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WHO IS RUNNING THE IMF: CRITICAL SHAREHOLDERS OR THE STAFF?

by

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Abstract

The paper deals with the principal-agent relationship at the International Monetary Fund (IMF). We argue that residual control rights at the IMF are vested with the critical shareholders, the countries included in the G-7. This group controls vast financial resources and enjoys the highest regulatory and governance standards among IMF members. Imperfect incentives for monitoring and the complexity of the issues give staff and management a degree of autonomy. The evidence marshalled in the paper suggests that critical shareholders are in charge on those issues they care most about, leaving discretion to staff and management on peripheral issues.

Key words: IMF, G-7, principal-agent relationship, critical shareholder, staff autonomy.

JEL Classification: D71, F13, F15.

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I. INTRODUCTION

The International Monetary Fund (IMF), as one of the Bretton Woods institutions, was designed to provide the public good of an efficient international monetary system. But over the years, the IMF has transformed itself into a multi-product institution: its output ranges from a good housekeeping seal of approval to member countries through so-called surveillance and conditionality lending all the way to technical assistance. Presiding over this wide array of activities are member governments, the shareholders of the IMF. But, as it is true of privately-owned corporations, these shareholders face a monitoring problem and may not be able to fully achieve what they wish. The purpose of this paper is to examine who is in charge at the IMF: the principal, the agent, or both. The key questions are: who sets the mission, who controls the agenda, who implements decisions, and how independent are management and staff from shareholders.

The theme is not new. Vaubel (1986), for example, is an early proponent of bureaucratic growth of international organizations (IO) due to the fact that shareholders have small incentives for monitoring. Vaubel et al. (2003) corroborate this finding by estimating a larger-than-unity elasticity of staff size with respect to member states, without however controlling for the size and complexity of the output. Along the same lines, Barnett and Finnermore (1999) posit that international organizations, once created, develop their own agenda. Staff autonomy is grounded on the ability of the staff to retain control over vital information. Frey (1997), instead, emphasizes prestige and influence with reference groups as the main forces motivating the staff of IOs. Using this insight, Willett (2001, p. 323) reasons that “the environment of the IMF is much like that of central banks and finance ministries. As such, there would seem to be relatively little

incentive for key decision makers at the IMF to maximize staff size." Nielsen and Tierney (2003) hypothesize that the IO agent (in their case the World Bank) retains some degree of autonomy so long as his actions are not greatly at odds with the principal's preferences. When significant differences emerge, the principal finds an incentive to re-assert his authority and to bring about a change in the agent's behavior. Martin's (2003) study of the IMF combines elements of informational asymmetries and preference alignment between principal and staff. The principal delegates more autonomy to the staff when issues become more complex and the environment is riskier to the principal, for example during financial crises. On the other hand, if staff actions divert significantly from the principal's preferences, staff autonomy declines. If shareholders trusted completely the agent, delegation would be complete and so would agent autonomy (Majone 2001). Clearly, we have not reached this stage at the IMF. The central message of our paper is that a core of shareholders at the IMF is in full control of the institution's mission on the big issues and that staff autonomy is restricted in areas of marginal interest to the critical shareholders.

The rest of the paper is organized as follows. Section II presents general considerations on the principal-agent relationship in the public sector. The key point there is that, while agency problems tend to be more serious in the public sector than in the private sector, the nature of the production function of the underlying institution determines agency costs and the restrictions placed on the agent by the principal. Section III discusses two sharp alternative hypotheses concerning the governance of the IMF: critical shareholders are in charge versus management/staff are in charge. We explore also that that the two hypotheses can co-exist but for different states of the world. Section

IV presents evidence obtained from the literature. The sum total of the evidence is more qualitative than quantitative given the nature of the topic. Conclusions are drawn in the last section.

II. AGENCY COSTS AND THE PUBLIC SECTOR

Casual observation suggests that agency problems and effective monitoring of the agent are more serious in the public sector than in the private sector. To begin with, corporations seek profit or shareholders' wealth maximization. Government agencies, instead, have multiple objectives and have to resolve the difficult task of assigning weights to each of those objectives. Furthermore, objectives or their associated weights change because of the political process and the power of interest groups. While privately held corporations remain focused on the maximization of profits or shareholders' wealth, the political process changes the rules of the game as political parties or groups, with different ideological agendas, alternate in power. In democracies, political control is contested at fixed dates or within fixed intervals. Elections are the equivalent of takeover bids in the private sector. Political takeovers can be interpreted in either of two ways. The first is that they give an opportunity to replace inefficient bureaucrats with more efficient ones (Breton and Wintrobe 1982, p. 97). The second is that elections serve the purpose of altering the ideological make-up of the civil service, either by replacing top management, as in the U.S. tradition, or by demanding that the civil service fully adhere to the policies of the new government, as in the U.K. tradition. According to the second interpretation, political takeovers are different from private takeovers. Private takeovers are motivated by profit, political takeovers by ideological agendas. This is the reason

why government agencies suffer from time inconsistency and their commitment to a given policy is weak (Tirole 1994, p. 5; Majone 2001, pp. 106-7).

Pecuniary incentives play a smaller role in government agencies than in the private sector. The multiplicity of objectives, the fuzziness of weights associated to them, and the lack of observable output and product prices make it difficult to remunerate the civil servant up to its marginal value product. This, in turn, gives rise to low powered incentives and the potential for capture by interest groups (Laffont and Tirole 1993). The principal, on the other hand, is the electorate or its representatives, one best characterized as being small, relatively uninformed and consequently at a big disadvantage in monitoring the agent. To offset these tendencies, government agencies tend to leave less discretion to their management and employees than their counterparts in the private sector. The extent of these restrictions depends on the production function of the agency and opportunity for conflicts of interest. A procurement agency faces more restrictions than a central bank.

The same principle applies to IOs. The potential for capture by interest groups is stronger for the World Bank than the IMF, the reason being that the former has a more specialized production function than the latter (Willett 2001, pp. 321-2). The World Bank lends for specific infrastructure projects that affect the income and wealth of identifiable, homogeneous, and well-organized interest groups. The IMF, in contrast, deals with macroeconomic issues and lends with macroeconomic conditions that impact on broad, heterogeneous, and relatively poorly organized constituencies. In a typical IMF standby arrangement, a member government draws hard currency against its own for a period of up to five years and pays an interest rate (called the rate of charge) that historically has

been lower than the interest rate on Special Drawing Rights.[1] The borrowing country receives an implied subsidy from the loan but "pays" for it by accepting a set of restrictions on its policy making. [2] While the conditions may turn out to be too harsh or too lenient relative to the implied subsidy, the central point is that IMF loans have a pecuniary and a non-pecuniary cost. Loan pushing, which is a key aspect of bureaucratic or capture theories, involves the softening of conditions below the equilibrium value of the subsidy. But who is responsible for the softening? The testable implication of bureaucratic growth theory implies is that the staff is doing the pushing against the wishes of the shareholders. The alternative is that the shareholders themselves are doing the pushing, in which case there is no agency problem. So, again, it is important to examine whether the actions of the bureaucracy are aligned with the shareholders' preferences.

III. ALTERNATIVE EXPLANATIONS OF IMF GOVERNANCE

In a formal sense the highest decision-making body of the IMF is the Board of Governors, consisting of one governor and one alternate governor for each of the 184 member countries. In practice, this body is too large and unwieldy and has delegated in fact much of the policy-setting to the Interim Committee, now called the International Monetary and Financial Committee (IMFC), consisting of 24 governors. The IMFC meets twice a year and directs the Executive Board (EB) to consider specific issues. The

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[1] The SDR interest rate is a weighted average of money market interest rates in the US, Euroland, Japan, and the UK.

[2] It is customary to argue that the IMF does not bear a credit risk because its loans enjoy senior status. Under this assumption, the subsidy is given by the difference between the

real power behind the IMFC and the Board of Governors is the small, powerful, and agile G-7 Finance Ministers, who are the critical shareholders of the IMF; more on this below.[3] The EB is made up of 24 directors and the Managing Director who chairs the EB.

Voting power in the EB is asymmetric and reflects the size of the quota of each member state. At present, the United States has 17.14% of the total votes, Japan 6.15%, Germany 6.01 %, France and the United Kingdom 4.96% each, Italy 3.26%, and Canada 2.95%; the G-7 countries, as a group, hold 45.43% of the votes. Nothing of substance in the IMF can take place without the approval of the G-7 countries, or for that matter the United States. Given the distribution of votes within the G-7 group and the history of the institution, the United States is *primus inter pares* among the G-7 countries. While some decisions require a simple majority, for example the approval of a loan, the EB in practice works by consensus (Boughton 2001, p…). Other decisions require a 70% majority, for which the G-7 has veto power. Finally, other decisions require a super-majority of 85%, for example quota increases, for which the United States has veto power.

The staff of the IMF produces a steady flow of position papers and reports, interacts with and advices officials in member countries, is involved in surveillance activities, and designs (after negotiation with national officials) the conditions attached to loans. This output, with policy recommendations, flows up first to management and then to the EB who can either approve a position, not approve it, or ask for changes. The entire process is supervised by the Managing Director who, as Chair of EB meetings,

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SDR interest rate and the rate of charge, which is quantified by Jeanne and Zettelmeyer (2000) at less than one per cent of borrowers' GDP.

controls the agenda. Martin (pp.13-14) takes the view that this bottom-up information flow gives management and staff considerable influence, a sort of first-mover advantage plus agenda-setting power. Rieffel (2003, ch. 11), instead, sees the process more as a top-down flow from the G-7 to the IMFC, the EB, and ultimately management and staff; more on this below.

The governance issue at the IMF is an old one and goes back to the very roots of the institution. The United Kingdom (that is, Keynes) and the United States (that is, White), the two countries responsible for the architecture of the IMF, had sharply different views on who should be in charge of the institution. Mikesell (1994, p. 52), at the time an U.S. Treasury economist who was intimitately involved with the Bretton Woods meetings, recalls that:

> "White had wanted control of the Fund to be in the hands of a board of directors whose members represented their governments and who would be continuously involved in decisions on exchange rates, drawings and other matters".

Keynes, on the other hand, wanted an international secretariat to manage and direct day-to-day operations. Mikesell goes on to say that:

> "White's position, and that of the U.S. administration generally, reflected a desire to have the Fund heavily influenced by the United States in order to promote the U.S. economic objectives of stable exchange rates, nondiscrimination in trade, and international financial equilibrium".

It is not surprising that the Articles of Agreement of the IMF were never clear on the matter, a convenient resolution of the differences.

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[3] The G-7 group consists of the United States, Japan, Germany, France, the United Kingdom, Canada, and Italy. The first three countries define G-3, and the first five G-5.

On the basis of both the history of the institution and the above discussion, two alternative hypotheses emerge to explain governance at the IMF. The first is that residual control rights at the IMF are vested with the critical shareholders, a small group of industrial nations, one that certainly includes the United States, Germany and Japan but can stretch to the G-7 finance ministers and possibly, but less likely, to G-10 finance ministers. This group controls vast economic and financial resources and enjoys the highest regulatory and governance standards. Furthermore, critical shareholders own equivalent number of shares in all important international financial institutions (e.g., World Bank and Bank for International Settlements) and thus can effectively coordinate their strategies by relying on a portfolio of international institutional and financial assets in addition to their national assets. Critical shareholders meet regularly during the year and delegate execution of policy to the national directors. Executive directors at the IMF are simply an extension or a proxy of their finance ministers. Agency costs are small and management and staff behave in accordance with the preferences of the critical shareholders.

An implication of this hypothesis is that benefits are distributed asymmetrically across shareholders. In privately owned companies, controlling shareholders may capture a disproportionate share of the profits by inducing management to deal preferentially with companies owned or controlled by the shareholder (Hart 1995, p. 683). The capture of excess profits is the return from monitoring by the controlling shareholder. Corporate and securities laws are designed in part to reduce the scope for abuse and to protect minority shareholders. At the IMF, critical shareholders may obtain a disproportionate

share of the benefits by persuading directors and management to divert a disproportionate share of the institution's resources to governments that are friendly to those shareholders.

The sharp alternative to the critical shareholder hypothesis is that management and staff make important decisions that are at odds with the preferences of the shareholders. Costly monitoring, including specialized staff knowledge, may be the reasons for agency costs. Management and staff, under this alternative, would seek self-preservation and aggrandizement, and would cater to the interest of client governments, the borrowing countries.

It is also possible that the two hypotheses can co-exist for different states of the world. Critical shareholders may face two types of agency costs: low for big issues, that is issues that are important to the critical shareholders; and high for small issues, that is issues that are of marginal value to the critical shareholders. Since monitoring is largely a fixed cost, the per unit cost of monitoring a few big or high-value products is smaller than many low-value products.

In sum, decisions reached by the IMF can be interpreted as implications of three different hypothesis: either critical shareholders drive the decisions without much dilution in representation by management and staff, or management and staff drive decisions even when they do not reflect shareholders' preferences, or a mix of the two depending on the importance of the issues to the critical shareholders. In what follows, we review the evidence on governance that already exists in the literature to arrive at a qualitative assessment of whether the IMF is run by the critical shareholders, the staff or both.

IV. EVIDENCE FROM THE LITERATURE

In this section we review the literature that bears directly on the hypotheses discussed in the previous section. We start with studies that favor an interpretation along the lines of the critical shareholders' model, then continue with those favoring staff autonomy, and finally with the evidence that indicates that the two hypotheses can co-exist depending on the states of the world.

Critical shareholders

Solomon (1977, p. 5), in his analysis of the international monetary system from 1945 to 1976, remarks that "to call it a system is to impute more formality to it than it deserves." Yet he identifies in the G-10 Ministers and their Deputies an important group:

> "the IMF Executive Board was expected to do the preparatory work and to receive the views – in practice, the decisions – of the Interim Committee" (p. 303).

The Interim Committee was formed in 1974 to replace the Committee of Twenty and was renamed IMFC in 1999. As we have mentioned it in the previous section, members of the IMFC have played the role expected of corporate directors, which is advising and recommending strategies to management for them to implement.

Williamson (1977, p. 60) goes a step further on the role of the G-10:

> "The G-10 had filled the role of discussing such issues for the previous decade and it had been active … as the natural body in which to negotiate the exchange rate realignment".

For Plumptre (1977, p. 281):

> "[the Interim Committee] is to stand between the Board of Governors – massive and cumbersome, with more than 125 members who deliver set speeches to audiences of thousands at annual meetings -and the twenty Executive Directors…In short, the intention was to introduce a more effective political influence into the Fund's decision-making".

Even more direct is Rieffel (2003, pp. 28-9):

> "The other mistake is to view the IMF as an independent authority. The IMF is an instrument of the G-7 countries. There is no example that comes easily to mind of a position taken by the IMF on any systemic issue without the tacit, if not explicit, support of the United States and the other G-7 countries".

In contrast, the EB of the IMF is described by Solomon (1977, p. 87) as "reflecting the diverse views of 20 Executive Directors from Europe, Asia, Africa, and North and South America, [and] was inevitably bland in its recommendations, overt or implied." The irrelevance of the EB is also emphasized by Woods (2001, p. 87):

> " … real debates over policy and issues are conducted outside of the Board. Controversial cases and stand-off debates are rare. For example, a loan that did not meet with US approval would seldom be presented to a Board for discussion."

Boughton (2001) has an extensive discussion of the relationship between the IMF and its critical shareholders. In chapter 5, he examines the review process under Article IV of the Articles of Agreement between the IMF and each of the G-5 countries. The opening sentence of the chapter sets the tone for what follows: "Nowhere is the difficulty of conducting surveillance more apparent than in the relationship between the IMF and the major industrial countries" (p. 135). The G-5 countries are too powerful to mind the advice of the IMF, and this is especially true of the United States. In chapter 7, Boughton tells the history of policy cooperation, starting with the creation of G-10 and the General Arrangements to Borrow in the early 1960s, then G-5 and its enlargement to G-7 in the

mid-1970s, then the Plaza Accord of 1985, and finally Louvre of 1987. [4] In retrospect, the critical shareholders were acting quite cooperatively in 1980s, although there were signs that even the G-7 was too large a group and had its own ‘super-cooperative’ core of G-3 countries (the United States, Germany and Japan).[5] In all of this activity, the IMF played a subsidiary and technical role. Boughton candidly acknowledges that “the Fund participated only at the pleasure of the countries’ officials and had no real standing to guide the process” (p. 186). In sum, the G-7 countries stand out from the rest of the shareholders of the IMF, and behave as controlling shareholders.

The International Financial Institution Advisory Commission (2000, p. 48) laments the undue influence of the critical shareholders:

> “[the] IMF should not be used as a ‘slush fund’ to satisfy decisions of the G-7 finance ministers or other groups of powerful members”

The Commission’s main recommendation of setting a rule whereby the IMF would lend only short term, at penalty rates, and conditional on ex-ante standards of financial soundness (p. 8) may be interpreted as a mechanism to rein in the disproportionate influence exercised on the IMF by its critical shareholders (Tarullo 2001, pp. 625-6).

According to Blustein (2001), who covers the period of the currency and banking crises of the 1990s, the G-7 finance ministries, but in particular the US Treasury, control the agenda of the IMF. (p. 9). With a touch of irony, Blustein calls the critical shareholders “…the guardians of global financial stability [who] were often scrambling, floundering, improvising, and striking messy compromises” (p. 14). The messy

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[4] G-10 consists of G-7 plus Belgium, the Netherlands, Sweden and the affiliated Switzerland (the 11th member of the Group).

[5] The core within the core comes out loud and clear in Funabashi (1988).

compromises are driven often by incentives to rescue the creditors of industrial countries. Like the Meltzer Commission, Blustein is concerned that the High Command encourages moral hazard behavior with large country bailouts.

Momani's (2002) PhD dissertation develops an informative case study of the influence of the United States on IMF loans to Egypt. By relying on internal IMF documents covering approximately ten years of IMF staff reports on IMF-Egyptian agreements, as well as on archival material from the U. S. Department of State, the study arrives at the conclusion that the U.S. government was instrumental in pushing for lenient terms in the 1987 and 1991 agreements despite contrary opinions by IMF staff.

Further evidence on the the critical shareholders' hypothesis is offered by Rieffel's (2003, ch. 11) careful review of the history of so-called private sector involvement (PSI). At the root cause of PSI is the search for a solution to moral hazard behavior. One way to do it is to let creditors and debtors agree on debt restructurings. These can be facilitated either by changing sovereign bond covenants or through a new international agreement on restructuring. While each solution has its own advocates, both approaches aim at reducing the cost of debt restructuring; for a review see Eichengreen (1999).

Collective action clauses –the contractual solution-- were first mentioned as a possible solution to facilitate debt restrcturing in a report by the G-10 finance ministers following the G-7 Halifax summit meeting of 1967 (Rieffel, p. 223). A more structured approach to the problem came to light during the meeting of the G-7 finance ministers in Cologne in 1999. Their report includes a section on "Framework for PSI," aimed at reducing the risk of moral hazard, without giving additional incentives to debtor countries

to renege on their commitments (p. 239). The First Deputy Managing Director of the IMF endorsed the statutory approach in 2001 (Krueger 2001). In the following year, the Krueger proposal became the official IMF management position, with the new institution to be called the Sovereign Debt Restructuring Mechanism (p. 253). But as soon as US Treasury Secretary John Snow told his opposition to the statutory approach during the April, 1993 meeting of the IMFC, the initiative was quickly dropped (p. 256). In the meantime, the contractual approach has gained when Mexico issued in 2003 a new sovereign bond with a collective action clause. The account of these events, to sum up, indicates unequivocally that the *primus inter pares* of the critical shareholders prevailed over senior management on an important issue.

More systematic evidence on the critical shareholders' hypothesis is provided by Barro and Lee (2002) who test econometrically whether the probability and size of an IMF loan is a positive function of the "closeness" of the borrowing country to an important IMF member country. Using panel data encompassing 130 countries over five-year intervals from 1975 to 1999, these authors estimate Tobit and probit models to explain the size of IMF programs, and the frequency with which a member country benefited from an IMF program. The explanatory variables include country-specific economic factors (e.g., per capita GDP), time dummies to account for shifts in global shocks, the borrowing country's clout with the IMF, and the borrowing country's political-economic closeness to critical shareholders. The borrowing country's clout with the IMF is measured by the relative size of its quota and by the relative size of nationals among IMF professional staff; closeness to critical shareholders by fraction of votes at the U.N. General Assembly that agrees with the positions taken by critical shareholders

and by the ratio of the bilateral trade between borrowing country and critical shareholder to borrowing country's GDP. There are four critical shareholders in the sample: the United States, France, Germany, and the United Kingdom. While the empirical findings differ from equation to equation, the overall pattern is that both clout and closeness to critical shareholders matter for participation in IMF programs.

Finally, a more balanced view of the role of critical shareholders is provided by Bird (2003, ch. 3) who acknowledges that powerful members exert influence on IMF lending but cautions "not to get overexcited about their consequences for prediction. Since IMF agreements are present in only about 20 percent of the observations, in most large sample econometric studies a prediction of 'no agreement' would be correct about 80 per cent of the time" (p. 60). However, for the purpose of this paper the relevant issue is not whether the prediction of 'no agreement' is 0.8, but rather what effect political considerations have on the 20 percent of the cases where agreements have been reached.

Staff autonomy and capture

Vaubel (1991) argues that the rapid expansion of the IMF's loan programs was fueled by bureaucratic self-preservation, power, and prestige, an outcome that is consistent with the implications of the capture hypothesis. Meltzer (1999) is even more explicit on this theme:

> "IMF officials are judged partly on their contacts with high officials of borrowing governments. Critical reports by an IMF task force reduce the welcome the IMF team can expect on its next visit…Borrowing governments recognize this power,

> so they are able to restrain criticism and prevent or delay information from reaching the IMF's top management." (p.).

Bordo and James (2000, p. 7) echo similar concerns and speak of "clientism" among Fund staff. These authors also emphasize how the IMF branched into development work that went beyond the original function (p. 20) and for which it was not well prepared. In the private sector, moving into a new business without shareholders or directors' approval and without adequate disclosure to shareholders generally would be considered a serious governance failure.

Mussa (2002, p.70) finds a pro-borrower bias among the staff of area departments:

> "…by the nature of their responsibilities and because of their need and desire to maintain close cooperative relations with the authorities of member countries, this bias toward the member tends to be particularly strong in the Fund's area departments."

This bias, in turn, is neither compensated for, nor controlled by other departments that work with the area departments, nor by management that "normally sides with the area departments in their efforts to be as cooperative with members as possible" (p. 70). The friction between area departments and the Research Department of the IMF is underscored in a report of a group of independent experts commissioned by the IMF to assess IMF surveillance (IMF 1999). For the experts, disagreements between the two departments:

> "…were at least in part responsible for the fact that that concerns about the health of Korea's financial system were not properly reflected in surveillance nor communicated to the Executive Board" (p. 32)

Coexistence of the two hypotheses

The literature reviewed seems to agree that non-economic considerations enter into IMF loan decisions, but it is more ambiguous whether the main source of the problem lies with the critical shareholders or with the IMF management and staff. Fratianni (2003) argues that both elements are present. Consider again IMF conditional lending. The single most important goal of conditionality lending, seen from the viewpoint of the IMF, is to restore external balance while preserving long-term internal balance. Governments of borrowing countries, instead, consider external balance a constraint on their domestic economic policies, which have a plethora of political, social and economic objectives. Also, governments want to remain in power or win the next election. Thus, it may pay off politically for a government to ignore temporarily the balance-of-payments constraint and embark on fast-growth policy, which implies above-average output growth rates, balance-of-payments deficits and a rising inflation rate. An unsustainable external deficit will put an end to the expansionary policy and will start an adjustment program financed by the Fund.[6]

The logic of conditional lending is to set restrictions that translate into costs in terms of output and employment. Costs of the program occur typically before benefits. Most borrowing governments are aware of the intertemporal cost-benefit tradeoff implied in conditionality lending. They may accept the conditions set by the IMF but find them unpalatable politically and are ill disposed to implement them. This outcome is

[6] The policy of Peru in 1986-87 is a good example of this illustration (Boughton 2001, p. 612).

consistent with the view of those critics –typically from the political left-- who claim IMF conditionality lending is too costly for the borrowing countries. There is, however, a second possibility. Governments of borrowing countries are aware of the intertemporal cost-benefit tradeoff but feel they can improve it by claiming extenuating circumstances. This outcome is consistent with the view of those critics –typically from the political right- who claim that IMF conditionality lending ends up encouraging repeated lending and moral hazard behavior.

Both paradigms may co-exist because the IMF discriminates between rich and poor, large and small, geopolitically important and irrelevant members. This discrimination is to a large extent driven by the preferences of the critical shareholders who use the IMF as a multilateral agency of foreign policy and foreign aid. Critical shareholders bear heavily on IMF management when their interests are at stake; otherwise, for small and unimportant countries, their monitoring activity is low and opinions of Fund staff have a much larger influence on outcomes. An illustration of the selective activity exercised by critical shareholder at the IMF is provided by Blustein's (2001, pp. 101-102) account of the IMF's mission to Indonesia during the 1997 currency crisis:

> "The reason for the turnaround was pressure from members of the IMF board representing Western industrial countries. Karin Lissaker, the U.S. representative, was particularly assertive. ...'The mission went out [to Jakarta] with the usual recipe –tweak a little on monetary policy here and fiscal policy there,' Lissaker recalled. 'We stepped up the heat, the more we found out about the issues, hearing about these massive subsidies to cronies and family members…This was clearly pushing the outside of the envelope'."

Evidence that the two hypotheses co-exist, in different states of the world, can be gleaned from Martin's (2003) review of the power swings between the EB –representing shareholders—and management and staff over decisions on conditional lending. The US government was an early advocate of conditionality in opposition to the United Kingdom and other member governments. The United States, in the end, had its way. In the early years of conditionality the EB called the shots. By the 1950s, Martin finds that the staff had gained a degree of autonomy from the EB. As new conditionality guidelines were introduced in 1969, after developing countries complained of unfair treatment with respect to industrial countries,[7] power shifted back to the EB. Conditions were streamlined in 1979 with a further shift in power in favor of the EB. In sum, much of the evidence is consistent with the implications of the critical shareholders' hypothesis.[8] When shareholders feel that the staff shares their preferences, delegation is deeper without raising agency costs. But other evidence is not. For example, when shareholders are polarized, as it happened in the 1960s, the evidence favors the alternative of the staff gaining more autonomy from shareholders.

Do countries benefit from IMF loans? One of the sharpest criticisms leveled against the IMF is the high failure rate of conditional lending programs. For Boughton (2001, p. 617), some borrowing countries do not benefit from the loans because of their unwillingness or inability to make adjustments and because the IMF staff misforecasts the extent of the needed adjustments. Furthermore, these patterns repeat over time. For example, in 1990, the number of countries that had borrowed five or more times in the preceding 10 years and with outstanding credit of at least 100 percent of their quota had

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[7] The case in point was the 1967 loan to the United Kingdom.

[8] Martin does not actually distinguish critical shareholders from the EB.

quadrupled with respect to 1980 (Boughton 2001, Figure 13.6, p. 619). Bird (2003, Table 4.2) provides further evidence of recidivism: over the 1980-96 period Argentina, Central African Republic, Democratic Republic of Congo, Costa Rica, Ivory Coast, Ecuador, El Salvador, Hungary, Jamaica, Kenya, Madagascar, Malawi, Mali, Mauritania, Morocco, Niger, Philippines, Senegal, Togo, Uganda, and Uruguay had tapped IMF resources at least seven times, an average of almost a program every two years. The consensus is that for the bulk of the above-mentioned countries IMF programs serve the undeclared purpose of economic aid. Clearly, shareholders are responsible for this state of affairs. Without their explicit or tacit consent, redicivism would peter out. But not all countries fall under the economic assistance category; for example, Argentina and Uruguay. What is the failure there?

Mussa (2002), an insider, gives a straightforward assessment of the IMF failure with regard to Argentina, a country that "…throughout the 1990s…operated under the auspices of a Fund-supported program" (p. 3). The IMF made two egregious mistakes, the first to overlook Argentina's profligate fiscal policy in the first half of the 1990s and the second to provide the country with a huge financial package of $40 billion in 2001, despite the evidence that the crisis could not be averted (p. 4). Mussa blames both the critical shareholders and IMF staff for this state of affairs. In the eyes of the critical shareholders,

> "…Argentina was generally seen as a country deserving sympathy and support; and the Argentine authorities were certainly willing to draw on this sympathy and support" (p. 47).

This support has continued to these days. In January, 2003 the IMF approved an eight-month stand-by credit to Argentina for $ 2.98 billion, a decision pushed by the G-7

against strong opposition on the part of IMF's management (Financial Times, January 20, 2003). But Mussa also blames IMF management for acting "too much as a sympathetic social worker" (p. 69) and the staff for indulging in advocacy instead of hard-nose analysis (pp. 80-1).

V. CONCLUSIONS

We have analyzed the IMF from the viewpoint of the principal-agent relationship. Our point of departure is that residual control rights in this institution are vested with a small group of shareholders, the G-7 governments. This group controls vast financial resources and enjoys the highest regulatory and governance standards among IMF members. The critical shareholders face an agency cost at the IMF, stemming from costly monitoring and complex issues that give staff and management a degree of autonomy. The cost tends to be smaller at the IMF than at the World Bank because of the nature of the production function. The World Bank deals with micro issues where interest groups are homogeneous and well-organized. The IMF, in contrast, deals with macro issues where interest groups are heterogeneous and poorly organized.

We relied on two sharp alternative hypotheses to understand IMF governance. The first implies that critical shareholders are in charge and face small agency costs. The second is that management and staff are in charge. The two hypotheses can co-exist for different states of the world. In fact, the IMF discriminates between rich and poor, large and small, geopolitically important and irrelevant members. This discrimination is to a large extent driven by the preferences of the critical shareholders who use the IMF also as a multilateral agency of foreign policy and foreign aid. Critical shareholders bear

heavily on IMF management when their interests are at stake; otherwise, for small and unimportant countries, their monitoring activity is low and opinions of Fund staff have a much larger influence on outcomes.

The evidence marshaled in the paper suggests that a core of shareholders at the IMF is in full control of the institution's mission on the big issues and that staff autonomy is restricted in areas of marginal interest to the critical shareholders. This evidence, on the whole, is qualitative and obtained from the literature. There was no effort to quantify and estimate econometrically the implications of the hypotheses. It is a drawback of the study that one hopes that can be remedied in future work.

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