
The International Monetary Fund and Developing Countries: A Review of the Evidence and Policy Options

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As its systemic role evaporated with the collapse of the Bretton Woods system, so the International Monetary Fund (IMF) became drawn into a much more specific role in the context of the balance-of-payments (BOP) problems that developing countries were encountering. At its inception, the IMF had been seen as having no specific role in developing countries, but now it became exclusively these countries that formed its clientele. While during the 1970s the IMF had continued to make a few relatively large loans to a limited number of industrial countries (Italy and the United Kingdom), beyond the mid-1970s industrial countries ceased to draw any resources from it.

In the early 1990s the emergence of the Central and East European economies (countries in transition) presented the IMF with a new challenge as well as a new opportunity, but developing countries continued to dominate the pattern of its lending.

The IMF's change in focus provided plenty of ammunition for its critics. At one end of the political spectrum the argument was that it had inappropriately become a development agency. In this context the loss of its systemic role was seen as sufficient reason to close it down. At the other end, nongovernmental organizations (NGOs) argued that the Fund was an inadequate development agency. Here the argument was that IMF-supported policies did more harm than good and that developing countries, particu-

larly the poorest of them, would be better off without it. During 1994, the year of the IMF's fiftieth anniversary, NGOs put together a coalition claim- ing that "Fifty Years Is Enough."

In the same year the Bretton Woods Commission, under the chairmanship of Paul Volcker, also suggested that the IMF's continuing involvement in developing countries was in many ways unfortunate and misplaced and that it might be sensible at some stage to consider merging the Fund's lending operations with those of the World Bank.

Mexico's economic crisis in early 1995 gave further fuel to the debate over the IMF's role in developing countries. Some saw the crisis as additional evidence of the deficiencies of IMF conditionality; others saw it as justification for increasing the lending capacity of the Fund; and still others saw it as reason for leaving private capital markets and governments to sort things out on their own without the intervention of any outside agency.

At their meeting in June 1995 the Group of 7 (G-7) leaders urged the introduction of a new emergency financing mechanism (EFM) to provide rapid-response finance in Mexico-type situations. But this was to be financed by doubling the size of the general arrangements to borrow (GAB; rather than by increasing IMF quotas. In terms of quotas and special drawing rights (SDRs), the G-7 merely recommended that the existing state of affairs be reviewed. Less ambiguously, however, the leaders argued for strong IMF conditionality and for the Fund to return to its core concern of macroeconomic policy.

There is then no shortage of policy proposals with respect to the Fund's future role in developing countries. However, the scholarly basis for many of these is often rather superficial. In this chapter I attempt to provide a more measured review and analysis of the part played by the IMF in developing countries as both a BOP financing and adjustment organization. To do this I survey and draw on the large amount of economic research that is now available. I do not set out to provide a fully comprehensive treatment of this literature, nor do I seek to cover the growing bodies of research into the politics of economic adjustment and the political economy of economic reform, although I allude to both from time to time.

Moreover, as a survey of the IMF and developing countries, I gloss over some important issues. IMF policies and decisions represent the outcome of a complex negotiating process involving various elements of the Fund's management and executive board. The executive board represents different points of view reflecting different political interests. The IMF is clearly not a unified actor. Having said this, however, and for an institution of its size and complexity, reasonably well-defined policies do emerge, especially in the context of its dealings with developing countries, and this probably legitimizes the generalizations that follow.

An additional complication is that individual developing countries dif-

fer widely. They face different economic problems, differences in the scope for economic adjustment, and differences in the domestic political context within which adjustment is pursued (or not pursued). They possess different degrees of creditworthiness and experience differences in their appeal to aid donors. Furthermore, they have different degrees of political, military, and strategic importance and may be more, or less, familiar with the way in which the IMF operates. The nexus of support for them within the executive board of the IMF will therefore vary from case to case. All of this leaves plenty of room for studying the details of dealings between individual developing countries and the IMF. Again, however, the focus here is much broader, attempting to extract generalizations from which policy conclusions may be drawn.

I begin by providing a brief account of IMF involvement in developing countries, which shows the twin roles of the Fund as both a financing and an adjustment agency. In subsequent sections I examine each of these roles in turn and show the principal deficiencies that have emerged. In the final section I suggest a policy approach designed to help remedy these deficiencies comprising proposals that are rather different from those advocated by the G-7 leaders at the Halifax summit in 1995.

The IMF and Developing Countries: Country and Policy Coverage

IMF Lending: Size and Pattern

That the IMF has become heavily involved with developing countries is beyond question. Looking first at the breadth of country coverage, Tables 11.1 and 11.2 show the overall size and pattern of lending to developing countries. At the beginning of the 1980s it was most heavily involved in lending to African and Asian developing countries; but the debt crisis radically changed the picture. The highly indebted countries of Latin America now became major users of IMF financing while loans to Africa actually fell. However, while the Fund continued to be involved with highly indebted developing countries throughout the rest of the 1980s, the surge of lending in the early 1980s turned out to be temporary. For almost the entire period beyond 1986 net IMF credit to developing countries was negative.

A number of other features of IMF lending to developing countries are noteworthy. First, Table 11.3 reveals large swings in the use of individual facilities, particularly the extended fund facility (EFF). This had been the facility under which most of the additional lending to Latin America took place in the early 1980s. By 1987, however, there was only one EFF arrangement. Although the EFF became more popular after 1987, a

Table 11.1 Developing Countries: Net Credit from the International Monetary Fund 1982-87 (in billions of U.S. dollars)^a

	1982	1983	1984	1985	1986	1987
<i>Developing Countries</i>						
By region	6.9	11.0	4.7	0.3	-2.2	-4.7
Africa	2.0	1.3	0.6	0.1	-1.0	-1.1
Asia	2.3	2.5	0.3	-1.0	-0.9	-2.4
Middle East and Europe	1.2	1.1	0.5	-0.2	-0.5	-0.4
Western Hemisphere	1.5	6.1	3.4	1.5	0.1	-0.8
Sub-Saharan Africa	0.7	1.3	0.5	-	-0.4	-0.5
By predominant export						
Fuel	0.2	1.7	1.3	-	0.8	1.0
Nonfuel exports	6.7	9.3	3.5	0.3	-3.0	-5.7
Manufactures	3.6	4.7	3.0	-0.6	-1.0	-4.0
Primary products	1.2	3.4	0.6	1.1	-0.5	-0.3
Services and private transfers	0.6	0.6	-	-0.2	-0.6	-0.6
Diversified export base	1.5	0.5	-	-	-1.0	-0.8
By financial criteria						
Net creditor countries	-	-	-	-	-	-
Net debtor countries	6.9	11.0	4.7	0.3	-2.2	-4.7
Market borrowers	2.0	5.9	4.0	1.2	0.6	-1.8
Official borrowers	1.8	1.6	0.3	-0.2	-1.0	-0.8
Countries with recent debt-servicing difficulties	4.0	7.9	3.8	1.7	-1.0	-1.8
Countries without debt-servicing difficulties	2.9	3.1	0.9	-1.4	-1.2	-2.9
<i>Miscellaneous Groups</i>						
Small low-income economies	1.0	1.2	0.2	-0.2	-0.9	-0.6
Fifteen heavily indebted countries	2.2	6.3	3.3	1.6	-0.2	-1.3
Least developed countries	-	-	-	-0.1	-0.3	-
<i>Countries in Transition</i>	-	-	-	-0.3	-0.5	-1.1

Sources: International Monetary Fund (IMF). *World Economic Outlook*. Washington, D.C.: May 1991, May 1992, May 1993, and October 1994.

Note: a. Includes net disbursements from programs under the general resources account trust fund, structural adjustment facility, and enhanced structural adjustment facility. The data are on a transaction basis, with conversions to U.S. dollar values at annual exchange rates. Converted to U.S. dollar values at end of period exchange rates.

relatively large proportion of total Fund arrangements now began to take the form of credits to low-income countries under the newly created structural adjustment facility (SAF) and enhanced structural adjustment facility (ESAF). While structural adjustment lending contributed to the widening influence of the Fund, SAF and ESAF arrangements accounted for only a

Table 11.2 Developing Countries: Net Credit from the International Monetary Fund 1988-93 (in billions of U.S. dollars)^a

	1988	1989	1990	1991	1992	1993 ^b
<i>Developing Countries</i>						
By region	-4.1	-1.5	-1.9	1.1	-0.2	1.0
Africa	-0.3	0.1	-0.6	0.2	-0.2	1.1
Asia	-2.4	-1.1	-2.4	1.9	1.3	0.7
Middle East and Europe	-0.5	-0.2	-0.1	-	0.4	-
Western Hemisphere	-0.9	-0.2	1.2	-1.0	-1.6	-0.8
Sub-Saharan Africa	-0.2	-0.4	-0.3	-	-	-0.1
By predominant export						
Fuel	-	2.0	2.7	0.3	-1.3	-1.0
Nonfuel exports	-4.1	-3.5	-4.6	0.8	1.2	2.1
Manufactures	-2.9	-2.6	-2.6	1.3	1.1	-
Primary products	-0.4	-1.0	-0.9	-0.8	-0.4	1.0
Services and private transfers	-0.6	0.2	-0.4	0.3	0.3	0.3
Diversified export base	-0.3	-0.1	-0.7	0.1	0.1	0.8
By financial criteria						
Net creditor countries	-	-	-	-	-	-
Net debtor countries	-4.1	-1.5	-1.9	1.1	-0.2	1.0
Market borrowers	-1.4	0.2	0.7	-1.2	-1.6	-0.3
Official borrowers	-0.8	-0.2	-1.1	0.3	0.3	-0.1
Countries with recent debt-servicing difficulties	-1.3	-0.5	0.4	-1.0	-1.8	-0.3
Countries without debt-servicing difficulties	-2.8	-1.0	-2.3	2.1	1.6	1.3
<i>Miscellaneous Groups</i>						
Small low-income economies	-0.3	-	-0.6	0.4	0.2	0.1
Fifteen heavily indebted countries	-1.4	-0.8	0.6	-1.4	-1.8	-0.8
Least developed countries	-0.2	-0.3	-0.4	0.1	0.2	-
<i>Countries in Transition</i>	-0.9	-0.9	0.1	3.5	1.7	2.1

Sources: International Monetary Fund (IMF). *World Economic Outlook*. Washington, DC.: May 1991, May 1992, May 1993, and October 1994.

Notes: a. Includes net disbursements from programs under the general resources account, trust fund, structural adjustment facility, and enhanced structural adjustment facility. The data are on a transaction basis, with conversions to U.S. dollar values at annual exchange rates. Converted to U.S. dollar values at end of period exchange rates.

b. Figures for 1993 are estimates.

small fraction of the total amount of Fund lending, which remained dominated by a small number of relatively large loans to big middle-income developing countries such as Brazil and Mexico.

Significant changes in the use of other lending facilities also occurred. The Fund's compensatory (and latterly contingency) facility had been an important source of finance to developing countries in the mid-1970s, and

Table 11.3 International Monetary Fund Arrangements in Effect in the Financial Years Ended 30 April 1975-95, by Facility Type^a

Financial Year	Standby		EFF		SAF		ESAF		Total	
	No.	Amt. ^b	No.	Amt.	No.	Amt.	No.	Amt.	No.	Amt.
1975	12	337	—	—	—	—	—	—	12	337
1976	17	1,159	2	284	—	—	—	—	19	1,443
1977	17	4,673	3	802	—	—	—	—	20	5,475
1978	19	5,075	3	802	—	—	—	—	22	5,877
1979	15	1,033	5	1,611	—	—	—	—	20	2,643
1980	22	2,340	7	1,463	—	—	—	—	29	3,803
1981	22	5,331	15	5,464	—	—	—	—	37	10,795
1982	23	6,296	12	9,910	—	—	—	—	35	16,206
1983	30	9,464	9	15,561	—	—	—	—	39	25,025
1984	30	5,448	5	13,121	—	—	—	—	35	18,569
1985	27	3,925	3	7,750	—	—	—	—	30	11,675
1986	24	4,076	2	831	—	—	—	—	26	4,907
1987	23	4,313	1	750	10	327	—	—	34	5,391
1988	18	2,187	2	995	25	1,357	—	—	45	4,540
1989	14	3,054	2	1,032	23	1,566	7	955	46	6,608
1990	19	3,597	4	7,834	17	1,110	11	1,370	51	13,911
1991	14	2,703	5	9,597	12	539	14	1,813	45	14,652
1992	22	4,833	7	12,159	8	101	16	2,111	53	19,203
1993	15	4,490	6	8,569	3	83	22	2,137	45	15,279
1994	16	1,131	6	4,504	3	80	22	2,713	47	8,428
1995	19	13,190	9	6,840	1	49	27	3,306	56	23,385

International Monetary Fund. 1993. *IMF Annual Report, 1995*. Washington, D.C.: International Monetary Fund.

Notes: a. EFF = extended fund facility; SAF = structural adjustment facility; ESAF = enhanced structural adjustment facility. Includes arrangements where the three-year commitment period has expired but the third annual arrangement remains in effect (three cases in 1991 and two cases in 1992). The committed amounts exclude these cases. Includes amounts previously committed under SAF arrangements that were replaced by ESAF arrangements.

b. In millions of special drawing rights (SDRs).

even as late as 1982 drawings under the compensatory financing facility (CFF) accounted for about 30 percent of total IMF purchases. But following changes in its design in 1982, which had the effect of making it a high-conditionality facility, the CFF became much less heavily used, and by 1990 drawings under the remodeled compensatory and contingency financing facility (CCFF) were less than SDR 0.1 billion.¹ The Fund's buffer stock financing facility (BSFF) has been used even less.

While the data in Table 11.2 suggest that the number of arrangements has increased steadily since the mid-1980s this gives a misleading impression of the number of countries involved with the IMF. A significant feature of IMF lending to developing countries is the recidivist tendencies of many

borrowers—a tendency most pronounced among but by no means limited to low-income countries. Developing countries have often had credit outstanding from the Fund for as many as fifteen consecutive years and, in some cases, have had such an outstanding balance for almost thirty years.² The long-term involvement of the IMF in many developing countries calls into question the temporary and revolving character of IMF lending envisaged in its Articles of Agreement.

But how should the IMF respond to such long-term involvement? Two opposing responses are possible. The first argues that its Articles of Agreement remain appropriate and that measures should be taken to shorten the duration of IMF involvement. The second argues that the nature of the problems faced by developing countries requires the Fund to adopt a longer-term perspective than was envisaged when the Articles of Agreement were originally drafted. In this context the word “temporary” needs to be interpreted as meaning “nonpermanent” rather than “short-term.”

But if the IMF is to make resources available to developing countries in support of longer-term adjustment as well as shorter-term stabilization, is its existing array of facilities appropriate? What is the logic behind the Fund's portfolio of lending windows, and is there not scope for rationalization? We return to this issue later.

Policy Coverage

The IMF exerts an important influence over the design of economic policy in countries that turn to it for financial assistance. This influence is at its strongest in areas where the IMF stipulates preconditions and prior actions or where there are quantified performance criteria. The IMF therefore has a powerful say on the exchange rate, domestic credit creation, interest rates, and fiscal imbalances. But it will also have to approve a much wider range of policies within the context of the “letter of intent” signed by the relevant borrowing government. In particular, in the context of its ESAF, the IMF also has become involved in structural conditionality covering pricing policy, trade liberalization, privatization, the structure of taxes and government expenditure, as well as the reform of the financial sector. Such structural provisions have acquired the status of performance criteria in about 40 percent of SAF and ESAF arrangements, and this has served to accentuate the trend toward increasing conditionality. Whereas during 1968-77 standby arrangements had on average included fewer than six performance criteria, by 1984-87 this had increased to more than nine.³ The trend has been further emphasized by more recent moves toward social conditionality under which the Fund seeks to offset the effects of adjustment programs on “vulnerable groups . . .”

Other potential indicators of IMF involvement in the design of economic policy in developing countries are less easy to quantify because of lack of data. It is therefore difficult to comment with authority on the depth of the Fund's policy involvement, since the details of programs generally are not published. To observe that credit ceilings are an ever-present performance criterion only tells part of the story. How restrictive are the ceilings, and how much more restrictive are they than those that might have been set by governments outside the influence of the Fund?

Explaining Fund Lending to Developing Countries

In order for the IMF to provide financial support to a member country, two sets of circumstances have to coexist. First, the country has to demand a loan, and, second, the Fund has to be willing to supply it. In a significant sense, however, the demand side is more important, since the IMF cannot volunteer loans; it can only respond either positively or negatively to requests from members.

Generally speaking, demand may be expected to vary with the state of a country's BOP and the availability (and cost) of alternative sources of finance. This is essentially what is found.⁴ Periods of relatively heavy use of IMF credit by developing countries coincide with deteriorating BOP performance and falling creditworthiness. Furthermore, poorer developing countries, where BOP deficits are more severe and creditworthiness is lower, have a more persistent demand for Fund credit than do middle-income countries where the BOP and creditworthiness vary.

From time to time, however, the IMF may exert an influence over the amount of lending by reforming its facilities and by modifying conditionality. The reduced use of the CFF and CCF in the period since 1982 surely is associated with the deliberalization of the facility that occurred. Moreover, the near abandonment of the EFF in the mid-1980s must to some extent be associated with the IMF's reservations about the effectiveness of extended arrangements-reservations that were relaxed in the late 1980s.

More detailed econometric examination of the economic characteristics of user countries confirms much of the overall picture painted above.⁵ Developing countries have drawn more resources from the IMF as their BOP deteriorates although the cause of the deterioration may be either excessive credit creation and rapid inflation or deteriorating terms of trade. Equally clear is the finding that the IMF is a more important source of finance for the poorer developing countries. Economic growth and development can, so it appears, wean countries away from the Fund. At an early stage of economic development, low-income countries are heavily dependent on the Fund. At an advanced stage high-income countries do not

depend on the IMF at all. And, at an intermediate stage, middle-income countries place time-variant demands on the Fund. Yet, strong inertial elements in borrowing exist: countries that have borrowed from the **Fund in the** recent past are more likely to borrow from it in the reasonably near future.

This perhaps implies some form of threshold. Below it, countries remain reluctant to borrow from the Fund even where their economic situation is weak; the costs of involving the IMF are seen as outweighing the benefits of the additional finance that will be forthcoming. Above it, however, and having once accepted IMF involvement, the costs and benefits are reassessed with the result that future Fund involvement becomes more probable. Either the perceived benefits rise or the perceived costs fall. Perhaps a significant component of the perceived cost of IMF involvement is a fixed cost that, having once been incurred, becomes irrelevant to future decision making over some specific time span.

The evidence reported above has a number of important implications for the design of future policy. First, to the extent that the BOP problems encountered by developing countries are associated with external shocks, such as movements in the terms of trade or interest rates, disengagement from the Fund in the long run will depend on reducing their vulnerability to such shocks. Second, since slow economic growth and low levels of economic development are associated with relatively heavy use of IMF resources, it is important that the interface between economic development and the balance of payments is fully acknowledged. If developing countries are to reduce their reliance on the Fund they must secure economic growth. Adjustment programs supported by the IMF therefore need to ensure that any adverse effects on long-term economic growth are minimized. Third, if there is a demand threshold that is explained by erroneous ex ante expectations concerning the nature of conditionality, these expectations need to be corrected. Otherwise the expectations may become self-fulfilling. Delaying the implementation of an appropriate adjustment strategy is likely to deepen the underlying macroeconomic disequilibrium, and this in turn implies that IMF-supported programs, when eventually adopted, will need to be stricter than they would otherwise have had to have been. Fourth, while the IMF cannot proactively offer financial support in individual circumstances, it has scope to manage the demand for its loans by modifying the facilities under which it lends as well as the nature of its conditionality.

Therefore the Fund's increasing involvement with developing countries can lead to a much more positive and constructive response than discontinuing or off-loading its lending operations. This approach seeks to explain the factors that combine to cause increases in lending, with a view to exerting an influence on them. If we know what causes developing countries to seek assistance from the Fund, we know what needs to happen to reduce demand in the future.

The IMF as a Direct and Indirect Source of External Finance: Too Little, Too Late

If the Fund did not exist, countries' access to external finance would depend on international capital markets' perceptions of their creditworthiness as well as the proclivities of aid donors. Relying on commercial capital markets would not be a cause for concern if they were both efficient and equitable. Experience suggests otherwise: commercial flows are highly unstable. The feast-and-famine aspects of commercial lending during the 1970s and 1980s provide evidence for this, as do the ebbs and flows of commercial lending to Latin America during the first half of the 1990s.

Where such instabilities reflect the underlying economic performance of countries one might legitimately argue that capital movements are effectively policing economic policy. But much of the observed instability reflects speculation, with strong elements of contagion as problems in one country are quickly transmitted to others. Where short-term financial considerations dominate capital movements, there is little reason to believe that capital will be allocated to uses where the real rate of return is highest.

Moreover, commercial lending may bypass countries that are viewed as uncreditworthy. Although advocates of the market mechanism see this as encouraging such countries to pursue policies that enhance their creditworthiness, others see a commercially based system as imposing severe and unmanageable pressures on countries to correct BOP deficits. In this context markets fail because they are incomplete, and the IMF fills the gap.

The above features of commercial markets imply that the poorest countries in the world will carry a disproportionate share of the global adjustment burden, with damaging consequences for poverty. The alleviation of poverty has proved a long-standing and resilient justification for the sorts of resource transfers that the IMF organizes. The IMF can, in principle, both provide its own resources in support of adjustment programs and galvanize additional finance from other public and private sources. Although frequently downplayed in assessments of the role of the Fund in developing countries, the availability of finance is usually an effective constraint on the design of an adjustment program, and the Fund's impact on it is therefore of considerable importance.

Much evidence suggests that developing countries use the IMF as a lender of last resort, only turning to it when all other financing options have been exhausted. The economic situation in these circumstances is usually critical with severe BOP difficulties, depleted international reserves, and high levels of external debt. Low investment and slow economic growth are also characteristics of countries borrowing from the Fund.⁶

Yet why should countries put off turning to the IMF if it directly or indirectly provides a significant source of external finance? Clearly, they

may prefer to avoid the apparent loss of national sovereignty associated with IMF conditionality. Even here, however, sufficiently large amounts of external finance might be expected to afford compensation. The revealed preferences of developing countries suggest, therefore, that they do not perceive the Fund as providing adequate financial support; the benefits of additional external finance via the Fund do not exceed the costs of the loss of sovereignty over economic policy, except when external finance from other sources has become exceedingly scarce.

Does then the IMF provide adequate direct financial support? The answer depends on the size of the BOP problems that countries face, on the availability of alternative sources of finance, and on the appropriate blend between financing and adjustment in dealing with BOP deficits. Conceptual problems in calculating the implied financing gap mean that it is difficult to measure the extent to which IMF lending is adequate. However, we can gain some insight by examining the success of IMF-backed programs relative to the amount of Fund finance provided. If a lower success rate is associated with smaller amounts of financial assistance this could constitute prima facie evidence that it is the inadequacy of financing that has contributed to the low success rate (particularly as the reverse causation is unlikely).

Among thirty-eight developing countries that negotiated programs with the IMF over 1979-89, the average size of Fund credit represented about 30 percent of the base-year current account BOP deficit. **However**, when the programs are subdivided into those that were completed and those that were not (with the criterion for completion being that no more than 20 percent of the credit was left undrawn), and making allowance for interruptions in the flow of credits associated with the suspension or cancellation of programs, it turns out that significantly more IMF finance was provided in the case of completed than uncompleted programs: 50 percent as opposed to 20 percent of the base-year current account deficit.⁷

A further analysis of all 266 programs negotiated with the IMF over 1980-90 (excluding SAF credits that were subsequently converted into credits under the ESAF) shows that the majority of these programs (52 percent) broke down. This suggests that the limited amount of direct Fund finance may be potentially significant in explaining what is a relatively unimpressive performance of IMF-backed programs in developing countries. Could more financial support from the Fund have increased the success rate?

Limited direct financing would be less important were the IMF indeed to act as a gatekeeper, unlocking the door to capital inflows from other sources. This catalyzing role has often been treated almost as a stylized fact. Does it deserve such status? What does the theory of the capital account of the BOP suggest, and what does the empirical evidence reveal?

Theory suggests that the relationship between IMF lending and other forms of lending could cut either way. To the extent that IMF-backed programs are associated with rising domestic interest rates as well as the elimination of currency overvaluation and are seen as part of a coherent economic strategy to which the government is committed, the Fund's involvement should raise investors' confidence. On the other hand, where rising interest rates are seen as a precursor of economic recession and where devaluation generates expectations of further devaluation, there will be incentives for capital to leave. The IMF may be seen as providing a "seal of good house-keeping," but its involvement may also be seen as a summary indication of severe economic distress. Moreover, as will be seen later, the track record of IMF-supported programs is not strong. Combine this with the significant inertial component of Fund lending that was identified earlier, and it becomes unsound to presume that Fund involvement will be short-lived and associated with a significant turnaround in economic performance. Even where an improvement can be anticipated, such improvement may be insufficient to raise creditworthiness enough to affect capital flows. Marginal increases in creditworthiness will only be significant where they alter a country's credit rating.

If the theoretical analysis leads to ambiguous conclusions, what does the empirical evidence show? This also generates mixed results. Some studies do indeed find a positive relationship between borrowing from the Fund and borrowing from private capital markets, but even where this is statistically significant it is generally rather weak. Others find a negative but statistically insignificant relationship.* New tests based on 235 observations involving developing countries that made purchases on the Fund during 1980-85 yielded the following correlation coefficients on private borrowing (with F ratios in parentheses): +0.095 (4.88), +0.008 (3.82), +0.046 (1.96), and +0.018 (3.23), suggesting, at best, that the catalytic effect is weak.

Further empirical evidence on the catalytic effect may be gleaned by examining the performance of the capital account of the BOP following the negotiation of a program with the IMF (reported more fully later). Based on taking a representative sample of sixteen developing countries over 1979-85, the net effect is found to be a reduced capital inflow. Countries seem to be using a substantial part of any observed improvement in the current account to finance the repayment of foreign loans, which are not then matched by new disbursements. Rather than serving to generate new flows, IMF credits are often in effect repaying other creditors.

This evidence also allows some examination of the claim that the IMF's involvement will have a delayed effect on other forms of lending: is the catalytic effect lagged? In fact, the negative relationship appears to become progressively more pronounced during the three years following

the negotiation of a program with the Fund. Perhaps foreign investors start off with higher hopes than are later justified by events.

Case study evidence is also broadly consistent with the conclusion that IMF lending does not have a strong catalytic effect. A reasonably detailed analysis of seventeen countries with IMF programs during 1979-89 reveals a clearly discernible catalytic effect in only two cases (the Gambia and Ghana), and even in these the effect was mainly on noncommercial flows. For the rest, including countries where IMF-backed programs were linked with debt rescheduling, no measurable effect on either public or commercial inflows was found. This case study evidence confirms the results of earlier case study work based on the period 1971-79 which concluded that IMF involvement was neither a necessary nor a sufficient condition for attracting capital from other sources.⁹

Interviews conducted with commercial bank lenders during the late 1980s in the context of debt restructuring provide yet more evidence on the catalytic effect. All banks included IMF involvement in their country-risk matrices, but while some included it with a positive sign seeing the Fund as providing some implicit guarantee of sound economic management, others gave it a negative sign viewing IMF involvement as an indicator of the extreme severity of a country's economic difficulties.¹⁰

Since the Fund presents its central role as supporting and catalyzing other support for members' economic adjustment efforts, the failure to discover any strong argument for its existence either theoretically or empirically is of considerable relevance. The Fund's seal of approval does not seem to carry a very high market value. Future policy needs to address the apparently mythical status of the catalytic effect. Can it be strengthened? If not, should the IMF itself provide a larger proportion of the necessary external financing? Moreover, should the Fund distinguish more clearly between countries where the catalytic effect may be strong or weak, as well as between the forms of lending it is seeking to catalyze? If the IMF does seek to increase its own lending capacity, it must address a further issue since over the last fifteen years it has usually possessed spare lending capacity. What can it do to encourage its members to turn to it for assistance in situations other than quasi economic crisis? Yet again, a more complex and nuanced reform agenda is implied than one that seeks merely to close down the IMF or merge its lending operations with those of the World Bank.

IMF Conditionality: Weaknesses in Design, but Slow to Change

Important links exist between flows of external finance and IMF conditionality. First, programs have a greater chance of success if they are adequate-

ly financed. Second, the greater the success of IMF conditionality the greater the willingness of countries to turn to the Fund earlier, when they need less financial support, and the greater the willingness of private capital markets and aid donors to provide financial support. But have IMF programs been designed appropriately to meet the economic and political circumstances often found in developing countries? Has the IMF responded to criticisms of conditionality? And have developing countries implemented the programs that they have negotiated?

During the last fifteen years the IMF has probably been criticized more over the issue of conditionality than anything else. Research has attempted to describe the policies favored by the Fund by putting them in the context of an underlying analytical framework. This has then been assessed in terms of its relevance to developing countries.

In essence, IMF-backed programs are based on a monetary (as opposed to monetarist) model of the BOP. This model not only rests on restrictive theoretical assumptions, such as the stability of the demand for money, that do not hold in many developing economies but also leads to policy conclusions that assume a degree of policy control beyond the reach of many developing countries for either technical or political reasons. It is hardly surprising that an essentially monetary framework focuses on the fundamental importance of controlling domestic monetary aggregates. This requires governments to hold credit under ceilings stipulated by the anticipated growth in money demand. But, in practice, the degree of financial control may be highly imperfect because of unreliable data, the difficulties of forecasting and regulating budgetary outcomes, vulnerability to shocks, and the unpredictable responses of banks, financial institutions, and the private sector to government policy.

The model creates an attention bias toward monetary excesses as the principal cause of BOP problems and away from fiscal imbalances and problems that stem from structural weaknesses in production and trade. A danger is that the policy recommendations that follow from it may be at best inefficient, imposing significant costs on borrowing countries in terms of lost output and employment as well as human development, and therefore imposing social and political instability. At worst, these recommendations may be ineffective, failing to induce the sought-after strengthening in the BOP.¹¹

In this context, IMF conditionality offers a demand-based solution to what is frequently just as much a supply-side problem. A large amount of evidence shows that BOP difficulties in developing countries are caused by external factors such as adverse movements in the terms of trade or increases in world interest rates as well as by domestic economic mismanagement.¹² Indeed, recent evidence from the IMF shows little support for the idea that it is excessive monetary growth that distinguishes between those

developing countries that turn to it and those that do not.¹³ Neoliberalist critics have gone on from this to claim that IMF conditionality not only is irrelevant to the real problem but also has a negative effect via its stagflationary consequences.¹⁴

A more recent source of criticism has been that the financial programming model used by the Fund is too static, failing to deal adequately with the time lags, uncertainties, and elastic expectations that underlie the adjustment process.¹⁵ Moreover, the model clearly is oriented toward BOP stabilization rather than toward economic growth, which is treated as exogenous. Attempts to modify the model to endogenize economic growth therefore serve only to illustrate its fundamental shortcomings. Its inability to deal with economic growth in a formal fashion has, so it is claimed by some critics, resulted in a narrow approach to the supply side of the economy, which concentrates on reducing price distortions, encouraging privatization, and curtailing public expenditure. A shift toward less state intervention and a greater reliance on market forces is seen by the Fund as the principal means by which aggregate supply may be increased.¹⁶

Excessive reliance on the financial programming model may be a source of much of the inflexibility in implementation and the overemphasis on quantitative targets of which the IMF has been accused. Such preoccupations tend to replace more meaningful qualitative discussion of the overall thrust and complexion of policy, with the result that governments remain uncommitted to the programs that result from negotiations and may even feel alienated from the measures they are supposed to implement. Even when flexibility is present, some critics have claimed that it reflects bargaining power rather than economic circumstances and that it is driven largely by the political self interests of the Fund's major shareholders.¹⁷

Using the financial programming model has not, however, prevented the IMF from favoring the exchange rate as an expenditure-switching policy; a subarea of research has concentrated on the likely effects of devaluation in developing countries. Criticisms of devaluation have not only ranged over familiar elasticity pessimism territory and the inflationary consequences of devaluation but have also covered the contractionary effects of devaluation and, more recently, the erosion of counter-inflationary credibility that is associated with frequent use of the exchange rate instrument, although the Mexican peso crisis reminds us of the BOP consequences of currency.¹⁸

All this material is contentious, and for each claim there is a counterclaim. To the claim that the financial programming model reveals the underlying monetarist credentials of the Fund is the counterclaim that the model may easily be interpreted in a neo-Keynesian context but that, in any case, IMF missions do not slavishly follow any formal model. To the claim that the Fund is short-termist, there is the counterclaim that it makes loans

under a range of medium-term facilities (the EFF and ESAF) and in any case can (and does) engage in a succession of programs. To the claim that its favored policies are essentially demand-side is the counterclaim that exchange rate policy, financial liberalization, privatization, and price deregulation are important supply-side measures. The debate goes on in similar vein.

Furthermore, the IMF has responded positively to criticisms relating to the design and implementation of its conditionality. In recent years it has reduced its reliance on quantified indicators of demand control, such as ceilings on credit to the public and private sectors. While such "performance criteria" remain central, the Fund now makes greater use of (usually half-yearly) review missions to take an overall view of program execution and adjusts program details in the light of the most recent economic data.

The Fund is also moving away from concentration on simple budgetary aggregates, such as total spending or the budget balance, in favor of paying more attention to the "quality" of fiscal adjustment. Since the economic impact of its fiscal provisions are much affected by which expenditures are trimmed and what is done with taxes, the Fund is becoming more insistent on knowing how a government proposes to implement promised reductions in the budget deficit, increasingly urging governments to install social safety nets and asking awkward questions about military spending.

In other respects, too, it is paying more attention to achieving a better balance between demand-management and supply-side measures, even in its short-term (typically eighteen-month) standby programs. The extension of conditionality into measures bearing directly on productive structure have found further expression in the greater use of structural adjustment arrangements. In the case of the SAF and ESAF, this involves establishing a "policy framework paper," which is to be drafted jointly by borrowing governments, the IMF, and the World Bank.

Under pressures from the United Nations International Children's Emergency Fund (UNICEF) and others, the IMF's managing director, Michel Camdessus, who took office in 1987, has changed its stance on the social effects of its programs. It formerly insisted that it was for national governments to decide whether to protect the poor from hardships resulting from programs. Now, its missions commonly discuss distributional aspects with governments when preparing programs. Policy framework papers must include measures to protect the well-being of vulnerable groups.

However, doubts remain about how much difference these changes have made in practice. Examination of program content reveals considerable continuity in their hard core.¹⁹ Indeed some evidence suggests that devaluation and credit ceilings became increasingly common components of Fund-backed programs during the 1980s.²⁰ In a recent IMF study, Malcolm Knight and Julio Santaella are able to give a good explanation of

the probability that the Fund would offer a financial arrangement by using an empirical specification of its determinants that focuses only on "the core policy variables relating to the demand management aspects of a macroeconomic adjustment program." While acknowledging that the IMF increasingly has emphasized other areas of policy action in recent years (with the result that program design has become more complex and comprehensive), Knight and Santaella also revealingly state that, "a balance of payments deficit usually reflects an excess of aggregate domestic demand relative to domestic supply" and that "Fund programs, which are dedicated to restoring a sustainable external position, must emphasize measures of demand restraint . . . as essential . . . elements of a stabilization program."²¹ IMF-backed programs therefore continue to focus on measures that tighten domestic credit, enhance fiscal revenues, reduce government expenditures, and adjust the exchange rate.

If we know what the basic ingredients of IMF-backed programs look like, do we know the extent to which countries carry them through to completion? As noted earlier, taking as a criterion for noncompletion the extent to which credit remains undrawn, a study of 266 programs over 1980-90 yields the following results.²² First, the majority of programs break down. Second, EFF arrangements have a greater tendency to break down than do standby arrangements. Third, where programs break down, they often do so quite quickly. Sixteen percent of all standby programs break down almost immediately with often little or no use of the credit beyond the first installment. Fourth, noncompletion became an increasingly common phenomenon at the end of the 1980s. Of the thirty-nine programs negotiated during 1988-90, 72 percent broke down, even though this was not a time of particular world economic turbulence. Finally, programs are more likely to break down where the borrowing country is moderately or severely indebted.

But why do programs break down? Potential explanations include: the size of the initial disequilibrium that needs to be corrected; the overambition of the targets set in relation to the country's ability to achieve them; and external disruptions caused by such things as terms of trade movements. However, perhaps even more important is the government's degree of commitment to carrying through the agreed program. Commitment will in large measure depend on the extent to which the government views the program as its own. Certainly, evidence on the World Bank's policy-based lending programs identifies ownership as a highly significant influence on implementation, and there is little reason to believe that anything different would be found in the case of IMF-backed programs.²³ A key problem, therefore, becomes that of finding ways in which countries not only may be persuaded to accept the advice offered by the Fund but also may be brought fully on board in agreeing with it.

This problem has spawned a large amount of research into the political