The Politics of the International Monetary System: Address

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Politics has been defined as *the constrained exercise of social power* (Goodin and Klingemann 1996, p. 7). In turn, power can be described as the ability of A to get B to do what A wants, which B would not otherwise do (Dahl 1957); or, more precisely, as an inverse function of the cost to A of getting B to do what B would otherwise not do.

Politics as I have defined it is absent from perfect markets. Indeed, the "perfect market," as an ideal point, is the absolute zero of politics—the point from which measurement starts. In a perfect market, no one has power, since no agent gains influence over any other agent.

Real markets are imperfect. They involve some degree of bargaining. And they are embedded in political institutions. Political context matters—a major reason why so few generalizations about the "best" policy to follow seem to be valid.

Most of what we know analytically about bargaining comes from economics and decision science—especially from game theory—more than from traditional political science. That is, *the models of causal mechanisms* come from economics. And this audience understands the ins-and-outs of specific bargaining in the international monetary system better than I do. You have been speaking and writing the prose of politics, as I have defined it, even if you thought you were engaged in the poetry of economics. I feel a bit like the man who survived the Johnstown flood and then led a most unremarkable life except for being a bore to his friends. When he died, St. Peter told him he had a right to a "show and tell" the first afternoon in Heaven. Since the man had only one important event, the Johnstown flood, he talked on and on about that until St. Peter

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finally said, "You can talk about whatever you want, but don't forget, Noah's in the audience." What, then, can a political scientist who has not been focusing on the specifics of bargaining over monetary issues contribute? Are there any gains from interdisciplinary exchange?

You will be the judge. My own view is that both economic modeling and international monetary policymaking often fail to make explicit the political variables that affect the results of particular economic policies. Our discussion this morning, for instance, implicitly agreed that countries should choose flexible or pegged exchange rate regimes, or impose capital controls, only "under some conditions," but the conditions were not systematically specified. If specified, some of them would surely be political. Economic analysis alone is like a laser: precise, well-focused, but only illuminating a small part of the environment. Political science is like a flashlight—maybe a dim one—illuminating a larger area, but less well. My approach this evening will be to use political science concepts to formulate hypotheses that might be provocative for discussion and, perhaps, useful in the future for research. Gertrude Stein on her deathbed is reported to have said to her friend Alice B. Toklas, "Well, what is the answer?" Receiving no answer, Stein then asked, "Well, then, what is the question?" Similarly, I am going to try to raise some questions, rather than pretend to give answers.

The definition of politics that I have borrowed speaks of social power "within constraints." Choices—so cogently analyzed by economics in certain domains—are made under constraints. To understand outcomes, we need to understand the constraints. The positive aspect of this talk proposes some conjectures about the constraints within which power is exercised in the contemporary international monetary system.

The other aspect of this talk is normative. What are the values at stake, and how should we think about the trade-offs between them? I will spend my last few minutes on these issues, and especially on the issue of both creating and constraining power. Harold James told us last night about Napoleon III. I will counter with James Madison.

Both aspects of these talks have the same punch line. The collective consequences of self-interested behavior are often bad even in self-interested terms, and therefore they generate rational attempts to organize institutions to change incentives. To understand the system, and how to modify it, we have to understand its institutionalized constraints.

Five Constraints

1. The Self-Interests of Politicians

The micro-foundations of the politics of the international monetary system are domestic, since leaders are chosen domestically. Hence, monetary policies and international agreements must be in the selfinterest of politicians. Policies are not made by public-spirited unitary governments. So we need always to keep in mind what Robert Putnam has called a "two-level game," domestic and international (Putnam 1988).

Three conjectures: 1) Since "the economy, stupid," is crucial to electoral prospects of incumbents, the most important long-term determinant of overall policy in large liberal democracies will be public beliefs about the effects of international monetary policies on the domestic economy. 2) In the short term, in these democracies, the most important determinants of overall policy will be opportunities to blame one's opponents, or to avoid blame oneself. One example is the GOP's agreement to provide extra funding for the International Monetary Fund after the financial crisis of last fall; they hoped to avoid blame for any further crises that might occur after Russia's default. 3) In many countries, even liberal democracies, the interests of concentrated sectors and large firms will be more important, on specific issues, than public sentiment, especially if the issues are not widely publicized. On such issues, to understand policies, one needs to identify the key members of the ruling coalition. These may be export sectors, as Sebastian Edwards argued with respect to Chile. They may be local bankers—the "crony capitalism" of IMF lore. Or they may be money-center banks in the United States, as in the Korean debt restructuring of late 1997.

2. Linkage

The world monetary system is clearly a central component of the world political economy, but it is "nested" within political-military relationships involving physical security. This morning we discussed the difficulties of building credible domestic or international monetary institutions, but no one pointed out that the critical motivations for building such institutions—in Europe but also in countries such as Singapore and Taiwan—were security concerns. The European Union and the Marshall Plan are cases in point, of course. These institutions were erected and reinforced primarily for political reasons. Economic motivation alone was not sufficient to overcome the disincentives to bearing the costs of change. Similarly, during the Cold War, security concerns led the United States to relax economic pressure on its partners. And in 1995 the United States relaxed trade pressure on Japan in order to avoid jeopardizing the U.S.-Japanese alliance, which was in turn seen as crucial to the policy of engagement with China.

Two conjectures: 1) Large and painful institutional changes are often facilitated by political-security concerns. 2) When supposedly "conflictual" security issues become involved, U.S. economic policy, including financial policy, often becomes more cooperative. Think of Russia, Korea, Taiwan, or even the overall justification for including China in the World Trade Organization. One reason for this tendency relates to the "two-level games" mentioned a moment ago: It is easier to persuade the American people to be generous when their security is supposedly at stake.

3. Credibility

Possession of information is clearly a crucial resource in world politics: Asymmetric information is a source of power. But the obverse is also the case: Credibility is a key power resource in the information age (Keohane and Nye 1998). Who can lend credibility? The Bundesbank and the Fed. Who needs to borrow it? The French, Italian, and Argentine central banks. These asymmetries of credibility tell us a lot about power in the international financial system.

Conjecture: Variation in credibility is a better predictor of ability to achieve national objectives in the international monetary system than is variation in economic size. Furthermore, the credibility of state institutions depends ultimately not on institutional tricks but on the coherence of the society, and on the quality of the society's mechanisms for resolving social conflict (compare Rodrik 1999).

4. Multilateral Institutions

We often think of influence simply in terms of bilateral bargaining, using asymmetric resources. But much political activity in the contemporary world political economy takes the form of *multilateral persuasion*. Much of the persuasion within multilateral institutions, like bilateral bargaining, rests on assessments of material interests. States that have clear interests pursue them, in part by bargaining for support from others, and in part, as Lawrence Summers (1999) has recently emphasized, by using "peer pressure" to induce others "properly to pursue their own interests." For this sort of bargaining, standard game-theoretic models are helpful. Actors selectively communicate private information, they update on other apparent "types," they bluff or call.

But a distinctive feature of modern multilateral institutions, not always captured in the models, is that precedents matter. As a result, members of these organizations who have no direct stakes in a conflict have to think not only of the side-payments they might be offered to favor one side or the other, but also of the impact of their decisions on rules and precedents. This is not to suggest that agents without direct interests will act pro bono publico. But the potential impact of a current decision on unknown future cases creates a Rawlsian "veil of ignorance" situation, in which decisions are important to actors who cannot know their consequences for themselves.

Conjecture: The scope for persuasion on the basis of long-term collective interests may be increased by the institutionalization of decisionmaking.

5. Exit and Voice

Exit options—open to mobile individuals, firms, and factors of production—amplify power. Exit magnifies voice but reduces incentives to use it (Hirschman 1970). The impact of exit on voice is conditional on institutions. Specifically, in the absence of credible institutions and effective democratic governance over markets of substantial size, exit options will amplify voice. That is, mobile factors, especially capital, will wield disproportionate influence. Democratic institutions reduce the power of exit by providing mechanisms for voice to immobile individuals. Credible authoritative institutions, over a market of sufficient size, are necessary for making democratic decisions effective in markets.

Conjecture: Democratic publics will support both the extension of economic market areas and credible economic institutions, when they can be persuaded that these are means to maintain effective democratic governance in the information age. Democracy should, in the long run, be conducive to the expansion of the domain for authoritative governance.

Generalizations

It would be highly misleading to view international monetary politics as an interacting system of unitary self-interested actors defined entirely by their size, location, and factor endowments. Equally important are attitudes and institutions within societies, and the character of international institutions. The overall lesson is the same as the one to draw from Douglas North's work (North 1990), or from David Landes's recent book (1998) on the wealth and poverty of nations: Institutions matter. Institutions are path-dependent social constructions. They are very difficult to create and, once in place, they are hard to change; and to a considerable extent, they define incentives, capabilities, and constraints for the exercise of power.

Normative Issues

Politics involves not only empirical issues but also social purpose. The study of politics, and policy, is therefore normative as well as positive. In the world political economy, we are—and should be—always concerned about efficiency. And any policy measures are constrained by considerations of political feasibility. But the efficiency-feasibility relationship does not fully define the trade-off structure: We should also seek to realize other values. I want to mention three such values and to offer three associated normative propositions.

1. Autonomy and Local Control

What is the desirable trade-off between efficiency, on the one hand, and autonomy on the other? The naive "economistic fallacy" is to assume, positively, that efficient solutions will always occur, and normatively, that they are always desirable. The result is Dr. Pangloss's view, satirized by Voltaire in *Candide*, that "all is for the best in this, the best of all possible worlds."

The *normative proposition* I would like to offer is that the value of protecting autonomy depends not only on the trade-off with efficiency, but also on the quality of deliberation and on the degree of democratic representation in national decisionmaking. Autonomy for democracies is valuable; autonomy for autocracies and kleptocracies is not.

2. Equity

There is a three-way trade-off among efficiency, political feasibility, and equity. I conceive of equity in terms of Amartya Sen's notion of equal opportunity to realize one's capabilities, behind a Rawlsian veil of ignorance about one's own position (Sen 1999). Since power and wealth are highly correlated, the politics of this trade-off are weighted against equity. Politics is the "mobilization of bias" or even the institutionalization of bias. Thus, equity is not naturally served by the political system, even in democracies.

My *normative proposition* about equity is that those who seek to manage the international monetary system should seek to "lean against the political wind." They should work against the wealth-power bias that is so evident in modern politics, and therefore seek to promote equity at the margin.

3. Creating and Constraining Power

In the long run, important economic institutions are political. Democratic publics will support such institutions only if they perceive them as meeting their interests. Individual international institutions can hardly be expected to be accountable on the domestic model; but if the overall process does not make the policy process transparent and the key policy outcomes responsive to the wills of democratic publics, it will not be sustainable. In this sense, it is an illusion to try to "depoliticize" international institutions—it will not happen, and it should not happen because political support is a crucial condition of our important economic institutions.

But publics do not always demand *electoral* accountability. The U.S. Federal Reserve System is extremely popular. And the U.S. public fortunately does not demand that the IMF be minutely accountable to the whims of a majority of the U.S. House of Representatives. Policy effectiveness can also be a source of legitimacy and political support. So it may be possible to *insulate* institutions from short-term political pressures even if, in the long run, political support will be essential to the viability of institutions and the success of economic policy. In the twenty-first century, we will need a "Madisonian moment" on an international level. That is, we will have to figure out how simultaneously to create and constrain power.

How are we to both create and constrain power? Like Gertrude Stein, I do not have the answer, but I think we should raise the question. In thinking about this question, I go back to the premise of the English Utilitarians: that human nature cannot readily be changed, but that human beings respond to institutional incentives. We need to create institutions with the capacity to act, but also recognize, in Lord Acton's phrase, that "power corrupts, and absolute power corrupts absolutely." Madison's Federalist Paper No. 51 is the best conceptual guide to this issue: "In framing a government which is to be administered by men over men, the great difficulty lies in this: You must first enable the government to control the governed; and in the next place, oblige it to control itself."

We are unlikely to proceed to world government in the twenty-first century, but if peace and prosperity are to prevail, we must create institutions of governance that "control the governed" while themselves being controlled. The first part of the next century will have to be a time of institution-building. Thinking about how to build effective institutions will benefit from deep and extensive exchange between students of economics and students of politics.

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