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IMF surveillance and financial markets—A political economy analysis

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ABSTRACT

The International Monetary Fund (IMF) is in the process of re-inventing itself with bilateral and multilateral surveillance emerging as a key function. The paper analyses how IMF surveillance announcements may be influenced by political power that member countries exert at the IMF. First, we analyze the content of Article IV Public Information Notices (PIN), and second, we use the financial market reaction to the released PINs as tools to identify the role of political economy factors for IMF surveillance. For a set of emerging market economies, the paper finds that financial markets react more favorable to PIN releases for politically influential member countries. Moreover, IMF surveillance appears to be systematically more favorable for countries with larger IMF loans outstanding, consistent with the finding in the literature that the IMF may engage in 'defensive surveillance'.

1. Introduction

The recent financial crisis has induced an intense search by policy makers for a fundamental change in the international financial architecture, with the objective of not only re-establishing global economic and financial stability in the short-run but also to safeguard such stability over the longer term. The G20 process, where much of this policy debate is currently taking place, envisages endowing in particular the IMF with a widened set of responsibilities in this regard. The IMF is thus standing at a cross-road in its search for a clearly defined role in the global economic and financial order. It is undergoing two fundamental changes. One concerns a re-definition of its function in the global financial system, in particular in light of the financial crisis; the other a fundamental shift in the balance of political power within the institution. A central tool for the IMF that is set to gain further in importance is surveillance, both at the bilateral level and at the multilateral level, which is emerging as a key function for the IMF.[1]

The second major change the IMF is currently undergoing, and one that is intimately linked to the first change, concerns the balance of political power within the institution as in particular a number of emerging markets push for greater influence, so as to reflect their growing global economic importance. The often controversial debate has been focusing on quota reform, on the

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[1] To underline the important role of bilateral surveillance, the IMF on 15 June 2007 implemented a landmark framework on bilateral surveillance that commits its members to a code of conduct on domestic and exchange rate policies (IMF, 2007).

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institutional structure for instance regarding seats in the Executive Board, as well as the precise role of exchange rate policy within bilateral surveillance activities.

What do countries expect to gain from a bigger say at the IMF? And why are others, in particular many industrialized countries, so reluctant to give up political influence? A benign possibility is that countries wish to maintain or take on a greater share of responsibility in global economic and financial affairs. After all, the IMF is the foremost global financial institution with systemic importance, and a stable global financial system is in the interest of all. Another possibility is that countries wish to derive gains or may hope to exert influence in their own interest. Indeed, as financial markets are sensitive to IMF surveillance recommendations, a more favorable assessment by the IMF can entail gains for countries in the form of more favorable financing conditions and higher foreign investment.

Do countries extract such gains from holding political power at the IMF or other fora? Specifically, does IMF surveillance favor countries that are able to exert political power over those that do not? In our paper, we use a novel approach to evaluate the impact of political economy factors on IMF surveillance by analyzing the financial market reaction—specifically of sovereign spreads—to IMF surveillance communication. More precisely, we use the market reaction to the release of Article IV consultations through a Public Information Notice (PIN) as our proxy for the favorableness of IMF surveillance and the influence of political power. These PINs are basically short summaries of the IMF Executive Board's main assessment of the various elements of a country's economic performance and its economic policy.

In principle, a favorable financial market reaction to IMF surveillance implies that the IMF assessment is more positive than investors expected. There are two potential reasons for such a positive reaction. A first one is that countries use their political weight to influence an IMF assessment in their favor. This can take place either directly if a country has more influence at the IMF—such as through an Executive Director or a high voting share—or through other fora or in close support from powerful members such as the US or the EU.

A second possibility for a favorable market response to IMF surveillance assessment is that the IMF provides new, and more positive information about its assessment of a country's fundamentals than anticipated by financial markets. Similarly, a PIN release of the IMF may be interpreted by market participants as entailing a stronger commitment by the IMF to e.g. make an existing program work successfully. Another possibility is that financial markets may, on occasion, misinterpret the information provided in a PIN, and thus react positively. However, in all of these cases, there should be no *systematically* positive or negative reaction of financial markets.

The main objective of the paper is to test whether political economy factors influence IMF surveillance. Two elements are central to our identification methodology. First, we use the release of the Public Information Notice (PIN) of the Article IV consultations about the IMF's assessment to identify and measure the presence of political economy factors in IMF surveillance. Although the information content of IMF surveillance goes beyond the releases of PINs, PINs are arguably the most important and timely pieces of information for financial markets about the IMF's assessment.[2] We have available the day of PIN releases, which take place every one to two years, for all IMF members since 2001, so that we can cleanly identify their market impact on sovereign spreads and other asset prices of emerging markets economies.

The second element of our approach is to test for the influence of political power on IMF surveillance.[3] We look in particular at the political power that countries exert via three potential channels that have been emphasized in the literature (see Steinwand and Stone, 2007, for a recent survey of IMF lending determinants): first, the power they hold at the IMF through the presence of an Executive Director, a large voting share, an IMF program or high staff share (see e.g. Bird and Rowlands, 2001; Barro and Lee, 2005; Przeworski and Vreeland, 2000, 2002); second, through geopolitical influence through e.g. a seat in the UN Security Council or a high UN voting correlation with the US or the EU; or other channels such as military links with the US or through oil (see e.g. Broz and Hawes, 2006; Thacker, 1999; Dreher et al., 2008, 2009; Reynaud and Vauday, 2009); and third, economic linkages vis-à-vis the United States and the EU countries as the most influential IMF members (see e.g. Eichengreen et al., 2006; Pop-Eleches, 2009). In short, countries that hold more such power should not be treated differently by IMF surveillance than other countries. If such countries face systematically a more favorable market reaction (for given macroeconomic fundamentals) in response to IMF surveillance, this suggests therefore the presence of an influence of political economy factors on IMF surveillance.

The empirical analysis of the paper proceeds in two steps. The first part of the analysis classifies the favorableness of the IMF assessment in all PINs for the 36 EMEs in our sample. While we stress that any such classification is necessarily subjective, the findings are telling in that the favorableness of the PIN assessment of a country appears to be influenced by that country's political influence.

In the second part of the analysis, our results confirm that IMF surveillance is influenced by political economy factors. Financial markets react systematically more favorable to PIN releases of countries that are politically powerful, in particular through their influence at the IMF and the UN. Moreover, surveillance is systematically more favorable for countries with greater IMF loans outstanding relative to GDP, consistent with the finding in the literature that the IMF engages in "defensive surveillance". This political economy influence on IMF surveillance appears to be sizeable: Sovereign spreads of countries with large political influence *systematically* fall by up to 50 basis points more than that of other countries.

These empirical findings need to be interpreted with caution as there are a number of caveats that should be kept in mind. In particular, one interpretation could be that the releases of new information is affecting the level of uncertainty and therefore is

[2] Collier and Gunning (1999) argue that an important role for the IMF in post-stabilization is to provide credible signals to private investors. This is compellingly illustrated by Glennerster and Shin (2003), who state: "Directors of country risk of the major banks in New York […] indicated that IMF Article IV reports were one of the first places they turned to in assessing country risk."

[3] The focus in this paper on IMF surveillance is novel, though there is a large and growing body of literature addressing how political and bureaucratic interests influence IMF lending practices (see Steinwand and Stone, 2007, for a recent survey). For instance, Dreher et al. (2008, 2009) find that countries voting with the United States in the UN General Assembly receive lower inflation forecasts as domestic elections approach and countries with large IMF loans outstanding also receive lower inflation forecasts, suggesting that the IMF engages in "defensive forecasting." Lombardi and Woods (2008) also discuss governance issues affecting IMF surveillance, but their work is more focus on surveillance effectiveness.