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Subscription prices for 1996 are as follows:

Institutions: £215.00 (UK/Europe), £261.00 (Rest of World), \$420.00 (North America)  
Individuals: £61.00 (UK/Europe), £77.00 (Rest of World), \$125.00 (North America)\*

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**US Mailing.** Second class postage paid at Rahway, New Jersey. Postmaster: send address corrections to *The World Economy*, c/o Mercury Airfreight International Ltd Inc., 2323 E-F Randolph Avenue, Avenel, NJ 07001, USA.

**Back Issues.** Single issues from the current and previous three volumes are available from Marston Book Services, PO Box 87, Oxford OX2 0DT at the current single issue rate. Earlier issues may be obtained from Swets & Zeitlinger, Back Sets, Heereweg 347, PO Box 810, 2160 SZ Lisse, Holland.

**Issues on Microform.** The journal is available on microfilm (16mm or 35mm) or 105mm microfiche from the Serials Acquisitions Department, University Microfilms Inc., 300 North Zeeb Road, Ann Arbor, MI 48106, USA.

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Indexed in Index of Economic Articles in Journals and Collective Volumes, The Journal of Economic Literature, ABC POL SCI, Management Contents, PAIS Bulletin, COREJ.

Printed and bound in Great Britain by Redwood Books, Trowbridge.  
This journal is printed on acid-free paper.

# Political Economy of the Bretton Woods Institutions: Adapting to Financial Change

*C. Randall Henning*

## 1. INTRODUCTION

**I**NTERNATIONAL institutions must adapt to changes in their political and economic environment. Those that do not adapt risk becoming irrelevant to economic problems of the day and losing the political support of key actors in the international system. The Bretton Woods institutions — the World Bank and International Monetary Fund — presently face formidable challenges of adaptation. The international financial environment and the domestic political environment within major states are changing rapidly and require these institutions, like others, to evolve accordingly.

The evolution of international institutions in response to contemporary international economic problems, of course, is not necessarily either smooth or efficient. The evolutionary path of a particular institution is determined by the identity of its stakeholders and their relative influence within the organisation. Those stakeholders — including governments of member states, secretariats, other international organisations, and nongovernmental organisations — respond in turn not only to other international actors but also to domestic political pressures.

This article examines one particularly important feature of the political economy of adaptation by the Bretton Woods institutions: the private financial markets and institutions and their relationship to the Bretton Woods twins. The private financial sector does not determine institutional evolution on its own; pulling and hauling over the direction of the institutions involves many other

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interested parties. But private finance plays a special role, as described below, which has not been addressed systematically in the literature and bears particularly strongly on the current challenges facing these organisations.

The present article reviews briefly the historical evolution of the International Monetary Fund and the World Bank, referring to the roles adopted by private and official finance respectively over the course of that evolution. The article then compares the political economy of these institutions, focusing more on the Fund than the Bank, in the debt crisis of the 1980s and the world of highly mobile capital of the 1990s. It draws analytical lessons from the contrasting outcomes of the Mexican rescue packages of 1982–83 and 1994–95. The article elaborates on the present challenge facing the Bretton Woods twins and concludes with a brief discussion of the utility of a mechanism to provide the international equivalent of Chapter 11 or Chapter 9 bankruptcy protection in the United States — ‘orderly workout arrangements’ — for countries in financial crisis.

The central argument presented here revolves around the relationship of the International Monetary Fund and World Bank to the private financial markets. In short, the shift in the composition of capital flows to developing countries from bank loans to securities and direct investment complicates the work of the two institutions while weakening the political support for their taking an active role in financial crisis management. This scissors movement has transformed the political economy of these institutions and created political obstacles that must be overcome for them to adopt new roles that would assure their relevance in the coming decades.

## 2. CO-EVOLUTION OF THE BRETTON WOODS INSTITUTIONS AND PRIVATE INTERNATIONAL FINANCE

The evolution of the Bretton Woods institutions over the decades illustrates the importance of private finance. The IMF and World Bank were conceived partly out of antipathy toward private finance stemming from the experience of the interwar period. Over time, however, the two institutions developed in ways that did not threaten, and indeed supported, the international operations of private financial institutions.

There are two principal reasons why the roles of the international financial institutions came to be restricted to areas that private financial institutions avoid. First, while not always guided by considerations of efficiency, member states of international financial organisations generally have an incentive to economise on resources and thus avoid redundancy of official and private capabilities. Second, and more importantly, redundancy would inspire the political opposition of private finance, which might be able to block participation of key governments in the official institutions. The second reason applies in particular to the United

States government because it is the most influential single shareholder within the Bretton Woods institutions.

As private financial markets have changed, and as international flows of capital have changed, the complementarity of official financial institutions with private institutions has changed as well. Accordingly, international financial institutions must redefine their roles in order to maintain both their relevance to economic problems and their political support among private financiers.

Within the United States, the main threat to the Fund and the Bank historically has been from an isolationist coalition of the far right and left wings of the political spectrum. Opposition emerges from the far right out of concern that participation in these organisations impinges on the ability of the United States to act unilaterally. Opponents on the right also often argue that the institutions do not play any role that the private markets cannot perform better. Opponents on the left argue that the institutions have been 'captured' by the attitudes and priorities of private finance, impose unnecessarily strict economic programmes on foreign countries, and create foreign competitors for American firms and workers. Though motivated by different and sometimes conflicting views, the two groups of opponents often form a coalition of extremes. Thus, the political posture of private finance is critical: a posture favourable to the international financial institutions could neutralise the coalition of extremes; a negative posture could solidify a domestic coalition that could block American support.

#### *a. Creation*

When designing their blueprints for the Bretton Woods institutions, neither the British nor the American government favoured its national financial community. The financial instability associated with the Depression of the interwar years had discredited private bankers politically. The Roosevelt administration had sought, in the words of Treasury Secretary Henry Morgenthau

to move the financial centre of the world from London and Wall Street to the United States Treasury, and to create a new concept between nations in international finance. (quoted in Gardner, 1980).

The American plan for the IMF was thus an international extension of the New Deal programme that the administration pursued domestically while private finance was on the defensive.

Accordingly, American private financial institutions were deeply sceptical of the Bank and the Fund when they were first proposed. Members of the New York financial community were concerned that the Bretton Woods institutions would compete with private institutions and contribute to early postwar inflation, and that the Fund would be too lenient on deficit countries wishing to devalue their currency or finance deficits. Bankers lobbied the Roosevelt administration to

adopt a more unilateral approach to international finance. Some bankers urged the administration to abandon creation of a fund and to concentrate on trade negotiations instead. After the Bretton Woods conference, some bankers urged the administration and the Congress to modify the agreements by adopting a 'key currency' approach, in which the dollar would explicitly become the centrepiece of the postwar monetary system (which later transpired despite the rejection of this proposal), (Eckes, 1975; Gardner, 1980; and Helleiner, 1994)

Private bankers were weaker at the creation than at any other point in the lifetime of the IMF and World Bank. Given the dominance of the New Deal coalition in Congress, the bankers did not have the political power to either block or modify the Bretton Woods agreements once those agreements had been struck. One critical manifestation of that weakness was that the IMF Articles of Agreement condoned capital controls. Capital account convertibility was deemed dispensable if sacrificing it were necessary to achieve and maintain current account convertibility and exchange rate stability (Pauly, 1994 and 1995; Helleiner, 1994).

Nonetheless, the American negotiator, Harry Dexter White, modified his original plan for the IMF in recognition of a strengthening of the conservative coalition in Congress in 1943. The plan that he submitted in 1944 was thus considerably more favourable to the perceived interests of the banking community than was the plan proposed by the British negotiator, John Maynard Keynes. The Roosevelt administration also provided numerous assurances to conservatives — that IMF financing would be restrictive, for example, and that the Treasury would determine American policy in the IMF in consultation with the other executive agencies — in order to secure passage of the Bretton Woods agreements through Congress (Gardner, 1980, p.77). The conflict between American bankers and the Roosevelt administration over the Bretton Woods institutions, moreover, represented simply the opening act of a longer drama through which the financial sector would have multiple opportunities to modify the missions of the Fund and Bank.

#### *b. Early Decades*

During the 1950s and 1960s Wall Street came to accept the Bretton Woods organisations. As the World Bank developed over these decades, it took a broadly market-oriented approach to economic development in the third world despite being restricted by its charter to lending to governments. The Bank has been criticised for lending to countries pursuing import-substitution strategies for projects that were government owned and operated, thereby contributing to a misallocation of resources and perpetuating a *dirigiste* or paternalistic role of the state. But by and large the Bank was a force for economic liberalisation in developing countries and subjected its lending programmes to market tests of

feasibility and desirability. The Bank, although an official institution, sought a positive rate of return on its capital after all. With the backing of the member states, and the implicit senior status of its credits which that backing conferred, it sought profitable business in sectors and niches where private institutions feared to tread. The International Finance Corporation (IFC) was formed within the World Bank Group specifically to advance market finance and private sector development of developing countries. The Bank raised funds on the New York capital market as well as capital markets abroad, using private investment banks as underwriters. Several presidents of the Bank were selected from among the Wall Street community, precisely to maintain links to that community and political support from that quarter (Mason and Asher, 1973).

Under the pegged exchange rate regime in place in the 1950s and 1960s, the Fund played a useful function in helping to stem financial crises, forcing needed balance of payments adjustments, and fostering exchange rate stability among the industrial countries. The Fund promoted current account convertibility ardently. These roles and functions were deemed desirable at the time by private financial institutions in the major countries.

### *c. Regime Change*

The development of international financial markets over the 1960s, particularly the Eurodollar market centred in London, and the resulting increase in the mobility of capital placed increasing stress on the Bretton Woods monetary regime. The dissolution of the fixed exchange rate system and the first oil shock dramatically changed the economic environment of the Fund in the early 1970s. The first event weakened the Fund's *raison d'être* as overseer of the monetary regime and sent it in search of a new purpose. The second created large current account imbalances and a correspondingly increased need for international finance.

A principal question was whether OPEC's enormous surpluses of 'petrodollars' would be 'recycled' through private banks or official institutions. In the event, private banks handled the largest part of the recycling problem. Countries that did not have access to bank finance, however, relied more heavily on official financing, including financing from the Bank and the Fund. The Fund added new loan windows, and expanded access to existing credit tranches, for this purpose.

Owing to the oil shock, the need for balance of payments financing was not eliminated by the switch to flexible exchange rates. International financing became so plentiful to countries deemed good risks, however, that industrialised countries virtually ceased to borrow from the Fund. After drawings by Britain and Italy in the mid-1970s, and by the United States in 1978, only developing countries resorted to Fund financing and programmes. Most of these developing countries, of course, continued to tie their currencies to the currency of an

industrialised country or to an industrialised-country currency basket.

The role of the Fund and its relationship to private finance thus shifted in several important respects. First, a programme with the Fund became a 'good housekeeping' seal of approval, a signal to international banks that it was safe to lend to that country. An agreement with the Fund, therefore, could mobilise far more capital than the Fund itself offered. (See, for example, Cohen 1981). A breakdown in relations with the Fund, on the other hand, could signal that the country in question was in financial trouble. Second, the Fund exercised influence through conditionality attached to its lending programmes. (Polak, 1991 and 1994) Such conditionality, though it was not always effective, furthered the interests of international banks, as creditors, in the solvency of their borrowers. The banks themselves did not have the legal or political standing to negotiate with governments over macroeconomic policy; the Fund did. Third, with less importance placed on maintaining fixed parities, capital controls were increasingly viewed as unnecessary, and indeed counterproductive from the standpoint of financing current account imbalances. Accordingly, the Fund modified its previous stance on capital account convertibility and increasingly encouraged liberalisation of capital and exchange controls, which, of course, was generally desired by private financial institutions.<sup>1</sup>

Thus, over the first half of the postwar period private banks increasingly accepted the Bretton Woods institutions as organisations that played a broadly useful role, did not compete with their own interests directly, and in fact supported their lending activities among developing countries in a number of respects.

The second oil shock of 1979 greatly magnified the recycling problem. Owing to a deluge of deposits from oil producers, banks became so liquid and so anxious to lend that the 'seal of approval' of the Fund was temporarily devalued. As a consequence, the Fund lost leverage over borrowers, particularly the middle-income developing countries, to which banks lent readily. This exclusion of the Fund ended abruptly, however, when Mexico threatened to default in mid-1982.

#### *d. The Debt Crisis*

The debt crisis of the 1980s again changed the global financial environment of the Bretton Woods institutions. The crisis jeopardised the solvency of important

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<sup>1</sup> A report on the problem of capital surges into emerging markets that was released by the IMF staff in August 1995 provides a recent example (Folkerts-Landau and Ito, 1995). The report sanctioned the use of 'measures to influence the level and characteristics of capital inflows, such as taxes on short-term bank deposits and other financial assets, reserve requirements against foreign borrowing, prudential limits on banks' offshore borrowing, and limits on consumption credit.' However, these measures were prescribed judiciously, after foreign exchange intervention and fiscal adjustment had been applied and found insufficient, and limited to inflows only; controls on outflows were specifically discouraged. Thus, despite publicity to the contrary, the view that capital liberalisation is highly desirable is the dominant premise of the report and the present orientation of the IMF staff.

private banks in the industrialised countries. Because the largest problem debtors — Mexico, Brazil, and Argentina — were in Latin America, a market which American banks dominated, the debt problem became in essence an American problem. The Reagan administration and the Federal Reserve gave priority in their debt crisis strategies to sustaining the integrity of the banks, over alternative strategies such as debt relief (Cohen, 1992).

The Bretton Woods institutions, dominated as they were by the industrialised countries and the United States in particular, took on an important role in this long-term workout strategy. The debt crisis is thus a classic example of the major governments applying the resources and capabilities of the Bank and the Fund to manage a serious policy problem, the solvency of their banks and domestic banking systems and the international financial system. (Whether this strategy also protected the interests of debtor countries is a lively debated issue, but too complex to resolve here.)

When the Mexican debt crisis broke in mid-1982, Federal Reserve Chairman Paul A. Volcker directly encouraged the Fund to take a leading role in resolving the situation. The Managing Director, Jacques de Larosière, brokered a bargain among a diverse group of actors: the Mexican government, the private banks, creditor governments, and the IMF itself. Because the private banks had the most to lose from outright default, and because they could be relatively easily located and brought into the negotiations, de Larosière prescribed a particularly important role for the banks in the financial rescue package. As the Managing Director threatened to withdraw the Fund's participation, and thus the package of policy adjustments pledged by the Mexican government in exchange, unless the private banks were forthcoming, the banks' commitments were described as 'forced lending.' When the dust of these negotiations settled in early 1983, the private banks had contributed \$5 billion in 'new money,' while the Fund had loaned \$1.3 billion and national governments \$2 billion. In addition, the commercial banks had rescheduled \$20 billion in outstanding loans (Kraft, 1985; Volcker and Gyohten 1992).

As other countries became unable to service their debt, this rescheduling formula was broadly replicated, with amendments, in each case. Under the crisis packages developed by the Fund, the private banks were asked to cough up additional funds — 'involuntary' or 'non-spontaneous' lending — to which they objected but ultimately acceded. The Fund performed the central role in a strategy, developed mainly in the US Treasury and Federal Reserve, to avoid outright default, avoid debt forgiveness, return the indebted countries to full debt service, and sustain the value of loan assets on the books of the banks until such time as bank exposures as a percentage of capital could be reduced. In these cases, as in the Mexican case, the IMF contributed some of its own funds on a conditional basis. The conditionality was designed to produce the stabilisation necessary for debtors to service both their new and existing obligations.



American policy subsequently evolved from the original Mexican formula, to the Baker Plan of 1986, and the Brady Plan of 1989 (Cohen, 1992). This succession of debt strategies increasingly recognised the necessity of some degree of debt relief and contributed increasing amounts of government funds to the solution. In the late 1980s and early 1990s, banks had to set aside loan-loss reserves and write down the value of many of their assets.

These debt strategies nonetheless proved to be very successful from the standpoint of the interests of the private banks. With the help of the IMF, bank losses were spread out over a sufficiently long period of time that the banking system could absorb them. Contributions to financial packages on the part of the Fund and creditor governments enabled some small and medium-sized banks to shed their bad loans as the debt problem persisted. Indeed by the time the debt crisis faded away in the early 1990s, the main threat to many international banks was overlending in their *domestic* markets. The defusing of the debt crisis was a monumental achievement, from the banks' perspective, considering their enormous exposure at the outset. The Fund thereby helped to save the banks from the most drastic consequences of their collective overlending in the late 1970s and early 1980s.

*American politics.* The evolution of American domestic politics with respect to the Bretton Woods institutions during the debt crisis is instructive. When the first Reagan administration entered office, it promptly launched an attack against international organisations and American participation in them in general and against the Bretton Woods institutions in particular. (US Treasury 1982; and Gwin 1994) The analysis advanced by that administration was that the private sector would undertake any international lending that was worthwhile; if private financial institutions were unwilling to lend, then the level of risk was too high to justify using government funds either directly or indirectly through multilateral institutions.

The Reagan administration completely reversed its policy, however, with the outbreak of the Mexican debt crisis. Treasury Secretary Donald T. Regan moved to support an increase in quotas for the Fund, and in 1983 proposed this to Congress. Having inflamed the passions of Fund critics on the right and then reversing position so blatantly, however, Treasury confronted opposition in both the Democratic House and the Republican Senate. Both the right and left wings of the political spectrum objected to 'bailing out the banks.' (US House 1984; and Kahler, 1990) In the event, the centre held and the quota increase was approved by a narrow margin. Though the banks were not popular on Capitol Hill and could not take a high-visibility position on the quota increase, their behind-the-scenes support was critical to this result, and in particular to the administration's decision to lend its political weight to the cause in Congress. Without the active support of the banks, it is doubtful that there would have been a Fund quota increase in the first half of the 1980s.

*e. After the Debt Crisis*

The strategy by which the debt crisis was resolved, while safeguarding the interests of the banks, stimulated a broad spectrum of nongovernmental organisations (NGOs) and developing country governments into opposition to the policies of the Bretton Woods institutions. As a critical part of the attenuated workout strategy adopted during the debt crisis, the Fund and Bank imposed stiff conditionality on borrowers. Policies designed to stabilise the economies of the large debtors contributed to prolonged stagnation within them, which in turn spawned opposition from several sources to not only conditionality but the Bretton Woods institutions themselves. Opposition naturally emerged within borrowing countries among the domestic groups directly affected by the reduced government spending and tax increases imposed by the Fund and Bank. But opposition to conditionality, and to the Bretton Woods twins, also emerged among a host of nongovernmental organisations (NGOs) that worked for humanitarian and developmental causes within these countries, such as Oxfam, CARE, Catholic Relief Services, among many others, and United Nations organisations such as UNICEF. The dislocations that accompanied austerity policies — increased unemployment and poverty and cuts in poverty alleviation programmes of local governments — shifted a larger burden onto these NGOs. Modern technology — principally the facsimile machine and Internet — brought together in a particularly effective way disaffected groups within borrowing countries, opposition in advanced countries, and the NGOs. The NGOs in turn took it upon themselves to oppose the policies of the Bank and Fund in developing countries, making their opposition known both directly to these organisations and to the primary shareholders, the member governments.

One critical point of entry into the policy process for NGOs was national legislatures, the US Congress in particular. NGO activism accounted for a notable increase in congressional interest in the work of the Bretton Woods institutions in the late 1980s and early 1990s. Other national legislatures have also taken a more active role in their nation's politics in these organisations. Legislatures have been a force, for example, for greater public disclosure of analysis, lending agreements, and surveillance consultations of the Bank and particularly the Fund. Several, the US Congress included, have enacted instructions to their governments on how to vote in Executive Board decisions. Resistance to this 'interference,' originating largely from finance ministries which tend to control national policies within the Bank and Fund, has generated additional domestic political opposition to these institutions.

The end of the Cold War represents another important, although *nonfinancial*, change in the international environment of the Bretton Woods institutions. Liberalisation and reform of countries in transition from centrally planned to market economies brought a new group of countries into the membership of the

two institutions, countries with new problems and needs for substantial amounts of financing (Allen, 1992). Both the Bank and Fund made adjustments to accommodate the new geopolitical landscape. The Fund created a second European department and, on the initiative of the industrialised member states, created the Systemic Transformation Facility (STF) to facilitate the structural shift to market economies and attenuating the usual requirement of satisfying stabilisation conditions. An effort on the part of the industrialised countries to distribute SDRs to the countries in transition failed owing to the united opposition of the remaining developing countries to a special, as opposed to a general, allocation. The industrialised countries viewed the international financial institutions principally as mechanisms to channel resources to the countries in transition without having to tap overburdened national budgets; the opposition of the developing countries placed clear limits on this strategy.<sup>2</sup>

The Bank expanded programmes in the countries in transition and created a new vice presidency for Europe and Central Asia to direct this new effort (Dervis, Selowsky, and Wallich, 1995). China became the largest borrower from and the second largest debtor (behind India) to the Bank. The European governments, not content to have the US-based World Bank alone address the development needs of the countries of Central and Eastern Europe, wanted their own institution and created the European Bank for Reconstruction and Development (EBRD).<sup>3</sup>

These developments, however, did not fundamentally change the nature of the relationship between the Fund and the Bank on the one hand and the private financial markets on the other. Private financial institutions had no stake in the countries in transition at the beginning of the 1990s similar to that in the highly indebted countries at the beginning of the 1980s. No Western bank was threatened with immediate bankruptcy. The Bretton Woods institutions thus responded more slowly to the changes in Central and Eastern Europe than they responded to the debt crisis. However, the institutions' policies in this region — stressing privatisation, development of banking and financial systems and openness to capital flows, in addition to economic stabilisation — were consistent with the interests of private financial institutions.

### 3. PRESENT CHALLENGES

Challenges of two sorts currently confront the Bretton Woods institutions. At the international level, the increasing mobility of capital and the changing

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<sup>2</sup> For a discussion of the caucus of developing countries on monetary and financial matters, the Group of Twenty-Four, see Henning (1992).

<sup>3</sup> The United States is a member of the EBRD but possesses less voting strength than within the World Bank group.

composition of capital flows magnify the potential size of financial crises and urgency with which governments and multilateral institutions must respond to such crises. At the domestic level, shifts in the particular private financial institutions that are engaged in distributing capital abroad are potentially eroding political support for these institutions. The present section explores the political economy of direct finance at both levels.

*a. Highly Mobile Capital*

Capital has become increasingly mobile over the course of the last three decades. At the end of the 1980s and early 1990s, capital mobility reached new heights, flowing through a broader range of financial markets and benefiting a larger number of countries.

By the beginning of the 1990s, the debt crisis was more or less resolved as bank exposure to the precarious debtors fell to acceptable levels as a proportion of bank capital. Moreover, during 1991–93, interest rates fell to a cyclical low in the United States and other advanced industrial countries. As a consequence, developing countries, particularly those that had instituted market-oriented reforms, now offered relatively attractive returns to capital. International investors responded in droves. Capital inflows to developing countries rose from low levels of \$21.6 billion in 1988 and \$41.2 billion in 1989 to extraordinarily high levels of \$110.7 billion in 1992 and \$115.7 billion in 1993 (IMF, 1993).

Equally importantly, the composition of those capital flows changed as well. Banks, still chastened by their experience in the 1980s and restrained by the weight of domestic problem loans, were slow to resume lending to the so-called 'big emerging markets'. Rather, capital flowed through other channels: direct investment and portfolio investment in equity stock and bonds. For developing countries as a group, during 1990–93, banks' share of capital flows declined to 17 per cent, direct investment rose to 51 per cent, equity rose to 16 per cent, and bonds rose to 15 per cent (Fernandez-Arias and Montiel, 1995). While banks accounted for two-thirds of inflows to Latin America in 1981–82, they accounted for only 10 per cent in 1991–92 (Cline 1995a). Cline (1995a) estimates that, owing also to the conversion of bank debt to bonds under the Brady Plan, bonds now account for 80 per cent of outstanding Latin American debt.

Indeed, by 1994, excessive capital inflows became a problem for several of the emerging markets, including the big three Latin American debtors, Mexico, Brazil, and Argentina. Such flows caused the currencies of the recipients to appreciate and forced their central banks to purchase foreign exchange, threatening to undermine successes in price stabilisation. A number of prescient analysts warned of the danger of precipitate capital withdrawal (Calvo 1994).

*b. Political Economy of Direct Finance*

The shift in the composition of international capital flows brings new actors with different concerns to the politics of the international financial institutions and financial crises. Bank lending is very different from capital market financing, of course. Whereas banks intermediate the flow of funds between savers and borrowers — ‘indirect finance’ — the markets for stocks, bonds, and short-term financial instruments transmit funds without intermediation — ‘direct finance.’ The differences between indirect financing and direct (or ‘capital market’) financing have major consequences for the political economy of international finance.

*Homogeneity.* To begin with, banks are homogeneous relative to holders of international stocks and bonds. Although banks vary in size and character, including small, regional, and large money-centre institutions, all banks take deposits or borrow on the money markets to lend at longer maturities. Investors in developing country capital markets, by contrast, range from large institutions to individuals, with institutions comprising mutual funds, pension funds, and insurance companies, among others, each engaged in very different lines of business.

*Centralisation.* Secondly, banks are more centralised than are nonbank investors. To spread the risk of international lending, banks syndicate large loans. A lead bank organises the subscriptions of other banks and the mechanics of the dispersal of funds and receipt of payments. Typically, the large banks dominate international lending syndicates. When a debtor cannot pay, the banks with greatest exposure, usually the leaders of the largest syndicated loans, comprise the bank steering committee responsible for negotiating a rescheduling agreement. The results of this agreement are communicated to other bank lenders through a hierarchy defined largely by share of participation in the syndicated bank groups. Bank coordination is facilitated by the geographic concentration of the large banks in financial centres, New York, London, Tokyo and Frankfurt being the most important.

By contrast, nonbank investors are more dispersed geographically. The process of lending through capital markets does not automatically bring investors together; they remain decentralised. When a debtor cannot pay, no pre-arranged mechanism exists for facilitating communication among investors, aggregating investor interests, and coherently representing investors in negotiations with debtors.

*Regulation.* The nature of governmental regulation and prudential supervision of banks and institutional investors also affects the solidarity of interests, centralisation, and communication within each group. Banks are regulated by relatively few agencies (although in the case of the United States that may be still too many from the standpoint of prudential efficiency).

Institutional and individual investors, being heterogeneous, have a multiplicity of regulators. Insurance companies, pension funds, and mutual funds, for example, are each responsible to different regulatory agencies.

The varying form of regulation has several implications. First, the institutional structure of regulation helps to define the interests of creditors in the regulatory process and identify their natural allies and potential competitors in attempts to influence government policy. Second, because regulators often become advocates for 'their' private sectors — a process called 'regulatory capture' — banks tend to have more cohesive advocacy within government than do portfolio investors. Third, and perhaps most importantly, regulatory relationships give banks access to those agencies of government — in the United States principally the Treasury and Federal Reserve — responsible for international financial policy, foreign relations with large debtors, and policy within the international financial institutions. Regulators of institutional investors, on the other hand — state insurance commissioners, the Securities and Exchange Commission, the Labour Department, in the case of the United States, for example — are generally completely outside the international financial policy 'loop' within national governments.

*Feasibility of Exit.* Finally, by virtue of the financial instrument, banks are more committed to their debtors than are investors, for the term of their loan. Investors in developing country stocks and bonds can more easily 'exit' by selling their assets on the capital markets on which they bought them. The greater possibility of exit lessens the likelihood of collective action among investors compared to bankers.<sup>4</sup>

Each of these differences aggravates dilemmas of collective action by investors relative to bankers in financial emergencies and debt workouts. They raise the cost of organising investors, relative to bankers, to avoid creditor panic and to renegotiate international debts. They render investors as a group a less cohesive bargaining partner than bankers for not only the debtor but also the

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<sup>4</sup> This argument about exit stands in spite of three potentially countervailing considerations. First, a secondary market in bank loans evolved in the 1980s to permit banks to shed under-performing assets. Nonetheless, these markets are not typically as liquid as the capital markets and do not exist in the case of loans to some borrowers. Exit therefore generally remains a more feasible and less expensive strategy for investors than for banks.

Second, exit from both banking markets and securities markets can be blocked by a foreign exchange constraint: neither a banker nor investor can repatriate proceeds if no foreign exchange is available. This, however, is only true in the extreme case where the foreign exchange constraint is binding. One attraction of bonds, shares, and short-term paper, furthermore, is that they may sometimes be traded offshore.

Third, as noted by Cline (1995a), holders of securities might not be able to exit without selling at a loss. To the extent that such a penalty exists, however, it dramatically strengthens the incentive to cut losses by beating other investors out of the market, and thus aggravates the tendency toward creditor panic.

governments of the creditors and the IMF and World Bank.

These organisational differences between bank and capital market financing have profound consequences for the political economy of the Bretton Woods institutions at both the international and domestic levels (discussed in the next two sections respectively). At the international level, collective action in debt and crisis management is more difficult and costly to organise. The absence of a reasonably cohesive creditor bargaining partner works to the disadvantage of all parties in financial emergencies where defection is individually tempting but collectively disastrous. It shifts the roles of the bargaining partners, including the roles of the Fund and Bank, and the balance of influence and authority among them.

### *c. Mexican Packages Compared*

A comparison of the two Mexican financial crises illustrates nicely the impact of changes in the composition of capital flows on crisis outcomes. When Mexico could no longer service its debt in August 1982, its main creditors, the international banks, formed a relatively identifiable and organised group, with which the Mexican government could negotiate, and with which the IMF could play an important role as broker, specifying appropriate conditionality for Mexico and appropriate financial concessions on the part of the banks.

By contrast, in 1994–95, when nonbank investors held most of the Mexican external debt, creditors did not form a cohesive group and creditor panic materialised. No negotiation was possible with the bulk of the creditors as a group. Given the ability of investors to exit by selling Mexican paper, moreover, rapid action was required. The rescue effort was led by the United States Treasury, rather than the IMF, and it was the Treasury that asked the Fund and other industrialised countries to contribute. The international banks were asked to provide a very small portion of the financing (\$3 billion), which they ultimately declined to supply. The main direct beneficiaries of the rescue, the investors in Mexican obligations, were not asked to make any sacrifice (although the market value of some of their assets declined). Instead, the US government pledged \$20 billion in short- to long-term loans and the IMF committed \$17.6 billion. This commitment was seven times Mexico's quota at the IMF, the largest line of credit ever offered by the Fund to any country in its fifty-year history.<sup>5</sup>

The mix of official and private funds therefore differed markedly in the two Mexican rescue cases. Whereas the 1982–83 package provided mostly private concessions supplemented with government and multilateral loans, the 1995

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<sup>5</sup> The central banks provided short-term bridge financing through the Bank for International Settlements in both cases, but much larger amounts (\$10 billion) in 1995 than in 1982 (\$1.85 billion).

rescue package was entirely official financing. The difference in the mix coincides with, and is causally related to, the difference in the composition of creditors.

Several commentators argue that the outcome of the Mexico package reflects the power of American institutional investors over the US Treasury. The argument presented here, however, is exactly the opposite, that the benefits accruing to private investors from the rescue package are an example of the paradoxical strength of weakness (Schelling 1960). Because investors could not be organised quickly and effectively, creditor panic was severe and potentially very costly. The Clinton administration could hardly ignore the political and economic problems, extending to destabilisation of the international financial system beyond Mexico, that such panic would create if left unchecked. Despite having come to Washington from the Wall Street investment bank Goldman Sachs, US Treasury Secretary Robert Rubin denied that bailing out private investors was a motive in the Mexican rescue. Despite widespread scepticism regarding this denial, there has been little documented evidence of direct lobbying on the part of institutional investors for the Mexico package.

#### *d. Domestic Politics*

The organisation of international capital flows — through banks versus capital markets — affects not only the mix of private and official financing in rescue packages but also the *domestic* political economy of the Bretton Woods institutions. As with the international effects of the composition of capital flows, the domestic effects stem from dilemmas of collective action among private financial actors; but in the domestic case the dilemma is with respect to influencing policies of national governments.

Each of the factors discussed in the previous section — homogeneity, centralisation, regulation, feasibility of exit — magnify problems of collective action for investors relative to bankers in domestic lobbying. This dynamic operates in exchange rate policy (Henning 1994), and also applies to government policy towards and within the international financial institutions.

Individual and institutional investors in developing country securities are not mobilised to influence international financial policies of the government. Even if they were organised, they would not have the entrée to the policymaking process that the banks have, because the principal regulators are not the agencies making international financial policy, the Treasury and Federal Reserve. Investor interests, therefore, do not constitute a mobilised constituency for an activist role for government, the Fund, or the Bank in international liquidity crises such as that in Mexico during 1994–95, even when investors would benefit from such activism. Investor interests, furthermore, are a much weaker domestic constituency than banks for US (and other nations') support for the Bretton



Woods institutions.

Consider American politics in the two Mexico cases. The Republican party, in both 1982-83 and 1994-95, had recently achieved political gains in American government. During the first episode, Republicans controlled the US Senate as well as the presidency. During the second episode, Republicans had recently won control of both houses of Congress in the stunning landslide election of 1994. Republican ascendancy coincided with intensification of criticism of the Bretton Woods institutions, the IMF in particular, from the right. Such criticism was delivered by such figures as Patrick Buchanan in presidential politics and Jesse Helms in the Senate, and critics often went so far as to propose strict limitations on American participation and even withdrawal. The attack from the right was joined by forces on the left, to confront American supporters in the centre with a formidable coalition of extremes.

The role of private financing, critically, differed in the two episodes, principally because different private interests were involved. The banks were active in 1982-83, as noted above, in support of the Mexico package and an increase in IMF resources and IMF activism to manage future contingencies in the evolving debt crisis. When the Fund adopted the critical role of broker in debt workout packages, American banks urged the US government to be supportive, notwithstanding their distaste for forced lending. Their support, while necessarily low-key, was critical to the political centre's prevailing against the coalition of extremes.

In 1994-95, institutional investors and other private investors held the principal stakes as creditors. The banks were disengaged and were likely to remain so because they had minimal exposure. They were thus less active in domestic politics and provided little counterweight to the coalition of extremes.

The disengagement of the banks also bodes ill for future US support for strengthening the Bretton Woods institutions. Specifically, it suggests that the Clinton administration and future administrations cannot count on congressional support for expanding the General Arrangements to Borrow (GAB), as proposed at the Halifax summit (Group of Seven, 1995), and could well encounter strong opposition to any proposal to increase the quotas of the Fund. Given the opposition in Congress to the Mexican rescue package, which extends in part to the international financial institutions, any weakening of support from the financial sector could be critical.

#### 4. CONTEMPORARY ADAPTATION

The argument presented here suggests that the Bretton Woods institutions have adapted over time to changes in their international economic environment. Of particular importance has been their complementarity with private financial

markets; as the latter evolved, so too did the roles and missions of the World Bank and International Monetary Fund. With financial change in the late 1980s and early 1990s, the Bretton Woods institutions are in the early stages of yet another round of institutional adaptation.

*a. Complementarity with Capital Markets*

The displacement of bank finance by direct, capital-market finance creates new requirements for international organisations. Of particular importance is the role of official institutions in the provision of information. While both banks and capital markets require good information about borrowers in order to assess creditworthiness and risk, the relationships that banks possess with borrowers give them a comparative advantage over capital markets as channels of finance when information is scarce. The existence of public and inexpensive information undercuts banks, relative to capital markets, as preferred creditors.

It is no coincidence therefore that present proposals to reform the Fund stress the provision of information that would permit capital markets to work more efficiently. When the G-7 leaders met in Halifax in mid-June 1995 to consider institutional reform, the area of greatest agreement was on the need to strengthen the Fund in overseeing the provision of economic and financial data by member governments to the markets. The G-7 summit intended that such oversight should contribute to 'an improved early warning system' (Group of Seven, 1995). Better data would enable capital markets to price risk appropriately and would contribute to financial market stability by smoothing changes in market expectations.

The heads of government also agreed at Halifax that the Fund should strengthen multilateral surveillance, provide 'sharper' policy advice to all governments, 'and deliver franker messages to countries that appear to be avoiding necessary actions.'<sup>6</sup> This means that the Fund staff should be more forthright and hard-hitting when it identifies policy maladjustments in member countries and convey its assessments of these problems officially but confidentially to the government during Article IV consultations. Some governments, notably the United States, are also pressing for public release on a voluntary basis of the record of Article IV consultations. This has been resisted by a majority of the membership, which fears that voluntary release by some governments would put strong public pressure on others to follow suit. The US Congress is attentive to this cause and the issue will almost certainly be revisited

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<sup>6</sup> Goldstein (1995) proposes that the Fund go further and in egregious cases gently but publicly blow the whistle on governments that have mismanaged their economies by, for example, maintaining an overvalued currency, as in the case of Mexico. By policing the provision of data among its members, the IMF would go a long way toward fulfilling this role.

periodically.

For instances where early warning and multilateral surveillance fail to prevent crises, the G-7 proposed that the Fund create an 'Emergency Financing Mechanism' to be financed by a doubling of the General Arrangements to Borrow (GAB). As grounds for advocating this, the G-7 explicitly invoked the 1994-95 Mexican financial crisis. (The proposal received further impetus from the finance ministers and central governors of the G-10 the following October.)

However, the G-7 stopped short of endorsing several other proposals. Rather than proposing another review of quotas, the G-7 urged only a 'continued discussion' of the matter. Rather than proposing the development of orderly workout arrangements directly, the summit only vaguely encouraged review within the G-10 of 'other procedures that might usefully be considered' for the orderly resolution of debt crises.

The World Bank is also the object of pressure to seek roles that are complementary with private finance, capital markets in particular. For example, the Bank is seriously considering substantially increasing the use of loan guarantees in addition to the use of conventional loans, a proposal offered several times in the past with little success (Richardson and Haralz, 1995). The Bank is being nudged out of lending sectors covered by private markets — which increasingly includes infrastructural investment in some countries — and into education, social programmes and environmental defence. The Bank has also begun using NGOs in the implementation of some of its programmes.

We have yet to see how much progress the proposals of the Halifax summit will make. Although a G-7 consensus may be necessary, it is not sufficient to ensure implementation. As acknowledged at the outset, the preferences of private finance are not perfectly reflected in adaptations of the institutions; they are filtered and refracted by national governments and their relative standing in the executive bodies and decision-making processes within the institutions. The argument presented here suggests, nonetheless, that the proposals that are likely to prosper are those that have the backing of private finance.

#### *b. Countering Financial Instability*

The diverse, decentralised character of the private creditors to emerging markets and developing countries in general in the 1990s requires a re-examination of the international mechanisms for debt crisis management. The workout strategy of the 1980s — with the IMF setting the conditions for debtors and identifying commitments needed from creditors for successful rescheduling — succeeded in preventing systemic collapse because the primary creditors, the banks, could be identified and made party to the agreements. The current diversity of creditors jeopardises this strategy in the future, as the Mexico 1994-95 case demonstrates.

Precipitate capital withdrawal can be triggered by smaller, less drastic policy errors than in the past and is now more likely. The resulting crisis, though, is also more likely to be a liquidity problem (as opposed to a solvency problem) and thus amenable to bridge financing. Even if the Mexican crisis is not repeated on the same scale elsewhere (Cline, 1995b), therefore, there is a strong case for the public sector and international financial institutions to play a central role. Given this diagnosis, the G-7 endorsement of the emergency mechanism and doubling of the GAB is wholly appropriate. Raising the US line of credit through the GAB, however, requires the approval of the Congress and other national legislatures, where it is bound to meet political resistance.

The problem of creditor panic in the new financial environment also bolsters the case for creating the orderly workout arrangements that the G-7 leaders shied away from at Halifax. Under such arrangements, debtors finding themselves in an untenable financial position could seek protection from creditors by filing for bankruptcy with the appropriate agency. They would be eligible for debtor-in-possession financing — credit which would be senior to pre-crisis credit — to sustain their international trade and prevent economic collapse. They would negotiate with creditors for restructuring of debt and domestic economic stabilisation. Creditors, voting by class (banks, bondholders, holders of short-term debt instruments, etc.), would approve the stabilisation package; but small minorities of creditors would be *unable* to block agreement (Cohen, 1989; Williamson, 1992; Sachs, 1995; Hurlock, 1995).<sup>7</sup>

Such arrangements for dealing with international bankruptcy might take the strong form of a new subagency of the IMF and World Bank (Cohen, 1989; Sachs, 1995) through an amendment to the Articles of Agreement of the Fund and Bank. Alternatively, much of the same mechanism could be created through amendments in national law, such as the US Foreign Sovereign Immunities Act (Hurlock, 1995). Another possible solution would be to offer insurance to bondholders through an international agency (Cline, 1995a), and let the agency negotiate directly with the defaulting debtor; although this solution would treat only the portion of future debt problems represented by bond debt. Identifying the ideal mechanism requires further study and is beyond the scope of this article. Given the new financial environment, however, the case for such arrangements, closely associated with or located within the Bretton Woods institutions, is strong.

Would such arrangements receive requisite political support within key countries, the United States in particular? Banks and investors can be expected to withhold support as long as their interests are protected by emergency financing offered by governments and official financial institutions. Banks successfully managed to work out their problems of the 1980s and, if confronted with the same

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<sup>7</sup> See, as well, Eichengreen and Portes (1995).

problems in the future, would probably prefer to repeat the exercise without institutional innovations. Institutional investors, having been rescued for the moment by the 1995 Mexican financial package, are not presently motivated to seek institutional change.

Rescue packages of the 1995 variety will meet increasing domestic political resistance in the United States, however, even ones of more moderate size. Congress balked at approving large loan guarantees for Mexico in January 1995 and later registered its displeasure with the Clinton administration's use of Treasury funds that did not require congressional approval. Nothing like the magnitude of the American and IMF commitments to Mexico in 1995 is thus likely to be politically feasible for the foreseeable future. Orderly workout arrangements are attractive, among other reasons, because they would avoid a call on the financial resources of governments and thus meet a principal objection of national legislatures.

If, owing to the refusal or inability of governments and multilateral institutions to mount a rescue, a future crisis devastates some private investors, investors might well see greater virtue in arrangements that would limit losses and secure partial repayments in a more orderly way. The political climate for orderly workout arrangements might become more favourable. For investors to affect the policy process, however, they would have to become more politically mobilised than at present. This is not impossible: the financial history of the 1930s, for example, shows that bondholders can organise in a crisis. But the decentralisation of capital markets and investors suggests that such mobilisation requires much more energy and entrepreneurship than organising banks for collective action.

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# THE WORLD ECONOMY

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