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Introduction

WITH THE END of the Cold War, the International Monetary Fund (IMF) emerged as the most powerful international institution in history. The Western countries designated the IMF as their primary vehicle for funneling aid to the countries that had emerged from the ruins of the Soviet empire and made it responsible for creating a strategy for interacting with them. That strategy, as it gradually unfolded, was ambitious: nothing less than the economic transformation of every society in the region. The early years after the collapse of the Soviet bloc were heady ones for the IMF: A vast new territory was becoming integrated with the world economy, international capital movements were rising to the top of the political agenda in Central Europe and Eurasia, and multilateral lending agencies were beginning to figure prominently in cabinet meetings and parliamentary debates. The Fund eventually signed loan and conditionality agreements with every country of the former Soviet Union and Eastern Europe except Serbia and Turkmenistan. Even as this ambitious institutional strategy took shape, however, questions were raised about whether the instrument was equal to the task. Can an international institution really hope to exercise influence in a nation's domestic affairs? If it does so, will that influence be beneficial?

Formal international institutions are the peculiar innovation of the advanced industrial democracies, which have relied on these institutions since World War II as a central pillar of their effort to impose order on the anarchy of international politics. In the aftermath of the worst war the world has ever known, the United States and its allies had sought to promote international cooperation by creating an impressive architecture of international institutions: the United Nations, the International Monetary Fund, the World Bank, the General Agreement on Tariffs and Trade, the European Economic Community, and numerous specialized agencies. The Cold War between the United States and the Soviet Union quickly became the focus of attention in the international system, and it redefined many of the purposes of these institutions. Still, whenever the United States and its allies tried to foster cooperation after World War II, they created international institutions. International institutions became an essential part of the relations among these countries, and a broad consensus on the rules that they embodied helped to foster an unprecedented blossoming of coordinated action across a variety of issue areas.

The International Monetary Fund is an unusual international institution because it has some enforcement powers. International institutions generally rely on convention, normative suasion, modest efforts at monitoring, and decentralized collective action to promote cooperation. To be sure, the Fund extends carrots, not sticks, when it attempts to influence government policies. However, it signs intrusive agreements with governments that regulate sensitive aspects of their domestic and international economic policies; it typically does so when countries are particularly vulnerable and dependent on international financing; and it threatens to withdraw support if its detailed policy prescriptions are not observed. This enforcement mechanism would seem to give the IMF a significant edge over gentler international institutions.

Two strong traditions in international relations shed doubt on the ability of international institutions to influence public policy. The first, commonly known as realism, emphasizes the priority of security concerns, the overriding interest of states to assert their autonomy from foreign control, and the tendency for international norms or rules to be manipulated by powerful countries for their own purposes. According to this perspective, the IMF is likely to find that borrowing countries are unwilling to submit to its tutelage and that powerful donor countries will subvert its objectives in order to advance their own. The second perspective emphasizes the importance of domestic constraints and argues that economic policy involves distributive and redistributive issues that go to the heart of politics. If political coalitions and alignments are fundamentally about economic policy, there are severe limitations to what foreign intervention in these matters can achieve.

This book argues that both perspectives are right, up to a point: International power and interests constrain what the IMF can achieve; so do domestic power and interests. Nevertheless, I will argue that the IMF plays an important role in the nexus between power, interests, and policymaking, and exerts a significant influence over national policies. The effects of domestic and international constraints can obscure IMF influence in quantitative and qualitative studies if we fail to take them into account. However, carefully studying both sets of constraints reveals the very important role the IMF has played in the post-Communist countries.

If it is true—and it is—that IMF conditions are often violated and inconsistently enforced, that the IMF has made a number of mistakes in managing the economics of transition, and that countries have misused IMF funds in sometimes spectacular and intricately fraudulent schemes, this still does not answer the question: Has the IMF exerted a meaningful influence over economic policies in these countries? To answer this question, we have to do more than simply measure the economic policies of countries in transition against the ideal of IMF performance criteria or merely catalogue the Fund's tactical errors and the instances of corruption. In this book I do both in great detail; but to answer the question, we have to examine the counterfactual: What policies would have been followed without the involvement of the IMF?

In some sense, of course, we can never know. The IMF was a feature of the international system into which the post-Communist countries were born, and its existence shaped the incentives they faced as they sought to define economic policies right from the beginning. We cannot remove the IMF from the equation and restart history from 1990. However, there are three ways in which one can do meaningful counterfactual analysis that can shed light on the effect that the IMF has had on the post-Communist transition. First, one can be rigorous about what effects one ascribes to the causal variable, and explore the influence it has in an abstract formal model. Second, statistical analysis with a large sample enables one to make certain kinds of counterfactual inferences. Third, detailed studies of relations between the IMF and several borrowing countries can fill in the context, the actors' expectations, and the intermediate causal links that, on balance, lead us to believe certain causal inferences and reject others. In this book, these three approaches form the legs of a tripod that supports a causal argument. Without any one of these supports—analytical rigor, generalizable inferences, or contextual knowledge—the structure becomes unstable and the argument untenable. In combination, each approach complements the others by supplying pieces of the puzzle that the others cannot.

The first step in my research design is to define the effects that IMF intervention is expected to have, and the precise conditions under which it is supposed to have them. To do this I develop a formal model that specifies the hypothesized relationships among the IMF, international capital markets, and borrower countries. The key innovation of the model is that the IMF is treated as a strategic actor that seeks to defend its reputation for enforcing conditionality, but suffers from credibility problems. In the model I assume that every actor is sophisticated about the strategies and beliefs of the other actors, so they all anticipate that IMF programs will not always be properly implemented, that countries will sometimes find it advantageous to cheat, and that the IMF will sometimes find it difficult to hold them accountable. Nevertheless, IMF programs affect the economic policies of the borrowing countries, and because of this they influence capital flows to those countries. The results of the formal model can be thought of as a possibility theorem. They show that even in a messy world where things often do not go as planned, it is still possible for an imperfect institution like the IMF to exert influence. The IMF can still lend credibility, even if the credibility of its lending is in question. The model spells out the kind of influence that the Fund is expected to have—both over countries' policies and over market expectations—and it defines the conditions that limit that influence because of the Fund's own credibility problems.

The second step is to subject the hypotheses that the model advances to quantitative tests. Testing these hypotheses requires a data set with novel features: one that allows the analyst to control for the political factors that influence countries' abilities to stabilize their economies, and that measures country policies and IMF responses with sufficient precision to untangle the causes from the effects. With the help of several research assistants, I have compiled a data set designed for this purpose. The result is a unique statistical database that comprises monthly economic and political time series for twenty-six countries over the decade of the 1990s. Using a variety of statistical methods that are explained in the text for the layperson, and with more technical detail in an appendix, I estimate models to explain IMF strategies, government longevity, government policies, and market expectations. To foreshadow, I find that the IMF does have a significant effect on government policies but that this effect is mitigated whenever the IMF cannot credibly threaten to impose lengthy punishments, namely, in large countries and countries that receive substantial amounts of foreign aid from the United States. As the model predicts, countries that are harder to punish are punished for shorter periods, and the reduced severity of the IMF's response significantly increases their propensity to pursue inflationary policies. Conversely, however, these pessimistic conclusions imply an optimistic one. In order to be vastly less effective in some countries, the IMF must be vastly more effective in others; indeed, in small countries and those without recourse to U.S. intervention, the IMF plays a very critical role in moderating the incentives that fuel inflation and in establishing credibility for stabilization policies.

The third step is to check the plausibility of general conclusions by plunging back into the details. A detailed study of the bilateral relations between the Fund and particular countries, based on interviews with policymakers, negotiators, and Fund officials, can go beyond the thin description accessible in statistical form. Participants can be asked counterfactual questions and asked to share their own hypotheses about which variables caused which effects, based on the accumulation of years of experience. This book is based on extensive field research in Russia, Ukraine, Poland, Bulgaria, and the IMF headquarters in Washington, D.C. Readers of the detailed country studies may find that the picture that emerges confirms the broad-strokes critiques of the Fund as an ineffective organization; indeed, there are numerous anecdotes that could be used as cautionary tales. In part, this is a matter of whether the reader chooses to view the glass as half full or half empty. I believe that what emerges is a picture of an organization that has remarkable influence in spite of the fact that it is working against tremendous odds. Certainly, the case studies in this volume suggest that the Fund should be humble about offering advice and that our expectations of success in difficult cases should be modest. However, they also demonstrate that the deck was terribly stacked against reform in most of these countries and that the IMF was almost always a relevant player—sometimes the only relevant player—lobbying for economic reform. In some cases, when circumstances were right, the IMF did exactly what the model predicts: It tipped the balance of incentives in favor of a long-run strategy of fiscal and monetary restraint, and reinforced the credibility of governments that presided over fragile capital markets. Even in cases where IMF programs failed and ultimately had to be abandoned, the Fund typically exercised a significant influence over policies.

The primary focus of this book is on the effectiveness of the IMF at influencing government policies. However, a prior question that must have occurred to the reader is whether it is normatively desirable for the IMF to exercise influence, and I turn to this question before proceeding with my argument. Critics of unbridled capital markets and the "Washington Consensus" that supports them worry that international institutions and global capital flows may so constrain economic policies during the transition that weak democratic institutions are swept away by popular discontent. Furthermore, they argue, the IMF's neoliberal economic prescriptions of tight monetary and fiscal policies, deregulating the economy, and lowering the barriers to the "creative destruction" wreaked by markets—stabilization, liberalization, and privatization—represent a naïve application of standardized recipes to a much more complex reality. In the felicitous Russian aphorism, it is easy to turn an aquarium into fish soup, but only God can reconstitute the aquarium.

To the contrary, I argue that the basic thrust of the policies urged by the international financial institutions was, in fact, correct. At this point, I want to distinguish carefully between the basic strategy of transition and the specific tactical choices that were made in particular countries. By tactical choices I mean operational decisions on which economic theory does not yet provide straightforward guidance, such as the best ways of targeting exchange rates, the ideal method of privatization, and the optimal sequence of structural reforms. The Fund supported programs in countries that chose a wide range of approaches to these issues, but in some cases IMF staff promoted specific policies that turned out very poorly. We have learned things about economic transitions over the last ten years that would have made it possible to make better choices, had we known them earlier. On the other hand, the key IMF strategy for reform was clear: Accelerate the full spectrum of market reforms as much as possible, and lead with rapid macroeconomic stabilization and liberalization. This appeared to be a rather risky strategy from the vantage point of 1990. After a decade of experience, however, it is clear that this was the strategy best suited to promoting economic growth and consolidating democracy in post-Communist countries, because inflation has such disastrous consequences during the transition.

1.1 THE STRATEGY OF TRANSITION: INFLATION AND DEMOCRACY

Critics of austere, anti-inflationary policies in post-Communist countries point to the apparent success of gradual reform in China, and to the enormous human costs and political instability associated with neoliberal policies in Latin America.[1] The image that captures the imagination is Adam Przeworski's "J-curve," which describes a trade-off between the short-term and long-term pain of the transition.[2] As countries enter the reform process, they adopt austerity measures that reduce output, cut social transfers, and create unemployment, moving down into the "valley of the transition." The more rapidly this is done, the more quickly comes the recovery—but at what cost? What if the misery of the transition is so intense that popular patience is exhausted and democratic institutions are swept away? Perhaps a flatter "J-curve" would be preferable, one that spreads the transition over a longer period but reduces the depth of the recession.

The evidence of the last ten years is that there is, in fact, no such trade-off.[3] Instead, the post-Communist countries that succeeded in quickly bringing inflation under control suffered a smaller drop in output than those that continued to endure the ravages of inflation.[4] They attracted foreign investment and began to grow, laying the groundwork for long-term prosperity and political stability. Economies that failed to tame inflation declined more precipitously and continued to decline long after the transition had been completed in more successful countries. In addition, the low-inflation countries maintained a much less skewed distribution of wealth and income, maintained more social services, and sustained a higher quality of life. Table 1.1 summarizes the data by presenting the results of bivariate regressions of growth, foreign direct investment, income inequality, the United Nations' Human Development Index, and life expectancy on inflation, using a variety of methods. Each row represents a variable that is affected by inflation, and the columns represent a series of econometric models for assessing the effects. The analysis uses all available annual data for post-Communist countries from 1990 through 1999.

The significance of these results is that countries with higher inflation grew

[1] Note that there are some good reasons for questioning whether Chinese-style gradualism would have been successful in the more highly developed countries of Eastern Europe and the former Soviet Union (Woo 1994).

[2] Przeworski 1991, p. 163.

[3] Hellman 1998.

[4] This is consistent with a large quantity of scholarship that shows that inflation leads to lower rates of growth in gross domestic product (GDP) (Kormendi and Meguire 1985, Grier and Tullock 1989, Barro 1991, De Gregorio 1992, Roubini and Sala-i-Martin 1992). Levine and Renelt (1992) criticize the robustness of some of these findings; Gylfasson and Herbertsson (1996), Andres, Domenech and Molinas (1996), and Andres and Hernando (1997) find that the negative correlation between inflation and growth is robust to changes in the specification of the model.

Table 1.1: Effects of Inflation on Growth and Quality of Life.

		Inflation (in 1,000%)			
	n	*OLS*	*Robust SE*	*Fixed Effects*[a]	*Random Effects*
GDP Growth	135	−5.34** (1.02)	−5.34* (2.45)	−4.43** (1.06)	−4.93** (1.00)
Foreign Direct Invest. (% GDP)	132	−.797** (.293)	−.797* (.167)	−.694* (.282)	−.717* (.270)
Income Inequality (Gini Coeff.)	52	5.97** (2.06)	5.97** (.46)	1.14 (.81)	5.97** (2.02)
Human Develop. Index	82	−.026* (.011)	−.026** (.0076)	−.0086 (.0055)	−.01 (.0055)
Life Expectancy	131	−.47 (.032)	−.47 (.031)	−.012 (.011)	−.011 (.011)

$^{*}p < .05$; $^{**}p < .01$, two-tailed tests

[a] F-tests reject the hypothesis that all fixed effects are equal to zero at the .01 level for each of the equations.

more slowly, or declined more rapidly, and attracted less foreign direct investment. Furthermore, it was the poor rather than the relatively wealthy who suffered most from inflation: High inflation caused income inequality to increase. There is also some evidence that high inflation caused countries' scores to decline on the United Nations' broadest scale of the quality of life, the Human Development Index. This captures a wide range of factors, such as health care, education and nutrition as well as per capita income. Inflation may cause life expectancy to decline as well, but these data cannot prove this to be the case. Figure 1.1 presents the relationship between growth and inflation in graphical form using the same data.

Taming inflation was the most urgent task facing post-Communist countries, because high levels of inflation threatened to derail all other aspects of their reform programs. All these countries faced a substantial jump in prices when they abolished price controls, and most accelerated inflation by continuing to subsidize state-owned enterprises. High inflation is a self-fulfilling prophecy: The longer it persists, the more stubborn inflationary expectations become, and the more difficult it becomes to restore confidence in the currency. Meanwhile, financial instability distorts economic decisions and, in particular, increases the risks for investors. In addition, a high level of inflation has proven to be a profoundly destabilizing force in politics. While the costs

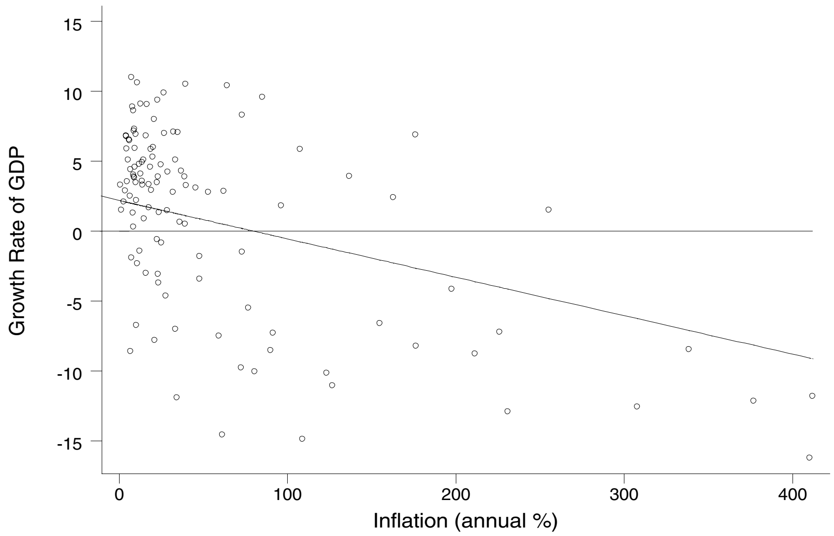

Figure 1.1: Inflation and GDP Growth.

of inflation have been vividly demonstrated in developing countries such as Argentina and Brazil, inflation has the potential to be even more devastating in post-Communist countries, for three reasons.

First, inflation and the policies that lead to high levels of inflation—loose credit, budget deficits, and government subsidies—warp the incentives of firms, preventing industrial restructuring. Firms make choices about whether to make costly investments in future competitiveness or to engage in lobbying activity, and when the latter is relatively inexpensive and lucrative, they fail to restructure. This is particularly costly in post-Communist countries, because the structure of production inherited from central planning is highly inefficient. The evidence indicates that controlling inflation contributes substantially to industrial restructuring.[5] Countries that succeed in controlling inflation and restructuring industry, in turn, experience higher rates of growth.

Second, inflation undermines the confidence of international investors. Recent research shows that inflation significantly depresses capital flows to developing countries and leads to higher real interest rates.[6] International investment provides foreign exchange, technology transfers and management expertise. Foreign investment takes on critical significance for post-Communist countries, because it determines the success of privatization programs and represents the best hope for rapid industrial restructuring. In the most successful

[5]Berg 1994.
[6]Pindyck and Solimano 1993; Sobel 1997.

Central European countries, foreign direct investment has made a substantial contribution to export-led growth and has turned centrally planned dinosaurs into modern, competitive firms. In countries like Russia, on the other hand, potentially lucrative investments remained mired in political risk and economic uncertainty.[7]

Third, high inflation leads to a skewed distribution of wealth. The evidence for the post-Communist countries is striking, as Table 1.1 demonstrates. Econometric studies of developing countries have led to the same conclusion: High inflation leads to increased inequality.[8] This observation clashes with widespread assumptions about the distributional effects of inflation, but there is a good reason: These assumptions are largely based on the American experience in the nineteenth century, which was unique in important respects. The Left in America has long assumed that inflation was good for the poor and bad for the rich, because it deflates the real value of debt. Since the poor in America tended to be in debt and the rich tended to hold the debt, it was clear whose interests were served by a policy of tight money and a strong currency. In William Jennings Bryan's phrase, the common folk of America were being crucified on a "cross of gold." The Left understood its interests properly in nineteenth-century America; but the inflationary strategy of the Populists was only attractive because there were no low-cost alternatives to holding dollar-denominated assets, labor was virtually unable to engage in collective bargaining, and the government provided no transfer payments. Once the wealthy become able to shelter their assets from the inflation tax at low cost, it is no longer possible to use it to redistribute their wealth. Meanwhile, if labor has any bargaining power, inflation is disadvantageous because it shifts the status quo in favor of management. Nominal wage bargains become less valuable, and indexation becomes a concession that management makes grudgingly in return for something else of value. Finally, if government makes transfer payments, inflation erodes their value. Again, if policymaking is a bargaining process, inflation shifts the status quo away from the beneficiaries of transfer payments, who face dwindling real payments.

The transition countries are unusually prone to the inegalitarian effects of inflation, because the combination of inflation with far-reaching structural reform and political instability creates opportunities for nonproductive activities that generate a great deal of profit, usually at the expense of the state. For example, Russian banks made most of their profits in the early years of the transition by taking subsidized credits from the Central Bank of Russia, investing in foreign currency, and repaying the credits after the ruble fell.[9] Similarly, high rates of inflation and access to subsidized credits for the privileged

[7] Halligan and Teplukhin 1996; Watson 1996.
[8] Crisp and Kelly 1999.
[9] Åslund 1995; Treisman 1998.

few led to the pervasive pattern of manager ownership, frequently referred to as "*nomenklatura* privatization," that has tarnished the legitimacy of Russian reform. Although most of the shares in enterprises were distributed to their workers, managers ended up with controlling interests because they were able to buy up shares with cheap credits and repay the loans with deflated currency. Workers, on the other hand, had higher discount rates because they did not have access to subsidized credits, so they sold. While elites with political access make fortunes in inflationary times, ordinary citizens without access to arbitrage opportunities suffer from inflation because their savings are eroded and their wages and pensions fail to keep pace with rising prices.

In the post-Communist context, therefore, the first step toward establishing political legitimacy for reform is to slow inflation. The failure to restructure industry and attract foreign investment traps post-Communist countries in a spiral of economic decline, which poses severe challenges to the legitimacy of a democratic order. The corrosive influence of inequality is even more insidious. Economic reform always entails winners and losers, but at least rapid reform keeps the winnings and losses within bounds. An extended, inflationary transition transfers most of the dwindling wealth of society to a narrow and largely criminal elite that is closely linked to the government—a prospect profoundly disheartening to democrats.

1.2 WHAT WOULD WE LIKE THE IMF TO DO?

Inflation does not arise primarily because someone benefits from inflation per se; it arises primarily because politicians find it difficult to resist the short-term temptations that lead to inflation. The politicians who set monetary and fiscal policies face a commitment problem: *ex ante*, a policymaker prefers to be able to commit to an anti-inflationary policy for all future periods; yet, *ex post*, the policymaker prefers to renege.[10] Inflation rates depend on the expectations of private agents such as wage setters, investors, and currency traders, so the policymaker would like to be able to commit to an anti-inflationary strategy to reassure markets. The dilemma is that there are many temptations to renege on such commitments. Economic models often invoke the idea that "surprise" inflation has macroeconomic benefits, while political models point to imminent elections and the disproportionate power of narrow interests.[11] The temptation to pursue inflationary policies compels private agents to hedge their bets, driving the inflation rate higher than it would be were policymakers able to pursue a strategy of full commitment.

The consequence is that inconsistent authorities cast about for ways to tie their hands. The classic solution is to delegate monetary policy to an indepen-

[10] Kydland and Prescott 1977; Barro and Gordon 1983.
[11] Alesina and Perotti 1995; Alesina and Rosenthal 1995.

dent central bank, but this may not be feasible for countries still in the process of building democratic institutions. The same short-term considerations that drive politicians to promote inflationary policies will also compel them to undermine the independence of the central bank. In principle, however, the IMF can substitute for entrenched domestic institutions by monitoring compliance with stabilization programs and offering rewards and punishments that tip the balance of incentives in favor of the full-commitment equilibrium.[12]

International capital markets play a key role in enforcing the bargain. As the volume of international transactions increases, national governments become increasingly subject to the power of markets.[13] As barriers to capital flows fall, exit becomes less costly for private agents, and governments concerned about promoting welfare and productivity are compelled to provide more hospitable conditions for capital. The greater part of the IMF's leverage over borrowing countries arises, consequently, because it is able to coordinate the actions and expectations of the dispersed actors who comprise capital markets.[14] Investors can punish bad economic policies without coordination, simply by diving for cover. It is more difficult, however, for decentralized actors to reward good policies, because a sound investment climate is a state of mind that has to be painstakingly constructed. When the Fund negotiates a stabilization program with a government that imposes policy conditions, it creates a focal point for investors to coordinate their expectations. Investors benefit from following IMF signals, because the threat of IMF sanctions for noncompliance helps to protect the value of their investments. In return, the impact of the Fund's resources is vastly magnified by world capital markets, which are opened up by the IMF seal of approval. Under favorable circumstances, a virtuous circle can arise, in which IMF intervention, government policies, and international investment reinforce one another.

The picture becomes somewhat more complex, however, when we consider that the IMF's own credibility is in question. IMF lending decisions are not informative signals about the borrower's ability to repay, because they are not costly: The Fund does not have to worry about default.[15] Therefore, the IMF seal of approval is only valuable if conditionality is backed by rigorous enforcement. The IMF, however, is not an autonomous actor, analogous to an independent central bank. Rather, IMF policy is closely controlled by the Fund's board of directors, which is appointed by the donor countries. A coalition of a few large donors can set policy under the IMF system of weighted voting, and

[12] Dhonte 1997; Swoboda 1982; Jones 1987. Similarly, the European Monetary System (EMS) has been modeled as a means for low-credibility countries to borrow credibility for their macroeconomic policies from high-credibility countries. See Giavazzi and Pagano (1988).

[13] Cohen 1996; Keohane and Milner 1996.

[14] Lipson 1986.

[15] For a discussion of the complexity of official creditor seniority, see Bulow, Rogoff and Bevilaqua (1992).

all decisions about new agreements, loans and disbursements must be cleared by the board. Consequently, the autonomy of the IMF staff varies in inverse proportion to the international significance of the case at hand. The Fund has a relatively free hand in negotiating with small developing countries, but in important cases the interests of the donor governments dictate the negotiations.[16] International strategic concerns and trade policies frequently override the stabilization agenda.

A major objective of the research design described above is to address exactly this objection. Is it possible for an institution whose basic mission is compromised in this way to nevertheless exert a positive influence? How significant is the influence of noneconomic considerations on IMF lending decisions, and how strong are the effects of IMF intervention on government policies? Answers to each of these questions emerge from the formal model, the quantitative empirical analysis, and the detailed country studies and interviews with participants in the negotiations. The conclusions show that the IMF's credibility problem is indeed severe, and consequently the organization's effectiveness is compromised in some of the most important countries. At the same time, this study finds ample evidence that the IMF has exerted significant influence over the economic policies of post-Communist countries. This mixture of findings suggests a synthesis of perspectives on international relations that emphasize power and interests with those that emphasize the role of international institutions. The interests of powerful countries define the parameters within which the International Monetary Fund operates, and the limits of what it can achieve. The IMF is, after all, an international institution, not a supranational one. However, international institutions are not only instruments that powerful nations wield in order to obtain whatever objectives appear to be expedient; they are also strategic actors in their own right. Furthermore, even when the playing field is uneven and the rules are subject to manipulation, international institutions create incentives for countries to shape their national policies in accordance with international norms.

[16] I introduced a formal model based on this argument, and econometric tests using data from Russia, Poland, the Czech Republic, and Romania, in Stone (1997).