land-owners or capitalists. Chinese Indonesians were granted economic privileges on the grounds of expertise and political impotency even under the Dutch colonial regime (Robison, 1986): a pattern that has been remarkably consistent in Indonesian history ever since.

² Indigenous (or perhaps more accurately non-Chinese) Indonesians.

dismantle a system of political patronage and convert it rapidly into an orthodox liberal market economy. The historical experience in Indonesia is perhaps most important in determining the political prospects for such an ambitious programme.

6.1.1 The 'New Order' before the 1980s

The New Order and its origins

Suharto promoted his New Order by highlighting its contrasts with the experience of the 1950s under Sukarno. He came to power promising economic stability and growth (in comparison with 1950s hyper-inflation), political stability through benevolent authoritarianism (in contrast with faction fighting and coup attempts), and an end to the ideological strictures imposed by the communist part of Sukarno's communist – nationalist - Muslim political support .

In some ways prefiguring the New Order, Sukarno's economic policies reflected attempts to harness economic policy to the cause of nation building³. In the early years, various economic sectors were reserved for *pribumi* businesses, corporations in strategic industries were nationalised with a view to later divestment to *pribumi* and exclusive import licences were issued (under the Benteng programme) to encourage private capital accumulation. Some of these favoured businesses did transform themselves into successful import businesses in their own right or diversified into distribution or machine assembly but the majority continued to be reliant either on political connections (including expanding networks of political patronage) or partnerships with more experienced and better connected Chinese businessmen.

In the late 1950s, the failure of these efforts to produce a significant *pribumi* business class led to a radicalisation of nationalist economic strategies and a large-scale nationalisation of foreign owned businesses. The majority of nationalised industries suffered from incompetent, politically appointed management, limited commercial incentives and a broader environment of poor macroeconomic policy, which was also harming private business. The economy gradually slipped into chaotic hyperinflation.

Politically, there is also some truth in later portrayals of the political chaos and factionalism of the 1950s⁴. Post-independence parliamentary politics was troubled by a four way split between two Muslim parties, Sukarno's nationalists and the Indonesian communist party. Coalitions were difficult to form and unstable. Meanwhile the constitutional process was stalled in debates between a broadly liberal position, an 'integralist' position stressing the need for a strong central state in the interests of national unity, and a faction representing Indonesian Muslims and calling for some recognition of *Sharia* as binding on the Muslim community.

During the struggle for independence Muslim leaders thought they had succeeded in incorporating such provisions into the 1945 constitution only to have them removed at the last minute under pressure from Christians and nationalists fearing their consequences for national unity. In the post-

³ The economic parts of this section rely on (Robison, 1986) except where otherwise indicated.

⁴ A good overview is provided by (Schwarz, 1999).

independence constitutional debates of the early 1950s, they were determined not to let the same thing happen again and the debates became deadlocked. A variety of political disturbances around the archipelago gave Sukarno the excuse to intervene decisively, banning Masyumi (one of the modernist Muslim parties) on the basis that it had been involved in a coup attempt, and reinstating the centralist pre-independence constitution of 1945.

This was portrayed as a move for national unity against Islamic sectarianism but it was also clearly an authoritarian response to the threat of national disintegration. The integralist view of the Indonesian state based on the doctrine of *Pancasila* or five principles⁵, had triumphed over the Muslim or liberal alternatives.

Sukarno's improbable political support – a coalition of communists, military nationalists and moderate Muslims - inevitably proved hard to hold together though, particularly in a context of economic collapse. It unravelled into an orgy of military-supported popular anti-communist violence throughout the country in response to a still somewhat mysterious military coup. The New Order emerged out of that crisis.

Although Suharto emphasised the differences between the New Order and the Sukarno regime there were also significant continuities. Under Sukarno, *Pancasila* was initially seen as an enlightened compromise between the different perspectives involved in framing the constitution but rapidly came to be used as a justification for 'Guided Democracy':

In guided democracy, the key ingredient is leadership. The guide...incorporates a spoonful of so and so's opinions with a dash of such and such always taking care to incorporate a soupcon of the opposition. Then he cooks and serves it with a final summation wave "OK now my dear brothers it is like this and I hope you agree..." (Sukarno cited in Schwarz 1990)

In a similar way, the promise of cultural freedom under the New Order once the communist party was eliminated was only briefly fulfilled. Suharto, too quickly moved to centralise political power. All pre-existing political parties were merged to form the nationalist *Parti Demokrasi Indonesia* (PDI) and the Islamic *Partia Persatuan Indonesia* (PPP). In addition he founded 'Golkar' – not technically a political party but rather an umbrella organisation incorporating a huge array of pre-existing social groups (peasant groups, labour groups, bureaucrats, businesses etc). It was very much a *state-corporatist* institution designed as a vehicle for maintaining government support rather than a channel for the articulation of social interests (MacIntyre, 1994). It was also clear that the bureaucracy and military would be the dominant 'social groups' in the organisation.

The two legislative bodies, the Parliament (DPR) and the People's Consultative Assembly (MPR) charged with electing the president were restructured so the government could appoint 20% and 33% of the respective representatives. Finally, under the doctrine of 'floating mass' the rest of

⁵ Belief in God, justice and civility amongst Indonesia's peoples, the unity of Indonesia, democracy through deliberation and consensus, social justice for all. For more details of the original intention behind Pancasila and adaptation in its meaning over time see (Ramage, 1995).

society was to be depoliticised so that their only involvement was in 5-yearly elections. Civil society was almost entirely absorbed into the Indonesian state (Schwarz, 1999).

The promises of economic stability, order, economic growth and the end of communism were broadly met but, as we will see in the next section, despite far more rational macroeconomic policy, microeconomic measures continued to be directed towards a variety of non-economic goals.

Economic policy under the New Order

Economic policy making under the New Order has been the outcome of tensions between three different but overlapping imperatives: the drive for current economic efficiency; the nationalist desire over the longer term to create a modern integrated industrial economy owned and controlled largely by *pribumi*; and the need to supply resources for political patronage (Robison, 1986; Robison, 1997). As economic and political circumstances have changed, groups representing these different programmes have been able to exercise different levels of influence over the bureaucracy and, more importantly, over Suharto.

In the late 1960s, restoring economic order in the midst of a debt ridden, inflationary economy, was a political priority. Aware of his limited economic expertise, Suharto gave a group of Western trained economists based in Bappenas, the state planning ministry a relatively free hand to negotiate with the IMF and creditors, introduce a series of market friendly reforms, and draft a new, investor friendly foreign investment law (PMA) (Robison, 1986; Winters, 1996).

The reforms were extremely successful in restoring foreign investment and economic stability (Hill, 1996) but were the subject of growing opposition throughout the 1960s and 1970s. The incentives under the PMA and its subsequent domestic counterpart tended to favour larger businesses. Two thirds of investment during this period went into oil and gas. Of the remaining third less than half was domestic, leaving *pribumi* capital as far behind as ever. Foreign investment, largely market-seeking in an effort to avoid high tariffs, had tended to compete directly with pre-existing domestic industry fuelling unrest (Jomo et al., 1997; Robison, 1986).

This environment provided support for nationalist intellectuals looking to the Japanese state-led model for economic inspiration and politico-military figures such as Ali Moertopo who were attracted by the allied vision of the kind of authoritarian politics I described in Park's Korea. Crucially this vision also had the support of Ibnu Sutowo who possessed the twin assets of Suharto's confidence and control over Pertamina's (the state oil company) vast resources. He used Pertamina's funds (which the technocrats could not control) to invest in a variety of large industrial ventures and obtained funds from Japanese investors on the basis of pledges over future income. These activities were economically disastrous over the longer term triggering a massive debt crisis later in the 1970s but, in the interim helped create some of the large Indonesian conglomerates (often with Chinese-Indonesian partners) that would later add their support to nationalist policies in the hope of securing greater state assistance.

Political protests beginning in the early 1970s and culminating in the Malari incident in 1974 added fuel to these economic nationalist inclinations. In fact the protests had wider and more complex sources including liberal middle-class concerns over restricted political freedom and the effects of the liberal economic turn on equity and rural poverty. However, the government response was to crush liberal protest about political rights while shifting economic policy in a more nationalist direction (Schwarz, 1999).

The measures announced included: a greater emphasis on directed credit for small *pribumi* businesses; regulations on foreign investment including a 51% domestic equity requirement; more areas of economic activity reserved for *pribumi*; and measures to promote industrial deepening. The latter took the form of investment, usually through state industries, and regulations designed to restrict foreign investment in businesses that Indonesians were capable of conducting. Regulation was also used to prevent textile overcapacity, maintain state dominance in the banking sector, and promote technological upgrading in the logging industry through export restrictions (Jomo et al., 1997; MacIntyre, 1993).

While the stated aims of policy were ethnic redistribution and industrial deepening, the effects were often more complex. The largest uses of preferential credit were to fund Pertamina's debts, springing from Sutowo's over-ambitious projects and to fund BULOG, the agricultural marketing board. BULOG acted to ensure both stable prices and the supply of key commodities and, independently, was a vital dispenser of patronage in the form of monopoly distribution and processing contracts (particularly, as we will see later, cloves and flour milling).

Unusually for developing countries, the agricultural sector more generally was the most consistent beneficiary of state credits, along with rural education and health care facilities. This was perhaps partly because of concerns about communist influence in the countryside but it also provided a contact between technocrat and nationalist agendas since agriculture was an indigenous based industry with comparative advantage (MacIntyre, 1993).

While some credit did go to promote *pribumi* industry, it is also widely acknowledged that large amounts were diverted to serve patrimonial interests, securing political support by providing economic favours, and that much credit was never repaid (particularly by smaller borrowers). MacIntyre suggests that poor performance by smaller borrowers may have provided further incentive to divert credit to larger well-connected businesses.

Pressure on foreign companies to form joint ventures with Indonesian firms also had mixed results. Large Chinese firms or indigenous firms with good political connections were clearly more attractive partners than small indigenous business. Often domestic equity holders had their stakes financed by foreign partners. Given the limited skills and capacity of Indonesian business it was, again, often large Chinese firms that benefited from restrictions on foreign investment (Robison, 1986).

Politically, the nationalist turn provided the state with enormous influence over the domestic economy and over foreign investment approvals. Even the private sector was heavily dependent on spin-offs from these huge state owned projects. This provided enormous scope for patronage, particularly in the late 1970s when the majority of investment decisions were delegated to 'Team 10' operating under the control of Sudharmono, a key economic nationalist (Winters, 1996). Political support was increasingly dependent on this expanding network of economic relationships. The system was facilitated by growing oil revenues which offset the negative effects regulations had on foreign investment.

Results: Indonesia in the early 1980s.

Suharto's concentration of political power was remarkably successful. After the Malari incident, debate and opposition in the media and academia were stifled with the Campus Normalization Law of 1978 and a series of press bannings in the 1970s and 1980s. Political scientists at the time described Indonesia as a patrimonial state, almost completely independent of society and interested only in serving itself (Anderson, 1983; Crouch, 1979).

Later writers have suggested that this portrayal is in need of minor modification. Although there was little potential for organisation independent of the state, 'structural pressures' (such as the needs of the capitalist class) did force responses. Liddle has added that the appearance of invulnerability was also a mark of astute political management with the state taking action to preempt possible sources of dissent or social pressure (Liddle, 1992). MacIntyre has shown that certain business pressure groups were able to press their wishes on the state where circumstances were favourable (MacIntyre, 1994).

Nonetheless, the 1970s and 1980s were a time of consolidation and centralisation. At the same time, the patrimonial system of politico-bureaucratic interests sustained by Suharto's economic policies were becoming increasingly capable of influencing state spending if not broader financial policy. MacIntyre has concluded that

The seemingly strong state of Suharto's New Order – a state that is remarkably insulated from organised social pressures – reveals itself to be surprisingly weak in terms of developing and implementing coherent strategies in [financial policy]. Patrimonial imperatives and sheer bureaucratic incapacity have been the principal stumbling blocks (MacIntyre, 1993, 161).

In economic terms, the nationalist turn of the mid-1970s had mixed results. Some large indigenous owned conglomerates did emerge during this period but, with the exception of the few that managed to convert Sukarno era privileges into joint ventures with foreign companies, the majority of Indonesian capitalists were either Chinese or emerged from within the state itself. Most notable was the emergence of large business groups owned by the Suharto family and Suharto's close political associates. This is perhaps unsurprising given that:

For most domestic corporate groups...the springboards to business success were the state allocated monopolies, which gave access to crucial sectors of economic activity. Forestry concessions, import licences, distributorships for basic commodities and contracts for construction and supply were allocated by the state (Robison 1992, 40)

Political rhetoric notwithstanding, Chinese business groups were, if anything, able to consolidate their hold on the economy during this period particularly through the foreign joint ventures mandated by local equity requirements.

Despite the increasing influence of patronage over economic policy, and resulting declines in foreign investment, the story was not all negative in terms of growth and technological upgrading. Import substituting industries expanded strongly and GDP growth per annum was 7.7% between 1973 and 1981. Jomo et al (1997) also argue that 'Indonesia succeeded in avoiding the worst consequences of financial 'Dutch disease' by rapidly developing non-oil production and expanding non-oil exports'. Between 1970 and 1980 agriculture declined as a share of GDP from 47.5% to 24.3% with industry increasing from 19.8% to 43.1%. Much of this was the result of growth in oil revenues but manufacturing industry also increased from 10.9% to 13.4% GDP in the same period and total factor productivity also improved by a modest 0.9%.

Economic policy then, clearly had its unsavoury eccentricities. On the other hand, Suharto's corruption was astute corruption. The need to keep the economy moving to provide further patronage resources and in the interests of broader social legitimacy placed limits on how far corruption was allowed to go and ensured prudent macroeconomic management (MacIntyre, 2000). The result was considerable growth, though that growth might have been faster if resources had been allocated with greater economic rationality.

6.1.2 The 1980s and 1990s: economic liberalisation and political centralisation

Economic liberalisation in the 1980s and its limits

The oil price fall of 1982 was a second turning point in New Order economic policy. It signalled a shift in power to the technocrats (Winters, 1996) at a time when international pressure was growing for more liberal economic policies (Bierkersteker, 1992; Toye, 1993). At the same time, some of the larger Indonesian conglomerates were becoming less reliant on the state and had begun to see it as restricting their activities, at least in some areas. While wishing to retain state protection, they were anxious to make it easier to attract foreign investment and to obtain access to sectors that had previously been state monopolies (Robison, 1997).

These priorities were reflected in the reforms that took place. Financial deregulation and relaxation of restrictions on foreign investment (both in terms of closed sectors and domestic equity requirements) were a key part of the reforms (Robison, 1997; Winters, 1996). Trade reforms were aimed, particularly, at removing import monopolies on upstream inputs to export-oriented industry. State monopolies on power generation, telecommunications, ports and road construction were opened to domestic and foreign investment. The state divested parts of some state enterprises (usually as public offerings on the Jakarta Stock Exchange set up in 1988) and all of others.

On the other hand, some reforms that were potentially less popular – notably tax reform and the privatisation of the customs service to boost state revenue – were also achieved, echoing the pattern of limited restraints when patronage threatened to get out of hand.

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

Contrary to the expectations of liberal reformers, though, the conglomerates' domination of the economy actually increased as a result. The politico-business families that had emerged during the late 1970s were best placed to take advantage of economic opening. The enthusiasm of foreign investors for politically well-connected conglomerates meant that the stock market was a cheap source of funds. In addition, 'inadequate rules and enforcement capacity allowed companies to go public without adequate disclosure, insider trading was rife and fake share scandals occurred frequently' (Robison, 1997)⁶.

While considerable liberalisation did occur in export sectors, cartels, price controls, entry and exit controls, exclusive licensing and public sector dominance remained for many areas of the domestic economy (World Bank, 1995). BULOG retained its central position in controlling access to domestic food and even allocated new monopolies during this period – notably the economically perverse clove monopoly awarded to Tommy Suharto amidst much controversy in 1990⁷ and a monopoly on fertilizer pellets granted to Suharto's grandson. Equally important was the state's ability to grant contracts for the construction, supply and maintenance of state 'mega-projects'.

Finally the rise of Habibie as Suharto's political protégé ensured that industrial policy was not dead. Habibie had an unorthodox vision of a direct leap into hi-tech industries, the most prominent example being his personal aircraft manufacturing project. Production was successful in that the plane was a reasonable product but it was by no means economically viable.

Politics – embracing Islam, suppressing democracy, growing discontent

The 1980s and 1990s can be seen as a period in which the influence of a rapidly expanding middle class⁸ first began to be felt in Indonesia. In particular, at least with the benefit of hindsight, secular liberal opposition and growing Muslim assertiveness began to emerge – both signs of growing political activity outside the narrow confines of the Indonesian state.

Muslim disappointment when the rewards for participation in the extermination of the PKI failed to materialise in the late 1960s had gradually been transformed over the 1970s and 1980s into a change of tactics for the majority of Islamic activists. NU, which had always been more sympathetic to a restricted political role for Islam (Feillard, 1997; Ramage, 1995) had staged a strategic withdrawal from politics in 1984. After bitter opposition, Muslim organisations had also succumbed

⁶ See also (Kwik, 1993) and *Tempo* 10th April 1993.

⁷ See (Schwarz, 1999) for more details.

⁸ For early academic responses to this development see (Tanter & Young, 1990) – particularly (Dick, 1990) and (Lev, 1990).

to Suharto's mid 1980s drive to make *Pancasila* the sole basis (*asas tunggal*) of all mass organisations in Indonesia. Paradoxically, the result, aided by the growth of a better-educated Muslim middle class (Mahasin, 1990), and the channelling of much student political energy into Islamic groups in the universities (Hefner, 1997), was a resurgence in the political influence of Islam.

With the Muslim threat to *Pancasila* in decline as a result of this shift from political to cultural advocacy of Islam, Suharto felt able to turn the Muslim community for support against rising military opposition in the late 1990s. The most significant manifestation of this change was the establishment, under Habibie (then Minister for Technology) and with Suharto's blessing, of the Association of Indonesian Muslim intellectuals (ICMI).

Indonesian Islam is highly diverse and this diversity was reflected within ICMI. For a relatively academic minority (the 'real' ICMI) it represented a welcome forum for public debate about the future of Indonesian Islam. For many others, though, it was a vehicle with the potential to harness popular political support. It provided a power base for Habibie and a group of bureaucrats close to him. It was also an opportunity for the resurgence of political Islam of various varieties.

Key groupings were right wing Muslims based in KISDI, and two groups of more moderate Muslims based around Adi Sasono, and Amien Rais. KISDI saw Suharto's renewed enthusiasm for Islam as an opportunity to push for further advances in the position of Muslims. This view was strengthened by Suharto's appointment of key Muslim generals (Hartono, Feisal Tanjung, Hamid and Prabowo) and the aim was to use ICMI as a vehicle for the Islamization of Golkar and the military.

Sasono was closely connected with the NGO movement and in some ways represented the opposite extreme. He was a champion of small-scale business, appropriate technology and the cooperative movement. Adi's Islamic politics was centred on egalitarianism and human rights. In the late 1990s this had crystallised into concern with *pribumi* economic marginalisation, providing some potential for links both with Habibie's economic nationalism and more conservative 'crony' figures like Probosutedjo, Suharto's brother-in-law. This unity was reflected in calls for (religious) *proportionalism* in politics and business. Sasono too supported Suharto, believing that the establishment of ICMI indicated the potential for further pro-Muslim support but wanted the military out of politics and had longer term ambitions to turn ICMI into a mass political opposition movement.

Rais was more moderate. He was critical of the regime but felt that concerns for political stability required gradual reform with a continuing role for the military and Suharto over the short term, but with greater openness and some electoral reform. For Rais and others, ICMI was a platform for political pressure but no more. On the other hand some reforms went further than others. Sri Bintang Pamungkas was a much more outspoken critic about human rights and corruption and was eventually expelled from ICMI in 1996.

Finally the largest Muslim movement, the traditionalist Nahdlatul Ulama under the leadership of Abdurahman Wahid, was concerned by the reconessionalisation of politics and refused to have any part in ICMI, concerned that there was a danger of becoming a pawn in Suharto's political games.

In the secular realm, the PDI was also becoming increasingly assertive, carrying out a highly successful (in terms of media coverage if not vote winning) campaign for the 1992 elections under the leadership of Suryadi. This clearly unnerved Suharto who resorted to a heavy handed removal of Suryadi from PDI leadership. This move backfired when Megawati Sukarnoputri was elected in his stead on the back of unprecedented mass demonstrations of support (Heryanto, 1997).

Tensions grew as an alliance between the PDI and NU began to look possible. Suharto's response was to use a think tank close to the regimist wing of KISDI and sponsored by 'green' generals (Feisal Tanjung, Hartono and Prabowo) to conduct a dirty tricks campaign against both Wahid and Megawati - a notable shift away from Habibie's bureaucratic ICMI and towards more radical conservative support. These events culminated in the forced expulsion of Megawati from PDI headquarters in July 1996. Under increasing pressure, Wahid established a temporary rapprochement with Suharto by agreeing to distance himself from Megawati⁹ but the incident demonstrated that Suharto's grip on power was weakening and that conservative Islam was becoming an increasingly important part of his political support.

During the same period, the media was temporarily allowed to play a larger role. Presumably conscious of growing middle class pressure, Suharto flirted with a policy of *keterbukaan* or openness in 1989 and again in 1993 but was unable to deal with the consequences in the form of outspoken criticism of the regime's corruption. This was clearest when Suharto banned three newspapers in 1994 (including *Tempo* – the leading current affairs weekly) in response to critical reporting of Habibie's less than transparent use of state funds – including the purchase of a number of East German Warships which particularly angered the military.

In both cases, Suharto's overt repression turned what were probably minor threats into major public issues.

Finally, underlying the issues underlying these political tensions were a mixture of liberal issues such as human rights and political freedom but also economic issues particularly corruption (from all sides) and continuing *pribumi* economic marginalisation (within ICMI).

6.1.3 Conclusions – background to the crisis

The creation and maintenance of an Indonesian nation has been central to Indonesian political discourse since independence. The Indonesian nation was formed from a collection of territories encompassing large geographical, historical, cultural, ethnic and religious variations. It also inherited

⁹ Apparently the strategy was to outflank his more radical Muslim rivals, who were orchestrating the attacks on him, by securing Suharto's favour. At the same time, Hartono, one of the key CPDS funders was wavering between support for Suharto's daughter Tutut and his earlier Muslim allies. Tutut saw Habibie as her chief rival for the presidency and Wahid as a potential ally.

a distribution of wealth and education that was skewed towards European and ethnically Chinese groups. Much of post-independence Indonesian political history has involved a gradual concentration of power legitimised by the difficulties of forging national unity. Nation building through the advancement of *pribumi* economic interests has also formed a key legitimating rationale for much of Indonesian economic policy.

Of course, threats to national unity provide convenient legitimation for a military authoritarian regime. Nationalist economic policies can also provide a convenient justification for the direction of funds to the politically well connected, particularly when encouraged by the imperatives of authoritarian patrimonial political regimes. It is clear that both of these dynamics have been at work in Indonesia.

On the other hand, as I argue throughout this thesis, legitimating arguments are only likely to be successful to the extent that they are broadly credible. The experience of the 1950s and early 1960s clearly showed that the question of national unity was a genuine one. The current of *pribumi* discontent and anti-Chinese resentment that can be seen throughout Indonesian history also demonstrates the need for some measure of re-distribution of economic resources. Arguably the relative absence of rural dissent may also demonstrate the success of Suharto's strategy of funnelling resources to rural areas to prevent communist resurgence or other forms of political dissent. Overall there was considerable evidence that the majority of Indonesians did accept the general New Order bargain of economic development and national unity at the price of authoritarianism and patronage, albeit in the context of considerable attempts by the state to depoliticise the population.

However, in the 1990s there was growing evidence that this compromise was beginning to unravel. Economically, the combination of deregulation that transferred power away from technocrats in the bureaucracy and towards big (crony) business interests, and of increasing incorporation into the world economy undermined general and big business support (respectively) for government economic management. At the same time Suharto's moves towards ICMI driven by suspicion of the military, together with an rapidly expanding middle class led to increasing space for political expression outside the confines of the state. These increasingly dissenting voices were then amplified by a series of heavy-handed attempts to control them to the point where Heryanto could talk of 'the final countdown' by the end of 1996 (Heryanto, 1997).

The IMF apparently saw patronage as the key to the crisis. Removing monopolies and inefficiencies would soon reinstate confidence in the Indonesian economy triggering a return of capital. The danger was that this conviction would react explosively with increasingly complex and fractious Indonesian politics.

6.2 The Crisis in Indonesia

The rupiah began to come under pressure in the wake of the Thai devaluation. The government responded quickly by widening the rupiah intervention band on the 11th July and allowing it to float on 14th August. The exchange rate immediately fell but recovered as the central bank drastically tightened monetary conditions pushing overnight interest rates to 81% (World Bank, 1998b).

Despite widespread praise for this response from the media, World Bank (World Bank, 1998b) and IMF (IMF, 1997b), the rupiah began to fall again in late August and continued to do so throughout September (see Figure 6-1).

As conditions continued to worsen, Marie Muhammed, the Finance Minister, announced a package of measures including fiscal control through the cancellation of a number of infrastructure projects, removal of import tariffs on 150 items, and the removal of the 49% limit on foreign ownership of listed companies. Market commentary was that this was a good sign but not enough, particularly as the negative impact of high interest rates was a greater concern than the government budget (*FT* 17th September 1997). Behind the scenes, the technocrats had pushed for a more extensive programme but had had it rejected by Suharto, setting a pattern in which it became clear to Indonesians that the president was more eager to take advice from his children than from the technocrats (Haggard, 2000; Nasution, 2001; Soesastro, 2000).

Negotiations began with the IMF on October 13th. The first programme was signed on October 31st and officially announced on November 5th. It was met by a brief improvement in the exchange rate (Lane et al., 1999; World Bank, 1998b). However, implementation commenced with the mismanaged closure of 16 Indonesian banks on November 1st resulting in a widespread panic in the Indonesian banking sector (Lane et al., 1999; McLeod, 1998; Radelet & Sachs, 1998b; World Bank, 1998b).

The programme was later undermined further by two swift failures in implementation. Bambang Trihatmojo (Suharto's second son) and Probosutejo (Suharto's step-brother) refused to close their banks (*Asia Wall Street Journal (AWSJ)* 5th November 1997, *Jakarta Post (JP)* 2nd, 5th and 6th November 1997). Both eventually succeeded in staying in business under different names (*JP* 26th November 1997, 31st December 1997). Suharto also reinstated 15 previously postponed infrastructure projects, some of which provided clear benefits to the Suharto family without having any other obvious economic rationale (*JP* 8th November 1997, *AWSJ* 5-6th November 1997, Robison & Rosser, 2000). If insiders had already had signals that led them to question Suharto's ability to put the interests of the economy above those of his children, everyone now had significant cause for concern.

As withdrawals from private banks accelerated, the central bank began issuing emergency credits in large numbers. The inevitable inflationary consequences of these moves (combined with political uncertainty) lead to further attacks on the rupiah. Indeed, it later emerged that many of these credits

were used to buy further foreign exchange – Bank Indonesia was effectively subsidising attacks on itself (Haggard, 2000; Soesastro, 2000).

Up to this point rupiah depreciation was broadly comparable with that in other Southeast Asian countries. On December 9th, though, it began to go into freefall, parting company with the other regional currencies (Robison & Rosser, 2000; Schwarz, 1999; World Bank, 1998b). This fall coincided with the announcement that Suharto was seriously ill and can be attributed to uncertainty over the presidential succession.

The budget announced on January 6th precipitated the decline. It was perceived to be based on wildly unrealistic assumptions and drew extensive market, US and IMF criticism although later re-evaluations suggest that this criticism was misplaced¹⁰ (Radelet & Sachs, 1998a; Robison & Rosser, 2000).

A second IMF package was announced on January 15th and Suharto himself signed it publicly with Camdessus looking on¹¹. It failed to calm market nerves despite mild fiscal easing and the inclusion of even more extensive structural reforms including: central bank independence, withdrawal of privileges for the national car project, elimination of cement, paper and plywood cartels, withdrawal of support for IPTN, removal of restrictions on investment in retail, elimination of monopolies in cloves, flour, sugar, soybeans and other basic commodities and the phased elimination of subsidies for fuel and electricity (Government of Indonesia, 1998). By the third week in January the rupiah was trading at Rp.15,000 to the dollar (compared to 2,500 in July 1997).

A package of reforms aimed at restructuring the banking sector and rescheduling the private debt overhang announced by the government on 27th January finally began to calm market nerves. It established the Indonesian Bank Restructuring Agency (IBRA) and provided a blanket guarantee on the obligations of all domestic banks. At this stage no moves were made towards dealing with corporate debt (revealed, in early February when the figures had been worked out, to be about US\$73 billion (*Antara* 6th February 1998). Indeed the government, with IMF support if not under IMF pressure, was insisting that it would ‘not get involved in negotiations and will not give any guarantee for corporate debts’ (quoted in *JP* 7th February 1998).

However, at this point political events that had been developing since the autumn began to move to centre stage. The crisis had boosted support for Megawati and Wahid and had begun, again, to add NU support for calls to end corruption and human rights abuses.

¹⁰ Essentially the negative assessments fail to take into account the extent to which the Rupiah had already depreciated when making comparisons with previous budgets – see (Radelet & Sachs, 1998b) and (Radelet & Woo, 2000)

¹¹ The press photograph of this event with Suharto seated at a desk and Camdessus standing behind, arms folded, caused enormous offence throughout Asia.

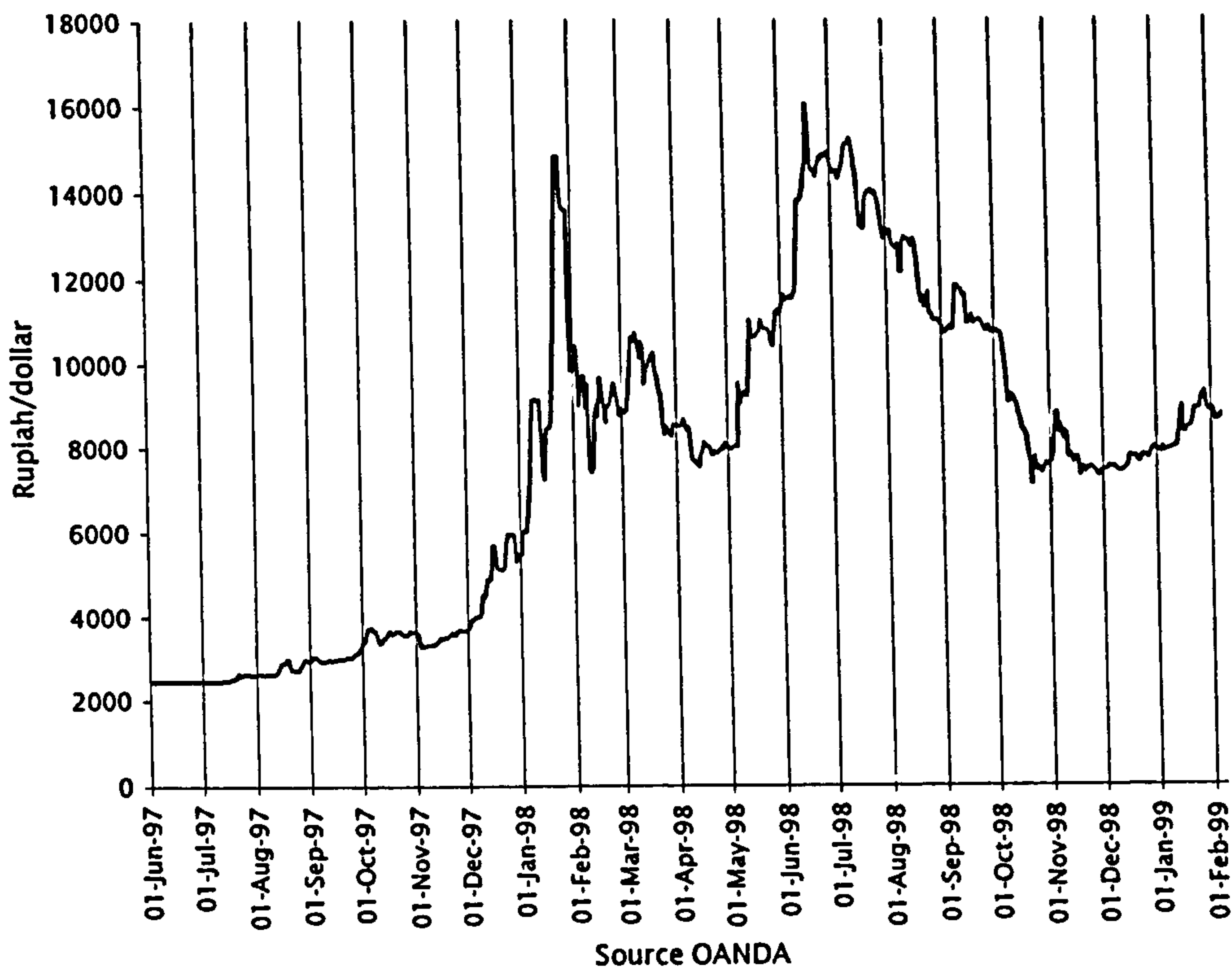


Figure 6-1 Rupiah-dollar exchange rate

Suharto's political vulnerability was most clearly demonstrated by Amien Rais' decision (announced in late September) to stand against him in the presidential election scheduled for March 1998. After his expulsion from ICMI in early 1997, Rais had attempted to court more mainstream support by playing down his anti-Chinese and anti-Christian rhetoric. This initially isolated him from more radical Muslim support in KISDI, its sympathisers in the military grouped around General Prabowo, and radical elements of Muhammadiyah and ICMI without winning the support of NU (and the more moderate military grouping around General Wiranto) (Hefner, 2000; Mietzner, 1999). However, as the economic situation continued to deteriorate in late November, Abdurahman Wahid (the NU leader) was becoming increasingly critical of Suharto. By January there were growing rumours of a Megawati-NU-Rais alliance (although it never ultimately materialised).

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

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

Over this period, the inevitable effect of rupiah depreciation and inflation was beginning to translate into food price rises. Suharto initially succeeded in putting pressure on traders to provide a price freeze but this was clearly a temporary measure and there were growing concerns about what would happen when full price rises took hold (*FT* 25th January 1998, *South China Morning Post (SCMP)* 25th January 1998, *AFX(AP)* 4th February 1998).

At around this stage food riots began to take place, particularly targeted at Chinese Indonesians who are responsible for a large part of rice distribution and retail (*JP* 4th February 1998, 14th February 1998, *SCMP* 15th February 1998). In keeping with the anti-Chinese shift government spokesmen suggested that food prices resulted from speculation in the rice markets and forced a further price freeze. This time, though, assistance was also provided by Pertamina price cuts (for fuel) and BULOG market operations (for rice) (*JP* February 5th 1998, 6th February 1998, *FT* 21st February 1998) Government spokesmen also acknowledged that 'we will have to be very careful when it comes to the price of kerosene so the less privileged will not have to shoulder too huge a burden (Sudjana quoted in *AFX(AP)* 17th February 1998). As with later riots there was some evidence of deliberate provocation – rioters reported to the *South China Morning Post* that they had been paid for their participation (*SCMP* 18th February 1998).

Heat was added to the protests when Suharto awarded a Jakarta water contract to a company controlled by his grandson (*JP* 6th February 1998).

At the same time, Suharto began to criticize the IMF openly calling for an 'IMF plus' programme to address the continuing slide of the Rupiah (*JP* 18th February 1998, *ASWJ* 2nd March 1998). He also invited Stephen Hanke of Johns Hopkins University to advise on the possibility of setting up a currency board¹², apparently at the instigation of his eldest daughter 'Tutut' and Peter Gontha, a prominent Indonesian businessman (*ASWJ* 10th February 1998). This provoked heated opposition from Fischer and Camdessus (*JP* 14th February 1998 *AWJSJ* 17th February 1998) culminating in the delayed disbursement of US\$5.5 billion in loans from the IMF, World Bank and Asian Development Bank (*Asiaweek* 20th March 1998).

By March 8th, Suharto was claiming that the IMF package could not be implemented because it was 'unconstitutional' requiring a liberal economy which is not in line with the Indonesian constitution (*Straits Times* 9th March 1998) His daughter, even more forthright, argued that 'if the funds sacrifice and degrade our nation's dignity, we do not want them' (*Asiaweek* 20th March 1998).

¹² For Hanke's account of this episode see (Hanke, 1998; Hanke, 2000).

Meanwhile, rioting and civil unrest were growing throughout the country. Given the tense situation, and the fact that Suharto had clearly garnered enough military and modernist Muslim support to ensure his election, Rais felt compelled to ask his supporters not to demonstrate. By mid-February, NU and Muhammadiyah had made statements which reluctantly supported Suharto's re-election and Megawati disappeared from the political scene (Mietzner, 1999).

When it became clear that elite politics was not going to force a transition, action moved to the University campuses. Protests started in Yogyakarta and spread around Java with hundreds of thousands gathering on campuses. Demands focused on the price of basic commodities, the need for an end to Suharto's rule and a transition to democracy, and the elimination of corruption (Hefner, 2000; Schwarz, 1999).

Suharto also began to lose his carefully won elite support as he tried to split the military by appointing Wiranto as head of the armed forces (to counter Prabowo) and failed to appoint any ICMI bureaucrats to his new cabinet in March. 'Crony' influence in the cabinet (it included Tutut and Bob Hasan, head of the country's plywood cartel) also sent a message to demonstrators and the markets that he was not listening to their demands and was not ready to reform. Meanwhile the moderate Muslim opposition - Rais and Sasono - toured the campuses winning the sympathy of the students.

The third IMF programme was negotiated in this tense atmosphere. The government argued that further reforms – and the proposed reductions in government subsidies in particular – posed a serious threat to social and political stability in Indonesia (*AWSJ* 16th February 1998, *JP* 20th March 1998). The programme, negotiated between 17th March and 18th April, allowed the government to continue with subsidies on basic commodities until October (though initial price rises were to take effect on April 1st) and to delay dismantling BULOG. The IMF also allowed the government to become more involved in debt negotiations. In return (or perhaps in the aftermath of his successful re-election (Haggard, 2000)) Suharto agreed to give up the currency board.

While there were some moves to implement this programme (suggesting that some of Suharto's opposition may have been political posturing), it was soon overtaken by events. Suharto raised fuel prices sharply on 4th May for reasons that remain unclear. The IMF required the elimination of subsidies by October but there was no requirement for this sharp rise in early May – the risk of social unrest was, as we have already seen, well known in government circles. In any case, the rise triggered riots in Medan in which Chinese shops were burned and looted.

They escalated over the next few days and when four students were killed outside Trisakti University in Jakarta on 12th May massive riots broke out all over the city. These riots were partly spontaneous, but there were also worrying signs of Prabowo's involvement. The military had left the city centre before the riots and black clad *agents provocateurs*, widely identified as KOPASSUS units under Prabowo's command, were seen directing the violence echoing earlier unexplained

'ninja killings' in NU controlled areas of Indonesia in late 1996 (Hefner, 2000). Over 1,000 people were killed and large numbers of ethnic Chinese women were systematically raped.

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

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

However, problems in implementation continued, particularly with attempts at banking and corporate sector restructuring (see section 6.5 below). Populist pressure for the redistribution of assets grew with the appointment of Minister for Small Business and Cooperatives Adi Sasono, champion of a 'people's economy' based around a greater role for cooperatives and SMEs. There were also suggestions that assets seized by IBRA should be redistributed to *pribumi* or other measures taken to promote a Malaysian style ethnic redistribution policy¹³ (*JP* 11th July 1998, 17th July 1998, 27th July 1998, 10th September 1998, 14th November 1998). Political stability was also in question with Habibie's position insecure and growing pressures for regional secession coupled with escalating religious violence.

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

6.3 The economics of the crisis

In Indonesia the issues revolve around the relationship between patronage and market confidence. Was patronage the root of the Indonesian crisis or was it contagion? Did the IMF's structural reforms address underlying problems or trigger renewed anxiety? What does that say about the prospects for a market confidence based approach to crisis resolution?

6.3.1 The IMF response

The IMF account of the crisis

The press release put out by the IMF when the first Indonesian programme was announced on 5th November provides a useful summary of the IMF's view of the crisis¹⁴.

¹³ On the Malaysian approach see chapter 7.

¹⁴ See also the fuller, but broadly consistent account in (IMF, 1997e).

Long-standing rigidities in the form of domestic trade regulations and some import monopolies impeded economic efficiency and competitiveness. At the same time, less transparency in decisions affecting the business environment and data deficiencies increased uncertainty and adversely affected investor confidence. In addition, large capital flows intermediated through a weak banking system exposed Indonesia to a shift in financial market sentiment... Prompted by large interest rate differentials between domestic and foreign interest rates, private companies had increasingly borrowed abroad to finance domestic operations, which in the context of a relatively stable exchange rate, were largely unhedged (IMF, 1997c).

The 'shift in financial market sentiment' was provided by contagion from the Thai crisis. It set in train a vicious circle in which domestic corporations scrambled to buy foreign exchange to cover their unhedged liabilities before an anticipated depreciation. This process itself put further pressure on the rupiah resulting in further depreciation in a downward spiral.

Lack of sufficient information meant that foreign lenders were unsure which banks were or weren't good credit risks. As a result they were reluctant to roll over short-term debts exacerbating the problems. The fact that, although Indonesian banking regulations were in accordance with international standards, it was well known that implementation was poor added to uncertainty about the quality of banks' balance sheets. The history of politically directed credit and connected lending undermining commercial risk assessment made matters worse.

Finally pre-existing structural problems in the Indonesian economy (trade regulations, monopolies, and 'lack of transparency') further undermined confidence in the economy's ability to recover.

The IMF programmes

The first IMF programme included the following measures:

- Tight monetary and fiscal policies designed to provide incentives for the repatriation of capital and to prevent the current account deficit from growing wider due to capital outflows. Fiscal policy was to ensure a continuing budget surplus despite the 'cyclical downturn'.

This would be achieved by cancelling infrastructure projects, raising excise taxes and removing some tax exemptions. Expenditures on basic education, health and social services would be protected as would the special assistance programme for small villages which was to be increased under Repelita VII (the latest five year development plan).

Measures to improve fiscal management by increasing the transparency of public sector activities would be introduced, enhancing the quality of governance. The government was also to bring off- budget activities (particularly the much abused 'reforestation fund') within the budget to increase transparency.

- The closure of 16 unviable banks and other measures to restore the health of the banking system. These measures were to include steps to 'strengthen the legal and regulatory environment and establish strong enforcement mechanisms and clear exit policy'. For banks which were viable but in trouble, rehabilitation plans would be drawn up.

- A broad range of structural reforms including ‘the liberalization of foreign trade and investment, dismantling of domestic monopolies, allowing greater private sector participation in the provision of infrastructure, and expanding the privatisation program’ (IMF, 1997c). Import and marketing monopolies were to be phased out and price restrictions removed for all commodities except sugar and rice.

The privatisation of infrastructure provision would happen after ‘the establishment of a clear framework to guide decision making, to level the playing field for both domestic and foreign investors and thereby assure investor confidence’. New regulations on government procurement were to be introduced to further this aim. The privatisation programme would require similar reforms to establish ‘explicit criteria for determining whether an enterprise would be closed, restructured or privatised’. For those enterprises remaining in the public sector, performance targets would be publicised and reported annually to ensure efficiency.

Tariff reductions were to take place for chemicals, steel/metal products and fishery and all non-tariff barriers were to be removed. There was also a promise to implement any WTO decision against the National Car ahead of schedule of the dispute panel ruled against it.

Later a number of legal ‘governance’ reforms were added to the programme including: a new competition law, provisions for better company registration and accounting practices, a consumer protection law, a law securing independence of Bank Indonesia and a new bankruptcy law.

Overall, then, the strategy was designed to ‘restore confidence’ or tempt foreign investors back by showing that the Indonesian government was willing to take tough measures to restore the economy to a ‘healthy’ state. This seemed to require the government to address all the aspects of the economy that neo-classical economists would be unhappy with.

6.3.2 Academic debates

Causation – did cronyism cause the crisis? Or was it liberalisation?

In Korea the suggestion that the developmental state was economically flawed was itself a matter of some debate. In Indonesia, there is no doubt that high profile monopolies; corrupt allocation of state infrastructure contracts; connected lending from banks to their associated corporations; lax prudential regulation and a general atmosphere of cronyism were economically undesirable. The question is which, if any, of these problems was actually *responsible* for the crisis.

Given that, as in Korea, there was a large build up of short-term debt a strong culprit for the crisis is poor financial sector regulation. However, if in Korea there were questions about the inefficiencies of directed credit, in Indonesia a different explanation had to be found. Indonesia had radically liberalised its financial system in the late 1980s in a deliberate attempt by the technocrats to insulate credit allocation from state control. Explanations therefore had to be based on too little

state control (in the form of prudential regulation and general legal enforcement) rather than too much.

The existence of monopolies, trade restrictions and general inefficiency in the use of resources, either as a result of pure patronage or of Habibie's slightly more ambiguous industrial policy, fit better with the neoliberal rent-seeking paradigm but are initially less easy to blame. After all, these problems were certainly not disguised before the crisis, indeed they had been well documented for many years – during Indonesia's period of rapid economic growth.

However, most commentators saw a shift in emphasis over the 1990s as patronage was increasingly narrowly distributed to Suharto's own family and long established allies. It is certainly true to say that this was a cause of growing political dissatisfaction in Indonesia, including growing frictions between Suharto and the technocrats. Whether or not it was also creating greater economic problems is difficult to assess. Many commentators initially viewed Indonesia as the most clear cut case of contagion in the region (McLeod, 1998; Pincus & Ramli, 1998; Radelet & Sachs, 1998a; Radelet & Sachs, 1998b). The strongest argument for those that wish to blame cronyism for the crisis is that the central problem was growing doubt in the markets about Suharto's willingness to inflict costs on his cronies in order to induce economic recovery as he had been willing to do in the past (Soesastro, 2000).

At the same time none of this corruption prevented substantial inward investment to Indonesia. Indeed the vast majority of foreign joint ventures involved partnerships with at least one first family connected venture. If the crisis is to be blamed on cronyism, foreign investors themselves have to accept some of that blame.

Confidence versus debt restructuring

Given the weaker links between market imperfections and crisis causation, the question of the extent to which IMF policies were confidence enhancing becomes more acute. For some, the inclusion of a large range of structural measures in the first IMF programme was like screaming fire in the theatre. Their very inclusion in the IMF programme turned them from non-essential, unpopular (from Suharto's point of view) reforms into essential (but still politically painful) preconditions for recovery as the markets were instructed to believe that they were at the root of the problems (McLeod, 1998; Radelet & Sachs, 1998a; Radelet & Sachs, 1998b).

For some of these authors, the emphasis on market opening suggested that these conditions were in fact little more than the price Indonesia was expected to pay for international assistance (McLeod, 1998). Indeed, where the Korean programme only mandated swifter implementation of previously agreed measures, the Indonesian programme included a wide range of policies that were wholly new (Soesastro, 2000).

What the programme should have contained, according to these critics, was the narrow macro-economic measures that Suharto seems to have expected (see section 6.2) together with concrete proposals for corporate and banking sector restructuring (McLeod, 1998; Radelet & Sachs, 1998a),

possibly combined with some kind of forced debt roll-over. This view receives some support from the sharp turn around in the exchange rate in Indonesia that, just as in Korea, took place once a government guarantee was provided in the context of moves towards debt restructuring in late January 1998 (Figure 6-1).

Indonesia's slower recovery since then may be partly due to continuing political uncertainty and difficulties with implementation, but it appears to be most affected by the difficult process of debt restructuring (see section 6.5 below).

The macro-economic effects of the IMF's choice of a market-based strategy (i.e. high interest rates) have also been criticised in Indonesia just as they have been in Korea (and indeed Thailand).

In terms of the evidence, the positions are again difficult to separate in economic terms. Since the programme *wasn't* implemented it is difficult to know whether it would have been successful if it had been. The issues are far easier to see in political terms. Since it was fairly clear that Suharto *wouldn't* implement reforms that the IMF wanted (regardless of their economic credibility), what should the IMF have done? To what extent should IMF economic preferences give way to political reality? Would the IMF measures have been politically possible if Suharto hadn't opposed them – did they have any social support? Crucially, to what extent is it reasonable to see the IMF as responsible for Suharto's fall and how does that relate to IMF legitimacy?

6.4 The politics of the crisis

In Korea, the more democratic environment and the existence of state support led me to discuss the politics of the crisis largely in terms of a variety of social interests and the political appeals elites made to those social interests. In Indonesia, by contrast, the state under Suharto was never fully convinced by the case for implementation so social interests that might prevent programme implementation are less central to the debates – although they have an influence on the political rationale for elite scepticism. The politics surrounding negotiations and Suharto's strategic responses are far more important.

In addition, because the programme *wasn't* implemented, questions about IMF legitimacy are raised more sharply and clearly. I will therefore bring these issues into discussion rather earlier than I did in the previous chapter so the significance of events can be understood in the context of broader Fund legitimacy.

I begin with analysis of the reasons why Suharto initially seemed to favour IMF involvement, later turned away from the IMF programmes, and finally seemed to be turning back. I then go on to ask questions about the extent to which IMF behaviour can be seen as responsible and assess some alternative strategies.

6.4.1 Economics and interests

If the starting point is non-implementation, the important issues concern how *politically* misguided the programmes were (since they clearly weren't implemented) and what the alternatives might have been?

From this perspective it is clear that the IMF programmes were designed to cut to the heart of Suharto's patronage networks and that they harmed the interests of large-scale political business together with allied bureaucratic interests.

In contrast over the longer term, to the extent that they succeeded in their aim of establishing a level playing field in the Indonesian economy, the programmes had the potential to benefit the large segments of the middle class that were increasingly mounting opposition to Suharto's rule during the mid to late 1990s. In the short term though, as in Korea, the IMF's macro-economic policies were likely to have a sharply negative impact on small businesses as high interest rates and bank closures triggered a collapse of the domestic credit system.

The same factors would have a negative impact on the urban poor who would find themselves unemployed.

For the rural poor the situation was different. The combination of exchange rate depreciation and freer inter-island and export trade could be expected to boost agricultural production. On the other hand, the poorest of the rural poor who were net consumers of rice were likely to be the worst hit of all. The rural economy's function as social safety net for the urban unemployed could also be expected to dampen any positive economic effects.

Persistent food price riots, although perhaps partly stirred up for political purposes, demonstrate the limitations of early attempts to address social concerns as does, implicitly, the IMF's change of course after the May riots. The question of who was responsible though remains somewhat in doubt – to what extent did the IMF influence the lack of social provision (did it challenge Suharto on the issue, were logistical limitations considered, was the issue discussed at all given early optimism about a swift resolution?).

If Suharto *had* been concerned about popular sentiment, then, the attractions of the programme would have had to be based on the expectation of rapid economic recovery and a particular concern for non-conglomerate middle-class support. Ultimately he does not seem to have been convinced that was the right strategic course of action. Securing elite support from his traditional business allies, the Muslim military and the more radical (in Islamic rather than political terms) corners of ICMI was more important. To the extent that he did try to rally popular support, it was through using the IMF as a scapegoat and appeals to *pribumi* economic nationalism: a strategy that he presumably felt was more politically logical given the nature of his sources of elite support. The political struggle in Indonesia at this period seems to have been a battle over the Muslim middle ground. Suharto seems to have decided that he had lost the reformist wing and that anti-Chinese,

nationalist appeals would win him more Islamic-radical support and ensure his military and elite alliances.

6.4.2 Negotiations and the first three programmes

The negotiation process for the first two programmes provides indications of the factors driving that choice.

What information there is suggests that Suharto initially hoped the IMF could be used to perform very much the 'catalytic effect' that it has been busily promoting over the 1990s. Indonesia had not run down its reserves in defending a currency peg like Korea and the president had already implemented a package of reforms in September that echoed the moderate part of the IMF agenda. There was no urgent financial need to turn to the IMF and at this stage (and indeed afterwards) most market analysts agreed that Indonesia's crisis was the clearest case of unjustified contagion in the region (Enoch et al., 2001; McLeod, 1998).

Reports in the press suggest that Indonesia had asked the IMF for a small, relatively low conditionality loan in the hope that it would boost attempts to enhance confidence (Soesastro, 2000). In Suharto's words:

We are not asking for money, as we already have policies...we just need the IMF to look at these programmes as it has experience (quoted in *FT* 20th October 1998. See also *FT* 10th October 1998, *JP* 15th October 1998).

However, the ultimate programme was far more extensive. The exact mechanics of the negotiations remain unclear. Schwarz (a veteran reporter for the *Far Eastern Economic Review* in Indonesia) suggests that, contrary to rhetoric about what I have labelled the 'new IMF', the Fund responded with

a powerful mix of arrogance and ignorance...[and]...dismissed the advice of the World Bank and the Asian Development Bank both of which had a much larger presence on the ground (Schwarz, 1999, 339).

suggesting a largely IMF agenda. Kwik Kan Gie also argued that the negotiations for the third programme after Suharto's fall were the first time that Hubert Neiss (leader of the IMF missions) had spoken to non-government personnel – in this case mostly politicians.

Other commentators point to the technocrats' enthusiasm for the first programme (Soesastro, 2000). Riesenhuber's interviews in the Indonesian finance ministry persuaded her that, once the IMF had ruled out any direct engagement with the debt problem, the technocrats agreed with the Fund that some kind of structural reforms were the only remaining option to prevent capital outflows. They agreed to include a fairly wide range of reforms in the programme but none of them were performance criteria, leaving flexibility over the timescale for implementation (Riesenhuber, 2001). The strategy appears to have been based heavily on faith in the strong version of the catalytic effect argument (see section 4.1.2 above).

What is fairly clear is that the bank closures were carried out at Fund insistence, possibly with a view to heading off criticisms of Fund bail-outs (Riesenhuber, 2001) and were the subject of considerable government resistance¹⁵.

It was the failure of this first programme that heightened Suharto's animosity to the Fund, pushing him towards less orthodox policies. Later non-implementation - reversal of some of the closures and the reinstatement of previously postponed infrastructure projects - clouds the issue of why market confidence did not return. However, any faith in the strong catalytic effect produced by programme signature again looks misplaced.

When it came to the second programme, negotiations were clearly going badly wrong. Suharto came under intense international pressure. He responded by insisting on negotiating the programme directly with the Fund and Bank, agreeing everything he was asked, but privately argued he was engaged in 'guerrilla war' and had signed the programme to gain breathing space¹⁶.

The Fund perspective was that Suharto's failed implementation was as much to blame as the bank closures for the failure of the first programme (Enoch et al., 2001; Lane et al., 1999). The solution was to procure an even more radical programme of reforms to demonstrate stronger government commitment to orthodox liberalism. Arguably, though, even from this perspective fund officials overplayed their hand. The very extent of the measures and the clear evidence of international pressure for their implementation may merely have undermined the programme's credibility¹⁷ (Radelet & Sachs, 1998a; Radelet & Sachs, 1998b)¹⁸.

There was certainly considerable political naivety involved on the IMF's part, if not in believing Suharto would implement the first programme¹⁹, then at least in not being suspicious about his acquiescence in the second round of negotiations²⁰. The Indonesian technocrats were apparently absolutely furious about the second programme. Wijoyo Nitisastro was reportedly so angry that he refused to speak with World Bank officials for months after telling them 'we've been working with Soeharto for thirty years and now you are destroying everything' (Schwarz, 1999, 341). On the other

¹⁵ Personal interviews with officials involved in the negotiations Washington 2000, *FT* 31st October 1997.

¹⁶ (Riesenhuber, 2001) citing interviews with IMF staff and Indonesian government officials.

¹⁷ Some foreign press reports at this stage also suggested that the programme could not be implemented eg. *Evening Standard* 20th January 1998.

¹⁸ Arguably because this interpretation suggests that there was an alternative programme at this point that might have been implemented and restored market confidence, a contention that other authors question (Haggard, 2000; Schwarz, 1999).

¹⁹ Apparently, the Fund was initially working on the basis that, since Suharto claimed that the Indonesia economy as a whole was his principal concern and genuinely believed his childrens' businesses were good for that economy (as part of economic nationalist development), if he was convinced that they were in fact damaging he would be willing to sacrifice them. (Based on interviews with Fund staff cited by Riesenhuber, 2001).

²⁰ The most thorough available account of the second round of negotiations is provided by (Riesenhuber, 2001). Anecdotal references in other accounts such as (Schwarz, 1999), based on good contacts in Indonesia from years as a FEER reporter, and some hints in papers by the Indonesian technocrats (Soesastro, 2000) are generally consistent with Riesenhuber's account.

hand, it seems quite likely that the technocrats' early moves towards dismantling the worst excesses of corruption had, by this point, created an international political momentum of their own²¹.

In any case, the prospects for implementation of the second programme may have been greater if the programme had been more successful technically – though how far Suharto would have been willing to go will remain a mystery. There is some evidence, though, that Suharto's attitudes hardened and his strategy shifted towards maintaining elite support (even at the cost of economic collapse) as time went by.

I will discuss the implications of these issues further in section 6.4.3. For now, I want to finish my review of the negotiation process with Suharto by looking at the events surrounding the third programme. Here things become more difficult to understand. In the aftermath of Suharto's re-election, there seems to have been an about face towards programme implementation. That about face culminated in some concerted steps towards implementing the third IMF programme but was rapidly overtaken by chaos after the unexpected fuel price hikes.

One possibility is that, seeing the situation slipping away from him and in the light of greater IMF willingness to address the debt issue, he was genuinely interested in working with the IMF at this point. Price rises could either be seen as a deliberate attempt to put pressure on the IMF for further concessions to calm the resulting social unrest²², or as an overenthusiastic demonstration of commitment immediately preceding further negotiations.

Another more Machiavellian possibility is that Suharto expected a violent response to price rises but hoped that this would separate middle class support from working class animosity, renewing support for the militarily enforced status quo. Support here comes from the suggestion that Prabowo and the radical Muslim military were responsible for fanning the flames of the riots (Hefner, 2000).

Finally, it is possible that Suharto simply underestimated the strength of popular and elite opposition growing around him and was not listening to anyone but his family and close associates.

6.4.3 Analysis and implications for IMF legitimacy

In terms of securing implementation, the Fund's strategy for the second programme seems to have been the turning point: the point at which IMF policy is most questionable and issues of IMF legitimacy are raised most sharply. That raises pragmatic issues about what might have been implemented and more normative issues about Fund authority and the proper conception of the Fund's role. In particular, if one sees the IMF as partly responsible for Suharto's downfall, as many people undoubtedly did (Hanke, 1998; Hanke, 2000), questions about IMF authority are particularly significant. One way of exploring the implications of these questions is to compare the IMF

²¹A huge procession of international (and particularly US) figures called or visited Suharto during the negotiations for the second programme.

²²In terms of the logic of two-level games, imposing a very visible narrowing of the domestic 'win set' can strengthen negotiators' hands (Putnam, 1988).

approach with the alternative advocated by some economists (concerted debt roll-overs and less extensive structural reforms).

Leaving causal explanations of Fund choices apart for now, there are two ways of *justifying* Fund interventions. Most fundamentally, technical authority is key. If one is convinced by the Fund view that Indonesian economic recovery was impossible without at least some degree of structural reform then there are better grounds for later policies that plainly attack the basis of Suharto's political power. If there is no technical alternative, if Indonesian failure could be expected to trigger further regional and global contagion, and the Fund's role is to enforce economically responsible behaviour at an international level there is arguably some justification for using all available resources to press appropriate policy on Indonesia regardless of the political consequences.

Following on from that is a more political justification relying on emergent international norms of good governance. To the extent that the technical position is correctly characterised in those terms, Suharto was not acting in the interests of the Indonesian people or the world at large. He was retreating into policies favouring himself and a narrow elite at the expense of millions of Indonesians. The IMF response was to put as much political pressure on him as possible. The logic of the second programme is then that of my 'third vision' for IMF engagement with civil society. The Fund would appeal to civil society by portraying the crisis as one of cronyism putting maximum political pressure on Suharto from below in the interests of good governance. At the same time, it would give him the opportunity to show both Indonesians and the markets a dramatic conversion to orthodoxy.

The problem with this strategy, as subsequent events demonstrate, is that it is a very high stakes game, justifiable only on the basis of considerable technical conviction or perhaps popular support. The more one is tempted to doubt the IMF's technical position the more politically intrusive IMF intervention looks and, as we have seen, the technical case is not cast iron. We are left with genuinely difficult counterfactual questions about the IMF's role.

Part of the debate revolves around the alternative administrative solutions to debt themselves, which we have seen remain contested even after reviewing the empirical evidence in Indonesia: would an administrative approach have worked and what would the international consequences have been? On the other hand those questions cannot be separated from debates about structural reforms.

That is clear from the Fund position which is that, even if we imagine, for a moment, that this alternative approach would have worked to resolve the immediate crisis, Indonesia would in any case have ended up in the same difficulties again sooner or later in the absence of structural reforms (Fischer, 1998b). There are two points here: the first is that the debate is centrally about the consequences of departing from the IMF's vision of a proper market economy (arms length transactions, market discipline, the rule of law and transparency). The second is that, if we accept

the Fund view, the perception of the IMF's role involved suggests that it has a responsibility for *more* than simply crisis resolution.

The first danger of that Fund argument is that, although there is some ambiguity, it can be interpreted to imply that the Fund had deliberately chosen a market-based solution *because* it would exert more pressure for structural reform. If that is (or is perceived to be) the Fund argument, then the notion of conditionality as being about securing crisis resolution as swiftly as possible *without breaching the code of conduct* takes on a far more serious meaning than might initially be apparent. That raises very significant issues about the justification for the IMF's Asian crisis interpretation of what the 'code of conduct' might mean in the context of capital account convertibility.

That is perhaps the most important message from the Indonesian crisis. The gap between the IMF's conception of an acceptable economic system and what existed in pre-crisis Indonesia is particularly great. That is demonstrated in the sheer extent of legal and structural reforms that were eventually included in IMF programmes. If such measures are to be considered as compulsory international obligations, rather than desirable objectives, that has extremely serious implications for any state that aspires to emerging market status, unless of course it already conforms to IMF stipulations.

That emphasizes the weight placed on IMF authority, on its technical and democratic justifications, particularly when, as we have already seen, there are reasons to doubt both kinds of justifications. The technical issues involved are very much those surrounding debates about rent-seeking that I discussed in Chapter 4. How secure is the connection between corruption inefficiency and market confidence in Indonesia? How much account should be taken of political stability?

Politically, the issue is about whether Suharto had any right to govern in Indonesia and how much influence the IMF had on his departure. The IMF official position is that it simply insisted on necessary economic policies and that political events were not of its making. Unofficially, though, the Fund has also been willing to claim some of the credit for Suharto's fall. Given that side to the issue, it is important to explore the potential good governance justifications for Suharto's ouster a little further. First of all, the IMF did not expel Suharto. At most it provided ideological support, technical authority and potential financial incentives for opposition which in the end turned out to result in a political transition. It altered the nature of the strategic choices available to various Indonesian actors but did not actually attack Suharto directly. Suharto was already in political trouble or the IMF could not have removed him and he clearly made some ill-advised strategic choices during the crisis. That does not, however, remove the question of how one should assess the costs and benefits of the actions the IMF *did* take towards supporting the opposition.

That is clearly an extremely complex question. I have already shown that the issues are deeply contested and have reviewed the evidence that is relevant in making a decision, I do not want to do anything further here in the way of providing answers.

What I do want to suggest, though, in keeping with my discussion in Chapter 4, is that there are grounds for arguing that appropriate assessment ought to be made on the basis of a comparison between Suharto's Indonesia and the possible alternatives rather than by comparing Suharto's flawed governance with some unrealistic ideal. That is the essence of the debate about alternative policies.

To be fair to the IMF that was probably very difficult *ex ante* but since debates about IMF reform take place with the benefit of hindsight, it is worth exploring what events after Suharto's fall tell us about the feasibility of transforming Indonesia into a liberal market economy. That will not answer the question of whether or not it was essential to do so but it will help in evaluating what the realistic choices actually were.

That is the task I want to carry out in the next section. Was it merely that IMF policies couldn't be implemented *by Suharto* (which would give support to good governance justifications) or whether there were more fundamental constraints at work? Was non-implementation a matter of insufficient 'political will' as it is sometimes portrayed in Fund accounts or was there simply not enough social support for the IMF programme to carry it through? If so the pragmatic case, at least, for an alternative Fund strategy would be stronger.

Here the reform experience under Habibie and Wahid is likely to be informative. Obviously, the situation had already changed significantly by the time Habibie came to power. The fourth Fund programme provided greater provision for social safety nets and measures directly addressing corporate and bank debt. If anything, that should have made matters easier for subsequent Presidents. In practice, though, implementation has not been entirely satisfactory.

On the other hand, we also need to look at what the realistic prospects for the alternative approach might have been and take seriously the IMF's views on structural issues. Can the need for structural measures really be dismissed?

6.5 Post-Suharto reform and implementation

This section will review the information that is relevant to that choice. Was Suharto's lack of political will the only obstacle to implementation or were there other factors? What kind of political enthusiasm was there for the IMF agenda and which groups were able to offer resistance after the crisis? How easy would a solution based around debt restructuring have been and what might the resulting political economy have looked like?

6.5.1 Populism and post-Suharto presidential policy

Protests against Suharto made it clear that there is popular enthusiasm for the drive against corruption and arbitrary authority in Indonesia.

Post-Suharto politics, though, suggested that it is often allied with populist economic nationalism rather than with the kind of preferences for rationalist economic efficiency that the IMF supports. The alliance between political reform and economic liberalism is loose and fragile (Robison, 2001).

Habibie

Whatever Habibie's personal inclinations (and past performance suggests that they were not towards a pure free market), political realities required that he present himself as a reformer and some progress was made on the programme during his premiership. However, he was also in a very precarious political position, widely seen as representing continuity with the old regime and with tenuous political legitimacy having been handed the presidency by Suharto. His primary aim, therefore, was to consolidate his political power.

The chosen method seems to have been through moderate appeals to populism spearheaded by Minister for Cooperatives and SMEs Adi Sasono. That should not perhaps be too surprising given Habibie's support base in ICMI and the tendencies towards economic nationalism evident within the organisation before the crisis. Sasono made very public calls for a people's economy (*Ekonomi rakyat*) by which he meant a system of special preferences for small (i.e. *pribumi*) business and cooperatives. A variety of measures were proposed: extra credit provided by Bank Rakyat Indonesia; a public venture capital fund for SMEs, greater involvement of coops in forestry and food distribution, and at his most extreme the transfer of IBRA's acquired assets (most of the Indonesian banking system) to *pribumi* entrepreneurs and small businesses. The appeal of this sort of programme to the public, traditional Golkar supporters and Habibie's newer radical Muslim allies should be obvious.

In the event the worst excesses of populist policy were restrained through a combination of IMF pressure and Habibie's concerns for a broader economic recovery. Nonetheless, populist issues triggered significant debate in the Jakarta Post and resurfaced during the election campaign in 1999.

Megawati and Wahid

Economic policy was not at the top of the agenda in the election campaign (Linnan, 1999b), suggesting that the IMF programme's popular appeal lay in its attacks on big business and corruption rather than in its economic rationality.

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

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

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

Even when Wahid (who has been a long term opponent of confessionalisation of politics) had taken power²³, he said that he was happy with the broad thrust of the IMF programme but that he wanted to see more attention paid to the agricultural sector and the poor, something which Neiss quickly said he could accommodate (*JP* 5th August 1999).

Indonesian leaders seem to have been content to go along with IMF policies since the economy was not the central issue in post-Suharto Indonesia. On the other hand there is less reason to believe that the IMF reform programme was top of the agenda or something that they were particularly keen to press forward²⁴.

6.5.2 Bank and corporate sector restructuring

Once the exchange rate had begun to stabilise somewhat the most important issue in recovery involved restructuring the corporate and banking sectors.

Banking

Banking sector restructuring was completely delegated to IBRA. IBRA was responsible for: overseeing audits of all commercial banks in Indonesia; deciding which were to be closed, merged or taken over; taking on non-performing assets and the assets of closed banks and maximising possible returns; recovering sums lent under BI's LLR operations; and overseeing payments under the governments' guarantee of the banking system announced in January 1998 (Enoch et al., 2001).

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

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

²³ See (Meitzner, 2000).

²⁴ Space does not permit full justification on this point. Particularly during Wahid's presidency the IMF was evidently disappointed with progress and the Fund programmes tended to be subordinated to other issues, particularly political stability and the threat of secessionist movements.

Early problems under Suharto should not be particularly surprising given previous discussion. So, IBRA's first head was rapidly removed apparently for being too diligent. IBRA's first bank takeovers were also undermined by Suharto's insistence that they remain secret, undermining IBRA officials' authority and preventing any significant changes in bank management (Haggard, 2000).

However, difficulties continued under Habibie. Most startling was the Bank Bali scandal. It emerged that difficulties in obtaining payments under the government's guarantee had enabled well connected officials to act as 'facilitators'. They took a commission for ensuring that payments were made quickly. The company involved in the Bank Bali scandal was run by Golkar heavyweights and there were widespread reports that its commissions were being used to finance Habibie's election campaign (Enoch et al., 2001; Haggard, 2000; Hamilton-Hart, 2000).

There were other more shadowy problems, though, that also suggested high-level interference in the restructuring process. There was a very long gap between the audit process and announcements of banks' fate (Haggard, 2000). At one point Habibie announced, without IBRA consultation, that particular banks would be first to receive recapitalisation, including Bank Lippo owned by the Riady family who were close Habibie allies (Hamilton-Hart, 2000). There were also delays fuelled by concern over recapitalising 'Chinese' Bank Central Asia and by Sasono's attempts to allow *pribumi* preference to affect the process of asset recovery and disposal. More generally Habibie's Financial Sector Action Committee was able to exert more political influence over the operations of a supposedly independent institution than the IMF felt comfortable with (Enoch et al., 2001).

In addition to these difficulties with political interference and outright corruption, which demonstrated the continuing direct influence of the established Indonesian conglomerates, IBRA's involvement in debt recovery ran into some of the broader institutional obstacles that also undermined the broader corporate restructuring process.

Corporate restructuring

The government, perhaps under IMF instruction, had been reluctant to become involved in corporate and banking sector bailouts from the start (Enoch et al., 2001; Hamilton-Hart, 2000). The banking sector guarantee eventually became inevitable but the government remained aloof from corporate sector issues.

It did develop the Jakarta Initiative Task Force (JITF), which was supposed to provide advice and a framework for debtor-creditor negotiations. It also introduced INDRA to guarantee corporate debts against further exchange rate shifts (following the *Fiorra* model used in Mexico). However, the INDRA guarantee offered little protection as it was introduced after the currency had hit its low point. The JITF offered few incentives for restructuring and no guidance on what appropriate deals might look like (Radelet & Woo, 2000).

The situation was made more difficult by the inadequacy of Indonesian bankruptcy law. In the five years before the crisis only 120 companies had been declared bankrupt and the government

admitted that both Indonesian and foreign creditors had no confidence in it. A new bankruptcy law was introduced but the courts proved unable to implement it.

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

Linnan suggests that this was partly because there was a feeling that bankruptcy law was designed to favour foreign creditors at the expense of Indonesia debtors (Linnan, 1999a). It was also noticeable, though, that bankruptcy petitions were more likely to be successful against smaller rather than larger companies and corruption cannot be ruled out. Indeed the crisis revealed a greater crisis of confidence in the Indonesian legal system. IBRA's lack of success in obtaining bankruptcy petitions resulted in the appointment of a number of 'ad hoc' judges from business and academia to hear bankruptcy cases. When the House of Representatives reviewed Supreme Court judges, only 17/46 judges passed its 'fit and proper' test. Apparently many failed because they would only accept 'gifts' after they had delivered their verdicts (JP 26th July 2000, Economist Intelligence Unit, 2000a)²⁵

In the absence of a credible legal solution, it was particularly difficult for creditors to conduct effective negotiations. Such negotiations usually take place 'in the shadow of the law' but there were no legal decisions to provide guidance. In any case both creditors and debtors had incentives to avoid negotiations. 38% of Indonesian corporate debt was owed to Japanese banks (Radelet & Woo, 2000) who were not in a position to acknowledge debt write downs. Corporate managers either hoped that time would rehabilitate asset values or, having already lost all their equity, had few incentives for anything other than corporate plunder (Linnan, 1999b).

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

Overall, the process suggests that the future of the Indonesian economy remained the object of political struggle. The political and legal system was not able to keep the power of the conglomerates wholly in check. In any case, at least under Habibie, it was by no means clear that political action was directed at creating an IMF style liberal market economy. Finally, even given the political will, the legal system was not up to supporting the barrage of legislation introduced in the course of the crisis. We have seen how this affected bankruptcy and debt restructuring but it was also a far wider problem (Lindsey, 2000; Siedjipto, 2000). At the same time the sheer difficulty of dealing with the debt problem casts some doubt on any sanguine view of the prospects for the

²⁵ For a review of difficulties with the Indonesian legal system and its implications for post crisis law reform see (Lindsey, 2000).

critics' approach to crisis. On the other hand an earlier solution to the debt problem might have prevented the crisis from becoming so severe.

6.5.3 Social safety nets

Finally, the development of social safety nets in the aftermath of the crisis was also difficult. The government was not accustomed to this sort of operation. It had limited figures on the exact nature of the problem²⁶ making targeting very difficult. There was also no infrastructure suitable for dealing with the distribution of social funds.

Local government would normally have been the correct choice but Golkar's power structures extended down to the village level and there were serious doubts about the diversion of Funds for political purposes. The most visible contribution of Indonesian NGOs during the crisis was to draw attention to these difficulties and ask whether Funds were being diverted for political purposes. This was particularly obvious under Habibie, when calls for *reformasi* had spread throughout the country, placing particular demands on local government.

In the end, the World Bank felt compelled to stop funding the social safety net programme around the elections for fear that its already damaged reputation²⁷ would suffer further through allegations of political favouritism.

Here again, we see the difficult issues raised by the need to work through a less than ideal state structure. Problems in implementing social safety nets are also important in wider discussions about the way in which IMF programmes are legitimated and the possibilities that might have been available to avoid political meltdown in Indonesia. The difficulties with the social safety net programme suggest that, although it is possible to argue that the Fund paid insufficient attention to these issues before Suharto's fall (there was a marked change of emphasis afterwards), it is not clear that greater effort would have prevented serious social problems

6.5.4 Conclusions: the case for an alternative strategy

The point of this section was to provide some indications of how the Indonesian crisis might have turned out differently. Were Suharto's personal failings at the root of things or were broader factors at work? What does that say about the IMF programmes and about the alternative approach (some form of administrative solution with a more pragmatic approach to structural reform).

In fact the indications are very mixed. Indonesian leaders do not seem to have been radically opposed to the IMF's preferences but they were also not enthusiastic supporters. That was very damaging to prospects for the kinds of radical reform the IMF was seeking. Fund influence itself was used to limit later corruption.

²⁶ There was some indication that figures were, in any case, produced with political purposes in mind. In the early stages of the crisis estimates suggested catastrophic consequence which later failed to materialise, on both points see (Booth, 2000).

²⁷ Bank documents acknowledging the extent to which its Funds had been diverted in Indonesia over a long period of time came to light during the crisis, causing the bank much political embarrassment.

the IMF has been able to force the government to withdraw policies that do not conform to the overall programme, by withholding the disbursement of funds...curiously enough such IMF actions have not been criticized by the public. In fact, its actions were supported by the public and the media as well as by the leaders of the reformist parties. (Soesastro 2000, 138)

Some real progress was made and inroads were made into the power of the old Indonesian business families that were unthinkable under Suharto (Robison, 2001) but ultimately there was not enough political support for the IMF agenda to press through such radical reforms. Particular processes could be monitored by the Fund but overall:

although the conditions attached to the use of IMF funds have provided reformers with a considerable source of leverage, the reform process has done virtually nothing to improve financial governance even though the reforms have brought changes to the law and upgraded the technical qualifications of those administering it (Hamilton-Hart 2000,109).

That suggests that, if complete structural reforms were required to restore market confidence, that confidence would not have been forthcoming over even the medium-term. What about the alternative approach then? The evidence also undermines that view to some extent. Much of the debt in Indonesia was corporate debt involving complex and diffuse relationships between a large number of debtors and their creditors. The prospects for a *corporate* debt workout organised through the IMF were slim, particularly given the position of Japanese banks. The sheer scale of governance problems revealed in Indonesia also raises questions about how easily one can write off the structural reform agenda as unnecessary.

There are two obvious conclusions. The first is that international investment in Indonesia before the crisis was certainly not taking place on the basis of any 'normal' (in IMF terms) risk assessment procedures. Market discipline does not seem to work except through occasional bouts of violent punishment. The second is that smooth crisis *resolution* would involve making very difficult pragmatic choices. The Fund's principled stand was a very drastic solution and highly unrealistic in causal terms. On the other hand, available compromises would all have been unsatisfactory to some extent making them difficult to justify on the kinds of impersonal technical or legal principle that the Fund has previously claimed to maintain.

6.6 Conclusions

Indonesia

The economic evidence is again inconclusive. As in Korea, market confidence did not materialise quickly. Corruption clearly was a problem in Indonesia but its relationship to crisis causation remains unproven. A good case can be made that governance issues contributed to political instability and therefore impeded recovery from December 1997 onwards. There is a question, though, about the extent to which the IMF *created* anxiety about governance by (incorrectly) pointing to the influence of corruption in Indonesia's difficulties. Was the collapse of confidence in the political system that seemed to have taken hold by December partly of the Fund's own making?

If we do accept that corruption was an issue, there are difficult pragmatic questions about how much of an issue it was. In terms of broader debates about the IMF governance agenda it is also still possible to debate the extent to which corruption was fuelled rather than reduced by 1980s efforts at economic liberalisation in the context of a political system where the rule of law was weak at best. If getting the state out of the market will not resolve the problem it is harder to see what the technical solution should be.

In other words, in Korea there were technical doubts about whether state-government relationships were the problem. In Indonesia there is less doubt that corruption was harmful but more room for doubt about the technical fix approach that the IMF hoped would resolve corruption problems.

The possibility that a more administrative solution to the debt problem would have been more effective, reducing the importance of structural reforms is also raised in Indonesia by the relative success of the government guarantee in stabilising the exchange rate. However, administrative solutions would have been difficult in the Indonesian context because of the diffuse nature of the debt owed by a variety of different corporate groups and the importance of Japanese banks as creditors.

It is probably fair to say that, at least from an IMF perspective centred on a wish to resolve the crisis through market-based means and a conviction that patronage was responsible for Indonesia's problems, the situation in Indonesia involved far more difficult political choices than that in Korea. That was principally because the gap between the Indonesian system of political economy and a system that the IMF would regard as safe for capital flows was so wide.

At one level that simply serves to further underline the *political* aspect of IMF interventions. The political context of industrialisation in Indonesia and Korea was very different to that of 18th century Europe or America. In both Asian countries the business class was essentially a creation of the state. If in England or the United States liberal values were promoted by civil society itself in the form of a bourgeoisie rebelling against a more economically backward political order, in late 20th century Asia challenging the authoritarian state would also require challenging the most powerful economic interests in the country. The separation between the technical prerequisites for industrialisation and liberal political preferences is more obvious. To create a liberal economy in Asia would require a considerable degree of creative destruction orchestrated by the state itself. Something that Kim Dae-jung (unlike the IMF) seems to have understood.

In Korea a non-*chaebol* owning middle-class of small business managers and professionals had already become far more powerful and assertive over the 1990s and was in a position to press its interests through Korea elections. That was simply not the case in Indonesia. The political task confronting the Fund was therefore far more challenging.

What were the difficulties the Fund encountered in trying to meet that political challenge? How helpful were good governance and civil society engagement in that context?

Firstly, the Indonesian case makes it very clear that it is still states that must implement IMF policies. Public protest can go some way towards giving them further incentives to follow IMF advice but, at the end of the day, such pressure has its limits. States must be the ones to legislate and control macroeconomic policy. Even implementing social safety nets, though, is impossible where the relevant state infrastructure is not in place. Lack of state support therefore puts the IMF in a very difficult position. The comparison with Kim Dae-jung's assistance in Korea is instructive.

Even within the state, though, there are potential problems. In this case the relationship between Suharto and the technocrats was evidently difficult. He seems to have placed total faith in them on the first programme and to have lost all faith in them by the second. The Indonesian situation is unusual but it does point to the gap between agreement with the technical financial arms of government and sovereign consent, which seem to be a common issue in IMF negotiations.

In terms of domestic opposition or support for the programmes, Suharto was providing little assistance and to that extent the relationship between the IMF and civil society was important. However, all the Fund could do was put pressure on Suharto from below by providing programmes that appealed to popular sentiment. If Suharto chose to ignore that pressure the Fund was largely powerless.

In any case it is not possible to negotiate with 'civil society' as a whole. Someone has to be responsibly for converting civil society preferences into an appropriate programme in some way. They have to choose which messages from civil society are to be taken seriously. That is normally the purpose of politics and government. One way of seeing that, perhaps, is to observe the way post crisis experience suggested that there was clear popular support for some aspects of the IMF programme but not for others. There was support for attacks on corruption and cronyism but not for a wholesale reworking of Indonesian society on the basis of liberal norms. If anything there was greater support for a populist, economic nationalist agenda in which a form of state intervention favouring big business would be replaced with a more 'democratic' form of state intervention to help the poor. Arguments about civil society then, can conceal the way in which some choices need to be made about which civil society views are important and which groups are to be listened to.

In the absence of a state-civil society relationship in Indonesia that the Fund could build on, it will have been difficult for the Fund to judge the kinds of policies that it would be politically possible to implement in Indonesia. It is perhaps unsurprising, then, that a lot of (at least reasonably) technically competent legislation was passed without a great deal of implementation on the ground. The lack of social support in Indonesia for the Fund's liberal agenda is another important factor in preventing implementation.

That analysis points to the genuinely difficult dilemmas the IMF faced in Indonesia. If state assistance was likely to be essential but Suharto could not be expected to cooperate what choices were actually open to the Fund? The principle alternatives were either not to lend at all or to adopt

a more pragmatic solution to Indonesia's problems based on greater acceptance of the political realities on the ground.

Not lending was politically problematic given the increasingly systemic nature of the Asian crisis. The risks of contagion were very severe and the social consequences for ordinary Indonesians would be politically difficult to ignore.

What might a more pragmatic solution have looked like? That, of course, depends on one's views about the necessity of the structural reform agenda. It is at least possible to argue, on the basis that the Fund agenda involved a certain amount of overkill, that a strategy directed at civil society which was inevitably going to create animosity from the Indonesian state was politically doomed to failure. The Fund's choice to adopt an approach along the lines of the third vision I set out in Chapter four was unlikely to be wise from the point of view of implementation, particularly when, as I argued above, it was not entirely clear that the claim to speak on behalf of civil society was wholly convincing.

The Fund was claiming to implement a strategy that followed the wishes of both civil society *and* the financial markets even if it was rejected by the state but in fact both claims were open to some doubt. I have discussed division within civil society already. Even that market-based part of IMF authority though was open to the charge that the Fund was in fact respecting the will of its major shareholders as much as the markets. If state assistance is vital for implementation, one conclusion that could be drawn is that a more pragmatic approach with more limited structural reforms, perhaps supported by an administrative solution to the debt issue may have had a better chance of success by being more accommodating to the Indonesian state.

The principle problem with that path is that it would have involved making very explicit concessions to Indonesian political conditions. That would be problematic for the IMF's broader claims to technical legitimacy and equal treatment – it would set a precedent that acknowledged that the IMF's good governance agenda was *not* technically essential. Once technical authority was compromised, it would be clear that decisions about the kinds of political compromise that needed to be made were very much political decisions. For the reasons I discussed in Chapters 2 and 3 the Fund's claims to that kind of political authority are distinctly limited. In any case, as we will see in Chapter 8, politically, once governance issues had been raised it would have been very difficult to deal with the crisis in that way since Congress would have seen that kind of intervention as a clear case of bailing out a dictator with public money.

Indonesia suggests a number of difficulties then for the Fund's new agenda where the country in which it is to be implemented differs significantly from the economic models on which Fund reasoning is based. If the state is opposed to a programme the chances of implementation are poor. There is little point in agreeing a perfect programme that stands little chance of implementation.

The question then is whether it is better to press for political change through civil society engagement or to be more accommodating to the state in the hope of securing implementation of a

'second best' programme. That suggests that very political choices are being made: ultimately that comes down to the argument I was making about the nature of the Fund's governance agenda and the concept of rent-seeking. A comparison of a rent-seeking society with an economic ideal is easy to make. Comparing it with a system of political economy that there is a realistic chance of introducing is far more difficult and harder to see in purely technical terms but, if the IMF's new agenda is to continue, it is a choice that it will be difficult for the Fund to avoid.

The alternative, of course, is a radical change in the Fund's agenda involving an acceptance of greater political limits to market discipline – something I will discuss further in Chapter 9.

The crisis country case studies

Where do those conclusions and the conclusions from the Korean chapter leave us in terms of the questions I set out at the end of Chapter Four?

The economic evidence is not wholly compelling either way. It is clear that the IMF's market confidence strategy was not particularly successful but it is still possible, at least, for the Fund to argue that non-implementation was at the root of the difficulties. How necessary the structural aspects of the Fund programmes actually were remains hotly disputed. Politically, there was some support amongst sections of the elite in each country for the Fund's technical agenda but that support was stronger and deeper in Korea than it was in Indonesia.

On the basis of the case studies, though, it is very difficult to ignore the political implications of the Fund's new agenda. At one level, given the technical controversy, the Fund's strongest arguments for its interventions in Asia are in fact political ones about the authoritarian and corrupt nature of Asian states. That was certainly the aspect of Fund policy that was easiest to sell to broader society in both countries and it is difficult to object to the statement that the swiftest recovery took place in the country with the 'best' governance.

At another level, though, it is also clear that it was only *part* of the Fund's agenda that was popular. Nationalist resistance to fire-sales in Korea and the rise of populist policies in Indonesia suggest that there was also a strong desire to retain some kinds of political management over economic affairs. The Fund was not only dismantling one kind of institutional arrangement (designed to facilitate various kinds of intervention in the market), it was also attempting to create another kind whose democratic (if not technocratic) credentials were also limited.

In terms of the multi-level relationships involved the appropriate conclusion is that the Fund's technical market-based agenda, dictated largely by its principal shareholders but with some support from financial bureaucrats in developing countries remains firmly in charge. The Fund is then willing to cooperate with whichever political groups are most sympathetic to that agenda. Seen in that light, civil society and good governance have some role to play in legitimating Fund programmes but flexibility is distinctly limited by the overall institutional framework within which consultation takes place. That inevitably means that the scope for enhancing Fund legitimacy through greater civil society engagement will also be limited. The realistic prospects for

implementing the Fund's new agenda are therefore questionable where the requisite social conditions are not in place.

In Korea they were in place and the elected Korean government supported programme implementation. There was some political resistance but the programme was broadly successful. In Indonesia, the IMF was left with very difficult choices and the programme was largely a failure.

Even in Korea, though, the *ad hoc* and uninstitutionalised nature of the relationships surrounding Fund negotiations left considerable room for doubt about who was 'really' in charge. The lack of institutional reassurances provided by the system of programme negotiation meant that it was possible for domestic political actors to portray the programme as imposed even when (at least if the Fund is to be believed) large parts of it were not in fact – sending worrying signals about the contribution IMF decision-making systems make to Fund legitimacy.

There are a wide range of conclusions that might be drawn from all this depending on one's interpretation of often deeply contested technical and political issues. Perhaps the best way to illustrate that is to set out two extreme positions that tend to call attention to each other's weaknesses.

At one extreme, from a critical perspective, the suspicion is that the structural reform agenda was either: never really necessary in the first place; only in fact necessary in the context of a commitment to free capital flows and market-based solutions to financial crisis; or even only necessary in the eyes of the Fund's leading shareholders who have an interest in market opening in Asia. There is considerable technical doubt about those issues and the Fund's institutional structures, biased toward creditor and investor countries, provide little additional reason for confidence. That is particularly important where technical performance was poor. Engagement with civil society sounds like a good idea but, in a context of a pre-fixed Fund agenda, looks more like an attempt to harness domestic political resources to the cause of securing implementation of the Fund's agenda. In Korea that may have largely corresponded with popular wishes but there is no guarantee that the Fund's agenda would have been any different if it had not. For onlooker developing countries, then, it may send dangerous messages despite successful performance.

At the other extreme, it is possible to conclude that Asian country governments should have been under greater political pressure to implement the 'right' policies. In Korea, Kim Dae-jung was doing his best and the results were positive. In Indonesia Suharto's self-interested political agenda disrupted implementation and market confidence and created politically uncertainty that was deeply damaging to ordinary Indonesians. The IMF's solution is therefore a stronger framework of peer pressure in favour of the 'right' policies in normal times to prevent crises and a continuing insistence on existing Fund policies.

I have explored the evidence and arguments behind these different positions in some depth now. Of course what matters for Fund political legitimacy is the lessons that were in fact drawn by key political actors in other countries less directly affected by the crisis and the extent to which those

conclusions led to effective political challenges to Fund authority. It is those questions we will address in the next two case studies.

7 Malaysia

The crisis country case studies reviewed in Chapters 5 & 6 provide valuable information about the circumstances in which it will be possible to implement an IMF programme and about the political nature of IMF interventions. They also suggest arguments that could be raised challenging IMF legitimacy but leave open the issue of the ways in which those arguments were in fact raised and of factors affecting their credibility.

The Malaysian case is important because Malaysia suffered a similar crisis to Indonesia and Korea but ultimately adopted a very different method of crisis resolution: capital controls rather than an IMF-style market based approach. Malaysia's alternative strategy for crisis resolution therefore has the potential to shed further light on the issues raised by the previous two chapters. Was the Malaysian approach effective? Could the Malaysian solution have been adopted in other countries? Does it offer a viable economic alternative to the IMF's market based approach? What were the political determinants of the Malaysian approach and what were the political consequences?

However, ultimately more significant than the existence of arguments that *could* threaten IMF legitimacy is the extent to which these arguments actually *are* raised in practice. Who raises them, and how much political support can they expect to receive? That is the second way in which the Malaysian case is instructive. Mahathir and other Malaysian leaders were in fact highly critical of IMF intervention elsewhere in Asia and raised criticisms at Board of Governors' meetings and in other international fora. Two questions follow: what part did perceptions of Fund programmes elsewhere play in triggering or justifying the resulting dissent; and how credible were the criticisms raised to other actors within the IMF?

The second question can only finally be answered in Chapter 9 but both questions raise issues that will be discussed in this chapter. The credibility of Mahathir's position will partly be bound up with

the apparent reasons for his dissent. Those reasons will also help us to understand the significance of the other Fund programmes within a Malaysian context.

The main purpose of this chapter, then, is to understand why Malaysia ultimately opted for a different method of crisis resolution: what the politics of that decision were. That will give us further insight into the politics of the new conditionality. It will suggest what is likely to drive dissent to the IMF agenda, provide a basis for assessing how widespread that dissent may be, and indicate the implications of dissent for IMF legitimacy and IMF reform.

7.1 The state and development in Malaysia

Officially, state intervention in the Malaysian economy was predominantly concerned with advancing the economic prospects of the indigenous Malays (known as *bumiputera* or sons of the soil¹) relative to the more prosperous Chinese population in the interests of national unity. This system, like those in Indonesia and Korea, underwent significant change with liberalisation in the 1980s. By the time of the crisis, there were growing questions about the extent to which it had degenerated into mere patronage in support of authoritarian politics but the issue remained unresolved.

It is an important one though because key issues in the international and domestic debates surrounding the capital controls revolve around their relationship to policies of ethnic redistribution and to Mahathir's authoritarianism. We therefore need to understand the historical relationships between ethnicity, politics and the economy in Malaysia before we can understand the significance of crisis debates.

Post-independence Malaysian politics has been dominated by a coalition of ethnically based political parties under the leadership of the United Malays National Organisation (UMNO).

Prior to independence, slightly less than 50% of the Malaysian population were *bumiputera* with the remaining 50% made up of the families of those encouraged by the British to emigrate to Malaysia primarily from China (37%) and India (12%) (Ratnam, 1965, 2)². There was little integration between ethnic groups. The Chinese were originally involved in urban-based tin mines, Indians in self-contained plantations and most Malays engaged in peasant agriculture.

By independence in 1957, only one in five city dwellers was a Malay, and most of those were employed by the government (Ratnam, 1965). The Chinese, on the other hand, had branched out into a range of activities with particular dominance in small to medium scale trade. The working class was also predominantly non-Malay. In terms of capital ownership, European companies controlled 60% of Malaysian output while the remaining 40% was almost wholly in Chinese hands. Europeans owned 83% of the lucrative rubber plantations with 14% of the rest owned by the

¹As with many such ethnic designations, in practice (particularly since Sabah and Sarawak were incorporated into Malaysia) a number of groups with different genetic and historical origins are included in the term *bumiputera*.

²In 1996 these figures had become 61%, 30% and 8% respectively (Gomez & Jomo, 1999).

Chinese (Putuchear, 1960, xiv-xvi; Yeoh, 1987 cited in Gomez & Jomo, 1999). The only area where the pattern was reversed was in the higher reaches of the bureaucracy which were an essentially Malay preserve since the British regarded the Malays as the legitimate rulers of the country (Roff, 1967, Ch4).

Politically there was a strong Malay elite with little popular political mobilisation. UMNO was very much a product of this political and economic vulnerability. It was formed by Malay aristocrats in 1946 in opposition to early British proposals for a Malay Union. Key concerns were that the plan involved the grant of citizenship to all permanent residents (including non-Malays) and that it would undermine the position of the traditional Malay Sultanate. Though initially an elite-led party, UMNO soon gained popular support for its Malay nationalism. However, despite its likely electoral dominance³, UMNO's economic weakness and British concerns over handing over power to a single communal based party meant it would be unable to govern alone.

The solution was an alliance with the Malayan Chinese Association (MCA). The British had encouraged Chinese business leaders to form the MCA in 1949 in an attempt to undermine Chinese support for the Malayan Communist Party (which was later banned). It was fundamentally a bourgeois party interested in protecting Chinese business interests. In crude terms, a bargain was struck in which Malays would dominate politics in exchange for an agreement that Chinese business would not be undermined by the state. A third party, the Malayan Indian Congress (MIC) also joined the Alliance when it became clear that, given the limited popularity of a multi-ethnic platform, its multi-ethnic aspirations would be best served by joining a coalition.

Ethnic Tensions

The Alliance government, elected in 1955, instituted a number of measures to advance Malay interests. Scholarships and educational grants were set up. Positive discrimination was practised in public service employment and the award of various licences and permits. Two public enterprises were established to assist with rural development. Some measures were introduced to promote import-substituting industrialisation, particularly tariff protection under the Pioneer Industries Ordinance of 1958. However, in keeping with the bargain struck between UMNO and the MCA and with previous British policy, the government ran a largely laissez-faire open economy. Much of the benefit of tariff protection accrued to foreign companies and this may have been partly the result of Malay fears that Chinese capital would benefit from a greater stress on domestically owned industry (Gomez & Jomo, 1999).

There was significant economic growth during this period but it resulted in increasing intra-ethnic inequality. The income of the top 10% of the population increased by 51% while that of the lowest 40% declined by 13% (Snodgrass, 1980). There was growing dissatisfaction in all ethnic groups that the parties they expected to fight for their interests were failing to do so. The MCA and MIC were seen as successful at granting patronage in the form of Malay political support to well-to-do members of the Indian and Chinese communities while neglecting poorer non-Malays. UMNO, on

³Once the citizenship issue had been conceded, the Malay population formed 80% of the electorate (Ness, 1967).

the other hand, was not pursuing its redistributive goals fast enough to satisfy the Malay community. The (temporary) incorporation of Singapore and the need to review the use of English as the official language 10 years after independence increased the tensions.

In the 1969 election both non-Malay opposition (particularly Gerakan and the DAP (Democratic Action Party)) and the Muslim Malay PAS (Parti Islam Se-Malaysia) made significant gains. The jubilant celebrations of DAP and Gerakan supporters triggered racial riots in which at least 196 people were killed⁴.

The New Economic Policy

The government response was two-fold. The Alliance was broadened to include some of the opposition parties including Gerakan and the PAS and was re-named the Barisan Nasional (National Front). The UMNO-led Barisan Nasional has governed ever since. Secondly, the new Barisan Nasional government adopted the New Economic Policy (NEP) designed to “reduce and eventually eradicate poverty, by raising income levels and increasing opportunities for all Malaysians, irrespective of race” and “accelerat[e] the process of restructuring Malaysian society to correct economic imbalance, so as to reduce and eventually eliminate the identification of race with economic function”. More specifically the government set three targets to be achieved by 1990: a reduction of poverty from 50% to less than 20%; restructuring of employment so that, in all sectors and occupations, it reflected the racial composition of the country; and restructuring of corporate ownership so that at least 30% would be owned by *bumiputeras* (Malaysia, 1976).

In terms of policy influence, the second and particularly third targets were most significant⁵ and resulted in a large increase in state intervention in the economy. This included increased provision of infrastructure, the growth of state development corporations (particularly Petronas the state oil company), and state owned corporations (including HICOM - the Heavy Industries Corporation of Malaysia). A number of ‘*bumiputera* trust agencies’ were set up to hold shares managed by the state on behalf of the indigenous population. These were intended to: act as a form of forced savings scheme to accumulate capital for *bumiputeras*; spawn new economic projects in strategic sectors which could be divested to *bumiputeras*; and create human resource and technology spill-overs into the wider economy (Gomez & Jomo, 1999, 32). Discretionary dual pricing of shares also allowed some *bumiputeras* to acquire shares at par value or at a nominal premium. Finally the Industrial Coordination Act (ICA) of 1975 provided for a compulsory *bumiputera* quota of 30% ownership for all non-exempt companies (the most noticeable exemption being export-oriented companies, and therefore most of the foreign companies operating in Malaysia).

⁴Official figures probably underestimate the number of Chinese killed (Crouch, 1996).

⁵Though the poverty target has been broadly met, observers argue that this is not the result of particular government efforts (Gomez & Jomo, 1999; Jomo, 1989) The OPP2, published in 1991 suggests that the Gini coefficient in Malaysia declined from 0.513 in 1970 to 0.445 in 1990 but Gomez & Jomo point out that the report doesn’t show that this was the result of government intervention. In fact official data suggest that the greatest reduction in inequality took place during the 1984-1987 recession. Hal Hill suggests that similar reductions in inequality may be taking place during the current crisis at least in Indonesia as urban middle-class occupations are worst hit (Hill, 1999).

The resulting provision of infrastructure combined with tight labour regulation, tax incentives, partial exemptions from *bumiputera* shareholding requirements and the creation of free trade zones encouraged the move to foreign-financed export-oriented industrialisation (EOI) which had begun in the late 1960s. This move was well timed, with developments in the international division of labour encouraging TNCs to out-source production.

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

Privatisation and liberalisation

It soon became clear that public enterprises were performing poorly and the state was overburdened. At the same time, neo-liberal influences were at their height in the multilateral institutions. Mahathir began to argue that public enterprise had been a temporary vehicle to promote a *bumiputera* property-owning class which should now be weaned from its dependence on the state. Privatisation would accomplish this, ease state budget constraints, and help to foster a new breed of Malay rentier entrepreneurs who would eventually form the basis of an internationally competitive industrial community (Gomez & Jomo, 1999, Chapter 4).

From the mid-1980s, state corporations were sold off, licences were issued to firms to compete in sectors which had been public monopolies and infrastructure projects were contracted out. Many assets held under Malay 'trusteeship' were redistributed to Malay entrepreneurs as a reward for performance and to promote their advancement (Khoo, 1992).

The first half of the 1980s was a time of economic difficulties for Malaysia. The combination of commodity price shocks and the over-extended public sector produced an economic downturn. The government response was a combination of reduced state spending⁶ (of which privatisation was a part) and more general fiscal retrenchment. While this was successful in balancing the national budget, it intensified the recession which reached its low point in 1987. During the downturn, ethnic tension and factionalism within UMNO increased.

In the face of recession the government embarked on further liberalisation including a partial lifting of NEP requirements first for export-orientated foreign capital and later for domestic (Chinese) capital. This coincided with a depreciation of the ringgit which made Malaysia an attractive destination for North East Asian relocation in the wake of the 1985 Plaza Accord (Jomo et al., 1997). The result was an investment surge that revitalised the economy and had a powerful impact on the Kuala Lumpur Stock Exchange (KLSE).

Money Politics and Malaysia Inc.

The growth of state involvement in the economy and the attempt to redistribute wealth to the *bumiputera* community under the NEP also had political consequences. As state economic activity

⁶Development spending was halved between 1983 and 1987 (Khoo, 1992).

increased, there was more scope for the distribution of patronage. Business opportunities were granted to *bumiputera* business people (or simply to politicians) who were expected to reciprocate with political and financial support for UMNO. Those who were successful in business were rewarded further, resulting in some meteoric ascents to positions of wealth and political power⁷. The resulting close relationships between corporate and political power increased the prevalence of money politics 'blurring the distinction between corporate and political power' (Gomez & Jomo, 1999).

The advent of privatisation began to change the nature of state-business relationships. The state withdrew from direct participation in the economy. In its place, large conglomerates sprang up which competed for state infrastructure contracts and licences to enter sectors that had previously been public monopolies (such as utilities and telecommunications).

Since assets were often divested (and contracts awarded) to 'those who come to us with good ideas' as Mahathir put it (Khoo, 2000a, 222), these corporations were still beholden to the state to a greater or lesser degree. At the same time, as they began to represent a larger share of the economy, and as the state became dependent on them to build Malaysian infrastructure, they became increasingly powerful. Given the dominance of FDI in manufacturing for the export sector, there were also concerns that the conglomerates were concentrated in sectors which could benefit from patronage and political connections (manufacture for protected domestic markets, finance, property, resource extraction, telecommunications, etc.) rather than in more 'productive' activities (Gomez & Jomo, 1999; Jesudason, 1989; Jomo et al., 1997).

The situation was further complicated because political parties themselves became involved in business. UMNO set up Fleet Holdings in 1972, which rapidly acquired companies including Renong Bhd, a huge corporation with interests in construction, financial services and the media. In response to UMNO's dominance in the corporate world, and to NEP policies generally, the MCA also became involved in business via a 'corporatization movement'. The clearest manifestation of this was the establishment of Multi-Purpose Holdings Bhd - an investment company owned by an MCA-owned co-operative. It grew phenomenally between 1975 and 1983 but then entered a swift decline amidst scandal in the mid-1980s (Gomez, 1999). UMNO claims to have divested its business interests since 1992 but there is still speculation that key political/business figures such as Daim Zainuddin the ex-finance minister hold shares on trust for UMNO.

It wasn't just that business was penetrated by politics. Increasing amounts of patronage also led to fighting over spoils within UMNO. Gomez & Jomo (1999) argue that UMNO was

increasingly torn between its own financial needs, the ambitions of those ostensibly acting on behalf of the party, and its obligations as 'protector' and 'patron' of Malays desiring to accumulate.

⁷See for example the description of Daim Zainuddin's career in (Gomez & Jomo, 1999, 52-56).

During the post-1985 recession tensions within UMNO came to a head with a tussle for party leadership culminating in the split of 1987. While some commentators have interpreted this as merely a fight over personalities and control of patronage (Shamsul, 1987), others argue that it reflected a response to the changing nature of economic management in the 1980s. Khoo (1992) argues that the rebel party lead by Musa and Razaleigh represented smaller Malay businessmen and middle ranking bureaucrats. These groups stood to lose by the re-orientation of the economy away from state accumulation in favour of the Malays towards a more market-friendly strategy under which patronage was distributed to a narrower group of entrepreneurs through privatisation. In other words there was a growth party (headed by Mahathir) and a redistribution party supporting Musa and Razaleigh (see also (Gomez & Jomo, 1999; Khoo, 2000a)) The growth party was eventually victorious and, with economic recovery, UMNO presented a united front - at least until the onset of the crisis.

From NEP to Wasan 2020

These changes in state-business relationships and moves from redistribution towards growth and from public to private sector industry were accompanied by a gradual change in the official vision of future development. This vision was codified in 1991 in Mahathir's announcement of *Wasan 2020* (Vision 2020) and the publication of the National Development Policy (NDP) and the 2nd Outline Perspective Plan (OPP2) to replace the NEP.

While objective 9 of the 8 major goals of Wasan 2020 is 'an economically just society with inter-ethnic economic parity' the fostering of an 'integrated and harmonious Malaysian nation' heads the list of goals. Milne & Mauzy (1999) argue that the new attitude to ethnic redistribution can be characterised as a shift from concerns with 'quantity' towards concerns with 'quality'. More attention will be paid to the qualifications of *bumiputeras* given special training and focus will be on creating a commercial and industrial community rather than on wealth redistribution per se. The NDP also pays more attention to poverty and intra-ethnic inequality with a particular focus on 'hard-core' poverty.

It also re-emphasises Mahathir's move to more neo-liberal policies in its stress on the role of the family in welfare provision and on the role of the private sector. In terms of the new emphasis on growth, the other central part of Vision 2020 is for Malaysia to achieve developed country status through accelerating industrialisation, growth and modernisation. The extent to which economic practice will change to reflect the new vision is unclear but the vision at least gives an indication of the intended direction of development policy in Malaysia before the crisis.

Groups bypassed by the NEP and Wasan 2020

While the NEP clearly benefited elite Malay business interests, other groups were less fortunate. Both foreign and domestic non-Malay businesses were particularly affected by *bumiputera* ownership and employment quotas imposed under the ICA. The state used its resources to take over large numbers of foreign-owned firms and, with more reluctance for political reasons, some Chinese

corporations. The increasing domination of some economic sectors by state-run business also caused concerns (Jesudason, 1989).

However, Chinese business was politically weak and foreign businesses reluctant to interfere in what they saw as political issues (Jesudason, 1989). They were prevented from uniting due to conflicts of interest. Chinese business leaders hoped (vainly) to steer public enterprises into areas controlled by foreigners (Jesudason, 1989, 128-132) while foreign business benefited from the state's preference for granting pioneer status to foreign rather than Chinese capital as part of its EOI drive.

Rather than seeking political power, the Chinese response tended to be more covert. There was considerable capital flight (estimated by Morgan Guaranty at US\$12 billion (Khoo, 1995)). Chinese businesses also moved into increasingly short-term investments offering quick returns in the non-tradable sector such as property and finance (Jesudason, 1989, 163-4; Yoshihara, 1988). Later, some larger Chinese corporations formed political alliances with influential Malays (Gomez, 1999). This became particularly significant with privatisation in the late 1990s and Mahathir's gradual move from the NEP to *Wasan 2020*.

It is important that, though Chinese political power has always been subordinate to that of the Malays, there are still constraints on the government's promotion of Malay interests. The continuing structural power of Chinese capital could not be ignored. In addition, in periods of political turmoil the BN has still relied on Chinese votes. This was particularly clear in the 1990 elections when Semangat '46 (the offshoot of UMNO which appeared as a result of the split in 1987) was likely to split the Malay vote. Significant concessions were made on long-standing (though often symbolic) Chinese concerns such as greater freedom to visit China and the unbanning of Chinese cultural expression such as lion and dragon dances (Mahathir even attended a lion dance competition). The government also adopted a much more sympathetic tone at least on the difficult question of education⁸ (Crouch, 1996, 124).

The modifications of the NEP in the late 1980s and early 1990s had narrowed the range of *bumiputera* beneficiaries. Reduced state involvement in the economy and the shift towards privatisation had reduced the range of patronage available and the importance of minor civil servants. The stress on big business and patronage through the award of privatisation contracts had reduced opportunities for smaller businesses with less lobbying ability. It had also created conflicts between smaller businesses who acted as sub-contractors to the more politically well-connected firms (Gomez & Jomo, 1999).

As I noted at the beginning of this section, less specific attention was paid to poverty reduction. While poorer Malays as a group had benefited from the NEP through greater chances of social

⁸ There were a number of issues which had been debated for some time. Quotas at Universities, English language education, Mandarin speaking primary school teachers, forced Islamic prayers etc. (Crouch, 1996).

mobility, less had been done for rural communities (though there were considerable advantages in the form of patronage to be had from UMNO support in rural areas)⁹

Electoral Politics

Malaysian politics have been dominated by ethnically based parties since independence. The Barisan Nasional has formed the government in Malaysia since 1969. The description of Malaysian political economy outlined indicates the nature of this alliance. The majority Malay population and the fact that the rural (mostly Malay) electorate has a disproportionate share of the vote has meant that UMNO has always been the strongest partner in the coalition. Government policy has clearly favoured Malays. However, while re-distributive policies have dominated economic management, the need for economic growth (and perhaps for wider government legitimacy) has meant that attacks on non-Malay business have been constrained within grudgingly accepted limits.

The inclusive nature of the BN coalition, along with the continuing importance of communal politics, has made it difficult to mobilise an effective opposition. The obvious base to mount an opposition under these circumstances is to pursue ethnic interests more enthusiastically than the relevant party involved in the BN compromise. So the principal Malay opposition is the Muslim PAS which, before the mid-1980s, based its support on being more Malay nationalist than UMNO. It then moved in a less Malay but more explicitly Islamic direction with the creation of an Islamic state as a key priority¹⁰ but has since retreated from this position slightly in an attempt to broaden its support base. The main 'Chinese' opposition party, the DAP, has pursued more recognisably liberal policies demanding equal treatment irrespective of race - but this can also be seen as pushing Chinese interests more effectively than the MCA.

This has made the task of forming an opposition coalition with sufficiently widespread support to challenge UMNO particularly difficult¹¹. While the DAP and PAS can now both claim to be in favour of equal treatment for different ethnic groups, PAS varying commitment to an Islamic state is a clear disincentive to Chinese voters, particularly since Malay numerical superiority would make the DAP a junior partner in any coalition. The structuring of politics around ethnic issues has also made it difficult to articulate more class-based issues. In particular, labour has been severely controlled and has never played a significant part in politics¹² partly because the labour movement has been fragmented along ethnic lines (Crouch, 1996; Jesudason, 1989)¹³.

⁹ (Crouch, 1996, 39) reviews some of the relevant literature.

¹⁰ This move was partly the result of a younger group of party leaders who entered PAS via the Muslim youth movement (ABIM) set up by Anwar Ibrahim and who began to criticise UMNO's ethnic chauvinism as anti-Islamic. Under their leadership, PAS gained control of the Northern state of Kelantan. Mahathir used this as an opportunity to call their bluff by daring them to introduce Islamic law in the state (Jesudason, 1996). Feeling pushed into a corner they did so - though enforcement of many provisions has been less than enthusiastic - increasing the concerns of non-Muslim Malaysians about PAS' intentions.

¹¹ For a particularly good treatment of this issue see (Jesudason, 1996).

¹² For more details see (Crouch, 1996).

¹³ It is also noteworthy that the MCA has always been a bourgeois party and UMNO's support is split between business and the Malay peasantry - reducing the importance of labour to both major segments of the BN coalition. So Gomez & Jomo (1999) argue that the Barisan Nasional is essentially an elite coalition.

There has been an increasing tendency to use authoritarian means to control dissent. The media are tightly controlled (Milne & Mauzy, 1999). The state has powers under the Internal Security Act to detain without trial. Although these are usually used to diffuse ethnic tension, it is noticeable that those connected with opposition parties have been more likely to be detained (Crouch, 1996).

There are also significant questions over the independence of the judiciary¹⁴. Government media control, already significant at election time, is enhanced by outlawing mass political rallies (which had been the principal avenue through which opposition parties could make their views known in advance of elections).

Nonetheless, as we saw in the last section, the government cannot be wholly unresponsive to threats from opposition parties. Increasing factionalism within UMNO has allowed some views to be articulated that do not correspond with those of Mahathir. However, the overall system can, at best, be described as a semi-democracy.

Summary and conclusions

The Malaysian system of political economy defies simple characterization. There has been considerable state intervention in the economy, but state policy has always been clearly pro-business. Intervention has been primarily motivated by attempts at ethnic redistribution but has also successfully promoted impressive economic growth (albeit less than in some other countries in the region). On the other hand, growth has been uneven, with a foreign-dominated high technology export-oriented sector and a largely separate sector oriented at domestic production and owned principally by domestic capital.

The political system has been formally democratic since independence but one single party has led every government. This has partly been the result of growing authoritarianism and the control that the government has been able to exercise over media, patronage, and the coercive resources of the state. On the other hand, UMNO has also been popular (at least until recently), receiving votes from a wide spectrum of the Malaysian population.

Politics in Malaysia are still primarily ethnic. The government has always involved a broad consociational coalition of ethnic groups, but with UMNO wielding disproportionate influence. This influence has been used pragmatically to keep ethnic discontent within certain boundaries. The ethnic basis of politics has also masked the elitist nature of the ruling coalition with (for example) little place for the representation of labour within government. However, populist rhetoric and an extensive patronage network used to distribute benefits to supporters down to village level has allowed the coalition to maintain broad support.

However, societies are never static and the nature of the Malaysian political economy has its critics. The pervasive presence of patronage and the inefficiencies this has produced in the economy have long been criticised by academics (Gomez & Jomo, 1999), NGOs (particularly Aliran) and

¹⁴ During the UMNO split, a court ruled that, as a result of a legal technicality, UMNO was not a valid legal organisation. This enabled the rebel faction - Semangat '46 - to attempt to seize UMNOs assets in the courts. At this point Mahathir intervened to remove the attorney general in an attempt to ensure a sympathetic hearing.

opposition politicians (notably Lim Kit Siang of the DAP). Some Muslim groups have also argued that ethnic discrimination is un-Islamic. Equally, Mahathir's increasing authoritarianism has not gone unnoticed. Times of economic stress have revealed the extent to which political-economic bargains struck within Malaysian society depend on continuing economic growth. Finally, Vision 2020 demonstrates some gradual moves away from inter-ethnic redistribution and towards a more orthodox liberal political economy, at least at the level of rhetoric.

IMF intervention elsewhere in Asia attacked state involvement in the economy. Debates about crisis resolution in Malaysia were strongly coloured by the policies the IMF had adopted elsewhere so debates over the crisis were about the relationship between redistributive policies, market discipline, and foreign investor sentiment.

7.2 The Crisis in Malaysia

Malaysia, like other countries in the region, showed signs of asset price bubbles by early 1997. Bank Negara (the central bank) responded by restricting lending for property and share purchases in March. This triggered a gradual fall in the Kuala Lumpur stock Exchange (KLSE). By late May, when the Thai Baht was coming under serious attack, analysts in Malaysia and overseas began to question whether other economies in the region including Malaysia might be under threat. At this point, consensus was that Malay property companies were less indebted than their Thai equivalents. Malaysian banks were less dependent on collateral lending to the property market. It was also felt that the Malaysian system was more cohesive¹⁵ and that the government had more control over the economy. The fall in the KLSE was thought to be driven by foreign investors (contagion) who would return when they recognised variations within the region (*FT* 24th May 1997, *New Straits Times (NST)* 19th May 1997).

By late June, concerns were focusing on the trade deficit which was expected to rise further as bank Negara raised interest rates to defend the ringgit (*FT* 21st May 1997). The trade deficit attributed to a loss of competitiveness as full employment drove wages up faster than productivity and other currencies in the region depreciated¹⁶. Finally, on 15th July, the Ringgit was allowed to float.

At this stage, Mahathir was touring Europe to encourage investment in Malaysia's high profile Multimedia Super Corridor project. Anwar Ibrahim, the Deputy Prime Minister, had been left to run the country in his absence. Anwar's response was the orthodox one of supporting raised interest rates while pointing to Malaysia's sound fundamentals and arguing that the problems would be temporary¹⁷ (*NST* 11th July 1997). Mahathir returned at the end of July and began to argue (with

¹⁵ If the going gets rough in Malaysia, the strong are likely to come swiftly to the aid of the weak (*FT* 21 June 1997) - there is some irony in this position given the attention which 'crony capitalism' was to receive later in the crisis.

¹⁶ Presumably this could be expected to have knock on effects on the rest of the economy including in particular the property sector.

¹⁷ A position echoed, at that point, by the Financial Times' editor Martin Wolf (*FT* 15th July 1997)

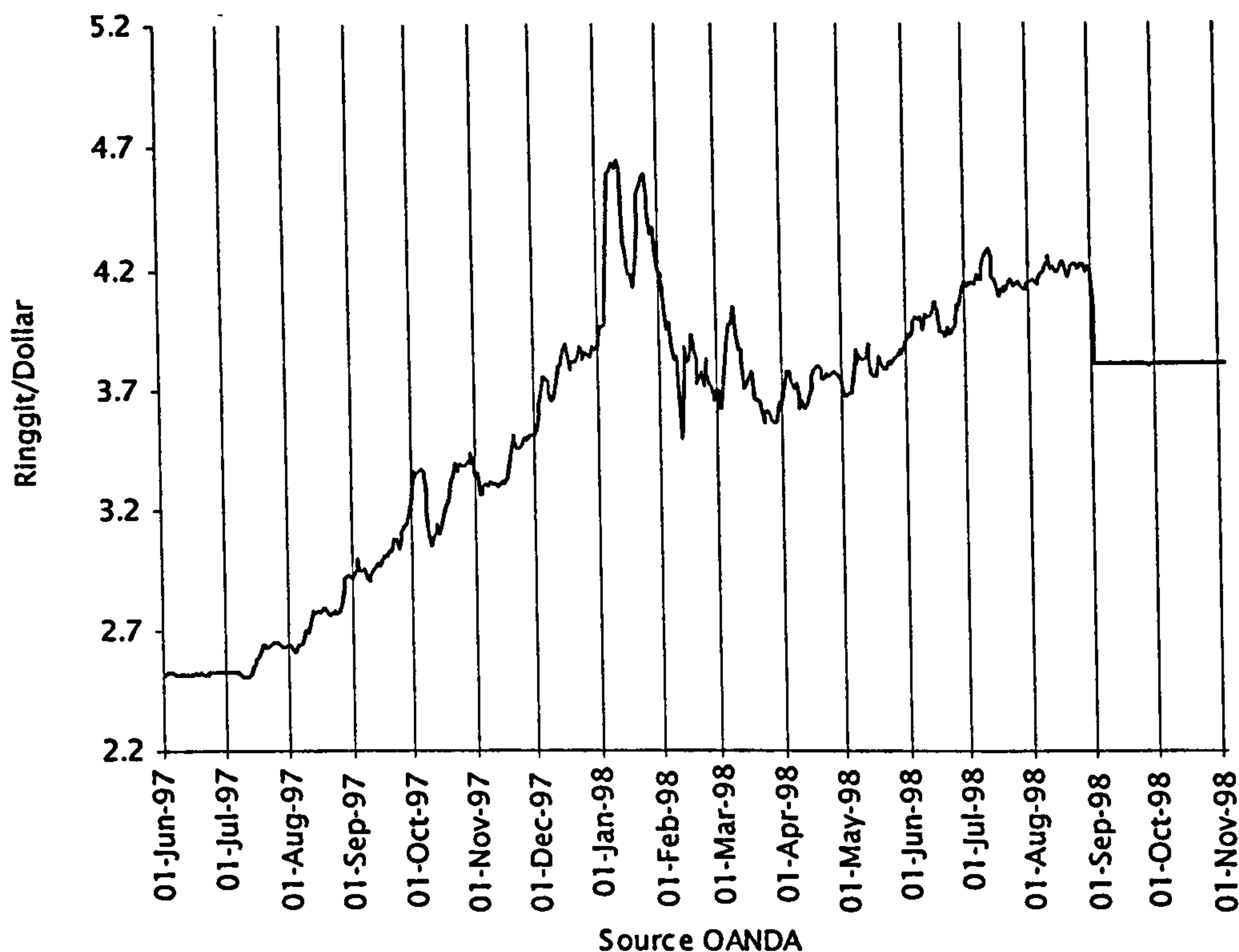


Figure 7-1 Ringgit-dollar exchange rate

less orthodoxy) that the Malaysian economy was suffering from politically motivated speculative attacks by 'a certain powerful American financier'¹⁸ (*NST* 22nd July 1997).

Over the next few months perceptions of a rift between Anwar and Mahathir continued. The principal areas of market concern were: Mahathir's enthusiasm for large infrastructure projects ('mega-projects')¹⁹; Mahathir's continuing insistence that economic difficulties were the result of manipulative speculators rather than any problem with economic fundamentals²⁰; the use of government controlled funds to prop up the KLSE; and unsuccessful attempts to regulate the market so as to prevent speculation.

The first attempt, a restriction on lending ringgit over a certain value to foreigners, was designed to close the swap market in Singapore so that interest rates could be lowered. The result was a rise in value of the ringgit but accompanied by a compensating fall in the stock market (*FT* 5th August 1997). The second involved changing stock market rules to prevent short selling of the 100 most valuable stocks on the KLSE. This was particularly unpopular with the markets, triggering a vitriolic response from analysts who claimed that it demonstrated a lack of commitment to the free

¹⁸Referring, as everyone knew, to George Soros.

¹⁹See for example *NST* 23rd July 1997 *FT* 22nd July 1997 *FT* 23rd July 1997 *NST* 19th August 1997.

²⁰See Mahathir, 1997; Mahathir, 1997a; Mahathir, 1997b etc.

market which would undermine Malaysia's credibility for years²¹. Since the measures coincided with Mahathir's attempts to use government pension funds and cash rich companies to prop up the KLSE, there was little immediate effect on the stock market. However, the fall did soon materialise and Mahathir was forced to concede defeat and delay some infrastructure projects (*NST* 6th September 1997).

Meanwhile, Anwar made speeches to state governments urging restraint in project planning and defending his commitment to a balanced budget (*NST* 23rd July 1997). It was Anwar who announced attempts to restrict imports by placing penalties on goods available in Malaysia (*FT* 13th August 1997), Anwar was not present at the meeting where Mahathir announced that local pension funds would attempt to prop up the KLSE and it even became necessary for Mahathir to deny rumours that Anwar had resigned (*FT* 1st September 1997). It also fell to Anwar to calm the nerves of foreign investors after Mahathir's most high-profile attack on currency speculators at the World Bank annual meeting in Hong Kong. (*FT* 22nd September 1997).

The contrast between Anwar and Mahathir was probably overdrawn by the foreign media at this stage. Anwar's eventual ousting in September (see below) probably owes more to struggles for power within UMNO, partly provoked by foreign media reaction, than it does to radical economic differences²². However, power considerations spilled over into economic differences, particularly on the issue of corruption, given the importance of business interests within the party. Perceived differences remain important though as they have coloured some foreign accounts of the Anwar affair and therefore market reactions to political events in Malaysia²³.

Despite promises of a realistic austerity budget, the measures which Anwar eventually announced in early October did not satisfy the markets. They were seen as part of a high-risk attempt to keep supply going in the hope that the country could export its way out of trouble. If the strategy failed, problems which would have to be resolved by demand compression would be much greater in future²⁴.

During November, two corporate deals were widely perceived as attempts by Mahathir to bail out companies that were politically connected. A reverse take-over of Renong by UEM was allowed despite the fact that it involved a breach of stock market rules. Later, the government agreed to

²¹see for example the quotations cited in *FT* 30th August 1997.

²²see for example Anwar's speech to the UMNO Youth Wing in which he claimed that the country was involved in economic battle 'no less significant than the struggle for independence' (*NST* 5th September 1997) Anwar also made repeated calls for better regulation of currency trading (Ibrahim, 1997) while, as we will see in the next section, Mahathir was keen to show a continuing interest in capital investment in Malaysia.

²³ For an excellent extended discussion along these lines see (Funston, 2000).

²⁴see for example *FT* 21st October 1997.

take-over the struggling Bakun dam project in a move that was widely seen as a bail out of Ekran²⁵. The stock market fell rapidly in response.²⁶

The Renong saga continued into January as Anwar attempted to revoke the waiver of stock market rules only to have it reinstated in January 1998. Other 'bail-outs' occurred throughout 1997 & 1998. The list includes an investment in Proton by the state oil company Pertronas, the merger of bedevilled former state Bank *Bumiputera* with Commerce Asset Holdings Bhd on terms favourable to the bank, the purchase of ailing Phillipino Steel by a Renong subsidiary and the transfer of its debts to Danaharta, the bail-out of scandal ridden Perwaja Steel by the state controlled Employee Pension Fund, and the purchase of Mahathir's son's shipping business by Petronas (for more details see the analysis section below).

Presumably as a result of the failure of more accommodatory policies, a supplementary budget was announced on December 6th. This contained far more orthodox measures and was described as a "virtual IMF" policy. However, it was noted that Mahathir was not present when the measures were announced²⁷.

The economy rallied briefly in early 1998 but growing regional instability (particularly in Indonesia) and developments in the continuing Renong saga precipitated a further decline. The structure of the Malaysian political economy was increasingly questioned with concerns that Malaysia was not undertaking the sort of restructuring measures which the IMF had recommended in Indonesia and Thailand (*FT* 16th February 1998, 18 February 1998, 24 March 1998, 25th March 1998). In particular, there was pressure to encourage investment by removing restrictions on foreign ownership of shares in Malaysian companies (*FT* 6th May 1998, 23rd March 1998, 25th March 1998, 25th February 1998). There were also allegations of controls on the media aimed at hiding the extent of the crisis (*FT* 24th March 1998).

In the run up to the UMNO General Assembly in June 1998 there was speculation that Anwar would bid for the leadership. While not actually contradicting Mahathir's policy line, he was willing to point out its dangers – corruption was a key concern at the heart of his differences with Mahathir. A speech given in Washington demonstrates this balance:

there is no room for the rancid rhetoric of misplaced nationalistic sentiments and protectionists...However, their claims will gain legitimacy if the global community does not commit itself unequivocally to reforming the international finance regime...we do recognise that state interventions in the economy are fraught with risks...Legitimate affirmative action policies can also degenerate into perverse patronage, creating a breeding ground for the rent-seeking activities of leeches' (*NST* 17th April 1998).

²⁵ According to Lex in the *FT*, an example 'of the sort of crony capitalism and opaque market practices that suggest the government is more concerned with helping its friends than achieving an equitable environment for all' (*FT* 21st November 1997).

²⁶ see Haggard & Low 2000 for further details and the discussion in the analysis section below

²⁷ He was at a meeting in Lankawi and, when questioned by the media, appeared less than enthusiastic about the measures. See also (Mahathir, 1998a; Mahathir, 1999a) where he claims that the policies were always against his inclinations.

Speculation was re-enforced by a speech by the head of the Youth Wing immediately prior to the assembly which was highly critical of corruption within the party and was widely interpreted as the first stage of an attempted take-over by Anwar. Particularly provocative, given the recent ousting of Suharto, was the adoption of the Indonesian phrase *KKN* (or corruption, collusion and nepotism).

In the event, Anwar's conference speech called for national unity behind Mahathir. The debate on corruption was hijacked by Mahathir who claimed that all *bumiputeras* were his cronies and produced a list of all who had benefited from privatisation (including many who were campaigning for transparency).

By June 26th, Mahathir's policy had triumphed. He announced that Daim Zainuddin would be appointed Minister of Special Functions, in charge of dismantling the 'virtual IMF policy' in favour of more accommodatory policy (*NST* 26th June 1998). After that, a fiscal stimulus package was announced (7 billion ringgit for economic and social projects and 5 billion ringgit for construction (*FT* 2nd July 1998)) and interest rates were lowered (*FT* 1st August 1998).

The stakes were raised again when Mahathir introduced controls on short-term capital flows on the 1st September. This move was greeted by outrage in the markets:

With capital controls slapped on many investors will not return to Malaysia for a decade or more, regardless of how attractive their asset values become. The capital account problems will be dragged out for many years. Any prospects of getting this crisis over with by "doing the right thing" have been shot (Bridgewater, 1998 cited in Wade & Venerosso, 1998b).

The IMF was also unenthusiastic. Camdessus reportedly claimed that the controls were 'dangerous and indeed harmful', while Stanley Fischer said they were a step backward and would bring no long-term benefit (*International Herald Tribune* 17th September 1998 and *Reuters* 11th September both cited in Wade & Venerosso, 1998b)

A day later Anwar was dismissed from office. His dismissal and subsequent trial on charges of sodomy and corruption triggered unprecedented outrage. Mass vigils of up to 10,000 people were held outside his house in early September with protesters complaining about Mahathir's dictatorial behaviour and the lack of domestic press freedom (*FT* 11th September 1998). When access to Anwar's home was restricted, protests moved to the national mosque where they were broken up by police (*FT* 25th & 26th September 1998). Further protests materialized when Anwar was sentenced in April 1999.

Shortly after the initial protests a Coalition for People's Democracy was formed from political parties, human rights groups and NGOs (*FT* 28th September 1998). By mid-1999, this had also resulted in a political alliance between the DAP, PAS and the 'National Justice Party' established by Wan Aziza Wan Ismail (Anwar's wife). However, despite significant gains for the PAS in Muslim areas, the Barisan Nasional easily retained its 2/3 majority in the November 1999 general elections.

7.3 The politics of the crisis

Mahathir's stance on the crisis was widely perceived as a very public departure from the IMF approach. Some of his more outrageous speeches received particularly wide coverage, especially his running battles with George Soros that often had racist overtones. Nonetheless, an examination of Mahathir's speeches reveals a fairly coherent position on the role of the IMF that bears a strong resemblance to a number of more 'respectable' academic accounts.

Mahathir spent a good part of the 1990s boosting his image as a fighter for developing country interests and a key member of the non-aligned movement. His position was therefore elaborated to a number of domestic and international audiences as the speeches referred to below make clear. I begin by outlining Mahathir's analysis of the IMF's role in the crisis in section 7.3.1.

Both the IMF's position and Mahathir's are attempts to legitimate a particular policy position. Mahathir is keen to question the IMF claim that Fund policies reflect objective scientific truth about economic policy. He attempts to undermine the IMF's credibility and legitimacy by pointing to political motivations that are at odds with the Fund's public statements. At the same time, Mahathir's critics offer a similar analysis of his position. Section 7.3.2 is devoted to an analysis of this debate to assess the credibility of the rival claims.

While the political issues are my primary interest, they rely on economic claims and it is therefore important to provide a brief view of the economics of the Malaysian capital controls (section 0).

7.3.1 Mahathir's policy claims

Mahathir argued from the beginning that the crisis in Malaysia was driven by speculators rather than economic fundamentals. Citing Camdessus' glowing endorsement of the Malaysian economy in June 1997²⁸, he argued that the crisis was caused by currency speculators who could profit from forcing devaluations and had no regard for the longer-term economic or social consequences of their actions²⁹. The markets were not acting in a way that maximised social welfare. Currency speculation should therefore be regulated in the same way that other aspects of the market economy were regulated (Mahathir, 1997)³⁰.

Once the currency speculators had done their work, the IMF stepped in. It used the opportunity to attempt to push its narrow neo-liberal agenda. An IMF programme:

does not guarantee our economic recovery. What is certain is that it will restrict our freedom to design and initiate new ways of stimulating foreign direct investments in our country and the implementation of new economic policies and strategies. Malaysia has always been innovative and that is why we have progressed (Mahathir, 1997c).

²⁸ See for example (Mahathir, 1997b).

²⁹ In more extreme speeches he suggested that the attacks were initiated by a vengeful George Soros, upset by Malaysia's support for Myanmar's membership of ASEAN (NST 23rd July 1997). In less extreme speeches he acknowledged that there were some weaknesses in Asian economies but that these did not justify the scale of the currency corrections which took place (Mahathir, 1997d).

³⁰ Or again in his more extreme speech at the World Bank annual meetings in Hong Kong: currency speculation is 'unnecessary, unproductive and immoral. It should be stopped. It should be made illegal' (Mahathir, 1997).

In particular, IMF policies would prevent any form of industrial policy, undermining the relationship between the state and the private sector that was key to East Asian success, and have disastrous social consequences in terms of bankruptcy, unemployment and poverty. The IMF's high interest rate policies would ensure that local companies would go bankrupt, and the only way to recovery would be to sell them to foreigners at fire-sale prices (Mahathir, 1998). This would be facilitated by the IMF's insistence on removing restrictions on foreign investment. In the Malaysian case this would clearly undermine the principles of the NEP which, Mahathir argued, was responsible for the political stability of Malaysia's ethnically divided society (Mahathir, 1998d). In later speeches this was often accompanied by references to the ethnic violence in Indonesia in May 1998.

The 'markets' and the IMF then fed off each other, so failure to follow IMF policies was an excuse for further devaluation and capital withdrawal (Mahathir, 1998d; Mahathir, 1998e). The combined effect was an erosion of sovereignty (Mahathir, 1998b).

We are also warned that these are powerful people. If we make noise or act in any way to frustrate them they would be annoyed (Mahathir, 1997),

resulting in a concentration of power in the hands of capital:

the advocates of the free market insist that somehow the punishment of these Governments through their people is justified because in the end there would be a free market and absolute freedom for the capitalists to make as much money as they can for themselves (Mahathir, 1998c).

So, for instance, the IMF wants to force governments to provide safety nets 'to discipline the government so that it would use force to ensure employees accept being sacked' (Mahathir, 1998c). Not only was this an attack on sovereignty, it was an attack on democracy. States were no longer able to respond to the democratic demands of their populations without paying regard to the will of the markets (Mahathir, 1998). He also pointed out that 'while they [the markets] require governments to be open and transparent, they themselves will remain shadowy and their operation closed to inspection' (Mahathir, 1998b). There was a similar democratic deficit in the mechanisms of global governance.

Mahathir argues that IMF and market interventionism is a response to the end of the Cold War. The welfare state was implemented to ensure that workers would not be attracted by the communist alternative. Once the Cold War was over, the situation changed from one in which workers could do no wrong to one in which capitalists could do no wrong (Mahathir, 1998). In his more radical moments, Mahathir argued that this intervention was a new colonialism which risked that

people will think of regaining control over their economies. They will regard this as a new war of liberation. Even if they want to avoid violence, violence must come as the new capitalists disregard the signs (Mahathir, 1998)

In response to allegations of corruption, cronyism and bail-outs of favoured companies, Mahathir again appealed to the rationale for the NEP. He argued that, once one accepted the need to

distribute wealth to *bumiputeras*, the rest simply followed. Spreading wealth too thinly would not create capitalists with sufficient resources to compete in the global economy. Given these considerations it was inevitable that particular individuals would benefit substantially. Whoever had been given these opportunities, Mahathir argued, would have been labelled a crony by foreigners (unless, of course, contracts and licences were granted to foreigners). He added that many incompetent *bumiputeras* had been allowed to fail and that additional contracts had been given to those who had demonstrated their business ability (Mahathir, 1998e)³¹. In fact, as we saw above, the net had been spread widely.

In relation to bail-outs Mahathir again suggested that all countries protect some companies which they regard as too important to fail. What was distressing foreigners, Mahathir claimed, was that they had not been able to buy up assets at fire-sale prices as they had in the rest of Asia.

Nonetheless Mahathir was often careful, particularly in front of investor audiences, to stress that Malaysia was in favour of continuing its open economy and business-friendly traditions (Mahathir, 1998e). In the 21st century 'trade and productive investment must be the arteries, the veins, the tissue, the muscle and bone of our global prosperity' (Mahathir, 1997b). Malaysia was still anxious to encourage capital inflows for 'productive purposes' (Mahathir, 1997c; Mahathir, 1997d).

'Globalisation can be good...just as capital flows can be good if regulated'. It was just that markets have 'no sense of commitment and responsibility' (Mahathir, 1997b) or 'morality' (Mahathir, 1998d) and require regulation. In the same way that anti-trust legislation was instituted in response to the realisation that monopolies were harmful, a similar realisation about currency trading and hedge funds could lead to their better regulation (Mahathir, 1997).

Finally, Mahathir (unsurprisingly) pointed to the success of the currency control measures that were adopted. He takes pleasure in citing predictions that appeared in the wake of the imposition of currency controls and contrasting them with later assessments of Malaysia's performance. So, for instance, the IMF's World Economic Outlook 1999 conceded that 'economic performance at least to date has been broadly similar to that of the other countries' and Joseph Stiglitz added that FDI had not been adversely affected and that the lifting of controls in September 1999 had not disturbed the market (Mahathir, 1999e). Morgan Stanley analysts had commended Malaysia on using controls 'properly' and acknowledged that they had reduced vulnerability to external shocks (Mahathir, 1999a). Mahathir added that this had been achieved without: having to 'kowtow to anyone', sacrifice full employment, expel migrant workers, reduce school enrolment, decimate the middle class, slaughter Malaysian entrepreneurs, suffer blood on the streets, sell off businesses at fire-sale prices, or go into massive foreign debt to the IMF or anyone else, etc. (Mahathir, 1999a; Mahathir, 1999c; Mahathir, 1999d; Mahathir, 1999e).

³¹Note the parallels with Mustaq Khan's arguments discussed in chapter 4 (Khan & Jomo, 2000).

7.3.2 Interests

Mahathir was keen to point out that the choice of IMF policy solutions tended to favour particular political interests. Financial orthodoxy would be particularly attractive to foreign financial interests. The IMF solution was to provide foreign capital with strong profit-based incentives for remaining in Malaysia. More generally, it favoured financial interests over the real economy with the likelihood of significant levels of corporate insolvency. If this were combined with an easing of restrictions on foreign investment in Malaysia it would offer considerable opportunities for foreigners to purchase Malaysian assets.

In some of his later speeches, particularly to non-aligned leaders, Mahathir also suggested that *bumiputera* businesses had been particularly badly hit by the crisis. Easing foreign investment restrictions would hamper attempts to redress the balance in the interests of NEP priorities and would strengthen Malay-Chinese and foreign business at the expense of the *bumiputeras*.

Mahathir suggested, conversely, that Malaysian policies served the interests of all Malaysians. Arguably capital controls enabled the government to pursue an economy wide recovery based on fiscal and monetary stimulus³². This prevented *all* Malaysian business from suffering unnecessary insolvency and therefore protected jobs and livelihoods. It also allowed the government to pursue expansionary fiscal policies without provoking capital flight.

However, just as IMF policy involved a mixture of economic rationality and what could be interpreted as political purpose, Mahathir's policies were also designed for particular groups. While IMF policy tended to favour foreign interests, Mahathir's railing against speculators, attempts to control the market and capital controls clearly favoured domestic interests. In addition, as we have seen, there are long-standing concerns about corruption in Malaysia. Foreign and Malaysian observers were particularly concerned with bail-outs of politically well connected companies (see p13).

Foreign observers (and academics) have attributed much of the fall in the stock market in early 1998 to market concerns over government favouritism towards individual companies (particularly Renong). Bail-outs undermined foreign investors' confidence in the government's commitment to a market economy based on a level playing field. It was also argued that, if poorly managed companies were not allowed to fail, the economy could be saddled with bad debts and uncompetitive corporate groups for years to come – market discipline would be undermined³³.

Many suggested that Mahathir's more outrageous remarks (particularly his speeches in Hong Kong and Chile) resulted in instant stock market plunges. While anecdotal evidence suggests that investors with local knowledge at least tended to be more concerned by his actions than his words, Mahathir himself accepted and even seemed to relish this view.

³²Rather than a recovery based on attempts to attract more foreign capital which would inevitably favour foreign interests.

³³ *FT* May 1998. Most commentators cited the example of Japan.

For many Malaysians the issue was also one of the way in which public funds were being used to assist particular private interests. The use of capital from the Employees Pension Fund and Petronas to bail out economically fragile politically connected companies had a direct impact on the livelihoods of less well connected Malaysians. Smaller businesses found themselves outside the shrinking net of UMNO patronage and, at the same time, hit by the withdrawal of foreign capital. It is not surprising, under these circumstances, that Mahathir's overtly nationalist responses to the crisis, combined with perceived favouritism towards big business damaged his support amongst sections of the middle class.

These concerns created additional support for proponents of more traditional liberal policies. Technocrats in Bank Negara, government bureaucrats who had seen their influence decline with the growth of political conglomerates in the 1990s and more traditional liberal middle class groups such as Aliran who had long been calling for cleaner, more transparent and accountable government are all in this category.

Mahathir's policies were obviously, in part, an attempt to maintain his support with so called 'crony business' interests. These include corporations whose owners have strong political links and other business groups who are probably actually owned by UMNO. But Mahathir's arguments that the web of beneficiaries was wider than narrow accounts of 'crony capitalism' might suggest are not wholly unfounded.

As he points out, IMF policies would have struck at the heart of NEP redistribution policies. The list of beneficiaries that Mahathir produced at the UMNO General Assembly makes clear that these policies have benefited wide sections of the business community. There is no doubt, either, that they have a wider symbolic importance in terms of Malay nationalism. Mahathir's railing against foreign speculators can also be seen as an appeal to this nationalist community (and a classic populist blame shifting tactic).

With the exception of Mirzan Mahathir's shipping business, the major rescued companies all served some wider social purpose in addition to merely enriching their owners. Renong was involved in a wide range of important Malaysian infrastructure projects. Proton and Perwaja were part of a wider programme of technological upgrading. Phillipino Steel had originally been purchased by a Mahathir 'crony' for foreign policy purposes. The use of private businesses to carry out public infrastructure projects is part of the worldwide drive towards privatisation which began in the 1980s. It does raise difficult issues but it is not confined to Malaysia as the growth of PFI projects in the UK demonstrates. On the other hand, the award of these sorts of contracts in Malaysia is rarely the result of transparent competitive tenders and is frequently part of the network of political patronage.

In sum, the contrast between IMF policies and those adopted by Mahathir reflects both different conceptions of appropriate economic management and different sets of political interests. The credibility of Mahathir's response depends in part on whether one is inclined to view the NEP as a

cover for crony patronage or a source of Malaysian political stability. Similarly, the credibility of the IMF position depends partly on whether one is inclined to view the Fund as a stooge for Western capital or the bearer of rational liberal values.

7.3.3 Conclusions

If Mahathir's views can be regarded as convincing, they provide a clear challenge to the four aspects of IMF legitimacy that I have used to structure the thesis. They attack the Fund's emerging role in promoting capital account convertibility. Mahathir is keen to emphasise broad enthusiasm for market forces but argues that capital flows need to be regulated (implicitly also pointing to the absence of any legal agreement on capital account convertibility). The freedom of movement of capital should be limited in the interests of various social priorities and countries should maintain the option of introducing capital controls. He also attacks the IMF's institutional authority, questioning its technical credentials and its political neutrality. Finally, Mahathir's refusal to accept IMF conditionality at least raises questions about state consent (though of course Malaysia never threatened anything like a withdrawal from Fund membership).

Of course there is a counter argument, relying particularly on the rent seeking paradigm I discussed in Chapter 4. Mahathir's policies are portrayed as a cover for corrupt support of powerful elite allies against the interests of the normal working class. Sometimes he is also portrayed as a xenophobic nationalist – a position lent some credibility by his more outspoken exchanges. Mahathir's authoritarian politics and support for 'Asian values' are also connected with this type of account.

These are very much the dimensions of the debate about IMF legitimacy following the crisis and the important questions which I will explore further in Chapters 8 & 9 concern the extent to which the two viewpoints have been capable of garnering political support.

The debates themselves, though, are already interesting in illustrating what is at stake in the IMF's new role. Particularly interesting is the relationship between technical and political issues when trying to make the case for either viewpoint.

So far I have looked particularly at the political debates since these provide the context in which economic questions need to be set. However, economic issues are clearly a very important part of the debate. The more the relative positions on economic causation can be given empirical support, the stronger the respective cases will be. Was the Malaysian solution to the crisis more successful than the IMF approach? Will it founder over the longer term as cronyism stifles economic efficiency?

7.4 The economics of the crisis

Mahathir and his ministers point out that their initial approach to the crisis closely followed IMF prescriptions (reflected in Camdessus' (1998) early endorsements) and go on to argue that:

The experiences of the affected countries thus far clearly demonstrate that the traditional policy prescription has not produced results. In the case of Malaysia, the combination of high interest rates and tight fiscal policies further distressed economic activities and led to a contraction of the domestic economy (Mohamed, 1998).

Adopting capital controls enabled them to resolve Malaysia's problems since they:

provided the stability required for recovery measures to be effective. What is perhaps most significant is that the economic recovery was achieved with minimal social costs to the most vulnerable segments of society (Mohamed, 1998).

The question is whether this assessment is shared by more objective academic economists and by the IMF.

7.4.1 Controls and economic recovery

As we have seen, initial market reactions were highly negative. The suggestion was that Malaysia would suffer a massive decline in investor confidence and, once controls were removed, portfolio capital trapped in the country would be rapidly removed. There were also concerns that the controls would be ineffective and that to the extent that they did offer protection, Malaysia would use them to bail out politically well-connected companies at the expense of longer-term economic stability.

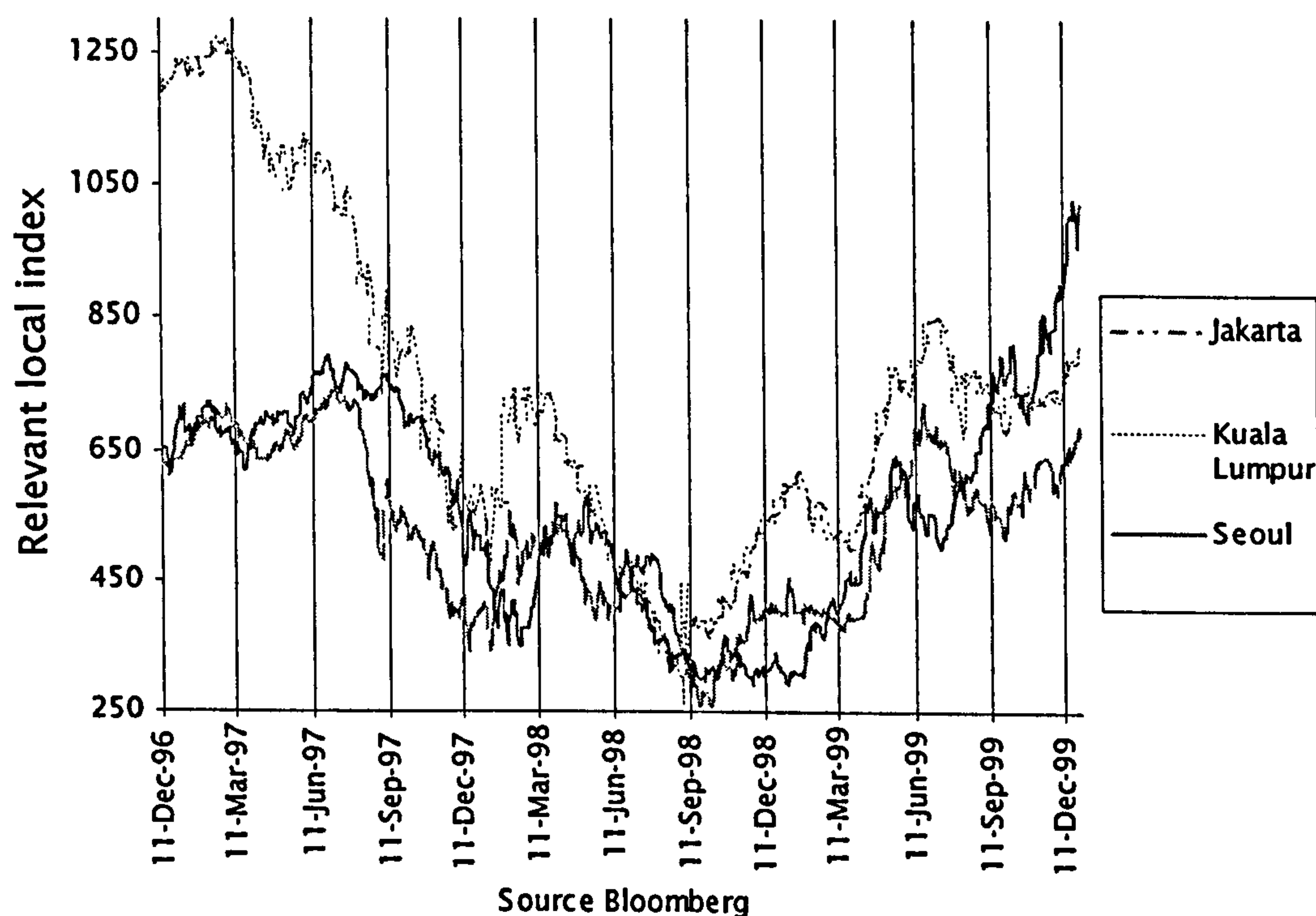


Figure 7-2 Stock markets during the crisis (three countries not adjusted for exchange rates)

In fact, the emerging consensus amongst economists is that they have been something of a non-event:

The pattern of economic performance in Malaysia since the emergence of the crisis has in many respects been similar to that of other countries in the region. This makes it very difficult to disentangle the impact of Malaysia's capital controls from broader international and regional developments (IMF, 1999b, 9).

The virulent criticism at the time controls were implemented now looks rather foolish. The IMF's assessment strongly endorses the controls' effectiveness, accepts that 'the authorities have pressed ahead with bank and corporate sector restructuring' and that 'the reduction in interest rates that accompanied the controls helped to contain the increase in non-performing loans of the banking system'. It argues that this is because the controls were comprehensive, well implemented and widely supported by the domestic business community. The ringgit was fixed at the lower end of its real value and the country continued to push ahead with economic reforms (IMF, 1999b, 8-9).

The rapid outflow of capital expected once the controls were lifted in October 1998 failed to materialise (Athukorala, 2000; Haggard, 2000; Herald-Perkins & Woo, 2000). Some analysts argue that FDI has been marginally slower to recover but the differences are slight and could be caused by other factors (notably sales of assets as part of the restructuring process elsewhere) (Athukorala, 2000).

On the other hand, Mahathir's claims about the controls' effectiveness also look to be somewhat overplayed. Recovery has not been any faster than elsewhere in Asia and other countries, too, had begun to lower interest rates and boost fiscal spending in late 1998, without the shield of capital controls (see Figure 7-2).

For those sceptical of capital controls, doubts revolve around the extent to which the deflation that the controls have allowed has merely removed a problem of temporary illiquidity, or alternatively, has allowed Mahathir to bail out poorly-managed firms either directly (Renong, UEM etc.) or indirectly (Herald-Perkins & Woo, 2000). It is no surprise that this debate has political dimensions with opposition leaders, particularly in the Chinese DAP, inclined to cry 'foul', and the government defending its record. The Malaysian International Chamber of Commerce and Industry remains concerned that 'there does not seem to be enough strong action against those people who were responsible' but broadly endorses the capital controls (Khoo, 2000b).

For those who are more positive, the possibility that deflationary policy would have triggered capital flight cannot be dismissed. This is particularly important given the political instability in Malaysia in autumn 1998 following the dismissal of Anwar (see below). Again, these writers tend to refer to the Indonesian experience (Athukorala, 2000).

The most compelling defence of capital controls is mounted by Ethan Kapstein and Dani Rodrik. They start by pointing out that (contrary to accepted wisdom about the possibility of capital controls in the face of modern financial markets) the controls were effective in separating domestic Malaysian interest rates from international market rates. They go on to argue that a comparison of

Malaysian performance with that in Indonesia and Thailand in September 1998 inappropriate. Thai and Indonesian policy was already sustainable prior to the turn around in stock markets. Malaysia still faced offshore ringgit interest rates of 20-40%, a depreciating exchange rate, and declining reserves: 'pressure on the ringgit reached its peak just before the Malaysian authorities decided to implement capital controls' (Kapstein & Rodrik, 2001, 6). Many felt that it was heading for a crisis and would soon be visiting the IMF.

If the counterfactual used to evaluate the controls is the response to IMF interventions at the beginning of the crises elsewhere, a year earlier, Malaysian performance looks a great deal better than Korea's, even when efforts are made to control for easing of international interest rates and no adjustment is made for the fact that Malaysia received no IMF funding.

7.4.2 Controls, social stability – a special case?

The second claim the Malaysian authorities make is that the controls allowed Malaysia to recover without the social instability experienced elsewhere in Asia (presumably referring particularly to Indonesia). Certainly, the crisis had a lower impact on unemployment and poverty. The question, though, is whether that was because Malaysia adopted heterodox policies or because it was in a better position to start with.

For those who accept the consensus position of a rather limited effect for the controls indications are that Malaysia's earlier strength is probably the correct interpretation. Particularly importantly the Malaysian government had introduced prudential controls limiting banks' overseas borrowing to sums covered by their reserves. Malaysia's exposure to unhedged short-term foreign debt was therefore much more limited. The crisis was largely driven by a domestic asset-price bubble concentrated in the property and equity markets (or alternatively by an unwarranted correction in such asset prices driven by speculation). Malaysian corporates had a tendency to obtain loans on the basis of the proceeds of shares in subsidiaries and to guarantee these loans with the shares as collateral leaving them highly vulnerable to stock market shocks (IMF, 1999b).

In short, Malaysia's resilience was largely the result of better prudential regulation prior to the crisis, so capital outflows were concentrated in the equity markets and the impact on the banking sector was therefore largely indirect through corporate failures.

A corollary is that the controls were not tested against the kind of rapid outflow of capital that took place in Indonesia and Korea. This was partly because they were applied quite late on when capital flight was probably decreasing. It was also because Malaysia's international exposure was less significant in the first place. At their worst, though, they were not disastrous.

Those who are convinced by Kapstein & Rodrik's account will again be more positive about the effect of controls. Malaysian banks may have looked relatively sound but few banking systems could withstand the kinds of exchange rate shocks that took place in Indonesia and Korea. If that was what Malaysia was facing without the controls, Mahathir's claims look more convincing.

7.4.3 Conclusions

The most significant conclusion is that the markets' (and indeed the IMF's) initial claims about the likely effects of Malaysian capital controls were simply wrong. There is no evidence that using controls to control capital outflows has disastrous economic consequences. More controversially, there is some evidence that it is a very effective strategy, though it wasn't tested against rapid capital outflows in 1997.

Despite limited negative economic effects, IMF public statements though tend to remain negative, even when IMF analysis was rather more balanced. So Fischer's view that

I believe that the controls introduced a year ago are not a good way to operate in the international financial system, particularly for a country anxious to attract foreign investors³⁴ (Fischer, 1999b).

is not particularly well supported by staff studies which merely express loosely related concerns over the extent to which there is sufficient market discipline in Malaysia (IMF, 1999b).

7.5 International Politics, Malaysia and IMF legitimacy

In Chapter 4, I argued that the crisis case studies (Indonesia and Korea) were interesting for IMF political legitimacy in two ways. Firstly they spoke to the political limits to the IMF's chances of implementing the new conditionality and secondly they fed into more direct debate within the Fund about crisis reform.

Malaysian events and Mahathir's response to the crisis raise both these issues. Firstly there are issues about the causes of the Malaysian decision to avoid the IMF and introduce capital controls: how much was it a reaction to the 'failure' of IMF policies elsewhere and therefore a decline in IMF legitimacy? Secondly, there are questions about the consequences of Malaysian policies: the extent to which Mahathir's speeches and the Malaysian example undermine the IMF's attempts to legitimate its policies to a wider audience.

7.5.1 Causes of Malaysian policy

On IMF performance influencing Mahathir's policy choices, what can be said is that criticisms made of the IMF's actions elsewhere clearly provided ammunition when he sought to justify his approach. That is clear from the speeches quoted earlier. The fact that Malaysia tried an IMF style approach initially but subsequently changed course is also strong evidence. One of the strongest empirical conclusions emerging from Chapters 5 & 6 was that the IMF's hopes of enhancing market confidence over the short term were misplaced. Additionally, the nature of IMF

³⁴ The speech was made at a conference that Mahathir also addressed. Kohler seems to have a slightly more positive view. He warns that controls become more problematic over time but explicitly accepts that the controls were not the disaster that had been expected. His comments were connected to an acknowledgement of Fund over enthusiasm for capital account liberalisation (Kohler, 2000).

interventions elsewhere in Asia – limiting state control over credit allocation – was certainly a central motivation behind Mahathir's decision to avoid IMF tutelage.

On the other hand it was obviously not the only motivation. This sort of decision is the result of a number of factors, particularly, as I have pointed out throughout, political factors. It is the interaction of IMF policy preferences with the pre-existing political economy of crisis countries that is key. Mahathir's concerns may not have been shared by other countries where state intervention was less politically important. Equally, other countries might not have been in a sufficiently strong position to avoid IMF conditionality.

Overall, how much pause for thought Malaysia's decision to avoid IMF assistance ought to give the IMF is unclear. On the worrying side, Mahathir was put under considerable pressure to go to the IMF by the financial press and there don't seem to have been any legal impediments (Athukorala, 2000). He chose not to do so because he believed that the costs of IMF intervention outweighed the benefits. On the other hand, Malaysia might have tried to avoid the Fund irrespective of the Indonesian and Korean experiences and Malaysia's decision may not be echoed by large numbers of other countries. The relevance of the Malaysian message depends on the responses of other countries to future IMF conditionality and the extent to which Malaysian objections will receive enough international support to affect reform debates - issues I will look at further in Chapter 9.

7.5.2 Consequences of Malaysian policy

The second issue concerns the importance of Malaysia's policies in terms of demonstration effects and Malaysia's public advocacy of an alternative position on the crisis as a whole.

International advocacy

In terms of advocacy at IMF meetings, the Malaysian position has been highly consistent and rather more moderate than press accounts of Mahathir's 1997 performance might suggest (Ibrahim, 1997; Mohamed, 1998; Mohamed, 1999).

Malaysian ministers have not wholly denied domestic aspects of crisis causation but they have been particularly keen to stress that there were also international causes which need to be addressed in the context of debates about a new international financial architecture.

They have been particularly concerned about hedge funds which, they argue, should be forced to disclose their trading positions and be subjected to tighter supervision. They have questioned the extent to which increased transparency (the IMF approach) is enough to deal with financial volatility. Instead, they have suggested that the IMF should provide better regulation of international markets and abandon moves to include capital account convertibility in its Articles. They have also questioned the process of reform, pointing to limited developing country membership of the Financial Stability Forum and G20 processes. No ASEAN countries were originally members.

On the Malaysian capital controls, they have stressed that they were a temporary measure to provide some breathing space for necessary reforms, not a substitute for them. Many other

countries had taken similar measures in the past including, for example, in the aftermath of the ERM crisis in 1992.

Initially, Mahathir's and Anwar's (Ibrahim, 1997) criticisms were dismissed as blame shifting. However, as the Malaysians were keen to point out, international opinion changed significantly towards their point of view during 1998 (see for example the changes in IMF policy in Korea and Indonesia in early 1998 noted in the two previous chapters) and particularly in the wake of the LTCM disaster (Ibrahim, 1997).

I will examine broader responses to these issues in chapter 9. For now it is sufficient merely to point out the ways in which Malaysian leaders took up some of the academic criticisms at IMF debates I reviewed in Chapter 4 and presented them at the international level. Mahathir also took his message to the non-aligned movement, the Commonwealth and other fora.

Demonstration effects

How much did the demonstration effects of Malaysian policy strengthen or undermine the government position, affecting Mahathir's national and international credibility?

That clearly depends on contested interpretations of the underlying economics. In the section on economics, I concluded that Malaysian controls did no noticeable harm, undermining any claim that the IMF provided the only technically viable solution. On the other hand, the case is still open on whether they are transferable to other contexts.

Given that the economics is contested, questions about the political consequences of alternative courses of action become highly relevant.

The IMF is supposed to allow countries maximum flexibility to adjust without breaching the code of conduct. Capital controls are certainly not outlawed by the Fund's Articles. If we accept the consensus position that the capital controls were not particularly different in effect from policies elsewhere in Asia, that at least suggests that there are few good economic reasons for outlawing them.

The principal remaining objection is that they may prevent necessary structural reforms. Again, then, the debate looks to be as much about political economy as about methods of crisis resolution. Fund assessments of Malaysia ask whether structural reforms have been sufficient, suggesting that a more expansionary approach may have prevented the failure of unsound (implicitly crony) business.

Of course, how one feels about these issues will depend on one's technical views about the importance of 'market discipline' and on the rationality of financial markets. More locally, though, it will also depend on attitudes towards the NEP. The most difficult questions concern the extent to which it is still necessary, given that many of its aims have been satisfied (see for example (Herald-Perkins & Woo, 2000)) and the extent to which it has degenerated into a patronage machine for UMNO (Gomez & Jomo, 1999).

Now the fact that these questions are raised, again, underscores the extent to which the new good governance agenda, responsible for much of the IMF programmes' local popularity in Korea and Indonesia, is also a political agenda. Under the post-war sovereignty regime that Jackson questions (see chapter 2) such 'interference' would have been regarded as deeply problematic. Countries simply would not have accepted that it was reasonable to expect them to give up so much. Under the evolving new sovereignty regime, some technical and ethical considerations can override arguments about sovereignty.

Are issues of cronyism and the NEP amongst such questions? After all, it is clear from Malaysian political debates that Mahathir's views are no more unassailable than those of the IMF, even within Malaysia? Or is the fact that Malaysia is a democracy sufficient to override these concerns? In particular, are they considerations that should legitimately be decided on political criteria or is there an overriding technical, or perhaps ethical / liberal, rationale?

The close connection between the imposition of controls and the subsequent treatment of Anwar Ibrahim clearly gives cause for concern. The verdict of the Malaysian electorate does not allay this. UMNO lost a great deal of support. However, the shift was largely by Malay voters moving their allegiance to the Muslim PAS. Mahathir, anticipating this, waged a scare campaign suggesting the dangers of ethnic unrest and the imposition of an Islamic state. Chinese voters responded by moving from the DAP to the MCA, offsetting the shift so that overall UMNO did no worse than in 1990³⁵.

The issue though is whether these kinds of issues are ones that the IMF should have the right to make decisions about.

7.6 Conclusions

Yet again, economic issues surrounding the crisis are inconclusive. A case can be made for the superiority of capital controls but it is contested. It is clear that the markets' dire prophecies were highly inaccurate. It is too early to tell whether Malaysian long-term competitiveness will be damaged and, in any case, the counterfactual issues are likely to be sufficiently complex to prevent any particularly persuasive evaluation.

The contested nature of the NEP adds a potential new dimension to debates about rent-seeking and corruption. Again, it is very much a political as well as an economic issue and, regardless of official rhetoric, is impossible to separate from economic evaluations of the Malaysian experience.

Mahathir raised a range of issues that challenge IMF legitimacy. He began by attacking the IMF's technical credentials, emphasising successful heterodox policies in Asia's past and accusing the IMF of closing off potential heterodox solutions in the future. He then went on to accuse it of political

³⁵ For a more extended debate on the importance of the Anwar affair for Malaysian politics see (Khuo, 2000b) and (Funston, 2000)

bias in favouring markets over states, capital over labour, and international creditors over local debtors. He stressed the social and political aspects of the debate about policy in Asia and used the IMF's poor performance in Indonesia and Korea to justify his claims.

The congruence between Mahathir's views and the kinds of potential logical challenge that I raised in Chapters 2 & 3 should be noticeable. The argument is explicitly that Fund interventions should be seen as political rather than technical. It is also clear that what swung the balance towards making that criticism was a collapse of confidence in the welfare enhancing effects of capital inflows: based on the experience elsewhere in Asia the bargain between capital inflows and policy reform I discussed at the end of Chapter 3 started looking less attractive. On the other hand, Mahathir was not challenging the virtues of market economies *per se*, he was merely calling for better regulation of capital flows in the interests of domestic social and political priorities. The parallels with the arguments made in the run up to Bretton Woods should be readily apparent. How credible is this line of attack likely to be to outsiders? What kind of support might Mahathir expect to attract from other developing countries?

That will partly depend on perceptions of the strength of the contested economic arguments: capital controls versus market confidence; market rationality versus market panic; lack of market discipline or lack of state regulation; corruption or industrial policy. On the other hand interests will play a part in determining propensity to accept particular arguments.

For states that do not have ambitions towards industrial policy there may be less advantage in attacking the IMF's structural agenda. As we saw, the advantages of various forms of industrial and redistributive policy were very much a matter of debate even in Malaysia. For other emerging markets there may even be advantages in blaming such policy in an effort to reassure the markets or even their own populations about their own economic credentials. Distance from immediate crisis (or even proximity to it) may affect the positions adopted within the Fund. Closeness to a crisis may mean that the financial personnel who set policy on these issues within the Fund may be under less pressure to consider the domestic political consequences of Fund policy in a crisis situation. Countries close to crisis, on the other hand, may have strong incentives to distance themselves from the patterns of corporate governance blamed for Asian problems.

As well as the influence of domestic politics on these kinds of debates, the economic views themselves may of course be subject to change over time. The policies of the 1980s and 1990s mark a sharp break with those of the 1960s and 1970s and, in the aftermath of the Mexican, Asian and now Argentinian crises there is always the possibility of a change of views.

On capital controls or other forms of debt resolution involving greater costs to creditors, the issue remains one of balancing short-term gains against potential long-term costs for market access.

On better regulation of international finance and more developing country participation in decision-making processes, though, there is the potential for greater solidarity. On the other hand,

for low-income developing countries with little access to private finance, many of the issues are largely irrelevant at the moment.

From a lender perspective the issues will be very different and Malaysia may chiefly be a concern because Mahathir's reactions signal potential difficulties in securing future programme implementation. I will look at those issues further in the next Chapter. For now, though, it is worth pointing out that Western media reaction was to portray Mahathir as an authoritarian maverick with eccentric views about the markets and an unpleasant style of political management – so many Western readers will have been surprised by my review of Mahathir's speeches in section 7.3.1.

Here Mahathir's apparent political motivations for adopting unorthodox policies become very important. The ability to portray NEP policies as a combination of corruption and xenophobia is helpful in undermining Mahathir's credibility, just as Mahathir's ability to point to Fund pro-Western and pro-capital bias strengthens the political force of his arguments amongst some audiences. The fact that there was considerable domestic political debate about the appropriate set of policies for Malaysia, with an apparently more IMF friendly path supported by more liberal Malaysians including Anwar makes it more difficult to press the arguments that do exist in favour of Mahathir's approach.

I have made an effort to do that here. I do not wish to deny the difficult aspects of some of the more dramatic speeches. Accusations of a Zionist conspiracy under Soros are hard to defend and did little for Mahathir's Western credibility. On the other hand the actual arguments he presented are harder to reject and potentially present significant threats to IMF orthodoxy. The question is whether they attracted sufficient political support to change IMF policy.

8 The United States

The previous case studies have suggested that IMF interventions were heavily influenced by the United States. In Korea there were allegations of unwarranted US influence on negotiations around the structural aspects of the programmes. In Indonesia there was also evidence of direct US pressure on Suharto to implement the second programme. Those interventions were important in the politics of implementation and I will investigate the evidence for them and the reasons behind them in this chapter.

However, we also saw in the introduction that the Fund's role in Asia was the subject of heated political debates. This chapter will investigate the diversity of US political positions on the Fund and the ways in which those perspectives were able to influence subsequent US policy.

IMF legitimacy is still important in the United States. However, in the context of a lender country, the issues are very different. Primarily, IMF policy is interesting to the US for the kind of environment it provides for US corporations and financial interests to work in. It is not likely to have a great deal of impact in terms of restricting the United States' ability to conduct its own domestic economic policy.

The key issue, from a US point of view, is whether the contributions the Fund makes to that environment justify the costs of US involvement both directly in terms of quota contributions and less directly in the restrictions it places on US ability to exert bilateral pressure to further its foreign economic policy goals.

Additionally though, as I suggested in Chapter 4, there may be strategic issues about the extent to which IMF intervention is a cause of resentment overseas and to which that intervention is blamed on the US. Non-implementation may heighten these concerns. Was there a perception of a need to secure the IMF's wider legitimacy in the aftermath of the crisis or merely to defend it against domestic criticism? What does that tell us about the issues concerning IMF flexibility that were raised by the crisis case studies?

In this chapter I am interested in investigating the forces that determine what form US oversight of IMF regulation is likely to take. Which issues are important? What kinds of results will be regarded as proof that IMF membership is valuable? How does the US seek to influence Fund policy and who has the greatest say on the form that influence will take?

Issues of influence over Fund policy in the US are also important because reform debates put the Fund under pressure to become more transparent and accountable. That is often thought of in terms of accountability to developing countries but increased transparency, at least, must also result automatically in greater accountability to developed country citizens. If wider publics become involved in scrutinizing the Fund's role in developed countries, what can we expect the outcome to be? Obviously the details will be different in different developed countries, just as they were for different borrowers. The US is chosen, partly because it is the most powerful nation in the Fund and partly because the nature of US democracy means that debate over the Fund is carried out relatively transparently.

Elite level debate in the United States was particularly noticeable because the crisis coincided with a request for a quota increase that had to be passed by Congress. In this chapter I use Congressional debates to investigate the domestic influences that drive US Treasury input into IMF policy and to explore the influence these have on US preferences for reform of the IMF and the international financial architecture.

8.1 Institutional environment

My main focus in the thesis has been IMF conditionality and I have already devoted some attention to the institutional relationships between the Fund and developing countries in that context. An understanding of the importance of US debates now requires further information on the institutional links between the Fund and United States so that we can understand how different actors in lender countries can hope to influence IMF policy¹.

8.1.1 Overview

The United States has two formal sources of influence over the IMF, its Governor (and Alternate) and its Executive Director (and Alternate) who are appointed by the President with Senate approval.

Day to day oversight of Fund operations is the responsibility of the Executive Director (who, during the period reviewed here, was Karen Lissakers). She reports to the under the International Monetary Affairs department. The Treasury supplies her with an economic advisor, three technical assistants and two administrative assistants at the Fund (Geithner, 1998)² as well as support from a

¹ Of course institutional relationships and political cultures will vary between countries but the US example will at least give some indications of what one might expect to take place elsewhere

² Geithner was the Treasury Under Secretary for International Affairs in 1998 and now works for the Fund's policy development and review department

department based within the Treasury itself. The Treasury, in turn is accountable to American citizens through oversight by their elected representatives in the House (Senate and Congress) and through presidential elections.

In practice Congressional oversight is only exercised when the Executive needs Congressional permission for an amendment to the Fund's Articles of Agreement or, more commonly, for an increase in the US quota³. At that point, Congress tends to grant permission only subject to a list of matters that it expects the US Executive Director to promote using his/her 'voice and vote' during Executive Board meetings – a tactic that will be discussed further below.

Treasury oversight, on the other hand, is continuous and the position of the IMF offices in Washington probably means that the US Executive Director is held more closely accountable than any other. Thomas Dawson, an ex US Executive Director and now head of External Affairs at the Fund advised the House Banking Oversight Subcommittee that, in exercising its oversight it should 'lay it on Treasury not on the poor US director' (House Banking Oversight Subcommittee, 1998 106). Treasury also consults with the Department of Commerce and the US Trade Representative (USTR) to ensure that the Executive Director is aware of any ongoing US trade issues. Unlike in the UK, for example, where DFID has a clear input into IMF policy, USAID is not involved in IMF policy making, the position being that the IMF is 'not a development institution'⁴.

8.1.2 Achieving US purposes within the IMF

Within the IMF, the Executive Director's job is to attempt to ensure that Treasury policy (as influenced by Congress and USTR) is, as far as possible, implemented by the IMF. Testimony given by Treasury officials to the Congressional committee charged with IMF oversight suggests that she does this by a combination of means. Since, as we saw in chapter 2, most decisions are made by consensus and formal votes are rarely taken:

the US must engage in coalition building to obtain the necessary support for its views on most issues. This is accomplished through a variety of channels including frequent contacts with the Management, staff and the Offices of Executive Directors, either individually or in groups. These efforts are often supplemented by contacts with the home governments of member countries, including within the G7 framework, other multilateral fora and bilaterally (Geithner, 1998).

In other words, formal Executive Board discussions are only one of the fora in which the US Executive Director tries to exercise her influence.

The board discussions themselves can be quite fluid and lively; however much of my work is done behind the scenes through informal meetings and discussions with other Directors, with management and with senior staff (Lissakers in (House Banking Oversight Subcommittee, 1998, 24)).

³ The right of Congressional veto on these issues was enshrined in the original legislation authorising US membership in the IMF. The absence of Congressional oversight at other times was confirmed in confidential interviews with activist Congressmen and with Jim Orr of the Bretton Woods Committee. See also Thomas Dawson's testimony to the House Subcommittee on Banking Oversight (House Banking Oversight Subcommittee, 1998, 105-6).

⁴ Personal communication from USAID external affairs.

Geithner, responsible for international affairs at the Treasury, went on to outline the US strategy for implementing issues of concern to Congress that were not generally regarded as 'economic' such as labour rights and the environment and which had limited support from other country representatives. Here pressure is put on IMF staff to carry out research into the 'economic' aspects of these issues (their effect on other economic policies, consequences on trade, investment and the balance of payments etc.). Pressure is placed on the Managing Director to raise the issues in public fora and discussions take place with other Executive Directors initially informally. Only then are issues brought up in public discussion or reviews of country programmes (Geithner, 1998).

8.1.3 Treasury and the administration

The Treasury is largely in control of the USED's input into Fund policy.

High-level Treasury officials are appointed by the President as part of his administration and are accountable to the White House. They only have to account to Congress for IMF policy under particular circumstances (see below).

Since US administrations are made up of outsiders rather than career politicians, there is a tendency for Treasury officials to come from business or academia (the principal resources of economic talent). The circulation between academia, Treasury, Wall Street and the IMF has led many to complain that the Treasury, particularly under the Clinton administration, has been too willing to have its policy driven by Wall Street preferences (Bhagwati, 1998; Bhagwati, 2001).

In keeping with a broader trend in Western countries since the late 1970s, respect for economic expertise and a preference for insulation from 'political interference' in economic management has led to increased respect for the 'expertise' of Treasury officials. Andrew Baker has argued that there is increasingly a self-reinforcing consensus within the G7 around a particular set of economic policies centred on free capital flows, flexible exchange rates and monetary policy that is independent and largely directed at inflation targets. Sound monetary and fiscal policies aimed at medium term price stability ensure a broadly appropriate exchange rate through the reception they receive in the markets. Exchange rates are largely a demonstration of the markets' verdict on domestic macro-economic policy. That kind of perspective casts the Treasury role very much in terms of a particular kind of relationship with the financial markets involving modest opportunities for influence but, generally, a task seen in terms of ensuring that nothing is done to damage market sentiment (Baker, 2000).

The kinds of argument around 'market confidence' that I explored in debates on good governance are also evident in this kind of perspective on economic management in which decisions are to be taken by technocrats (who have close contact with the financial markets) rather than 'politically' motivated politicians. Treasury dependence on market confidence for the cost of borrowing to fund an increasing US government deficit may help to increase this idea of dependence on market views.

That agenda is open to challenge were it conflicts with the views of more politically minded arms of government but, where the Treasury is left to itself, is likely to dominate policy approaches.

8.1.4 Congress and the wider public

As I indicated in the overview section, the principal powers reserved to Congress under the Bretton Woods Agreements Act relate to the approval of quota increases or amendments to the Articles of Agreement. Congress is also able to pass specific legislation directing the way in which the Executive Director should act in her role at the IMF. In practice it has tended to do so when quotas come up for review.

Two important questions are raised here. The first concerns the effectiveness of such legislation in promoting Congressional preferences and the second concerns the sources of those preferences – what issues interest Congressmen and what kinds of incentives guide their interventions?

I will discuss the practical effects of the legislation that was passed as a result of debates on quota renewal in 1998 below (section 8.4). For now it is enough to point out that legislation of this kind is a relatively blunt instrument and its effectiveness will largely depend on Congress's ability to monitor the ED's compliance and impose sanctions for non-compliance. This is particularly difficult since Congress cannot legislate for 'results': the ED can only do her best to press Congressional preferences within the Fund's decision-making bodies. While, as I have already suggested, the US exercises considerably more influence than its 17% of the vote would suggest, it cannot act alone and does not always achieve its goals.

Although the scope for continuous oversight is limited, the need for periodic Congressional sanction of quota renewal can be a powerful lever. Legislation sends messages about Congress's preferences and therefore about issues that are likely to be raised when it is time for the next round of quota renewals. In a sense quota renewal has the same kind of influence as voting does in normal electoral politics. It does not provide a system of continuous oversight but it does mean that, periodically, Congressional assessments of past performance will become very significant.

It may appear unlikely that Congress would refuse a quota increase outright, but it is not entirely impossible given recent difficulties in securing UN subscriptions. In any case, there is a real danger that Congress will pass obstructive legislation or cause embarrassing delays in authorisation. These dangers can be used to encourage Treasury concessions during the quota renewal process and to enhance Congressional control, particularly when new rounds of negotiations are pending.

What drives Congressmen to engage in this kind of scrutiny and what form can we expect it to take?

There has been a lot of debate about the significance and desirability of a more 'activist' Congress on foreign policy issues. The US constitution is somewhat ambiguous about the division of foreign policy powers and the relative importance of the role of the Executive and Legislature has varied over time. During the 1950s there was a tendency for Congress to bow to Presidential leadership.

Particularly since Watergate and the Vietnam war, Congress has become less content to abandon differences 'at the water's edge' (Lindsay, 1994). In relation to foreign *economic* policy, there have been similar fluctuations. In the 1950s, Congress tried to tie its own hands on trade policy by delegating much of its constitutional authority to regulate 'Commerce with foreign Nations' to the President. During the 1980s, this position too was partly reversed with more active attempts to legislate on trade issues (Bayard & Elliott, 1994; Destler, 1995).

For some this has raised concerns that Congressmen have incentives that are counter productive for foreign policy. Particularly concerned are those who stress narrow electoral incentives. In this view, Congressmen tend to have parochial preferences based on the short-term wishes of their state electorate, preventing them from adopting a more thoughtful, long term, and national or even international perspective.

Lindsay (1994) argues persuasively that this is an overly simplistic conception of Congressional behaviour. Obviously, (and usually appropriately) Congressmen will generally wish to avoid providing public support for policies that the majority of their constituents oppose. However, in practice, the majority of American citizens are simply not that interested in foreign policy issues. As a result,

Rather than slavishly following constituent opinion, members of Congress try to accomplish their personal, policy and political goals subject to a constraint laid down by constituent opinion (Lindsay, 1994, 34)

Lindsay suggests that, although the strongest electoral incentives tend to favour silence on foreign policy questions (electoral ambivalence suggests that there is little to gain and much to lose) there can be other political advantages in pursuing personal foreign policy goals. Involvement in Congressional committees can be good for the career of a Congressman seeking higher political office. The importance of the 'attentive public' – interest groups, particularly but by no means exclusively those with an ethnic basis (Jewish Americans, Asian Americans, African Americans), can make foreign policy a vote winner and can certainly mobilise campaign finance from interested groups. Taking a high profile stand on issues can gain media coverage, raising a politician's profile more generally.

Committee posts can also be a route to advancement within the party and therefore to higher political office. They provide an opportunity to make a name for oneself within Congress. For those 'policy entrepreneurs' who become involved in foreign policy issues for career reasons, electoral calculus remains important but largely in influencing the way those policies are presented in public. The line between policy preference and 'pandering' to constituents can sometimes therefore be blurred by astute presentation of policy issues in ways that constituents can relate to.

8.1.5 Summary

Treasury policy is particularly key in determining US positions within the Fund. But Treasury acts within political constraints imposed by the wishes of the President, Congress and less directly, the

general public. Direct public influence on IMF policy is only likely on the back of very large political protest or concerted lobbying. Congress has more significance but only exercises intermittent oversight. Congressional interest could be driven by a number of reasons including the personal agendas of activist Congressmen as well as electoral incentives.

Oversight of Treasury policy is difficult because it is hard to keep track of exactly what is being done. Lack of transparency in Executive Board discussions is one reason for this, but influence is also exercised informally in ways that are extremely difficult to monitor.

8.2 Pre-Crisis US foreign policy

Now I have set out the institutional nature of policy on the Fund I can turn to relevant pre-crisis policy preferences. We have already seen allegations that the US was key in driving the IMF's agenda in Asia. US foreign policy before the crisis is important in assessing those claims. If we are interested in the influence of post-Asia debates on US policies towards the IMF, pre-crisis policies will also provide a point of comparison. Finally, a short review of changes since the Cold War will give a guide to the overall place of foreign economic policy within more general US foreign policy priorities.

What effect had post Cold War changes had on foreign spending? What were pre-existing goals for the Asian region? How much importance did the Clinton administration place on the IMF? What might it have been hoping could be achieved through conditionality?

8.2.1 Foreign policy after the Cold War

During the Cold War, overseas aid and foreign economic policy more generally had often been driven by strategic priorities. The Cold War came to an end during George Bush's presidency and the struggle began to determine and articulate a new vision for American foreign policy. Bush's preferred vision seemed to be one of America as a sort of 'chairman of the board'. A US led multilateral approach with considerable (if distinctly inconsistent) stress on

world order, peaceful adjudication of disputes under international law, the advancement of liberal democracy and market economics, the maintenance of liberal economic regimes...achieved through collective action (ideally associated with the United Nations) (Dumbrell, 1997, 164).

Unfortunately for Bush, this approach, particularly during the Gulf War, seemed to offer too much as well as too little. Too much in terms of the costs, both economic and human. Too little in that the demonic rhetoric Bush used to mobilise support against Saddam Hussein could not be matched with action – the outcome of the war was restrained by the limitations of international law and UN mandate, by US desire to retain Iraq as a counterweight to perceived continued threats from Iran and by limits to international cooperation.

US public support for intervention in the Gulf was always limited. In the run up to the 1992 election the full financial costs of the conflict were becoming apparent to a US population already

concerned at economic decline. At the same time, continuing difficulties in Iraq (attacks against the Kurds, refusal to allow access to weapons inspectors, etc.) were becoming more apparent.

In 1990, Congressional debates on the Food for Peace programme also made it clear that there was now considerable resistance to security justifications for aid. Congress made strenuous efforts to reduce Presidential discretion on aid allocation arguing that it was now time for greater democratic oversight to ensure that aid was used for a combination of global development and the advancement of US interests⁵.

8.2.2 The Clinton administration

Clinton's election campaign demonstrated a clear awareness of these issues. He came to power presenting himself as primarily concerned with a domestic agenda in general and, in particular, with the domestic economy. As we will see below, this was reflected in foreign policy. As Secretary of State Warren Christopher put it 'I make no apologies for putting economics at the top of our foreign policy agenda' (*Newsweek* 6th March 1995).

The second key plank of Clinton foreign policy was 'enlargement'. Echoing the Carter administration's concerns for human rights, administration officials went on to argue that human rights could best be protected through democracy and (linking to the economic agenda) free markets. Key figures such as Warren Christopher, Anthony Lake and Strobe Talbott all publicly argued that promoting democracy and markets was not merely 'idealist' but also represented the national interest⁶.

Although this stress on liberal values was important in Clinton rhetoric, it is important to emphasize its limitations in practice – particularly in relation to the multilateral institutions such as the IFIs and the UN. Stephen Walt argues that

President Clinton's handling of international institutions and multilateralism illustrates the central irony in his handling of foreign policy, namely the degree to which he departed from his initial idealism and embraced *realpolitik*...Clinton may cloak US policy in the rhetoric of "world order" and general global interests, but its defining essence remains the unilateral exercise of sovereign power (Walt, 2000, 79).

Nonetheless, a tendency to use multilateralism where it is convenient and to abandon it when it is not in no way undermines the importance of liberal values in providing *justifications* for post Cold War foreign policy. It is also by no means a signal that economic imperatives are unimportant. In fact economics is crucial:

Clinton's strategy is hegemony on the cheap because it is the only strategy the American people are likely to support (Walt, 2000, 79).

⁵ See also the more general discussion of the rise of good governance in Chapter 3.

⁶ See also the quote from Strobe Talbot at page 75 above.

8.2.3 Foreign economic policy

Trade

Despite general US enthusiasm for multilateral trade liberalisation under the GATT, there have been growing undercurrents of dissatisfaction since at least the late 1970s. GATT was largely designed to reduce tariff barriers, particularly on manufactured goods. For a growing current of US opinion, the GATT's success in doing so revealed its own limitations. Particularly key were agriculture, originally excluded with some US enthusiasm, and services which had not been an issue when GATT was set up but which were now an increasingly important part of US business and a key sector targeted for exports.

This dissatisfaction grew under the Reagan administration as what George Bush famously dubbed Reagan's 'voodoo economics' (high interest rates and loose fiscal policy) created an overvalued dollar and a corresponding trade deficit. Congress, unwilling to accept the macroeconomic causes of the deficit, tended to blame it on restrictive trade policies overseas and particularly in Japan. Initially reluctant to intervene, the Reagan administration came under increasing Congressional pressure throughout the 1980s. Eventually, in 1985 the administration responded with the Plaza accord to adjust the yen-dollar exchange rate and sector specific talks with Japan in 1985-6. However, given the inevitable lag between exchange rate adjustment and the emergence of new trading patterns, difficulties continued.

The apparent failure of the Japanese surplus to respond to the sharp appreciation of the yen fed the growing body of opinion that Japan's fundamental institutions – its economic and political systems, even its culture – were themselves barriers to trade (Bayard & Elliott, 1994, 23).

In 1988, Congress implemented new trade legislation including the 'Super 301' provisions which were designed to put pressure on the administration to publicly name countries that were 'unfair' traders. The legislation also made USTR's retaliation mandatory for breaches of international obligations and provided tight deadlines for action. Stronger provisions still, requiring a 'results oriented' trade policy were defeated but resurfaced in the early 1990s. These developments demonstrated clear conflict between Congress on the one hand and the Executive on the other, with the Executive more inclined towards multilateral solutions.

For those who were concerned by increasing signs of a bilateral rather than multilateral approach to trade pressed, particularly, by Congressional Democrats, Clinton administration rhetoric was not immediately reassuring. Key Clinton economic advisors had published books advising a 'strategic' trade policy in response to growing Japanese competition in high technology sectors. So, for example, Laura D'Andrea Tyson, Chair of the President's Council of Economic Advisors, described herself as a cautious activist on trade and had written a book arguing that barriers to trade in Japan were increasingly structural. Effectively, the Japanese version of the developmental state in itself constituted a trade barrier. If the US was to win the growing battle for 'competitiveness', she argued, the US either needed to provide more direct support for its own strategic industries or to prevent other countries from supporting theirs (Tyson, 1992).

Others, notably Jeffrey Garten and Theodore Moran, equated economic success with national security arguing that, in the new world order, economics was power. Trade issues should therefore be seen in strategic terms (Garten, 1992). This was echoed in Clinton's decision to set up a National Economic Council alongside the National Security Council in the White House. As key Clinton policy makers put it in a pre-election summary of ongoing Clinton policy:

National security must be broadly construed to include both economic and geopolitical concerns. And in many circumstances economic policies may prove the best instrument for achieving geopolitical objectives (Bowman Cutter et al., 2000, 82).

This 'economic security' approach provoked stringent criticism from more orthodox economists and from traditional security analysts. For the economists, the overarching focus on trade policy, particularly in high technology, as the determinant of economic success was at best misguided and at worst dangerous in that distracted policy makers from far more important domestic problems such as low US savings (Krugman, 1994). The tendency to think in narrow nationalist terms and to pursue bilateral negotiations ignored the broader systemic implications for world trade and WTO negotiations. Short-term gains for particular US industries could have long-term implications for the economy as a whole (Krueger, 1995).

For security analysts, the stress on economics was a dangerous reversal of priorities.

Trade policy is seen not as a means to confront major geopolitical challenges and opportunities in former cold war adversary states such as China and Russia, but rather as a tool to grab markets share from allied states, such as Germany and Japan (Nau, 1995, 4).

In a World where geopolitical threats had clearly *not* vanished, an aggressive drive to maximise US market share risked alienating allies that were still all too necessary to US security interests.

Obsession with the economy prevented the Clinton administration from articulating a coherent conception of strategic policy that could command the support of the American public (Sicherman, 1994; Wolfowitz, 1994).

In fact, both sets of criticisms perhaps run the risk of mistaking strident rhetoric for a more modest reality. During the early years of the Clinton administration there was considerable bilateral trade pressure on Japan – including a notorious dispute over car sales in early 1995 (Nau, 1995). Clinton, under Congressional pressure, also reinstated a rather watered down version of 'Super 301'. On the other hand, the stress was on foreign market opening rather than on domestic protection. Major early successes included completing NAFTA and the Uruguay Round. Fairer criticisms are those that argue Clinton policy failed to overcome tendencies to be inward looking and perhaps over responsive to domestic interests, particularly those of multinational business and the financial sector.

Trade in services and capital account opening

Within this general approach to trade policy, a particularly important development was US pressure to encourage trade in services and particularly, for our purposes, financial services.

Congress had been aware for some time that the US economy was increasingly service driven and was particularly concerned that this comparative advantage was poorly served by the GATT regime. The Reagan administration had, unsuccessfully, tried to instigate GATT negotiations on services as far back as 1982. However, it was only in the aftermath of considerable deregulation of services markets outside the US during the 1980s that there was enough interest to put trade in service on the Uruguay round agenda.

Introducing trade in services involved considerable challenges to the WTO framework:

freer trade in services, including financial services, implies much more than free cross-border trade; it raises the broader issues of market access and, more generally, of doing business in a foreign country, which involves investment, regulation, and public and private anticompetitive behaviours (Dobson & Jacquet, 1998, 76).

Concerns about regulation were particularly key and it is clear that the US agenda on services liberalisation remained significantly out of step with views in both developing countries and Europe and was heavily driven by a number of US services companies – particularly the financial services industry under the leadership of American Express (Dobson & Jacquet, 1998; Hoekman & Kostecki, 2001). EU resistance eventually ensured that GATS would be based on a positive list system where countries could choose which sectors to include in the agreement.

Financial services proved particularly problematic and negotiations had to be extended after the majority of the Uruguay Round had been completed and were only concluded at the end of 1997. The US agenda was driven by intensive Wall Street lobbying for market access, encouraged by the experience of deals with Korea and Japan that had been struck in the late 1980s and early 1990s under the threat of unilateral US trade sanctions. Access to Korean insurance markets had been obtained as part of the negotiations designed to stave off super 301 action against Korea in the late 1980s. The US Primary Dealers Act of 1988 then forced government to press for ‘reciprocal national treatment’ for the financial services sector and these issues were pressed in the ‘Structural Impediments Initiative’ talks with Japan (Frankel, 1993).

The GATS negotiations were clearly disappointing for the US. By 1995, the expiry of the first post-Uruguay Round negotiating deadline, the US administration began to argue that the inadequacy of developing country offers in multilateral negotiations suggested they should proceed on the basis of bilateral pressure. US financial institutions put considerable pressure on the US stressing the dangers of free riding⁷:

They relied on pressure from the US government to lead to better offers and, should that fail, on denying MFN to punish developing countries and educe from them a wider degree of opening (Dobson & Jacquet, 1998, 80).

⁷ Since WTO commitments are provided on the basis of MFN, any US liberalisation would benefit all countries including those that kept their markets closed. In fact, of course, it was unlikely that any developing countries had much interest in providing financial services to the US markets – one of the key reasons for developing country reluctance in the first place. However, US negotiators were concerned that, if US markets were opened now, there would be little future leverage when such negotiations were more possible.

While the EU felt that the offers that had been made established an important principle for agreement and promised further liberalisation in the future, the US was adamant. The government withdrew its offer and instigated a MFN carve out for the whole sector in June 1995. It was only in 1997 that the US reversed course and an agreement was reached.

By the mid-1990s, the trade concerns driven by perceptions of economic decline in the 1990s had become less significant in the context of a booming US economy. However, pressure from Wall Street on financial market access had not abated. Indeed, pressure for international financial liberalisation continued with moves towards financial sector liberalisation being driven through the OECD (abortive attempts to produce a multilateral agreement on investment), WTO (financial services and trade related investment measures) and IMF (calls to make capital account liberalisation an official Fund objective through an amendment of the Articles of Agreement).

Economic policy in Asia

East and South-East Asia played an important part in many of these developments in US foreign economic policy. The most high profile trade disputes of the 1980s and early 1990s were with Japan but Korea was also the subject of considerable US attention (Mo & Myers, 1993). By 1990, the Treasury was already reporting to Congress that

until the Korean Government allows domestic banks to compete in a market environment, fully liberalizes its interest rates, and eliminates credit allocation and exchange controls, there is little likelihood of major advances in equality of competitive opportunity for foreign financial service providers in the Korean market (quoted in (Frankel, 1993, 131)).

More generally, in 1993, the Clinton administration set out a strategy to target economic relations with 10 'Big Emerging Markets' (BEMs) that included Indonesia and Korea (Thailand was apparently just off the list (Stremlau, 1994))⁸. The BEMs were seen as regional leaders in both economic and strategic terms. Promoting US engagement and economic involvement would ensure US influence facilitating the 'convergence of bilateral interests and values in order to achieve greater mutual domestic prosperity and security'. It would also help to promote the institutionalisation of developing countries into multilateral fora.

The chosen countries were seen as regional leaders economically. There were also potential strategic interests. Involving them in the global economy and international institutions would help to turn them into positive examples for their respective regions. Economic engagement was also intended to be a channel through which pressure could be exerted towards human rights and political liberalisation to provide positive, successful, pro-Western examples. Issues about Indonesian human rights had already been raised in the context of the debate.

Perhaps more importantly, these countries were seen as potential consumers of key US exports: IT, telecommunications, healthcare, medical equipment, transport, power generation and financial services. A particular success of the approach involved a mission to Indonesia which won

⁸ The strategy was set out in a Commerce Department report to Congress entitled 'Towards a National Export Strategy' announced on 30th September 1993.

significant contracts for US firms including a \$2.5 billion undertaking for Mission Energy in East Java (Stremlau, 1994).

The South East Asian countries were also important in the context of WTO financial services negotiations. Disagreements over the commitments submitted by countries involved in the crisis were, until the last minute, a crucial part of US objections to the proposed schedule.

In terms of more specific issues, the USTR's annual 'Trade Estimate Report on Foreign Trade Barriers' for 1997 listed a number of concerns in Indonesia and Korea.

In Indonesia issues were: BULOG's monopoly in imports of bulk food commodities and licensing requirements on other agricultural products; general barriers to trade in services (accounting, auditing, law); and restrictions on foreign ownership – particularly in the banking and securities industries. Particular highlights were the national car project and measures designed to restrict exports of unprocessed wood to encourage processing within Indonesia.

In Korea, the list was longer – indeed the report took up 19 pages. Particular concerns with trade in goods centred on agricultural products (rice and citrus fruits – but also a wide range of other fruit, dairy and meat products), automobiles, cosmetics and steel. In services there was a high profile dispute over telecommunications access.

Particularly relevant in the context of the crisis, the report was highly negative about access for foreign banks citing a 'relatively non-transparent regulatory system' and

high cost procedures and restrictions on ...financial activities which are more reminiscent of an emerging economy than of one of Korea's level of development....From a company's point of view and despite its claims otherwise, the Korean Government has actually accomplished relatively little deregulation of practical importance in its controls over transactions involving foreign exchange, imports and exports.

Finally,

foreign investors' effective access to the Korean market continues to be highly conditioned by law and regulation, as well as by inexplicit administrative guidance and bureaucratic fiat (p247).

Concerns were also raised about the periodic appearance of 'anti-luxury' campaigns targeting Western goods.

The congruence between these pre-existing US concerns and the content of the IMF programmes in Indonesia and Korea is very noticeable.

Treasury views on international monetary economics

The Treasury and G7 consensus on appropriate macroeconomic management that I discussed in section 8.1.3 is also an important influence. It was clearly demonstrated in the response to the crisis that took place in Mexico in 1994-5 where the stress was on improving transparency to encourage more effective and rational market discipline (Kenen, 1996). Baker argues that Treasury officials explicitly regarded the post-Asia agenda for reforming the international financial architecture as a more proactive extension of the post-Mexico approach (Baker, 2002).

8.2.4 Summary

There is strong support for claims that IMF interventions in Asia reflected US priorities. Discontent with industrial policy in Japan and Korea had begun with concerns about American decline during the 1980s. As the economy picked up in the 1990s, these concerns were replaced with an enthusiasm at the prospects for financial globalisation. Clinton foreign policy was particularly focussed on economic issues reflecting the US electorate's post Cold War preferences. Pressure for 'development' spending to have a social as well as strategic justification was also significant, particularly in relation to Indonesia, which had been the subject of some Congressional concerns prior to the crisis.

The aspects of the programmes relating to macroeconomic policy and finance owed much to the sort of economic wisdom espoused by the Treasury but it also reflected a wider G7 consensus and, perhaps to a lesser extent, a consensus amongst the economics profession in the US.

Finally, multilateralism was very much part of US rhetoric though, not surprisingly, there was also a tendency to abandon multilateral frameworks when they ceased to serve US interests.

8.3 US response to the IMF's role in Asia

If pre-crisis Treasury policy was so closely reflected in IMF programmes in Asia, why was there such an outcry in the US media following the crisis? How far did that outcry convert into policy debates in Congressional Committees? Which issues were important and what was it about the crisis that triggered concerns? Who had access to those committee debates and therefore direct influence on policy outcomes?

8.3.1 Congressional debates

Moral hazard, transparency and equity

What made the press when Congress came to debate its reactions to IMF interventions in Asia, and therefore whether it would renew IMF quotas, was an emergent anti-IMF alliance between left and right wing Congressmen brokered by Bernie Sanders, an independent left-winger (*FT* 23rd January 1998 (US edition), *American Banker* 15th January 1998). The issues that united the parties were problems with IMF transparency and accountability (the degree of control that Congress could exercise over the institution) and the view that IMF programmes had bailed out foreign lenders at the expense of US and foreign taxpayers (moral hazard). Despite this agreement, the concerns driving these issues were very different for left and right wing Congressmen.

For right-wingers moral hazard was significant because the IMF was undermining the market mechanism, reducing incentives for debtors and creditors to negotiate settlements and enabling foreign investors to avoid penalties limiting their incentives for better risk analysis in the future. Concern about transparency and accountability was largely a question about the fact that US taxpayers' funds were being used without providing Congress with control over how those funds

were deployed. The underlying suspicion was that the IMF was a waste of money since US preferences (broadly access to markets for US traders and investors and remoulding those markets to make it easier for US companies to operate in them) were watered down by the multilateral nature of the IMF.

We should not commit US taxpayer resources unless and until we can answer the question ‘will it be used in a way which protects our national interest?’...the IMF is not an open institution. Some argue that the Treasury Department bureaucrats wield tremendous influence at the IMF...but that is insufficient accountability to the American taxpayer (Bachus in House Banking Oversight Subcommittee, 1998 at page 3)⁹.

Of course, as Jim Leach the chair of the committee was keen to point out, IMF quotas are a loan not a gift. They earn interest and are a US asset. The costs are the difference between that interest and market rates, and the more limited liquidity of drawing rights in the Fund.

Still, the headline sums involved in quota increases can make a powerful political impression. In addition, external support for the free market moral hazard views came from right wing think tanks such as the Cato Institute (Calomiris, 1998) and Heritage Foundation (Vasquez, 1998)], some economists (*WSJ* 27th August 1997, 3rd February 1998) and figures associated with the American Enterprise Institute (Lawrence Lindsay gave testimony at the April hearings (Lindsey, 1998)).

On the left, concerns about moral hazard and about IMF governance were driven more by equity considerations. Was it appropriate for US and Asian taxpayers to bail out large American financial institutions? Who would the IMF programmes benefit – powerful financial interests or labour and the poor? Was accountability to the Treasury going to provide comfort on those issues and was the negotiating process in developing countries likely to enhance developing country democracy?

In keeping with broader left wing US enthusiasm for promoting international standards on labour rights and the environment, there were questions about why it was possible to force Indonesia (in particular) to set up an independent central bank but not to force it to implement core labour rights¹⁰. Supporting witnesses here came from Asian NGOs (Bello, 1998) labour unions (Becker, 1998), and left wing lobbies (Nader, 1998) and a number of Indonesian pro-democracy activists (see *AFX(AP)* May 8th 1998).

Although, as I will argue below, NGOs were not particularly active in lobbying on Asia, left wing Congressional concerns echoed pre-existing perceptions that Fund policies tended to hurt the poor disproportionately, which had been bolstered by a range of popular protest movements in the US during the 1980s and 1990s including, for example, the ‘Fifty Years is Enough’ campaign around the Fund’s anniversary in 1992. In interviews I conducted in Washington in autumn 2000, left wing Congressmen and Congressional staff argued that, on the whole, they would rather there was no Fund, but if that was unlikely they would at least press for more ‘positive’ conditionality. Bernie

⁹ See also comments by Saxton,

¹⁰ See particularly the comments by Sanders and Frank in (House Committee on Banking and Financial Services, 1999) and (House Banking Oversight Subcommittee, 1998)

Sanders, for example, was also in the process of introducing legislation taking issue with conditionality in the HIPC initiative and a further bill calling for small scale human development¹¹.

Security concerns

The Administration had stressed the importance of engagement in the Asian region to show US solidarity with its Asian allies (see section 8.3.2 below). Some Congressmen supported this view but others (particularly Jackson, Bachus, Roach and Malpass) were concerned by negative reactions in Asia:

I have been to Asia five different times in the last fourteen months...And I am not saying I pick up a representative sampling of opinion, but I certainly hear and feel an undercurrent of anti-American, anti-IMF, anti-G7 backlash (House Committee on Banking and Financial Services, 1999, 130).

At least one senator felt that the IMF had been instrumental in Suharto's fall (Locke, 2000). A number of Congressmen recognised that the IMF was closely identified with US interests and many of the witnesses (both right and left wing) confirmed this perception (Bello, 1998; Hanke, 1998; Nader, 1998). Others, on the other hand, suggested (pointing to the ill feelings caused by early reluctance to get involved in Thailand (Connors, 2001)) that while there were risks to action, inaction was worse (Bergsten in House Committee on Banking and Financial Services, 1998).

Domestic effects and 'special interests'

In keeping with more electorally minded interpretations of Congressional behaviour, there was also strong evidence that Congressmen were keen to connect issues to a domestic agenda. For those in favour of the IMF important points were the extent to which Asian markets were an outlet for US goods, the dangers continued currency depreciation implied for US jobs and the potential to use the crisis to reduce Asian export dependence and enhance US market access. For those against the question was why the administration could find money to prop up US banks while it couldn't find more to spend on medicare (Sanders) and why regulatory incentives encouraged US banks to lend to foreign governments rather than 'small businesses in my district'.

An entire hearing session was reserved for US industrial interests: Boeing Asia (Bracy, 1998), Micron Technology (manufacturers of DRAM chips) (Appleton, 1998), the American Forest and Paper Association (Moore, 1998), the American Farm Bureau (Kleckner, 1998), and IPSCO Steel Inc (Russo, 1998). The general perspective was to encourage IMF support but with concerns to ensure that it resulted in more open markets for their goods and did not involve 'bail-outs' of competing firms. There was therefore a marked tendency to argue that corruption and crony capitalism had led to overcapacity and that the crisis was an opportunity to attack the unfair subsidies that had made it difficult to compete in Asia.

Perhaps one of the more interesting contributions came from Becker, representing the unions, and particularly US steelworkers. His testimony was, at one level, concerned about the effects on union members in Indonesia and, at another, worried about job losses for his members as a result of

¹¹ Sanders acknowledged that the legislation had no chance of getting passed but was introducing it to raise awareness. (These initiatives are documented on his website - <http://www.house.gov/sanders>).

currency depreciation. He didn't seem to be aware of the conflicts of interest involved in that position (Becker, 1998), a problem that affects anti-globalisation movements more generally.

Technical criticisms of the Fund

The technical issues I raised in Chapter 4 and have reviewed since also made their way into these Congressional debates, partly through academic witnesses but also via the versions that were published in the financial press which were taken up by various Congressmen and often placed on the record of Committee debates.

The possibility of moral hazard; whether there was a need for greater transparency; the desirability or otherwise of pegged exchange rates; the appropriateness of initial IMF mandated fiscal policy; and the necessity of tight monetary policy for the resolution of capital account crises were all discussed, though a wider range of Congressmen felt able to contribute to some issues than others.

The arguments different Congressmen took up were, unsurprisingly, chosen according to political perspective but the impact of the American academic economic elite is important. These expert economists lend credibility to politicians' statements and the fact that there was disagreement within the economics profession opened much of the space for subsequent political debate.

8.3.2 The Treasury, the Federal Reserve and the Clinton Administration

In the Chapter on Korea, I suggested that the US Treasury had been heavily involved in negotiating the Korean programme. It should be little surprise, then, that figures from the Treasury and Federal Reserve were strongly supportive of the IMF. A huge amount of effort went in to persuading Congress to agree the quota increase¹².

Early statements echoed IMF diagnosis of the crisis blaming domestic policy in Asia, particularly moral hazard and lack of transparency. Greenspan was particularly triumphant

My sense is that one of the consequences of this Asian crisis is an increasing awareness in the region that market capitalism...as practiced in the West, especially the United States, is the superior model...The IMF's current approach in Asia is fully supportive of the views of those in the West who understand the importance of greater reliance on market forces, reduced government controls, scaling back of government-directed investment, and embracing greater transparency (Greenspan, 1998b).

Rubin was also keen to stress the potential advantages to the US, citing 'critical economic and national security interests' in Asia and pointing out that 'the recent IMF programmes in Asia involved significant market-opening and structural reform measures' (Rubin, 1998). Others were even less subtle talking about the IMF as a 'battering ram for US interests' (Kanter, cited in Kapur, 1998, 115). The Treasury placed a short note on its website pointing out the extent of US Trade with various Asian countries.

¹² Baker quotes Treasury officials as saying that liaising with Congress took up 50% of their time rather than the normal 25% (Baker, 2002). A series of documents designed to explain to Congressmen why they should fund the IMF appeared on the Treasury website and officials addressed a wide range of committees from banking (Geithner, 1998) to agriculture (Rubin, 1998).

Congressional concerns about backlash in Asia were dealt with by stressing the extent to which the crisis itself, rather than the IMF, was responsible for political problems, so the IMF's intervention in Indonesia was

a creative response to the crisis, not a cause. The IMF program did include difficult measures, but implementing difficult measures is always necessary in restoring financial stability (Rubin, 1998)

On transparency and accountability, speakers emphasised the degree of control that Treasury was able to exercise over the Fund¹³. Various people in the Committee hearing suggested that the problem was not the degree of US influence but that some Congressmen had a problem with the way that influence was being exercised – echoing the concerns I raised in section 8.1.3.

In relation to left-wing concerns, they pointed to pro-poor measures in IMF programmes (Rubin, 1998, Lissakers, 1998) and argued that, whilst they had pressed for more movement on core labour rights, consensus had been against them (Geithner, 1998; Lissakers, 1998).

Finally on moral hazard, Treasury officials acknowledged the issue but stressed the difficult nature of the choices involved. Letting matters take their course implied a small but significant chance of serious consequences for the US economy (Greenspan, 1998b). More concerted efforts to involve the private sector such as work-out procedures or standstills risked impairing developing country market access and systemic instability as foreign investors became even more nervous of emerging markets than they were already (House Committee on Banking and Financial Services, 1998).

8.3.3 Beyond the Beltway

The issue of IMF funding is not likely to arouse much interest amongst the American public as a whole but did raise concerns amongst a narrower attentive public. I have already discussed some of the views appearing in the financial press in Chapter 1, 5 & 7 and these give some indication of views circulating in the business and financial community. I have also talked about the range of interests that were invited to provide Congressional testimony (business groups, financial practitioners, labour representatives and some Southeast Asian NGO activists).

It is perhaps worth noting, though, that there was little development NGO lobbying about the Asian crisis. This is one point at which it is important to re-emphasise the particular nature of issues involved in capital account crises. They are primarily issues about appropriate economic policy, though welfare effects are important. NGOs are better placed to contribute in debates over the PRGF and approaches to that and the HIPC initiative are clearly very different¹⁴. Nonetheless,

¹³ Lissakers, Geithner and Dawson (an ex USED) all made this point (House Banking Oversight Subcommittee, 1998).

¹⁴ So, for example, policymakers involved in the debates couldn't tell me about any NGO involvement. Jean-Marie Griesgraber, an experienced lobbyist on Fund issues now working for Oxfam US told me that she had not been involved at all. There was some suggestion that Friends of the Earth US had been involved in lobbying over deforestation in Indonesia but I uncover no further NGO input. Treasury officials also complained that they had found it difficult to get feedback for the upcoming conditionality review. On HIPC, pressure for debt cancellation

prior NGO views on structural adjustment remain influential in colouring Congressional debates on the Fund.

The other major indication of the public mood on these issues was provided by the growth of mass anti-globalisation protests first at Seattle and then at other international economic meetings including the Washington annual meetings of the Bretton Woods institutions. This scale of social protest had not been seen in the US for many years and raised significant anxieties even within the Treasury. However, protests were difficult to interpret since the protestors came from a range of different groups with different aims from environment and labour groups to anti-debt development campaigners and its direct effect on political debates around IMF reform is hard to assess¹⁵.

Perhaps indicative is a paper published by key Clinton aides in Foreign Affairs prior to the 2000 presidential election. The article is called 'New world, new deal: a democratic approach to globalisation'. It acknowledges an 'emerging backlash against globalization in the United States' but blames it on domestic factors: 'rising income inequality, job insecurity in a rapidly changing and harshly competitive environment, and a sense of powerlessness and uncertainty about the future'. The solution is 'policies to sustain America's expansion and give Americans the tools they need in the global marketplace'. In practice that means lifelong education, health care and social safety nets. In other words the solution is largely a domestic one of paying more attention to policies that compensate for globalisation's ill-effects in the hope that that will head off pressure about more international issues (Bowman Cutter et al., 2000).

8.3.4 Negotiations and legislative outcomes

The debates in Congress went on through much of 1998. Those opposing the IMF had particularly strong incentives to raise the publicity of the debate and went to considerable lengths to attract media attention¹⁶.

However, during interviews I carried out in Washington it emerged that there was never any real doubt that the quota increase would ultimately be passed¹⁷. The Republican House leadership knew that the issue was very important to the Clinton administration¹⁸. On the other hand, delaying the issue was unlikely to do them much electoral damage¹⁹. They therefore raised continuous objections in committee debates and used their majority status to delay any vote on the floor of the House in the hope of obtaining concessions on other issues. Mainstream opinion in Congress, though, was apparently persuaded that bailing out Asia was good for American jobs and for more general

organised through the Jubilee network has been enormously significant. Post-crisis attempts to raise the issue of debt workouts have attracted less public attention (see Chapter 9)

¹⁵ For a variety of academic interpretations of the significance of events in Seattle see Millennium Volume 29 No 1

¹⁶ Confidential interview with staff reporting to key anti-Fund Congressman autumn 2000

¹⁷ A view expressed by pro and anti-IMF politicians, Congressional staff (committees and reporting to particular Congressmen) and Jim Orr at the Bretton Woods Committee

¹⁸ Clinton made this clear in his 1998 State of the Union address and other interviews

¹⁹ Even the most committed anti-IMF Congressmen agreed, in author interviews, that their constituents weren't really interested

relations with the region, particularly in the context of an IMF programme that promised considerable market opening.

Nonetheless, dissenting interests did need to be assuaged and the final legislation, passed as part of the broader 1999 foreign spending appropriations act, contained a wide range of issues for the US ED to address. Some of these measures were directed at safeguarding the wishes of existing IMF supporters²⁰. So the legislation called for the IMF to promote market-oriented reform, trade and financial sector liberalization, independent central banks, anti-trust law, bankruptcy legislation, better financial sector supervision, and more privatisation. More specifically, it also called for 'opening of markets for agricultural products', and an end to Korean credit for the steel and semiconductor industries demonstrating the power of US industrial lobbies to influence Congressional debate.

For sceptics on the left there were attempts to ensure that the IMF included core labour standards and environmental issues in its programmes. The Fund was asked 'to the maximum extent feasible to discourage practices which may promote ethnic or social strife' (presumably a reference to Indonesia). The Fund was to prevent military expenditures and 'show case' projects and encourage investment in human capital and social programmes to protect the neediest and promote social equity. Finally it was to tailor its policies better to country circumstances and 'recognize that inappropriate stabilization policies may only serve to further destabilize the economy' (echoing macroeconomic criticism).

Domestically significant, there were a number of measures designed to enhance the IMF's accountability to Congress, which was the key point of agreement between the various sceptical factions. Treasury was asked to provide regular reports to Congress on its success in promoting the objectives of the legislation and the USED was instructed to press for greater IMF transparency and release of further data. The legislation also established an 'International Financial Institution Advisory Committee' to investigate the possibility of future reform of all three Bretton Woods institutions.

The other key issue on which critics were united, moral hazard, also received attention. Here, though, the wording was somewhat contradictory, with some measures concentrating on involving creditors in crisis resolution and others on greater surveillance in the interests of prevention. The USED was to 'vigorously promote policies that aim at appropriate burden-sharing by the private sector' but when it came to details this included a mixed bag of proposals. Measures ranged from 'intensified consideration of mechanisms to facilitate orderly workout mechanisms for countries experiencing debt or liquidity crises' at the anti-banking end of the spectrum to calls for better

²⁰ In fact, many of these provisions simply asked Treasury to press the Fund to do things it has always done anyway – their purpose seems to have been to draw Congressmen's attention to what the IMF *does* actually achieve. So, for example, the USED was to ensure that the Fund would 'promote policies and actions that will contribute to exchange rate stability and avoid competitive devaluations that will further destabilize the international financial and trade systems' (Foreign Operations, Export Financing, and Related Programs Appropriations Act, 1999 s.610 (1))

surveillance and more information provision to the private markets at the other. It was noticeable though that the wording was mandatory for the prevention side but only required *consideration* of more anti-creditor measures (orderly debt workout mechanisms, sharing clauses in bond contracts, making the private sector pay for crises, and greater lending into arrears).

At the end of the day, then, the IMF quota increase was passed with an enormous range of conditions attached that appeared to incorporate the concerns of almost all interested parties. The question, then, was what effect they would have in practice

8.4 Outcomes and analysis: understanding Treasury policy after the crisis

Treasury responses can be assessed on the basis of the various reports to Congress that the legislation required (US Treasury, 2000a; US Treasury, 2000b) and the views articulated by Larry Summers on necessary IMF reforms (Summers, 1999).

8.4.1 Treasury policy after the crisis

In the previous sections we saw that Congressional concerns included: the cost of the crisis; IMF accountability; and a variety of social issues. The legislation also mandated the establishment of an International Financial Institution Advisory Commission to report to Congress on reform of the Fund and the various multilateral development banks including the World Bank.

The legislation designed to reduce costs of financial crisis included measures promoting both better prevention and less costly cure of financial crises. The prevention measures involved endorsement of the kinds of regulatory reforms the IMF had mandated in Asia such as better domestic bankruptcy legislation. They also included measures that followed very closely the stress on data provision and policy transparency that had been pushed after the Mexican crisis (Kenen, 1996) but this time with greater emphasis on surveillance over the capital account and financial sector.

With Treasury support, those issues all became part of the IFA reform process. The IMF, together with a variety of other bodies set about establishing a series of 'standards and codes' for everything from release of government fiscal data to international corporate accounting standards. With Treasury support, there were a number of moves to extend IMF surveillance to include Financial Sector Stability Assessments (FSSAs) and Reports on Standards and Codes (ROSCs) in an attempt to prevent future crises. The Treasury pressed hard for these to be published in the interests of transparency and market discipline (Summers, 1999) but, as we will see in Chapter 9, there was strong developing country resistance.

When it came to the issues mandated for 'consideration' though, progress was rather more limited. Specific proposals in the legislation included sharing clauses in sovereign bond contracts, more willingness to 'lend into arrears', and linking provision of assistance to the willingness of creditors to provide significant contributions and participate in crisis resolution. The Treasury reports to

Congress endorsed all of these as a good idea but did nothing to promote them. So, for example, there had been calls for collective action clauses in bond contracts after Mexico but it had become clear that developing countries would not implement them for fear that they would be penalised on cost, unless developed countries took the lead. The Treasury, however, refused point blank to consider suggesting such a move in the US:

we have become convinced that it is not appropriate for the official sector to mandate the terms of debt contracts between countries and their creditors (Summers, 1999)

On broader private sector participation in rescues, the Treasury insisted on 'voluntary market-based approaches' on a case by case basis, avoiding any formal requirements. It reiterated the standard, but contradictory, principle that 'creditors should bear the consequences of the risks they assume, while not undermining the equally essential principles that debtors should honour their obligations and that the IMF should not encourage default'.(ibid). It would only be in exceptional cases that a Korean type solution would be adopted and in more severe cases still that the IMF would consider lending into arrears, though this was not ruled out completely. Instead the focus was to be on encouraging better 'dialogue' between debtors and their creditors.

On IMF accountability there were some positive moves, particularly in the domestic context. The Treasury agreed to provide Congress with annual reports on the implementation of the new legislation, potentially providing Congress with more frequent opportunities to assess Treasury policy within the IMF. It also agreed to press forward with increasing IMF transparency. However, interestingly, this was largely converted into pressure for more release of IMF documents, particularly to the markets. What had started as a Congressional desire for more information on IMF *decision-making* had become a reason to use the Fund as a supply of free data to the US financial markets in the interests of better market discipline. At the same time it was partly legitimated on the basis of good governance

we are learning that transparency and the closely related issues of governance and corruption are fundamental to maintaining financial stability (Summers, 1999)

On the need to prevent ethnic strife, ensuring fiscal policy was focussed on investment and on the appropriateness of Fund policy to the country concerned, the Treasury simply called attention to pre-existing Fund policy – the development of the PRGF and increased attention to social safety nets in Fund programmes. Though, to be fair, some Congressional opposition did seem to have taken limited note of the greater attention paid to safety nets by the Fund in the 1990s. If pressure didn't promote an immediate extension it at least sent strong messages that any retrenchment would be politically difficult. Treasury did seem to be pushing the Fund on labour and (to a lesser extent) environmental issues but that met with strong resistance from the Fund's developing country members who have long seen these issues as covert US protectionism.

The IFIAC, mandated under the legislation materialised as a republican dominated committee of economists and policy makers under Alan Meltzer. The main motivation behind the report seems to have been to concentrate on reducing the costs of IMF lending and the amount of lending in

total (International Financial Institution Advisory Commission, 2000). The report's aim was to refocus the IMF on the capital account equivalent of its original role, but without any attempt at re-establishing symmetry. The Fund should provide short-term, low conditionality assistance to emerging market economies, pulling out of its relationships with poorer countries. Lending should be at penalty rates to prevent IMF resources substituting for private Funds. Rather than relying on conditionality, countries would be asked to pre-qualify for assistance on the basis of compliance with a set of rigid rules. The OECD countries would be given the chance to opt out of surveillance.

The administration rejected most of the proposals on the grounds that they were largely impractical (US Treasury, 2000c) but there was growing advocacy of more expensive Fund facilities with rates rising as the term of the loan increased to provide incentives for 'graduation' (Summers, 1999). The Fund also adopted the Contingent Credit Line (CCL) which would work on very much the Meltzer principles. Countries with 'good policies' could sign up for automatic access to a relatively expensive facility to protect them against contagion.

Not directly related to the Congressional legislation, but reflecting broader criticisms of the Fund, the Treasury called for a readjustment of the IMF quota system to better reflect countries' true economic strength. It began to acknowledge more publicly that some short-term prudential capital controls on the Chilean model might be appropriate. Finally, it also called for efforts to focus conditionality more tightly. Although the logic that over extensive conditionality was problematic and potentially counterproductive seemed to have been taken on board, the impulse to pursue US policy preferences still seemed hard to resist.

The basic principle is clear: programs must be focused on the necessary and sufficient conditions for restoring stability and growth. Intrusion in areas that are not related to that goal carries costs that exceed the benefits, and may undermine the legitimacy of the IMF's advice. But the stability of banking systems, issues of social cohesion and inclusion, and the capacity to enforce contractual arrangements - these will all, in many cases, be critical to restoring confidence, and they can and should be addressed as a condition for IMF support. (Summers, 1999).

8.4.2 Analysis

There is a high degree of broad-based support in the US political establishment for much of the IMF approach. There is considerable overlap between IMF policy and the US free market, anti-government political culture. The idea of the developmental state that was of such concern to academics and some Asian leaders was barely even mentioned in Congressional debates. To the extent that country autonomy was an issue, it was debated in terms of possible social resentment for the outcome of policies that were perceived to be dictated by the United States. It was a matter of issues about security and implementation. Even left wing critics were more inclined to add new goals to IMF intervention than they were to question the range of its operations.

Major objections came from the isolationist or free market right and the anti-globalisation left. The messages the US political elite took from the Asian experience were about: the financial costs of crisis and sometimes about how they were distributed; the social costs in direct welfare terms; and

some concern that the IMF was promoting a globalisation agenda. The possibility that various forms of government intervention (such as those associated with the developmental state) might be advantageous was not an issue.

The preferred solution to the primary cost issue was to pay more attention to prevention since that would fit with everyone's preferences and was less costly to the US.

On crisis resolution there was movement which, as we will see in Chapter 9, converted into modest policy shifts on the ground. The Korean approach was officially acknowledged as a possibility and even lending into arrears should be considered in exceptional cases, since there was a genuine collective action problem in debt negotiation. But the shifts were marginal and there was resistance to anything that looked like sanctioning debt standstills before they were more or less *de facto* operating. The IMF was not to be allowed to interfere in crises in a way that could be seen as increasing the power of debtors. The right wing lobby was also pressing for more expensive loans on the basis that countries might *want* to borrow from the Fund (despite overwhelming empirical evidence to the contrary).

From the left, pressure revolved around concern for the poorest. However, it tended to be directed through the lenses of the Western left. The macroeconomic aspects of Fund programmes were a target but more concerted pressure was exerted on issues such as environmental degradation and labour rights. Although labour rights are important, in a country like Indonesia where enforcement is weak and the majority of the population are self-employed or work in the informal sector they can be exaggerated²¹. There is significant danger that the real concern on the American left is over developing countries undercutting US jobs. Debates on the environment have also long been seen by developing countries as to do with a heavily consuming North attempting to transfer the costs to the South. The strongest issues of concern on the US left, then, turn out also to be issues on which there is greatest potential for conflict of interest between the Northern and Southern poor. It is therefore not clear how much prospect there is for a truly global anti-globalisation movement.

Pressure for social safety nets and better investment in human capital is a more positive development. However, it is a difficult argument to make strongly at the Fund where the feeling is always that those are 'development' issues and not the Fund's concern.

More generally there is a tendency for 'development' concerns in the North to be driven by NGOs who tend to distrust Southern states almost as much as Northern ones. There is little impetus to support Southern state autonomy.

In any case, this left-wing pressure seems to have been difficult to translate into change in Treasury policy. As I said in section 8.1.4, legislative provisions are a relatively blunt instrument. Unless policies can be precisely specified, there is the danger that existing policies will simply be redescribed in more Congress friendly terms. This is particularly noticeable in relation to transparency but provisions about country appropriateness and avoidance of social strife were also

²¹ See, for example (Pangetsu & Henyio, 1997)

met with Treasury assurances about the continuing importance of safety nets but little visible change in policy.

Here again we see the importance of financial ministry contacts with the Fund in filtering domestic political concerns. Issues that attract particularly strong public support such as labour rights and the environment are capable of making an impact on policy but more marginal issues are relatively easily ignored.

What is most striking about the final Treasury position is the extent to which it conforms with an expanded version of the responses to the Mexican crisis. Increasing recognition of the costs of financial crises was able to shift the debate at the margins (more discussion of crisis resolution, more acceptance of very limited capital controls, and the need to take into account a new set of crisis causes). Continuing pressure on pro-poor measures, labour and environmental issues may also make marginal differences and Northern NGOs clearly do have some leverage over Fund policy but the overall approach based on developing country reform to make emerging markets safe for investors remains the central thrust.

8.5 Conclusions

What we know about US foreign policy prior to the crisis provides strong supporting evidence for claims about US influence on the structural reforms in Korea and Indonesia. On the other hand, those measures were also congruent with pre-existing economic perspectives at the Fund.

The Treasury remains solidly in command of US policy within the Fund. The factors most likely to influence the Fund are therefore those most likely to influence Treasury. Economic opinion is important but so too are the views of Wall Street and the US financial markets.

There is scope for Congressional influence at the margins but it requires concerted political pressure. Issues that spread into the domestic arena such as labour rights and the environment were able to influence a Democrat administration to some degree. Some concerns were also expressed about the negative economic effects of IMF programmes, particularly on the poor.

Overall, though, indications about the likely effects of enhancing IMF accountability to wider interests than simply the Treasury are not wholly positive from a developing country point of view.

We saw in Chapter 2 that one argument in favour of limited accountability was that international negotiators are more aware of the need for international compromise than domestic populations. There were few signs that Congress was considering how developing country governments would feel about being told to implement particular policies. They were more interested in making sure that the policies were 'right', reinforcing the Fund's technocratic bias.

Concerns about development (rather than simply US interest) were voiced but they were concerns driven largely by an NGO and often US-centric viewpoint. That coloured the kinds of issues that were raised. On the whole they were issues about ends rather than means – about the importance

of poverty or labour rights rather than about how such things could be achieved. In contrast, Mahathir's criticisms (for example) were more often about means – about the right to choose particular kinds of development policy. That meant that developing country states can expect little support for many of their goals. It also left the way open for the Treasury to use its claims to economic expertise to evade some of the intent of the legislation passed. Treasury reports could point to the wish to foster growth and the existence of social safety net programmes as answers to Congressional stipulations about programme appropriateness and poverty focus.

In any case, those left wing approaches were very much the minority. Far more time was devoted to witnesses from American industry who were keen to promote more market opening – the farm lobby, the steel lobby, the paper lobby and the semiconductor lobby. There is no reason to expect that to change in the near future.

That goes some way to explaining the limited final outcomes from the debates over IMF funding. There was broad based concern about the costs of crisis but the strength of financial and business interests succeeded in turning this into an issue about crisis prevention. While faith in the possibility of preventing crisis through more transparency and better policy persists it will be difficult to force movement on the issue of private sector bail-ins (despite the potential for that to be an issue on which Asian governments and the Western left might potentially unite).

There is some evidence that concern about implementation and developing country resistance was filtering into Treasury positions - most obviously in calls for more tightly focussed conditionality. There was less evidence, though, of awareness of that issue in Congressional debates. My personal interviews with left wing Congressmen suggest that they would rather the IMF didn't exist at all but that, since it does, they see pushing for the 'right' kind of conditions in addition to market based ones as the best available strategy. The overall dynamic, then, was one of ever increasing pressure for wider programmes.

9 Lessons, reforms and prospects

The thesis began with three questions: what caused the Fund's post-Asia legitimacy crisis, why were subsequent reforms so limited and what does an explanation of that paradox tell us about the politics of Fund policy-making and the sustainability of post crisis reforms. We have now reviewed most of the evidence required to answer those questions with the exception of a review of the post crisis reform process.

This chapter will draw together the lessons provided by the case studies about the reasons for challenges to IMF legitimacy and the extent to which those challenges were transformed into political pressure for reform. It will then review the reform process in that light, evaluate it and discuss the future prospects for Fund legitimacy.

9.1 Lessons

In Chapter 1 I argued that analysing Fund legitimacy involved two stages: an exploration of the reasons the Fund could provide countries with for compliance with its policies and a more political examination of the strategic reasons particular key actors might have for challenging those reasons combined with the resources they could bring to support those challenges. I argued that the Asian crisis therefore needed to be seen in the context of wider debates about the changing nature of Fund legitimacy claims and that historical comparisons would help to illustrate the issues involved.

This section begins with a reminder of the historical context in which the crisis took place. It goes on to explore the logical implications of the crisis in terms of IMF legitimacy claims and, finally, relates those logical debates to the incentives, interests, and political resources of particular actors to gain an understanding of the political nature of the Fund's legitimacy crisis prior to my discussion and assessment of the reform process in sections 9.2 and 9.3

9.1.1 The historical context

As Louis Pauly (1997) has shown particularly clearly, it has never been right to conceive of the Fund as equivalent to a state, able to exercise coercive power to perform most tasks it feels are appropriate. States have always been reluctant to delegate power to the Fund although they have ultimately felt that it was necessary to do so in order to provide some political control over the international aspects of the global economy. The Fund's ability to influence matters has been correspondingly limited and dependent on state cooperation. Over time, developed country states have become increasingly unwilling to delegate that power and the Fund has become more concerned with helping middle-income countries adjust to international financial conditions than it has with regulating those conditions.

Initially the Fund was created as a bargain between a creditor US and debtor European countries. The Great Depression and its consequences had concentrated the minds of the international elite on the potential economic and political consequences of unfettered market mechanisms. The Fund was designed to moderate the ill effects on countries most likely to have to adjust to international conditions – debtor countries – in the interests of preserving the legitimacy of the system as a whole. However, even in a context of post-War reconstruction, and later cooperation against a common enemy, there were distinct limits to how far creditor countries were willing to go to legitimate free trade and the monetary conditions required to support it.

The experience of 1970s stagflation served to undermine the kind of Keynesian consensus (or in political terms the concept of 'embedded liberalism' (Ruggie, 1983)) that underpinned the post war settlement. Industrial countries have become more tolerant of financial flows and more willing to adjust their economic management to financial preferences (Helleiner, 1994). That has created a very different international economic environment that the Fund has had to adapt to.

Developing countries were not a party to the initial Fund negotiations and have never had enough political power to significantly affect these kinds of global trends. They have always been in the kind of debtor position that the Europeans faced in 1942 but without the accompanying political power. It is not surprising, then, that it has been easier to see Fund membership for developing countries as a choice from an unattractive set of alternatives rather than anything more enthusiastic. Nonetheless, it is important to emphasize that there were benefits relative to the historical alternatives. Adjustment has been consistently disruptive but, as we saw in Chapter 2, that has always been the case for developing countries. At least under the Fund regime there was the double screen of sanctioned devaluation and IMF financing to ease the burden even if there was a price to pay in terms of conditionality. The existence of an institution such as the IMF at least implied a political acknowledgement that adjustment was a global problem and held out the hope of causing some political embarrassment to states in control of the financial centres.

Over time, however, the rise of international capital flows has made the bargains involved more problematic. Developing countries have lost any hope of attracting European allies in attempts to

ensure that the system remains one of reciprocal obligations (as they were able to do in the 1970s). The amount of finance the Fund provides is far less significant relative to the volume of international trade, let alone capital flows.

The kind of financial volatility that Triffin argued was characteristic of 'peripheral' countries' pre-War experience has gradually reappeared (see Triffin, 1964 and page 33 above). The responsibility to adjust to that volatility in developing countries cannot wholly be denied but, with the breakdown of the kinds of universal legal obligations that ensured some political regulation of financial relationships globally during the Bretton Woods period the burden is no longer shared in any significant way by developed countries. Historical experience suggests that while developing country policy may be better or worse at dealing with fluctuations in capital flows, those fluctuations are unlikely to disappear regardless of how well developing countries manage their economies.

The Fund response has largely been to come up with ever more elaborate policies that are regarded as essential for developing countries if they are to ensure continuing successful integration into the international financial system. In the 1980s, there was a disproportionate faith in markets' ability to regulate themselves and measures tended to concentrate simply on reducing state intervention. Failures in Africa and, more compellingly in Eastern Europe, led to a 'rediscovery' of institutions within the economics profession, and particularly by development economists, in the run up to the Asian crisis.

Immediately prior to the crisis, then, the Fund's role had evolved significantly from the one envisaged at Bretton Woods. Rather than providing political regulation of macro-economic relations between states, the Fund had become an intermediary between developing countries, minimally regulated international financial markets, and the states in which those markets were based. Since capital flows (unlike the current account) are responsive to a wide range of issues, the Fund's mandate in developing countries had expanded considerably and it was increasingly involved in regulating matters *within* as well as between states.

Over the 1990s, this situation began to look particularly problematic. Shifts in economic knowledge and practice began to emphasise the need for the appropriate institutional management of economies at a domestic level. That domestic management was to take particular forms conditioned largely by the *lack* of any regulation over capital flows at an international level: a distinctly inconsistent position, in technical (if not political) terms.

As I argued at the end of Chapter 3, this was highly problematic in the context of the relationship between the Fund's role and its institutional structures. Originally, the Fund's decision-making bodies had been designed to deal with narrow technical issues within the context of a framework of reciprocal legal obligations agreed between states. By the time of the crisis, it was dealing with a far wider range of issues in developing countries and Executive Board discretion seemed to be subject to few legal restraints. Executive Board authority, in turn, had become more problematic because

developed countries had the majority of votes but were highly unlikely to have to bear the consequences of decisions about conditionality. Board authority had always been less secure than legal rules agreed on the basis of sovereign equality but was now more suspect than ever. The Fund was therefore increasingly reliant on technocratic justifications for its authority, since it did not matter who made that sort of decision so long as it was correct. Paradoxically, at the same time, it was becoming increasingly involved in issues with significant social and political consequences that were in fact difficult to legitimate in this way.

From a Fund point of view, that was an inevitable consequence of the need to adapt to a changing global economy. For all practical purposes, the position was simple: developing countries wanted finance and the Fund's job was to explain how to get it by harnessing market confidence. 'For all practical purposes' was a fair description for the Fund itself to adopt but the authority of market discipline was ultimately the result of industrial countries' political choices to undo the Bretton Woods work of controlling capital flows. The Fund may not have been able to alter the situation but its leading shareholders could have.

In terms of my four part conception of Fund legitimacy, then, at the eve of the crisis:

1. The Fund's role had become less obviously advantageous to developing countries. The Fund provided some assistance in the event of crisis but fewer reassurances that crises would be reduced through international market regulation. Its policies were more domestically intrusive than they had been in the past. Developed countries were conscious of the costs of crisis resolution but less aware of the benefits they gained in terms of the legitimacy of the system
2. The Fund's legal mandate no longer provided much support for its activities in developing countries: it had failed to keep pace with the expansion of conditionality and the adoption of a capital account agenda
3. The authority of the IMF's decision-making bodies was increasingly only justifiable on the basis of their technical authority
4. Consent to the Fund's legal framework continued to provide a baseline of legitimacy. Formal consent to Fund programmes was also an important factor but it was also undermined by the practice of government scapegoating, suggesting that consent had not really been freely given.

In the absence of secure political or legal authority, Fund legitimacy was essentially based on two overlapping bargains: one with developed countries in which the need to provide finance was traded for the opportunity to secure trade and investment opportunities in emerging markets; and another with developing countries where the desire for rapidly increasing flows of private finance was traded against the danger of extensive policy conditionality. The first bargain was fragile because of the potential for non-implementation of Fund programmes and the second was fragile because the Fund's institutional structures did not provide much confidence that it would be

implemented fairly. Nonetheless, the combination of the promise of rapidly expanding capital flows and a high degree of convergence in economic understanding within academia, policy making circles, and developing country states seemed to be holding the bargains together prior to the Asian crisis.

9.1.2 The crisis and the normative basis of IMF legitimacy

For Mahathir at least, as we saw in Chapter 7, the crisis provided new information about the nature of the underlying bargains and suggested the need for a reassertion of political authority over market preferences. For others, favouring the *status quo* (Chapter 8), that is exactly the wrong conclusion to draw.

The debates essentially revolve around the balance between the potential advantages technical decision-making has in its scope for objectively compelling authority on the one hand and the need for political control in the interests of legitimacy on the other.

Over time, the Fund's role has shifted in the direction of technical reactions to free capital markets rather than political control over those markets. That has increasingly meant that the Fund assists states to adjust to capital flows: its technical authority is conceived in terms of telling countries what the markets want. The best justifications for that move are the utilitarian judgement that markets are welfare enhancing and the liberal judgement that state interference in the market should be kept to a minimum since markets can be a largely self-regulating sphere of individual freedom within liberal society untarnished by the problems of irrational political struggle.

Paradoxically, what the markets want (if the IMF is right at least) is increasingly a particular kind of 'technical' and 'neutral' institutional regulation. This rediscovery of institutions in development economics though makes the self-organising freedom of the markets look a good deal less free than it might have appeared in the 1980s. The Asian financial crisis also dramatically illustrated the weakness of claims that the markets were rational welfare enhancers, even, as we saw in the introduction, to many market friendly economists¹. Indeed it caused a more general crisis in the technical economic consensus that had been so important in securing IMF legitimacy in the 1980s.

Traditional crises respond to traditional medicine. We know how to diagnose them and how to treat them...the problem for the future will be how to cope instead with "high-tech" crises with a dominantly financial as opposed to macro-economic component...and it is much less obvious how to deal with these...problems (Eichengreen, 1999a, p3).

For critics, those technical difficulties provided strong reasons for interpreting the Fund's technical neutrality as tainted with political bias. The crisis also showed how socially and politically intrusive

¹ That claim ultimately relies on the first fundamental theorem of welfare economics which shows that, under certain conditions, free markets are welfare maximising. At least since Keynes, economists have acknowledged that various kinds of information problem raise questions about the applicability of the theorem in the context of financial markets. Until the crisis the consensus in the economics profession was that derogations from the relevant conditions were an unimportant peripheral problem. Since the crisis, that has been a harder position to maintain. For a clear presentation of the technical arguments, see (Stiglitz, 1994). For some more normative and ethical aspects see (O'Neill, 1998; Sen, 1987).

the imperative of adjusting to free markets could be, at least if the Fund was correct in its diagnosis, and the danger of crisis itself raised questions about whether the costs were worthwhile.

For Mahathir the solution is to reassert political control over financial markets and domestic economic policy through: Fund retrenchment; greater regulation of capital flows in source countries, or failing that domestic capital controls; and /or greater developing country representation within the IMF.

For the Fund and G7 it is to further strengthen the Fund's technical authority. Here interests or ideological conviction imply continuing faith in financial markets and the costs of flouting the markets are too high to contemplate. The problem in Asia was bad policy driven by politicisation, particularly authoritarian attempts to cling to power through patronage.

Mahathir's position rests on a diagnosis of market failure, technical failure and IMF political bias. The Fund's, curiously, seems to rest most powerfully (though often implicitly) on liberal claims about the dangers of state intervention in the markets in limiting the potential for civil society resistance to authoritarianism. These are tied up with technical claims too about the negative efficiency consequences of rents and rent seeking, but as I argued in Chapter 4, the technical claims are far less compelling and, as we saw in Chapters 5,6 and 7, the arguments keep coming back to the explicitly political issues of patronage and corruption (or social and industrial policy depending on one's views).

To me the blurred distinctions between technical, political and liberal based normative authority leave the Fund in a politically untenable position that springs from an inaccurate identity of democracy and liberalism. For the Fund, the fact that democracy and liberalism are both opposed to arbitrary authority makes them identical. Liberal preferences are therefore both economically necessary and politically desirable. In reality the relationship is far more paradoxical (Beetham, 1999). Democracy does require elements of liberal support: without liberal rights such as freedom of speech and of association and, particularly, the independent basis of power that free economic power can provide, there is a danger that the state will become too powerful. In the *economic* sphere, though, there are distinct contradictions between liberal *laissez-faire* preferences and the social aspects of democratic control. Democratic values need only suggest that a *balance* needs to be struck over how much the state regulates economic life. Ultimately that remains the position on both sides of the debate but the issue is where the balance should be struck. Mahathir accepts that markets are important but believes they need to be better regulated in the interest of other values and social and political goals. The US Treasury would acknowledge the right to political self-determination and democratic control but is also concerned to maintain market freedom.

The desirable balance will depend on the productive benefits that a relatively free market economy provides relative to the social and political costs it imposes. That is a matter of values to some extent but is also about the costs and benefits demonstrated in practice: in terms of legitimacy it is

about the relationship between purpose and performance on one hand (hence the significance of economic debates about the crisis) and institutional authority on the other.

The first aspect (technical benefits) is best assessed by technical experts while the second (evaluation relative to social and political costs) is best decided through democratic debate. The Fund's awareness of the importance of technical expertise is not wholly unfounded. Technical arguments have a role to play in making the arguments: in setting out the possibilities and the likely consequences of the available choices.

On the other hand, ultimately markets serve society rather than the other way round. Where the limits of the 'technical' are to be found cannot be determined from the technical side of the debate. Production is not an end in itself and other values remain legitimately important. How much the values of market freedom and economic efficiency are to dictate the nature of social life can only justifiably be a democratic and political decision. The solution is that technocratic decision-making needs to take place within a politically legitimate framework, both to limit technical authority and to ensure that it is not being used to cloak ideological and political interventions. There are good reasons for delegating some kinds of decisions to technical experts but the powers of those experts should be limited and they should be forced to account for their actions to politically legitimate authorities. As changes in the Fund's role have undermined the justifications for its claims to political authority, the Fund has lost that politically legitimate framework and its absence (at least in the context of the Fund's current role) is at the root of IMF legitimacy problems.

Do the Fund's moves towards greater civil society engagement provide sufficient compensation then in the form of greater democratic input to programme determination? Again, the distinction between liberalism and democracy is important. The crisis case studies suggest that the Fund remains too ready to identify civil society interests with a limited state and a free market economy where, in fact, there was some evidence that civil society favoured at least some state intervention in the interests of what in both Indonesia and Korea is referred to as 'economic democracy'.

A footnote in the Fund's recent study on fostering programme ownership (which I look at in more detail in section 9.2) is particularly enlightening on the underlying confusion:

The role of stakeholders outside government may in some instances be to promote narrow interests rather than the general welfare. The distinction between "vested interests" and "civil society" is critical but may be ambiguous or controversial (IMF 2001b, 20, note 7)

A Fund policy discussion on relationships with civil society also attempts to grapple with the same issue by questioning how representative various kinds of NGOs in fact are (Dawson & Bhatt, 2001).

These IMF approaches essentially miss the point which is that civil society is not helpful for legitimacy because civil society groups are 'representative' of the population. Representing 'special interests' is what civil society groups do. Even the most 'civil' NGOs represent special interests – those of the poor (or more cynically perhaps what developed country donors consider are the

interests of the poor). Space for civil society to articulate interests is important for legitimacy to ensure that voices are heard but, ultimately, those interests need to be interpreted, evaluated, traded off against one another and converted into policy. That was what I meant when I said that there was a tension between the popular and sovereign aspects of popular sovereignty back in Chapter 2 (see page 29). Legitimacy comes from the fact that the sovereign body that ultimately decides (usually the state) is itself (hopefully) legitimate and ideally accountable to those it serves. Civil society is a complement to legitimate institutional (state) power not a substitute for it.

In Chapters 5 & 6 I reviewed evidence that civil society input in practice was confined within boundaries set by the IMF and perhaps (in Korea) the state. In Korea the extent to which the Fund rather than the Korean government was dictating policy remained unclear. Fortunately for the IMF, clear state support for the programme and skilful political management that stressed the aspects of the programme that would have broad popular appeal resulted in reasonably successful implementation. In Indonesia, Fund attempts to claim to speak for civil society against the state made implementation under Suharto highly problematic. The extent to which the Fund was choosing how it would interpret civil society preferences (if not simply imposing the will of the markets), combined with failure in implementation even after Suharto had been replaced suggests the limitations to a 'civil society' based approach. Even in Korea, the *chaebol's* ability to question the politics of Fund interventions sent dangerous messages about the potential consequences of 'civil society engagement' in other contexts.

Ultimately, civil society engagement may, under certain circumstances which I will discuss more fully in section 9.3 below, help Fund legitimacy. However, it is only as beneficial as the overall political framework within which it is operating. While the Fund's own political legitimacy is in doubt because developing country states are under-represented, greater civil society engagement will not ultimately resolve the Fund's difficulties because the Fund does not carry the political authority to do the job of interpreting civil society preferences.

As we saw in Indonesia, if states are unwilling to implement programmes, civil society engagement can do little to help. Worse, there is a danger that attempts to use civil society pressure to persuade states of the political viability of Fund programmes has the potential to be highly counterproductive. Firstly, if the Fund appears to be interfering in the domestic political process in an attempt to secure state compliance that clearly *is* a violation of sovereignty. Secondly, I have argued that the most domestically persuasive aspects of civil society engagement in practice were the more political and less technical ones. There is considerable inconsistency in a position stressing technical authority as the reason why states should comply with IMF authority while using political justifications in an attempt to secure consent at a domestic level. Finally, if state responses to civil society pressure are restricted by the Fund's overall framework, encouraging civil society to articulate demands will put states in a politically difficult position.

The potentially perverse effects of civil society engagement (from a Fund point of view) are particularly well demonstrated by responses to the financial crisis in Thailand. The crisis created a

wide movement championing 'localism' which received support even from the Thai king. World Bank attempts to involve civil society groups in monitoring social safety nets gave them a new political legitimacy and salience. These groups were able to instigate a high profile debate about what 'good governance' should mean (or how it should be translated into Thai) with NGOs pressing an interpretation based on grassroots deliberative democracy and rural self-sufficiency².

For all these reasons, IMF attempts to interact with civil society are ultimately in contradiction with the institutional arrangements between states. Attempting to enhance domestic authority through governance conditionality and civil society consultation, beyond fairly narrow limits, risks undermining IMF relationships with states. The evidence from both Indonesia and Korea is that that is not a recipe for success.

The conclusion must be that the Fund's loose emerging system of multi-level governance will not be adequate to legitimate the kind of power the Fund is currently exercising. If the Fund is to be in charge of interpreting civil society concerns, it will need to be securely accountable to developing country publics. Alternatively, if states are to be in charge of interpreting civil society concerns, the Fund will need to offer them sufficient flexibility to accommodate those concerns. If states are tempted to use scapegoating strategies to avoid that accommodation, the Fund will be in a better position to call them to account if the obligations it imposes are more clearly defined and have a more secure justification on the basis of either political neutrality or pre-agreed legal obligation. If creating such a political and legal framework is politically impossible, why should the Fund be confident that the policies it adopts on the basis of discretion have any chance of implementation? In short, the Fund's current agenda will remain subject to legitimacy challenges unless its institutions are reformed in a direction that provides better representation for developing country states. That is partly for normative reasons but it also reflects the pragmatic reality that states remain essential in implementing IMF programmes.

The conclusion is very much the one reached by Peters and Pierre that I quoted on page 121 above. Loose systems of multi-level governance do not tell us enough about who is wielding power in what context to secure the legitimacy of the process where political and distributional issues are at stake. They are best confined to the kinds of technical issue and coordination problem that the Fund was originally intended to deal with. For more demanding roles, better defined systems with tighter legal frameworks are required. Otherwise,

multi-level governance, while tempting and attractive in its informality and orientation towards objectives and outcomes rather than focused on rules and formal arrangements, could be a "Faustian bargain" in which core values of democratic government are traded for accommodation, consensus and the purported increase in efficiency in governance. (Peters & Pierre, 2001)³.

² See (Connors, 2001) and (Pasuk & Baker, 2000), where Chapters 5 & 8 provide discussions of high level political debate about good governance and the King's 'Walking backwards into a *khlung*' speech respectively

³ For similar conclusions see also (Hooghe & Marks, 2001)

9.1.3 The audiences for legitimacy claims and political pressure for reform

In the introduction, I argued that politics and legitimacy were closely intertwined and that the key to understanding the relationship was to realise that legitimating arguments are designed to be persuasive to a broad audience but that what is politically important is how they play to particular actors at particular times in particular places. The normative arguments reviewed in the previous section are all very well then but what matters is not whether my analysis of the correct relationship between technical and political decision-making is correct but whether the consequences of what (to me) is a problematic position turn out to create difficulties for the Fund in practice.

Were developing country onlookers sufficiently concerned by the nature of Fund interventions to offer resistance within the Fund's institutional structures? Did the level of dissent suggest to those favouring the *status quo* that future implementation was under threat? Did developed country interpretations of the crisis countries' experiences support that view or was the new civil society and good governance agenda deemed sufficiently successful to provide reassurance? If that was the conclusion that was drawn is it a stable one or are future crises likely to prove that it was mistaken? How did the political interests of relevant actors affect their propensity to adopt pro or anti-reform views and what does that tell us about the politics of Fund decision-making?

On looking developing countries and dissent within the Fund

We saw in Chapter 7 that Mahathir, at least, was willing to protest openly within the Fund's institutional structures and call for reforms in response to what he saw the Fund doing in neighbouring countries. For Mahathir the crisis demonstrated the Fund's pro-Western political bias and its willingness to interfere in domestic social and political processes both for economic reasons and in an attempt to secure programme implementation. That served the interests of the Fund's leading shareholders rather than the common good and, in more technical terms, tended to close off opportunities for heterodox solutions to development problems such as those adopted with so much success by Korea and Japan. It was time to question the IMF's identification of the 'technical' with the will of the markets. That is one explanation for Mahathir's personal attacks on Soros: they were attempts to re-personalise the 'natural force' of the markets.

What about other actors though? How much support did Mahathir receive from his developing country colleagues and how is that best explained?

Mahathir certainly did receive some support but there were difficulties in establishing a unified front of opposition. Developing country reaction was mixed and less vocal than one might perhaps have expected. As Azizali Mohammed, G-24 coordinator, put it:

the sharp divergence in interests was reflected in differing approaches to financial architecture reform. The 'emerging-market' members did not like the Group to take positions that most other members wanted to espouse (e.g., an international bankruptcy regime or a lender-of-last resort) for fear that anything that sounded radical might impair their access to private markets (Mohammed, 2001b, 4).

What factors might account for that? I reviewed the most likely explanations at the end of Chapter 7. Other developing countries with different approaches to political economy may have been less threatened by IMF policy. As the consequences of Mahathir's anti-market speeches demonstrate, the desire for continued market access provides incentives for caution in criticising Fund policy, particularly around market sensitive issues such as mechanisms for the resolution of debt problems. In any case the fact that it is financial officials that are involved in Fund policy-making may militate against a full appreciation of the potential domestic consequences of Fund programmes, particularly since developing country EDs are relatively insulated from home governments because of the broad constituencies they represent. Mohammed notes a

significant fault-line [between the G77 and G24 that] derives from the fact that the G-77 in New York is run by each country's Permanent Representative at the United Nations and reports to Foreign Ministers. The G-24 representatives at the political level are Governors of the IMF or the World Bank and are either Ministers of Finance or heads of Central Banks. The latter tend to be quite acutely aware that their pronouncements can affect their country's standing in private financial markets...central bankers tend to be perhaps even more 'market-sensitive' than their Ministerial counterparts and both consider it essential to maintain credibility as an expert group (Mohammed, 2001b, 6).

Developing country financiers shared economic training, then, may make them less critical of the Fund's liberal approach than the general public. In any case, liberal views may be quite widespread even within developing countries. We saw that it was only the costs of financial crisis that finally swung the balance away from more orthodox policy in Malaysia and that considerable sections of the Malaysian population continued to favour a more liberal solution. A range of political and technical views were possible (pro-democratic populist, pro-democratic and liberal, pro status quo etc.).

Although my research did not concentrate on the positions taken by other developing country officials, so comments will necessarily be fairly general, interviews with developing country personnel at the Fund suggest that the Latin American countries were particularly keen on market-based approaches to crisis resolution. That makes sense in terms of the factors I have suggested are important. Latin American countries had already undertaken a very public conversion to liberal economic management during the 1980s, in sharp contrast to the Asian traditions of economic and even broader political management. The threat of further financial withdrawals gave financial officials strong incentives to try to distance Latin America from the kinds of problems affecting Asia. So, for example, at an ODI meeting on the Asian crisis I attended in London, the Brazilian Ambassador to the UK was keen to stress the extent to which Brazil had already undertaken the kinds of reforms the Fund was urging in Asia.

Nonetheless, despite a range of factors limiting developing country dissent, the crisis did trigger resistance to some aspects of the Fund agenda. As we will see in section 9.2, the continuing expansion of the good governance agenda and the absence of reciprocity in Fund regulation were both publicly challenged. That suggests that, even if developing country resistance is weakened in

areas where opposition will be market sensitive, it is likely to be easier to oppose the more political aspects of the Fund agenda.

Crisis countries and the messages sent by the politics of implementation

As I argued in Chapter 2, crisis countries themselves are usually in a poor position to influence Fund policy debates directly. However, the messages sent out by the crisis experience are important.

In section 9.1.2, I argued that the Fund's authority claims looked problematic because: market confidence and finance failed to materialise; structural measures were politically intrusive; the Fund's relationship with civil society was more complex and problematic than it would like to acknowledge; and those relationships also threatened to undermine relationships with states. In the event, although policy implementation was broadly satisfactory in Korea, it was very weak in Indonesia.

The comparison between Korean success and Indonesian failure I carried out at the end of Chapter 6 suggested that the Fund's ambitious agenda would need a particular constellation of social forces if it was to be successful. As Richard Robison has put it in relation to Indonesia:

Restructuring these regimes is no technical matter of policy fixes – of separating the 'natural' market from the intervention of politics and vested interest or of better leadership and more clever policies. No less than any other, the neo-liberal agenda is embedded in coalitions of interest and power...[in Indonesia] the neo-liberal agenda has not been successful in assembling a broad and powerful political coalition (Robison, 2001, 1 & 20).

The evidence also suggested the importance of state cooperation in implementing programmes, further underlining the political nature of Fund interventions. Given the politics of industrialisation in East and Southeast Asia, an orthodox liberal market economy would not construct itself, it would need to be constructed as a political project. The implication is that successful implementation in contexts that are less favourable than Korea will require very skilful political management combined with a considerable degree of pragmatism.

We have already seen the conclusions Mahathir drew from a broadly similar analysis. For him the conclusion was that the Fund was carrying out a deeply political agenda tainted with bias towards Western financial interests, masquerading as technical authority. That is significant because it triggered direct political pressure within the Fund and indirectly because Malaysian opposition suggests the potential for difficulties with programme implementation elsewhere in the future.

In this section, though, I want to concentrate on the extent to which pro *status quo* interests are likely to share that kind of analysis.

To a large extent, of course, they are not. If developing country finance ministers were not likely to pay a great deal of attention to the domestic political consequences of Fund policy unless closeness to crisis created more political oversight of EDs than was usual, Treasury officials in countries that never expect to borrow cannot be expected to be particularly sensitive. Their economic training militates against it as do their political interests. The need to head off attempts to enhance

developing country political control over the Fund gives Western governments incentives to continue trying to portray Fund interventions as technical rather than political since that reinforces arguments about weighted voting and, in any case, economists are simply trained to think in that way⁴.

Still, although much of the radical literature on international economics stresses the disproportionate power of Western capital, the time and effort developed countries spend pressing their desired policies on the Fund should also emphasize how important the Fund's ability to create a good environment for international trade and investment is for them. Private capital markets don't disburse funds out of charity, they do it because emerging markets offer the potential for significant profits. The Fund's purpose is to legitimate open markets and that should therefore be a purpose valued by the developed countries.

The systemic consequences of capital account crisis and the fact that the catalytic effect did not in fact materialise, regardless of the cause, should focus minds on the need to do better at reducing the costs of financial crisis. Mahathir's reactions, as much as the costs in developing countries, will have sent dangerous signals about the potential for a rebellion on capital account openness at least over the longer term.

On structural policies, we have already seen how closely the Fund's policies corresponded to pre-existing US preferences, again suggesting likely enthusiasm for the *status quo*. However, even from a relatively self-interested point of view, there are also reasons for caution about expanding lists of conditions too far. There is little point in having the 'right' programme if it will be impossible to secure implementation. In fact, if a programme is not going to be implemented, that returns considerable choice to the borrower government, which gets to choose which aspects of the programme it will ignore.

For political purposes it was convenient to argue that non-implementation in Indonesia was about Suharto's inclination to devote more effort to maintaining his own political power than resolving Indonesia's economic crisis. The evidence though is somewhat different. Suharto seems to have been prepared to implement an IMF programme that was not *too* costly (the first programme) but was later put off by the failure of that programme to create market confidence⁵.

Even without particularly sophisticated political analysis about the potential for implementing the IMF's new 'technical' agenda, it should be clear that the more expansive the Fund's agenda becomes, the more difficult it will be to implement and the more likely it is that political opposition will materialise.

⁴ For a similar analysis of the structural constraints pressing the World Bank's management and leading shareholders to emphasise technical authority see (Wade, 1996)

⁵ Of course, for those that see the problem as non-implementation of bank closures, rather than the closures themselves, that conclusion might still be questioned. My response would be to point to the Fund's own acknowledgement of flaws in the bank closure strategies, leaked to the New York Times.

Of course that does raise very difficult issues. If one is convinced that the Fund's structural agenda is essential to support capital account openness and is in the best interests of domestic populations - that the problem is obstructive states and political leaders - the choice is really one between not lending (and risking contagion) or lending on a poor programme. However, even then a more pragmatic assessment of what is essential, rather than merely necessary, may enhance Fund legitimacy at the margins and result in a programme that is easier to get implemented. The stronger the normative and technical justifications the Fund can provide, as I have pointed out all along, the better the chance of implementation (though there are no guarantees). The failure of the market oriented approach to crisis resolution makes these issues all the more salient.

In other words, even if the imperative of parsimony is something begrudged because it is seen as a response to the need to work with perverse and immoral states, it remains a compelling pragmatic, if not normative, response to the events in Asia. That is particularly so in the light of the evidence from the case studies suggesting that there is ultimately no alternative to working *with* developing country states. In any case, my analysis suggests that the need for parsimony is a conclusion that will only be reinforced over time as similar problems are discovered in different contexts: politically at least there are only so many developing country leaders one can condemn as wholly immoral or incapable.

How *much* parsimony is required and how much alteration to current policies on financial crisis, though, will remain a matter for political debate and political struggle. Here relatively successful results in Korea and a tendency to see Indonesian problems as 'political' and therefore beyond the IMF's control will be important in limiting change. The apparent success of civil society engagement in Korea and the political popularity of claims to have supported the Indonesian people against Suharto may mean that it will take longer before the limits to the civil society and good governance agenda are wholly appreciated.

Of course, the Asian crisis was also particularly significant because the countries concerned were relatively powerful in economic terms and important strategically. That might imply that worrying messages will be easier to ignore in other contexts. However, the crisis also demonstrated how relatively isolated difficulties can escalate into systemic problems through contagion. That suggests that the problems will be hard to ignore indefinitely.

If no more pragmatic compromise can be arrived at, and Fund policies cannot in fact be implemented, the conclusion must increasingly be that the world cannot be made safe for free capital flows.

Developed countries, the status quo and domestic political challenges

I reviewed the kinds of international factors that might influence developed country EDs in the direction of IMF reform in the previous section. What about the domestic political process?

Again, it is important to emphasize the dominance of Treasury officials in domestic political debate. We saw, in chapter 8, how challenging the Treasury's free market economic perspective is very difficult.

Concerns were raised very publicly in US debate. In particular critics on both left and right were worried about costs to the tax payer (although these were in fact far smaller than the debates might have suggested – IMF assistance comes as a loan not a gift). Congress felt that it was not sufficiently in control to ensure that it obtained value for money. For the free market right, the danger was in sending the wrong message to financial markets (though a less explicit reluctance to approve any foreign spending was also an issue). For the left the concern was that, since Fund assistance was basically seen as aid, it should not be helping the richest (financial institutions and conglomerates) rather than the poorest (usually seen incorrectly as labour) and the environment. If the Fund could ask for central bank independence, why not labour rights and environmental protection?

Although these issues were raised in the media and gained credibility through backing from *op-eds* penned by highly respected economists, ultimately the nature of underlying interests meant that lobbying from US multi-nationals, domestic companies facing competition from 'unfairly' favoured Korean businesses, and the US financial services industry was likely to have more political impact. That kind of lobbying was far more likely to re-enforce pre-existing Treasury preferences and was, in turn, given credibility by the Treasury's near monopoly of credible economic expertise within national political institutions.

Of course all those interests still had a stake in effective crisis resolution and technical doubts about the effectiveness of the IMF's approach in Asia left room for economic debate about possible reforms to Fund policy. Economic challenges, then, do have significant potential to lead to Fund reform and the pragmatic issues raised in the previous section may also have been influential but there are also countervailing pressures.

We also saw that the American left was not totally lacking in influence. However, the agenda promoted in Congress was driven by the kinds of approach championed by Northern NGOs and, perhaps also by the experience of social problems in the United States. Pressure for change on this front was therefore more likely to be in the direction of governance conditionality and civil society engagement than it was in the direction of greater developing country government autonomy in economic policy-making. The political nature of support for this kind of agenda both within Congress and in the context of Seattle style public demonstrations tends to mean that discussions about how best to harness the benefits of markets are unlikely. It is very important to note that there was almost no positive mention of the 'developmental state' approach in political debate in the US.

Instead, pressure from NGOs tends to concentrate on pressing particular *values* (poverty, inequality, environmentalism) rather than on putting forward concrete proposals for how these values are to

be realised (Kanbur, 2001). That makes it easier for the Treasury to subvert legislative intent by arguing that pre-existing policy does indeed serve those goals. On the other hand, there is some strategic logic to that kind of NGO pressure. If technical issues are unlikely to be changed, concentrating on more 'positive' conditionality has a better chance of success to the extent that it does not undermine Treasury's own goals. In the light of my earlier arguments about the contradictions between a social and political agenda and IMF technical authority over states, though, again there are questions about how much scope there is for further movement on these kinds of issues.

Left wing pressure, then, largely tends to favour issues that may be more popular with sections of developing country civil society than they will be with developing country states. However, there are still some potential areas for strategic alliance. In particular pressure for greater Fund transparency and political accountability can serve developing country interests to some extent.

Just as there are differences between developing country responses to the crisis, there were also differences in developed country responses. Again, my research only permits some fairly general observations. However, it is worth pointing out that the US perspective on economic management is particularly liberal. European and particularly Scandinavian countries have a more interventionary social democratic tradition. That may well affect the intellectual environment within Treasury ministries. The traditional importance of development spending and development ministries within some of those governments may also imply a more developing country friendly tradition. Those cultural factors may also be related to economies where financial services are a less important part of the domestic economy than, for example, manufacturing concerns.

Another factor is the institutional structuring of debate over these issues. In the US it was the need for Congressional approval of a funding increase that triggered domestic legislative debate. In other countries debates were less open to the public eye. In the UK for example, Fund policy is reviewed by a Treasury Select Committee. The implications are complex and difficult to specify in the abstract. For example, Clare Short's input to Fund policy may serve as a modest corrective to purely Euro centric views in the Treasury whilst in the US USAID has no input to Fund policy as the Fund 'is not a development institution'. On the other hand, there is less scope for public input into the policy-making process. Within the Fund, though, public debate has important effects on US power. Congressmen were well aware that their public dissent could be used by the Treasury as a lever in Fund negotiations and more private debate in Europe reduces that kind of political opportunity.

9.1.4 Conclusions

The IMF's crisis of legitimacy sprang from a growing mismatch between its role and the nature of its authority. Its role had shifted from one of securing the legitimacy of market openness by helping states, globally, to exercise a degree of political control over financial markets into one of helping developing country states to adapt to the demands those markets were making on them. As

controls over capital flows were reduced and economic health began to depend on market confidence, the kinds of issues involved in adapting to the will of the markets were involving greater institutional change at a domestic level in developing countries while the Fund's institutional structures provided it with very limited claims to political authority over developing country states.

The rapid increase in capital availability for emerging markets in the 1990s had given countries some reasons to accept the bargains involved but the crisis experience in Asia began at least to change that sanguine view.

In section 9.1 I argued that the kinds of interventions the Fund was involved in were increasingly difficult to evaluate in purely technical terms. The separation between economics and politics was becoming harder to maintain as markets became more demanding. It is not exactly that the IMF's current role contradicts state sovereignty (states retain an exit option and the kinds of regulation the Fund is demanding are in fact exercises of sovereignty), it is rather that the imperatives of adjustment to the international financial markets, as mediated by the Fund, puts pressure on states to exercise their sovereignty in a particularly narrow fashion. Since state sovereignty has always been justified ultimately in terms of efficacy, on the grounds that it is necessary in the interests of securing goals valued by domestic populations (Dunn, 2000), the narrowness of states' room to manoeuvre is threatening to their domestic legitimacy unless the economic benefits are readily apparent and widely distributed.

States have increasing incentives to ask whether the restrictions placed on them by financial markets are really worth the benefits. Not only is adjustment more intrusive, financial flows themselves are more uncertain. The crises, after all, took place in countries that were previously regarded as good performers and the policies the Fund mandated to adjust to market preferences did not appear particularly effective at mobilising finance. Either that suggests that the Fund is doing a poor technical job (its policies were *not* appropriate to restore market confidence) or that the costs of adjustment are very high.

Greater engagement with civil society in an effort to counter these concerns and attempts to point to the political-liberal, as opposed to technical, consequences of the Fund's preferred policies at a domestic level has had some success in diffusing the political problems involved in programme implementation over the short-term but is ultimately an unstable strategy.

That is partly because of contradictions involved in the Fund's tendency to identify democracy with liberalism and partly because of the contradiction between using technical justifications for the Fund's authority over states and political justifications for its authority at a domestic level.

If the Fund is to be more accountable to civil society, surely it should also be more accountable to developing country governments? A negative answer to that question must surely imply that the Fund and perhaps Northern NGOs are more reliable people to determine developing country politics than developing country governments. Put in those stark terms, it should be very clear that that is not an acceptable answer for a wide range of reasons (wrong incentives, limited knowledge,

narrow perspectives, no accountability etc.). There may be situations in which the adequacy of developing country government is in doubt but there is ultimately no alternative to dealing with that situation through domestic political struggle (perhaps with external support).

In more political terms, though, there are factors that stand in the way of a general acceptance of that pro-reform point of view. Those with greatest control over the Fund's institutions also have the strongest interest in maintaining the *status quo*. Internationally, developed countries have the largest voting share in the Fund and are least likely to suffer the political consequences of Fund programmes. Domestically, economically trained financial elites have greatest control over Fund policy. In any case conflicts of interest between different developing countries as competitors to attract finance make a united front difficult to achieve.

Nonetheless, the logical and normative difficulties revealed in my analysis of Fund legitimacy do have direct political impact in that they explain some of the difficulties of programme implementation and account for public developing country complaints about the scope of Fund authority. Economic integration is a fundamentally cooperative activity and the opportunities emerging markets provide for developed country profit are not easily ignored. Even given imbalances in international political power, then, there are pressures operating on the Fund's leading shareholders to do something about Fund legitimacy in the wake of the crisis.

Politically, though, the most immediate pressures do not necessarily press in the direction of greater flexibility for developing country states. The dominance of NGO interests goes some way to explaining the contradictions in the Fund's attitudes to civil society engagement. The dominance of developed country interests in the Fund means that it can be under more pressure to accommodate the views of Northern NGOs than it is to accommodate those of Southern states. That seems to be creating a dynamic of attempts to secure programme implementation through providing carrots to developing country populations in the form of more socially and politically (rather than technically) attractive policies rather than through amending the Fund's institutional structures in a way that would give greater voice to developing country governments.

The same dynamic is also noticeable in the unstable articulation between technical and political aspects of the good governance agenda. The political aspects of the agenda such as transparency in policymaking and accountability play well with the NGO lobby and domestic society in developing countries and can also be explained to financial technocrats as measures that make policy more predictable and easier to assess for the markets. At the same time, technical measures such as market liberalisation and the publication of corporate accounting data can be portrayed to the NGO lobby as related to corporate accountability and the need to restrain state authoritarianism. There is a danger that this can be pushed too far though, straining the overlapping agenda and drawing attention to the tensions within the good governance concept. So, for example, the US Treasury's tendency to interpret Congressional demands for greater transparency in Fund decision-making as a call for more information release to the financial markets begins to make the strains particularly clear.

Although the contradiction between those approaches and the need for developed country state cooperation in implementation makes those moves politically unstable, they do have a certain political logic in the context of the Fund's current institutional structures.

In Chapter 1, I argued that what was important about IMF legitimacy claims was how they play to key audiences. That discussion of the pressures favouring reform and resistance puts us in a position to discuss who those key audiences actually are. I argued that key audiences for legitimacy claims were those who were in a position to prevent the Fund from carrying out its purposes.

We can see that there are in fact a number of audiences in that position in different ways. Executive Directors and, to a lesser extent Governors need to be persuaded to agree to Fund policy. That is important for lender countries to ensure continuing flows of finance and to borrower countries to ensure cooperation with conditionality. The better the level of consent to general obligations agreed in Fund fora, the more difficult it will be later to object to conditions imposed in the context of conditionality.

The discussion of the case studies has made it particularly clear how crucial borrower country governments are as an audience if programmes are to be implemented. However, they have also suggested that, given the breadth of current Fund programmes, consent from finance ministries alone will no longer be sufficient to secure programme implementation. Beyond that, domestic populations in both types of countries are important but slightly less crucial. Their dissent is, to some extent, something that needs to be managed by governments but if domestic cooperation is threatened too much that will have an impact on governments' willingness to cooperate with the Fund. Domestic reactions then place a more indirect limit on legitimate Fund action.

For many observers there is one final audience of what is often referred to as 'international civil society': development academics, NGOs, and a variety of international protest movements. I am personally more inclined to see these groups as a particular kind of domestic interest since their influence comes most directly through the anxiety it causes domestic political actors. The significance of internationalism is in the extent to which the same message can be articulated in different contexts which is potentially important. Politically what matters is that the status of these groups as an 'attentive public' can give them a disproportionate influence over Fund debates. For economists, that is particularly related to the Fund's concerns to secure its technocratic legitimacy. For NGOs it is related to their increasingly sophisticated advocacy skills which can have a significant influence on public opinion.

The difficult question for Fund legitimacy and politics raised by this range of different audiences concerns where the balance is to be struck between financial stakeholders (and those that influence them) and stakeholders that can deliver implementation. That is not simply a normative question, it is also a pragmatic one about making sure that sufficient concessions are made to relevant actors to ensure that the institution continues to function. The Fund's institutional structures currently give it incentives to take more notice of finance providers and their domestic constituencies (including

Northern NGOs). The danger is that the result will be a tendency to be able to reach agreements within the institution that are not implementable outside it. That will be facilitated by the fact that representatives from implementing countries that are present are likely to be those with an economic and financial perspective that may be poorly suited to understanding the political implications of expanded Fund policy.

Pragmatically, the actors who are able and likely to disrupt Fund programmes are unlikely to be sufficiently considered. Even if the resulting policies *are* in their interests they will have few reasons for believing that is so. In any case, the quality of Fund policies is likely to be impaired where practical considerations surrounding implementation are not taken into account.

The question for the next section is the extent to which this mismatch between institutional incentives and the stakeholders whose cooperation is required has shaped the reform process and, therefore, whether or not that process has led to a more sustainable relationship between the Fund's role and its institutional makeup.

9.2 Reforms

The concerns about IMF authority reviewed in section 9.1 were principally about a form of technical authority that tended to see its role as simply facilitating the working of liberalised financial markets. For those inclined to challenge Fund legitimacy, pressures were therefore in the direction of reasserting political control.

Looking back to the original model of the Fund created at Bretton Woods, we can imagine that taking place in a number of ways. Firstly, the Fund's original mandate was relatively tightly defined and legally enshrined in the IMF's Articles of Agreement. The crisis suggested that exactly what it was or was not reasonable for the Fund to do was no longer clear. A legal framework backed up by state consent would therefore be one potential way to bolster Fund legitimacy, particularly if it went some way to placing obligations on non-borrowing countries to promote global financial stability.

Part of the Fund argument for the necessity of its structural reforms was that market confidence would not return without them: there was in fact little practical room for political choice about the extent of the Fund's mandate. The eventual need for borrower country guarantees and the Malaysian experience suggests that various kinds of non-market approach to crisis resolution could help to restore the scope for political choice.

The second form of political control originally involved in the Fund's mandate concerned the voluntary nature of conditionality and states' right to negotiate and ultimately reject Fund programmes. How much freedom of choice states are actually given remains difficult to determine since negotiations go on behind closed doors. Nonetheless the uniformity of programmes in Asia and more public arguments in Indonesia suggest that there is not much room for flexibility. Given the arguments I made about the importance of state acceptance in programme implementation,

greater flexibility – essentially less demanding conditionality – provides another obvious avenue for exploration.

In the context of conditionality, I argued that both good governance conditionality and civil society engagement had some potential to bridge the gap between finance ministry consent and popular acceptance but that they also risked undermining Fund legitimacy with state audiences. There were tensions that would need to be resolved through political debate.

Finally, on the other hand, my analysis of relevant audiences for legitimacy claims suggests that there will also be resistance to change within the Fund. From the point of view of funding, the IMF will be most concerned with the opinions of a US Treasury (and perhaps other G7 Treasuries) that has considerable interests in keeping things as they are. The question for this section is how these political tensions are played out in the reform process and whether the resulting reforms are likely to be adequate to revitalise Fund legitimacy. How much has evidence of political strain succeeded in persuading dominant players of the need to move towards more robust political authority over financial markets at a domestic and international level?

9.2.1 Reform debates

Codifying the Fund's mandate: surveillance, standards and codes

In the aftermath of the crisis, the Fund has made an effort to codify some of the new areas that it has started to regulate, providing a closer relationship between conditionality and a broader set of permanent international obligations.

However, from a developing country point of view, there are two difficulties with this process as it currently stands. Most fundamentally the new codes are 'soft law'. They have not been developed on the basis of negotiation between sovereign states. Instead they have been developed by a series of 'experts' under the supervision of the IMF and the Financial Stability Forum (FSF). The vast majority of these expert bodies involve no developing country representation at all⁶. That raises obvious questions about whether the resulting codes are in fact appropriate and implementable at a domestic level (Pistor, 2000) and certainly about whether appropriate attempts have been made at prioritisation given the sheer costs of implementation for developing countries and given the other pressing claims on their resources (Rodrik, 1999; Rodrik, 2001b).

In terms of policy content, it is perhaps unsurprising that the main thrust of the regulations has been to encourage developing countries to adapt themselves to the ways in which Western financial markets are accustomed to doing business. It has not looked anything like Mahathir's hopes for greater international control over those markets.

G24 ministers and sympathetic economists (Akyuz, 2000; Mohammed, 2001a; Ocampo, 2001) have argued that while the codes do address acknowledged weaknesses in developing countries, they fail

⁶ The nearest the FSF membership comes to developing countries are Hong Kong and Singapore and, indirectly, representatives from the Fund and Bank. Standard setting bodies include the Basle Committee, the International Accounting Standards Committee, and the International Organisation of Securities Commissions none of which have any developing country representation. (see <http://www.fsforum.org>)

to deal with the underlying instability in the sources of international finance. Particular targets have been Mahathir's old enemies the hedge funds and currency traders (G24, 1997; G24, 1998) but there is also considerable emphasis on the adverse consequences of swings in the G3 currencies⁷.

In terms of the original conception of the Fund, it is interesting that the issue of adjustment continues to be related to the broader framework of international financial management suggesting that the issue of symmetry continues to hold out potential for enhancing Fund legitimacy. In that connection, developing countries acknowledge the contribution G7 interest rate cuts during 1998 made to crisis recovery but note that the IMF played no part in ensuring that this took place and that it provides no guarantee that such help will be forthcoming in the future (G24, 1999; Ocampo, 2001)

Perhaps unsurprisingly, then, the overall process remains controversial and that has had an impact on the status of the new codes, which remains unclear. The G24 have repeatedly insisted that they remain voluntary and only form part of surveillance where countries choose to adopt them. The US clearly wants to see them made compulsory and to have the results published for the benefits of the financial markets.

Some within the G24 believe that, once the codes have been elaborated, they will become a *de facto* standard in any case and market discipline at least will effectively make them compulsory for countries wishing to attract significant private finance. There is little publicly available data on how much the markets in fact use IFI data so this concern is difficult to evaluate and the situation may, in any case, change over time if the ROSC process proves successful. Some of the issues about information use prior to the crisis, though, suggest that the markets (at least in the past) have not always taken much notice of such public sector data and a survey of US emerging market Fund managers provides modest indications that this may not have changed⁸.

Suspicion that political agreement on a new legal framework will be difficult or impossible to obtain has led the Fund into pragmatic attempts to create a code on the basis of technical authority. There are two obvious disadvantages. The first is that the resulting code does not command the same kind of political authority that it could have obtained through a more satisfactory process of negotiation and the second is that there are few guarantees that the codes that result will be appropriate in developing countries since those best placed to decide have had little input in their formulation.

For the more sceptical, this reliance on 'soft law' replicates a pre-established pattern involving:

⁷ Every major developing country financial crisis has been preceded by significant exchange rate misalignments (Akyuz, 2000). In Asia it was swings in the yen-dollar exchange rate that were implicated (see section 4.1.1 above).

⁸ See also (Mosley, 2001). In a survey of emerging market Fund managers in the US, Mosley found that very few were more than vaguely aware of the IMF's flagship SDDS paying much more attention to the private brokerage houses and the international financial press. However, a survey of bond traders would have been more useful in relation to the SDDS and her information from credit ratings agencies suggested greater awareness.

the deliberate cloaking and minimisation of the role of law by States in monetary matters – especially in developed countries. This is manifest through the elaborate constructions of soft law rather than firm law that characterise IMF jurisprudence (Qureshi, 1999)

On the other hand the codes demonstrate an awareness of the need for a global legal framework if Fund legitimacy is to be secured. They also present, potentially, the starting point for developing countries to push at the logic of that in a direction of more symmetry over the longer term, though the political obstacles are enormous.

Bailing in the private sector

Since the costs of crisis were such an important issue in triggering debate, one might have thought that this was an issue around which there was greatest potential common interest in a solution placing more pressure on private creditors to take losses. Neither developed nor developing countries wish to meet the costs of private sector bail-outs.

The magnitude of the crisis did trigger significant debates about these issues and there was broad acceptance (even from the financial markets) that *something* needed to be done to promote more orderly debt workouts⁹. The problem was in coming up with any universally acceptable agreement on what exactly that something should be.

There appears to have been a debate between one view emphasising the need for international rules about this issue and another arguing that, since every case was different, a ‘case by case’ solution had to be adopted. Interestingly the fault lines were not between creditor and debtor countries but cut across that division. There was a preference in Canada and some European countries for more rules, a presumption that if Fund resources over a certain level were required private sector involvement would be mandatory (Mohammed, 2001a). The US was strongly opposed. Amongst the developing countries, Asian countries were more likely to favour rules while the Latin Americans (particularly Argentina) preferred a market-based solution. Similar divisions were evident on the question of sharing clauses in bond contracts. Such clauses were not uncommon in bond issues under English Law already and the UK, Canadian and German governments have all issued such bonds since the crisis but the US has refused to follow suit.

The debate, of course, revolved around the potential effects of more concerted solutions on assessments of emerging market risk and therefore on the costs of emerging market finance. Since Argentina’s entire development strategy was based around an attempt to reduce bond prices through removing government discretion over economic policy making (Rodrik) it should be no surprise that the Argentinian authorities were keen to minimise any potential ill effects. To the extent that subsequent problems were already brewing (see below) that position may also have reflected pre-existing concerns about the costs of government borrowing.

A European concern with rules may reflect a greater general willingness to see regulation of financial markets in Europe. Differences, then, were about *perceived* national interests mediated

⁹ See for example comments by Robert Gray of HSBC recorded in the transcript of the UK Treasury Select Committee’s review of Fund policy 18th Feb 2000 (available on the House of Commons website)

through a variety of technical economic perspectives as much as they were by some kind of more objective 'national' interest as a lender or borrower country. Concerns for global economic stability were important as well as merely the short-term interests of powerful financial markets.

Of course the nature of country experience, though, will also provide incentives to view matters in one way rather than the other. One high-level South-east Asian financial policy maker, for instance, told me confidentially that the 'Malaysian option' now looked quite attractive to him.

Overall, though, once the G7 had decided on a solution that lay closer to the case-by-case end of the spectrum there was never going to be a sufficient developing country consensus to push through a different policy. Even if the middle-income countries had been united (which they weren't) HIPC countries did not have sufficient interest in the issue to stick their necks out.

By late 2000 the Fund position was to all intents and purposes identical to the US Treasury position set out in Chapter 8 (though the position has changed significantly since then – see section 9.3 below). That solution does involve a willingness to officially acknowledge the possibility that concerted debt roll-overs, like those in Korea, might be necessary under certain circumstances. The Fund has also accepted the need to extend its policy of lending into arrears at the margins but, overall, it is clear that those are to be regarded as exceptional solutions and that the decision is to be made on a 'case by case' basis.

Here the central problem is the structural power of capital. Developing countries need resources and attempts to ensure more stable and sensible flows of capital will inevitably mean more expensive capital too. Over the long term that may, nevertheless, constitute good policy, at least for the most creditworthy, but it is going to be a hard decision for domestic financial elites to make when they are closest to IMF ideology and to the domestic financial institutions with most interests in a continuing flow of Funds. When everything looks rosy there is little incentive even for emerging markets to push this issue. It will take more crises before anything more substantial is done.

Conditionality and ownership

Since Horst Kohler became Managing Director in mid-2000, the Fund has undertaken an intensive review of its conditionality. There was already an acknowledgement, in the face of intense economic criticism and recessions in Asia, that early fiscal policy had been mistaken (Boorman et al., 2000; Lane et al., 1999). However, the Fund initially mounted a fierce defence of its structural policies (Fischer, 1998b).

By the time of the conditionality review, though, there was a growing acknowledgement of unease over the rapid expansion of the Fund's mandate:

Such flexibility and responsiveness is undoubtedly encouraging but at the same time, it is important to safeguard the effectiveness of the institution and the legitimacy of its activities by ensuring that the IMF's activities are well prioritised and focussed in areas where the IMF has a mandate and expertise (IMF, 2000b).

IMF programmes had a tendency to contain:

Structural conditions [which] are no doubt useful but, [in relation to which] it is debatable whether they are important for the restoration of confidence and needed to be dealt with at the height of a crisis (IMF, 2001c).

Although G24 working papers do not necessarily reflect the views of the G24 ministers, it was significant that research had been commissioned on the expansion of conditionality (Kapur & Webb, 2000). A series of G24 communiqués later questioned governance conditionality and Horst Kohler admitted that

The appropriate scope and depth of structural conditionality in Fund programmes has been raised consistently in my discussions with member country officials (IMF, 2001a).

In response, the Managing Director issued an *Interim Guidance note on Structural Conditionality* in an attempt to streamline conditions. It revolves around the

Presumption that structural conditionality will be limited to a core set of essential measures that are macro-relevant and in the Fund's core area of responsibility, with a broader approach requiring justification based upon the specific country situation (IMF, 2001a, para 2).

On the other hand, conditions that are macro-relevant but not critical can still be included if a case is made and conditionality that falls outside the Fund's expertise may still be adopted with World Bank assistance (paras 7,9,11). The main difference between these guidelines and the pre-existing 1979 ones is that the explicit acknowledgement that structural conditionality will exist allows the Director to emphasize the need to provide explicit macroeconomic justifications for it when it is included in programmes (para 6).

The fact that the issue is being acknowledged, then, is important but how much difference the guidelines will make in practice remains to be seen. Past experience provides reasons for scepticism: I talked about the fate of the guidelines issued in 1979 above¹⁰.

Further indications of IMF concern come from a recent internal consultation document on fostering ownership that was recently reviewed by the Executive Board (IMF, 2001b).

It suggests the possibility of recruiting staff with a broader social science background in an attempt to attain a better understanding of 'domestic heterogeneity'. Resident representatives and more continuity on country desks might help awareness of these kinds of issues. Appropriately trained staff should be more willing to engage in public debate in an effort to put the Fund's views across, particularly where they conflict with those of government or key stakeholders.

Wider participation can be advantageous where it results in wider acceptance of the need for reform. The Fund's job is to strengthen the hand of pro-reform factions:

¹⁰ See also Summers' comments on conditionality on page 254. As Evans and Finnemore (2001) point out, the staff's response to suggestions in the external surveillance evaluation suggesting that surveillance should focus 'only on the core areas of exchange rate policy and directly associated macroeconomic policies' was to argue that this 'ran counter to the demands of IMF members and the international community for more emphasis on interactions among macroeconomic, structural and social policies'

A common feature of many successful cases is that the authorities will initially resist undertaking difficult reforms but, by the time the programme is approved they will embrace at least the major components.

Failures on the other hand take place when the government as a whole never buys into policies that 'some of the authorities agree'. In other words the Fund is becoming increasingly aware that finance ministry consent, alone, is not enough and that there needs to be engagement with the highest levels of government from the start.

There is some acceptance that civil society consent is also important. However, the concerns about civil society's representativeness and the danger that particular disaffected groups might capture debates continued to temper Fund enthusiasm. The report ultimately emphasizes that

Members of the IMF are sovereign states and the right of the authorities to implement economic policies of their own choosing should not and cannot be abrogated .

On conditionality, staff should be more open to

Programmes that differ from the staff's preferred options as long as the objects of the programme are not compromised .

Greater effort should be directed at building negotiating capacity in borrower countries and the staff should at least ensure that they present a number of different alternatives in programme negotiations.

The tension between political and technical aspects of Fund authority is particularly evident in these documents. The Fund is struggling with the issues I explored in section 9.1.1 and their political manifestations. There is an enthusiasm for greater domestic debate and civil society engagement but that is tempered with a continuing insistence on the primacy of the state and by concerns that disaffected groups may be able to use the democratic process to push their own agenda. My interviews with officials within Fund External Relations suggested that there were groups that 'could not be reached' in discussion (Dawson & Bhatt, 2001).

That suggests that, at one level, the Fund is anxious to respond to NGO pressure, particularly in developed countries while, at another, it knows that this plays badly with developing country states and has the potential to raise awkward questions about Fund political authority¹¹. It is perhaps not surprising, then, that civil society involvement in practice tends to be relatively limited and that this is leading to some dissatisfaction, as rhetoric and reality remain some distance apart. The Fund commissioned external evaluation of ESAF, which covers a rather wider range of countries than the current study, suggested that civil society groups are far from convinced by the IMF's overtures (see IMF, 1998, particularly the case study on Bolivia). The report writers came away with the impression that ownership was still seen in terms of persuasion rather than genuine dialogue. Other academic research has come to the same conclusion:

¹¹ (Dawson & Bhatt, 2001) also provide some indications of Board members' views on these issues.

It does seem that, on the whole, achieving 'consensus' has, for the Fund, not meant building new understandings out of different points of view, but bringing the notional 'owners' round to an unaltered Fund position (O'Brien et al., 2000, p188)

Lending

In terms of lending facilities, the agenda has been very clearly set by the right wing US concerns raised in the Meltzer report. The Fund has adopted a Contingent Credit Line which is supposed to increase market confidence by enabling countries to sign up for a fast disbursing credit line if they are willing to commit to a series of relevant policies. In fact no country has yet signed up. That seems to have been partly because of the cost of the facility and partly because, despite pre-qualification, disbursement would not be automatic. The Fund has already eased the terms once in an attempt to drum up clients but the initiative continues to show embarrassing signs of insufficient consultation.

Under US pressure, the Fund has also changed the charging structures for its facilities with interest rates that increase over time to prevent long-term reliance on Fund finance. That move was met by bitter resistance from developing countries and the post-communist countries (suggesting the potential for interesting political alliances in the future). Increases still went through but at a lower level than originally planned.

Developing countries have pressed for a greater willingness to use the SDR as a source of international liquidity in the face of contagion, indicating greater faith in an injection of liquidity than in any solution to debt restructuring that is likely to emerge from the IMF process (Mohammed, 2001a). However, G7 countries remain resistant.

Other institutional reforms

In addition to the standards and codes process and further discussion of civil society engagement, there have been some minor reforms of the IMF's institutions. Most potentially significant is the establishment of an independent evaluation office. The independent evaluations carried out in the late 1990s were commendably critical of aspects of the IMF's role and seem to have had some impact on Fund thinking. The report on ESAF has been particularly influential on subsequent discussions of ownership of Fund programmes. If the EVO can continue in this tradition it could be a valuable institution.

Although it has no formal power and there are obvious questions about the extent to which its findings will filter into policy change, the IMF's self-perception as a neutral technocratic institution could potentially provide the EVO with significant influence. It will be difficult not to respond to the opinions of respected economists and financial officials selected by the Executive Board.

A further review of Fund quotas is also about to commence and the Fund has commissioned a number of papers on possible ways to reform quotas. However, the approach remains strongly wedded to the idea of weighted voting. The proposed changes are about adjusting the weights to make them more rationally justifiable (which would probably lead to a modest increase in Asian

countries' votes) rather than on enhancing basic votes (see page 66 above) or on some more radical reform.

9.2.2 Analysis and assessment

The post-crisis reforms demonstrate an awareness of the significance of the kinds of normative issues that I raised in section 9.1 but do not go a very long way towards dealing with them.

Most notable is a general unwillingness to contemplate any solution that involves revisiting the legal framework under which the Fund operates. The standards and codes are soft law and there have been no moves towards altering the Fund's fundamental institutional structure. Where institutional issues are discussed the focus continues to be on enhancing the Fund's technical authority, rather than on acknowledging its political role.

The prominence of arguments based on the need to work within rather than attempt to alter market preferences has been heavily influential in both the standards and codes process and debates over better methods of crisis resolution, although there have been modest movements towards an acceptance of capital controls and the potential for more administrative solutions but only at the margins.

The greatest impetus towards reform is in the way conditionality negotiations are to take place. Some of the statements coming out of the Fund are positive. The idea that countries should be presented with choices by Fund staff is an interesting one. An acknowledgement that more efforts need to be made in the direction of parsimony is also to be welcomed. However, part of the reason why those are the issues that can be discussed is that, fundamentally, they are not subject to any kind of regulation. That means that there are no legal safeguards to ensure that any real change takes place and no institutional factors to change the underlying incentives for the Executive Board. If the problem is a temptation for developed country states to press for ever more extensive conditionality, little has been done to actually restrain them from continuing to do so. Of course what happens in practice will need to be assessed over time but previous efforts at restricting conditionality in this way have been less than successful.

There has been little movement away from the loose and unstructured multi-level relationships that I argued, in section 9.1.1 were problematic for Fund legitimacy. Since such negotiations continue to take place within a framework that favours developed country interests, it is unlikely that the solutions will resolve the problems with Fund performance as far as developing countries are concerned. Even if the Fund did do a good job much of the time, the absence of any politically convincing institutional framework would still provide little reassurance and leave the Fund very vulnerable to performance failures.

9.3 Assessment and Prospects

In the previous section I argued that the Fund's response to demands for re-establishing political control had not been particularly accommodating. Before examining the reasons for that – which will suggest significant obstacles to future radical reform at least in the short term - I want to suggest, largely for rhetorical purposes, what a more acceptable solution might involve.

The thrust of the argument in section 9.1 was that an ideal solution would involve a considerable rethink of the relationships between states in order to provide greater Fund political accountability, particularly to developing countries. That would need to involve a reform of voting rights within the Fund¹². It might also involve separating strategic control from day to day oversight of staff.

Conditionality is currently only formally reviewed after programmes are negotiated. Before negotiations, political control is very *ad hoc* tending to favour the Fund's better-resourced principal shareholders. Executive Board overwork and a staff tendency to prefer to resolve issues before presenting them to the Board add to the problems. One might imagine a more political body exercising a more strategic role, perhaps with a more egalitarian voting system to balance the Executive Board's economically related voting weights and technical management of day to day matters¹³. That political body could hold its deliberations more publicly since such general policy considerations could not be described as market sensitive. If that raised developed country concerns about developing country dominance too much, one solution might be to build in a tighter set of legal rules for Fund operation.

Of course there are two obvious objections. The first is that all this fails to deal with the issue of civil society and the second is that such measures are not politically feasible.

My problem with trying to use some kind of direct civil society engagement through the Fund is that I find attempts to secure political reform through international engagement very problematic. I can understand the temptation to deal with unpleasant regimes in this way. However, it is actually very difficult to do so: political change must ultimately come from within. In any case a Fund with dubious political legitimacy is not a good institution to use for these purposes. What gives the Fund the right to decide what an appropriate regime should be and why should anyone be confident that the decisions it makes will centre on the interests of developing country citizens rather than its leading shareholders? For me calls for the Fund to deal with poor governments are most appropriately seen as a reflection of an already over-extended role in developing countries for what was once designed to be a narrowly focussed economic institution (something I will discuss in more detail shortly).

If the Fund's overall political legitimacy was on a sounder footing that might ease the problems of potential state-IMF collusion in any case. A clearer legal framework for the limits of Fund authority, and more transparent decision-making would make it clearer what was demanded by the

¹² For some detailed proposals see (Gerster, 1993a; Woods, 1999)

¹³ That conception is a far more politically minded adaptation of suggestions made in (De Gregorio et al., 1999)

Fund and what *kind* of political pressure should be exercised to reform Fund policy. It would solve the problems of blurred accountability even if it would not eliminate power imbalances. That may be the best service that can be done for civil society in pursuit of more satisfactory influence over Fund policy: at least it would be clear who to lobby, who to blame, and what the right strategy was for political struggle. At the moment lack of transparency over the relative influence of the Fund, states and other donors makes those issues very difficult.

In connection with the need to justify policy better and to clarify who is making it, some aspects of the Fund's current policy on engaging with civil society are also to be welcomed. A greater willingness to provide public justifications for Fund decisions can only enhance the quality of domestic debate and civil society's ability to hold states to account in the domestic context. A Fund outreach initiative involving training Southern NGOs in economics is a particularly valuable initiative, at least in theory. To the extent that 'civil society engagement' translates into genuine flexibility in negotiations with states in order to limit the social ill-effects of Fund programmes it is also to be welcomed but states must remain in charge. It is difficult to justify social and political interventions dictated by Northern (rather than Southern) NGOs even if they are dictated with the best intentions.

The question of political feasibility is more problematic. The previous two sections showed a number of factors that work against this kind of reform. There is a mismatch between Fund incentives to adapt to the preferences of economically trained institutional insiders and politically motivated outsiders. More fundamentally there is a mismatch between the representation of countries in control of Fund finance and those responsible for implementation. The Fund has shown some inclination to deal with the first problem, under pressure particularly from Northern NGOs, but less inclination to deal with the second.

The present system has short-term pragmatic advantages. The 'epistemic community' of economists makes internal agreement easier and prevents the institutional paralysis often seen at the UN. Domestic political debate may genuinely be poorly suited to reaching international agreements and the requirement for technical expertise may, to some extent, militate against democratic control of economic policy making. However the danger is that internal consensus will not translate into appropriate and implementable policy on the ground unless there is greater pressure both to force economists to justify their decisions in politically comprehensible terms and to take into account practical political and technical problems existing in developing countries.

If those who are supposed to be persuaded by the Fund are not in a strong position to make their views felt *within* the institution they may begin to engage in forms of political action outside it that the Fund finds hard to control.

As I have already argued, the civil society and good governance approach to these problems is superficially appealing too. It is calculated to diffuse pressure in the Fund's most powerful shareholder countries. It also avoids the need to renegotiate the Fund's legal framework since the

interactions involved are already *ad hoc* and poorly regulated in legal terms. However, it fails to consider sufficiently the importance of *states* as key audiences for IMF legitimacy claims and key actors in programme implementation. It also obscures rather than illuminates the limitations imposed by the framework within which civil society negotiations take place. It is the legitimacy of that framework which ultimately determines the contribution that civil society engagement can make to Fund legitimacy.

These political difficulties may mitigate against institutional reform but the whole point of my discussion of Fund legitimacy so far is that the Fund's institutional arrangements remain politically unsustainable if the Fund is to carry out the role it currently envisages. The Fund's current legitimacy problems, and their practical political consequences, are not just going to go away and current attempts at reform are inadequate to overcome them.

If institutions really cannot be reformed (and perhaps even if they can) there is a need for the Fund to reduce its role in developing countries. Is a narrower role any more feasible than a more politically legitimate Fund though? The Fund and some of its supporters have tried hard to press the case that its interventions are essential (Eichengreen, 1999b; Fischer, 1998b). However, the evidence of this thesis casts doubt on that strong position. The crises seemed to be resolved most effectively by government debt guarantees, concerted roll-overs or capital controls. Although the markets asked for structural reforms the evidence that they actually responded to them was less strong. In any case, the Fund position is predicated on the assumption that free capital markets are technically essential, a position which is less secure even within the economics profession than it might have looked before the crisis.

Limits to what seems to be possible in terms of enhancing the Fund's political authority in developing countries and the case study messages about the importance of tailoring economic policy to very specific local circumstances all press toward a more restricted role for the Fund (and other IFIs),

not as an institution devoted to harmonization and the reduction of national institutional differences, but as an institution that manages the interface between different national systems as Dani Rodrik as put it in the related context of the WTO (Rodrik, 2001b, 45).

That may imply less complete financial integration which may, in turn, involve some costs to developing countries in terms of the costs and availability of finance, but that may still be a price worth paying.

At the present time, though, this solution too is not currently on the table as we have seen.

Over the longer term my analysis suggests that pressures for reform will be impossible to ignore. In the short term, though, what are the more pragmatic prospects for reform suggested by the analysis so far?

The most likely pressure for reform will come from more financial crises and their social and economic consequences. The political analysis in this Chapter has suggested that the Fund's

technocratic self-perception makes it most responsive to technical failure and changes in economic perspectives. That connects with the fact that it is not in developed countries' financial interests for the emerging markets to collapse. Although Krueger denies that the experience in Argentina has had any influence (Krueger, 2002b), the coincidence between crisis in Argentina and the Fund's announcement of discussions of a new debt restructuring mechanism¹⁴ is distinctly suggestive.

We can also expect the political unrest triggered by crises to have an international political impact, especially where they continue to be dealt with by deflationary attempts to attract further financial flows, again Argentina is suggestive of the possibilities. Here Northern NGOs do have a role in putting pressure on their governments over the negative social consequences of unfettered capital markets.

If further crises create political pressure, though, how can developing countries capitalise on it to maximise reform? If, as I have suggested, economic debate will continue to dominate within the Fund, coming up with alternative economic solutions and proposals that are technically robust will be particularly important. Here, the G24's research programme has a role to play and there are strong arguments in favour of pressing for richer member countries to contribute funding to expand it¹⁵. On similar lines, there are also grounds for arguing that the Fund should be offering more research support to developing country Executive Directors who are typically under resourced (they serve more countries and have fewer support staff than their developed country counterparts).

Evans and Finnemore point to the problems springing from the unstated assumptions of the economics profession itself and argue that these are particularly problematic in a context where Fund staff, without a single exception, have received their graduate training from academic institutions in the industrial countries. They argue that one solution would be for the Fund to take on more mid-career recruits from developing country governments whose practical hands on experience of local problems may have created a more diverse outlook (Evans & Finnemore, 2001).

Although I have been somewhat sceptical about direct NGO participation in Fund decision-making, if the practical reality is that Northern NGOs have a disproportionate influence over the Fund there may be some strategic mileage for developing country governments (perhaps through the G24) in attempting to forge areas of common interest. There are some signs of increasing NGO sophistication on financial issues in the aftermath of the Jubilee 2000 initiative and there may be issues over which genuine partnerships can be formed. In any case, at the least, greater engagement between high profile internationally active Northern NGOs and developing country governments would give the developing countries an opportunity to educate NGOs about some of their more macro-level concerns.

¹⁴ For details see (Krueger, 2002a) and (Bossone & Sdrlevich, 2002)

¹⁵ Perhaps by analogy to the modest moves towards technical and legal assistance for developing countries within the WTO.

If the dramatic institutional changes I suggested above are impossible then some more modest moves such as enhancing the level of basic votes (Gerster, 1993a; Woods, 2000b) or at least increasing the number of African Executive Directors (which wouldn't require a change in voting) would be a very modest shift in the right direction (Evans & Finnemore, 2001).

None of these changes though is ultimately more than a modest move in the right direction. What is ultimately possible in terms of more fundamental reform will sadly depend on the outcome of further crises.

10 Conclusions

The thesis set out to determine what the IMF's crisis of legitimacy in the aftermath of the Asian financial crisis would tell us about IMF political legitimacy more generally and the politics of IMF policy making in particular.

In Chapter 1, I argued that legitimacy was about the extent to which the justifications an institution could provide for continuing compliance with its policy preferences were sufficiently convincing to key political actors to ensure that it could continue to function. Legitimacy is a matter of degree and the logical strength of legitimating arguments is difficult to untangle from strategic political factors when trying to account for political compliance. It should not surprise us if an institution continues to function despite discrepancies between the justifications it provides and its operation in practice or even problems with the logic of its justifications. However, the less credible justifications appear the more problematic institutional compliance procured through legitimacy rather than coercion will be. We shouldn't expect institutions' normative arguments to be wholly compelling but there is a degree of convergence between normative and practical political legitimacy

As an international institution with limited coercive resources of its own to draw on, the IMF has particularly good reasons to be concerned about the strength of the arguments it can use to persuade actors to cooperate.

Unfortunately, the IMF's interventions in Asia seemed to trigger unprecedented levels of public opposition to the Fund's role. That implied that its legitimating justifications were weak and in need of rethinking but the reforms that ultimately materialised in the wake of the crisis were decidedly limited. That could either be because the public criticisms offered of the IMF were not sufficiently politically problematic to cause political change or it could signal a failure to deal with the underlying problems.

Understanding which was the case has involved an analysis of the reasons behind challenges to the IMF's legitimacy in response to events in Asia and of the political pressures that were, in practice, brought to bear in the direction of reform.

Fundamentally, the Asian crisis caused a crisis of IMF legitimacy because it played to pre-existing problems with IMF authority. A gradual surrender of global political authority over financial markets, the collapse of symmetry in relationships between the Fund and its shareholders, a decline in relative funding and the failure of Fund legal frameworks to keep up with institutional changes had all undermined the political aspects of the Fund's authority. At the same time, its policies in developing countries, which were increasingly justified on technical grounds, were becoming ever more politically intrusive.

Prior to the crisis, technical economic consensus, the promise of increasing capital inflows and a lack of clarity over what exactly the Fund's new agenda would entail initially limited the political difficulties involved. The crisis was significant because it provided new information on the nature of the underlying bargains. It demonstrated a failure of Fund performance in stimulating capital inflows and a failure of market performance which, between them, seriously questioned the rationale behind ever more extensive economic and institutional adaptation to market preferences. Since the basis of remaining Fund authority was largely its ability to assist developing countries with that adaptation, the Fund's authority began to look very weak.

In normative terms, the debates revolved round the appropriate balance between political control and technical authority based on market rationality. The strongest case against the Fund built on technical and market failure, the strongest defence on political failures in Asia.

In political terms, financial instability stemming from the crisis and political and social difficulties with implementation put pressure even on developed country financial elites to rethink the Fund's role to some degree. If policies cannot be implemented there is little point in putting them in programmes. Developing countries also protested within the Fund's institutions, with Mahathir in particular calling for a reassertion of political authority over the markets, but some were more vocal than others.

Arrayed against this pressure for change there were also powerful forces that tended to favour the *status quo*. The influence of conformity within the economics profession was one factor. Another was that developed countries are in charge of the Fund but face few incentives to consider the political consequences of the policies they promote. That is a consequence of both structural position in the international economy and the limits to domestic political debate over these issues. Even some middle-income finance ministers suffer from this incentive mismatch because crises are only periodic, insulating them from the difficult political questions involved in the Fund's new agenda.

Generally, then, there is a mismatch between the actors with most influence within the Fund and those with the greatest ability to resist Fund policies. That served to limit dissent within the

institution but also meant that reform was uneven and did not appear to be adequate to remove the danger of future legitimacy problems.

The Fund's preferred solution to its legitimacy problems seems to be to leave institutional structures largely as they are, reform policy at the margins and attempt to forge greater informal links between institutional insiders and institutional outsiders. That preference, in turn, can be explained politically. There are significant political obstacles to fundamental reform but there is an awareness that something needs to be done. The most vocal pro-reform lobbies in the Fund's principal shareholders are Northern NGOs (or those influenced by them) who tend to support the idea of more 'positive' conditionality and greater accountability to an NGO community.

The problem with that strategy is that attempts to alter these informal aspects of Fund relationships do not deal with the fundamental institutional obstacles to greater Fund authority. They say nothing about which groups will finally prevail in the event of conflict and the suspicion, not unnaturally, is that the answer will continue to be the Fund's developed country clients.

The idea of civil society involvement is particularly ambiguous politically. Discussions have tended to be insufficiently clear on the fact that civil society views are always in need of interpretation. Fund (and outside) accounts talk about how 'representative' various civil society groups are but that is merely to emphasise that the ultimate decision-making institution is having to choose between different political interests in coming up with a decision.

I have argued that a politically effective solution will therefore involve accepting that there is no alternative to more fundamental institutional reform, giving a greater say to developing countries and forcing the more economic parts of the Fund's management to talk with more politically minded officials. If that reform is impossible, then the only other viable solution to the Fund's legitimacy problems is Fund retrenchment.

The Fund has been anxious to argue that retrenchment is impossible or at least prohibitively expensive in terms of market access. However, the evidence of the thesis suggests that that is not a wholly accurate view. The technical case that Fund structural policies were essential for crisis resolution was not entirely compelling. The unexpected success of Malaysian capital controls presents a particularly clear challenge.

If neither of these solutions is adopted, the IMF's legitimacy problems will not simply go away. The increasing demands that adjustment to the needs of financial markets are making have pushed the Fund's agenda in ever more politically intrusive directions. Under the Bretton Woods system, those kinds of demands were deliberately moderated by a degree of political control exercised over financial markets. The Fund's original role was partly to provide space for that kind of political control in the interests of legitimating integration with the international monetary system. The resurgence of liberal orthodoxy in the 1980s and 1990s and enthusiasm for the potential benefits of globalisation has made it harder for some economically trained officials to appreciate the need for that kind of legitimation. In any case the political climate is very different to that of 1942 and

developing country governments do not have the same resources as their post-war European counterparts when it comes to pressing for more protection against the less benign effects of market integration.

However, the need to respond to free capital flows, itself a consequence of developed country political choices, has forced the Fund into very intrusive interventions in domestic political economies in an effort to stipulate appropriate forms of institutional regulation at the domestic level. The political nature of those interventions seems to me to be an unavoidable fact. That fact may go some way to explaining the ways in which the boundaries between technical justification and justifications based on liberal norms have started to be blurred in Fund rhetoric and practice, particularly in relation to good governance and civil society engagement.

However, as technical imperatives (at least as the Fund currently interprets them) start to close off the range of potential domestic political solutions, the strength of liberal justifications for free markets based on their self-regulating apolitical nature are increasingly threatened. The more 'appropriate' forms of political and institutional arrangements are to be restricted on the basis of the requirements for participation in global capital markets, the greater the danger that liberalism will undermine the more normative aspects of its appeal based on democracy and freedom, especially if technical performance is ultimately poor (Hawthorn, 1999). In a sense that is a restatement of Polanyi's classic argument that purely liberal economic management undermines itself and will ultimately force a resurgence of political control in the interests of social stability (Polanyi 1957).

My interpretation of events, then, is that the solution to the gap between apparent difficulties with Fund legitimacy and the extent of ensuing reforms owes more to insufficient reform than to an overestimation of the problems.

The Fund's current institutions, combined with continuing fears about market reaction to attempts at reasserting political control, have succeeded in limiting direct political pressure for reform in the short term. The relative success of Korea, interpreted in terms of 'good' policy rather than conducive social conditions, has made it easier for some to be sanguine about the minimalist reform agenda. Over the longer term, though, the danger is that, if the incentives to resolve issues *within* the institution are not sufficient, the alternative will be institutional paralysis or solutions that take place outside it.

Over the long term that might mean moves towards greater regional cooperation. The swap agreements established between Asian nations in the wake of the crisis are a modest indication, with the scotched proposal for an AMF being a more ambitious version.

That is perhaps an optimistic scenario. A pessimistic one involves the temptation for developing countries to either leave the Fund or simply refuse to borrow. The historical experience of unregulated developing country relationships with financial markets is sufficiently gloomy to make that a very unattractive option, which is part of the explanation for continuing developing country

engagement with a less than ideal IMF. On the other hand the experience of the Great Depression should be a reminder that even the threat that such an option might be considered should be deeply worrying to developed country governments. More worryingly, nationally, there may be more examples where pre-existing political processes are decisively rejected. The unwillingness of anyone to govern post-crisis Argentina, the rise of the far right in Europe and disengagement from the political process in industrial countries more generally raises the possibility of more dramatic follow-ups to Seattle-style demonstrations.

Those are perhaps unduly pessimistic scenarios but they do emphasise the point of thinking about these issues in terms of legitimacy. Realist writers tend to think solely in terms of material power and emphasise the dominance of leading industrial states. However, economic cooperation is not ultimately something that can be coerced. Liberal attempts to portray international markets as a sphere characterised largely by mutual interest are too optimistic. However, there is no denying that developed and developing countries still need each other's willing cooperation. Thinking about relatively unaccountable institutions in terms of legitimacy emphasises that they will find it increasingly difficult to function when those in power have insufficient incentives to consider how their policies are to be justified to those whose cooperation they require. It provides pragmatic as well as normative reasons for reform.

The argument presented here, then, is that problems with the weakness of legitimating arguments put a sort of structural strain on the Fund's institutions as they stand. There is nothing forcing immediate change and the Fund's current institutions are designed in a way that will tend to make Fund management blind to the factors that do suggest a need for reform but the underlying problems suggest that the present situation is also unstable.

If some more drastic solution is required over the longer term, what does the analysis of Fund policy-making suggest about potential reformist strategies in the short-term? The dominance of developed country influence in the Fund suggests that developing countries might wish to seek social allies in developed countries. However, my analysis of debates in the US suggests that this will be difficult. Much of the anti-globalisation and even NGO agenda fits poorly with the wishes of developing country governments. There are particularly stark conflicts of interest when it comes to issues such as labour rights and the environment. In a sense the problem is that such NGOs are themselves a 'special interest' group and are less well equipped to articulate a compelling broader development strategy.

The macro-level of debate within the Fund and the importance of technical authority both suggest that what is needed is a collaborative effort by developing countries and advocacy NGOs to elaborate a technically compelling alternative conception of economic management to that put forward by the IMF. There is a need to meet technical complacency within the centres of financial power with articulate technical opposition. Unfortunately the left is still struggling to articulate any such compelling alternative conception (though there are a few promising attempts around such as (Unger 1995)). NGOs, too, are only just beginning to acquire the expertise to debate international

economic issues, though the debt campaigns orchestrated by Jubilee 2000 have done much to raise broader public awareness of the politics of international finance. Still mobilising popular political pressure around technical economic debates remains a daunting task. However, just as I have argued that there is ultimately no alternative to reasserting political control over the Fund, there is also no alternative over the longer term to enhancing the quality of democratic debate over technical economic issues.

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Interviews

I carried out ten interviews in Washington DC in late September or early October 1998.

Most interviews were off the record. Job descriptions of interviewees are as follows:

A developing country Executive Director of the IMF

A senior official in IMF External Affairs

A more junior official in IMF External Affairs

Azizali Mohammed, the G24 Coordinator at the IMF

A left wing Congressman

One of that Congressman's senior staff

A staffer for the House Banking and Financial Services Committee

Jim Orr at the Bretton Woods Committee

A campaigner for a major development NGO

A senior member of the Clinton Administration

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