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On US politics and IMF lending

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Abstract

The political factors shaping IMF lending to developing countries have attracted attention in recent empirical work. This goes in particular for the role and influence of the US. However, scant formal modelling makes interpretation of empirical results difficult. In this paper, we propose a model in which the US acts as principal within the IMF and seeks to maximize its impact on the policy stance of debtor countries. We derive an optimal loan allocation mechanism, which leads to the testable hypothesis that the probability of an IMF loan is increasing in the amount of political concessions countries make. A political concession is defined as the distance between a country's bliss point and its actual policy stance measured relative to the US. We introduce a bliss-point proxy and demonstrate that our hypothesis is strongly supported in the data. Moreover, we show that not accounting for bliss points may lead to endogeneity bias in empirical work.

JEL classification: F33; F34; O1

Keywords: IMF lending; Political factors

1. Introduction

Countries in need of an arrangement with the International Monetary Fund (IMF or Fund) typically approach the Fund once alternative ways of financing balance-of-payments deficits are no longer available. The need of borrower countries for Fund arrangements is therefore likely to respond to a variety of economic factors (Knight and Santealla, 1997; Goldstein and Montiel, 1986; Bird, 1995, 1996). On the other hand, the

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granting of IMF loans depends on Fund willingness to approve an arrangement on the basis of the economic stabilization program put forward. Hence, IMF lending is, as demonstrated by Knight and Santealla (1997), a joint outcome of economic demand and supply factors.

Moving beyond the economic determinants of IMF lending, claims have over the years been made based on anecdotal evidence that political factors play a critical role in determining whether countries are successful in obtaining IMF loans or not; and the particular role and influence of the US on IMF behavior has attracted much attention. Calomiris (2000) provides two interesting recent examples:[1]

> Ecuador has been suffering a deepening fiscal crisis for several years caused by the combination of an unresolved internal policy struggle, adverse economic shocks to its terms of trade, and a poorly regulated banking system [...]. As yet, there is no consensus for reform in Ecuador, and there is no reason to believe that reforms will be produced by a few hundreds of millions of IMF dollars. Why in the world is the IMF sending money to Ecuador? Some observes claim that IMF aid to Ecuador is best understood as a means of sending political payola to the Ecuadorian government at a time when the United States wishes to ensure continuing use of its military bases there monitoring drug traffic. (p. 88).

> A knowledgeable insider informs me that the U.S. government has told Pakistan that its access to IMF subsidized lending depends on its willingness to sign a nuclear nonproliferation treaty. According to this person, unless Pakistan agrees, the U.S. will block its IMF program. (p. 99).

Moreover, the Meltzer Commission (2000) implicitly accepts the view that G7 governments, particularly the US, use the IMF as a vehicle to achieve own political ends (see also Bird and Rowlands, 2001). This is feasible since voting power in the IMF Executive Board is based on the size of the quotas of member countries. The US holds around 17% of the votes, and this in effect gives the US veto power over all decisions requiring so-called special voting majority (85%). In addition, the US Executive Director is appointed by the American Government and is obliged by law to clear his or her decisions with the US Secretary of the Treasury (Oatley and Yackee, 2000).

Econometric studies of the role of political factors in the decision making of the IMF have also started to emerge. Examples include Thacker (1999), Bird and Rowlands (2001) and Barro and Lee (2002). The common characteristic of these papers is that they specify empirical models based on a long list of potential explanatory variables, and they all conclude that political and institutional factors, including US influence, matter and add to our understanding of Fund lending.[2] However, none of the papers provide any formal theoretical model of the rationale governing the allocation of IMF loans.[3]

[1]See Killick (1995) for earlier case-study-based evidence.

[2]Dreher and Jensen (2004) analyze whether political relations with the US have any bearing on IMF *conditionality*. Interestingly, they find that a debtor country's relationship with the US influences the number of conditions the IMF imposes on a the country.

[3]Bird and Rowlands (2003), for example, call for "a better understanding of precisely what the political economy variables are, and the modalities through which they exert their influence".