

## INTERNAL ORDER VS. EXTERNAL DISORDER. IMF AT THE CROSSROADS

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**Key words:** Moral order, internal-external order, heterogeneous principles, IMF, conditionality, weighted votes.

### ABSTRACT

Prior to Bretton Woods, international economic exchanges did not take place under an institutional vacuum. For at least one century, international arbitrations have remarkably settled conflicts between private enterprises with costly but not insurmountable endeavors. The creation of formal international institutions became inevitable only when governments laid a claim to settle those conflicts. The consequence was that conflict resolution evolved into a potential war between states. Drawing upon Public Choice analysis, the paper scrutinizes and contrasts the Kantian and the Hobbesian logic and focuses on the following questions:

- Is the Kantian/Hobbesian scheme a suitable key insight to start from?
- Have international monetary institutions been created to solve governments' failures? If so. Can they be viewed as supra-governmental institutions?
- Is the International Monetary Fund (IMF) with its conditionality policy an institution operating as if it were a supra-governmental institution? If so, how should it be changed in a globalized world?

The paper concludes that IMF's monopoly power is doomed to decrease as a consequence of the institution of supranational organizations like the European Union.

**JEL Classification:** F02, F33, G 15.

## 1. Introduction

In the past fifteen years or so, the term globalization has been in the spotlight and has filled many titles of books and articles. As one can expect, it has opened the field to at least two divergent viewpoints: the market-oriented and the welfare approach respectively<sup>1</sup>. Market-oriented economists have seen in the phenomenon a way to set limits to the ever increasing government intervention in the economies. By contrast, welfare economists and large a part of the non-academic press have seen globalization as a drive slowly depleting social achievements. Another lingering concern is that globalization will also alter the configuration of national markets that are apt to face the potential threat of multinational enterprises' competition. Globalization raises yet another and more general policy concern. Is democracy compatible with globalization given that the structure of nations is based on a geographically limited polity?

With these and like questions as to the role that the International Monetary Fund (IMF) has played during the past fifty years and its policies, which have dramatically changed after globalization, the paper largely concerns itself. This is accomplished by using a Public Choice approach, namely Buchanan contractarianism, which seeks to establish internal order *lato sensu* as a way to overcome the Hobbesian anarchy. We then try to fit such a paradigm into the Western institutional settings regulated by contracts between morally equal individuals, according to the Kantian categorical imperative.

For Buchanan (Buchanan, 2001), as well as for Kliemt (Kliemt, 2004), who explicitly follows Buchanan, both political and economic international relationships rest in a context of Hobbesian anarchy. In this context, the creation of international and supranational institutions aims at regulating economic and political international relationships that otherwise would be destined to fall into chaos, thus harming the survival of the Western internal order.

Yet different from the Buchanan and Kliemt paradigm as *prima facie* our interpretation is, it is however compatible with it. Differently from Buchanan and Kliemt, we think that prior to the establishment of International Organizations (IOs) international relationships did not take place in

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<sup>1</sup> It may be surprising that Public Choice, which has developed enormously in the past fifteen or twenty years with a wide production on topics such as institutions, bureaucracy and rent seeking, has made globalization central only very recently. Notable exceptions are B.S. Frey (1984) and R. Vaubel (1986). For a recent survey see H. Weck-Hannemann (2001).

an institutional vacuum such as that represented by an anarchic setting. For at least one century, international arbitrations have remarkably settled conflicts between private enterprises with costly endeavors, which were not insurmountable though.

But even assuming that such an occurrence might possibly emerge, it would be a result of failures in internal policies. Just as happens in national markets, the genuine actors in international economic relationships are individuals and firms and not national governments. Only when governments, as a consequence of war policies, claim to replace the genuine actors, relations among international producers and consumers are viewed as if they were relationships among nations.

It is no wonder that thus understood, international relationships, and *a fortiori* the globalization process, turn to be interpreted as a failure, a danger to be avoided. This is the consequence, however, of a rigidly ideological vision according to which competition for gaining markets among international producers is a fight for the conquest of national territories, thus putting democracies in jeopardy. What to Public Choice scholars would appear as a protectionist policy of national markets, it is routinely passed off as contingency policy ranging from national market defense, to employment support and finally to national security. What lies behind governmental activism is an opposition against internationalization and globalization. In fact, national economies were already open, at least from the semantic point of view of the term, well before the globalization process ushered in the scene. It was rather the war context the one that inspired the Bretton Woods Treaty. With the end of the war economy also the IMF needed to be reshaped for an age of peace, so it first changed informally and formally afterwards.

The remainder of the work is developed as follows. In section 2 domestic and international relationships are analyzed starting from the order vs. anarchy paradigm as developed by Buchanan. Sections 3 and 4 try to reconstruct IMF's conditionality policy during a fifty-year span. Specifically, they see the most important source of pressure promoting increase in conditionality as lying in the IMF official motivations and justifications. Section 5 develops an argument about a unique agency relationship, that between a single *international agent* and a plethora of *national principals* with heterogeneous and conflicting interests. It is as well examined the instrumental role that weighted votes play within IMF in insuring stability, and it is highlighted why the weighted vote criterion is to be preferred to the "one country one vote" procedure. Section 6 offers some concluding remarks.

## 2. A Kantian vs a Hobbesian paradigm

The appearance at the beginning of the 1970s of an edited collection in two volumes (Tullock, 1972) on economic behaviors in an anarchic setting was a manifestation of a marked change in Public Choice scholars. Surely no one would let himself for any such undertakings as to consider the distinction between internal economy and international economy in an anarchic setting. From the individuals' viewpoint all relationships can be but "external" and can be thought of as highly risk-bearing exchanges due to the absence of rules. In Hobbes's vision, rules are created to reduce uncertainty and their ultimate purpose is to guarantee individuals' survival. We have but to turn to Buchanan (J.M. Buchanan, 1975) to learn how to leap out of chaos and establish an internal order having the potential for being accepted by rational contracting parties, to whom consensual order is preferable to non-consensual one.

Moving from this premise, however, we still wobble uncertainly in the external order domain. The assumption seems to be that it is a form of society in which there are no external relationships, and conflicts are settled only resorting to war in a manner reminiscent of Hobbes's model of absolutism. Internal order at any cost, thus, yields a high degree of problems in its relation to external order. The absolute power by its manifestly despotic foundations, in fact, prevents external order from being achieved for the simple reason that there is no such a thing as negotiation, which is a feature alien to the absolute power. The real solution to the problem comes from the separation of powers on which internal order is based as a result of consensual constitutional rules. If such internal order needs involve constitutional coverage, surely this is something that international relationships never do.

It is unequivocally this vision that spurred Buchanan and Kliemt to see the two contrasting forces of internal order and external disorder in terms of constitutional order and anarchy respectively. Buchanan and Kliemt trace the political philosophical roots of the Western world in the separated and/or divided powers where the Kantian categorical imperative is an appropriate umbrella for guaranteeing moral equality among members of the national community, be they producers, consumers, politicians, bureaucrats or judges. The Kantian categorical imperative, which was expressively conceived as a moral code, seems to maintain its mesmeric appeal when it is extended to the political philosophy of moral order. But it ceases to be the energizing power in external relationships primarily because "moral anarchy" seems the most likely order. This fact might

provide some ground for supposing that moral heterogeneity makes all international exchanges and relationships spurious, so losing or at least bearing a partial economic value due to moral uncertainty, which arises from relationships between individuals who are reciprocally unknown, far and heterogeneous.

Although much of the energy of economists, from Ricardo, to Heckscher, to Ohlin up to Samuelson, has gone into demonstrating the advantages of international exchanges, their attention to institutions was scant and the impact of morals or ethics virtually inexistent<sup>2</sup>.

Inevitably, therefore, these ambiguities, produced a double evaluation: one for internal relationships; another for external ones. The double evaluation rests precisely on the dogma that divides the present world into “our world” and the “world out there”. It is a fight between Kant and Hobbes bearing consequences even on the taxation front: internationally traded goods should be taxed more than internal goods as a way of protecting internal markets where moral order has replaced moral anarchy. However, ever since World War I, the internal setting had to confront a more and more tangled web of internal and external relationships. With the relaxation of the Kantian categorical imperative in Western Europe some countries became victims of Fascisms, which manifestly were internal phenomena that pitched internal order into a Hobbesian world, bereft of freedom at home and with war replacing international exchanges. But it was by no means Fascism alone that broke the liberal internal order. The Communist ideology that entered the scene in Eastern Europe first and in China thereafter produced the same effect and it was the internal order that collapsed and, once again, without any external threat. One of the challenges that international institutions confronted was that of re-examining the old set of canons to build a new order. Policy attention concentrated where the threat seemed most urgent: in non-democratic countries. The lack of priority attention to non-democratic countries would have meant renouncing to spur those countries towards international exchanges, and in the end to forego political democracy.

If an international/supranational institution had to act as democracy promoter, surely this was something that the Bretton Woods institutions, which were created to stabilize economic and financial relationships primarily between the US and Europe, were incapable of doing. Given these circumstances, it is ingenious, absolutely ideal to think that an IO parameterized on the logic of blocks, would fulfill such a task.

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<sup>2</sup> A theoretical explanation of what stated in the text can be found in (Robbins, 1945).

Come into full existence in 1944 under the stimulus of war, the IMF was to be developed in peacetime as an institution to combat the evils of a world divided into two blocks mostly won by the momentum of controlling the gray zone of non-aligned countries.

With the end of the blocks in the upper 1980s, the IMF found itself acting in a very different scenario dominated by the creation of regional monetary systems, supranational currencies - such as the Euro that is now increasingly tending to side the dollar as an international currency - and nowadays Chinese exports.

The closing of international exchanges along a continuum, which goes along a line starting from the World War I, continuing in the inter-war period and during the World War II to an international policy based on blocks, has to be attributed to policy failures by governments rather than to failures in international markets. Interestingly though, while market-oriented economists have attributed the reason to political failures, welfare economists have charged the market to be responsible of those failures. Political failures, looked like two sides of the same coin: they first produced the end of international relationships and then came to be the leverage for re-opening them in their own right. Yet, the newly created institution was in many respects a replica of national institutions: the IMF habit of thought remained powerfully inspired to a policy of discretionary power.

If we were to accept the Hobbesian logic, globalization of economies, with the reduction in the weight of nation-state governments and with the expansion of financial exchanges not linked to territoriality, would leave those relationships without any institutional coverage. If, instead, we go back to the IMF philosophy, financial stability can be viewed as a full fledged public good. Hence stability as a public good becomes the true mission of the IMF. The problem of how best to coordinate governments or IOs has been the focus of PC scholars who have shown a growing unease especially with such superstructures where harmonization rather than coordination rules supreme for lack of a constitution limiting governments' behaviours. Harmonization, as the EU case shows, is a mechanism in the service of both central governments and related bureaucracies, and has, alas, a negative impact either on consumers and on the most efficient firms.

In this respect, the creation of IOs or supranational institutions such as the EU with quasi-unlimited discretionary power is hardly reconcilable with the vision that sees agents as rational actors. This depends on the fact that coordination does not arise out of political decisions, but it is the result of

negotiations among political agents. In the hands of political agents, coordination is used as a rent-shifting device.

It is no wonder then that the IMF has espoused the conditionality principle as a sort of quasi-constitutional praxis to be followed. Conditionality and its ever increasing employment will be the focus of the next two sections.

### **3. Nature and aims of conditionality**

The IMF makes disbursement of loans conditional upon the implementation of appropriate adjustment policies by the borrowing country. These policies are specified in the so-called '*letter of intent*' (to which a *memorandum* of economic and financial policies may be attached) which is drafted by the member country requesting for IMF financing. Conditionality is reinforced by the fact that loans are not usually paid outright, but are granted according to the "credit tranche" principle, as the program goes on, carried out) (credit tranches). This procedure enables the IMF to make disbursement of subsequent tranches conditional on the implementation of the policies and measures envisaged in the supported program.

IMF's official documents make clear that conditionality aims at guaranteeing donors that loans will be used to solve problems jeopardizing the borrower's external equilibrium and its financial stability. Conditionality also ensures that the borrowing country will promptly repay, thus making resources available to other applicant member countries. Moreover, conditionality is often indicated as an important factor for explaining IMF's catalyst effect in attracting additional resources. In particular, the IMF approval of a program would contribute to restore markets and the official community's widespread confidence in the borrower country's policies, so enhancing country access to both private and other official sources of external financing.

The IMF's catalytic role may result very important for developing countries, transition countries and emerging market economies recovering from financial crises, with a limited access to international capital markets. It is precisely the catalyst effect of conditional assistance that may

induce a country to apply for an IMF-supported program, even though its borrowing may represent only a small quota of its total financial requirements. Literature supportive of the IMF programs' catalytic effect on capital flows points out that in some circumstances this additional financing may turn out to have a key role in ensuring the success of an adjustment program<sup>3</sup>.

The emphasis on the catalytic effect of IMF's conditional lending has been changing over time. In a post-war world characterized by a parity system and widespread restrictions on international capital mobility, the IMF ability to mobilize market financing, in addition to its own lending, had necessarily to stay within narrow limits. The breakdown of the Bretton Woods system of fixed exchange rates in the early 1970s and the gradual opening up of international capital markets led the IMF to pay increasing attention to its potential role in favoring a country's ability to attract private capital flows<sup>4</sup>.

As to the explanation of the catalyst role played by conditionality, it has been argued that policy conditions attached to a program may act as a 'commitment device' for borrowing countries, which have incentives to implement the agreed reforms. According to this view, conditionality may help credit-constrained countries to overcome the well-known credibility and time-inconsistency problems. In particular, the adoption of a Fund-supported program would increase private and official creditors' confidence in the soundness of the adjustment measures and their actual implementation, which in turn would facilitate access to capital markets<sup>5</sup>. In this sense – following Tirole – the Fund role in exercising its conditionality may be viewed as one of “delegated monitor”. In a context of widespread asymmetric information, (Tirole 2002: 114-115) points out that “the IMF's role is to substitute for the missing contracts between the sovereign and individual foreign investors and thereby to help the host country benefit fully from its capital account liberalization. Accordingly, the IMF should act as a delegated monitor and a trustee for foreign interests precisely to facilitate the country's favorable access to foreign borrowing”.

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<sup>3</sup> Concerning this aspect, Fischer (1997, p.23) notes: “[In] many countries...the IMF program is *the* critical element in macroeconomic policy, and adherence to the program is in many cases a prerequisite to obtaining other (often larger) public and private loans”.

<sup>4</sup> Commenting on this point, Bordo and Mody (2004, p.3) observe: “As the fluctuations in countries' capital accounts acquired greater importance – and sometimes even dominated current account fluctuations – the IMF increasingly came to view the facilitation and maintenance of capital flows to developing countries as one of its essential functions”.

<sup>5</sup> The argument of conditional assistance as a theoretical foundation of the IMF catalytic role is illustrated by Bird and Rowlands (2002, p. 230) in the following terms: “In short, countries in crisis seek to improve the superior reputation of the Fund for economic management. Conditionality supposedly acts as a signalling device that reduces uncertainty and provides additional information about future policy and performance. It identifies and locks countries into better economic policies, raises credibility and helps to overcome the time-inconsistency problem”.

It is, however, important to remark that conditional assistance, acting as a commitment device, is not the only channel through which the IMF might help the borrowing country mobilize additional capital inflows. The theoretical literature has suggested two more potential channels at least. The first reflects the assumption that the IMF benefits from an informational advantage vis à vis private agents as to the member country economic performances and prospects. Such an advantage would not only spring out from the IMF position of 'privileged observer' but also from the fact that information is a public good which involves a free-riding problem. Owing to the IMF privileged informational position, a positive assessment on a credit-constrained member regarding its willingness and ability to implement sound policies may reinforce market confidence and therefore facilitate the country access to foreign financing. In a context of asymmetric information, the IMF may transmit its superior information to private and official donors and creditors by publishing the results of its surveillance activity as well as through the 'good housekeeping seal of approval' implicit in its endorsement of an adjustment programme.

The second channel has to do with the very fact that a country in troubles gets access to a loan programme. Following IMF's liquidity – it has been argued – private and official creditors are induced to assign the country a lower probability of defaulting. This, in turn, reduces the risks of financial panic (and contagion) and of sharp capital flow reversals. By the same token, renegotiation of foreign debt and access to new loans may be facilitated. In other terms, in a context of multiple equilibria and self-fulfilling expectations, potential financial support by the IMF may contribute to solve an illiquidity problem, making thereby more likely the prevailing of a "good" equilibrium for the borrowing country<sup>6</sup>.

In recent years, a vast empirical literature has investigated on the real incidence of the catalytic effect of IMF's approval of adjustment programs. Contrary to the standard trend, many of such studies suggest that this effect is modest if not negligible. Specifically, the presence of an IMF-supported program itself seems not to be enough to ensure a significant and positive catalytic effect for countries in severe distress. The IMF effectiveness in restoring lenders' confidence and in mobilizing additional financing for credit-constrained countries appears to depend crucially on the

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<sup>6</sup> Regarding such a modality through which the IMF may play a catalytic role, Cottarelli and Giannini (2002, p. 35) observe: "[The] gist of the argument is that the very existence of the IMF might reduce the probability of a self-fulfilling run caused by purely illiquid problems...The catalytic effect would arise from the provision to the private sector of the insurance service that is implicit in the LOLR [lender of last resort] function".

For a theoretical analysis of these channels through which the IMF may enhance its members' access to international capital markets see Marchesi e Thomas (1999), Cottarelli e Giannini (2002), Bordo, Mody e Oomes (2004) and International Monetary Fund (2004).

presence of additional various factors - basically associated with a program approval - which are apt to influence market expectations for successful policy reforms<sup>7</sup>.

#### 4. Macroeconomic conditionality vs. structural conditionality

Conditionality has evolved substantially through time. The average number of conditions in IMF-supported programs tended systematically to increase, especially during the 1980s and 1990s. The expansion of conditionality has been associated with a change in its contents. In particular, similarly to what happened to IMF surveillance activity and to a large extent for similar reasons, IMF conditionality, which up to the early 1980s was largely confined to macroeconomic policies, subsequently affected an increasingly wider spectrum of structural and institutional reforms<sup>8</sup>. The broadening of structural conditionality has often involved sectors usually deemed to be within the national decision-making process, such as banking and financial system regulation, market-state relationship, rule of law, welfare state, labor market, corruption, efficiency and transparency of the public administration and other aspects of public *governance*. Behind such changing in attitude towards the problem there were several factors.

A first factor that enhanced structural conditionality has to be found in the globalization process. The increasing opening up of trade and financial markets of national economies has resulted in a higher interdependence. The consequence that structural and institutional policies had larger implications than in the past for a country's macroeconomic policies and performances, thus affecting the balance of payments behavior and financial stability. Moreover, such policies may generate significant regional and international spillovers. A strong pressure towards the expansion of structural conditionality came from the Mexican (1994-95) and Asian (1997-98) financial crises. Besides the reduction in the effectiveness of stabilization policies, structural weaknesses in domestic banking and financial systems make a country extremely vulnerable either to an internally

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<sup>7</sup> Among others, the following factors have been suggested by the literature: the deterioration degree of a country's fundamentals; the size of the IMF financial support; the contents of the adjustment program. Accurate surveys of the empirical evidence on the catalytic effect of IMF-supported programs are provided, among others, by Bird and Rowlands (2002), Cottarelli and Giannini (2002), Mody and Saravia (2003) and Bordo, Mody and Oomes (2004). Bird and Rowlands (2004, p.118) suggest that the systematic overvaluation of the Fund's ability to enhance countries in troubles access to capital markets might have contributed to the failure of many programs in the past.

<sup>8</sup> On this point, an IMF study (2001a, p. 23) reads: "Until the mid 1980s, structural reforms in Fund-supported programs were typically confined to the exchange and trade system. In addition, programs occasionally addressed selected fiscal and financial sector issues, or generally pricing policies".

originated crisis or to the contagion of an externally originated one<sup>9</sup>. Both kinds of risk are amplified in a context of rapid expansion of international capital flows.

A second important factor contributing to explain the expansion of structural conditionality is given by the IMF growing involvement in low-income developing countries. For these countries, structural distortions and institutional weaknesses often represent a severe obstacle to the pursuit of a strategy favoring economic growth and poverty reduction, consistent with the targets of financial stability and a balance of payments position sustainable in the long run. The IMF concern about economic growth, poverty issues and supply-side reforms has increased chiefly since the late 1980s. This evolution, at least in part, reflected the fact that in those days developing countries were the principal beneficiaries of the IMF's financial assistance while, as a consequence of capital-account liberalization, financing needs of industrial economies were largely provided by international capital markets<sup>10</sup>.

Another factor that has played a key role in the expanding process of structural conditionality is the huge demand for IMF lending by former centrally-planned economies since the beginning of the 1990s. In fact, these countries' need of external financing has been largely related to the wide range of structural and institutional reforms that have accompanied their transition to a market economy<sup>11</sup>.

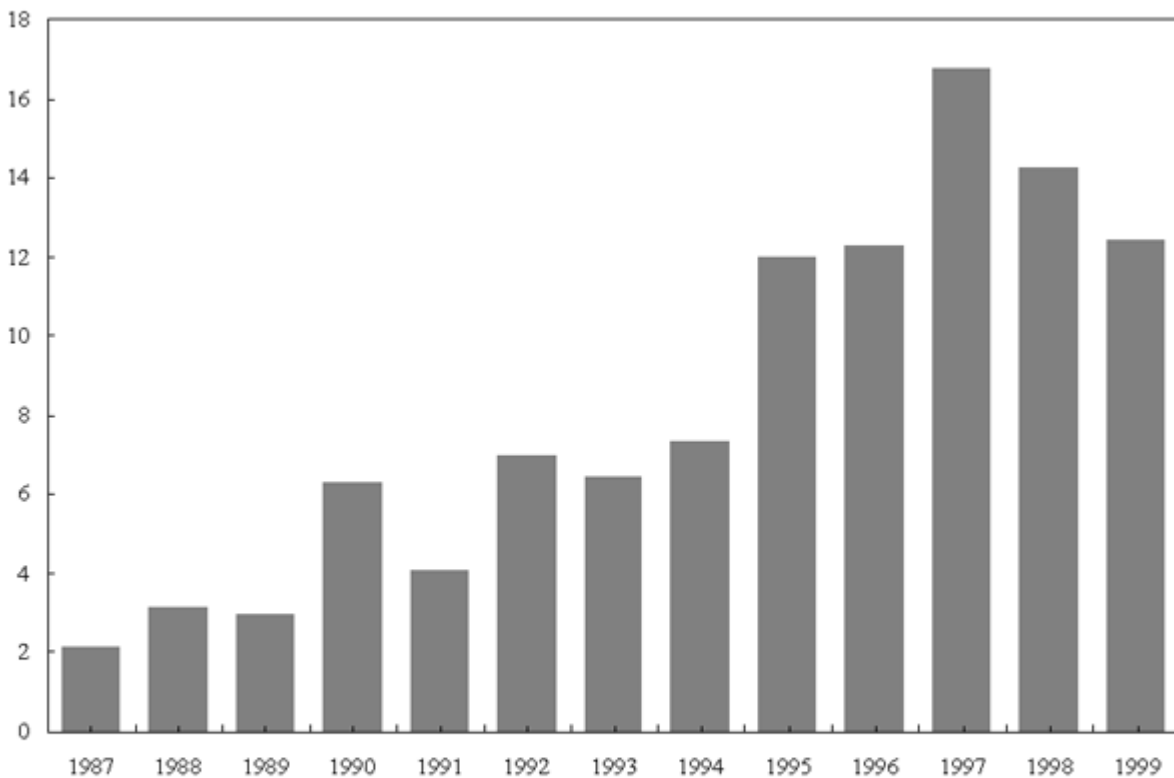
The increasing IMF involvement in the structural area is confirmed by data concerning the share of lending programs, which include structural conditions, as well as by data relating to the average number of these conditions per program year. IMF's sources show that structural conditions, rarely attached in IMF-supported programs before the early 1980s, were present in almost two thirds of these programs by the late 1980s and in nearly all programs by the mid 1990s.

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<sup>9</sup> Trying to justify the increasing resort to structural conditionality, the IMF's literature often stresses complementarity of macroeconomic and structural policies. "Behind the expansion of structural conditionality was an increasing awareness that the monetary and fiscal policy objectives that are key to macroeconomic adjustment often themselves depend critically on structural conditions – including the removal of extensive market distortions and the establishment of the international underpinning for effective policy making in a market economy" (IMF, 2001c, p.2).

<sup>10</sup> As Fischer underlines (Fischer, 1997: 23), the last industrial countries to borrow from the IMF were "Italy and the United Kingdom in 1977, Spain in 1979, and Portugal in 1983". On this point, see also Bordo and James (2000: 16).

<sup>11</sup> In his survey on possible explanations regarding the broadening and deepening of conditionality, Goldstein (2000: 69-70), indicates also pressures from various G-7 governments – and particularly the United States – for introducing "a long list of structural policies" in financial assistance programs which often – he argues – were far from Fund's core competence".

Figure 1. Average Number of Structural Conditions per Program Year <sup>1/</sup>

Source: International Monetary Fund, MONA database, and country papers.

<sup>1/</sup> Total number of structural performance criteria, benchmarks, prior actions, and conditions for completion of review in stand-by, EFF, and SAF/ESAF/PRGF-supported programs, adjusted for differences of program length

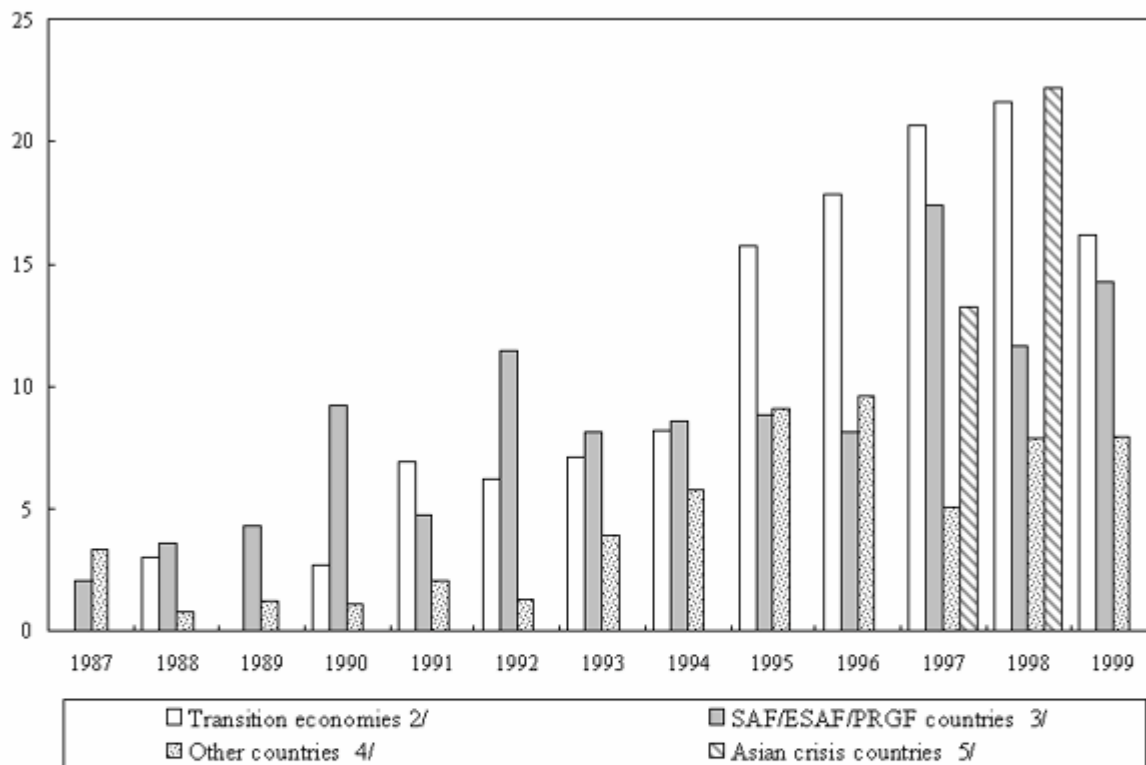
The same sources show that differently from macroeconomic conditionality, which remained relatively stable over time, the average number of structural conditions per program year increased from two/three in the mid 1980s to twelve or more in the second half of the 1990s<sup>12</sup> (Fig.1, reprinted from International Monetary Fund, 2001, c, p.3). The expansion of structural conditionality has been particularly significant in programs concerning low-income countries and transition economies. Nevertheless, such a phenomenon has involved also other countries, although to a lower extent<sup>13</sup> (Figure 2, reprinted from International Monetary Fund, 2001, c, p.4).

<sup>12</sup> This marked expansion of structural conditionality prevailed although the 1979 Guidelines suggested that conditionality should normally be limited to macroeconomic variables and be extended to other variables “only in exceptional cases when they are essential for the effectiveness of the member’s program because of their macroeconomic impact”.

<sup>13</sup> For an overview of this evolution of structural conditionality see, for instance, IMF (2001a; 2001b). On the same subject see also Goldstein (2000).

Several specific tools used to monitor policy implementation in IMF-supported programs are usually employed to quantify structural conditionality. These (monitoring) tools are classified as prior actions, performance criteria, structural benchmarks and program reviews. The initial disbursement as well as the phased disbursements of IMF financing depend on the accomplishment of the conditions which are included in the four forms of program monitoring.

Figure 2. Average Number of Structural Conditions per Program Year by Type of Country<sup>1/</sup>



Source: International Monetary Fund, MONA database; and country papers.

1/ Total number of performance criteria, prior actions, conditions for completion of review, and structural benchmarks per program, adjusted for differences in program length.

2/ As defined in the World Economic Outlook, covering former centrally planned economies in Eastern Europe, FSU countries, and Mongolia.

3/ Countries with SAF/ESAF/PRGF-supported arrangements, excluding transition economies.

4/ Residual group, encompassing programs in countries that do not fall into any of the other categories.

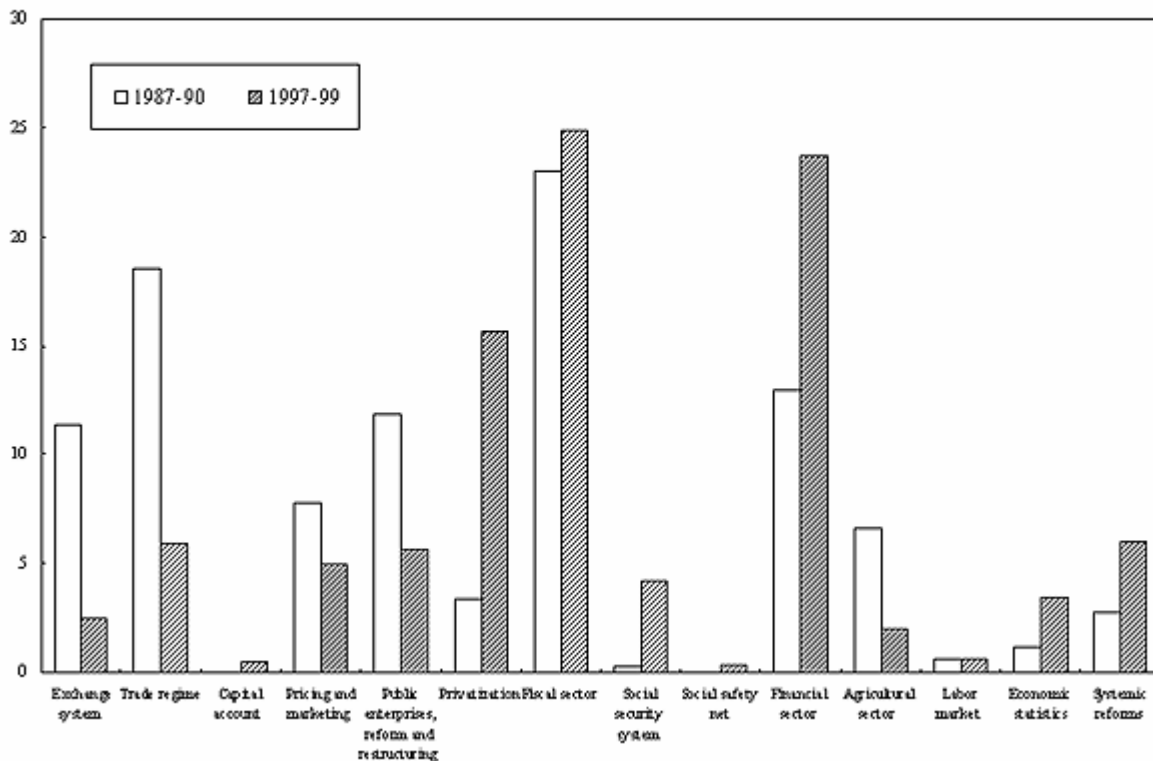
5/ Indonesia, Korea, and Thailand.

Commenting on these conditionality trends, various IMF studies stress that a large share of structural conditions “between half and two third – has been concentrated in a relatively small number of sectors that are at the very core of the Fund’s involvement in member countries: exchange and trade system, and fiscal and financial sectors”<sup>14</sup>. Structural weaknesses in these sectors – it is argued – would increase a country’s vulnerability to financial crises and would shrink its ability to restore its macroeconomic equilibrium. Nevertheless, one shouldn’t overlook the fact that empirical evidence shows cases of programs, including structural conditions, that on one hand

<sup>14</sup> IMF (2001b, p.27). According to IMF’s classification, structural conditionality has interested – in addition to the four above mentioned economic sectors – the following others: capital account; pricing and marketing; public enterprises, reform and restructuring; privatisation; social security system; social safety net; agricultural sector; labour market; economic statistics; systemic reforms.

do not fall within the IMF traditional areas of expertise and on the other are not essential for macroeconomic adjustment<sup>15</sup> (Figure 3).

**Figure 3. Distribution of Structural Conditions by Economic Sector**  
(In percent of total structural conditions 1/)



1/ Averages of the sectoral distributions of total structural conditions (performance criteria, structural benchmarks, prior actions, and conditions for completion of review) for each program.

Source: International Monetary Fund (2001 c, p.5)

According to a widespread view structural conditionality in Fund-supported programs during the 1990s has been excessive, too intrusive and unresponsive of the principle of national ownership of policy programs<sup>16</sup>. The way conditionality has been applied might have played a role in reducing the implementation rate of IMF-backed programs. Perhaps this and other criticisms have contributed, in a sense, to induce IMF to re-think its position and to issue new guidelines (September 2002) replacing previous guidelines dating back to 1979, with the aim of restoring a

<sup>15</sup> Examples of IMF-supported programs where structural conditionality may have gone beyond what could be essential for achieving macroeconomic objectives are provided, among others, by Goldstein (2000).

<sup>16</sup> On the complex and controversial relationship between conditionality and ownership see, for instance, Boughton (2003).

more restricted use of conditionality<sup>17</sup>. Despite the adoption of the new guidelines, the Fund's approach to conditionality still remains a very controversial subject-matter.

## 5. IMF: An agent of heterogeneous principals

Due to its historical background and governments' political behaviors, it is not so easy to find a non-controversial role for the IMF in the context of our investigation. In fact, one wonders whether the IMF can be depicted as a strengthened Leviathan or as an organization constraining states-Leviathans through its conditionality policy. What matters us is to scrutinize IMF relationships with its principals, particularly the role that these principals with heterogeneous interests may play in a context of weighted votes. Heterogeneity of interests comes from both a different economic dimension of countries and their degree of democracy. Conceiving of the IMF as an agent of governments is an interesting way that has been largely used in the literature<sup>18</sup>. Much less explored is the study of the impact that opportunity costs have on a government such as the USA when buys IMF membership.

Our assumption is that the advantage a country has in delegating part of its monetary and financial policy to the IMF is inversely proportional to its national income. In other words, to evaluate such an advantage/disadvantage requires that the USA should be able to confront the possible results deriving from joining or not joining the IMF. Without any doubt, the government of a rich and large country, such as the USA, may obtain very similar results by either joining the IMF or staying out. For instance, even assuming that the USA decided not to buy IMF membership, the dollar would be still the international currency anyway. Moreover, if the voting criterion were "one country one vote" instead of the weighted vote criterion presently in force<sup>19</sup>, the USA ought to contribute a higher share than it actually does. This may appear *prima facie* a contradiction in terms being the cost of buying membership via weighted votes higher for richer countries. One such cost, however, has to be viewed as representing the global cost, inclusive also of the decision-making power that

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<sup>17</sup> According to the new Guidelines, the Fund's conditionality should be inspired to the following five principles: (i) national ownership of reform programs; (ii) parsimony in the application of program-related conditions; (iii) tailoring of a program to a member's circumstances; (iv) effective coordination with other multilateral institutions; (v) clarity in the specification of conditions.

<sup>18</sup> A. Thompson (2003), D. Hawkins, D.A: Lake, D. Nielson, M.J. Tierney (2003).

<sup>19</sup> Very often the executive board that has competency over the loan granting does not vote explicitly, as stipulated in the IMF's *By-laws Rules and Regulations*, section C-10, but epitomizes the 'sense of the Executive Board meeting' (IMF, 1997).

the potential government has in granting a loan. Once the latter element comes into play, weighted votes are likely to have a more restrictive impact, and stability becomes the key objective while non-weighted votes are expected to have a more expansionary and, hence, a more redistributive role. Given these circumstances, it is clear that under the "one country one vote" rule the decision-making power shifts towards poorer member-countries. The consequence of such a hypothetical predicament will be a higher advantage for the USA to stay out of the IMF. With the USA outside the IMF would lose a large part of its stability power and would simply play a role of international redistributing agent. We would then face a sharp conflict also at an international level between the provision of public goods (specifically stability) and redistribution (equity). The conflict between efficiency and equity taking place in a context of trust agency, which cannot be monitored through a direct electoral control, would end up by following a bureaucratic conduct *à la* Niskanen.

Contrary to our stance, the traditional view, instead, tends to explain governments' delegation to IMF as a simple reduction in transaction costs without referring to countries' dimension, voting criteria etc. A particular flaw of this view is that it fails to capture that the reduction in costs could be more than compensated by IMF delayed policies especially when principals are heterogeneous. The delay in politics, however, might not be a good indicator and one should not attach much weight to it. Interestingly enough, not only could a government ask the IMF the adoption of extreme policies with the aim of having an announcement effect within the country, but also – and this is more serious – it would possibly end up by accusing the IMF of delays or looseness. However one reads it, a behavior of the sort would be but tactical since the prevailing vote would be that of the median donor government. It is exactly the prevalence of the median donor government that ensures that extreme policies will not prevail. But the point is exactly that of establishing what extreme policies consist of. It is fairly clear that one of the extreme policies prevents the achievement of a Pareto optimal position, but it is as much clear that the other extreme policy, the worst or anti-Pareto position, is avoided as well. Moreover, in a context of weighted votes the median voter gives different results if confronted with those coming from democratic electoral systems where the "one man one vote" principle is applied. The IMF vote is similar to that cast by a shareholder in a corporation whose vote weighs proportionally to his capital. The consequence is that IMF votes are rather stable and so are the results of the policies adopted. No expression could be more fit in such a context, than Tullock's "Why so much stability?" (Tullock, 1981). So interpreted IMF's conditionality policy loses a great deal of its discretionary value since conditionality would be the result of the implementation of a sort of *non-written rule* establishing that loans are granted free from risk of default in that defaulting would preclude stability.

## 6. Conclusions

Conditionality was fashioned to increase IMF's intervention in lending loans according to binding conditions defined as "low conditionality", understood as macroeconomic policy (section 3), and "high conditionality" as resulting from the conflation of macroeconomic and structural policies (section 4). The two types of conditionality mutually expanded and strengthened, so laying down the conditions for the IMF to be a pervasive bureaucratic organization whose decision-making structure has grown constantly larger. In this international scenario where politicians' control was even less motivated and more susceptible of failures in agency terms, conditionality became a strategic instrument through which the IMF revealed to be an interested and faithful agent to its principals. Such a device was used as a moral suasion on donors, USA *in primis*.

Freedom of movements of capitals consequent to the opening up of markets is likely to produce two effects: (1) a reduction in governments' fiscal powers and (2) market prices are apt to yield direct information on the economic conditions of firms. Yet, the global dimension of capital markets increases information costs, thus magnifying problems of information asymmetry. Hence the IMF should possess the capacity to guarantee information as a public good, while its role of global coordinator should be confined to financial stability only. Conversely starting from late 1980s, the IMF has done little more than distributing aids to underdeveloped countries, so overlapping the World Bank role.

IMF is then at a crossroads: it must adjust to globalization. Globalization implies a dramatic shift to a nuanced watershed between internal and external economy, so putting the IMF in the awkward position of adapting quickly to its new role.

Most typological changes of conditionality, which we have highlighted in sections 3 and 4, are characterized by both gradualness and occasional breakthroughs in decisions. The latter, however, were more in the direction of discretionary or even discriminatory steps. Conversely, the IMF gradual changes in conditionality suggest that the keeping of the *status quo* was a strategic value and such a strategic value requires that the IMF be able to pass a sort of reinforced test much the same as in constitutional changes. According to this vision, IMF's conditionality would not involve

an improper interference in democratic governments' policies (Schneider, 2004). Conditionality would emerge as a way to avoid the "worst result" coming from a misuse of subsidies or credit guidelines, which would result in instability and turbulence in international financial markets that the IMF was supposed to fight.

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