

## CHAPTER ONE

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Introduction

FEW ISSUES have attracted as much controversy as the removal of controls on international capital flows—a process known as capital account liberalization. The International Monetary Fund has been at the center of this controversy. The formal rules of the IMF provide member states with the right to use capital controls, and these rules have not changed significantly since the organization was founded in 1945. But informally, among many staff within the Fund in the 1980s and 1990s, capital controls, once part of economic orthodoxy, became identified as an economic heresy. Although liberalization was not encouraged indiscriminately, the belief that the free movement of capital was desirable—what I call the norm of capital freedom—became the new orthodoxy.

Critics of the Fund have subsequently charged it with encouraging governments to liberalize their controls prematurely, thereby precipitating the wave of financial instability that swept much of East Asia in 1997–1998 before moving on to Russia and Latin America.<sup>1</sup> Critics also used this wave of financial instability to renew charges that the Fund was promoting “one size fits all” policies that ignored the different circumstances of its member states. Without a careful examination of the evidence, many critics of the Fund have jumped to the conclusion that the IMF staff uniformly advocated capital account liberalization. In examining a critical case of how international organizations (IOs) work and evolve, this book shows that many of these criticisms are unfounded.<sup>2</sup>

While the staff shared a belief that capital freedom was desirable in the abstract long run, they conducted a vigorous internal debate about how to proceed toward this goal. To put it differently, though the staff adopted the norm of capital freedom in the 1980s and 1990s, they disagreed about how this norm should be interpreted and applied. As I discuss more fully below, this finding not only has important empirical implications for critics of the IMF, it also has important theoretical implications for scholars seek-

<sup>1</sup> Joseph Stiglitz, *Globalization and Its Discontents* (New York: W. W. Norton, 2002), p. 15; Padma Desai, *Financial Crisis, Contagion, and Containment* (Princeton, N.J.: Princeton University Press, 2003), p. 217.

<sup>2</sup> See also IEO, *The IMF's Approach to Capital Account Liberalization* (Washington, D.C.: IMF, 2005), which also documents variation in the IMF's advice but, in contrast to this book, does not seek to explain it.

ing to understand the behavior of IOs. Existing scholarly accounts of IOs, as well as critics of the IMF, devote insufficient attention to the possibility that a norm, once adopted, can be subject to a struggle over its interpretation and application. This book seeks to strengthen our understanding of IOs in general and the IMF in particular by bringing these important battles over norm interpretation and application into sharper focus.

Within the halls of the IMF these debates over norm interpretation and application took the form of a struggle between “gradualists” and supporters of a “big bang.” Gradualists emphasized sequencing (i.e., ensuring that certain supporting policies and institutions are in place before additional liberalizing measures are undertaken), while big-bang proponents argued for a rapid move to liberalization. In addition, though both groups generally agreed that controls on capital outflows were inappropriate, gradualists viewed temporary controls on inflows as legitimate in some circumstances, whereas big-bang proponents saw even selective restraints on capital mobility as outside the boundaries of legitimate policy. As a result, though the staff collectively shared a belief in the long-run desirability of liberalization, they often offered conflicting analyses and recommendations on how to proceed toward it.

In the mid-1990s, big-bang proponents gained the upper hand within the Fund, and their informal advocacy of liberalization converged with an initiative to amend the IMF Articles of Agreement to give the Fund the formal mandate to promote liberalization as well as fuller jurisdiction over the capital account policies of its members. In granting the Fund fuller jurisdiction over the capital account, the initiative would have prohibited governments from imposing virtually all types of controls without Fund approval and would have committed governments to liberalizing existing controls. The amendment also would have enabled the IMF, for the first time in its history, to include capital account liberalization as a condition for accessing its financial resources.

In the event, the initiative failed. Proponents of the big-bang approach and the amendment saw their efforts undermined by the financial crises in Asia and beyond. Although the financial crisis that struck Mexico in 1994–1995 had moderated support for the big-bang approach, it was the Asian crisis, which many attributed to “disorderly liberalization” undertaken without regard to sequence, that played a decisive role in discrediting this interpretation and application of the norm of capital freedom. Since the Asian crisis the IMF has been much more cautious in encouraging liberalization, emphasizing sequencing and bestowing greater legitimacy to selective restraints on capital mobility.

Nonetheless, in the decade between the Asian and subprime crises, a period of norm continuity within the Fund, the tacit presumption was that the main risks to financial stability lay with poor fundamentals and

institutions within emerging markets, thus placing the onus largely on these countries. Among emerging markets this norm interpretation and application generated much resentment. Emerging markets were encouraged to adjust their policies and implement structural reforms in line with universalist standards and codes that were largely Anglo-American in content, even though emerging markets had little, if any, input into the design of these standards and codes. Within the Fund scant attention was given to “supply-side” regulatory measures aimed at financial market participants based in the financial centers of developed countries; a prescription consistent with an alternative interpretation, often advocated by emerging markets and developing countries, that stresses factors intrinsic to the operation of international capital markets as contributing to financial instability and sees supply-side regulatory measures as integral to capital account management.

But there are signs that the subprime crisis that erupted in developed countries in summer 2007 is stirring changes within the Fund. Following the partial nationalization of many of their leading financial institutions, developed countries have launched a number of initiatives to reregulate international financial markets. During the subprime crisis the Fund has also come out strongly in favor of regulatory measures aimed at financial market participants in developed countries. However, even though capital inflows played an important part in fueling housing bubbles in the United States and other countries, there has yet to be any significant efforts to overturn the norm of capital freedom.

This book thus explores the inner workings of the IMF to understand the evolution of the staff’s approach to capital controls and why it changed so dramatically. In doing so, it offers an important investigation of how IOs operate and change over time. Much of the focus is on intraorganizational processes that gave rise to debates among the Fund’s staff over the legitimacy of controls and their liberalization and on how these internal debates shaped the organization’s behavior. While not discounting the importance of formal rules and the significant influence of member states, this book shows that the IMF staff exercised significant autonomy in developing their approach. Normative and behavioral changes in IOs, this book demonstrates, are driven not just by new rules or the influence of member states but also by the evolving personnel configurations, beliefs, debates, and strategic agency of their staffs.

## MOTIVATION

The IMF’s approach to capital account liberalization is not simply a matter of historical interest. Capital account liberalization continues to be an im-

portant concern of the IMF, scholars, and the official and private financial communities. The issue remains, as Barry Eichengreen suggests, “an oldy but a goody.”<sup>3</sup> Indeed, a recent IMF strategy paper identifies “understanding capital account liberalization” as one of nine vital “responses” to the contemporary “challenge of globalization.” Attesting to the ongoing importance of the issue to the Fund, the strategy paper observes: “There is no solid body of analysis on how best to proceed. This is a challenge to which the Fund must rise.”<sup>4</sup> In rising to this challenge, the IMF staff continue to strengthen and tailor their advice on liberalization and the use of controls.

Capital account liberalization also remains an important concern of some governments. The European Union (EU) and the United States view liberalization as one of their top policy priorities; with Brussels pushing for it in the context of accession negotiations, and Washington insisting upon it in recent trade agreements with Chile, Singapore, and South Korea, as well as in its ongoing “strategic dialogue” with China. But the EU and U.S. positions have, on occasion, diverged from the IMF’s approach, thus revealing important aspects of the political economy of the organization. For instance, in the context of Bulgaria’s and Romania’s accession negotiations, the IMF recommended the maintenance of selective controls, while EU officials opposed them. Similarly, the United States and the IMF have clashed over the need for China to liberalize its capital account. While the United States, in seeking to intensify pressure on the Chinese currency to appreciate, argues that China should liberalize more rapidly, some IMF staff members claim that China should slow down its liberalization until it strengthens its financial system and achieves greater exchange rate flexibility.<sup>5</sup>

The subprime crisis has also brought renewed attention to the regulation of international capital flows. The recycling of savings and trade surpluses from Asia and oil-exporting countries stirred “capital flow bonanzas”<sup>6</sup> into the United States and other developed countries that generated abundant liquidity and, when channeled through poorly regulated finan-

<sup>3</sup> Barry Eichengreen, “Capital Account Liberalization and the Fund,” High Level Seminar on Capital Account Liberalization and the IMF, Swiss Ministry of Finance, Bern, Switzerland, 12 December 2005.

<sup>4</sup> IMF, *The Managing Director’s Report on the Fund’s Medium-Term Strategy* (Washington, D.C.: IMF, 2005), p. 8.

<sup>5</sup> Eswar Prasad, Thomas Rumbaugh, and Qing Wang, “Putting the Cart before the Horse? Capital Account Liberalization and Exchange Rate Flexibility in China,” IMF Working Paper 05/01 (Washington, D.C.: IMF, 2005).

<sup>6</sup> Carmen M. Reinhart and Vincent R. Reinhart, “Capital Flow Bonanzas: An Encompassing View of the Past and Present,” NBER Working Paper 14321 (Cambridge, Mass.: NBER, 2008).

cial systems, housing bubbles of historic proportions. These bonanzas are not unique to the subprime crisis; in fact, both the 1980s debt crisis and the Asian financial crisis were preceded by massive capital inflows and the recycling of trade surpluses that created asset price bubbles that eventually burst.<sup>7</sup> Because the risk-taking behavior of financial market participants cannot be regulated perfectly, a few prominent academic economists have advocated taxes on capital inflows, along with a coordinated agenda to tackle global macroeconomic imbalances, as a way of reducing the size of these bonanzas.<sup>8</sup> Others point to controls on outflows as a means to manage “sudden stop” disruptions in capital flows, such as those faced by many emerging markets when the contagion from the subprime crisis spread from developed economies.<sup>9</sup> Indeed, as a number of emerging markets have turned to restrictions on outflows to manage pressures from the subprime crisis, some prominent observers have suggested we are perhaps witnessing “the return of capital controls.”<sup>10</sup>

The subprime crisis has also opened up space for greater consideration of regulatory measures aimed at financial market participants in developed countries. One prominent issue for capital account management has been the procyclicality of regulatory policies and industry practices, which amplify the “boom and bust” cycle in financial markets by contributing to the expansion of lending during economic upturns and the collapse of lending during downturns. The Group of Seven (G-7) leading developed countries, though initially slow to come around to the idea, now solidly supports introducing greater countercyclical tendencies through the development of new principles and regulations. The Group of 20 (G-20) leading developed and emerging economies—which has recently replaced the G-7 as the principal forum for leaders to discuss key issues in the global economy—also has directed regulators and standard setters to develop recommendations to mitigate procyclicality. The procyclicality of regulatory policies and industry practices will likely remain a priority for policymakers for the near future.

Current efforts to reform the IMF are also linked to its approach to capital account liberalization. Much of the resentment felt by emerging

<sup>7</sup> Carmen M. Reinhart and Kenneth Rogoff, “Is the 2007 U.S. Financial Crisis So Different? An International Historical Comparison,” *American Economic Review* 98, no. 2 (2008), pp. 339–344.

<sup>8</sup> Dani Rodrik and Arvind Subramanian, “We Must Curb International Flows of Capital,” *Financial Times*, 25 February 2008.

<sup>9</sup> Guillermo Calvo, “The New Bretton Woods Agreement,” in *What G20 Leaders Must Do to Stabilise Our Economy and Fix the Financial System*, ed. Barry Eichengreen and Richard Baldwin (London: Vox.Org Publication, 2008), pp. 53–55.

<sup>10</sup> Willem Buiter, “The Return of Capital Controls” 20 February 2009, available at <http://www.voxeu.org/index.php?q=node/3104>.

market countries toward the Fund stems from critical perceptions of its handling of the Asian financial crisis. Officials from emerging markets blame the Fund not only for pushing countries to liberalize prematurely but also for its general failure in the 1990s to warn of crises that were on the horizon. The Fund's response to the Asian crisis, which placed the burden of adjustment on emerging markets by mandating austerity, deep structural reforms, and the implementation of standards and codes, generated additional criticism and resentment.<sup>11</sup>

This resentment, and the sustained period of global expansion and macroeconomic imbalances from 2002 to 2007, led emerging markets, the Fund's traditional client base, to "self-insure" by paying off early their outstanding IMF loans, and accumulating massive stockpiles of reserves and developing bilateral and regional liquidity arrangements so as to avoid having to borrow from the Fund in the future. Self-insurance, along with the pursuit of export-led growth strategies, helped create the global imbalances that played a role in generating the underlying conditions for today's crisis. Without adequate reforms to restore the faith of emerging markets in the Fund, the risk is that these countries will continue to opt for self-insurance rather than collective insurance, with the result being that the cycle of inflow bonanzas could repeat itself.

Because the IMF's income model depends heavily on interest charges from outstanding loans, the Fund's legitimacy problems created a budgetary crisis for the organization. In response, it has been forced to adjust its own policies, downsizing staff and developing a new income model. The Fund has also begun a comprehensive overhaul of the way it lends money, which has included the introduction of new, more flexible lending instruments. The Fund's member states have also pursued modest governance reforms by agreeing to a slight increase in the relative voting power of emerging markets and developing countries. At the time of writing, these initiatives were pending approval by various national parliaments, with the subprime crisis prompting the G-20 to accelerate the timetable and scope of governance reform.

The Fund's approach to capital account liberalization is not only an important "cause" of current reform efforts, but an important "effect" of such efforts. One of the core lessons of the Asian crisis was that the Fund must develop a broad agenda in monitoring the economies of its member states (what it calls "surveillance") and subjecting its borrowers to conditionality, that is, setting requirements to obtain loans. Yet this lesson cuts

<sup>11</sup> Morris Goldstein, "IMF Structural Conditionality: How Much Is Too Much?" Institute for International Economics Working Paper No. 01-04 (Washington, D.C.: Institute for International Economics, 2001); Martin Feldstein, "Refocusing the IMF," *Foreign Affairs*, 77, no. 2 (1998), pp. 20-32.

against efforts to “streamline” conditionality and against member states’ interests in avoiding intrusiveness on the part of the IMF.

If surveillance and conditionality pertaining to choices about social institutions is to be perceived as legitimate and politically acceptable, the organization itself must be seen as legitimate and accountable to those member states where this advice and conditional lending is extended. Thus, as Eichengreen concludes, “The debate over capital account liberalization leads, as all roads seem to do these days, to the need to reform governance and representation in the Fund.”<sup>12</sup> If the interests and experiences of emerging markets are genuinely incorporated into the IMF (and other key international forums), then reform of the organization, which aims to strengthen its legitimacy and accountability, could foster among emerging markets a sense that surveillance and conditionality (as well as standards and codes) are legitimate and politically acceptable, which, in turn, could encourage greater compliance. Genuine participation from emerging markets could also translate into changes to how the IMF approaches capital account liberalization by giving greater weight to measures, such as supply-side regulation, that align with the interests and experiences of those countries. Without this participation, emerging markets may turn their back on the IMF and the universalist standards and codes it promotes through the pursuit of self-insurance as well as the development of alternative regionally defined norms of financial governance, a process that Eric Helleiner calls “regulatory decentralization.”<sup>13</sup>

The historical and contemporary relevance of these issues suggests that understanding the process of normative change within the Fund deserves close attention. Moreover, understanding how the Fund works and evolves has become increasingly important. As recently as October 2008 the IMF seemed to be slipping towards terminal irrelevance. For several years, the demand for its loans had been in sharp decline, as emerging markets were awash with private capital flows and many of them pursued self-insurance strategies. Even after summer 2007, as the world sank into financial crisis, there was little demand for its resources. But the intensification and spread of the crisis in autumn 2008 has changed all of this.

The IMF is now no longer at the margins of financial governance. It has been thrust back into lending business and faced with calls for it to play a more central role as a global supervisor of financial regulators. The G-20 has also agreed to treble the IMF’s financial resources and to strengthen its mandate to develop recommendations and engage in surveillance. In addition, the staff is also currently engaged in a number of high-profile

<sup>12</sup> Eichengreen, “Capital Account Liberalization and the Fund.”

<sup>13</sup> Eric Helleiner, “Reregulation and Fragmentation in International Financial Governance,” *Global Governance*, 16, no. 1 (2009), pp. 15–20.

exercises, such as those concerning global macroeconomic imbalances and sovereign wealth funds. These exercises place the staff at the center of efforts to define “exchange rate manipulation” and to identify “best practices” for government-owned investment funds.<sup>14</sup> All of this suggests that the Fund is positioned to play a central role in defining future norms of financial governance, and thus it is incumbent upon scholars to strengthen our understanding of how it approaches this task.

The evolution of the Fund’s approach to capital account liberalization also has important theoretical implications for how scholars understand IO behavior and change. Not surprisingly, the Fund’s approach to capital account liberalization has attracted much attention from academics and policymakers. In line with a state-centric approach to IOs, the conventional wisdom for some time, exemplified by Jagdish Bhagwati’s<sup>15</sup> and Robert Wade’s<sup>16</sup> writings on the “Wall Street–Treasury Complex,” was that the Fund’s approach resulted from its management acceding to pressure from U.S. officials, who in turn were shaped by demands from the private financial community. But this view has been shown to be problematic.

Rawi Abdelal’s interpretation of the construction of the formal rules of international finance challenges some elements of this view.<sup>17</sup> Abdelal’s legalistic narrative shows that the U.S. Treasury was at best indifferent to the initiative to amend the Articles in the mid-1990s, and that Wall Street was opposed. The strongest support came from IMF managing director Michel Camdessus and West European governments.

But this revisionist interpretation is *incomplete*, as it fails to explore the decisive influence of the staff and their internal debates on changes to organizational behavior. In focusing largely on the construction of *formal* IMF rules rather than *informal* behavior by the staff, the revisionist interpretation does not dig deeply into the inner workings of the organization to explain how it actually behaves and evolves. If formal IMF rules and the staff’s informal approach were always in alignment, then we would not need to go further than the revisionist interpretation. But they were not always aligned.

<sup>14</sup> Rodrigo Rato, “Statement on the Executive Board Decision to Approve New Framework for Surveillance,” IMF Press Release No. 07/137, 21 June 2007; IMF, *Sovereign Wealth Funds—A Work Agenda* (Washington, D.C.: IMF, 2008).

<sup>15</sup> Jagdish Bhagwati, “The Capital Myth: The Difference between Trade in Widgets and Dollars,” *Foreign Affairs* 77, no. 3 (1998), pp. 7–12.

<sup>16</sup> Robert Wade, “The Coming Fight over Capital Flows,” *Foreign Policy*, Winter 1998–1999, pp. 41–54. See also Wade and Frank Veneroso, “The Asian Crisis: The High Debt Model versus the Wall Street–Treasury–IMF Complex,” *New Left Review*, March–April 1998, pp. 3–22.

<sup>17</sup> Rawi Abdelal, *Capital Rules: The Construction of Global Finance* (Cambridge: Harvard University Press, 2007).

On the contrary, there was a great deal of what principal-agent (PA) theorists call “slippage” between formal IMF rules and the staff’s actions, with many staff members in the 1980s and 1990s encouraging liberalization even though formal rules to this day give member states the right to use controls. In fact, the initiative to amend the Articles in the late 1990s was in large part an exercise in empowering the staff with more tools to encourage a policy that many of them had already been promoting informally for nearly a decade. Formal rules, of course, matter, but a fuller understanding of how IOs work and evolve requires a focus on the staff, their beliefs, and their internal debates that shape the organization from within. Indeed, the story of the Fund’s approach to capital account liberalization is more about these factors than it is about member states’ construction of formal rules.

The behavior of IOs has generated a great deal of recent interest in the scholarly literature. Three general approaches have emerged. One is state-centric, viewing IOs as creatures and instruments of their member states. While offering useful insights, this approach ignores IOs’ considerable autonomy, which is partly a result of deliberate actions by member states and partly due to the internal characteristics of IOs.

Drawing on PA theory, a second approach, while generally focusing on IOs’ external environment, treats them as autonomous creatures. This approach explores factors that lead member states to delegate authority in the first place, and the efficacy of control mechanisms that states use to rein in IOs that behave undesirably. But this approach, while expecting autonomous behavior by IOs, offers little insight into what the staff will actually do with its autonomy. This approach also tends to place disproportionate emphasis on the role of external factors, and thus tends to overpredict the extent to which organizational behavior is externally driven.

A third approach turns its attention to the internal environment of IOs, offering sociological and constructivist arguments that emphasize the role of organizational culture in shaping staff preferences and the propensity for change. But this approach often fails to investigate the sources of these preferences and thus ends up treating organizational culture as an inert social environment that is impervious to demands for change. An overly structuralist and static depiction of staff behavior is thus offered, one that marginalizes the possibility and efficacy of strategic agency among the staff. Sociological and constructivist approaches therefore tend to underpredict the potential for organizational change and obscure the role the staff plays in facilitating it.

In addition to these theoretical shortcomings, each of these approaches tends to give inadequate attention to the diversity of beliefs that exist within IOs. Overlooked, then, is the possibility that a norm, once adopted, can be subject to a struggle over its interpretation and application. By

contrast, these struggles over interpretation and application feature prominently in this book.

## THE ARGUMENT

Building on sociological and constructivist approaches, this book focuses largely on the staff, their beliefs, and the internal debates that shape the work and evolution of IOs. The evolution of the staff's beliefs is critical for understanding IO behavior as these beliefs specify legitimate goals and means for the organization to pursue. These beliefs imbue the social world with meaning, shaping the manner in which external demands and events are interpreted and the responses that the staff will entertain and, potentially, implement. Thus, if we want to understand how IOs work and evolve, then we must attend not only to member states' interests but also to beliefs that prevail within IOs and the internal processes and debates shaping these beliefs.

This book is not the first to investigate beliefs that prevail within IOs, but this field of inquiry is hardly crowded. Although there has been an important revival of scholarly interest in IOs, there has been remarkably little empirical research that seeks to uncover how they actually work. As Michael Barnett and Martha Finnemore observe, "Scholars are only now beginning to treat seriously the internal workings of these organizations and ask hard questions about how to approach them analytically."<sup>18</sup> This book seeks to contribute to this important area of inquiry by posing a number of hard questions about IOs in general and the IMF in particular. More specifically, this book asks: How does normative change occur within IOs in general and the IMF in particular? What actors are responsible for normative change?

In its sixty-year history the IMF has developed considerable autonomy and influence, transforming itself from a relatively minor and marginalized organization to a powerful global actor at the center of financial governance. In doing so, the Fund has evolved into an organization that has its own distinct goals and interests. The staff in particular has developed a significant amount of autonomy. It is the staff members who conduct the bulk of the IMF's tasks; they formulate policy proposals for consideration by member states, exercise surveillance, carry out loan negotiations and design the programs, and collect and systematize detailed information. But how the staff approaches its tasks remains understudied. By investigat-

<sup>18</sup> Michael Barnett and Martha Finnemore, *Rules for the World: International Organizations in Global Politics* (Ithaca, N.Y.: Cornell University Press, 2004), p. x.

ing the internal workings of the Fund that shape the evolution of the staff's beliefs, this book seeks to rectify this shortcoming.

I argue that five intraorganizational processes—professionalization, administrative recruitment, adaptation, learning, and entrepreneurship—largely shaped the evolution of beliefs and influenced the adoption, interpretation, and application of the norm of capital freedom. The beliefs of the staff of any organization are linked to the beliefs that prevail within the profession(s) from which it recruits.<sup>19</sup> Although some studies allude to the importance of professionalization in shaping organizational behavior, few scholars have systematically and rigorously studied how professionalization actually functions. This book does otherwise, devoting special attention to how the Fund's relationship with the profession of economics shapes its behavior.

Professions are major agents in the construction of understandings, meanings, and standards of behavior. John Maynard Keynes was an early proponent of the view that the economics profession exercised what political scientists Michael Barnett and Raymond Duvall call “productive power” or what sociologists Donald MacKenzie, Fabian Muniesa, and Lucia Siu call “performativity.”<sup>20</sup> Keynes once famously quipped:

The ideas of economists . . . are more powerful than is commonly understood. Indeed, the world is ruled by little else. Practical men, who believe themselves to be quite exempt from any intellectual influence, are usually the slaves of some defunct economist. Madmen in authority, who hear voices in the air, are distilling their frenzy from some academic scribbler of a few years back. I am sure that the power of vested interests is vastly exaggerated compared with the gradual encroachment of ideas . . . [S]oon or late, it is ideas, not vested interests, which are dangerous for good or evil.<sup>21</sup>

However, much scholarship in international political economy neglects this power of professions. On the other hand, sociologists, as well as scholars of epistemic communities, have long recognized that professions wield

<sup>19</sup> Paul J. DiMaggio and Walter J. Powell, “The Iron Cage Revisited: Institutional Isomorphism and Collective Rationality in Organizational Fields,” *American Sociological Review* 48, no. 1 (1983), pp. 147–160; Peter A. Hall, ed., *The Political Power of Economic Ideas* (Princeton, N.J.: Princeton University Press, 1989).

<sup>20</sup> Michael Barnett and Raymond Duvall, “Power in Global Governance,” in *Power in Global Governance*, ed. Michael Barnett and Raymond Duvall (Cambridge: Cambridge University Press, 2005), pp. 1–32; Donald MacKenzie, Fabian Muniesa, and Lucia Siu, *Do Economists Make Markets? On the Performativity of Economics* (Princeton, N.J.: Princeton University Press, 2007).

<sup>21</sup> John Maynard Keynes, *The General Theory of Employment, Interest, and Money* (London: Macmillan, 1936), pp. 383–384.

this type of power based on their unique claims to socially recognized expertise.<sup>22</sup> I therefore draw on the insights of these scholars to investigate how professions can socially (re)construct understandings, meanings, and standards of behavior.

Since, as I argue later in the book, it is difficult to make a case for capital account liberalization on a pure efficiency or evidentiary basis, one must examine how it became constructed as desirable. Though economists (and other professionals) tend to present their views as based solely on technical knowledge, evidence, and internal truth tests, this information is in fact value laden and the product of human interpretation. Economists create, teach, and disseminate not only technical models of how economies work but also normative conceptualizations of how economies should be organized. These technical models and normative conceptualizations provide a lens through which economists develop shared diagnoses about the problems economies face and the appropriate solutions to them. Economists serve, as Peter Haas suggests, as the “cognitive baggage handlers” of these lenses.<sup>23</sup>

Professional training, in which individuals are exposed and socialized, both implicitly and explicitly, to particular beliefs is often the source of this “cognitive baggage.” By the 1970s, most academic economists had come to define capital account liberalization as desirable. A “wide consensus had emerged among economists,” Jean Tirole observes: “capital account liberalization—allowing capital to move freely in and out of countries without restrictions—was unambiguously good.”<sup>24</sup> Exposure of cohorts of graduate students to this belief fostered an informal transnational network of economists who supported the norm of capital freedom.

This informal network then sought to insert its beliefs within the decision-making processes of the Fund, and the Fund—which recruits almost exclusively from the economics profession—saw its behavior affected accordingly. In the mid-1980s, recruitment and promotion patterns brought to senior positions a new cadre of staff members who, as a result of their professional training, were inclined to view liberalization as desirable. This new cadre replaced retiring members of staff, many of whom had joined the IMF in the 1940s and 1950s and, because of the experience

<sup>22</sup> See, for instance, MacKenzie, Muniesa, and Siu, *Do Economists Make Markets?*; Peter M. Haas, “Introduction: Epistemic Communities and International Policy Coordination,” *International Organization* 46, no. 1 (1992), pp. 1–35; Emanuel Adler and Haas, “Conclusion: Epistemic Communities, World Order, and the Creation of a Reflective Research Program,” *International Organization* 46, no. 1 (1992), pp. 368–390.

<sup>23</sup> Haas, “Introduction,” p. 27.

<sup>24</sup> Jean Tirole, *Financial Crises, Liquidity, and the International Monetary System* (Princeton, N.J.: Princeton University Press, 2002), p. ix.

of the 1930s and their professional training, shared different beliefs about the desirability of liberalization. As a result, the normative outlook of the Fund changed.

But professionalization and administrative recruitment are not the whole story. Real-world events also matter, and organizational staff members can develop and refine their beliefs through experience. Yet experiences do not come with “instruction sheets,” as Mark Blyth suggests.<sup>25</sup> Prevailing beliefs can give rise to particular understandings of experiences, thus channeling the lessons that emerge and making existing interpretations “sticky” and resistant to change. Individuals tend to take seriously information that confirms their interpretations and to discount evidence that disconfirms them.

Consequently, the staff often interpreted events—such as the Asian financial crisis—to warrant ad hoc changes in beliefs about how to proceed to a particular goal (i.e., beliefs about legitimate means, such as a greater emphasis on sequencing) without any corresponding change in support for a particular goal (i.e. beliefs about legitimate ends, such as capital freedom). I find this process of *adaptation* to have occurred often in the Fund’s history. Real-world experiences, however, usually failed to induce a shift in underlying goals, or what might be called *learning*. A change from the norm of capital control to capital freedom (or vice versa) proved cognitively difficult without personnel changes that brought alternative interpretations to bear on experiences.

Though the staff in the 1980s and 1990s collectively shared the view that capital freedom was desirable in the abstract long run, a vigorous internal debate continued over how this norm should be interpreted and applied. A “battle of ideas” ensued between gradualists and big-bang supporters. This internal debate was very much a reflection of a similar intellectual battle occurring within the economics profession. While professionalization and administrative recruitment can help foster norm adoption, they can also facilitate the formation of subcultures within an organization, as new recruits bring contrasting interpretations and applications of a norm that reflect unsettled debates within the profession from which they were recruited. Although academic economists generally agreed that capital freedom was a desirable long-run goal, they disagreed over how to proceed toward it. Academic economists debated the emphasis to be placed on sequencing and whether allowances should be made for selective capital controls. These intradisciplinary debates helped create subcultures within the Fund, with some staff inclined to favor gradualism

<sup>25</sup> Mark Blyth, *Great Transformations. Economic Ideas and Institutional Change in the Twentieth Century* (Cambridge: Cambridge University Press, 2002), p. 7.

while others supported a “big bang” approach. These subcultures in turn provided an ideational basis for internal bureaucratic struggles. Thus, while the staff collectively shared the belief that capital account liberalization was desirable in the long run, members disagreed over the means to proceed toward this goal and whether to make allowances for temporary and selective deviations from it.

In contrast to existing approaches to IOs, I pay close attention to these important debates over norm interpretation and application and in doing so seek to reveal the crucial role of staff *strategic agency*; that is, the use of detailed means-ends calculations to maximize particular goals. These goals are not solely material in nature; rather they also reflect a commitment to particular beliefs and action that is directed at changing the preferences of others so that they better reflect these beliefs. Martha Finnemore and Kathryn Sikkink describe this process as one of “strategic social construction” in which “actors are making detailed means-ends calculations to maximize their utilities, but the utilities they want to maximize involve changing the other players’ utility function in ways that reflect [their] normative commitments.”<sup>26</sup>

This agent-centered approach contrasts with the structure-centered approach that characterizes much sociological and constructivist work. This work depicts agents as overly socialized creatures locked in to particular interests because of socialization dynamics associated with particular social structures. Agents are often presented as unable to engage in action beyond the “logic of appropriateness.”

While not denying the importance of structure, this book develops a more strategic and agent-centered approach and a more dynamic conception of normative change. This approach, what Nicolas Jabko calls “strategic constructivism,” enables a sharper focus on the persuasive and expressive practices that agents use to give meaning to particular events and to frame and construct what is appropriate and possible.<sup>27</sup> Many of the actors in this book are thus best understood to be what Finnemore and Sikkink call “norm entrepreneurs.” These actors, though partially socialized by their social environment, retain a capacity to (re)construct it strategically through persuasion, social pressure, material incentives, and positions of leadership. This book finds that the discursive influence of these entrepreneurs depends on their ability to cast a set of events as representing a “crisis” for opposing views and to frame new initiatives so that they resonate with prevailing organizational beliefs, principles, and practices.

<sup>26</sup> Martha Finnemore and Kathryn Sikkink, “International Norm Dynamics and Political Change,” *International Organization* 52, no. 4 (1998), pp. 887–918 at p. 910.

<sup>27</sup> Nicolas Jabko, *Playing the Market: A Political Strategy for United Europe, 1985–2005* (Ithaca, N.Y.: Cornell University Press, 2006), p. 8.

Professionalization, administrative recruitment, adaptation, learning, and norm entrepreneurship are thus critical for understanding how IOs in general work and evolve and how the Fund in particular adopted, applied, and interpreted the norm of capital freedom. But straightforward bureaucratic politics also matters. Indeed, in the 1990s, some staff—as well as management and the IMF board directors—were motivated by a desire to expand the Fund’s mandate in order to reassert its authority in an era when highly liquid capital markets threatened the institution with increasing irrelevance. The belief that liberalization was desirable mattered for these actors because it served as a crucial means for them to articulate their interests and to build coalitions with other like-minded actors. Beliefs therefore not only shape the interests of actors but also the coalitions that form among them.

Yet the professional norms of an organization’s staff can also trump bureaucratic motives for budget maximization and task expansion. Where new initiatives are not consistent with the skill set and expertise of an organization’s staff, the organization can prove reluctant to expand. Indeed, in the context of the subprime crisis, the IMF, with its core expertise in macroeconomics, has opposed transforming itself into a global supervisor of financial regulators precisely for this reason.

In crafting these arguments this book seeks to add greater methodological and empirical rigor to sociological and constructivist approaches. Emanuel Adler suggests that greater attention to methodology and empirical testing is the “major missing link” for these approaches.<sup>28</sup> One particularly egregious flaw is that these approaches typically assume that professional training socializes individuals to adopt particular beliefs without investigating and demonstrating this claim empirically. As a result, these studies tend to be impressionistic at best, rarely supported by detailed evidence that traces the effect of professionalization.

I seek to inject greater methodological and empirical rigor by employing a mixed-method research design to better demonstrate and trace the effects of beliefs about capital controls. A survey of nearly 300 economists is employed to explore the socialization dynamics associated with professional training. I also create a new dataset that codes the professional training characteristics of over 400 IMF staff to trace the effect of professionalization and administrative recruitment on organizational behavior. I utilize process-tracing that employs original archival data and extensive interviewing and contact with IMF and government officials as well as members of the private financial community to offer a detailed analysis of

<sup>28</sup> Adler, “Constructivism and International Relations,” in *Handbook of International Relations*, ed. Walter Carlesnaes, Thomas Risse, and Beth Simmons (London: Sage, 2003), pp. 95–119 at p. 109.

the Fund's adoption, interpretation, and application of the norm of capital freedom. I also supplement these sources by drawing on the rich secondary literature on the Fund and contemporary news accounts.

## OUTLINE OF THE BOOK

The goal of this book is to explore the processes that drive normative change and behavior in the IMF. Without denying the importance of member states' influence, this book turns its attention to the decisive role played by the staff and the intraorganizational processes that shaped how the organization adopted, interpreted, and applied the norm of capital freedom. The following chapters elaborate on these themes and arguments.

Chapter 2 begins by critically reviewing existing approaches to IOs. Building on sociological and constructivist approaches, it elaborates on the importance of examining the internal workings of IOs to better understand how they behave and evolve. It then develops more fully the role of professionalization, administrative recruitment, learning, adaptation, and strategic agency in stirring normative change "from within."

Chapter 3 consists of two parts. The first part traces the evolution of the economic profession's beliefs about capital controls from the late nineteenth to the late twentieth century. These beliefs are important because they served as a critical determinant of how the IMF staff viewed capital freedom. I identify eight schools of thought: neoclassical, Keynesianism, "neoliberalism,"<sup>29</sup> neoclassical synthesis, post-Keynesianism, monetarism, new classical, and new Keynesianism. Although these schools of thought offer starkly different views on a number of issues, one critical issue that divides some of them and unites others is the respective assumptions they make about the efficiency with which market actors use information. These different understandings of market behavior engender contrasting associated standards of behavior.

Keynesians, post-Keynesians, and some new Keynesians are broadly united by the view that factors intrinsic to the operation of international capital markets limit the extent to which market actors use information efficiently; the result often being myopia, herding, and rationing, which manifests itself in capital inflow "bonanzas" followed by abrupt and "sudden stops" and reversals. Because these factors are intrinsic to the operation of international capital markets and are difficult, if not impossible, to

<sup>29</sup> Throughout the book, I use scare quotes to differentiate this school of thought, which emerged in the 1930s, from the broader neoliberal continuum that comprised many schools of thought.

eliminate, capital controls are legitimated as an essential policy instrument. But these schools of thought prevailed within the economics profession only for a short period of time, if at all. The heyday of Keynesianism was roughly from the mid-1930s to early 1960s; new Keynesianism emerged in the late 1970s and strengthened in the 1990s; while post-Keynesianism has been generally confined to the margins of the profession.

By contrast, what broadly unites neoclassicals, “neoliberals,” neoclassical synthesists, monetarists, new classicals, and most new Keynesians within what I call the *neoliberal* continuum of thought is the view that market actors use information more or less efficiently. Because international capital flows are seen as generally reflecting economic and policy trends (at least in the long run), this continuum of thought prioritizes policy adjustment and structural reform, not capital controls, as the appropriate course of action to minimize financial instability. The neoliberal continuum of thought, which prevailed from the early 1960s through the 1990s, thus unites behind the view that capital freedom is a desirable long-run goal. But whereas neoliberals disagree with Keynesians, post-Keynesians, and some new Keynesians over the desirability of capital freedom itself, they disagree with one another over how the norm should be interpreted and applied. Although they agree that capital freedom is a desirable long-run goal, neoclassical synthesists and most new Keynesians disagree with neoclassicals, monetarists, and new classicals on two important issues: they place greater emphasis on sequencing, and they are more sympathetic toward temporary and selective capital controls. These differences within the neoliberal continuum of thought played an important role in fostering the development of subcultures within the Fund.

The second part of chapter 3 investigates, rather than assumes, the importance of professional training as a mechanism of socialization. Original survey data is employed to establish a link between these schools of thought, professionalization, and subsequent beliefs held by actors. The evidence is highly suggestive that there is a strong link between professional training in particular academic departments where capital freedom was viewed as desirable and subsequent beliefs that legitimate it. The survey evidence also reveals importance differences within the economics profession over how to proceed toward capital freedom.

Chapter 4 explores events from the early postwar years until the early 1960s. Collectively shared Keynesian beliefs produced widespread support in the 1940s and 1950s for the view that unfettered capital mobility—particularly for short-term flows—was undesirable and that controls were essential. Capital control was the norm. This norm had two bases of support. First, the IMF membership generally supported the legitimacy of controls. The United States, though it chose not to employ controls and viewed them more skeptically than most of the IMF membership, tended

to accommodate their use. Other Fund members lent greater support, with a number of other leading members, particularly in Western Europe, fearing the disruptive effects of speculative capital flows.

Second, IMF recruitment patterns ensured that the staff would support capital controls. In the 1930s and 1940s, Keynesian-minded academic economists played an important role in helping to construct the norm of capital control. Through their participation in the Bretton Woods delegations and the professionalization of their graduate students, these economists helped define the range of policy options that could be entertained by the Fund staff. When the staff members came to draw on their training to diagnose economic problems and to form policy judgments, the Keynesian content of this training helped ensure that the legitimacy of controls would be upheld, even when it contradicted the preferences of powerful principals, such as the United States and West Germany. Many staff members recruited in the 1940s and 1950s would serve in senior positions until the 1980s. Reflecting the enduring influence of professionalization, these staff remained largely supportive of controls throughout this period, even when U.S. officials began to take a more critical view of controls in the 1960s and 1970s.

Still, there were developments during this early period that foreshadowed the eventual unraveling of the norm of capital control. During a brief interval, 1945 to 1947, U.S. officials promoted a return to neoclassical orthodoxy. In the context of the 1947 economic crisis in Britain and Western Europe, U.S. officials undermined what remained of expectations that governments could turn to exchange and cooperative controls when unilateral capital controls proved ineffective. In a second critical development, governments began to turn to means other than capital controls, such as official financing, to manage disruptive capital flows. Finally, in the early 1960s, the creation of the Code of Liberalization of Capital Movements among members of the Organization of Economic Cooperation and Development (OECD) and steps to liberalize some controls among members of the European Community (EC) revealed the gradual emergence of new preferences that were more supportive of greater capital freedom.

Chapter 5 explores the decade of the 1960s. As Jacqueline Best argues, the 1960s were a period when Keynesianism was “hollowed out” and replaced by the neoclassical synthesis.<sup>30</sup> U.S. officials, reflecting the rise of advocates of the neoclassical synthesis to prominent policymaking positions, offered support to several changes to formal IMF rules that enhanced capital freedom. U.S. officials also began to insist that controls be

<sup>30</sup> Jacqueline Best, *The Limits of Transparency: Ambiguity and the History of International Finance* (Ithaca, N.J.: Cornell University Press, 2005).

used as only *temporary* policy measures and sought to redefine speculative flows—the chief villain of the international monetary system for Keynesians—as a “normal” feature of the international financial system.

Despite these changes to the IMF’s formal rules and its external environment, the staff retained a Keynesian understanding of market behavior. Countries’ experiences with greater capital freedom did, however, lead staff members to adapt some their beliefs. Staff reports began to show appreciation for the benefits that greater capital freedom could provide and to place greater emphasis on policy adjustment, as opposed to controls, as an appropriate means to deal with disruptive capital flows. But here and elsewhere there is evidence that prevailing beliefs channeled how the staff responded to experience. The Fund’s personnel configuration of Keynesian-minded economists made the organization largely unreceptive to the possibility that liberalizing all capital flows was desirable, even though some leading principals—particularly the United States and West Germany—were advocating such a view. As a result, the staff members adapted their existing beliefs to the perceived limits of Keynesianism but failed to learn new ones that identified complete capital freedom as a desirable goal. The receptivity of the staff to adapting beliefs was in turn facilitated by the overlap of these adaptations with the Fund’s emerging approach to balance-of-payments adjustment.

Chapter 6 turns its attention to the international monetary reform negotiations of the 1970s. Acting as a “norm leader,” U.S. officials insisted on changes to formal IMF rules so that they seemingly directed the staff to encourage liberalization, at least in circumstances where controls impeded balance-of-payments adjustment. Although the Fund’s external environment became even less permissive of the norm of capital control, the staff and organizational behavior did not demonstrate much substantial normative change. Remarkably, U.S. norm leadership, changes to formal IMF rules, and the collapse of the Bretton Woods system of exchange rates failed to induce significant change in the legitimacy lent to controls by the informal staff approach.

Chapters 7 and 8 explore the decades of the 1980s and 1990s. Without a legal mandate or active encouragement from member states or management, some staff members began to encourage, though not indiscriminately, capital account liberalization. Professionalization, administrative recruitment, learning, and norm entrepreneurship were critical in stirring normative change.

A realignment of IMF personnel occurred in the 1980s, which saw new staff, whose training inclined them to view capital freedom as desirable in the long run, replace long-serving staff who had joined in the 1940s and 1950s. This realignment helped to shift the normative outlook of the or-

ganization. This realignment also made the staff more receptive to viewing countries' experiences as demonstrating the desirability of liberalization.

But the new IMF personnel configuration in the 1980s, like the one in earlier periods, channeled how the staff responded to experiences. The split between the gradualists and big-bang supporters was shaped not only by ongoing debates within the economics profession over sequencing and temporary controls, but also by the subsequent application of different interpretations to the same experiences. For instance, supporters of each approach drew different lessons from Chile's experience in the 1990s with market-based controls on capital inflows. Whereas big-bang supporters interpreted the controls as an imperfect substitute for adjusting policies and recommended their removal, gradualists saw them as temporarily safeguarding the weak and poorly regulated financial system from capital flow volatility and therefore supported their use. In the battle of ideas that ensued, norm entrepreneurship proved critical.

The general enthusiasm for capital freedom underpinned the initiative to amend the Articles in the late 1990s. But divisions opened among the membership over the desirability of the amendment. When the Asian crisis erupted, and questions arose about the Fund's response to it, support for the amendment and capital freedom dampened greatly. The initiative subsequently failed.

In line with neoliberal understandings, the staff initially identified poor policies and institutions as responsible for the crisis, while downplaying the impact of self-fulfilling market expectations and herding behavior. This interpretation legitimated policy adjustment and structural reform, not controls on outflows, as the appropriate response. Thus, when Malaysia imposed controls on outflows in 1998 to deal with contagion from the crisis, it was subjected to severe criticism.

But the crisis and the Malaysian outcome, which some perceived to be successful, did prompt some staff members and academic economists to reconsider and challenge prevailing beliefs. A small, but influential, set of staff members and academic economists achieved some success in advancing an alternative Keynesian-inspired interpretation of the crisis. Advocacy within the Fund for this alternative interpretation has subsequently led the staff to pay greater attention to factors intrinsic to the operation of international capital markets that can give rise to financial instability. Some staff and academic economists, harkening back to Keynes, have even raised the possibility of *permanent* restraints on short-term capital inflows. Greater controversy surrounds controls on outflows, but Malaysia's rapid recovery from the crisis has led the staff to become more accommodative of their use in crisis situations.

The financial instability in Asia and beyond was thus widely perceived within the Fund to be a "crisis" for the big-bang approach. However,

although the Asian crisis undermined staff support for the big-bang approach (but, interestingly, not among some member states), it failed to discredit belief in the long-run desirability of capital freedom. A belief in the long-run desirability of capital freedom channeled the staff response, leading staff to attribute the means used to proceed toward this goal (“disorderly liberalization”), rather than the goal itself, as responsible for financial instability. This adaptation has led to an almost complete unraveling of support within the Fund for the big-bang approach, but not for capital account liberalization *per se*.

Chapter 9 explores the decade of norm continuity between the Asian and subprime crises. Although greater legitimacy was attached to temporary and selective controls, the onus, as evidenced by the development and promotion of standards and codes, remained on what emerging markets should do to minimize financial instability, with little consideration being given to regulatory measures aimed at financial market participants in developed countries. This approach, which has generated much resentment from emerging markets, is shown to have been due to the preferences of leading principals as well as intraorganizational factors.

The reluctance of the Fund to entertain regulatory measures in developed countries is linked, like many things seem to be, to its legitimacy problems. By eschewing supply-side regulation, the Fund reinforced the perception of many emerging markets and developing countries that it is not responsive to their interests and experiences. To prevent these countries from turning their back on the Fund, some have advocated, and the IMF has slowly started to implement, reforms to formal governance of the organization to give these countries greater “voice.” But while potentially useful, such reforms overlook the intraorganizational processes at the heart of this book that are shown often to exert a decisive influence on organizational behavior. With its emphasis on intraorganizational processes, this book suggests that the pursuit of formal governance reforms alone will likely be insufficient to improve the legitimacy of the IMF. Chapter 9 therefore concludes by offering some reform proposals aimed at these intraorganizational processes that seek to encourage greater intellectual diversity within the Fund. Such diversity, along with greater consideration of measures, such as supply-side regulation, could help improve the organization’s legitimacy by ensuring the Fund’s policy prescriptions better reflect the diverse interests and experience of its membership.

Finally, the epilogue traces changes through spring 2009 that have occurred to the Fund’s approach during the subprime crisis. We are potentially entering a period of profound normative change, with many developed countries having broken with long-standing taboos and policy norms and showing a growing interest in reregulation. But at the time of this writing there have yet to be significant efforts to reverse the norm of

capital freedom. The Fund, however, has become a more vocal proponent of regulatory measures aimed at financial market participants in developed countries. Although it is still too soon to reach definitive conclusions, new and heterogeneous preferences of the Fund's principals as well as adaptation and norm entrepreneurship are likely candidates underpinning this policy shift.

Significantly, the subprime crisis has resulted in symbolic efforts to strengthen the influence of emerging markets, such as the decision to convene the leaders of the G-20, rather than the G-7, to discuss the reform agenda. Membership of key international forums has also been expanded to include some emerging markets. But it is still unclear whether such efforts will prove substantively important. If not, we could witness growing resentment, self-insurance and regulatory decentralization, as emerging markets turn their backs on the key international forums and the norms they promote.