

IMF conditionality and the economic exposure of its shareholders

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Abstract

There is substantial evidence that IMF policies are driven by the powerful states which intervene to align policy with their preferences. In particular, many have argued that the United States uses its position as the Fund's largest shareholder to achieve its foreign policy objectives. As a result, a substantial volume of literature argues and presents evidence to support the claim that IMF decisions faithfully reflect US interests. My findings extend these claims. Using a new dataset on the presence in IMF agreements of binding conditions, which cause the agreement to be suspended or terminated if they are not met, I demonstrate that IMF agreements contain fewer binding conditions when a suspension of IMF lending plausibly would impose greater hardship on creditor country banks and exporters.

Keywords

conditionality, economic interdependence, global finance, IMF, intergovernmental organization, political economy

Introduction

International organizations have come to play a prominent role in an increasingly interdependent world. The International Monetary Fund (IMF), in particular, is one of the most important international organizations in modern times. Only a handful of developing countries have not participated in an IMF programme, and this list grows smaller every year. As a result, the extent of its involvement in the societies of developing countries is remarkable. When taken together with the depth of its involvement in national policy-making, via conditionality, its role is unique in contemporary international relations. Few

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international organizations can claim to have such a broad reach while still retaining the ability to make and enforce decisions that affect the core functions of sovereign states.

In return for an IMF loan, a country must agree to implement a list of policy conditions. The Fund's ability to set and enforce conditions has been a source of great controversy, with criticism coming from across the political spectrum over whether it, or any other international organization, should have the power to dictate economic policy to sovereign states. Apart from the normative debate over international organizations and the use of power, there is now a broad consensus that IMF policies are responsive to both political and economic pressures, and are not merely technocratic outcomes. Accordingly, many scholars argue that IMF policies are driven by the powerful states that oversee and guide policy, intervening when necessary to align policy with their preferences (Copelovitch, 2010; Kang, 2007; Stone, 2004). In particular, many have stressed that the United States uses its position as the Fund's largest shareholder to achieve its foreign policy objectives. As a result, a substantial volume of literature argues and presents evidence to support the claim that IMF decisions faithfully reflect US interests (Andersen et al., 2006; Dreher and Jensen, 2007; Kahler, 1990; Oatley and Yackee, 2004; Thacker, 1999).

Another common view is that the Fund's member-states have, for the most part, delegated their power to its bureaucracy (Barnett and Finnemore, 2004; Chwieroth, 2010; Dreher and Vaubel, 2004; Vaubel, 1996; Willett, 2002). Proponents of this view argue that specific attributes of the bureaucracy give it a lot of independence from its political masters. First, the bureaucracy has 'agenda-setting' power, which allows it to devise policy independently before presenting it to the Executive Board for approval. Second, the bureaucracy comprises some of the world's most skilled economists, making the organization a source of knowledge and expertise. Finally, some argue that staff are largely insulated from most forms of lobbying and political pressure.

While advocates of the bureaucratic politics approach all agree that the Fund has autonomy, they disagree over how the staff use this freedom. On the one hand, governments may have delegated autonomy to the Fund in the knowledge that it comprises responsible technocrats who will act mostly in the public interest. On the other hand, the Fund's bureaucracy may have escaped their control, engaging in rent-seeking behaviour and 'mission creep'. As a result, those who focus on the internal drivers of IMF policy differ on the nature of the organization and the forces that drive its behaviour.

Both arguments on the relative importance of states and international bureaucracies structure and guide much of the research on the IMF and the wider study of international organizations. Within each approach, however, researchers have identified the determinants and consequences of a range of specific policy outcomes. In this article, I build on previous studies by contributing a new argument on the determinants of conditionality based on the IMF shareholders' economic interests. My argument is that the organization's largest shareholders (the United States, United Kingdom, France, Germany and Japan) cooperate to reduce conditionality when they are exposed to risk and loss in a developing or emerging market. An IMF programme with too many binding conditions could create panic among creditors and investors; if a country fails to implement a binding condition it cannot continue to draw on IMF resources. In cases where the shareholders are exposed to a lot of risk, they will support fewer binding conditions and use their influence at the IMF's Executive Board to achieve this outcome.

To summarize, the IMF walks a tightrope between reducing the risks associated with conditionality to appease its powerful shareholders and promoting economic reform to bolster the credibility of borrowing countries. After outlining this argument in greater detail, I test its observable implications in a quantitative analysis of IMF conditionality agreements from 1997 to 2006. The findings indicate that IMF agreements contain fewer binding conditions when a suspension of IMF lending would impose greater hardship on shareholder banks and exporters.

IMF programmes and economic exposure

IMF programmes can have substantial distributive consequences. In today's more integrated global economy, these consequences are less confined to a single country or region than before. In this section, I explore the extent to which the IMF's largest shareholders have incentives to use the IMF to protect their domestic interests from the consequences of an economic crisis in a developing or emerging economy.

While the IMF's shareholders will hold incentives to protect domestic interests from economic crises, some interests will have more leverage than others. In particular, a private creditor is more likely to matter when it is located in one of the IMF's largest shareholders and is highly exposed to an economic crisis. As will a creditor which possesses enough resources to exert political pressure in domestic politics. Therefore, concentrated interests such as banks, exporters, and large institutional investors like pension funds will have the greatest impact on the shareholders' preferences. Some other groups, such as individual investors or taxpayers, are too numerous and diverse to overcome collective action problems and possess fewer resources to advance their interests.

Banks are in a good position to seize the opportunity provided by IMF financing because they are fewer in number than individual investors. Their smaller numbers make it easier for them to exercise influence.¹ Banks benefit from IMF financing when a recipient government re-directs it to them. For example, the terms of Ghana's 1983 IMF programme stipulated that Ghana's loan would be deposited in the Bank of England from where it would be directly transferred to Standard Chartered Bank to repay a short-term loan (Gould, 2006: 156). However, the extent to which banks are exposed varies. Some might lose out significantly from an economic shock, particularly if they hold government debt that is subsequently rescheduled or restructured. Others are less exposed or indirectly exposed via their links to other institutions. In either case, an IMF programme with less stringent conditionality is desirable to creditors. This way, banks can continue to receive payment while reducing their net exposure, as government debt is re-financed by the IMF rather than private capital markets.

Many experts see this as an inherent flaw in the international financial architecture. For example, former First Deputy Managing Director of the IMF, Anne Krueger, commented that:

We lack incentives to help countries with unsustainable debts resolve them promptly and in an orderly way. At present the only available mechanism requires the international community to bail out the private creditors (Krueger, 2001).

Exporters are another interest group that should prefer more IMF support to offset their losses. Economic shocks hurt exporters by reducing the demand for foreign imports in an afflicted country and also when they increase the competitiveness of an afflicted country's exports. A generous IMF programme can help to absorb some of the pain associated with an economic shock. In particular, if a country was to default, some buyers of foreign goods might no longer be able to pay for goods and services already supplied.² As well as immediate financial losses and possible future losses, a country experiencing an economic crisis might be a strategic location for exporters due to important networks of production. A debt crisis might even disrupt trade in specific sectors or harm intra-firm trade.

For both banks and exporters, the alternative strategies for recovering losses are also more costly than an IMF programme. Negotiations with the country experiencing financial difficulty, for example, is complicated by the number of actors involved, the diversity of financial assets and the variation in exposure of the actors involved (Lipson, 1985: 203). Overall, a private creditor should receive better terms in a debt-restructuring agreement under the aegis of an IMF programme than in a bilateral agreement with the debtor.

Another reason why exporters and banks should prefer a more generous bailout is because of their legal status in the international sovereign debt regime.³ Their lack of seniority relative to official lenders means that they might fail to recover anything from a sovereign default. By contrast, the IMF and other multilateral development banks are at the top of the creditor hierarchy. International institutions like these are almost risk-free lenders that borrowers must repay. Next in line are bilateral lending agencies — mostly export credit agencies financed by their governments — whose debts are easier to recover because they are publicly guaranteed by debtor governments.⁴ After the public creditors represented by the Paris Club seize the opportunity to recover their debts, the commercial banks represented by the London Club⁵ or Bank Advisory Committee are the next in line to receive treatment. Finally, bond investors and suppliers are the last to receive treatment in the process. Suppliers, including exporters, are the least likely to receive anything from a default or restructuring but sometimes their goods and services are insured against sovereign default through export credits. In fact, export credit schemes have promoted trade, albeit modestly, with high- and middle-income countries (Baltensperger and Herger, 2007).⁶ Similarly, banks and bondholders can also hedge against potential losses in their lending operations. As a result, the economic exposure of both banks and exporters should vary: some are highly exposed to risk and loss in a developing country following an economic shock whereas others are fully insured.

In summary, banks, bondholders and exporters are all lower down in the creditor hierarchy and must negotiate through different mechanisms to recover debt. Debt recovery is a difficult process taking years and often yielding nothing. International cooperation among debtors and creditors is difficult to achieve, and debt restructuring arrangements are not ideal for banks or bondholders as they are not priority creditors. With the odds stacked against them, private creditors in the large shareholders that have lost, or expect to lose from an economic shock, should look towards their own government for assistance. Through lobbying, and given their structural importance to a particular shareholder, their government should support additional IMF financing for a

troubled country with less stringent conditionality, as funding can be diverted back to private creditors.

Recent contributions to the IMF literature support the idea that domestic interests can affect IMF support. According to Broz and Hawes (2006: 375), campaign contributions from ‘money-center’ banks increase the likelihood that a member of the US Congress will vote in favour of increasing the US’s contribution to the IMF. There is also evidence that market actors expect IMF financing to be re-directed as the stock market capitalization of financial institutions tends to increase following IMF quota increases (Demirguc-Kunt and Huizinga, 1991).

The exposure of US agricultural exporters during the Asian financial crisis illustrates the kind of political processes that can unfold in response to an economic shock in another part of the world. According to the US Secretary of Agriculture at the time, 40% or \$23 billion of US agricultural exports went to Asia annually, meaning that this particular interest group was considerably exposed to economic shocks in that region. As a result of the 1998 Asian financial crisis, agricultural interests lobbied government intensely to mobilize IMF support to offset their losses. In testimony before Congress, the Secretary of Agriculture argued that without US support for IMF programmes, he would be unable to issue export credits (known as GSM-102) because Asian importers would not meet the ‘creditworthiness criterion’.⁷ Without being able to finance trade between the US and parts of Asia, US agricultural exports would collapse. Subsequently, several countries immediately entered IMF programmes, with relatively few binding conditions, and the US later issued the export credit guarantees.

Given Asia’s importance as a market for US agricultural products, it is crucial that we support the efforts of the IMF. The IMF stabilisation programmes and reforms are extremely important in continuing US agricultural trade with the Asian countries affected by the financial crisis.⁸

While I have illustrated how the various political processes can unfold in the US political system, domestic political institutions differ considerably across the large shareholders. Furthermore, shareholder governments may also respond favourably to creditor interests without lobbying because banks and exporters have structural importance, constraining the extent to which governments and politicians can act against their interests.⁹ There are many potential pathways to influence, but overall preferences should be strongly skewed towards a more generous bailout with fewer binding conditions when domestic interests are exposed to risk and loss. The next section takes up this point in more detail by examining why fewer binding conditions are desirable to exposed creditors and shareholders.

Binding IMF conditions, shareholders and economic exposure

IMF programmes are part ‘carrot’ and part ‘stick’. The Fund’s largest shareholders have incentives to relax the punitive element of conditionality where their banks and exporters are exposed to risk and loss in developing and emerging markets. By using their influence at the IMF to relax conditionality, the Fund’s major shareholders can take the pain

out of an adjustment programme by reducing the number of binding conditions that a borrowing country must implement. By making it easier for a borrowing country to implement the terms of its IMF programme, the G5 shareholders can maximize the amount of resources that can be diverted back to their domestic interests.

In order to reduce their exposure to an economic crisis, the shareholders should tend towards cooperation. This means that the other G5 shareholders should yield to the shareholder that is most exposed in a given crisis. In other words, shareholders should engage in logrolling as each holds similar preferences over conditionality but at different intensities. Without preference heterogeneity dividing the G5 shareholders, the IMF staff should have many fewer opportunities to go against their interests. These assumptions fit with the idea that IMF lending and conditionality is a process of risk and burden-sharing among the shareholders. More specifically, it fits with the idea that the shareholders cooperate to use the organization to protect private creditors.

Private creditors have good reasons to fear too many binding conditions: in order to receive each tranche of an IMF loan, a borrowing country must implement all binding conditions. Failing this, a borrowing country cannot continue to draw on IMF assistance. As such, the lending process is designed to reduce moral hazard and maximize the implementation of binding conditions. Creditors should want the lending process to proceed as smoothly as possible so that the borrowing country can continue to service its external debt without defaulting or entering into a debt-restructuring process. Above all, creditors will want to avoid a worst case scenario where a borrowing country fails to implement a binding condition and is forced to default on its obligations. This is a very real threat, as 85 countries on 405 occasions have signed Paris Club agreements since the 1950s, all of which involved some combination of debt-restructuring, relief, or cancellation.¹⁰

Recent studies on conditionality have uncovered much evidence that the shareholders matter. Dreher and Jensen (2007), for example, find that closer allies of the US — measured by voting affinity in the United Nations — have to meet fewer conditions. Similarly, Stone (2008) finds that the US intervenes strategically to reduce the scope of conditionality for favoured borrowing countries. Here, the scope of conditionality is defined as the number of dimensions along which IMF programmes are designed including monetary, fiscal, debt, exchange-rate and structural reforms.

While these authors provide significant evidence that the US intervenes to reduce conditionality, this is a complex policy instrument that must be decomposed into its constituents. It is important to clearly differentiate among binding and non-binding conditions. For example in countries such as Ireland, where the IMF's shareholders are exposed to massive losses from a potential debt-restructuring, the shareholders should prefer fewer binding conditions to reduce the risk that Ireland will exit its IMF programme for failing to comply with conditionality. Similarly, in other recent high-profile lending cases in Brazil, South Korea, Indonesia, and Argentina, shareholders should also attempt to reduce the odds of programme failure and termination by reducing the number of binding conditions on IMF loans. By contrast, the shareholders should be less inclined to support fewer conditions for countries where their exposure is minimal. This basic argument does not apply to non-binding conditions. Creditors and domestic interest groups should be largely indifferent to the number of non-binding conditions in a conditionality agreement.

However, the existing literature on conditionality has yielded mixed results on the determinants of binding conditions. Dreher and Vaubel (2004) and Dreher and Jensen (2007) find that neither political nor economic variables explain variation in the number of binding conditions in IMF arrangements. Copelovitch (2010) finds that the level of external debt matters, but that politics doesn't influence the number of binding conditions. On the other hand, Kang (2007) argues, and presents evidence to support the claim, that the G5 relax the number of binding conditions in IMF arrangements in order to advance their interests in borrowing countries.

Furthermore, by reducing the number of binding conditions, the G5 can allow a borrowing country more 'breathing space' to distribute the burden of fiscal adjustment according to the borrowing government's preferences, rather than to potentially stricter criteria. Private creditors, like banks and exporters, can also benefit from this outcome as it gives them more time to reduce their economic exposure to a borrowing country's economy — in other words, an easy IMF programme can help 'smart money' to 'get out'.

The G5 could furthermore favour creditors by inserting binding conditions that cater directly to their domestic interests. While this might sometimes be a viable strategy, it must rank second-best to reducing the overall number of binding conditions. This is because pro-creditor binding conditions are useful only if they are implemented by the borrowing country and implementation is tied to the overall strictness of the country's agreement with the IMF. As such, creditors are not against the insertion of favourable conditions into IMF agreements in principle, as long as the overall severity of the agreement is reduced to ensure the payment of the IMF loan.

From the borrowing government's perspective, there are several reasons why more binding conditions might increase the likelihood of programme failure (albeit temporary failure). First, governments that receive more of these conditions carry a greater burden: failure to adhere to even one condition results in the termination of their IMF loan unless a waiver is granted.¹¹ Some governments will have more difficulty implementing conditions than others. Even within a state the capacity to implement reform is not evenly distributed across a government and its bureaucracy. More binding conditions increase the likelihood that a condition will be applied in those areas where the government or civil service are incompetent or simply lack the capacity to implement reform.

Second, more conditions restrict the ability of a government to act independently. Because of reduced domestic policy autonomy, governments may find it more difficult to contain the negative political consequences of fiscal adjustment. While entering an IMF programme allows a government to shift some of the 'blame' to the Fund, a government will benefit in this way regardless of the amount of autonomy the Fund allows. Less autonomy makes it more difficult for a government to respond to constituencies or interest groups that want to be shielded from the burden of economic adjustment. Therefore, even more conditions are politically difficult for a government, because it cannot distribute the burden of adjustment according to government preferences, which may differ considerably from the outcome which is socially optimal.

While I have set out a new argument on the determinants of binding conditions in IMF agreements, conditionality is a more complex instrument. In recent years, the proliferation of non-binding conditions has also received much attention; even IMF staffers have voiced their discomfort and concern at setting non-binding structural benchmarks that

they feel are beyond their expertise in macroeconomics (Barnett and Finnemore, 2004; Gould, 2006; IMF, 2005). When the IMF's shareholders evaluate the risks associated with conditionality, they should not be concerned about non-binding conditions as they pose no threat to a borrowing country's IMF loan. Without any consequences for failure to comply with these conditions, creditors in the G5 are unlikely to fear their inclusion or proliferation. Rather, they present an opportunity to initiate economic reforms that favour interest groups in the G5, generally liberalizing trade and finance. According to Goldstein, there is anecdotal evidence of this having occurred, as structural benchmarks were added to Indonesia's and Korea's IMF programmes during the Asian crisis as a result of strong pressure from the Fund's largest shareholders (Goldstein, 2001:70). Nevertheless, there is limited quantitative evidence on intervention to set additional non-binding conditions.

Therefore, I seek to test the following hypothesis, which applies to binding conditions only:

The higher the economic exposure of the most exposed shareholder, the fewer binding conditions in an IMF programme.

Data and operationalization

To test Hypothesis I compiled an original dataset on conditionality drawn from IMF Letters of Intent (LOI), covering 87 countries from 1997 and 2006.¹² LOIs outline the policies that countries intend to implement as part of their agreement with the IMF. I recorded the conditions in 641 of these documents, which comprised 161 'initial letters' that mark the beginning of an IMF programme and 480 'review letters' that amend the terms of the previous LOI.

An observation in the conditionality dataset is a *conditionality agreement* (an initial or subsequent programme review). In other words, the data are cross-sectional, describing the characteristics of each country at each stage of the conditionality process, from a country's first point of contact with the IMF to its final programme review. The data are structured in this way because the IMF reviews the content of its programme at regular intervals and these are known as *programme reviews*. For many countries few changes are made at programme reviews. For the most part, the Fund adjusts the internal composition of performance criteria and sets new targets, ceilings and floors on macroeconomic variables and the programme continues on a new path. For some borrowing countries, however, new conditions are added and old ones are revised or dropped from the agreement altogether. Furthermore, the Fund has often granted one or more waivers at programme reviews to countries that have failed to implement a binding condition. Although each review is an important stage in the conditionality process, previous studies have examined only the conditions set down in the initial agreement with the IMF. At each stage in the conditionality review process, however, the IMF's Executive Board can make substantial changes, including the granting of a waiver or the termination of a programme.

The dependent variable in this study is the number of binding conditions in a conditionality agreement. Such agreements consist of detailed lists of policies that a country

must implement in order to draw on IMF resources. Binding conditions or performance criteria come in two varieties. The first are quantitative performance criteria which set targets or limits on macroeconomic variables such as government debt and international reserves. Structural performance criteria make up the other type of binding condition. These criteria are designed to take into account the individual and unique characteristics of borrowing countries and they first became part of conditionality agreements in the 1980s under the Fund's Structural Adjustment Facility. In terms of how this approach to measuring the dependent variable fits with the existing literature, I have followed the 'disaggregate' approach of Stone (2008) and Copelovitch (2010), as opposed to the approach followed by Brown (2009) and Dreher and Jensen (2007), where both binding and non-binding conditions are aggregated into a single indicator.¹³ With such different implications, aggregating binding and non-binding conditions into a single indicator is not advisable.

A model designed for count outcomes is appropriate with these data, as each condition is equivalent to an event. Consequently, I utilize the poisson regression model. The likelihood ratio test to check for the presence of overdispersion, which would indicate the need to use a negative binomial regression model, showed that the dependent variable was not overdispersed. Furthermore, to control for potential selection bias, I include a variable measuring the probability of IMF programme approval. This variable was generated from a binary regression model where the dependent variable indicates whether or not an IMF programme was approved in the current year.¹⁴

Independent and control variables

As the economic exposure of domestic interests should determine the shareholders' preferences over IMF policy decisions, I have coded separate measures of bank and trade exposure. The data on *bank exposure* are taken from the Bank for International Settlements. Commercial banks report the stock of assets they hold in developing and emerging markets to the central bank of the reporting country (McGuire and Wooldridge, 2005: 74). The BIS then collects these data and derives the flow from quarterly or semi-annual differences in the stocks, adjusting for exchange rates. Consequently, the data are a good proxy for the consolidated foreign claims of reporting banks (in millions of US dollars).

To measure *trade exposure* I have collected data from the IMF's own Direction of Trade Statistics. These data capture exports from the main IMF shareholders to developing and emerging markets (also in millions of US dollars). Each of the economic exposure variables measures the highest level of exposure from among the large shareholders (the G5) to reflect international cooperation to cover potential losses from a default or debt-restructuring scenario. The absolute values in the exposure variables are weighted by the shareholder's total exposure to the world, whether the claims of commercial banks or the market share of exporters.

Weighting the measures of trade and bank exposure in this way also controls for historical differences in bank lending and the financial sector that might introduce further bias. While these are clearly the best data on the extent of banks' exposure in foreign countries, there are some weaknesses that should be acknowledged. First, 45.7% of

observations are missing because there are no data available on the exposure of at least one member of the G5. This is not an unusually high number of missing data points, however, when one considers that the data on foreign direct investment would produce hardly any observations. Second, data on exports are more comprehensive with very few missing values. Interestingly, the descriptive statistics show that no single large shareholder dominates in developing and emerging markets. Rather, there is significant variation in the identity of the most exposed large shareholder.

Economic control variables

Domestic economic conditions in borrowing countries should affect IMF policy-making in several ways. First, the economists that set conditions might decide that countries with stronger economic fundamentals should require fewer reforms more generally, and fewer binding conditions more specifically. As the Fund specifically targets countries with balance of payments and short-term liquidity problems, it is necessary to include international reserves (in months of imports) and the current account balance as a percentage of GDP, in all of the specifications. The other technocratic determinants of IMF decisions over conditionality include the level of economic development, economic growth, and the quality of existing economic policy. Each of these variables captures the possibility that programme design is biased towards better performing economies, who may be subjected to fewer reforms in reward for their status. In addition, the quality of a country's existing economic policy could bias programme design towards fewer binding conditions. As a proxy for policy quality, I use Gwartney et al.'s (2008) index of economic freedom. It is important to acknowledge that this is not a perfect measure of policy quality by any means, but it is one that should resonate with the IMF, as it was a strong supporter of openness and capital account liberalization in developing countries during the 1990s. In summary, these control variables capture a possible bias in IMF programme design towards rewarding or punishing countries for their previous economic performance and policy decisions, while also taking into account the current economic climate.

While I have argued that bank and trade exposure among the G5 shapes decisively the number of binding conditions in IMF arrangements, countries that have a large external debt pose a greater threat to the IMF's collective membership in the event that they default or impose losses on their creditors. Consequently, it is necessary to control for external debt as a percentage of GDP. Similarly, the presence of a severe financial crisis should also influence the extent of conditionality. The likelihood of default or debt restructuring is heightened during a severe crisis, potentially biasing the Fund towards setting fewer binding conditions. To account for this, I include a variable to control for the presence of a financial crisis, which is coded '1' if a country experienced a currency, banking, or debt crisis at some time during the programme review process.¹⁵

This choice of control variable is motivated by the literature on financial crises, which shows that even countries with strong underlying fundamentals are sometimes vulnerable to speculative attacks (Leblang and Satyanath, 2006: 247). Therefore, the policies of interest in this article may well be crisis-driven and not necessarily reflected in the macroeconomic 'fundamentals'. Overall, the variables included to control for the economic

determinants of IMF behaviour capture both domestic economic conditions in borrowing countries, which tell us about the extent to which the borrower matters for international financial stability and the general state of their key macroeconomic indicators.

Bureaucratic politics

In order to control for some of the potential bureaucratic biases in the design of conditionality agreements, I include a variable binary variable — IMF quota review — for years in which the organization's budget was reviewed. The rationale underlying this decision is that the Fund may have an incentive to 'hurry up lending' before its budget is reviewed (Vaubel, 1983, 1996). By depleting its resources in the year of a quota review, the bureaucracy is demonstrating to the shareholders that its current budget allocation is stretched to capacity and should be increased. As a consequence, staff should hold incentives to reduce conditionality in advance of a quota review in order to increase lending.¹⁶

Several authors have also argued that the design and implementation of IMF programmes is affected by the level of autonomy that the bureaucracy possesses from the shareholders (Copelovitch, 2010; Dreher, 2006; Gould, 2003, 2006; Vaubel, 1996, 2006). The argument is as follows: as bureaucratic autonomy increases, we should expect to see a more autonomous institution that pursues its own interests ahead of the shareholders. To control for this possible outcome, I include an index that roughly captures the bureaucracy's level of autonomy from political decision-makers in any given year. It was developed by Brown (2010) and captures several features of organizational independence, including the IMF's autonomy in the filling of staff posts; financial autonomy; management autonomy; size of budget and staffing. One would expect that the variable is positively signed, as the bureaucracy should seek more conditionality in order to expand its mission and authority over borrowing countries. However, it should be noted that changes in the index from 1997 to 2006 are only driven by budget and staff size, as there were no significant institutional design changes during this time; therefore, the results should be interpreted with caution.

Political control variables

Scholars of international relations have long argued that the US has a privileged and commanding position at the IMF (Krasner, 1968). Its influence has been a source of great controversy, with many arguing that it is substantial and above that of any other member-state (Henning, 2009; Kahler, 1990; Oatley and Yackee, 2004; Thacker, 1999; Woods, 2003). In the empirical literature on conditionality, Dreher and Jensen (2007) find that closer allies of the US — measured by voting affinity in the United Nations — have to meet fewer conditions. Similarly, Stone (2008) finds that the US intervenes strategically to reduce the scope of conditionality for favoured borrowing countries. To capture strategic links with the United States, I include US military aid in millions of dollars in all of the specifications. I also include US–UN voting affinity as a robustness test.

Domestic politics in borrowing countries may have an impact on shareholder perceptions of a country's risk of default or debt restructuring. In an election year, a government might come under pressure to renegotiate or withdraw from a conditionality agreement

in response to societal demands. Consequently, the shareholders and staff should factor this into the design of a conditionality agreement, reducing the number of binding conditions in an election year. Indeed, Dreher and Jensen (2007) find that some countries receive fewer conditions prior to elections. A variable that measures the presence of an election to the executive or legislature is included to control for this possibility.

Furthermore, the number of veto players in domestic politics should also have an impact on shareholder perceptions of risk. More specifically, shareholders should prefer fewer conditions when a government faces strong opposition in domestic politics. Such governments will have difficulty making credible commitments to reform; political instability and time inconsistency problems increase the likelihood that an IMF programme will terminate prematurely through exit or lack of compliance.¹⁷ To control for domestic opposition, a variable measuring the number of veto players is included in the empirical analysis.

Findings

Table 1 presents the results. Six models are specified — the first model includes only the basic economic indicators and the index of bank exposure. Model 2 builds on this specification by adding variables to control for US strategic interests. Model 3 adds variables to control for the possibility that domestic politics in borrowing countries affects shareholder decision-making over conditionality. Models 4–6 repeat these specifications but substitute all bank exposure variables and control variables with trade exposure.

Before reviewing the results for each one of these dependent variables, several notable trends in all of the statistical analyses are worth discussing. First, it is interesting how poorly the economic variables predict variation in conditionality. The current account balance, level of reserves, external debt and a host of other control variables are not statistically significant in any of the models. Without even considering the political determinants of IMF conditionality, the poor performance of the economic variables implies that IMF financial programming tends to be an ad hoc process, as several authors already argue (Agenor and Montiel, 1999; Conway et al., 2006; Easterly, 2006). Second, the variable that controls for selection bias — the likelihood of *programme approval* — is not statistically significant (apart from model 4).

The economic exposure of the large G5 shareholders is a significant predictor of variation in the number of binding conditions in all models, regardless of whether it is measured as the exposure of banks or exporters. Accordingly, an increase in the economic exposure of the G5 leads us to observe and predict fewer binding performance criteria, all else being equal. We can also draw the same conclusion regarding US military aid: as aid increases, we observe and predict fewer binding conditions.

In addition to considering the economic determinants of programme approval and the role of the large shareholders, the statistical models incorporated the role of the IMF's bureaucracy by considering the incentives for rent-seeking among the staff during an IMF quota review, and by including a proxy to measure the bureaucracy's autonomy. Neither variable — a quota review nor bureaucratic autonomy — explains variation in the number of binding conditions, suggesting that bureaucratic incentives do not explain variation in conditionality over the course of the analysis. Rather, global investment and

Table 1. Determinants of binding IMF conditionality

	(1)	(2)	(3)	(4)	(5)	(6)
Shareholder banks	-0.08*** (0.03)	-0.09*** (0.03)	-0.08*** (0.03)			
Shareholder exporters				-0.07*** (0.03)	-0.07** (0.03)	-0.06** (0.03)
Reserves (mts imports)	0.00 (0.03)	-0.00 (0.03)	-0.01 (0.03)	0.02 (0.03)	0.02 (0.03)	0.01 (0.03)
Current account / GDP	0.01 (0.01)	0.01 (0.01)	0.01 (0.01)	0.00 (0.00)	0.00 (0.00)	0.00 (0.00)
GDP growth (%)	0.03 (0.02)	0.02 (0.02)	0.01 (0.02)	0.04*** (0.01)	0.04** (0.02)	0.03** (0.02)
GDP per capita (log)	-0.03 (0.07)	-0.07 (0.08)	-0.07 (0.08)	0.02 (0.06)	0.00 (0.08)	-0.00 (0.08)
Economic freedom	0.05 (0.05)	0.04 (0.05)	0.02 (0.06)	-0.04 (0.04)	-0.05 (0.04)	-0.05 (0.04)
Short-t debt / ex. debt	-0.00 (0.01)	-0.00 (0.01)	-0.00 (0.01)	0.00 (0.01)	-0.00 (0.01)	-0.00 (0.01)
External debt / GDP	0.06 (0.13)	0.11 (0.13)	0.08 (0.12)	-0.09 (0.10)	-0.02 (0.10)	-0.02 (0.09)
Financial crisis	-0.07 (0.09)	-0.05 (0.07)	-0.07 (0.07)	-0.14 (0.08)	-0.14 (0.08)	-0.15** (0.07)
IMF quota review	0.00 (0.06)	-0.01 (0.07)	-0.01 (0.07)	-0.02 (0.04)	-0.05 (0.05)	-0.04 (0.05)
IMF staff autonomy	-0.14 (0.21)	-0.19 (0.23)	-0.22 (0.22)	-0.24 (0.16)	-0.37 (0.20)	-0.32 (0.20)
Extended programme	-0.02 (0.17)	-0.06 (0.18)	-0.08 (0.22)	0.04 (0.19)	-0.00 (0.21)	-0.07 (0.22)
Low income programme	-0.14 (0.16)	-0.24 (0.17)	-0.26 (0.17)	-0.01 (0.16)	-0.09 (0.17)	-0.16 (0.18)
Pr(IMF Approval)	2.61 (2.00)	1.50 (2.24)	1.31 (2.05)	3.90** (1.65)	3.41 (1.86)	3.23 (1.76)
US military aid		-0.00*** (0.00)	-0.00*** (0.00)		-0.00*** (0.00)	-0.00*** (0.00)
Election year			-0.09 (0.06)			0.01 (0.04)
Checks (log)			-0.05 (0.10)			-0.14*** (0.04)
Observations	196	178	178	319	288	287
ll	-466	-418	-417	-773	-697	-691
chi ²	410	623	812	222	232	350
No. countries	31	30	30	45	43	43

Notes: Estimates from the poisson regression model. Robust standard errors in parentheses.

*** $p < 0.01$; ** $p < 0.05$.

trade links to rich creditor countries clearly trump both the IMF's own bureaucratic incentives and the economic fundamentals in borrowing countries.

While we can reach the general conclusion that performance criteria are responsive to the interests of the IMF's major shareholders, interpreting the value of the coefficients of event count models like the one presented here is not a straightforward exercise. In these models, coefficients represent the *expected change in the number of performance criteria*, based on a one unit change in the independent variable. *Change* is defined as the difference in the log of the expected count, holding all independent variables constant. Rather than interpreting the values of the coefficients in this way, I proceed with an interpretation of the effect of the explanatory variables using a more intuitive approach: predicted probabilities in terms of percent change.

Turning now to the effect of the key political variables, the estimates from model 1 demonstrate that a standard deviation increase in bank exposure leads to 14.6% fewer binding conditions, holding other variables constant. Model 5, which substitutes G5 bank with trade exposure, predicts a 7% reduction in conditionality from a one unit change and a 12% reduction from a one standard deviation increase in exporter exposure. In addition, for a standard deviation increase in US military aid of 51.8 million dollars, the model predicts 6.5 fewer binding conditions. These quantities, along with other key variables, are summarized in Table 2. (See also Table 3.)

Figure 1 illustrates the trends in some of the key variables when all other variables are held at their mean. The y-axis on these plots represents the predicted rate of change in the dependent variable (in this case the number of performance criteria). The plots on bank and trade exposure indicate that the models predict fewer performance criteria at higher levels of bank and trade exposure, but with less confidence at very low levels of trade and bank exposure. The plots illustrating the relationship between the current account and performance criteria show that countries with strong current account deficits tend to have more performance criteria in their agreements with the IMF.

Table 2. Substantive effects

Binding conditions (model 1)						
	b	z	p>z	%	%StdX	SDofX
Current ac/ GDP	0.00	1.43	0.15	0.7	4.7	6.45
Shareholder banks	-0.08	-3.15	0.00	-7.8	-14.6	1.95
Binding conditions (model 4)						
GDP per capita	0.02	0.38	0.70	2.4	2.8	1.17
Shareholder exporters	-0.07	-2.72	0.00	-7.0	-12.0	1.76
Binding conditions (model 6)						
US military aid	-0.00	-3.18	0.00	-0.1	-6.5	51.84

Notes: b is the raw coefficient, z is the z-score for the test of $b = 0$, $p > z$ is the p-value, '%' is a change in the expect count for a unit increase in the independent variable, '%StdX' gives the expected count for a standard deviation increase in the independent variable, 'SDofX' gives the standard deviation of the independent variable.

Table 3. Summary statistics

Variable	N	Mean	St. Dv.	Min.	Max.	Source
Binding IMF conditions	641	9.4	3.46	3	24	(1)
G5 bank exposure (%)	308	.01	.031	.000	.13	(2)
G5 trade exposure (%)	577	.003	.008	.000	.08	(3)
Reserves (mts imports)	564	4.02	2.02	.04	10.15	(4)
Current account / GDP	562	-4.65	7.36	-35.29	19.75	(4)
GDP growth (%)	623	2.46	4.72	-15.13	28.93	(4)
GDP per capita (log)	619	6.69	1.18	4.39	9.22	(4)
Short-term debt / ext. debt	911	9.68	8.04	0	46.61	(4)
External debt / GDP	580	.82	.47	.17	4.73	(4)
Economic freedom	759	4.99	.83	3.2	7.3	(5)
Financial crisis	626	.08	.28	0	1	(6)
IMF quota review	626	.21	.41	0	1	(7)
IMF delegation index	969	26.43	.76	25.22	27.47	(8)
US military aid (mil. USD)	881	19.42	199.25	0	5753	(9)
Election	1036	.26	.44	0	1	(10)
Checks	1003	.94	.55	0	2.079	(10)

Sources: (1) 641 letters of intent, www.imf.org, 87 Countries, April 1997–February 2007; (2) Bank for International Settlements; (3) IMF Direction of Trade Statistics; (4) World Development Indicators; (5) Gwartney et al. (2008); (6) Laeven and Valencia (2008); (7) Author's; (8) Brown (2010); (9) USAID (2008); (10) Beck et al. (2001).

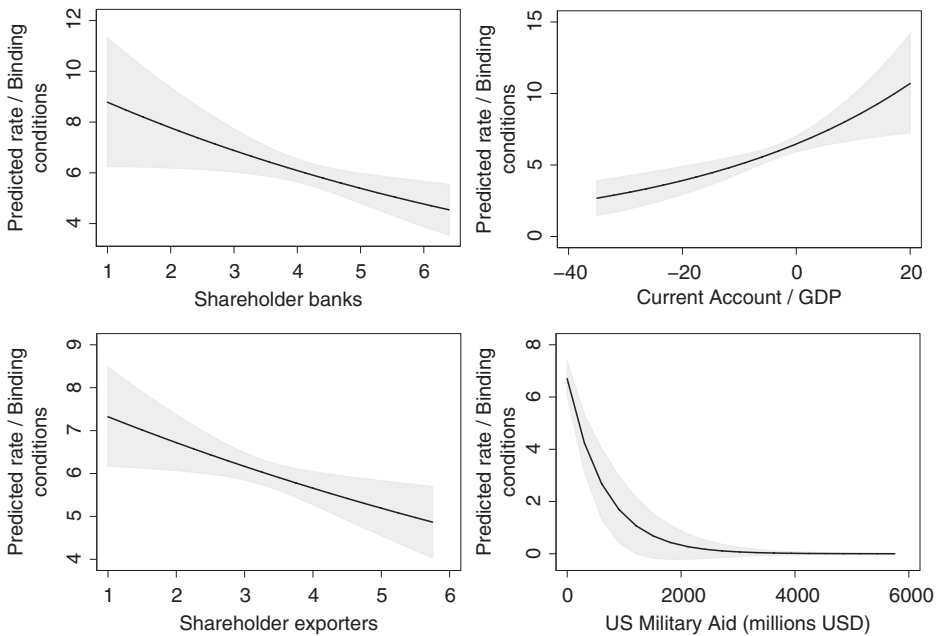


Figure I. Trends in key variables

Robustness checks

In this section, I describe the various changes I made to the models and specifications in order to test whether the results were robust to additional control variables and alternative measures of the key concepts and indicators. For all of the changes I describe here, the results were roughly comparable to the ones presented in the previous section, and are available on request.

First, with the new conditionality dataset it is now possible to check whether IMF programmes get easier over time. This is important because it is possible that shareholder governments might prefer more stringent conditionality at the beginning of a programme if, for example, market actors are sceptical about a government's commitment to reform. To control for the effect of programme duration, a variable that measures the number of previous programme reviews was included. The specifications were also replicated with a binary variable for initial programme reviews. The findings indicate that IMF programmes do get easier over time (with fewer binding conditions) but that this is not statistically significant.

Second, the specifications were repeated with a time trend to account for developments that I have not modelled such as increasing openness in trade and finance. All of the specifications were repeated with time dummies. A variable to capture a borrowing country's previous relationship with the IMF was also included (number of programmes in the previous five years). Furthermore, several of the countries that were affected by the Asian financial crisis, for which there are data, were dropped from the analysis.¹⁸

Third, I substituted shareholder bank exposure (as a percent of total bank lending) with bank exposure as a percent of GDP. This variable captures the exposure of the banking industry in the potential or actual recipient of IMF finance relative to the rest of the economy (rather than the rest of the sector) in each member of the G5.

Fourth, the models were replicated with UN-US voting alignment in place of US military aid. *UN-US voting* is a dyadic measure of affinity between the US and every other country computed using the S-score formula. Data are drawn from Dreher and Sturm (2006) and Voeten (2005). The logic underlying this choice of variable is that voting affinity should indicate whether a state is an ally of the United States. While US military aid is a better measure of long-term strategic alliances, the former is widely used in the literature on IMF polices.

Finally, I considered the possibility that the economic exposure of a larger group of states — the G10 — matters when it comes to explaining conditionality. Many different specifications showed little in the way of a systematic relationship between G10 bank exposure and the likelihood of programme approval or the size of an IMF loan. On the balance of evidence, G5 exposure appears to be a much more robust predictor of conditionality. The following variables were added to the base model with this possibility in mind:

- Binary variables taking the value of '1' where a member of the G10 was the most exposed bank lender from amongst the group (the US, UK, France, Germany, Japan, Canada, Italy, Belgium, and Switzerland).¹⁹

- Variables measuring the relative exposure (both individually taking the percentage of a country's exposure relative to the rest of the G10 and as a group) of Canada, Italy, Belgium, Switzerland, and the Netherlands.

In summary, the empirical analysis is robust to additional control variables and alternative measures of existing control variables, lending much support to my argument on the determinants of IMF conditionality.

Conclusion

Not long ago it seemed as if the IMF was 'on the verge of irrelevance' (Rodrik, 2009). A period of relative calm in the global financial system from 2004 to 2007 meant that few countries needed its assistance. Furthermore, most of the countries that had previously sought its assistance had either paid off their loans or let their agreements lapse. While some countries enthusiastically severed ties with the IMF, the lack of a major financial crisis had repercussions for the organization because it was dependent on the revenue generated from lending to finance its operations. Without a financial crisis in an emerging market, it quickly ran out of resources and had to take the step of downsizing for the first time since it was founded in 1944.

The global financial crisis saw a major reversal in this drift towards irrelevance. At their summit in 2009, the G20 group of industrialized and emerging economies agreed to strengthen the IMF's role in monitoring and surveillance and treble its resources to \$750 billion. With the crisis came also a surge in lending activity.

But this is not the only way in which the Fund has responded to the crisis. Since its onset, the IMF has eliminated much of the conditionality from its programmes, providing conditionality-free loans that are disbursed in single payments under the new 'Flexible Credit Line'. Even low-income countries can now avail themselves of reduced conditionality loans under the new 'Rapid Credit Facility'. Second, in March 2009, the IMF did what critics have demanded for years by discontinuing the use of structural performance criteria — the only binding structural reforms in IMF arrangements. This is a notable change in the direction of policy, as it implies that the Fund is getting out of the business of micro-reforms and focusing on macroeconomic policy. Finally, even programme approval is now automatically granted for some countries under 'pre-cautionary' stand-by arrangements (IMF, 2010). As national governments and policymakers continue to disagree over how to respond to the aftermath of the global financial crisis, two of the few areas of consensus were the decisions to increase the IMF's capacity to respond and remove the policies designed to limit the use of its resources.

This article tested the argument that the economic exposure of IMF shareholders influences the design of conditionality agreements. The evidence from the statistical analysis shows that the exposure of banks and exporters in the largest shareholders are both correlated with a significant reduction in the number of binding conditions. This supports the argument that conditionality is subject to change when strong societal groups in powerful countries stand to lose from strict conditionality in a borrowing country. This is a new finding, as the existing literature on conditionality has found no relationship between the economic interests of powerful states and the scope of the conditions

in IMF agreements. One might expect that because the IMF has been charged with maintaining an open international financial system it would tend to support private business interests like these anyway. On the contrary, the results show that the Fund is only a better friend to private interests located in powerful countries and tends to be an even better friend to those that are able to 'help themselves' by lobbying their government for assistance following an economic shock. Finally, in light of the severity of the global financial crisis, it is not surprising that the IMF has embarked on the process of dismantling conditionality. Essentially, the Fund has loosened the 'purse strings' in response to the global crisis, with the full support of its shareholders.

The findings from this article also have broader implications. First, the results show that even the most technical and complex of IO policies are subject to change when states have a lot to gain or lose. When a policy decision comes with serious costs and benefits, political actors have strong incentives to overcome informational barriers and intervene to exert influence.

Second, the results have wider implications for the debate over whether conditionality is an appropriate policy instrument and how it can be improved. Some critics argue that it should be abolished because it is unfair or inefficient. Others argue that it should be limited, with fewer structural conditions. While I have not provided any evidence to show that conditionality has a negative effect on borrowing countries, the findings are generally not good news for conditionality, as shareholder intervention to reduce the severity of conditionality defeats the very purpose for which it was designed: to reduce moral hazard.

More generally, the models provide new insights into the determinants of conditionality. The results imply that IMF programmes provide opportunities for the organization's major shareholders to relax formal conditionality in order to minimize the risk of a borrowing country defaulting. Although the results have established a robust link between the economic exposure of interest groups and the form of conditionality that borrowing countries receive, they also imply that the shareholders might react differently to pressure from banks and exporters.

Notes

- 1 See Tomz (2007: 197) on why banks can punish more effectively.
- 2 That exporters lobby their governments to offset losses is already well established in the political economy of trade. See for example Dür (2010).
- 3 The formal process is coordinated via the Paris Club. While it sets out rules and norms for restructuring sovereign debt, negotiations are conducted on an ad hoc basis (Rieffel, 2003). More advanced attempts at cooperation through international institutions, such as the IMF's recent SDRM initiative, have failed (Krueger, 2002).
- 4 For a more detailed discussion of debt restructuring and the seniority of sovereign debts see Roubini and Setser (2004: 249–288) and Rieffel (2003).
- 5 This organization is similar to the Paris Club but it is even more informal as it dissolves after every meeting (Rieffel, 2003: 2–3).
- 6 The authors also find that credit schemes had no effect in more unstable low-income countries.
- 7 Statement of Dan Glickman, Secretary of Agriculture, Before the House Committee on Agriculture, Washington, DC, 21 May 1998.
- 8 Statement of Dan Glickman, Secretary of Agriculture, Before the House Committee on Agriculture, Washington, DC, 21 May 1998.

- 9 The structural importance argument is based on the insight that the state is structurally dependent on capital; governments tend to dislike policies that hurt business interests because they are dependent on the private sector to provide revenue for the state (Wallerstein and Przeworski, 1988).
- 10 Paris Club, www.clubdeparis.org (accessed on 20 April 2010).
- 11 As the number of binding conditions increases, so should the likelihood that a government will fail to implement a condition and have its programme terminated.
- 12 The data start in 1997 because this is when the IMF started to publish letters of intent online. Coverage ceases in 2006 as some of the key independent variables are not available after this year.
- 13 Caraway et al. (2012) adopt a different approach by analysing a specific sub-type of condition: labour-related conditions.
- 14 The independent variables in the model are international reserves measured in months of imports, current account balance as a percent of GDP, external debt as a percent of GDP, debt service as a percent of GDP, the log of GDP per capita and the GDP growth rate. For the literature on the determinants of IMF programme entry see Bird and Rowlands (2009) and Knight and Santaella (1997).
- 15 The definition of financial crisis follows Laeven and Valencia (2008).
- 16 Recent reforms to the organization's finances after 2008 have weakened this incentive.
- 17 For a discussion of the credible commitment problem see Kydland and Precott (1977).
- 18 The countries include Indonesia, South Korea, and the Philippines. The overall trend in the data after the Asian financial crisis was that the IMF set more binding conditions but fewer non-binding conditions. However, it is not possible to be conclusive about the effect of the Asian financial crisis on conditionality as there are not enough years in the dataset before 1997.
- 19 The Netherlands was excluded as it was never the most exposed lender.

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