

# The IMF and Economic Development

JAMES RAYMOND VREELAND

*Yale University*



**CAMBRIDGE**  
**UNIVERSITY PRESS**

PUBLISHED BY THE PRESS SYNDICATE OF THE UNIVERSITY OF CAMBRIDGE  
The Pitt Building, Trumpington Street, Cambridge, United Kingdom

CAMBRIDGE UNIVERSITY PRESS

The Edinburgh Building, Cambridge CB2 2RU, UK  
40 West 20th Street, New York, NY 10011-4211, USA  
477 Williamstown Road, Port Melbourne, VIC 3207, Australia  
Ruiz de Alarcón 13, 28014 Madrid, Spain  
Dock House, The Waterfront, Cape Town 8001, South Africa

<http://www.cambridge.org>

© James Raymond Vreeland 2003

This book is in copyright. Subject to statutory exception  
and to the provisions of relevant collective licensing agreements,  
no reproduction of any part may take place without  
the written permission of Cambridge University Press.

First published 2003

Printed in the United Kingdom at the University Press, Cambridge

*Typeface* Sabon 10/12 pt.    *System* L<sup>A</sup>T<sub>E</sub>X 2<sub>ε</sub> [TB]

*A catalog record for this book is available from the British Library.*

*Library of Congress Cataloging in Publication data*

Vreeland, James Raymond, 1971–

The IMF and economic development / James Raymond Vreeland.

p. cm.

Includes bibliographical references and index.

ISBN 0-521-81675-0 – ISBN 0-521-01695-9 (pb.)

1. International Monetary Fund. 2. Economic assistance. 3. Economic policy. I. Title.

HG3881.5.158 V74 2003

332.1'52–dc21        2002071482

ISBN 0 521 81675 0 hardback

ISBN 0 521 01695 9 paperback

# Contents

<i>List of Tables and Figures</i>	<i>page</i> vii
<i>Acknowledgments</i>	xi
1 Introduction	1
A New Approach and New Findings	4
Where Do IMF Programs Come From?	8
Why Do Governments and the IMF Enter into Agreements?	12
The Data	17
Plan of the Book	19
2 Analytically Significant Cases	20
Tanzania	25
Nigeria	33
Summary	38
Uruguay	39
Conclusion	51
3 An Analytical Approach to the Politics of IMF Agreements	53
Preferences over Loans and Conditions	55
The Logic of Using IMF Conditionality	62
Extensions	73
Why Do Agreements Continue?	74
Conclusion	76
Appendix: The Decision of the Executive under Uncertainty	77
4 Testing the Selection Story	83
A Statistical Model of Bilateral Cooperation	84
Filling in the Story	87
The Results	89
Loans Versus Conditions	93
The “Stripped” or “Large Sample” Model	100

Conclusion	103
Appendix: Dynamic Bivariate Probit with Partial Observability	105
5 The Effect of IMF Programs on Economic Growth	107
Previous Methods	108
Estimating the Counterfactual	114
The Intuition Behind the Model	115
Correcting for Selection Effects	118
The Effect of IMF Programs on Growth	121
Other Samples and Specifications	126
The 1990s	129
Appendix: Correcting for Selection Bias	130
6 Distributional Consequences of IMF Programs	134
Background on the IMF and Distribution	135
Empirical Approaches	137
The Effect of IMF Programs on Labor Share	139
Are the Owners of Capital Better Off?	147
Conclusion	151
7 Conclusions	152
Selection Findings – Why Governments and the IMF Enter into Agreements	152
Performance Findings – The Effect of IMF Programs on Growth and Distribution	153
New Questions	154
Policy Implications	160
Appendix 1 Variables Used in This Study	166
Appendix 2 Country-Years in Samples	169
Countries grouped by region: Africa, North America, South America, Asia, Europe, and Oceania and Pacific Islands. 4,126 Observation-sample:	
135 Countries 1951–90	169
1,024 Observation-sample: 79 Countries 1971–90	176
2,095 Observations of Labor Share of Income from Manufacturing for 110 Countries	179
<i>References</i>	181
<i>Index</i>	193

## Tables and Figures

### TABLES

2.1	Participation in IMF agreements according to need for an IMF loan	<i>page 21</i>
2.2	Participation in IMF agreements according to lagged foreign reserves	21
2.3	Typical and extreme levels of foreign reserves	23
3.1	Size of IMF loan according to foreign reserve position	61
4.1	Government objectives	88
4.2	IMF objectives	88
4.3	Determinants of participation in IMF programs	90
4.4	“Loans” and “conditions” assigned to both actors	94
4.5	“Conditions” matter to governments, “loans” matter to the IMF	95
4.6	The effect of the number of veto players	99
4.7	“Stripped” or “large sample” model of selection	101
5.1	Effect of IMF programs on growth controlling for observable conditions	111
5.2	Effect of IMF programs on growth controlling for observable determinants of selection	112
5.3	Participation and political will (hypothetical)	115
5.4	Growth regression by participation status	119
5.5	Hypothetical rates of growth if selection were random	123
5.6	Growth according to transition type	124
5.7	Experience of countries that participated in IMF programs	125
5.8	Robustness checks	128
6.1	Labor share of manufacturing income (percentage) according to IMF experience	139
6.2	Labor share of income from manufacturing regression by participation status	142

6.3	Labor share of income from manufacturing regression by participation status (with the natural log of GDP per capita)	144
6.4	Labor share of income from manufacturing regression by participation status (without per capita income)	145
6.5	Hypothetical labor share of income from manufacturing according to IMF experience (selection-corrected estimates)	146

## FIGURES

2.1	Tanzania 1970–88: Foreign reserves (in terms of monthly imports)	26
2.2	Tanzania 1980–6: Investment (percentage of GDP)	29
2.3	Total number of countries under IMF agreements	30
2.4	Tanzania 1982–8: Government budget deficit (percentage of GDP)	32
2.5	Nigeria 1970–90: Overall balance of payments (percentage of GDP)	34
2.6	Nigeria 1970–90: Current account (percentage of GDP)	34
2.7	Nigeria 1970–90: Foreign reserves (in terms of monthly imports)	35
2.8	Uruguay 1961–93: Overall balance of payments (percentage of GDP)	39
2.9	Uruguay 1967–95: Current account (percentage of GDP)	40
2.10	Uruguay 1970–95: Foreign reserves (in terms of monthly imports)	40
2.11	Uruguay 1951–95: Inflation (percent change in consumer price index)	41
2.12	Uruguay 1970–95: Debt and debt service (percentage of GNP)	41
2.13	Uruguay 1951–90: Real gross domestic investment, private and public (percentage of GDP)	42
2.14	Uruguay 1972–94: Government budget deficit (percentage of GDP)	42
2.15	Uruguay 1983–93: Labor share of income from manufacturing	49
3.1	Conventional understanding of agreements	55
3.2	Governments may prefer to have some level of conditions imposed upon them	57
3.3	Indifference curves of four governments with different ideal levels of conditions	58
3.4	Two separate negotiation postures the IMF may adopt	59
3.5	Governments that prefer more conditions get higher loans	60
3.6	A simple logic of bringing in the IMF	66
3.7	The logic of using IMF conditionality	68
3.8	The condition for $G$ to proceed	70
3.9	Situation I, where $d_G < m$	77

3.10	In Situation I, $G$ “approaches” for values of $m$ and $s$ below this curve	78
3.11	Situation II (a), where $d_G > m$ and $d_G \leq 0.5$	79
3.12	Situation II (b), where $d_G > m > 2d_G - 1$ and $d_G > 0.5$	79
3.13a	In Situation II, $G$ “approaches” for values of $m$ and $s$ below this curve	80
3.13b	In Situation II, $G$ “approaches” for values of $d_G$ and $s$ below this curve	80
3.13c	In Situation II, $G$ “approaches” for values of $m$ and $d_G$ below this curve	80
3.14	Situation III, where $m < 2d_G - 1 < d_G$ and $d_G > 0.5$	81
3.15	In Situation III, $G$ “approaches” for values of $d_G$ and $s$ below this curve	81
4.1	Illustration of dynamic bivariate probit model with partial observability	85
5.1	Economic growth before and after programs	109
5.2	Growth by participation status	125
6.1	Labor share of manufacturing income by IMF experience	140
6.2	Iso-income curves for different values of initial capital share	148

## Introduction

The International Monetary Fund is at a crossroads. Its apparent power to dictate broad programs to sovereign nations has never before been greater. In the year 2000 alone, sixty countries participated in IMF programs intended to promote international financial stability and national prosperity. Yet, in the aftermath of the East Asian financial crisis (1997–8), where financial instability in Thailand, Indonesia, Korea, and Japan, followed by Russia and Brazil affected the lives of hundreds of millions of people and threatened economic turmoil in the rest of the world, the IMF has come under close scrutiny. Calls for its reform or even dissolution have come from across the political spectrum.

The recent debate has largely focused on the question of whether the IMF should be in the “development business.” That is, when providing loans to developing countries, should the Fund impose specific policy prescriptions (a practice called conditionality) to promote economic growth? At one extreme is the International Financial Institutions Advisory Committee (the Meltzer Commission), commissioned by the U.S. Congress in the aftermath of the East Asian crisis. It recommends that the IMF focus entirely on crisis prevention and cease the practice of providing loans with policy conditions after a country has already entered into a crisis. A more moderate view is taken by the Council on Foreign Relations, commissioned by President Clinton, which does not advocate doing away entirely with *ex post* policy conditions, but recommends that the IMF avoid long-term reform programs and focus rather on short-term crisis management.<sup>1</sup> Both these commissions – one put together by Republicans, the other by Democrats – conclude that the IMF should not focus on promoting economic growth.

<sup>1</sup> For a review of these recommendations, see Willett (2001a) and Mosley (2001). Also see Jager (2001). For a broader look at reform of the international financial system, see Eichengreen (1999).



But the promotion of “national prosperity” (*IMF Articles of Agreement*) has long been a goal of the Fund. According to the former Managing Director of the Fund, Michel Camdessus,

Our primary objective is growth. In my view, there is no longer any ambiguity about this. It is toward growth that our programs and their conditionality are aimed. It is with a view toward growth that we carry out our special responsibility of helping to correct balance of payments disequilibria and, more generally, to eliminate obstructive macroeconomic imbalances. When I refer to growth, I mean high-quality growth, not . . . growth for the privileged few, leaving the poor with nothing but empty promises. (*IMF Survey 1990: 235*)

After the East Asian crisis, a new Managing Director, Horst Köhler, took the helm at the IMF. Although Köhler has emphasized the importance of promoting world financial stability, he continues to echo the views of his predecessor, contending that “the IMF should strive to promote non-inflationary economic growth that benefits all people of the world” (Köhler 2000). The IMF is experimenting with some new lending programs in line with alternative views, focusing on *ex ante* rather than *ex post* policy conditions.<sup>2</sup> Still, the old lending windows, where loans are provided in exchange for policy changes designed ultimately to promote growth, remain open.

Do these economic programs sponsored by the IMF succeed in promoting economic growth? This question has been posed since the inception of the IMF after World War II. Throughout its history, the Fund has faced what economist Manuel Pastor (1987a, 1987b) calls the *growth critique*. In the 1950s, for example, opponents of tight monetary controls, designed by the IMF to stabilize exchange rates and limit inflation, argued that these policies stifled economic growth. As the Fund became more involved in the policies of developing countries, scrutiny of its policies increased.

In the 1960s, and particularly in the 1970s when the United States went off the gold standard and the fixed exchange system collapsed,<sup>3</sup> the IMF changed its focus from regulating currency to managing balance of payments crises and assisting countries with market-oriented growth strategies. These programs involved stabilization packages designed to address balance of payments disequilibria. The strategy of the IMF was to lower demand by cutting government budget deficits and raising interest rates. Many charged that these programs were contractionary, but the IMF contended that its policies favored growth in the long run.

With the onset of the Latin American debt crisis in 1982, the IMF faced new criticism. Fixing the economic problems of the Third World was no longer viewed as merely a question of stabilization. Rather, the fundamental

<sup>2</sup> Such as the “Contingent Credit Lines.”

<sup>3</sup> See Gowa (1983). Note that surveillance of exchange rates remains an important function of the IMF. See Simmons (2000).

structure and management of the economy was now seen to be at fault. In the long run, stabilization was a futile task as long as the underlying problems in the economy remained. Hence, the IMF began to require that countries receiving foreign exchange assistance implement structural adjustment. In the 1990s, the IMF stepped up the number of specific conditions it required countries to meet. IMF opponents nevertheless continued to believe that the policies of the IMF hurt growth, whereas the Fund argued the opposite.

The early empirical evidence seemed to slightly favor the Fund. Obviously countries selected to participate in IMF programs had low growth, but this appeared to be because these countries had problems to begin with. In study after study, after one accounted for observable factors that led to participation in Fund programs, the IMF seemed to have no negative consequences for economic growth (Reichmann and Stillson 1978; Connors 1979; Pastor 1987a, 1987b; Gylfason 1987; Killick 1995). The “growth critique” of the IMF was pronounced dead (Pastor 1987a). Later, additional studies showed that although the immediate impact of IMF programs might be negative, improved growth resulted within three years (Conway 1994; Khan 1990). But when the contagion of the East Asian financial crisis spread from Thailand to Indonesia, Korea and Japan, then on to Russia and Brazil – even shaking U.S. capital markets – the growth question resurfaced.

The importance of this question is clear. How well IMF programs have performed indicates whether the Fund should be in the business of promoting economic development. The purpose of this study is to apply a new methodology to the question of IMF performance. How does one assess the effectiveness of IMF programs? The answer eludes straightforward observation. Significantly, what one observes in the world is not a random experiment. Governments enter into agreements with the IMF only under certain conditions. Economically, they may have shortfalls in foreign reserves and high levels of debt. Politically, they may have the will to change these situations. As a result, observed outcomes are due in part to the effects of IMF policy prescriptions and in part to the characteristics of countries entering into IMF programs. To answer the important policy questions surrounding the IMF, one must be able to identify what part of the outcome should be attributed to circumstances under which countries find themselves and what part to the effect of IMF policies under these circumstances.

Hence this study entails two related questions: Why do governments and the IMF enter into agreements, that is, what is the mechanism of *selection*? And what are the consequences for economic growth? To underscore the importance of these questions consider the following. According to my “full model” sample of observations (described at the end of this chapter), sixty-seven out of seventy-nine countries participated in IMF programs during 465 of a possible 1,024 country-years from 1970 to 1990. While participating in Fund programs, growth was observed to be lower by 2.35 percent per year compared to observations of countries not participating. Cumulatively, this

amounts to hundreds of billions of dollars of output. Was this outcome entirely due to nonrandom selection or is some of the difference due to the inherent effect of IMF programs?

#### A NEW APPROACH AND NEW FINDINGS

Because countries often turn to the IMF under bad economic conditions, it is not surprising that countries participating in IMF programs experience lower growth rates than countries not participating. To conclude from this observation that IMF programs hurt economic growth, however, is akin to concluding that aspirin causes headaches or that doctors hurt their patients. People do not go to the doctor randomly. They often go because they are ill. If one fails to account for the initial health of a patient, one may understate the effectiveness of the doctor's treatment and conclude that the treatment hurts the patients.

Similarly, one must account for the fact that countries participating in IMF programs have economic problems to begin with. That is why they turn to the Fund. It turns out that if one compares countries participating with countries not participating in IMF programs – under the same *observed* conditions – the programs appear to have no negative effect on economic growth. Study after study replicates this result.

These previous statistical evaluations of the effects of IMF programs have all paid attention to the *selection* question, from early before-after studies (Reichmann and Stillson 1978; Connors 1979; Pastor 1987a, 1987b) and with-without studies (Gylfason 1987; Edwards and Santaella 1993), to more recent work which corrects for observable determinants of nonrandom selection of program countries (Khan 1990; Conway 1994). Each of these approaches makes implicit assumptions about what drives selection into IMF programs. For instance, the before-after approach evaluates IMF program effects by looking at the performance of countries before entering the program and after the program ends. One problem with this method is that other factors outside of the program may also change over the course of the program. The with-without approach attempts to control for this possibility by comparing the performance of countries with programs to the performance of countries without programs. A problem with this method, however, is that countries entering into programs may be systematically different from countries that do not participate in programs. Methods that correct for the observable determinants of selection begin to address this problem by separately estimating the probability that countries participate in programs and then including the probability of participation in the subsequent analysis.<sup>4</sup>

<sup>4</sup> For an excellent formal presentation of what can go wrong with each of these methods when evaluating IMF programs, as well as some empirical results, see Goldstein and Montiel (1986). I return to these methods with greater detail in Chapter 5.

None of these studies, however, accounts for the possibility that *unobserved* factors may also play a role in selection and performance.<sup>5</sup> How can unobserved factors influence the apparent effect of IMF programs on growth? Consider once again the analogy of doctors and their patients. Not all people go to the doctor when they are sick. People who are highly motivated to stay healthy may go to the doctor with more frequency, whereas people with low motivation may ignore health problems. One may not be able to observe “motivation,” but it may play a role, not only in determining who goes to the doctor, but also in who fares the best. Suppose highly motivated people get well faster than people with low motivation, independent of treatment. If one fails to account for unobserved motivation, one will mistakenly attribute the effects of motivation to the doctor’s treatment, *overstating* its effectiveness.

Unobserved factors may play a role in determining which countries participate in IMF programs and which do not. Consider “political will” as an example. When a country fails to persevere in a program, the Fund often claims that the government lacks the “political will” to continue. Graham Bird, a prominent scholar of the IMF, observes, “The IMF has frequently blamed the poor record of the programs that it supports on a lack of ‘political will’ to carry them through” (1998: 90). As an example, consider Norman Humphreys’ (author of *The Historical Dictionary of the International Monetary Fund*) assertion,

Fund-supported adjustment programs have had mixed success, with failures coming mainly as the result of internal political will . . . in the last analysis the elements of the program and the timing of their implementation must rest with the national authorities of the country in question. (1999: 17–18)

Note that by blaming a *lack* of political will when programs fall apart, one implies that countries persevering throughout a program do have political will.<sup>6</sup>

Despite constant references to a failure of political will, however, the IMF is notoriously bad at defining exactly what the term means (see Bird 1998 for a discussion; also see Nelson 1990). Humphreys seems to indicate that it has something to do with a government’s timing in following prescribed policies. Bird (1998) conjectures that it may have something to do with the government’s commitment to the program. Perhaps Fund officials are referring to the competence of the government and its advisors, or to the government’s

<sup>5</sup> Goldstein and Montiel note that unobserved variables can play a role, but they do not attempt “a vigorous implementation” of the method (1986: 338). They refer readers to Heckman (1979) “for a description of the appropriate procedure” (1986: 325–6). The Heckman approach is precisely the methodology employed in this study.

<sup>6</sup> Stokes (1996: 6) cites examples of countries who implemented reform packages which “actually went well beyond the advice of international economists.” She claims the program itself sends a signal to private lenders of the government’s “political will” to economic reform.

reputation or its publicly unobserved negotiation posture with international creditors. Alternatively, it may refer to other, as yet unnamed, factors. The bottom line is that there is some factor that observers close to IMF programs – the Fund officials themselves – claim systematically determines both selection into IMF programs (perseverance) and their outcomes (program failures).

This has important implications for the evaluation of the effects of IMF programs. Suppose the Fund continues signing agreements only with countries that have high levels of political will. If political will also affects economic growth, then one will overstate the effectiveness of IMF programs if one fails to control for this unobserved determinant of participation and performance. The Fund may not be involved just with the “basket cases,” but, in particular, with the basket cases that want to do better.

Other unobserved factors may also affect the decision of a government to participate in an IMF program. “Trust,” for example, can play an important role in selection and performance. IMF riots in the Dominican Republic, Egypt, Ghana, Indonesia, Jamaica, and elsewhere underscore the importance of trust in being able to persevere through an IMF program. Governments that do not enjoy a certain level of societal support may be less likely to continue participation.

At the same time, trust is a form of social capital that may also independently influence rates of economic growth (see Fukuyama 1995; Levi 1998). As Putnam suggests, trust “can improve the efficiency of society by facilitating coordinated action” (1993: 167; cited in Levi 1998: 83).<sup>7</sup> But if a labor force feels that it is paying unduly for the costs of an IMF adjustment program, or that the program is imposing unnecessary hardships, efficiency may suffer. Mistrust of this sort manifests itself violently in riots and ransacking of supermarkets, but there are many less obvious ways in which it may have effects under IMF programs, such as worker slowdowns.<sup>8</sup> Anticipation of this may make a mistrusted government less likely to bring in the IMF. The governments that actually do turn to the IMF may systematically enjoy higher levels of trust, which may in turn facilitate the success of a program. Thus, trust in government may affect selection into and performance of IMF programs. Although there are many possible ways one might attempt to measure such a variable, there may always be some systematic component that remains unobserved.<sup>9</sup>

<sup>7</sup> Also see Coleman (1988, 1990), Dasgupta (1988), and Hardin (1993).

<sup>8</sup> See, for example, Scott (1985).

<sup>9</sup> Whereas Solow (1995) argues that measurement of social trust “seems very far away,” Knack and Keefer (1997) use survey data from 29 countries to develop indexes of trust and trustworthiness in societies. They find that these “social capital variables exhibit a strong and significant relationship to growth.” Their data, however, cover just a few countries that have participated in IMF programs for limited years.

Overall, just because we do not observe all factors that affect selection and performance does not imply that we should ignore them. As we will see, it is possible and important to account for unobserved factors when addressing an empirical question. It is particularly important in this setting, where one can identify such factors a priori.

Given that participation in programs is not a series of random experiments, how can one evaluate the effects of IMF programs? To tell a story about the consequences of IMF programs, one must first tell a story about the determinants of IMF program participation. Only after such determinants have been identified can one distinguish between the conditions that lead countries to participate in IMF programs and their inherent effects.

Yet, the selection problem has been largely ignored and misunderstood in the literature on IMF programs. Consider what was said in a review of the statistical findings on IMF programs:

From the research available it is probably legitimate to claim that we now have a reasonable understanding of the overall effects of Fund-backed programs. But is there a similar degree of consensus about the characteristics of user countries? (Bird 1996b: 1753)

These statements exemplify how the literature on IMF programs has put the cart before the horse. One should ask questions about selection into IMF programs before evaluating their overall effects. If one does not know “about the characteristics of user countries,” that is, if one does not know what drives program participation, then one cannot claim to have an understanding of the effects of programs. Assessing performance entails understanding selection. Thus, although the ultimate goal of this book is a narrow one – to determine empirically the effect of IMF programs on economic growth – I first address the question of selection: Why do governments and the IMF enter into agreements?

The research strategy employed in this study to address the selection question is triangular. I begin in Chapter 2 by selecting analytically significant cases to explore potentially important features of selection into IMF programs. Chapter 3 develops these features into a coherent argument about selection using formal models of why governments enter into IMF programs. Finally, Chapter 4 presents statistical tests of the story to determine whether a typical pattern of selection can be identified.

Telling a statistical story of selection into IMF programs is of central importance to this study. A statistical story involves predicting different outcomes from observed variables. Predictions are then compared to actual observed outcomes. The difference between the prediction and the outcome is the “error term.” This error term is the part of the story that is “unexplained” or “unobserved” or perhaps random. Importantly, it is also a proxy for the unobserved factors discussed earlier that may influence IMF program participation.

Chapter 4 tells a statistical story of selection into IMF programs, and Chapter 5 tells a statistical story of economic growth performance. Each story has its own error term or unobserved factors. These unobserved factors may be “trust” or “political will.” If these factors are randomly distributed across countries that participate and countries that do not participate in IMF programs, then there will be no correlation between the error terms from the selection and performance statistical stories. If the error terms are correlated, however, then the unobserved factors are not randomly distributed across the population of countries. A significant correlation indicates that the same unobserved factors that drive selection into IMF programs also drive the performance of economic growth. Once such a correlation is detected, one can derive selection-corrected estimates of the effects of IMF programs. (A more detailed description of the method is found in Chapter 5. The appendix to that chapter provides the technical details.)

The results of this study are striking: after one controls for selection – caused by observed and unobserved factors – *IMF programs have a negative effect on economic growth*. The finding is robust to different specifications and time periods. Ironically, this finding leads back to the question of selection: If IMF programs hurt economic growth, why do governments and the IMF enter into these arrangements? The answer may have to do with the way the negative effects are distributed. Thus, I consider the distributional consequences of IMF programs in Chapter 6. It turns out that not everyone is hurt in the short run by the adverse effects of IMF programs on economic growth. Those persons who are worst off in a country, however, are doubly hurt: Total growth slows and their share of income decreases. The conclusion is clear: The IMF has failed to promote what Camdessus called “high-quality growth” (*IMF Survey* A90: 235).

#### WHERE DO IMF PROGRAMS COME FROM?

In 1944, forty-four countries signed the Bretton Woods agreement establishing the International Monetary Fund for the purpose of maintaining exchange rates for international free trade.<sup>10</sup> When the world shifted away from the gold standard in the 1970s, the old exchange system collapsed. The new system did not need the IMF, and the organization faced a crisis of purpose. The original purposes of the Fund, however, also included “providing [members] with opportunity to correct maladjustments in their balance of payments without resorting to measures destructive of national or international prosperity” (de Vries 1986: 14).<sup>11</sup> Thus, the IMF changed its

<sup>10</sup> This summary follows de Vries 1986, Pastor 1987a, and Bird 1995. For a discussion of the original purposes of the IMF, see Eichengreen (1996).

<sup>11</sup> The IMF defines a country’s overall balance of payments as the sum of the current account, the capital account, and the financial account plus net errors and omissions. The

major operation from regulating currency to managing balance of payments difficulties, becoming more involved in the national policies of much of the developing world.

The primary way in which the Fund intervenes in a country's balance of payments problem is by entering into an agreement with the government whereby the Fund promises to provide a loan of foreign currency and the government promises to make specific policy changes. Where does the IMF obtain the resources required to provide these loans? Each country that is a member of the Fund – there are currently 183 – contributes a deposit held by the IMF. This “contribution,” which earns interest for the member, is called a quota, and the size depends on the size of the member's economy. The bigger a country's economy, the larger is the quota. The quota determines each member's share of votes. (Most Fund decisions require a 50 percent majority, although some major decisions, such as adjusting a country's quota, require an 85 percent majority.) Thus, the larger the economic size of a country, the greater the voting power, although officials claim that actual voting at the IMF is rare, with most decisions being made by consensus.

The Fund uses the currency provided by quotas to lend to member-countries facing balance of payments shortfalls or shortages of foreign reserves. In this respect, “the financial structure [of the IMF] is close to that of a credit union [with] access to a pool of resources, which it can onlend [sic] to member countries” (Fischer 1999). By providing countries with loans during financial crises, the IMF plays the role of an international lender of last resort. Such an option is designed to lower the risks of international trade and thus encourage countries not to engage in beggar-thy-neighbor trade policies and competitive devaluations of currency.

The existence of this lender of last resort, however, introduces moral hazard concerns (see Bird 1995 and Fischer 1999). Moral hazard can occur whenever there is insurance against bad outcomes and thus risky behavior is encouraged (Spence and Zeckhauser 1971). In this case, shortfalls in foreign reserves may arise from normal trading, but they may also arise from bad policy. If a government knows it has access to an IMF loan (a form of insurance), it will have a weaker incentive to adjust its policies to avoid bad outcomes. The loan simply ends up subsidizing the balance of payments deficit.

current account of the balance of payments is the credits minus the debits of goods, services, income, and current transfers. The capital account refers “mainly” to transfers of fixed assets and nonproduced, nonfinancial assets. The financial account is the net sum of the balance of direct investment, portfolio investment, and other investment transactions. Net errors and omissions reflect statistical inconsistencies in the recording of entries and are included so that all debit and credit entries in the balance of payments statement sum to zero. By construction (of net errors and omissions), the overall balance of payments is equal to minus “reserves and related items,” the sum of transactions in reserve assets, exceptional financing, and use of Fund credit and loans. For more, see *International Financial Statistics*, published monthly by the IMF.



How does one distinguish between a balance of payments problem due to normal trading and one due to bad policy? The general view of the Fund is that the ebbs and flows of reserves due to trading-as-usual may lead to small balance of payments deficits, causing a government to draw on no more than 25 percent of its quota. Thus, a member can freely draw on other countries' currency up to an amount equivalent to 25 percent of its quota whenever it faces a balance of payments shortfall (Stiles 1991: 2). If a government needs to draw on more than 25 percent, it is assumed that the balance of payments deficit is due to bad policy. Consequently, in these cases the IMF calls for policy changes as a condition of the loan.

The Fund has instituted four main types of arrangements that involve policy conditions (or "conditionality"): the Stand-By Arrangement (SBA), the Extended Fund Facility (EFF), the Structural Adjustment Facility (SAF), and the Enhanced Structural Adjustment Facility (ESAF).

In 1952, the Fund designed the SBA to address temporary balance of payments deficits.<sup>12</sup> On October 1, 1952, the Executive Board adopted a general policy on SBAs: "[The Fund will consider requests for stand-by credit arrangements] designed to give assurance that, during a fixed period of time, transactions up to a specified amount would be made whenever a member requested and without further consideration of its position" (*Annual Report 1953*: 50).<sup>13</sup> The current definition found in the *IMF Articles of Agreement*, which applies to all four types of arrangements, states that they are "a decision of the Fund by which a member is assured that it will be able to make purchases from the General Resources Account in accordance with the terms of the decision during a specified period and up to a specified amount" (*Articles of Agreement*: Article XXX b). When a government enters into an arrangement, a certain amount of foreign exchange is set aside for the duration of the agreement, hence the name, "Stand-by." Provided the country lives up to the agreed conditions, the government can draw on these funds at scheduled intervals, purchasing hard currency with its own domestic currency. The latter, held by the IMF, is subject to "repurchase" with interest. The arrangement is thus thought of as a "loan" from the IMF, even though the government is under no obligation to actually draw down any of the foreign exchange provided.

<sup>12</sup> This summary is based on Polak (1991). Jacques J. Polak was a member of the Bretton Woods negotiations team (1944), is a former IMF economic counselor (1966–79), and a former IMF Executive Director (1981–6) (Bradley 1991: 46–8).

<sup>13</sup> The first transaction under this policy was announced May 12, 1952: "Finland might purchase up to \$5 million from the Fund at any time during the next six months" (*Annual Report 1953*: 50). In fact, this agreement was not actually signed until January 1953, and in the interim the first agreement with Belgium was signed on June 19, 1952. Under this agreement, Belgium could purchase with Belgian francs the equivalent of up to US\$ 50 million in currencies held by the Fund. The agreement was renewable for additional periods of 6 months for the next 5 years (*Annual Report 1953*: 50).

The SBAs – by far the most common type of program – are supposed to last twelve to eighteen months. Even in the early years, however, countries often signed consecutive agreements. From 1952 to 1962, countries entering into agreements participated for nearly three years on average. And Belgium, Colombia, Honduras, Nicaragua, and Paraguay were under SBAs for six years straight, Bolivia for seven years, and Peru nine.

Recognizing that some balance of payments disequilibria required longer programs, the Fund founded the EFF in 1963 to address medium-term problems. In 1986, the Fund made concessional loans available to low-income members through the SAF. Smaller concessional loans for high-risk countries were made available in 1987 through the ESAF.<sup>14</sup> Following the East Asian crisis, the ESAF was replaced with the Poverty Reduction and Growth Facility (PRGF), which is designed to allow more input in policy conditions from the government of the country in question – to promote greater “ownership” of programs – and to emphasize the importance of government accountability.

How does the Fund provide loans through these windows without encouraging moral hazard? To address the problem of moral hazard, the Fund requires an arrangement by which the executive entering into the agreement promises to follow specific policy conditions in return for the loan. Thus, governments do not have unlimited access to foreign exchange. If a government finds itself in a deep financial crisis, it must sacrifice the sovereignty of the country and submit to Fund conditions in order to receive a loan. The government must change its “bad” policies to what the IMF views as “good” ones.

Because balance of payments deficits are viewed as problems of excessive demand, IMF conditions usually entail fiscal austerity (cutting government services and increasing taxes), tight monetary policy (raising interest rates and reducing credit creation), and currency devaluation (Taylor 1993: 41–2).<sup>15</sup> Programs are intended to involve first *stabilization*, the “removal of macroeconomically disabling balance of payments and fiscal gaps as well as inflation,” followed by a presumed *adjustment* period which creates “conditions for sustainable growth” (Taylor 1993: 41–2).

Governments entering into an IMF program are required to follow these conditions and thus sacrifice some sovereignty in return for the IMF loan. They are often viewed by domestic constituencies as “selling out” (Remmer 1986: 7). Hence, “Policy conditionality can be interpreted as a . . . penalty, as

<sup>14</sup> The latter arrangements provide loans at below market rates, whereas the former arrangements carry loans at “essentially market interest rates” (Polak 1991: 6).

<sup>15</sup> Officials at the IMF have come to believe that some balance of payments crises are purely the result of random shocks and are not due to bad policy. Hence, the Fund has created facilities which provide unconditioned currency, such as the Compensatory Financing Facility and the Oil Facility. Arrangements under these facilities involve no policy prescriptions, so are not treated in this study as IMF “programs.”

seen from the viewpoint of the borrower country's policy makers" (Fischer 1999). Governments, it is assumed, do not want to pay these "sovereignty costs" and have conditions imposed upon them.

In sum, one can think of an IMF arrangement as composed of two parts: a "loan" and a set of "conditions" imposed by the IMF in return for the loan. When an executive of a country enters into an IMF arrangement, the Fund sets aside a certain amount of hard currency. The country can draw on the currency at specified intervals as long as it lives up to certain conditions set by the Fund. Note that while the IMF enters into agreements with the national executive alone, policy changes required to comply with conditions are made *ex post*. Disbursements of IMF loans are made over the course of the agreement only if the Fund observes what it deems as sufficient policy change.

IMF arrangements are a strange and rare breed of international agreement. "Ratification" of the agreement is not required *ex ante*. The IMF recognizes the finance minister appointed by the executive as the country's "authority." Thus, the Fund enters into agreements with this branch of government alone, even if the approval of other parties, such as a legislature, are required for the policy changes laid out in the agreement.

#### WHY DO GOVERNMENTS AND THE IMF ENTER INTO AGREEMENTS?

Conventional wisdom holds that governments enter into these agreements with the Fund for a straightforward reason: They need foreign exchange (Payer 1974; Haggard and Kaufman 1992; Taylor 1997; Bird 2001). They do not want to sacrifice their sovereignty and have conditions imposed, but they need the IMF loan and therefore accept IMF conditions because they have no choice.

Thus, the emerging literature on selection into Fund programs has considered potential economic determinants of the decision to accept IMF conditions. Significant disagreement exists, however, over the role of many of these variables. For example, whereas Knight and Santaella (1997), Conway (1994), and Edwards and Santaella (1993) do not find that the balance of payments matters in determining selection, Santaella (1996) and Goldstein and Montiel (1986) find that increasing the balance of payments deficit significantly predicts participation. Regarding inflation, Edwards and Santaella (1993) and Goldstein and Montiel (1986) find that higher inflation makes countries more likely to participate in IMF programs. Yet, Santaella (1996), Conway (1994), and Knight and Santaella (1997) find the rate of inflation does not affect the chance of program participation. There is also disagreement regarding the importance of terms of trade. Conway (1994) and Santaella (1996) find that it is a predictor of participation, but Knight and Santaella (1997) do not.

Reviewing previous studies, Bird (1996b) reports that there is consensus regarding development, foreign reserves, exchange rate, and GDP growth.

Low levels of development increase the likelihood of an agreement, as do low foreign reserves. An overvalued exchange rate is reported to make an agreement more likely. And low GDP growth makes a country more likely to enter into an IMF program. High debt is also associated with agreements (Santaella 1996; Knight and Santaella 1997; Conway 1994), and high deficits in tandem with credit expansion are cited by Edwards and Santaella (1993) and Santaella (1996) as making IMF programs more likely.

The only noneconomic variable which has received attention is *recidivism*. Knight and Santaella (1997) report that the dummy variable for a past agreement increases the likelihood of another agreement; Conway (1994) finds that previous participation lowers participation in subsequent years.

What about the political determinants of the decision of governments to participate in IMF programs? Contrary to the conventional view that governments turn to the Fund for a loan and do not want conditions imposed, some scholars have observed that governments may *want* specific conditions to be imposed upon them (Spaventa 1983; Remmer 1986; Vaubel 1986; Putnam 1988; Kiondo 1992; Stein 1992; Edwards and Santaella 1993; Bjork 1995; Dixit 1996).

One argument for why governments desire conditionality is that they can blame the IMF for unpopular policies. Remmer (1986: 7, 21) contends that the presence of the IMF “allows authorities to attempt to shift blame for austerity to the Fund” and that the “power of the IMF remains a useful myth to explain difficult economic decisions.” Edwards and Santaella (1993: 425) argue that governments facing domestic opposition to devaluation get the IMF to do their “dirty work”: “By involving multinational bodies in the decision-making process, local politicians can shield themselves from the political fallout associated with unpopular policies.” Generally, Vaubel (1986: 45) states, international organizations enable politicians “to shirk domestic responsibility for unpopular policies.”

Note that “trust,” although perhaps not easily observed, is a factor in this argument. A government can effectively use the IMF as a scapegoat only if the population believes it. A skeptical constituency may not readily accept that bad outcomes are entirely the fault of the Fund. Mistrusted governments may therefore be less likely to turn to the IMF to use it as a shield.

A separate, but related argument, is that the IMF is used to “tip the balance” in favor of economic reform. In Putnam’s (1988) seminal piece on two-level games, he notes that “International negotiations sometimes enable government leaders to do what they privately wish to do, but are powerless to do domestically... this pattern characterizes many stabilization programs that are (misleadingly) said to be ‘imposed’ by the IMF.”<sup>16</sup> An executive may enter into IMF agreements to push through unpopular

<sup>16</sup> Putnam’s argument about the IMF followed the work of Spaventa (1983) who was the first to make this observation about IMF agreements.