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The impact of IMF programs on asset values

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Abstract

This paper provides evidence on the effectiveness of the IMF by examining the impact of its program on wealth. We analyze all IMF press releases about forthcoming aid for 16 emerging countries during the period 1989–1999, together with references in the *Financial Times* to possible IMF support. Using event study methodology, we measure the impact of these announcements on the prices of a number of assets, including equities, currencies, domestic and foreign bank stocks, and sovereign debt.

Our findings suggest that neither the IMF announcements nor the *FT* news have a measurable effect on asset values. The exceptions are the announcements in the *FT* that suggest IMF support is *less* likely to be forthcoming. In these cases we observe negative abnormal returns.
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1. Introduction

Recent events in Asia, Russia and South America have prompted discussions about the role of the IMF and its effectiveness. This paper uses a fairly standard "events-study" methodology to provide evidence on the impact of IMF assistance.

There are two commonly cited roles for the IMF in resolving international financial crises. The first is to provide an international analogue to the domestic lender of last resort.[1] The second is to advise on, and encourage, policy reforms in the affected countries.

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[1] For examples of recent papers on the need for an international lender of last resort are Fischer (1999).

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The traditional role for a domestic lender of last resort was first discussed by Thornton (1802) and Bagehot (1873), and was more precisely formulated in Diamond and Dybvig (1983). Diamond and Dybvig observe that fractional reserve banks may be subject to a liquidity crisis, where agents rush to withdraw their deposits. One way to remove this incentive to run is if everyone knows that the central bank stands ready to supply whatever liquidity is needed.

A similar problem can arise when depositors make inferences about bank solvency from the actions of other depositors. In this case a withdrawal of cash by one group of depositors can lead to a rational cascade of further withdrawals. A central bank that has access to private information on bank solvency may be able to intervene to prevent a bad cascade and nudge the system towards a good equilibrium.[2]

Such liquidity and solvency runs assume fully rational agents. However, much of the comment on financial crises is colored by the notion that financial markets are subject to irrational and contagious "panics," which lead them to over-react. In this case the steadying hand of a lender of last resort may help to restore confidence and prevent "disorderly markets."

These arguments for a domestic lender of last resort have international analogues.[3] An international body, such as the IMF, may be of value where countries have a large volume of foreign currency deposits or loans, which may be subject to runs. However, the ability of the IMF to fill this role is hampered by its lack of resources. Unlike a central bank, the IMF cannot create money and therefore cannot provide open-ended access to liquidity.

This lack of financial resources may not be important if the IMF′s function is to control solvency-motivated runs. If investors could be confident that the IMF had superior information, then its willingness to put its money where its mouth is would constitute a signal to investors that their loans are safe and so remove the incentive to run. The credibility of this signal may depend on the amount of the assistance relative to the IMF′s total resources, but not on the absolute amount of the assistance. The problem for the IMF in this case is, therefore, not so much its access to cash but its access to the information that is needed to reverse a solvency run. Moreover, the IMF is often under political pressure to extend assistance to borrowers and this muddies the signal provided by the IMF.

The second role for the IMF in crisis resolution arises from the conditions that are attached to its loans. The IMF′s provision of support is typically linked to acceptance by the local government of a reform program, and funds are released in tranches only as the program is implemented. The fact that the required reforms are packaged with IMF lending both allows the IMF to exert leverage on the borrower and provides an incentive for it to monitor the implementation of the reforms.

The two models of the IMF′s role do not sit happily together and have different implications for the form of its assistance. For example, there is little place for

[2] Models of rational cascades were developed in Banerjee (1992) and Welch (1992).

[3] See, for example, Morris and Shin (1998), Detragiache (1996) and Obstfeld (1986).

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