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The credibility and signalling effect of IMF programmes

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1. Introduction

The IMF claims that the conditionality it attaches to its loans performs an important signalling function (IMF Survey, March 24, 1997). By negotiating a programme with the IMF a government signals its intention to implement an agreed programme of economic stabilisation and reform which is designed to enhance economic performance.

Governments could, of course, commit themselves to similar policies outside the Fund. But, so the argument goes, in these circumstances pronouncements about economic reform would carry relatively little credibility with private international capital markets and aid donors, since there would be nothing much to stop governments reneging on their policy promises. There is a time consistency problem. What governments say may not be what they do.[1] To overcome this problem they may choose to delegate elements of policy to independent policy-makers, giving up the control that it is feared they may misuse. Thus monetary policy may be delegated to an independent central bank free from political manipulation. Or macroeconomic policy may be constrained by a set of rules rather than being set purely by discretion. Policy-makers may opt to "tie their hands" in order to

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[1] Having received the benefit of announcing a policy change a government may decide to renege on its commitment in order to avoid the costs of the policy change. Anticipating this change of heart, the original commitment may carry little credibility. Governments therefore need a mechanism which constrains their ability to renege.

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eliminate the chance of policy reversals and reduce their degree of freedom in order to reduce the degree of uncertainty about future policy.

However for many developing countries and countries in transition (CITs) central bank independence may be premature and it may be difficult to define, let alone implement, appropriate policy rules relating to monetary goals and fiscal deficits. An alternative solution to the time consistency problem is therefore needed. One possibility may be to peg the exchange rate; many developing countries have used the exchange rate as a "nominal anchor." But again how strong is the commitment to defend it? Does the policy carry credibility? In a crisis the peg is likely to be abandoned. For this reason some developing countries and CITs have been pushed towards adopting currency boards (Argentina and Bulgaria) or have even gone as far as full dollarisation (Ecuador).

A second possibility is to agree a programme of economic reform with the IMF which is then monitored by the Fund to ensure that the government keeps on-track. Penalties for deviating from the programme are seen as giving it credibility. It is through this signalling role of conditionality that the Fund claims that its programmes exert a catalytic effect on other financial flows. Clearly if this is an effective way of overcoming time inconsistency and enhancing the credibility of policy reform, it would be a powerful argument for conditionality. But is it?

This brief article suggests that neither theoretical analysis nor empirical evidence is consistent with the signalling role of IMF conditionality. From this, the article goes on to examine what changes in the Fund's operations might allow a signalling role to be more effectively performed in the future.

2. The credibility of IMF programmes

In assessing the signal that is being transmitted by signing an agreement with the IMF a number of factors are important. Taken together these influence the probability that the government will try to keep to the programme.[2]

To begin with, there is the extent to which the government "owns" the policy reforms. Other things being equal, governments will be more committed to policies that they themselves deem to be appropriate and to whose design they made a contribution.[3] Where, on the other hand, there are large discrepancies between the policy preferences of the government and the Fund this will call into question the

[2] Countries may go off-track from the programmes they have agreed for a number of reasons, some of which may lie beyond their control. There may, for example, be an unanticipated adverse movement in the terms of trade or a sharp rise in world interest rates. In this paper we focus on the incentives influencing the desire of governments to stay on-track, while recognising that this desire may be frustrated by outside shocks.

[3] For a comprehensive discussion of ownership in the context of adjustment programmes see Killick (1998), which refers to the literature on the subject. Williamson (2000) also emphasises the importance of ownership.