

# The Politics of IMF Conditional Lending

*James Raymond Vreeland*

The author responds to Graham Hacche's review<sup>1</sup> of his latest book, *The International Monetary Fund: Politics of Conditional Lending* (London and New York: Routledge, 2007, 192 pp. Hardback, ISBN: 9780415374620. Paperback, ISBN: 9780415374637)

As a scholar of the International Monetary Fund (IMF), I am honored that the deputy director of the IMF's External Relations Department should deem it appropriate to write a lengthy review of my new book, *The International Monetary Fund: Politics of Conditional Lending* (Vreeland 2007). The book garners such attention because it is a synthetic review and extension of the literature, focusing on those areas of IMF activity of greatest import and contemporary concern. As such, the book presents prominent studies of the political economy of the IMF—many of them critical of the institution. A quarter-century veteran of the IMF, the author of the book review is well situated to respond. Indeed, as he has served as the deputy director of the IMF External Relations Department since 1999, one could say it is most appropriate.

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<sup>1</sup>Graham Hacche, 2007, "A Non-Definitive Guide to the IMF: a review article." *World Economics*, 8(2): 97–118.

The review makes some contributions that are informative and will be helpful to readers of the book. Certain important findings on the IMF, however, are critiqued by taking citations out of context. For example, the book reports that studies find IMF programs exacerbate income inequality. The review rebuts, "Vreeland acknowledges studies that have found that IMF-supported programs have tended to raise [social] spending, at least in some political systems" (p. 108). This is a true but misleading statement about a study by Nooruddin and Simmons (2006). Here is the complete passage:

Under dictatorship, where spending on health and education is small, the IMF indeed has a positive effect, although spending levels remain well below democracy levels. For democracies, however, the effect is the opposite. IMF programs have a statistically significant negative effect on health and education expenditures for democracies. Taken together, IMF programs make the two regime types look similar. IMF programs make democracies look more like dictatorships when it

comes to health and education. Nooruddin and Simmons conclude that optimism about the IMF successfully helping the poor “is out of place” (Vreeland 2007, 93–4).

To claim from the above passage that IMF programs have tended to raise social spending “at least in some political systems” is disingenuous. Considering the scope of the Nooruddin and Simmons study, we are talking about the well-being of billions of poor people living in democracies where social spending has gone down under IMF programs.

While the review scrutinizes findings that do not flatter the IMF, it accepts findings that do favor the institution. Thus, the review repeats the book’s evidence on the benign effects of IMF programs on balance of payments, fiscal balances, and inflation. But turning to the negative effects of IMF programs on growth, the review points out “The assumptions used in these papers [on growth] are susceptible to criticisms” (p. 107). In particular, the review questions the negative results because they may suffer from the problem of endogeneity—countries tend to turn to the IMF when facing specific economic and political circumstances, and it is difficult to disentangle the effects of IMF programs from these circumstances. Yet, *all* the results are subject to this criticism, including the neutral results on the balance of payments, fiscal balances, and inflation, about which the review is mute.

Ironically, the growth studies in question use the most sophisticated methodology to deal with the

endogeneity problem.<sup>2</sup> The Barro and Lee (2005) study is a good example, and the following statement is unfair: “Barro and Lee assume that output is a determinant of a country’s demand for a Fund-supported program, without taking into account its endogeneity” (p. 107). The Barro and Lee article is an explicit attempt to deal with the problem of endogeneity—this is made clear even by the title of their article: “IMF programs: *Who is chosen and what are the effects?*” [emphasis added].<sup>3</sup>

For all of the methodological difficulties in evaluating the effects of the IMF, the impacts are too important to ignore. At the writing of the book in 2005, 49 developing countries around the world—whose populations account for more than one billion people—were participating in economic programs supported by the IMF. Thus researchers use many different advanced methods to discern how people fare. As explained in the book, some excellent studies find qualified negative effects and even some evidence of positive effects on economic growth (e.g. Khan 1990, Conway 1994, Dicks-Mireaux et al. 2000). The most recent studies, using the best available methods, find an historically negative effect. Perhaps the IMF has done a better job in very

<sup>2</sup> The only way to remove endogeneity is to perform randomized experiments, something the IMF is either unwilling, unable, or uninterested in doing. See Vreeland (2007: 75, 82–4) and Vreeland (forthcoming).

<sup>3</sup> The other study mentioned is Przeworski and Vreeland (2000), which is criticized for the specification of the supply and demand of IMF programs. The model is further explored in Przeworski and Vreeland (2002). The implications for growth are further explored in Vreeland (2003: chapters 4 and 5). It turns out that the negative effect for growth holds across various specifications of supply and demand.

recent years, but scholars have yet to carefully analyze the most recent data.

So, let's suppose that, historically, IMF programs have had a negative effect on growth. Why might this be so? One possibility is that the fault lies with the governments in recipient countries, *not the IMF*. Chapter 4 of the book raises the possibility that the IMF is sometimes used as a "scapegoat." So this chapter is not critical of the IMF. How does the review view this good news for the IMF? It is described as the book's "least controversial chapter" (p. 105).

Despite the review's endorsement, however, this chapter is indeed "controversial." Perhaps veterans of the IMF are pleased to hear that the Fund is a scapegoat for developing countries. But there are those who take issue with this argument, particularly government officials who have been on the receiving end of a particularly tough IMF austerity program.

Chapter 4 appears to escape criticism not because it is uncontroversial, but because it is kind to the IMF. The research presented in other chapters represents strong work. All of the scholars covered in the book present sound theoretical arguments defended with empirical evidence. Where the results can be interpreted as critical of the IMF, the review attempts to discredit the research.

Consider the dismissal of formidable evidence on the question of who controls the IMF presented in chapter 2. This chapter presents four points of view:

(1) the IMF pursues the economic objectives laid out in its *Articles of Agreement*;

(2) the IMF is beholden to its major shareholders (the US and the G7), and pursues their *political* objectives;

(3) the IMF is beholden to private financiers whose supplemental financing is required for IMF program objectives to be met;<sup>4</sup>

(4) the IMF is a large bureaucracy that is difficult to control; as in all bureaucracies, there is room for the staff to pad the budget with extraneous programs.<sup>5</sup>

The review is most persuaded by the first perspective—the IMF follows its mandate. While chapter 2 begins and ends by acknowledging that the IMF often pursues this mandate, it also recognizes that other forces play a role. For example, there is ample evidence that the US and the G7 pressure the IMF to pursue political objectives, such as providing assistance to strategically important developing countries. This is well-known in the halls of the IMF, and many people on the IMF staff share off-the-record stories. Yet, the review makes the following claim (p. 104):

Some econometric studies (Thacker, 1999; Bird and Rowlands, 2001; Barro and Lee, 2005) have found that whether a country has received an IMF loan has depended not only on economic variables but on whether it supported policy positions of the United States (or other major industrial countries) at the United Nations, or shifted toward such positions, or on whether it was a temporary member of the Security Council. But the robustness of

<sup>4</sup> See Gould (2003, 2006).

<sup>5</sup> Vaubel (1986, 1991, 1996). Also see excellent new research by Copelovitch (2007).

these results is questionable: more recent research, using arguably better specified models, has found that such variables have had no significant effect (Ghosh et al. 2007).

The cited study, an IMF working paper, represents fine research on the question of whether “the recent decline in [IMF] credit outstanding is a temporary or a permanent phenomenon” (Ghosh et al. 2007, 1). However, the study does not represent (nor does it purport to represent) a thorough examination of the question of who controls the IMF. In fact, the paper merely asserts in a footnote that “UN votes and trade shares with the U.S. or Western Europe,” as measured by Barro and Lee (2005), are not statistically significant in the model used in the paper.<sup>6</sup> The claim that voting with the US at the UN has no significant impact on IMF lending is surprising since the finding survives extreme bounds analysis—a rigorous way of testing the robustness of a finding (Dreher and Sturm 2006).<sup>7</sup> The working paper makes no claim about the robustness of other indicators of political influence over the IMF such as (1) the shift in voting patterns at the UN towards US preferences (Thacker 1999), (2) US foreign aid (Stone 2002, 2004), (3) UN Security Council membership (Dreher et al. 2006).

Discrediting research published in academic journals with a footnote from an IMF working paper may seem like

<sup>6</sup> Ghosh et al. (2007, 18, fn. 23). The paper also includes an appendix that reviews the political findings, discussing some drawbacks without questioning the robustness of the results.

<sup>7</sup> Also see Oatley and Yackee (2004), Stone (2004), and Vreeland (2005).

a stretch, but this is a major issue: the abuse of the IMF as a tool of foreign policy for the United States and the G7. Ghosh et al. (2007) rightfully scrutinize these results. Anecdotes about the political abuse of the IMF abound:

- Russia received favorable IMF treatment in the 1990s because of US pressure<sup>8</sup>
- Pakistan has recently received favorable treatment because of its cooperation with the US in Afghanistan<sup>9</sup>
- Votes on the UN Security Council regarding Iraq in the Gulf War were bought by the US with IMF pressure.<sup>10</sup>

These anecdotes are difficult to prove and are easy to refute on a case by case basis. For example, Tanzania never received an IMF program until rising in political prominence by being elected to the UN Security Council in the mid-1970s. Confronted with this evidence, an IMF spokesman replied “the evidence is anecdotal and circumstantial” (*Washington Post* 2006).<sup>11</sup> Such anecdotes become much more convincing, however, when backed up by strong statistical evidence. Convincing research in this area continues to be advanced, showing a robust correlation

<sup>8</sup> See Stone (2002).

<sup>9</sup> See Vreeland (2002).

<sup>10</sup> Pilgar (2002) discusses how Zimbabwe was threatened with increased IMF conditionality if it failed to vote with the US regarding Iraq in the early 1990s.

<sup>11</sup> The World Bank appears to take a different approach, publicly explaining on their webpage: “It is true that during the Cold War years aid was politically motivated” (<http://web.worldbank.org/WBSITE/EXTERNAL/EXTSITETOOLS/0,,contentMDK:20264002~menuPK:534379~pagePK:98400~piPK:98424~theSitePK:95474,00.html>, accessed June 14, 2007).

between international political importance and IMF lending.<sup>12</sup>

Other parts of the review are critical about less important issues. For example, the book observes that the IMF was originally set up to facilitate trade amongst industrialized countries and gradually shifted attention to the developing world. The review rebuts that IMF financial support “has never been limited to any particular group of countries” (p. 99). No one claims any such limitation.<sup>13</sup> But the areas where the IMF is most involved today—Africa, Asia, and Latin America—had little to do with the original plans of the IMF’s principal architects, John Maynard Keynes and Harry Dexter White, who were concerned with the monetary problems of the industrialized world, problems that had led to the Great Depression. This is well known.<sup>14</sup>

Hence the IMF has evolved, and reformers seek further changes. What is interesting at this juncture in history is that critics on the left and right of the political spectrum agree that the IMF should reduce its role in developing countries. They disagree as to why. People who ideologically tend to favor government intervention in markets

(classically associated with the political left), argue against IMF conditionality, which typically calls for a reduced role of developing governments in the economy. People who ideologically tend to favor free markets (classically associated with the political right), argue against IMF lending, which may prop up corrupt or inefficient governments that simply ignore IMF conditionality. New research on IMF compliance<sup>15</sup> may help to settle this debate, but it is interesting both sides agree that the solution is to get the IMF out of the development business.

The review faults the book because it “says little” (p. 97) about the Medium-Term Strategy (MTS), the latest effort of the IMF to reform itself (see Vreeland 2007: 11, 117–8, 133–5, 137).<sup>16</sup> So what is the MTS? It is a three to five year strategy consisting of seven objectives for the IMF to deal with “new challenges”: (1) new directions in surveillance (including multi-lateral consultation), (2) a recognition of the changing role of emerging market countries (like China, India, Brazil, Mexico, and South Africa), (3) more effective engagement in low-income countries, (4) governance reform of the Fund (granting more voice to emerging market countries), (5) capacity building (helping countries implement the reforms suggested by the IMF), (6) streamlining (reduce the IMF “sea of paper”), and (7) financing the medium-term budget, “The overall approach of our strategy can and must be reconciled within a medium-term budget that deals with the projected

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<sup>12</sup> Interested readers should consider some studies: Kahler (1990), Thacker (1999), Stone (2002, 2004), Rieffel (2003), Woods (2003), Faini and Grilli (2004), Oatley and Yackee (2004), Barro and Lee (2005), Fratianni and Pattison (2005), Dreher and Sturm (2006), Dreher, Sturm, and Vreeland (2006), Broz and Hawes (2006), Dreher and Jensen (2007), and Copelovitch (2007).

<sup>13</sup> Membership has, of course, always been limited to *independent* countries. Only three African countries were original members of the IMF, but today there are 53 African members.

<sup>14</sup> See, for example, Eichengreen (1998). For a telling diagram of the shift, see Blomberg and Broz (2007).

<sup>15</sup> For a review see Vreeland 2007: chapter 5.

<sup>16</sup> Also see Vreeland (2006).

fall in the Fund's income."<sup>17</sup> The last point about Fund financing may really be what the MTS is about.

A cynical way to view the MTS is thus: Every decade or so, the IMF faces a crisis. In response, the IMF trots out a set of initials to address the current debacle. MTS (2005) follows other sets of initials, such as SBA (1952), CFF (1963), SDR (1969), EFF (1974), SAF (1986), ESAF (1987), PRGF (1999).<sup>18</sup> Some of these initials have made a bigger impact on IMF operations than others. Compared with others, the MTS is trivial. The IMF could have taken this opportunity for a major change, like taking an initiative on capital controls, for example. As the MTS stands, however, it will amount to rhetorical change, unless serious governance reform is achieved (for more on this, see Vreeland 2007, chapters 7 and conclusion). What is most notable about the MTS is that it is being proposed not in the face of a worldwide economic crisis. Instead, it addresses an internal IMF crisis. Few countries are borrowing from the IMF these days, and the organization is generating less revenue to pay its bills.

So these days, the IMF is in trouble. The organization extended the largest loans in its history during the East Asian Financial Crisis in the late 1990s.

Since then, these loans have been repaid, and no comparable lending has replaced them. Funding is now short for the Fund. Like so many of the countries it has worked with in the past, the IMF faces a severe budget constraint of its own. On top of this, the Fund's largest shareholder (the United States) has been governed for the past seven years by an administration that has been notoriously distrustful and unsupportive of international institutions.

It is, therefore, reasonable that people at the IMF who have devoted their lives to international public service feel besieged. Yet, we should remember, as the book asserts,

The IMF is staffed by some of the world's best, brightest and well-intentioned economists who forgo lucrative private sector opportunities to dedicate their lives instead to improving the conditions of people in the developing world...., the IMF has the potential to do much good (Vreeland 2007: 137–8).

Unfortunately, the track record is, at best, mixed—partly because of political problems. The constraints come in various forms: international political pressures, the domestic politics of recipient countries, principal-agent dilemmas that plague domestic and international bureaucracies alike, and technical know how. It is important to scrutinize evidence of these various constraints so that we can better understand how to improve the institution. In this vein, the reviewer has done a fine job. It is my privilege, as a proponent of internationalism, to work in this area with scholars both inside and outside of the IMF. My original research, which has also been reviewed

<sup>17</sup> <http://www.imf.org/external/np/exr/ib/2006/041806.htm> (accessed September 9, 2007).

<sup>18</sup> Respectively, the initials stand for Stand-By Arrangements, Compensatory Financing Facility, Special Drawing Rights, Extended Fund Facility, Structural Adjustment Facility, Extended Structural Adjustment Facility, and Poverty Reduction and Growth Facility. They are quite different from one another, but they all represent IMF responses to problems the institution faced. They are covered (and indexed) in Vreeland (2007). They are also described on the IMF website ([www.imf.org](http://www.imf.org)).

by colleagues at the IMF,<sup>19</sup> supports reform of the international institution, not abolition. I am pleased to have my introductory book also be taken seriously by people at the IMF, and I am grateful to the reviewer for the sincere attention he has given the work.

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<sup>19</sup> In particular, see the review in *Finance and Development*, a quarterly magazine of the IMF (Ramcharan 2004), and *IMF Survey* (2003).

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