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Economic Systems 30 (2006) 264–281

ECONOMIC SYSTEMS

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Macroeconomic policies and participation in IMF programs

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Received 25 December 2005; received in revised form 19 March 2006; accepted 1 May 2006

Abstract

This paper poses the question whether and to what extent developing countries' macroeconomic policies affect their participation in IMF programs. The data contain 91 developing countries that received four types of IMF programs during the period 1967–1996. Using survival analysis and generalized least squares, we examine the characteristics of interprogram years (years without any IMF program). The results suggest that the average number of years that countries spend without an IMF program is affected by their macroeconomic policies and exchange rate regimes. Policy combinations that prevent the reduction in reserves lengthen the average interprogram period.
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JEL classification: C34; E63; F32; F33

Keywords: The International Monetary Fund; Balance of payments crisis; Exchange rate regimes; Moral hazard

1. Introduction

Since the collapse of the Bretton Woods system in the early 1970s and the subsequent adoption of the flexible exchange rate regime in the developed countries, the International Monetary Fund has been providing balance of payments support mostly to the developing countries. Various studies evaluate the IMF's involvement in the developing countries.[1] The most common result of evaluation studies is that IMF programs improve program countries' current account and international reserves. A recent evaluation of Fund-supported programs shows that these programs have three characteristics (Evrensel, 2002). First, improvements that are achieved

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[1] See Ul Haque and Khan (1998) for a literature review on program evaluations.

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doi:10.1016/j.ecosys.2006.05.002

during program years in current account and reserves disappear in the post-program years. Second, most of the conditionality-related variables do not improve significantly even during the program years. Third, Fund-supported programs exhibit a recurrent nature in that developing members of the IMF have spent on average more than one-third of the period 1971–1997 under the IMF's care (Evrensel, 2002). Therefore, it has been suggested that the ineffective and revolving nature of IMF programs may create moral hazard (Dreher and Vaubel, 2004b; Edwards, 2000; Evrensel, 2002; Friedman, 1998; Niehans, 1985; Vaubel, 1983, 1991).[2] *Debtor moral hazard* implies the provision of undesirable incentives to program countries' governments to implement inconsistent macroeconomic policies, which may lead to further balance of payments problems. In this paper, we further investigate the relationship between program participation and macroeconomic policies through the examination of policy combinations during the interprogram years (years without any IMF program). By doing so, we identify the policy combinations that shorten the interprogram years and lead to an IMF program sooner.

Quantitative studies that examine the relationship between macroeconomic policies and participation in IMF programs have been scant. Evrensel (2002) finds that the average program country pursues increasingly expansionary fiscal and monetary policies, as the number of IMF programs in the country increases. Dreher and Vaubel (2004b) conclude that program countries tend to have larger budget deficits as the interest subsidy associated with IMF loans increases. Additionally, the extent of expansionary fiscal and monetary policies becomes larger, as the amount of IMF loans increases. Finally, Gai and Taylor (2004) find that declining reserves and the appreciation in the real exchange rate increase the probability of an IMF program.

We contribute to the existing literature in three areas. First, we use four different program types that reflect the income levels of program countries. Therefore, we are able to derive different policy implications for countries that are at different stages of development. Second, we employ survival analysis to describe the characteristics of program participation (failure) and identify the differences among various programs regarding failure. Third, we emphasize the relevance of foreign exchange regimes by including a regime-related variable in our estimations. The exchange rate absorbs any shock and it changes under a flexible exchange rate regime, which prevents currency crises. However, pegging the exchange rate in the presence of budget deficits and expansionary monetary policies leads to an appreciation of the real exchange rate, which eventually results in reserve loss and the subsequent involvement of the IMF in the country.

The data contain 91 developing countries that received four types of IMF programs during the period 1967–1996. In our empirical analysis, we employ survival analysis and generalized least squares. While survival analysis describes the characteristics of failure, the results based on the generalized least squares examine the effects of macroeconomic policies during interprogram years on the length of interprogram periods. The results suggest that the average number of years that countries spend without an IMF program is significantly affected by their macroeconomic policies and foreign exchange regimes. The empirical results verify the relevance of exchange rate regimes regarding the participation in IMF programs that less-managed exchange rate regimes lengthen the interprogram period.

[2] Even though studies on the IMF-induced moral hazard have emerged fairly recently, there exists a variety of definitions in the literature, which depends upon who receives *implicit guarantees* due to an IMF program. In recent years, the term moral hazard has been mostly used in the context of *creditor moral hazard*. This type of moral hazard may be created if investors altered their portfolio decisions and took excessive risks because of expected implicit guarantees associated with Fund-supported programs. See Evrensel and Kutan (2006) for a review of the literature on creditor moral hazard in emerging countries' stock markets.

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