Why did the International Monetary Fund change its policy approach in dealing with the 2008 financial crisis?

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Ana Ivanovic, Ruth Odipo, Eniana Kociaj, and Verónica Romanowski

Introduction

The severe financial crisis of 2008 left most of the European countries with inappropriate economic policies intended to counter the crisis. In this intention, in restructuring the international financial system (and governance), there are several actors involved: the European Union, the Group of 20, national governments, and international organizations, namely the International Monetary Fund (IMF).

The solutions proposed by the IMF at the beginning of the crisis, following its traditional homogeneous austerity policies, have not only shown themselves to be unsuitable to fight negative consequences of the crisis, but have themselves stiffened the scope of the crisis, and have therefore, been largely contested (not only by different groups in global civil society, NGOs, and the Fund's member states, but also by the Fund itself). The IMF governance is under an international crisis of legitimacy (Seabrook 2007: 1) and needs reconsidering.

This contestation, among other factors has led a shift in IMF policies, together with the enacting of a series of internal reforms, aimed at strengthening the Fund's governance legitimacy.

The IMF's policies have been largely contested in the past 30 years, but especially on the verge of the Asian crisis of 1997-1998. Nonetheless, this contestation to IMF's financial governance hegemony did not conclude in such a policy shift comparable the one observable during the Great Recession period. The question is: why? What makes today's scenario different to that of 15 years ago?

"While the organisation has continued to promote conventional loan policy targets aimed at achieving low inflation, low budget deficits, and sustainable public debt, the preliminary evidence also suggests the IMF is developing a more flexible approach to crisis management in borrowing member states. Changes include a greater tolerance for unorthodox policies such as short-term capital controls, greater differentiation in the treatment of borrowers based on their economic circumstances, easier access to precautionary IMF financing for prime borrowers, and more flexibility in the use of loan conditionality."(Broom 2010: 37)

This paper will examine the reasons why the IMF changed its policy approach towards the countries in crisis and how this is related to a change in the *material condensation of relations of forces* of a second order (Brand 2007).

"The IMF now accepts that for every £1 cut from government spending, the reduction of economic activity as a whole is potentially as much as £1.70 – far higher than the £1:£1 ratio the IMF's original predictions were based on, and of course in completely the opposite direction that British Government policy is based on: that cuts in Government spending will be more than replaced by increased private sector expenditure (based on the so-called 'crowding-out hypothesis'.)" (Tudor 2012).

Up to the crisis in 2008, that is, up to the breaking point in 2011, the policy responses used by IMF were in many ways similar to those used in other crisis in history. First, IMF tried to contain liquidity of countries giving the substantial liquidity support and guarantees to the banks on their liabilities. On the decision making side, a wide set of instruments was used this time as many times before, asset purchases, asset guarantees, and equity injections (Laeven and Valencia 2012: 12). Austerity measures in heavily indebted southern countries, huge cutbacks in government spending that drew with itself huge layoffs in government employment. Instead of helping the injured economies the insufficient demand and economic activity led to a deeper crisis. Social movements got stronger resilience towards IMF and sister institutions. Both people and governments start losing confidence in IMF, European Union, World Bank in resolving the consequences of crisis.

Academic discussion

At the core of theoretical reasoning of the IMF are the Neoliberal principles of the economy, proven in this as in many crises before. Neoliberalism and its four core ideas were presented in many interventions made by IMF. In its core the idea of monetarist analysis of inflation developed by Milton Friedman lately developed as inflation targeting – which should send a clear message to consumers, businesses and investors that price stability is established and therefore interest costs should be expected to fall or at least not rise. Still there is no economic evidence, nor economic agreement among authors, that inflation above 2-3 percent a year would impede economic growth.

Neoliberalism preaches about the self-equilibrating markets in the long run, and that any government intervention would be dangerous, unnecessary or rather obstinate. To them any government policy designed to increase the rate of economic growth and reduce the unemployment rate would be neutralized by consumers and businesses. The peak of this kind of thought can be found in Ricardian equivalence. This equivalence states that if Keynesian fiscal stimulus were adopted, consumers would save an equivalent amount of stimulus because its rational expectations would warn them about the future government raise in its taxes in order to compensate for the extra stimulus. (Peet 2003: 11)

Therefore, in beginning of the crisis the Keynesian fiscal stimulus programs (infrastructure expenditures and/or more generous support of social programs) that were suggested by some international organizations in late 2008 were adopted only by a small number of countries and were rather ephemeral.

Still, in the unfolding of the financial crisis (we will take 2009 as the cutting point) the Chief Economist of IMF, Olivier Blanchard, published “Rethinking macroeconomic policies”, admitting that the IMF was standing on the wrong side of the theory discourse, and that “Keynes was right”. Austerity programs did not help. The IMF became alarmed by the persistent austerity measures, as it realized that most of the developed world could lead to weaker and weaker growth even in the emerging economies like Brazil and China. Keynes argued that increased government spending creates a ‘multiplier’ with a strength greater than 1 (which means that government investing in public projects in the period of crisis will have greater impact on the economy and will push it further than the initial money infusion onto the market). On the other side, cuts in Government expenditure also have a multiplier effect greater than 1.

In our theoretical approach we will lean on the Neo-Gramscian reading of Nicos Poulantzas' state theory provided by Ulrich Brand in his notion that "the *material condensation of societal relations of forces of a second order and the related international state apparatuses* (INTSA) are central to an understanding at an international level" (2007:6).

We argue that the IMF, as an international state apparatus, maintains strong linkages with national states, especially with those countries which are powerful and "overrepresented" in the Fund's internal governance architecture, such as EU countries and the USA. In this sense, the "shift" in IMF's policies and internal governance reform actually represent the changes "pertaining to socio-economic reproduction and the associated relations of forces" (Brand 2007:5). Therefore, we will explore the concept of hegemony in the form of bourgeois domination.

<u>Research Question and a Unit of Analysis</u>

Research question: Why did the International Monetary Fund change its policy approach in dealing with the 2008 financial crisis?

<u>Unit of Analysis:</u>

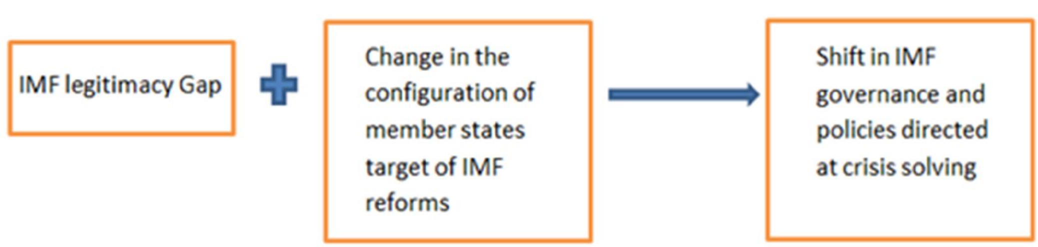
-IMF policies

-Internal governance architecture

-Group of countries receiving credits

<u>Hypothesis</u>

IMF's legitimacy gap, coupled with a change in the configuration of member states receiving IMF's credits (in the 2008 crisis, the global north countries), led to a shift in IMF's internal governance and policies directed at crisis solving.



In concrete, three forces were colliding to induce a reform in the management of the IMF. First, the IMF itself had huge financial problems and needed very fast solutions: either to find new borrowers or a new way to generate income. The response that the IMF provided to the countries affected by the East Asian financial crisis during the period of 1997–1998, had significantly damaged the policies of IMF and its legitimacy. Even the mainstream economists lost explanatory power to justify certain moves of the IMF. Korea, Russia, Brazil and Argentina, the biggest borrowers, and therefore the biggest fee-paying contributors to the IMF income, had abandoned it in droves, preferring to look for loans elsewhere even at the expense of higher interest rates. The IMF's income was suddenly oppressed, leaving the institution with a deficit of US$400 million. That even forced one of the most powerful international institutions to lay off 300–400 of its own staff, which is around 15% of the total of employees (Woods 2010).

Second, the East Asian crisis outcome cried for regaining the legitimacy and the assurance of key member countries.

Finally, the major changes in the world economy could not leave the IMF unaffected. IMF was pressured to adapt to it and to shift its policies towards the new international financial setting. Among these changes, the United States shift from being the world's largest creditor and one of the IMF creators to becoming the world's largest debtor in 2009. In this line, the European countries in crisis also became target of IMF economic restructuring, flipping from loans providers to loans receivers. Further changes in the international governance setting relate to the rise of China and other emerging economies, nucleated in the Group of 20, as contending actors in defining the policies to be applied when targeting crises (Woods 2010: 3).

The IMF itself acknowledges that the last set of governance reforms are intended to "better reflect the global economy" and "to strengthen its legitimacy" (IMF 2013).

In November of 2010, the IMF passed a wide set of governance reforms "to reflect the increasing importance of emerging market countries" (IMF 2013). These reforms were made effective in October 2012. Among the implemented changes, the 14th General Review of Quotas was also agreed upon and made effective on March 3, 2011. "The package includes a doubling of quotas, which will result in more than a 6 percentage point shift in quota share to dynamic emerging market and developing countries while protecting the voting shares of the poorest member countries. The reform will also lead to a more representative, fully-elected Executive Board." (IMF 2012) Of the 188 members, 54 countries received an increase in their quotas, being main beneficiaries Brazil, China, Korea, and Mexico. Simultaneously, the voting power of over 130 members –mainly "low-income" countries- was increased. Therefore, the governance reforms of the IMF included an important shift in quota share to emerging markets and developing countries.

Substantive Focus

Following this set of IMF internal governance reforms and the changes in the recipes prescribed in solving the global financial crisis -namely following unorthodox policies, greater differentiation in the treatment of borrowers, and more elasticity in loan conditionality- our research has a substantive focus on two historically contextualized cases: a) IMF's policies and internal governance configuration during the Asian Crisis of

1997-1998 and early 2000's (IMF legitimacy crisis starting point); and b) IMF's policies and internal governance configuration during the Global financial crisis of 2008-2013 (with focus on EU and the USA). We decided to take a clear cut in mid-2013 for the second period of time frame, respective to the whole application and implementation of the set of IMF's governance reforms.

A descriptive section will provide comparison of the applied IMF policies during these two periods. In order uncover how our proposed factors led to such a change in the IMF's position towards the crisis, we will evaluate the governance institutional structure of the IMF, as well as the financing and income creation mechanisms, together with the external factors, namely contending groups of global civil society agents (Brand 2007), which led to the increase of IMF's legitimation gap, which represents a change in the condensation of social relations of forces of a second order), causing the need of internal reforms as well as the shift in the IMF's policy approach.

Theoretical framework

The theoretical background on which our hypotheses will start being analyzed is particularly the Gramscian concept of hegemony. To start with hegemony is defined as "leadership through the active consent of other classes and groups" (Scherrer 2001: 573). The concept of Hegemony within and beyond Gramsci still remains a key concept among scholars in explaining different relations of power and domination. Gramsci has been considered as a departure point in conceiving hegemony as a theoretical unit, because of his new way of dealing with power relations in capitalist modes of production and because with him the articulation of the notion of politics and hegemony found a theoretically mature expression (Laclau & Mouffe 2001; Anderson 1976).

Furthermore, from a Gramscian perspective we will refer to the hegemony of finance capital as today's capitalist mode of reproduction and as a "societal formation" (Bieling 2013) within a certain configuration of power relations. From this point of view, key analytical concepts used for our purpose in this paper will be subordination, consent and struggle (here financial crisis), which will then lead us on different level of analyses such as (Bieling 2013: 285-286) the articulation of particularly political economic processes within a specific historic capitalist formation; the socio-political alliances and political projects/actors which reproduced and reconfigured the hegemonic position within the IMF. Moreover, the period of crisis (struggle) will help us have a deeper consideration on the (re)configuration of the hegemonic position within IMF, because being "crisis" the momentum that makes visible the struggle, it is also the moment when the legitimacy of certain power relations start being questioned, thus it either creates space for reconfiguration of power relations or for counter hegemonic discourses and practices which can gain terrain.

As explained in the introduction of the present proposal, our theoretical approach leans also on the Neo-Gramscian reading of Nicos Poulantzas' state theory provided by Ulrich Brand in his notion that "the *material condensation of societal relations of forces of a second order and the related international state apparatuses* (INTSA) are central to an understanding at an international level" (2007:6).

The IMF, as an international state apparatus, maintains strong linkages with national states, especially with those countries which are powerful and "overrepresented" in the Fund's internal governance architecture, such as EU countries and the USA. In this sense, the "shift" in IMF's policies and internal governance reform actually represent the changes "pertaining to socio-economic reproduction and the associated relations of forces" (Brand 2007:5). Therefore, we will explore the concept of hegemony in the form of bourgeois domination.

We will argue that political projects, initiatives and actors (i.e. the new change of policy prescriptions of the IMF; new discursively promoted statement of IMF; the establishment of new institutions like for instance the Financial Stabilization Board etc.) undertaken in the periods of crisis reinforced the pre-crisis hegemonic power relations and "the instruments for rescuing markets have been further refined" (Scherrer 2011: 222). Furthermore, mass protests in different parts of the world questioned the legitimacy of the already existent power relations, however they still could not succeed in their counter-hegemonic "project" for as long as (in our context) the authority of the global bourgeoisie through the IMF and other financial actors as "card crisis" is actively supported and consented.

Following Ulrich Brand, "…a better understanding of the international state apparatuses can be gained when they are understood as material condensation of relationships of forces of second order. Moreover, the multi-scalarity of socio-economic and political processes must be considered." (2007:1)

The production and reproduction of hegemony takes place in the realm of what Gramsci calls the 'integral state'. Following his argumentation, "this category indicates that the state, in the sense of an institutional ensemble-as the terrain for conflict settlement and compromise, as well as actor, discourse and praxis-is a preconditioned societal process."(Brand 2007:9). Therefore, resistance and struggles in civil society are given here central attention, in the sense that these make it possible, or not, the implementation of specific policies. We understand, hence, that global, or rather international, civil society *is* an international relation of societal forces (Brand 2007).

As Brand argues, the international state apparatuses (INTSA) represent a multi-scalarly (of first and second order) condensed relations of forces, which are, most importantly, material condensations. In this sense, they "are not centralized, but they are organized and institutionalized in certain forms; they are specialized and specifically political, because their functions are made permanent through laws and rules, as well as distributed throughout the different areas and formally separated from economic power." (2007:13). These apparatuses have, therefore, "their own density and power of resistance" (Poulantzas 1978: 162) hand in hand with the (global) civil society powers.

The IMF, as an INSTA which claims to be dominant, becomes dominant because "the ruling forces see their interests as being especially represented by them" (Brand 2007:14). In this way, the IMF guarantees the production and reproduction of bourgeoisie hegemony. Because the IMF is not just another INSTA, but rather a center of power, it is more strongly "isolated against the critiques and alternative purposes of the dominated social groups than is the case in other apparatuses" (Brand 2007:15). The IMF, together with the World Bank, has proven its relative autonomy and resilience towards socio-economic struggles at international level, despite of the drastic changes with the rise of global finance in the 1970's and, more strongly, in the 1990's. These two INSTAs have granted firm support in restructuring the Global North's international dominance vis á vis the Global South.

Concepts and Definitions

<u>Hegemony:</u> leadership through the active consent of other classes and groups (Scherrer 2001: 573).

<u>International state apparatuses (INTSA)</u>: "are parts of an embracing network of international regulation, i.e. the institutional handling of societal contradictions which are more or less successfully and over a certain period of time stabilized. This network adopts a powerlike form and is asymmetrically structured. (…) The notion of INTSA may not suggest a fixed constellation, but a specific materiality of international politics. The consideration of social power relations is important, in which the different forces struggle for the perpetuation of their interests, identities and values, develop the corresponding strategies and coherent projects, make alliances, and agree on compromises" (Brand 2007).

<u>Civil society:</u> "international civil society is not an intermediate sector, but an international relation of societal forces. It deals with a space of struggle which is decisive for the restructuring of socio-economic and political conditions" (Brand 2005). International civil society is the "object and medium of struggle" (Haug 1985: 174).

<u>Metaphor of condensation of societal relations of forces "of a second order":</u> "particular interests in the national states condense, within specific relations of forces, into state policies which are always integrated into interiorized international power constellations (condensations of a first order). These policies are expressed internationally in the sense of pursuing 'general' or 'national' interests. These (…) can be cooperative and/or orientated towards the management of global problems. Those interests, ethical values and identities, which are represented on an international level and which are quite changeable in every situation, meet, on international political terrains, with other 'national interests' and in particular interests of 'civil society'. With this, specific strategies or even more embracing projects of singular states, groups of states or more complex alliances are formulated" (Brand 2007:13).

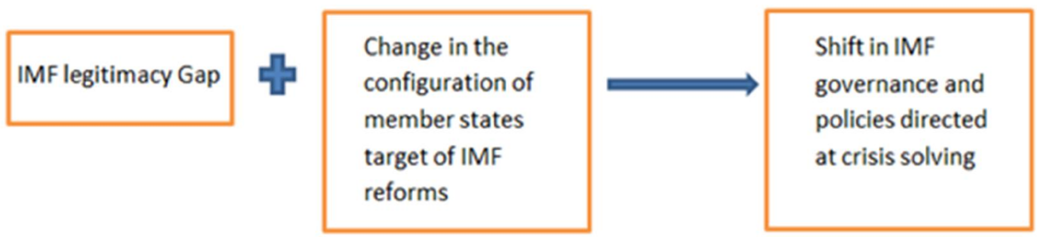
<u>International crisis of legitimacy:</u> it is a critical turning point when decline in an actor's or institution's legitimacy forces adaption (counterrevolution in Gramscian terms) or disempowerment. The IMF's international crisis of legitimacy can be traced to the Asian financial crisis of 1997-1998, when IMF's legitimacy was being contested even from within (Seabrook 2007).

<u>Legitimacy gap:</u> the difference between the International Monetary Fund's claims to legitimacy and how the Fund's member states -especially borrowers-, economists, private investors, and groups of civil society act and perceive the IMF's policies opened a legitimacy gap. This gap has been broadening as from the Asian crisis (1997-1998), when the IMF policies legitimacy began to be strongly contested. Following Seabrooke, the gap

of legitimacy is "understood as: the space between the claims to the fairness and the rightfulness of policy actions by those who seek to govern, and the conferral of legitimacy on these claims through belief-driven acts by those being governed (such as policy implementation)" (2007: 2). Seabrook provides the operationalization of "legitimacy gap" (see Annex).

Research design

Following our hypothesis: IMF's legitimacy gap, coupled with a change in the configuration of member states receiving IMF's credits (in the 2008 crisis, the global north countries), led to a shift in IMF's internal governance and policies directed at crisis solving.



A comparative case study approach is followed to explain why the IMF changed its policy approach and its internal governance structure.

Being our two cases:

a) IMF's policies and internal governance configuration during the Asian Crisis of 1997-1998 and early 2000's (IMF legitimacy crisis starting point); and

b) IMF's policies and internal governance configuration during the Global financial crisis of 2008-2013 (with focus on EU and the USA). We decided to take a clear cut in mid-2013 for the second period of time frame, respective to the whole application and implementation of the set of IMF's governance reforms.

In cases a) and b) the independent variable "IMF legitimacy gap" is constant, while what changes from a) to b) is the countries recipient of IMF credit funds ("configuration of countries target of IMF reforms"), and the outcome (IMF's internal governance structure and policies) proves different in both cases as well, suffering no change in case a) but being transformed in case b).

Although the IMF legitimacy was questioned in both crises, only the last one led to a change in the Fund's internal governance structure and policy shift. Hence, legitimacy (as the consent feature of hegemony) is well needed but not a sufficient factor; that is, only the combination of loss of legitimacy and another factor (the crucial one) could lead to the change in policy and governance altogether. That other factor is change in the configuration of countries recipient of the IMF's credits.

Comparative case studies are constructed to richly describe, explain, or assess and evaluate a phenomenon (Gall, Borg, & Gall 1996: 549). The selection of these cases was based on the steadfast view on the conduct of the IMF when the recession deepened while the fiscal policy wavered and the primary policy instrument, monetary policy, became largely ineffective.

Our research will be addressed qualitatively. The use of this method is justified by McMillan and Schumacher (1997), who suggest that "the characteristic of qualitative research entails collecting data in the form of words rather than numbers and the result is an in-depth verbal description of the phenomenon of interest". Quantitative data will also be qualitatively assessed.

With our comparative approach we intend to "unravel different causal conditions connected to different outcomes" (Ragin 1994: 108).

Following the "most similar with different outcome" (MSDO), as it was previously described, we have identified the most similar cases which nevertheless differ with regard to the dependent variable (the phenomenon we want to explain). The features our different cases do not have in common (dominant countries being recipient of IMF's credits/policies) explains whether the result is X or not.

Table 1 details our case selection:

CASE	**INDEPENDENT VARIABLES**	**DEPENDENT VARIABLE (OUTCOME)**
<u>Case a):</u> IMF's policies and internal governance configuration during the Asian Crisis of 1997-1998 and early 2000's	Context A (a,b) a: legitimacy gap b: non-dominant countries as recipients of IMF credits/policies	Outcome Y Y: No meaningful internal governance reform + Continuance of IMF's homogeneous and austerity-driven policies
<u>Case b):</u> IMF's policies and internal governance configuration during the Global financial crisis of 2008-2013	Context A (a,c) a: legitimacy gap c: dominant countries as recipients of IMF credits/policies	Outcome X X: Meaningful IMF internal governance reform + Shift in IMF's policies

Analysis:

Case a) and b) are very similar with respect to context and potential causes. Nonetheless, in case b) X occurs, in case a) it does not occur.

Case a) and b) differ only in one independent variable (b). Therefore, b is the cause of X (necessary condition: without b there is no X).

The data is analyzed based on historical analysis which is highly sensitive to time and context. The use of the analysis is fundamental because the research aims to investigate the correlations between IMF policy changes in dealing with two different crises, in which the Fund's legitimacy was likely contested, but the outcome was different.

The picked methodology helps eliminate wrong hypothesis, like Moschella's and Seabrook's, which claim that a legitimacy gap is condition enough to explain this shift in IMF's policies and its internal governance reform. Therefore, it helps to attune the theory on this matter and get closer to a causal explanation of this phenomenon. A strong theoretical ground has also been provided to this aim.

Finally, causal mechanisms provide a micro-foundation for the analysis of the Fund's inter-agents interaction and reveal how different actors, and their relative positions matter in the process (George and Bennett 2005: 135–45).

In cases of institutional legitimacy maintenance (hegemony construction and maintenance), both the independent and the dependent variables, i.e. IMF's legitimacy gap, and the configuration of member states target of IMF's policies, are located at the macro-level (second order following Brand).

"A causal mechanism links the micro-level of actors with the macro-level of institutions. Depending on the precise causal mechanism at work, several types of actors, including states, non-governmental organizations, civil society groups, may play an important role in institutional interaction" (Selin and VanDeveer, 2003).

Methodology and Data collection plan

Our data will be collected mostly out of the secondary sources using already existent discussions in the recent literature, IMF reports, as well as the critiques to the IMF policies. We will also use the public press reports as well as European Statistical office, Eurostat for further provided information.

Since in its methodology, our research will be a combination of more comparative and some quantitative methods, we will not perform interviews or intend to produce any kind of primary sources, although we will provide some fresh ideas to conceive the unfolding of the process.

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