Political Determinants Of IMF Balance of Payments Lending: The Curse of Carabosse?

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Abstract

How do political interests shape International Monetary Fund balance of payments lending decisions? We suggest that the institutional structure governing IMF decision-making creates an opportunity for American policymakers to influence IMF lending decisions. We then suggest two reasons, one based on interest group politics and one based on foreign policy objectives, why American policymakers have an incentive to exploit this opportunity. These expectations are then evaluated statistically against the entire population of IMF loans between 1985 and 1998 for which data were available. The results indicate that IMF lending decisions are responsive to American pressure. Larger IMF loans went to countries in which American banks were highly exposed and to governments closely allied with the United States.

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I hope that . . . there is no malicious fairy, no Carabosse, whom [we have] overlooked and forgotten to ask to the party. For if so, the curses which that bad fairy will pronounce will, I feel sure, run as follows:--"you two brats shall grow up politicians;. . . everything you determine shall not be for its own sake or on its own merits but because of something else." [1]
John M. Keynes, to the inaugural meeting of the International Monetary Fund's Executive Directors in Savannah, Georgia 1946

1. Introduction

How do domestic political interests shape International Monetary Fund lending decisions? Created in 1944 as part of the postwar international financial system, the International Monetary Fund provides governments with balance of payments support. With memories of the interwar period's international financial instability fresh in their minds, American and British policymakers agreed that a public institution able to provide assistance to governments facing foreign exchange shortages would be necessary if exchange rates were to be stabilized in the postwar era (See Gardner 1969; Helleiner 1994). A government facing a shortage of foreign exchange reserves relative to its short-term external liabilities can go to the IMF for a medium-term loan. Not all borrowing is automatic, however. At a certain level of borrowing governments become subject to IMF conditionality agreements. In exchange for access to IMF resources, governments must commit to programs of macroeconomic stabilization.

IMF conditional lending is the subject of a voluminous literature too large to be properly reviewed here. The important point for our purpose is that most extant work focuses on aspects of IMF conditional lending relating to the recipients of IMF loans. Econometric research has given us a certain (though narrowly economic) understanding

of who *demands* Fund loans (Bird 1996). For instance, Bird (1996, 484) suggests that the demand for IMF loans tends to vary "with the state of a country's BOP and the availability (and cost) of alternative sources of finance." Political economists have examined the ability of governments to successfully meet the terms of their conditionality agreements (Kaufman 1985; Haggard 1985; Bates and Krueger 1993; Krueger 1993). Others have looked at the consequences of conditionality and structural adjustment programs on economic growth and the distribution of income in the recipient country (Bienen and Gersovitz 1985; Pastor 1987a; 1987b).

Surprisingly little attention has been focused on the determinants of IMF lending. The central question here is remarkably simple: what determines how much assistance a given government actually receives once it turns to the IMF? Two broad approaches to this question can be suggested, one "technocratic" and one "political" (Assetto 1988). The technocratic approach suggests that IMF lending decisions are determined by relatively objective and impartially applied economic criteria. The political approach focuses on Keynes' feared "curse of Carabosse:" American political interests rather than objective technocratic criteria shape IMF lending decisions.

While analysts have investigated the technocratic determinants of IMF lending, with one notable exception (which we discuss in more detail below) little effort has been devoted to evaluating systematically whether and how IMF lending is shaped by political pressure from its member governments. The lack of attention to the political determinants of IMF lending is surprising for two reasons. First, technocratic models

perform poorly. A recent analysis, for example, predicts only 23 percent of the variation in Fund lending (Bird 1995; see also Bird and Orme 1981; Joyce 1992; Cornelius and Conway 1991). Second, abundant anecdotal and case study evidence suggests that IMF lending decisions are routinely influenced by political pressure. Killick (1998, 74), for example, attributes IMF lending to Argentina in the 1980s to U.S. pressure on the Fund to finance Argentina's "façade of debt repayment." Cohen notes that "the Reagan administration's active disapproval of earlier lending practices" caused the Fund to tighten its conditionality standards, while pressure from the Reagan administration led to a $3.9 billion IMF credit to Mexico in 1982 (Cohen 1985, 715, 722). In 1995 the Clinton administration exerted extraordinary pressure on the Fund to address the 1994-95 Peso crisis.[2] Concern in the wake of the Asian financial crisis about whether IMF lending practices encourages excessive risk taking by private financial institutions suggests that professional economists and policymakers alike are at least willing to entertain the possibility that the IMF is too responsive to the interests of large private financial institutions (Barro 1998; Fisher 1998; Meltzer 1998; Garten 1999; Eichengreen 1999).

In spite of the abundance of anecdotal and case study evidence indicating that political pressure influences the IMF lending process, we know of only one other large-*n* study that investigates whether, and for what purposes, political pressure shapes IMF lending decisions. Thacker (1999) presents statistical evidence that suggests that the IMF is more likely to lend to countries whose foreign policies shift towards U.S. foreign policy preferences. Like Thacker, we suggest that the institutional structure governing

IMF decision-making creates an opportunity for American policymakers to influence IMF lending decisions. We also share Thacker's belief that U.S. foreign policy objectives should shape IMF lending decisions. We differ from Thacker, however, by suggesting that U.S. *financial* interests should influence IMF lending as much as (if not more than) American foreign policy interests.[3]

We evaluate our expectations statistically against a sample of IMF stand-by and Extended Fund Facility (EFF) loans between 1985 and 1998. The results indicate that IMF lending decisions are responsive to American pressure. We find strong evidence that, *ceteris paribus*, larger IMF loans are extended to countries to which American banks have lent heavily. We find mixed evidence that U.S. foreign policy interests influence IMF lending decisions. Depending on the measure of bank exposure used, larger IMF loans appear to go to governments closely allied with the United States.

2. Political Determinants of IMF Lending

Why should we expect politics to shape the magnitude of the loans the IMF offers to governments that turn to the Fund for assistance, and what interests should we expect to be reflected in IMF lending decisions? We argue that the organizational structure of IMF lending practices and the institutions governing IMF decision making create opportunities for the United States to exert political influence. We then suggest that American policymakers have an incentive to exploit this opportunity to achieve two

distinct objectives: to satisfy demands made by private financial institutions in their role as members of political support coalitions; to achieve foreign policy objectives.

2.1 Opportunities for Influence in the IMF

The IMF's organizational practices and decision-making institutions create opportunities for the United States government to use IMF balance of payments support to achieve political objectives. These opportunities arise from two aspects of IMF procedures: the process through which loans are created and the rules governing IMF decision-making. Officially the IMF is committed to a technocratic model of lending, and in public professes to adhere to objective and universalistic criteria to guide its lending (Stiles 1991, Chapters 1 and 4). By "universalistic" we mean decision-making criteria that are in principle objectively and universally applied to all loan applicants. For instance, if IMF decision-making *was* universalistic, we might observe that all countries with a given current account balance (or a given debt burden, etc.) would receive with equal probability loans of equal size and conditionality. In practice, however, the Fund balances universalistic criteria against particularistic lending criteria. Particularist criteria are applied unevenly across loan decisions. For instance, the IMF may advance "softer" loans (e.g. loans with less stringent conditions) to countries allied with the Fund's more powerful members. This balance is particularly evident at the top of the IMF hierarchy, where the Fund's Managing Director has from time-to-time waived the IMF's uniform treatment policy. In the 1980s debt crisis, for example, Managing Director De Larosière

officially waived the policy of uniform treatment with regard to the Latin American debtors. This balance is also evident in the organizational structure through which IMF loan programs are created. One unit, the Exchange and Trade Relations Department, has a "widely accepted role of custodian of the virtues of 'consistency' and 'fairness,' and typically opposes the proposals . . . which it suspects are based on 'favoritism' and 'special concessions'" (Stiles 1991, 35). However, staff members working on particular regional desks are largely responsible for drafting IMF loan agreements, and loans are often tailored to the specific characteristics of a particular case.

This organizational tendency to balance between particularistic and universalistic criteria when developing specific loan packages, even when it can be justified on the basis of narrow technocratic considerations, creates opportunities for the exertion of political influence. The problem is similar to the familiar "rules versus discretion" debate in the literature on central bank independence. When decisions are bound by hard and fast rules, such as a previously established and widely known functional relation between the severity of a balance of payments crisis and the magnitude of IMF support, then departure from such practices can be easily identified. With departures from rules easily identified, accountability is readily maintained. Once greater discretion is allowed, however, it becomes difficult to evaluate the underlying reasons for a particular deviation from the universalistic rule. Was a larger (or smaller) loan offered to country *X* because specific elements of the particular case justified the loan on technocratic grounds, or does this departure reflect political pressure? When discretion predominates, therefore, the

factors determining lending decisions contain considerable ambiguity, an environment conducive to the exertion of political influence.

IMF decision-making institutions create an additional opportunity for the American government to exert influence over IMF lending decisions. The Executive Board's voting rules (the Executive Board approves all proposed programs as well as most other important decisions) provide the United States with effective veto power. Executive Board decisions require an 85% super-majority for approval, and the U.S. has controlled more than 15 percent of the votes (currently 17.53 percent) throughout the history of the Fund. The U.S. thus controls enough votes to block unilaterally proposals before the Executive board. As a consequence, "no managing [Fund] director . . .can make a major decision without clearance from the US . . . " (Swedberg 1986, 379). This rule interacts with a mechanism of accountability in the United States that gives American representatives to the Fund's Executive Board an incentive to use, or to threaten to use this veto power; the American Executive Director "is ordered by law to clear his or her decisions with the Secretary of the Treasury" (Swedberg 1986, 379). As Schoultz (1982) has documented in a qualitative analysis of the IMF's sister institution, the World Bank, Treasury's "interests" in a given loan or aid package are often influenced by the U.S. Executive (which appoints the Secretary) and Congress.

The organizational structure of IMF lending practices and the rules governing IMF decisions therefore provide American policymakers considerable opportunity to exert influence on IMF lending decisions. Given the opportunity for influence that

American officials face in IMF decision-making procedures, and as scholars of the left have noted (though not empirically demonstrated) for some time, it is highly likely that IMF lending decisions for balance of payments support are likely to reflect American policymakers' interests.

2.2 Interest Group Politics, Foreign Policy Objectives, and American Interests

How do we conceptualize American policymakers' interests? Two broad alternative approaches suggest themselves. First, American policymakers' interests may be shaped by narrow domestic interest group politics. Second, American policymakers' interests may be shaped by broader national foreign policy objectives. We develop the logic of each of these approaches and then consider briefly how they interact.

Interest Group Politics and IMF Lending

In the interest group politics model, politicians use international institutions to channel resources to important members of their domestic political coalitions. In the current context, interest group politics lead us to expect American policymakers to steer IMF resources to American private financial institutions. This pattern of interest group politics arises out of the interaction between three elements of the Fund lending process. The Fund's role in contemporary international finance provides private financial institutions with incentives to try to influence IMF lending decisions by lobbying the American government. Considerations of domestic electoral politics give American

policymakers an incentive to represent the interests of private finance in IMF deliberations. The disproportionate influence of the United States in the IMF provides IMF officials with an incentive to shape lending decisions in response to American pressure.

The International Monetary Fund sits at the nexus of public and private international finance. The Fund was created to provide governments with medium-term support for current account deficits. When current payments for imports of goods and services were greater than current receipts for exports of goods and services, a government could turn to the IMF for a medium-term loan to cover the gap. In this world, private financial institutions played little role. In fact, Keynes, one of the architects of the Fund, envisaged the IMF as a substitute for private capital markets' role in financing current account imbalances. Keynes believed that capital flows in the postwar period would be tightly restricted and that export revenues would finance imports. In other words, the working assumption was that countries would maintain current accounts in equilibrium over the long term and IMF lending would be available to finance short-term disequilibria.

Since the 1970s the type of balance of payments support that the IMF has provided has changed from that which was envisaged in 1944. Increasingly governments have turned to the IMF when their liabilities arising from external borrowings are larger than their current holdings and anticipated earnings of foreign currency reserves. In other words, while established as a mechanism to help governments finance short-term gaps in

their current account, the IMF has become increasingly involved in helping governments manage liquidity shortages arising from capital account transactions. In the typical case, a government borrows from private financial market agents such as commercial banks, and subsequently encounters a shortage of foreign exchange. Unable to keep current with its debt payments, the government turns to the IMF to cover the gap.

In this new world the IMF borrows from its member governments, lends to other member governments, and these governments then use IMF funds to repay private creditors. "Rather than serving to generate new flows, IMF credits are often in effect repaying other creditors" (Bird 1996, 489). This use of the IMF to shift liabilities from private to public financial institutions appears to be a broadly recognized phenomenon in financial markets. Demirguc-Kunt and Huizinga found that unanticipated increases in U.S. government financial commitments to the IMF (for instance, through quota increases) caused the market capitalization of exposed U.S. banks to rise. They conclude, "the [U.S.] stock market expects virtually all additional resources provided to debtor countries [by the IMF] to be used for debt service to commercial banks" (Demirguc-Kunt and Huizinga 1991, 17; see also Bulow and Rogoff 1988). The IMF, therefore, transforms government liabilities to private financial institutions into government liabilities to public financial institutions.

The IMF's role as a vehicle through which government liabilities to private financial institutions can be transformed into government liabilities to public institutions creates incentives for private financial institutions to expend resources to try to influence

IMF lending decisions. Private financial institutions confronting a potential sovereign default can choose between private and public solutions to their financial difficulties. Lipson suggests that large banks confronting the risk of default have strong incentives to seek private solutions that center on bank-organized cooperative restructurings of potential defaulters' debts. The banks' incentives to cooperate with each other arise in part out of the threat posed by default. Default, or even a major write-down of asset value, threatens quarterly and annual profits, share prices, and senior management's job security. In extreme cases, high exposure may lead to a run on the bank and bank failure. These incentives can be sufficient to induce cooperation between banks. Furthermore, heavily exposed creditors have strong individual incentives to bear the transaction costs of the agreement, and enforcement of the agreement is cheap because defection is transparent and sanctions against defection are "effective, low-cost" (Lipson 1985). When these incentives are not sufficient to induce cooperation the IMF can solve the coordination problem. "The evolving role of the Fund . . . can best be understood as incremental reforms designed to overcome gaps in cooperation among creditors" (Lipson 1985, 221-2).

While private solutions to potential sovereign default can be effective (and were in fact the dominant approach to sovereign defaults prior to the First World War), the IMF offers a public-sector solution that is likely to be even more attractive to private financial institutions. The public-sector solution involves pressuring national governments and/or the IMF to assume a portion of the default risk. This alternative is

particularly appealing if the costs of organizing and enforcing private cooperative agreements are high. Even if banks do *not* face serious collective action problems to private solutions, however, they are still likely to prefer the public-sector solution. The key is to recognize that under the private solution banks continue to bear the full risk of sovereign default. Under a public-sector solution, however, IMF credits repay a portion of the initial private loans. Thus, a public-sector solution transfers a portion of the default risk away from the commercial banks and onto the IMF and its member governments. In other words, the public-sector solution allows banks to reduce their risk, while a private sector solution forces banks to accept continuing and perhaps even increased exposure. Of course, the two solutions are not mutually exclusive. Much of the interaction between banks and the IMF revolves around distributing the costs and benefits of the emergency package.

While private financial institutions have an incentive to demand that the IMF assume a portion of their risk, American policymakers and IMF officials have incentives to assume a portion of the risks of default. In American politics, the banking constituency is valuable to the government in at least two ways. Bank employees and stock holders may be more willing to vote for candidates or parties that have supported the public underwriting of bank debts, while bank executives may be willing to trade campaign contributions in exchange for favorable government policy. In the absence of any international default of "debt crisis" proportions, the tax-paying public (which ultimately pays the costs of government underwriting) is unlikely to take much notice of

the government assumption of default risk. Thus, assuming a portion of the risk of default provides a concentrated benefit to a valuable constituency while spreading the costs across a large number of taxpayers. American policymakers can further reduce the costs to American voters by pushing the costs arising from this assumption of risk onto the IMF, where the multilateral nature of this institution distributes the potential costs of default across an even wider group of foreign governments and their taxpayers.

IMF officials might also have an incentive to respond to the demands of private financial institutions because private financial institutions are directly involved in negotiating the debt rescheduling arrangements and IMF loans. As Cohen notes, "the amounts . . . of lending are in most instances no longer a matter of negotiation solely between the authorities of a country and the IMF. Now a third set of actors is often prominently involved – private banking institutions (Cohen 1982, 332)" In this process the IMF and private financial institutions have a mutual dependence. Private institutions need the IMF to help minimize their risk, while the success of IMF support often hinges upon private financial institutions' willingness to rollover their loans. As a result, private financial institutions have considerable access to, and some leverage over, IMF lending decisions. IMF officials also have an incentive to be responsive to bank interests represented by American policymakers. The American ability to veto Executive Board decisions, either pertaining directly to a particular loan or to other areas, requires IMF officials to pay particular attention to the objectives sought by American policymakers.

The interest group approach suggests, therefore, that variation in the magnitude of IMF loans should reflect variation in the interests of American financial institutions. The interests of American financial institutions are focused on shifting the risk of a potential default to public sector institutions. Therefore, the interest group model suggests a simple hypothesis: the more that American financial institutions have loaned to a government seeking IMF support, the larger will be the IMF loan advanced to that government.

Foreign Policy Objectives and IMF Lending

American policymakers might also try to shape IMF lending decisions in accordance with American foreign policy objectives. There is abundant evidence that American policymakers have used bilateral and multilateral foreign aid throughout the postwar period to achieve foreign policy objectives. American policymakers have used foreign aid "to promote adherence to alliances; to secure the strengthening of a regime friendly to the United States or to weaken a hostile regime by removing a source of support; to preempt east bloc aid efforts or to match them; and to win trade or investment concessions" (McKeown et al. 1999, 1; see also Conteh-Morgan 1990; Zimmerman1993). There is no reason why American policymakers would not be expected to approach IMF lending with similar attitudes.

There are at least two ways to conceive of aid as a useful instrument of foreign policy. First, one can think of aid as an instrument used to alter the behavior of the

recipient government. This is the conditionality model. By making the availability of foreign exchange, a resource that the recipient government lacks and is in need of, conditional upon the adoption of policies preferred by the donor government, IMF loans might be used to alter the behavior of the recipient government. Second, whereas the conditionality model focuses on the use of aid to alter the recipient government's behavior, IMF assistance can also be used to support existing allies. In contrast to the conditionality model, where the political objective is to encourage a foreign government to adopt policies amenable to the donor government, in this conception political alignments are already established and aid disbursements are used to reinforce these existing alignments. The political objective of aid, in other words, is not to change behavior as in the conditionality model but to stabilize a friendly government against internal or external challenges by groups that once in power would be hostile to the donor.

While American policymakers have incentives to view IMF lending decisions as opportunities to achieve foreign policy objectives, IMF balance of payments support is not easily manipulated according to the logic of the conditionality model (See Moon 1985). Obviously conditionality is a central component in relations between the IMF and borrowing governments. IMF conditionality, however, pertains to the macroeconomic policies the borrowing government adopts, and not to the broader foreign policy orientation of concern here. IMF balance of payments support is not easily amenable to broader policy conditionality because its short-term nature limits governments' abilities

to impose effective conditionality in two connected ways. First, the short-term emergency nature of IMF support means that donors are unable to cultivate a long-run dependence that can be manipulated subsequently to desired ends. All influence, therefore, must be achieved in the short run. In the short run, however, borrowing governments will find it too easy to engage in cheap talk. In other words, the one-time and emergency nature of IMF support means influence has to be exercised in the short run while in the short run it is too easy for governments to make verbal commitments they have no intention to keep. For these reasons American policymakers have little incentive to view IMF lending decisions as opportunities to change the foreign policy orientations of borrowing governments.

The nature of IMF lending is particularly well suited to the second model of foreign aid, however. Balance of payments crises can have de-stabilizing consequences. The exhaustion of foreign exchange reserves and the consequent need to cut domestic consumption in order to reduce imports and free up goods for export usually requires a dramatic reduction of domestic incomes that in turn usually generates a rise in unemployment. The sharp drop in economic activity can in turn destabilize the political system, much as occurred in Indonesia in the wake of the 1997 crisis, as non-democratic governments that often owe their political legitimacy to their ability to deliver continuously rising standards of living come under attack from mobilized domestic opposition. The provision of foreign exchange can reduce the short-term severity of these domestic economic adjustments. Drawing on the IMF can reduce the degree to

which imports must be cut, thereby reducing the severity of the domestic economic adjustments that must be made, at least in the short-term. If the short-term domestic adjustments are less severe, a balance of payments crisis will have less deleterious implications for the domestic political system.

Thus, while IMF lending may not be particularly well suited for altering the foreign policy behavior of governments, it is particularly well suited for supporting allies and punishing enemies. Larger loans to allied governments reduce the probability that a balance of payments crisis will lead to political destabilization and a change in ruler; smaller loans to hostile governments raise the probability that a balance of payments crisis will lead to a change in government.[4] Thus, we hypothesize that larger IMF loans will be advanced to governments closely allied with American interests, and smaller loans will be advanced to countries hostile to American interests. [5]

Interaction between Bank Interests and Foreign Policy Objectives

While it is relatively easy to suggest that American policymakers have an incentive to shape IMF lending decisions in response to the demands of American financial institutions and in accordance with broader American foreign policy objectives, it is also clear that these two considerations cannot be treated independently. There will likely be instances in which the demands of American financial institutions cut against American foreign policy objectives and there will be cases in which bank interests and American foreign policy objectives reinforce each other in shaping American behavior on

the IMF Executive Board. In other words, the demands of American financial institutions and American foreign policy objectives interact to shape how American policymakers influence IMF lending decisions.

There have been cases in which the American government has sacrificed a foreign policy objective to safeguard American banks balance sheets. In 1982, for example, after having imposed economic sanctions on Poland in 1980 in response to the imposition of martial law, the U.S. government assumed interest payments on Polish debt held by U.S. banks (Cohen 1985, 708-9). American sanctions had included a suspension of talks to reschedule Poland's debt, a suspension that raised the short-run cost of this debt to Poland. By assuming interest payments, therefore, the U.S. diluted the sanctions against Poland and Russia.

While it may be possible that the U.S. government regularly sacrifices broad for narrower goals, it is also plausible that the U.S. government tends to be *unwilling* to sacrifice regularly its broader interests for the benefits of the financial sector. In other words, the U.S. government may be much less likely to "go to bat" for U.S. banks when doing so means supporting governments hostile toward the U.S, and much more likely to go to bat for private interests when doing so simultaneously supports a government closely aligned with American interests. The direction of this relationship is ultimately an empirical question; thus we hypothesize that U.S. foreign policy and private interests will have a significant interactive effect on IMF lending, though we are cautious in predicting the direction of this relationship. As in the Polish case, it may be the case that

high U.S. bank liabilities *decrease* the impact of U.S. foreign policy interests on IMF lending. Alternatively, it may also be the case that the U.S. is more willing to advance the interests of the financial sector when those interests do not conflict with broader objectives.

In summary, the magnitude of the balance of payments support the IMF extends to governments that turn to it for assistance will be shaped by American policymakers' domestic political and foreign policy interests. We hypothesize that larger loans will be extended to governments to which American financial institutions have loaned heavily and to governments that are closely allied with American interests. Smaller loans will be extended to governments that are not deeply in debt to American financial institutions and to governments that are hostile to American interests. The interaction effect between the two will be significant, though we remain agnostic as to whether policy-makers regularly sacrifice broader foreign-policy interests in order to advance the interests of the financial sector, or whether, conversely, broader objectives tend to trump the narrower sectoral interests of the banking community.

3. Data and Analysis

We test these hypotheses against the sample of IMF lending decisions made under the stand-by and Extended Fund Facility in the period 1986-1998 for which data were available. This yielded a sample of between 194 and 139 cases, depending upon the

model specification. A list of the cases and documentation for the data is provided in the appendix. The model we estimate takes the following form:

$$\mathbf{Y_{i,j} = a + b_1 Technocratic_{i,j-1} + b_2 Bank_{i,j-1} + b_3 Foreign_{i,j-1} + b_4\ Bank*Foreign_{j-1} + b_5 Dummy + e.}$$

Our dependent variable, *Y*, is IMF loans (in millions of standard depository receipts) (SDRs) extended to country *i* at time *j* under the stand-by and extended fund facility (EFF) programs.[6] We excluded loans made under the IMF's Structural Adjustment Fund and Enhanced Structural Adjustment Fund (the two other main IMF lending programs) because these programs provide support for long-term structural adjustment rather than for short-term balance of payments support, and should therefore be extended under different lending criteria. *Technocratic* is a vector of economic variables that previous work has found to be associated with Fund lending. We include GNP, the external debt to GNP ratio, the current account to GNP ratio, the current account to foreign exchange reserves ratio, the external debt to exports ratio, and a measure of foreign exchange reserves to imports. The GNP variable should capture any relationship between the size of a country's economy and the size of any loan it receives. Current account to GNP, current account to reserves, and reserves to imports should capture the fundamental sustainability of a country's balance-of-payments and reserve positions. Debt to exports and debt to GNP capture a country's relative debt burden.

Bank is our measure of American financial institutions' incentives to pressure the IMF, either through American policymakers or directly. We measure this incentive with

bank exposure data. Variation in the degree to which American financial institutions are exposed in countries experiencing debt-servicing problems will be correlated with *variation* in the losses American financial institutions suffer in the event of default. As exposure increases, the potential losses increase, thereby raising the incentive to pressure the IMF. Variation in bank exposure, therefore, should be positively correlated with the magnitude of IMF loans.

Two readily available measures of U.S. bank exposure exist. One measure is reported in the Federal Financial Institutions Examination Council's (FFIEC) "Country Exposure Lending Survey." The FFIEC compiles its exposure data through a quarterly survey of between roughly 100 and 200 banks of varying size. The variable represents the dollar amount of loans participating banks report outstanding in a given country, and is measured in millions of dollars. We construct two measures of bank exposure from the FFIEC data. The first measure equals the amount of bank exposure for all banks reporting to the FFIEC. The second measure includes only the amounts outstanding reported by the largest "money center banks.". The FFIEC survey includes from between six to nine money center banks. The second measure of bank exposure is reported in the *Treasury Bulletin* and represents the total amount of U.S. banking claims on foreigners. This variable is also reported in millions of dollars.

Neither measure covers the entire universe of countries receiving IMF loans during the period we cover. Moreover, each measure generates a different sample of cases. The Treasury measure encompasses 160 country-loan observations, of which 22

are not covered by the FFIEC. The FFIEC data encompasses 157 country-loan observations, 19 of which are not included in the Treasury data. For the 138 country-observations that are common to the two measures, the two measures are highly correlated: their Pearson Correlation is .959 (two-tailed, significant at the .000 level; n = 197). However, given the imperfect overlap of the two individual samples, results attained using one measure might differ from results attained using the other. Because we had no reason to believe that one measure was superior to the other, we estimated separate models using exposure data from each source.

Foreign is our measure of American foreign policy objectives. Our measure captures the extent to which a borrowing government's foreign policy is aligned with American foreign policy. To measure foreign policy alignment, we follow Thacker (1999) and others and rely on United Nations General Assembly votes. To measure country *i*'s foreign policy alignment with the United States, we calculated the percent of all UNGA votes in which country *i* voted the same way as the United States. This figure was calculated for each country-year observation in our sample. The higher this percentage, the greater the alignment between American foreign policy and country *i*'s foreign policy. We expect this variable to be positively correlated with IMF lending decisions.

*Bank*Foreign* is the interaction between bank lending and foreign policy objectives. To test the interaction between bank exposure and foreign policy objectives we created an interaction term composed of our UNGA vote-based measure of foreign

policy alignment and bank exposure. We created the interaction term after centering (subtracting the mean value from all observed values) the two independent variables. Centering reduces multicollinearity between the interaction term and its components without affecting the coefficient of the interaction term itself (Aiken and West 1991, chapter 3). We expect the effect of bank exposure on IMF lending decisions to be conditional upon the degree of alignment between American foreign policy objectives and the borrowing government's foreign policy objectives.

Finally, *Dummy* is a vector of dummy variables. First, to control for the possibility that the Fund systematically makes larger loans under some programs than others, we included a dummy variable for the program under which the loan was extended. Loans made under the standby arrangement are coded as "1" and those offered under the EFF are coded as "0." We also include a dummy variable for those countries at the heart of the 1997 East Asian currency crisis (in this case, Thailand, South Korea, and Indonesia), as well as a dummy variable for the three Russian cases in the sample (1992, 1995,1996). These financial crises were of exceptional magnitude, and we expect the coefficients on each dummy to be significant and positively signed.[7]

4. Results

We estimated four models, one pure technocratic model and three models in which the bank exposure, foreign policy, and interaction variables were added to the technocratic model. Two of the three political models were estimated with the FFIEC

measures of bank exposure (for all reporting banks and for money-center banks only), while the third political model was estimated with the Treasury measure of bank exposure. All models were estimated with OLS using robust standard errors clustered by country to control for possible cross-sectional heteroskedasticity and any lack of independence between multiple observations of the same country within the sample. The results are presented in Table One.

---Table One About Here---

The technocratic model provides results that are somewhat disappointing but consistent with previous work. Of the economic variables included, only GNP and reserves to imports attain acceptable levels of statistical significance. Both variables are correctly signed. Countries with larger economies tend to receive larger IMF loans. Countries with a more secure foreign exchange position (as measured by the ratio of reserves to imports) tend to receive smaller loans. Finally, two of the three dummy variables are also significant. Loans extended under the stand-by program are significantly smaller than loans extended under the EFF, while those countries most directly involved in the 1997 Asian crisis tended to receive larger than "normal" loans. This latter result seems to confirm that the IMF viewed the Asian crisis as a particularly severe, and perhaps unprecedented, threat to international financial stability, and responded in kind. Surprisingly, the Russian dummy variable is not significant in the technocratic model (though it is consistently and highly significant in the fully-specified models discussed below). The other four technocratic variables included in the model are

not significant.[8] While the poor performance of these variables is perhaps disappointing, the results of the technocratic model are consistent with previous work on the economic determinants of IMF lending.[9]

The inclusion of the political variables significantly improves the overall fit of the model. Our measure of financial institutions' incentives to pressure the IMF to make large loans returned a statistically significant and positive coefficient in all three models. The FFIEC and the Treasury measures of bank exposure all correlate highly with IMF lending decisions and the positive coefficients in all models imply that the magnitude of IMF loans is a positive function of American bank exposure. In more concrete terms, we can interpret the magnitude of the Treasury coefficient as implying that at the mean value of the foreign policy orientation variable a one-dollar increase in bank exposure increases the size of an IMF loan by .24 SDRs (or, at current exchange rates, a roughly 17 cent increase in the dollar amount of the loan). The conditional effects of a one-dollar increase in FFIEC money center bank exposure on the size of IMF loans is even greater – here, a one-dollar increase in exposure leads to a 31cent increase in loan size.[10]

It is important to emphasize here that our measure of bank exposure is not a proxy for the size of a borrowing country's total external debt burden. Total external debt is included in the model as an independent variable (total external debt to GNP), and it never attains conventional levels of statistical significance.[11] The absence of a significant total external debt effect, as well as the robustness of all three measures of bank exposure suggests quite strongly that what matters when it comes to the magnitude of an IMF loan

is not how much a given country owes to industrialized country financial institutions *writ large*, but the amount a given country owes to *American* financial institutions. This result provides strong support for our hypothesis that variation in the magnitude of IMF balance of payments support is shaped by pressure exerted on IMF officials by American policymakers on behalf of American financial institutions.

Our measure of foreign policy objectives yields mixed results. With the Treasury measure of bank exposure, UNGA voting coincidence is significant at the .10 level and is positively signed. As we hypothesized, countries more closely aligned to U.S. foreign policy preferences seem to receive larger IMF loans. However, this conclusion must remain tentative, as the UNGA variable is insignificant (though correctly signed) in the models using FFIEC data.

We also find mixed results for the interaction effect between bank exposure and foreign policy orientation. The interaction is highly significant and positively signed in the Treasury model, and is insignificant and positively signed in both FFIEC models. The coefficient on the interaction term in the Treasury model allows us to calculate how foreign policy alignment may shape the importance of bank exposure in determining IMF lending decisions. In this case, the coefficient indicates that the effect of bank exposure on the magnitude of IMF loans increases by .86 units for every one-unit increase in foreign policy alignment. In other words, when loan recipients are more closely aligned with U.S. foreign policy objectives, bank exposure has larger positive effect on the magnitude of IMF loans. This suggests that while the U.S. government is generally

willing to pressure the IMF on behalf of American financial institutions, the intensity of this pressure is shaped by the degree to which the borrowing government's foreign policies are aligned with American objectives. However, we emphasize that given the failure of the interaction term to reach standard levels of significance with the FFIEC measures of bank exposure, our conclusions on this issue must also remain tentative.[12]

In summary, the analysis suggests two broad conclusions. On the one hand, and consistent with existing work, there is evidence to suggest that IMF lending decisions are shaped to some extent by universalistic technocratic criteria. On the other hand, there is considerable evidence that IMF lending decisions are strongly influenced by American political objectives. The interests of American banks play an important role in shaping how much the IMF lends to the governments that turn to the Fund for balance of payments assistance. U.S. foreign policy interests appear to play a less certain, though potentially significant, interactive role, such that bank interests are more strongly represented in Fund lending the more those interests coincide with broader American foreign policy interests. Again, however, we emphasize that this latter result is suggestive rather than definitive.

5. Conclusion

As Keynes feared, the International Monetary Fund appears to have grown up a politician. The amount of balance of payments support the Fund provides to the governments that turn to it for assistance is strongly influenced by American financial

(and perhaps foreign policy) interests. We conclude by considering what we believe these findings imply for the contemporary international financial system and for the broader literature on international institutions.

The paper suggests two implications for the contemporary international financial system. First, the charge that the IMF balance of payments lending process contributes to moral hazard in international financial markets appears to be warranted. Moral hazard arises from the interaction of three behavioral components. First, monetary authorities provide an implicit or explicit commitment to absorb losses arising from bad debt. Second, because high risk implies a high return if debt is repaid (while a public bailout minimizes losses if borrowers default), the commitment induces private financial institutions to extend a larger number of high-risk loans than they would extend in the absence of a bailout pledge. Third, the incentive to lend too much to high-risk borrowers makes financial crises more likely, as risky borrowers prove unable to repay their debt and as financial institutions find that their capital is at risk due to a large number of defaults. While we provide no evidence indicating that the IMF lending process makes crises more likely, the paper does suggest that the IMF lending process relieves American financial institutions of the burdens of troubled international loans. In conjunction with other work that has found a relationship between IMF lending and stock market valuation of American banks, this suggests that an implicit guarantee well known to financial market participants is in place (Demirguc-Kunt and Huizinga 1991; Bulow and Rogoff 1988). Future work will be required to evaluate the degree to which this guarantee has

induced banks to alter their lending patterns and the extent to which international financial crises are more likely as a result.

Second, the paper suggests that the root cause of moral hazard is not easily eliminated. Following the 1997 Asian financial crisis policymakers initiated an ambitious series of reforms of the international financial system aimed, in part, at forcing private financial institutions to bear a larger share of the costs of their poor lending decisions. While obviously a step in the right direction, these reforms fail to address the underlying cause of the problem. The problem is not with the particular rules that guide IMF lending decisions, for Fund guidelines during the 1980s and the 1990s hardly explicitly encouraged bailouts. Instead, as Keynes recognized in 1944, the problem lays in how political influence shapes the application of rules. And here is the root problem: as long as American financial institutions are important international lenders and as long as American policymakers retain disproportionate influence over IMF lending decisions, the implicit guarantee the IMF provides to American financial institutions is likely to persist. To reduce moral hazard in the contemporary international financial system, therefore, American influence in the IMF will likely have to be reduced.

We also believe that the results presented here have important implications for how we study international institutions. The paper suggests a pattern of behavior somewhat at variance with the standard literature on international institutions. Rather than governments gaining utility from an international institution, private sector actors were the primary beneficiaries of IMF activity. Rather than an international institution

promoting aggregate welfare gains, IMF associated moral hazard probably reduces aggregate welfare. Thus, in contrast to existing literature, which emphasizes how international institutions promote welfare-improving inter-governmental cooperation, this paper indicates a pattern in which an international institution raises private sector incomes at the expense of aggregate social welfare. This suggests that two shifts in how we study international institutions might be productive. First, it may be productive to shift from the primary focus on how international institutions correct market failures that characterizes existing literature to a focus that incorporates governments' use of international institutions as providers of private goods. Our finding that IMF resources raise private financial institutions' incomes is only one example of this type of emphasis. Others can easily be found. Second, it may be productive to shift from the exclusive focus on the relationship between international institutions and governments that characterizes existing literature to a focus that explicitly incorporates private sector actors. Because the rules and procedures that international institutions provide often have important consequences for private sector actors' incomes, it makes sense to begin developing theories that, like endogenous policy theories in domestic political economy, examine how the interaction between politicians motivated by re-election and private sector actors motivated by the anticipated income consequences of international institutions shapes the creation of and processes within international institutions.

Data Appendix

Stand-by and EFF loans: The International Monetary Fund, *Annual Report*, various issues.
Current Account Balance: The International Monetary Fund, *International Financial Statistics* on CD-ROM.
Foreign Exchange Reserves: The International Monetary Fund, *International Financial Statistics* on CD-ROM.
GNP: The World Bank, *World Debt Tables*, various issues.
Total External Debt: The World Bank, *World Debt Tables*, various issues.
FFIEC Bank Exposure: Federal Financial Institutions Examination Council, "Country Exposure Lending Survey," various issues.
Treasury Bank Exposure: U.S. Department of Treasury, "Treasury Bulletin," Tables CM-II-2 (and CM-III-1, 2 or 3 where appropriate), various issues.
Military Assistance Program and Military Education and Training (MAP and IMET): Department of Defense, "Foreign Military Sales, Foreign Military Construction, Sales, and Military Facts," various years.
UN Voting Coincidence: U.S. Department of State, "Report to Congress on the Voting Practices in the United Nations," various year

Cases

The 176 cases listed below represent the sample of countries receiving an IMF stand-by or EFF loan during the years 1985-1998 for which either the Treasury's (T) or the FFIEC's (F) measure of bank exposure was available. This sample represents 73 percent of the total 242 IMF standby and EFF loans made during the period. Most of the countries missing from our sample are small African countries and states that were created from the Former Soviet Union. The actual sample of cases used in our regressions varied slightly depending on the measure of bank exposure used and the availability of data for specific economic control variables.

Argentina (F&T) 7/87, 11/89, 7/91, 3/92, 4/96, 2/98
Algeria (F) 5/89, 6/91, 5/94, 5/95
Bangladesh (T) 12/85
Barbados (T) 2/92
Bolivia (F&T) 6/86
Brazil (F&T) 8/88, 1/92
Bulgaria (F&T) 3/91, 4/92, 4/94, 7/96, 4/97
Burundi (T) 8/86
Cameroon (F&T) 9/88, (F) 12/91, (F&T) 3/94, 9/95
Central African Republic (T) 9/85, 6/87, 3/94
Chile (F&T) 8/85, 11/89
China (F&T) 11/86
Congo (T) 8/86, 8/90, 5/94
Costa Rica (F&T) 3/85, 10/87, 5/89, 4/91, 4/93, 12/95
Cote d'Ivoire (F&T) 6/85, 6/86, 2/88, 11/89, 9/91
Czech. (F&T) 1/91, 4/92, 3/93
Dominican Republic (F&T) 4/85, 8/91, 7/93
Ecuador (F&T) 3/85, 8/86, 1/88, 9/89, 12/91, 5/94
Egypt (F&T) 5/87, 5/91, 9/93, 10/96
El Salvador (F&T) 8/90, 1/92, 5/93, 7/95, 2/97
Gabon (F) 12/86, 9/89, 9/91, 3/94, 11/95
Ghana (F&T) 10/86, (T) 11/87
Guatemala (F&T) 10/88, 12/92
Guinea (T) 2/86, 7/87
Guyana (T) 7/90
Haiti (T) 9/89, 3/95
Honduras (F&T) 7/90
Hungary (F&T) 5/88, 3/90, 2/91, 9/93, 3/96
India (F&T) 1/91, 10/91
Indonesia (F&T) 11/97
Jamaica (F&T) 7/85, 3/87, 9/88, 3/90, 6/91, 12/92
Jordan (F&T) 7/89, 2/92, 5/94, 2/96
Kenya (F&T) 2/8/85, 2/1/88
Korea (F&T) 7/85, 12/97
Madagascar (T) 4/85, 9/86
Malawi (F) 3/88, 11/94
Mauritania (T) 4/85, 4/86, 5/87
Mauritius (T) 3/85
Mexico (F&T) 11/86, 5/89, 2/95
Morocco (F&T) 9/85, 12/86, 8/88, 7/90, 1/92
Nepal (T) 12/85
Niger (T) 12/85, 12/86Nigeria (F) 1/87, 2/89, 1/91
Pakistan (F&T) 12/88, 9/93, 2/94, 12/95, 10/97
Panama (F&T) 7/85, 2/92, 11/95, 12/97
Papua New Guinea (T) 4/90, 7/91
Peru (F&T) 3/93, 7/96
Philippines (F&T) 10/86, 5/89, 2/91, 6/94 (F) 4/98
Poland (F&T) 2/90, 4/91, 3/93, 8/94
Russia (F&T) 8/92, 4/95, 3/96
Senegal (F) 1/85, 11/86,10/87 (F&T) 3/94
Thailand (F&T) 6/85, 8/97
Trinidad & Tobago (F&T) 1/89, 4/90
Tunisia (F&T) 11/86, 7/88
Turkey (F&T) 7/94
Uruguay (F&T) 9/85, 12/90, 7/92, 3/96, 6/97
Venezuela (F&T) 6/89, 7/96
Yemen (T) 10/97
Yugoslavia (F&T) 5/85, 6/88, 3/90
Zaire (F&T) 4/85, 5/86, 5/87, 6/89
Zambia (F&T) 2/86
Zimbabwe (F&T) 1/92, 9/92

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Table 1: Determinants of IMF Lending

	Technocratic	Treasury	FFIEC-All Banks	FFIEC – Money Center Banks
IMF Loan	**-430.24*** **	**-346.21** **	**-451.78*** **	**-444.39*** **
	(152.00)	**(158.10)**	**(161.66)**	**(161.17)**
1997 Asian Crisis	**5553.95** **	**4328.32** **	**4459.16** **	**4553.30** **
	(2453.72)	**(1935.88)**	**(2246.98)**	**(2102.69)**
Russian Dummy	**1631.58**	**4428.82*** **	**3958.93*** **	**4433.50*** **
	(1415.04)	**(667.77)**	**(575.72)**	**(361.56)**
GNP	**.01** **	**.00**	**.00** **	**.00** **
	(.00)	**(.00)**	**(.00)**	**(.00)**
Debt/GNP	**158.09**	**-69.71**	**122.20**	**64.8**
	(117.40)	**(111.51)**	**(166.73)**	**(142.63)**
Current Account/GNP	**-832.26**	**-863.55**	**-852.28**	**-730.16**
	(1262.28)	**(1707.41)**	**(1723.09)**	**(1551.51)**
Current Account/Reserves	**.50**	**.16**	**.45**	**.39**
	(.43)	**(.43)**	**(.58)**	**(.55)**
Debt/Exports	**-54.36**	**-40.13**	**-116.60**	**-108.84**
	(50.16)	**(52.26)**	**(93.89)**	**(86.85)**
Reserves/Imports	**-783.17** **	**-1072.31**	**-1273.64** **	**-1241.66** **
	(464.27)	**(692.16)**	**(721.85)**	**(718.08)**
UNGA Voting		**1137.07** **	**894.62**	**862.81**
		(643.89)	**(923.67)**	**(839.74)**
Bank Exposure		**.24*** **	**.25*** **	**.42*** **
		(.05)	**(.10)**	**(.14)**
Interaction		**.86*** **	**.78**	**1.27**
		(.29)	**(.55)**	**(.78)**
R-Squared	**.69**	**.83**	**.78**	**.80**
F-Statistic	**4.15**	**38.92**	**18.75**	**58.66**
N	**194**	**140**	**139**	**139**

Endnotes

[1]Cited in Dam 1982, 114. Carabosse is the evil fairy that casts the spell on the infant princess in the ballet "The Sleeping Beauty." The two brats to whom Keynes referred, of course, are the International Monetary Fund and the World Bank.

[2]See "Mexican Rescue: Bitter Legacy of battle to bail out Mexico," *The Financial Times* Feburary 16, 1995.

[3]There are other methodological differences between our current analysis and Thacker's contribution – for instance, our dependent variable and method of estimation differ substantially from his, as does our sample of country-years. We discuss our methods in more detail below.

[4] IMF lending decisions, of course, have two dimensions: the magnitude of the loan; the severity of the accompanying conditionality requirements. One might expect American policymakers to operate along both dimensions. More stringent conditionality requirements and smaller loans will characterize borrowings by hostile governments, while less stringent conditionality requirements and larger loans will characterize borrowings by allied governments. We do not focus on the conditionality dimension, though it may prove a useful agenda for future research.

[5]Note that this is a key difference between our analysis and Thacker's (1999). Thacker presents a conditionality model of IMF lending, in which the U.S., through the IMF, trades loans for shifts in the recipient's foreign policy. We do not present a similar "dynamic" model for several reasons. First, as discussed above, the IMF is theoretically a poor instrument through which to exact aid-for-policy quid pro quos. Second, we do not posses a

measure of shifts in foreign policy that is sufficiently fine-grained enough to capture the short-term, issue-specific quid pro quos most likely to be demanded of potential loan recipients.

[6]The IMF uses the SDR as an international reserve asset and a unit of account. One SDR is currently (April 2000) equal to 1.34 dollars.

[7]The inclusion of either the East Asian or Russian dummy variable did not substantively change our reported results, though they do improve the fit of the models. In addition to the model presented, we also ran models that included a variable controlling for a country's "strategic importance" to the United States. We constructed this variable by creating five-year moving averages of a country's total receipts under two important U.S. military aid programs: the Military Assistant Program (which provides materiel) and the International Military Education and Training program. The variable was consistently insignificant, and its inclusion in the models presented here did not substantively affect our results. We thus do not include the variable in the models presented in the next section.

[8] We analyzed variance inflation factors (VIFs) for all reported models. Variance inflation does *not* appear to be the cause of the insignificance of the models' technocratic variables (all models had average VIFs below 2).

[9]See Bird (1995) for a discussion of the poor performance of most extant technocratic models of the determinants of IMF lending

[10] Note that the interpretation of the coefficients of components of interaction terms differs from the interpretation of non-component coefficients. Whereas non-interacted variable

coefficients indicate *constant* effects across the range of values of the other independent variables, the coefficients of the components of interaction terms represent *conditional* effects – e.g. effects that differ across values of the other component of the interaction term. Specifically, the reported coefficient represents the effect at the mean value of the other component.

[11] We also ran models that added a variable measuring external debt (as an absolute value) to the models presented here. The inclusion of a country's absolute level of debt did *not* substantively affect the results for our results.

[12] We also ran models that excluded both the UNGA voting variable and the interaction term; the results for the bank exposure variables were substantively similar to those presented here.