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The Effects of IMF and World Bank Lending on Long-Run Economic Growth: An Empirical Analysis

JAMES L. BUTKIEWICZ
University of Delaware, Newark, USA

and

HALIT YANIKKAYA *
School of Applied Sciences, Celal Bayar University, Manisa, Turkey

Summary. — The International Monetary Fund and the World Bank, frequently, and often repeatedly, extend loans to developing nations. These loans have been blamed for generating adverse economic outcomes. The growth impact of Fund and Bank loan programs is assessed using an empirical growth model that controls for other determinants of growth. A unique feature of this study is the use of the value of loans rather than the number of programs. The estimates indicate that Bank lending stimulates growth in some cases, primarily by increasing public investment. Fund lending is either neutral or detrimental to growth. The channel for this effect is a negative impact of Fund lending on public as well as private investment.
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Key words — development aid, empirical growth model, international lending, International Monetary Fund, World Bank

1. INTRODUCTION

The two major international financial institutions (IFIs), the International Monetary Fund (IMF or Fund) and the International Bank for Reconstruction and Development (World Bank or Bank), are important sources of capital funds for developing economies. The IMF now engages in developmental as well as "crisis" and adjustment lending, while the World Bank focuses on developmental loans.

In recent years, the lending practices of the IMF and the World Bank have been subjected to ever-increasing public scrutiny, and frequent criticism. The IMF's lending practices, in particular, are regularly criticized as "antigrowth" and "antipoor." Indeed, IMF lending, especially in "crisis" situations, requires domestic governments to submit to a set of conditions (conditionality) that typically reduce or restrain domestic demand, thereby having, at a minimum, adverse short-run economic consequences. However, there is frequent recidivism among the borrowing nations, and the IMF-imposed conditions may be necessary to address the fundamental problems existent in recidivist nations. [1]

World Bank lending has been less criticized and less studied than IMF lending. As Krueger (1998) argues, the IMF frequently lends to countries in the midst of a crisis when the borrowing nations suffer from external and/or internal imbalances. This is not the case for World Bank lending, which is typically directed toward long-term development projects. Thus, while the IMF is criticized as too harsh, the World Bank is often criticized as too soft in its lending practices.

The frequent, strenuous criticism of IFI lending raises questions about the efficacy of their loan programs. As discussed below, the Bank

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and IMF currently stress that their ultimate purpose is the promotion of sustainable economic growth. Thus, the resulting effects of their lending activities on growth can be used to evaluate the success of their programs. This paper presents the results of an empirical investigation of the growth effects of both IMF and World Bank lending, within a common framework that also includes fundamental economic and political factors affecting growth. The analysis is extended to examine the impact of IFI lending by country income level and degree of democracy, as well as an investigation of the effects of different IMF programs.

The next section discusses the relevant literature. The empirical model is presented in Section 3. The data and empirical methodology are discussed in section 4. Results are presented in section 5, followed by a discussion and a concluding section.

2. LITERATURE REVIEW

The IMF was established as a financial institution to promote world trade, international financial stability, and the macroeconomic stability and growth of member countries. [2] The World Bank has always viewed its mission as developmental, helping countries reduce poverty, by focusing on the institutional, structural, and social dimensions of development.

Although the division of labor between the IMF and the World Bank was clear when these institutions were established, after the collapse of the Bretton Woods System, and especially after the 1980s debt crisis, a considerable overlap developed as the IMF and the Bank both focused on assisting developing countries and transition economies. IMF development assistance lending began in 1986 with the creation of the Structural Adjustment Facility (SAF), subsequently evolving into the Enhanced Structural Adjustment Facility (ESAF), and more recently into the Poverty Reduction and Growth Facility (PRGF). These facilities brought the IMF into the traditional purview of the Bank. Recently, in a joint statement, the IMF and the World Bank (IMF and World Bank, 2002, p. 2) announced "the purpose of our institutions is to help all our member countries develop their human potential and productive resources, thereby building the foundations for sustainable economic growth." Furthermore, in several speeches (1994, 2000), the former IMF Managing Director, Michel Camdessus, emphasizes that the IMF's primary goal is not only growth but also "high quality growth." While he characterized this objective as "ambitious" he argued (1994, p. 2), "it is the only way that the world's economic and social challenges can be met."

However, recent studies (Bordo & James, 2000; Feldstein, 1998; Goldstein, 2003; International Financial Institution Advisory Commission, 2000; James, 1998) strongly criticize the IMF for straying from its core competence of macroeconomic and exchange rate policies into a host of structural policy areas such as corporate governance, trade policy, privatization, poverty reduction, and environmental management, areas in which the Fund does not have necessary expertise and staff resources to make timely and sound policy recommendations. [3] Critics of the Fund argue that the expansion of the scope of IMF programs more likely reduces program effectiveness, further increasing criticism of the Fund. For example, Mussa and Savastano (2000) claim that the objectives of high output growth and alleviating poverty are not explicitly among the Fund's core responsibilities. They also point out that much of the criticism of the IMF might be due to a disjunction between its core responsibilities and broader objectives such as a high rate of economic growth, low inflation, and the alleviation of poverty.

Although IMF programs have many different objectives, certain characteristics of Fund programs are linked to its mandate to confront external payment problems. This is the so-called "three-pronged approach" (Knight & Santaella, 1997; Krueger, 2003; Mussa & Savastano, 2000). The first component of this approach involves securing sustainable external financing, as external financing typically evaporates at the onset of a crisis. The IMF assists countries suffering balance-of-payments problems with short-term loans through its Stand-by Arrangements (SBA) and medium-term loans through its Extended Fund Facility (EFF). Another common element of Fund programs is the adoption of demand-restraining measures consistent with available financing. These first two measures comprise the macroeconomic policies intended to restore sustainable balance between aggregate expenditure and income in program countries. The last component of IMF programs requires structural reforms intended to promote growth and adjustment in the medium and long terms. These policies aim to reduce government re-

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