

THE EFFECT OF INTERNATIONAL FINANCIAL INTERVENTION ON ECONOMIC GROWTH: A REVIEW OF THE EVIDENCE

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Abstract:

Most of the developing countries have been clients of both the International Monetary Fund and the World Bank in the post-war era. Yet, their programs have usually been blamed for generating adverse growth effects in the recipient countries. The effectiveness of IMF lending, in particular, regularly criticized as “anti-growth” and “anti-poor”. Thus, this paper reviews the available literature and conclude that while short-term fund lending is either neutral or detrimental to growth, there are some evidence suggesting that longer term IMF programs are likely to have positive growth effects. Where as available evidence suggests that Bank lending has relatively more positive growth effects in developing countries. In the literature, a large number of factors cited as possible causes of failure of these programs. However, it is crucial to recognize other roles played by the institutions to get comprehensive view of their importance for the developing as well as developed countries.

Özet:

Uluslararası Mali Müdahalenin Ekonomik Büyüme Üzerine Etkileri: Bir Literatür Taraması

Gelişmekte olan ülkelerin çoğu II. Dünya Savaşı sonrası dönemde çeşitli zamanlarda uluslararası ekonomik sistemde önemli yere sahip olan

Keywords: The IMF, The World Bank, multilateral lending, economic growth.
Anahtar Sözcükler: IMF, Dünya Bankası, çok taraflı krediler, ekonomik büyüme.

Uluslararası Para Fonu (IMF) ve Dünya Bankası programlarını uygulamışlardır. Fakat, özellikle IMF programları olmak üzere bu programların gelişmekte olan ülkelerin ekonomik büyüme süreçlerini olumsuz etkiledikleri yönünde ciddi suçlamalar yapılmaktadır. Bu çalışmada, mevcut literatür incelenerek bazı sonuçlara ulaşılmıştır. Her ne kadar kısa dönemli IMF programlarının ülkelerin ekonomik büyüme süreçlerine etkisinin ya olmadığı ya da negatif olduğu yönünde sonuçlar mevcutsa da uzun dönemli IMF programlarının etkisinin olumlu olduğunu gösteren çalışmalar da vardır. Dünya Bankası programlarının ülkelerin ekonomik büyümesine etkisinin ise daha olumlu olduğu belirtilmektedir. Ayrıca, literatürde, bu programlardan beklenen sonuçların alınamamasının çok çeşitli nedenleri üzerinde durulmaktadır. Fakat, uluslararası sistemde oynadıkları bazı önemli rollerin olduğu gerçeği de bu kurumların etkinliğinin değerlendirilmesi aşamasında göz önüne alınmasının gerekliliği de açıktır.

INTRODUCTION

Recently, the International Monetary Fund (IMF or Fund) and the World Bank (Bank) lending practices have been subjected to ever-increasing public scrutiny, and frequent criticism. One of the frequently pronounced criticisms against Fund programs is that they are "anti-growth" and "anti-poor". The anti-growth complaint is apparently associated with the literature that shows demand restraining measures accompanied by lower output growth as a characteristic outcome of IMF programs. But these programs are often the response to the dramatic failures of domestic policies, and it may not be appropriate to attribute the pain experienced simply to the remedy rather than the underlying sickness. Yet, given the widespread recidivism among many countries, it may be unfair to put the blame on domestic policies at least for the recidivist countries.

In the literature studying the macroeconomic effects of multilateral lending (or IFI), more attention has been given to effects of IMF lending compared to those of Bank lending. Similarly, both the IMF and its programs have confronted with extremely harsh criticisms and probably more than the Bank and its programs. This is probably because the Fund lending has been more controversial, more politically oriented and less successful than Bank lending. About the controversies in these programs, Krueger (1998) argued that it is natural to IMF programs to be more controversial and have more negative implications because the Fund has been dealing with the countries that are already in crisis and especially with severe balance of payments difficulties. The same thing is not true for the Bank. One implication of this is that while the IMF has been too harsh on developing countries, the Bank has been criticized as too soft.

I. THE INTERNATIONAL MONETARY FUND AND THE WORLD BANK: THEIR ROLES IN HISTORICAL PERSPECTIVE

The IMF is primarily a financial institution whose basic goals as laid down in the first Article of Agreement include promoting world trade, international financial stability and the macroeconomic stability and growth of member countries. In order to achieve these objectives, the Fund focuses on its core responsibilities: monetary, fiscal, and exchange rate policies, and their associated institutional and structural aspects¹. The Fund performs its functions in three ways: taking surveillance, technical assistance to members, and lending in three modes (crisis, preventive, poor-economies).

Whereas the Bank sees itself as a development institution from the beginning. Thus, the Bank's core mandate is to help countries reduce poverty, particularly by focusing on the institutional, structural and social dimensions of development. Birdsall and Londono (1997) argued that Bank lending throughout the 1970s motivated by "financial gap" models. In the 1980s attention in the operational work of Bank shifted to adjustment issues. And in the 1990s, the Bank once again determined its primary focus as reducing poverty with a "new" strategy that emphasized the issues such as acceleration of economic growth, provision of basic social services to the poor, creation of social safety nets. Lately, in a joint statement by the IMF and the Bank (2000: 2), they announced that "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.

Although the division of labor between the Fund and the Bank was clear at the time of their establishments. Over the decades, considerable overlap occurred as the IMF and the Bank focused on much the same issues of developing countries and transition economies. After the collapse of fixed but adjustable exchange rate system and especially after the 1980s debt crisis overlapping between roles of these IFIs has increased substantially. For example, with the establishment of the Extended Fund Facility (EFF) and structural adjustment lending (SAL), the Fund and the Bank were now providing balance of payments loans (1 to 3 years) with medium term. Eventually, the establishments of the Structural Adjustment Facility (SAF) in 1986 and of the Enhanced Structural Adjustment Facility (ESAF) in 1987 by the Fund, which have primary objective of growth have also greatly increased the overlap between the two institutions. Actually, these two facilities brought the IMF into what had traditionally been the purview of the Bank.

Thus, eventually many studies (such as James, 1998; Feldstein, 1998; Goldstein, 2000; Bordo and James, 2000; International Financial Institution Advisory Commission, 2000; Stiglitz, 2001) strongly criticized the Fund being strays 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 in which the Fund do not have necessary expertise and staff resources to make timely and sound policy recommendations². For example, Felsdstein (1998: 1) claimed that “(T)he IMF’s recent emphasis on imposing major structural and institutional reforms as opposed to focusing on balance-of-payments adjustments will have adverse consequences in the both the short term and the more distant future.” At the same time, the rise of structural adjustment components of IMF lending is also regarded as encroaching on the division of the Bank and the case has been made for merging the two institutions. However, Bretton Woods Commission (1994) rejected the recommendation of merging these institutions because of the different objectives they have. Note that both the Fund and the Bank recognize the importance of the issue and state their intention of increasing the cooperation among themselves (see, Fischer, 1997; the IMF and World Bank, 2000; Mussa and Savastano, 2000). For instance, Fischer (2000a) emphasized the need for reforming of the IMF through sharpening the focus of its activities. The Fund’s focus must be on macroeconomic policies and the accompanying structural areas - on monetary, fiscal, and exchange rate policies, and on the banking and financial sectors. However, Easterly (2001) emphasized that in practice neither will proceed with an adjustment loan unless the other is satisfied with progress on "its" area of responsibility. For example Feinberg (1988) reported that only 3 out of 17 of the Bank sector loans signed during fiscal years 1979-1985 occurred in countries not engaged in Fund programs. It is thus probably safe to generalize that the Fund primarily focused on macroeconomic policies in developing countries (including exchange rates, trade regimes, and financial markets), while the Bank was mostly responsible for longer-term perspective analyzing real variables and directed its focus on increasing supply-side efficiency and domestic investment by focusing on microeconomic and infrastructure investments. However, both Fund and Bank programs have some characteristics common to all programs. These include currency devaluations and market determined exchange rate adjustments, the adoption of anti-inflationary and demand restraining measures such as reducing budget deficits and reducing domestic credit expansion, the restoration or construction of market mechanisms like freeing controlled prices and interest rates and reducing trade barriers, and privatization of state enterprises.

II. IMF AND WORLD BANK PROGRAMS: DESIGN AND OBJECTIVES

Although IMF programs have many different objectives, there are certain characteristics of the Fund programs linked to its mandates for confronting external payments problems. This is so called “three-pronged approach” that outlines the three components of these programs (see, Knight and Santanella, 1997; Mussa and Savastano, 2000; Krueger, 2000). First component of this approach is to secure sustainable external financing because at the onset of the crisis, the external financing is often severe for borrowing countries. Another common element of Fund programs is the adoption demand restraining measures consistent with available financing. These measures consist of macroeconomic policies in order to restore sustainable balance between aggregate expenditure and income in the program country by tightening fiscal and monetary policies. The last component of IMF programs is structural reforms that are intended to promote growth and adjustment in the medium and longer term. These policies aim to reduce government related distortions and structural problems leading the inefficient allocation of resources in the economy and hindering growth³.

Besides achieving macroeconomic stabilization and supply size adjustment, Fund programs as well as Bank programs are designed to mobilize other supporting capital flows⁴. As argued in Rodrik (1995), private capital flows follow the multilateral flows only if they value information provided by IFIs. Bird (1996b) and Rowlands (1996) reviewed previous studies analyzing the “catalyst” role of IMF lending and concluded that the catalytic effect of IMF lending at best is weak. Bird (1996b: 489) actually concluded that “the Fund’s seal of approval does not seem to carry a very high market value.” More importantly, Rodrik (1995) showed that multilateral lending has actually followed the other sources of capital. While IMF loans to member countries have followed the commercial bank loans, non-IMF multilateral lending has followed bilateral transfers. Rodrik and Bird eventually claimed that to the extent that multilateral lending follows private flows, we have to worry about the possibility that multilateral institutions end up bailing out private creditors. Although IFIs have claimed the seniority of their monies, any multilateral lending that helps governments’ service their debt is a form subsidy to private capitalists. However, further disaggregating IMF lending, Rowlands (1996) found that SBAs and EFFs did indeed induce official lending to developing countries but private lending was neutral. However, SAF/ESAF lending may actually discourage private lending.

Especially in the 1970s and early 1980s, Fund programs were frequently criticized by many studies (see, such as Bird, 1996b; Bordo and James, 2000;

and Bird 2001) and developing countries as being too demand-oriented and too short run, and as not paying enough attention to economic growth, to supply-side reforms. As one study nicely puts it “cannot solve long run problems by short term solutions”. Thus, the IMF have responded to these critics as both substantially increasing the number of structural conditions in its programs since the late 1980s and developing longer-term packages in which more attention given to growth and development issues (see also, Knight and Santanella, 1997). At the same time, Bordo and James (2000) argued that the IMF responded to the fundamental changes in global environment such as the breakdown of the par value system, and the new mobility of capital, financial deregulation, and the collapse of Soviet bloc by expanding its activities both in scope and in detail. Goldstein (2000) reported that there is a consensus in the literature analyzing Fund structural policy conditionality that there has been a marked upward trend in such conditionality over the past fifteen years, and this trend has probably become steeper in the 1990s. Further, since the mid-1980s, economic growth and later, “high-quality growth”, became the frequently stated objective of IMF programs as well as of Bank programs. For example, in a number of speeches (1994, 2000) former IMF Managing Director, Michel Camdessus emphasized that their primary role is not only growth but also “high quality growth.” Note that even he himself defined this objective as “ambitious” but argued (1994: 2) that “it is the only way that the world's economic and social challenges can be met.”

Many studies, however, argued that the rise in the scope of IMF programs is more likely to reduce their effectiveness and also to increase criticisms against them even further. For example, Mussa and Savastano (2000) claimed that objectives of high output growth and alleviating poverty are not explicitly among Fund's core areas. They also pointed out much of criticisms of the IMF might be results of disjunction between its core elements and some broad objectives such as a high growth rate, a low rate of inflation, and alleviating poverty that are considerably medium or longer term objectives. Furthermore, Goldstein (2000) claimed that the Fund's charter does not provide a basis for a broad agenda aimed at high quality growth. (2000: 77) argued that “IMF mission chiefs have considerable knowledge and experience in macroeconomic and financial policies but not in structural policy areas beyond this core competence. Efforts to include in Fund conditionality everything but the kitchen sink under the a loosely defined agenda of pursuing “high quality” growth have taken the Fund too far from its comparative advantage and have elicited legitimate charges of “mission creep.” For regarding the arguments that the IMF should not be in the poverty business; poverty is primarily the business of the World Bank and the regional banks, Fischer (2000b: 4) replied that “the poorest members of the world community belong to the IMF; they have macroeconomic

problems; they have a right like every other member to access the facilities of the IMF.”

III. AN ASSESSMENT OF THE EFFECTIVENESS OF IMF PROGRAMS

The literature on IMF programs can actually be divided into two parts. One studies the determinants of IMF lending⁵; the other studies the effects of IMF lending on the borrowing countries. There are numerous criticisms about the effectiveness of IMF programs. Since IMF programs include a number of macroeconomic objectives, which are lowering inflation, restoring the balance of payments difficulties, reaching the certain level of international reserves, the resumption or expansion of private capital inflows, exports, investment, and a sustained high rate of growth, there are thus a number of different criteria to judge whether IMF programs work. Mussa and Savastano (2000) argued that because encouraging growth or reducing inflation is not among the Fund’s core objectives, it might be unfair to evaluate these programs by looking at their effects on growth and inflation. Moreover, as Fischer (1997) emphasized, to evaluate the effects of IMF programs, it is important to distinguish two issues. The first is whether the IMF programs are appropriate prescriptions to encourage growth if implemented. The second question is whether the agreed-upon program is implemented as designed.

On the one hand, it seems that there is some level of consensus on the effect of IMF lending on the balance of payments and current account. As reviewed in Haque and Khan (1998), Bordo and Schwartz (2000), and Bird (2001), most studies found that IMF lending improve the balance of payments and current account. However, it is not surprising given the fact that the primary focus of IMF is to correct maladjustments in its member countries’ balance of payments without resorting to measures destructive of national or international prosperity. Meantime, their effect on inflation is negative but reportedly weak. On the other hand, for the growth effects of these programs, the literature is far away from consensus. While Haque and Khan (1998) claimed that they have negative effects on growth over the short-run probably due to the demand restraining nature of them, over the long-run it seems that growth increases, Bird (2001: 1861) concluded that “Fund programs seem to have a negative effect on investment and possibly growth, often do not enable countries to graduate from a reliance on IMF resources, more often than not remain uncompleted, and do not catalyze external finance from other sources.”

Empirical studies analyzing the effects of IMF programs have employed very different methodologies. Many studies (Haque and Khan, 1998; Goldstein,

2000; Bird, 2001; Barro and Lee, 2002) discuss the major shortcomings of these methodologies. “Before-after” comparisons are not reliable because they implicitly assume no change occurs except an IMF program between these two periods. Comparison of program targets and outcomes will not be useful because there are pronounced problems with the implementation of IMF programs and program targets may set too ambitiously or not ambitiously enough. Simulations of economic models can tell us something about the effect of Fund-type policies but not about the effects of actual Fund programs. And comparisons of outcomes for program and non-program countries will not do the job if the two groups differ systematically in ways that matter for economic performance. Haque and Khan (1998) concluded that studies use before-after and with-without approaches yield less favorable results than later studies used General Evaluation Estimator (GEE) methodology and simulation techniques and more confidence can be placed in the results produced by these studies. However, Dicks-Mireaux et al. (2000) claimed that there are considerable doubts on the validity of other applications of the GEE that do not rigorously test underlying assumptions. Given the fact that the GEE framework has many restrictive assumptions that are necessary to define the counterfactual and to specify in a simple framework the main determinants of important endogenous macroeconomic variables, a major shortcoming of most applications of the GEE is their focus on the bottom line with little or no evaluation of the validity of the underlying model. At the same time, both Hutchison (2001) and Barro and Lee (2002) argued that Heckman’s (1979) Inverse Mills Ratio (IMR) approach does not adequately control for selection bias. Besides methodological problems of these studies discussed in the literature, we believe that since the time period considered in most of these studies was short, it is more likely that their results pick up the business cycle effects rather than growth effects of these programs.

Goldstein and Montiel (1986) showed that IMF programs have negative effects on growth. Conway (1994) concluded that IMF programs have only favorable growth and investment implications in the long run. Recent studies on the macroeconomic effects of IMF lending have often reported adverse growth effects of these programs. A large number of studies (such as Barro 1998, Stiglitz, 2000; Bordo and Schwartz, 2000; Przeworski and Vreeland, 2000; Hutchison, 2001; and Barro and Lee, 2002; Butkiewicz and Yanikkaya, 2003) claimed that IMF programs do more harm than do good to the recipient countries. Yet, there is no consensus at all on the growth effects of IMF lending. There are of course some other studies who reported the positive growth effects of IMF lending (such as Dicks-Mireaux et al. 2000, Mercer-Blackman and Unigovskaya, 2000). These conflicting results may arise from several sources, including differences in the types of IMF programs that are investigated; differences in the groups of countries that are investigated (e.g. poor developing versus emerging market economies or transition economies); differences in the

methodologies that are employed; and, perhaps most important, how other growth determinants are taken into account.

After controlling a number of determinants of growth and endogeneity of IMF lending, Barro and Lee (2002) found that IMF stabilization programs (SBAs and EFF) have a statistically significant negative effect on growth in the subsequent five years but not on the contemporaneous growth using IV estimation. Similarly, Hutchison (2001) investigated the growth effects of IMF stabilization programs using the GEE. He found that participating in an IMF-program, regardless of whether a currency or balance of payments crisis has recently occurred, “costs” about 0.6-0.8 percentage points of real GDP growth annually. Przeworski and Vreeland (2000) estimated a growth model using all types of IMF programs. They divided the sample into (IMF) program observations and non-program observations and also include the IMR in the regressions to control selection bias. They concluded that these programs reduce growth while countries remain under programs and do not return benefits that would compensate the losses once they leave the program. Bordo and James (2000) using all types of IMF programs concluded that turning to the IMF may be harmful to a country’s real economic performance, once account is taken of the self-selection bias, and that this effect has been amplified since the Mexican crisis. Finally, Easterly (2001) using IMF and Bank structural programs found no systematic effect of adjustment lending on growth.

Dicks-Mireaux et al. (2000) evaluated the effects of IMF lending for low-income countries eligible for the IMF’s Enhanced Structural Adjustment Facility (ESAF) using the GEE methodology. They found significant positive effects of IMF-supported programs on growth. However, they concluded that the diagnostic tests cast doubt on the appropriateness of the restrictive assumptions underlying the GEE and accordingly about the reliability of the results. This finding raises questions about whether there are inherent problems in estimating GEE models with panel data. At a minimum, it strongly indicates that future applications of the GEE on other data sets need to incorporate standard diagnostic tests to ascertain whether the GEE methodology is valid for the sample under study. Similarly, Mercer-Blackman and Unigovskaya (2000) investigated whether greater compliance with Fund structural policy conditionality is associated with better growth performance. They found that, after controlling for other factors, transition economies that successfully implemented Fund programs measured as greater compliance with performance criteria had better records of sustained economic growth (defined as three consecutive years of positive real GDP growth); in contrast, they could find no significant relationship between compliance with Fund structural benchmarks and economic growth.

Furthermore, Rodrik (1995) claimed that multilateral lending is not expected to affect subsequent growth directly. Instead, using actual flows of multilateral lending over the period of 1970-1990 and OLS, he investigated that whether IFIs have had informational advantage, because of their close monitoring of government policies, in determining which countries have superior growth potential. He concluded that the estimated coefficients on lagged multilateral lending is uniformly negative, and becomes significant some versions of the regressions. Disaggregating further each category, the coefficient on net lending by the IBRD is consistently positive. However, IMF lending follows the similar pattern as multilateral lending.

A number of case studies analyzing the individual country experiences with IMF programs also reported adverse effects of these programs. Zaki (2001) argued that Egypt's arrangements since 1991 have successfully met the program targets but much less successful in meeting the targeted growth rates. He thus concluded that the experience of Egypt is that economic reforms and liberalization in the absence of commensurate political and institutional reforms will not produce the economic growth and prosperity for the poor. Similarly, Yeldan (2001) claimed that Turkish authorities were clearly successful in maintaining the 2000 Disinflation Program targets both in exchange rate administration and monetary control, as well as attaining the fiscal targets. In this sense the outburst of the November crisis (in 2000) -and the ultimate collapse of the program in February 2001- cannot be accounted to any divergence from the monetary targets. He indeed claimed the collapse of the Turkish program were the result of internal inconsistencies and errors in design and thus modest gains in disinflation achieved at the expense of de-stabilization of the Turkish economy along with worsening of its financial and external balances. Kaplan and Rodrik (2001) suggested a different counterfactual by arguing that the appropriate counterfactual for Malaysian capital controls in 1998 is the performance exhibited by the other countries subsequent to their resort to IMF assistance. Using the so called "a time-shifted difference-in-differences methodology" they found that the Malaysian controls produced better results than the alternative on almost all dimensions. On the real side, the economic recovery was faster, and employment and real wages did not suffer as much. On the financial side, the stock market did better, interest rates fell more, and inflation was lower.

IV. POTENTIAL CAUSES OF THE FAILURE OF INTERNATIONAL FINANCIAL LENDING

There are of course a number of factors discussed in the literature that can be responsible for the negative or no growth effects of Fund and Bank lending.

For example, Easterly (1999) showed that almost all international financial institutions (IFIs) have based their lending on so called “financing gap models”. In the 1980s world had yet come to realize that even in the presence of macroeconomic stability, giving money and advice to developing countries was not enough for sustainable development (or growth) without good policies and structural reforms. In the mid-1990s a new consensus so called “Washington consensus” began to develop that issues such as “good institutions, transparency, and good governance” have been the keys to sustainable growth. In other words, country’s political and economic environments are linked in a way that economic efficiency depends on the existence of good institutions and policies. A response to the new politics of the 1990s involved an expansion of IFIs activities into non-macroeconomic policy areas, such as criticisms of military spending, corruption, and non-democratic practices. Especially after the latest Asian crises, the IMF focused on areas such as corporate governance and accounting practices that traditionally lay outside its purview. Because “good governance” and “good institutions” have been top of their agendas since the second half of the 1990s, conditionality attached to Fund and Bank programs related to governance issue aim to raise efficiency of these programs and governments⁶. Some critics offer the latest East Asian crisis as an example of this because even though these economies had impressive records of macroeconomic management and developing competitive economies, they were slow to recognize the importance of governance and transparency. For example, Goldstein (2000) claimed that emerging economies with better corporate governance structures were affected less from the latest Asian crisis.

Another factor widely discussed in the literature (see, Stewart and FitzGerald 1996, Chang 2000, Krueger 1998 and 2000, Bordo and Schwartz, 2000, Bordo and James 2000, Kho and Stulz 2000, Hutchison 2001, Yeldan 2001) is moral hazard supposedly created or promoted by presence of IFI lending. Chang (2000) reviewed the problem of moral hazard through the historical perspective and concluded that moral hazard has been the integral part of the development of modern capitalism such as limited liability, central banking, the development of lender of last resort facilities, insurance, and the underwritings of risky ventures by governments. All of them primarily aim to socialize risk. Thus, he concluded that social benefits of these institutions are on the whole greater than the social costs arising from the moral hazard they create. The Fund has also been heavily criticized in recent years for its role as a crisis manager. For instance, Bordo and Schwartz (2000) characterized international lending until the 1980s as a rescue loan in which investors faced major losses on their loans but saved from closures. However, international lending in the 1990s have characterized as bailouts in which the lenders suffer no or minimum loss. Thus, this basically promotes moral hazard. They claimed that the safety-net provided by the IMF and other IFIs may be responsible for the greater

decline in real growth on average in today's crises compared to earlier ones probably due to the greater swing in capital flows (see also, Dooley and Verma, 2001). The loans provided by the IMF and other authorities to Mexico and the recent Asian crisis victims are seen as engendering moral hazard both for policy makers who may follow too lax policies in the knowledge that the Fund will intervene, and for lenders who believe they will be bailed out. Thus, a number of studies argued that risk of moral hazard increased greatly especially after IMF's role in Mexico because contrasted with holders of equities and bonds, commercial banks do seem to have emerged with few losses from this crisis. More importantly, it is argued that it has severe consequences in the future because it created a precedent and expectations and it also planted the seeds of 'moral hazard' that may have increased the likelihood and severity of the next set of crises. Note that it is often argued that both during the Cold War era and the post-Cold War era, political, strategic, or security considerations lead to support of some countries (Egypt, Zaire, or Russia) on the basis of weak conditionality and even in the absence of effective reform. Here the result was again a major moral hazard problem.

A number studies originated from the IMF (such as, Fischer 1999a, and 1999b; Lane and Phillips, 2000) naturally accept the concern about moral hazard created by the IMF lending. However, Fischer (1999b) argued that the language used in the existing literature misleadingly imply that the primary purpose of a Fund loan is to bail out investors rather than help the country deal with a crisis. Although the widespread belief of existence of moral hazard, empirical evidence on this point is mixed. For example, Dreher and Vaubel (2001) found support for moral hazard associated with IMF programs, while Lane and Phillips (2000) could not find the existence of moral hazard using interest rate spreads as measures of perceived risk. Lane and Phillips (2000) primarily examined whether there are declines in emerging markets bonds in response to the substantial events during the 1990s, which would support the moral hazard hypothesis and concluded that evidence fails to support it. They, however, also noted that although the Fund's support is small, it can enable the countries to cover their maturing debts for some finite period.

Note that Bordo and James (2000) argued that since most of the inflows to Asian and Latin American economies were private sector credits, they were not protected by IMF rescues, except to the extent that national governments used IMF resources to rescue domestic financial institutions with debts to foreign creditors. Moreover, Chang (2000) emphasized the sources of moral hazard created by national institutions of Asian countries besides the IMF bailouts. He also argued that the Fund bailouts in saving the international lenders are not fully predictable. For example, in the 1995 Mexican and or in the latest Asian crisis IMF bailouts were effective saving international lenders

especially commercial banks but during the 1982 debt crisis, most international lenders or investors incurred considerable amount of losses. Thus, it may have argued that the extent of moral hazard may not be large. Given that both the Fund and the Bank could not anticipated the Asian crisis before it happened it is difficult to argue that IMF lending cause big moral hazard problems. Further, Dooley and Verma (2001) argued that if the third party intervention i.e. the IMF is anticipated this can lead to investors' moral hazard, in terms of poor monitoring of its loans, as well as debtors' moral hazard. However, even if the existence of insurance intensifies the current account reversals and output losses, they claimed that anticipated and unconditional lending at the time of crisis is rational to avoid the costs of default that are built into contracts because uncertainty about the size and distribution of insurance can generate unpredictable defaults that intensify and prolong losses in output.

There seems to be consensus about that lack of ownership of the both Fund and Bank programs. It has been one of the most important factors for the effectiveness of these programs. We believe that this problem is one of the most important aspects of moral hazard. Given the hazard of moral hazard in which governments are reluctant to take reforms and not committed to implement IFI programs, both the Fund and the Bank emphasized the “participation” and “ownership” issues in the context of good governance to increase effectiveness of their programs. Further, James (1998) argued that political outlook in the 1990s has replaced the belief that economic reforms could be done more easily by authoritarian regimes with that only democratic and legitimate governments can take severe costs of adjustment. Thus, in the 1990s the issue of ownership became central. In a series of speeches both Camdessus (1999a, 1999b and 2000) and Fischer (2000a) recognized this problem and suggested solutions. For example, Camdessus (1999a: 3) noted that “years of experience have demonstrated that stabilization policies or structural reform are truly effective only, where the national authorities-and even more important, the people-are committed to change.” Fischer (2000a: 5) noted that “country ownership has proven to be a vital factor in determining the success of stabilization and reform efforts supported by the international organizations.” Outside the IMF, there are also a number of studies (Killick, 1995; Stewart and Fitz Gerald, 1996; James, 1998; Bordo and Schwartz, 2000; Woods, 2000; Krueger, 2000) pointed out to this problem as a potential source of ineffectiveness of these programs. For example, Bordo and Schwartz (2000: 21) emphasized that “it is clear that the countries themselves need to find the political will to change...Some of the financial technology can be imported but not the will.” Thus, they pointed out the lack of ownership for not achieving the status of development even after fifty years of the ministrations of both the Fund and the Bank.

Both Fund and Bank programs are designed to promote good policies through the conditions that attached to them. Conditionality attached to these programs intended to create incentives or to force program countries to implement and carry through these programs to the completion. Thus, many studies (Bird, 1996a: 2001; Mussa and Savastano, 2000; Goldstein, 2000) argued that noncompletion can be an indication of breakdown or failure of these programs. For example, Goldstein (2000: 47) reviewed the existing evidence and concluded that “obtaining compliance with Fund conditionality has been a serious problem, including the Fund’s structural policy conditionality. The compliance problem has been getting more serious over time.” Mussa and Savastano (2000) reported that more than a third of all Fund arrangements approved between 1973 and 1997 ended with disbursements of less than half of the initially agreed support. Mainly these were the cases where the program went off track because policies deviated significantly from those agreed with the IMF and subsequent negotiations failed to reach agreement on a modified programs. It is almost common to take disbursement of 75 percent or more of the total loan as implying close adherence to IMF policy conditionality. According to Mussa and Savastano (2000: Table 2), more than half of the all Fund arrangements would have failed to meet this benchmark. Note that compliance has been much lower for EFF programs (and slightly lower for SAF/ESAF programs) than for SBAs and compliance has also been lower for structural benchmarks than for performance criteria. Considering the fact that both EFF and SAF/ESAF have relatively more structural components and aim more to encourage growth and reduce poverty, it is not surprising the lack of positive growth effects of these programs. Meantime, Bank projects relatively higher success rate based on the internal evaluation these programs. For example, while Kilby (2000) reported that 86% of World Bank projects completed before 1980 were judged satisfactory, only 72% of projects completed since 1980 have achieved such performance. Dollar and Svensson (2000) using the data from the Bank’s operation evaluation department (OED) during the period 1980-95 reported that 36% of adjustment programs failed and this number was as high as 50% in the Africa. Thus, given that noncompletion is a rule rather than exception because of the high rate of noncompletion or failure, it is hard to understand the rationale to negotiate detailed conditionality further. Dollar and Svensson (2000) argued that their results imply that adding more conditions to loans or devoting more resources to manage them does not increase the probability of reform. Instead, they emphasized that development agencies should need to devote resources to understanding the political economy of different countries that success or failure of reform depends on.

It is probably safe to conclude that “ownership” or “participation” problem, which, in turn, is one of the most important aspects of moral hazard created by IFI lending, is the best candidate to explain the high rate of failure of

both IMF and Bank programs. High noncompletion or failure of these programs means that program countries are reluctant to employ reform policies that can make the differences in the long run for these countries by increasing productive capacity of these economies. It also means they are mostly interested in “saving the day” and when it comes to the structural problems they just delay the necessary reforms and this is what we think is the most important type of moral hazard caused by IFI lending. Because by lending their members especially to the recidivists ones, it creates a moral hazard because countries are not really committed to go deep into solving the structural problems and by lending them IFIs just lengthen the life of these governments that do not try to solve their structural problems.

In most cases (see, Mussa and Savastano, 2000; and Krueger, 2000) the IMF prepares the stand-by agreements that, we believe, is the main indication of “ownership” problem. In other words, although the lack of technical expertise is important for some low-income developing countries, the level of commitment to reform is directly related to the level of incentive to involve in the preparation of the programs. In some cases, the program either prepared by the help of the Fund or had already been adopted in the borrowing country. For instance, Zaki (2001) claimed that the difference between the successful IMF programs in the 1990s and the earlier failed- programs was that successful programs were developed by the Egyptian authorities with the technical help of the Fund. Another example was Turkey in 1980 that undertook sweeping reforms (which went far beyond what the Fund would have required in order to extend financial support) and then approached the Fund for a loan. We believe that similarly the success of Turkish economy during the second half of the 1980s and early 1990s can be explained by this fact that local authorities who were determined to reform took the lead of their economy with technical and financial help of the Bank and the Fund. Thus, it is clear that without political will to change and good policies, continuation of IFI lending enables the country to just “save the day”. Krueger (2000: 11) appropriately claimed that “it would do a disservice to a country to lend in support of a futile program: the outcome would be a renewed crisis at a later date, with more debt having accumulated because of the first program”.

Thus, given the fact that recidivism or the quasi-permanent involvement of the IMF with low-income developing countries has been considerable problem (Bird, 1996a and 2001; Easterly, 2001) and given the fact that multiple arrangements with both the Fund and the Bank is rule rather an exception, it is not surprising that many Fund and Bank programs have expectedly failed to reverse the underlying economic trends in developing countries. Krueger (2000: 15) characterized a typical experience of developing countries with the IMF as the “stop-go” cycle. The cycle begins with a Fund program that marked a period

during which the government fiscal deficit and the rate of domestic credit creation were reduced along with sizable depreciation in real exchange rate improving the current account. These usually resulted in some degree of domestic recession that, in turn, further improving current account through reducing the demand for imports. Simultaneously, reduced domestic demand usually more than offset other effects to result in - at least temporarily - a reduction in the rate of inflation. Thus, this points out the peak of the boom cycle. However, governments typically responded to this brief and temporary relief by increasing expenditures and easing the monetary situation. That, in turn, leads to gradual appreciation in the currency and increase in the incipient current account deficit along with accelerating inflationary pressures. The boom eventually ended when the next exchange rate or debt-servicing crisis became too costly, and once again the IMF was approached⁷. This was referred to as developing countries' "stop-go" cycles.

While recognizing the existence of moral hazard, the counter-argument for the above view emphasizes on the fact that top policy makers who were in office lose their jobs with the onset of the crisis. For example, in latest crisis-hit countries such as Korea, Thailand, Mexico, Brazil, and Indonesia top policy makers lost their jobs very quickly in any event. However hard it is to deny this fact that they forcefully leave the office at the time of the crisis, but it should be noted that, we believe, they had stayed in power more than they would have stayed in the case they had taken the necessary structural policies that their countries urgently needed. Furthermore, we believe that national politicians in developing countries have short time horizons that longer-term penalties are anyway unimportant (see also Krueger, 1998 and 2000).

There are of course several explanations for IFIs to continue to lend to recidivist countries. First, as discussed earlier, they have been slow to understand the importance of ownership. Second, they have been also slow or late to understand to the importance political-economy factors within the country attempting to reform and social consequences of their programs. Third, IFI lending to certain countries have been mostly motivated by the political considerations. Political aspects of IMF lending are beyond the scope of this paper but considerably wide literature on this issue arguing that the IMF itself is a political institution and make available its funds to member countries based on political considerations (see, Thacker, 1999; Bordo and James, 2000; Barro and Lee, 2002)⁸. Thacker (1999), for example, claimed that despite the low rates of borrower compliance with Fund conditionality, the continuation of IMF lending to many of these countries (such as higher probability of approval of loans to politically friendly South Africa, El Salvador, and Haiti but not so for political enemies of the U.S., such as Vietnam) may imply the pressures from the leading industrial countries. In the end, she (1999: 10) concluded that "in contrast to

common expectations, their results suggest that politics may be more important now than ever.” Bordo and James (2000: 39) emphasized the role played by the IMF for the general national interest of the United States and concluded that “such issues raise questions of political costs and limitations that may not always coincide with economic rationality, however. There is a strategic or geopolitical element to some of the work of the Fund.” This can also be seen the differences in IMF’s treatment to big and small states. James (1998, 7) cited this kind of criticism of international institutions is made by opposition politicians such as Grigory Yavlinsky who “explain the problems and failures of Russian reform programs by an unwillingness of the international community to go far enough in attacking corruption and in imposing reform from the outside.”

A large number of other factors that may cause the ineffectiveness of IFI lending have been also discussed in the literature. For example, Camdessus (1994: 5) summarized the vast literature on the effectiveness of aid by concluding that “without strong policies in place, official financing may merely encourage the postponement of adjustment, end up in capital flight, and add to the country's debt burden with no benefit to the country.” More importantly, Camdessus (2000b: 8) also claimed that there exists considerable incoherence in IFIs’ effort and concluded “the fact is that the international community is giving with one hand, but is taking away with the other.” Because a number of studies (see, Fischer, 1997; Mussa, 1997; Krueger, 1998; Mussa and Savastano, 2000; Goldstein, 2000) argued that Fund policy recommendations reflect the economics profession’s current consensus, another factor is that if non-program countries actually have followed similar policies to those IMF programs, frequently used methodologies may not be able to pick up positive effects of these programs. Finally, as frequently argued in the literature, Goldstein (2000: 49) argued that “despite all the rhetoric on “growth-oriented adjustment,” Fund programs are still mainly about getting out of financial crises and don’t much matter for growth in the medium to long-run.”

CONCLUSION

While the division of labor between the IMF and the World Bank was clear at the time of their establishments, over the decades, considerable overlap occurred as the IMF and the Bank focused on much the same issues of developing countries and transition economies, which has been strongly criticized by the number of studies. Yet, it can be stated that the Fund primarily focused on macroeconomic policies in developing countries, while the Bank was mostly responsible for longer-term perspective analyzing real variables and directed its focus on increasing supply-side efficiency and domestic investment

by focusing on microeconomic and infrastructure investments. However, both Fund and Bank programs have some characteristics common to all programs.

Lately, IMF and World Bank programs have been subjected to very harsh criticisms as being "anti-growth" and "anti-poor" probably because of the ignorance of social safety nets in the recipient countries and the demand restraining measures attached to these programs. Furthermore, IMF lending compared to Bank lending has confronted probably more criticisms probably because the Fund lending has been more controversial, more politically oriented and less successful than Bank lending. However, since IMF programs include a number of macroeconomic objectives, it is hard to judge these programs while looking at one or several aspects of these programs. On the one hand, there is some level of consensus on the effect of IMF lending on the balance of payments, current account and inflation, which are the primary focus of IMF programs. On the other hand, for the growth effects of these programs, the literature is far away from consensus. Empirical studies analyzing the effects of IMF programs have employed very different methodologies and concluded very diverse growth effects of these programs.

There are of course a number of factors discussed and listed in the literature that can be responsible for the negative or no growth effects of Fund and Bank lending such as IFI lending on so called financing gap models, moral hazard supposedly created or promoted by presence of IFI lending, lack of ownership of these programs, high degree of recidivism among the recipient countries, and internal inconsistencies and errors in the design of these programs.

However, although the effectiveness of IFI lending has been heavily criticized by many authors and developing countries themselves, it is crucial to recognize other roles (and probably more important) played by the IFIs to get comprehensive view of their importance for the developing as well as developed countries. A number of studies (Gavin and Rodrik, 1995; Rodrik, 1995; Krueger, 1998; Bordo and James, 2000; and Fischer, 2000b) argued that both the Bank and the Fund have very important roles to play other than lending to developing and transition economies. These roles include provision of public goods such as information providing and signaling in the form of gathering and disseminating primary statistics to research and analysis on a variety of issues, different aspects of training under Bank and Fund auspices, policy advices and technical assistance that affect growth prospects of member countries, and exercise of conditionality. For example Fischer (2000a) listed the countries (such as Canada, Sweden, PLO, small economies of the Pacific) that have consulted to the Fund for policy advices and technical assistance without asking loans. He also emphasized the fact that the IMF devotes more than twice as

many staff resources to surveillance and technical assistance, taken together, as it does to the operation of its lending programs. Moreover, Rodrik (1995) emphasized stabilizing role played by multilateral lending together with bilateral flows especially in the 1980s when private flows that are highly cyclical and geographically concentrated disappeared. Jenkins (1997) also argued that while the Bank has been only partially successful in implementing its own formal methodology for the economic analysis of projects, its impact on improving investment decision-making and the economic performance of investments in the developing countries has been enormous. Thus, it is extremely important to consider these roles played by these institutions, before making the overall conclusions about their effectiveness. Actually, as Krueger (1998) argued that many of the IFIs' contributions are intangible and it is impossible to assess them in a quantitative framework. Therefore, it is extremely crucial to take into account the different objectives of these programs to assess the successes of these programs. While these programs may be successful for some objectives, they cannot be for some others.

NOTES:

¹ See Krueger (1988) and Bordo and James (2000) for more extensive review the of the IMF's role in the past and present.

² Some studies (such as Goldstein, 2000; Stewart and FitzGerald, 1996; Thacker, 1999) put the blame on the powerful member of IMF for the rise in the scope of IMF programs.

³ For an extensive overview of IMF structural programs, see Goldstein 2000. He (76) concluded that "my reading of the record is that on structural policies the Fund has bitten off more -- in both scope and detail -- than either it or its member countries can chew."

⁴ Bird (2001) evaluated five counterarguments that make the theoretical basis for catalysis ambiguous. Moreover, Rodrik (1995) argued that the insistence of multilateral lenders that their claims be senior to private claims undercuts the signaling value of their exposure.

⁵ On the determinants of IMF lending, see Bird (1996a), Knight and Santanella (1997), Thacker (1999), Przeworski and Vreeland (2000), Barro and Lee, (2002). For example, Knight and Santanella (1997) found that countries with higher external debt, depreciated currencies, low rate of investment, lower levels of GDP growth and per capita GDP are more likely to seek a Fund's support. At the same time, they found that policy measures to improve fiscal revenues, to reduce government expenditures, to tighten domestic credits, and to adjust the exchange rate are significant factors that increase the probability of Fund approval. Thacker (1999) and Barro and Lee (2002) were primarily focused on the political determinants of IMF lending and found that political variables have been important determinants of IMF lending. At the same time,

Przeworski and Vreeland (2000) concluded that none of the economic variables matter for the government's decision to remain under agreements. The only variables that have significant effects on the government's decision to continue participation in an IMF agreement are sum of past years under agreements for a country and number of other countries currently under IMF agreements. Regarding the decision of the Fund to retain countries under its programs, only balance of payments has a significant effect. Note that a number of studies (Boone, 1996; Burnside and Dollar, 2000; and Alesina and Dollar, 2000) studying the determinants of official aid found that aid flows have been a large extent explained by political factors such as colonial links, alliances, strategic interests etc and but recipient's policy and political institutions are less important.

⁶ See, Woods (2000) for the discussion of governance issues on the side of the Fund and the Bank.

⁷ Bird (1996a) characterized the political cost of a first-time Fund arrangement as a quasi-fixed cost and this view has been consistent with stop-go cycles.

⁸ Note, however, that Rodrik (1995) argued that existing evidence suggest that multilateral flows are less affected by political considerations than bilateral flows. Bilateral flows tend to be determined to an extent by political and military considerations.

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