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## CHAPTER 19

# INTERNATIONAL FINANCIAL INSTITUTIONS AND MARKET LIBERALIZATION IN THE DEVELOPING WORLD

STEPHEN C. NELSON

With the 1980s economic policy-making in noncommunist developing countries involved heavy doses of state intervention in markets and regulatory actions that impeded the ability of residents to conduct transactions with nonresidents. Tariffs, quantitative limits, import financing restrictions, and export-proceed surrender requirements were among the panoply of policy tools used to protect producers for the domestic market and to discourage foreign trade. Governments set up multiple exchange rates for their national currencies. National financial systems were ring-fenced by controls on capital inflows and outflows. Capital controls went hand-in-hand with other policies—interest rate ceilings, deposit requirements, restrictions on the entry of foreign financial institutions, directives to channel credit to handpicked borrowers, and in some cases outright state ownership of banks—that governments used to “repress” their countries’ financial sectors (Agénor and Montiel 1996, pp. 152–159).

Governments took controlling interests in firms operating in many different sectors. State-owned enterprises exerted monopoly power in most developing countries’ infrastructure industries (Frensz, Zehner, and Guillén 2005). Farmers were forced to sell agricultural products to state-run marketing boards at prices that fell well below those prevailing in world markets. Foreign direct investment was heavily regulated; and, in any case, the multinational corporations that were able to build factories or contract with local firms faced the persistent threat of expropriation.

The year 1979 marks the inflection point for economic policy-making in developing countries. The thirty years that followed would be characterized not by deeper entrenchment of the state in the economy and ever-higher barriers between the domestic and the global markets; but rather by a wave of liberalizing policy reforms. Data reveal the extent of the “silent revolution” (Boughton 2001; Goldstein 2003, p. 410) in economic policy-making in the developing world. Abiad et al.’s (2010) financial liberalization index aggregates the

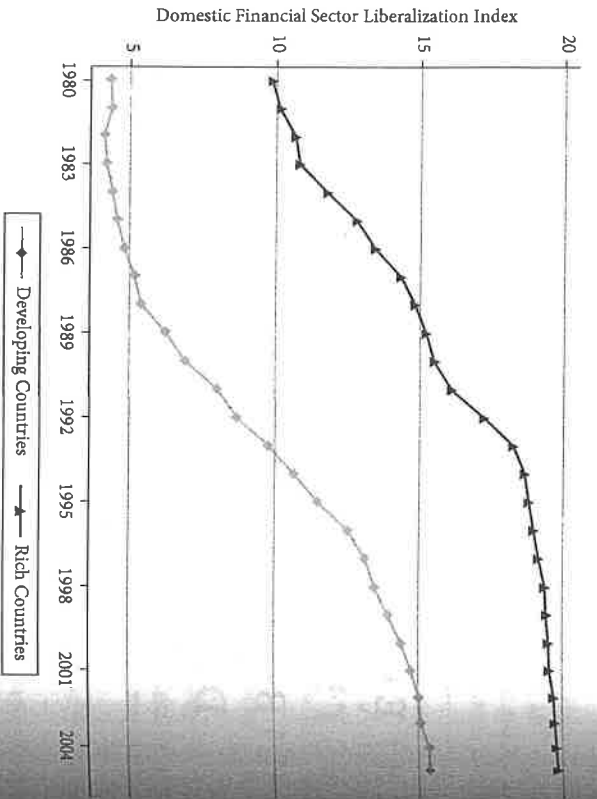


FIGURE 19.1 Financial Liberalization, 1980–2006

annual level of restrictiveness in seven areas of banking sector policy for ninety-one countries. A country with a fully liberalized banking sector receives a score of 21 in the index. Figure 19.1 displays the average level of the financial liberalization index for both historically rich countries (North America, Western Europe, the Antipodes, and Japan) and for low- and middle-income countries (hereafter referred to as the “developing countries”). Tracking the Abiad et al. index over time shows that the mid-1980s to late-1990s was a period in which governments in many developing countries moved away from financial repression toward more liberalized banking sectors.

The modal developing country in 1980 used extensive current- and capital-account restrictions to ration access to the currency that private actors (investors and firms) needed to be able to conduct market-based transactions with foreigners. As depicted in Figure 19.2, Quinn and Toyoda’s (2007) data set records the level of current- and capital-account restrictiveness, ranging from total closure (0) to complete, unrestricted openness (100) for a large number of countries up to 1999. While developing countries remained more restrictive than their rich-country counterparts at the end of the 1990s, policies that deterred residents from transacting with nonresidents became far less extensive over time.

The gap between the historically rich countries and developing countries in the area of trade-policy openness dramatically narrowed, as displayed in Figure 19.3. This figure tracks the proportion of countries in each year that Wacziarg and Welch (2008) classify as having liberalized trade regimes. Only 11 percent of all developing countries in the sample satisfied the criteria for having liberalized trade systems in 1970. Thirty years later less than one-third of the developing countries in Wacziarg and Welch’s data set retained tightly closed trade policy regimes.

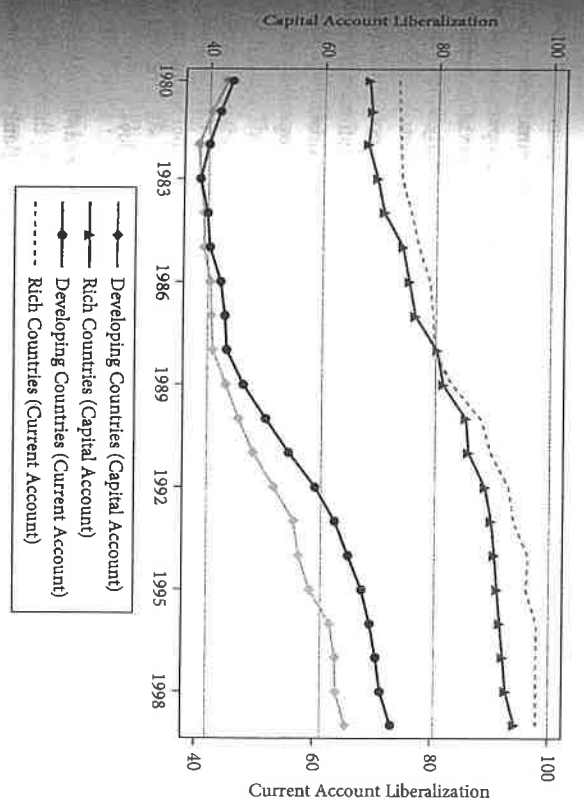


FIGURE 19.2 Capital and Current Account Openness, 1980–1999

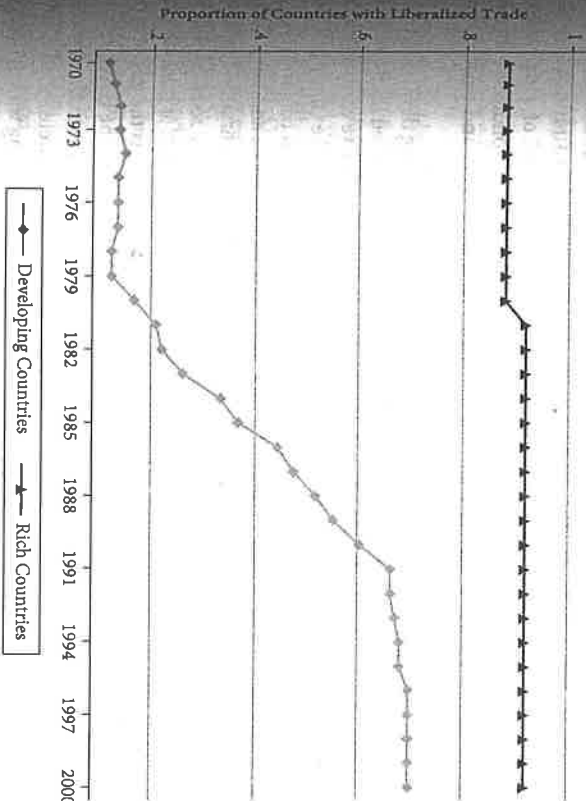


FIGURE 19.3 Trade Liberalization, 1970–2000

This chapter is about the role played by the two most important international financial institutions (IFIs)—the World Bank and the International Monetary Fund (IMF)—in the developing world's shift from control and closure to liberalization and openness. The conventional wisdom is that the IMF and the World Bank promoted the cause of market liberalization by serving as its most energetic cheerleaders and, more importantly, by conditioning access to much-needed funds in exchange for promises of market-oriented policy reforms in the near- and medium-term (Stiglitz 2003; Woods 2006). By the late 1990s the dominant public image of the IFIs had become the arrival of the organization's staff members at the international airport of the crisis-stricken country's capital city, "with substantial hard currency credit lines in hand" (Taylor 1997, p. 145), ready to preach to the country's governing officials from the institution's market-fundamentalist catechisms:

Brash youths, briefcases bulging with printouts, arrive from the International Monetary Fund (IMF) with a clear message, do this, do that, get your prices right, privatize your zoo and your post office, stop this nonsense about priority credit allocation, etc. and we will think about releasing the next tranche of your standby loan. Otherwise, no dice. (Dore 1994, p. 143)

The popular image's origin and enduring appeal is easy to understand. There is a good amount of circumstantial evidence for the IFIs' central role in driving the wave of liberalization that swept the developing world: the IMF's and the World Bank's turns toward "structural adjustment" occurred at the same time as the initial liberalizing policy shifts in developing countries began to gather steam; the IFIs' involvement with developing countries was extensive (a total of 100 low- and middle-income countries borrowed from the IMF in the 1990s), and the resources marshaled by the institutions were substantial (between January 2002 and July 2014 the IMF made a total of \$764.3 billion available to member governments); and, finally, the nature of the conditions attached by the IFIs to their loans became more numerous, more intrusive, and more market-oriented over time.

The popular image of the IFIs as the holders of the whip hand pushing developing countries to move their economies faster and farther toward the fully liberalized ideal type hardened into received wisdom in many circles. Conditional lending's positive effect on market liberalization was taken for granted; attention then turned to debating the effects of IFI-led liberalization on economic growth, income inequality, and currency and banking crises.

Among some economists and political scientists writing on the IMF's and World Bank's activities, however, a counter-narrative began to emerge: the pro-liberalization conditions attached to the IFIs' policy-based loans were largely ineffectual (Basterly 2005; Heckelman and Knack 2008, p. 526; van de Walle 2001). The futility of the IFIs' efforts at generating durable reforms in borrowing countries was illustrated by episodes such as the following, related by development economist Paul Collier: "during a 15-year period, the Government of Kenya sold the same agricultural reform to the World Bank *four times*, each time receiving it after receipt of the aid" (1997, p. 60). Nicolas van de Walle's (2001) extensive study of the "adjustment regime" in sub-Saharan Africa concludes that the IFIs (along with the foreign aid agencies) were much more successful at propping up wobbly governments than eliciting real, durable policy changes.

Which image of the IFIs—powerful "globalizers" (Woods 2006) of the developing world or feckless organizations whose grand plans are forever thwarted by savvy governments promising sweeping reforms that never materialize—is the right one? Over the past decade,

scholars have produced a raft of studies of the association of IMF and World Bank programs with various measures of policy liberalization. I review the findings from thirty-one recent empirical studies in this chapter. I conclude that the evidence for positive and substantively large effects of conditional lending by the IFIs on structural reforms in developing countries is mixed. In general the findings from this vein of research should be interpreted with caution. The inferential hurdles are high, the measurements of key concepts are imperfect, and the methodological assumptions are sometimes heroic.

Despite the ambiguous evidence for the direct effect of IFI loans on the shift toward market liberalization, I argue that we should not regard the IMF and World Bank as completely feckless agents in the effort to remake developing countries' economies over the past three decades. The *indirect* effects of the IFIs on liberalizing policy reforms may be more important than the direct effects.

The remainder of the chapter is divided into four sections. I start with an overview of the IFIs, focusing on the evolution of their conditional lending practices. The next section introduces a simple analytical framework for thinking about how the conditional loans dished out by the IMF and the World Bank relate to other covariates of liberalizing reforms. The third section reviews the recent empirical literature on the effects of the IFIs on market liberalization in developing countries. In the fourth and concluding section, I make the case that we should not ignore the potentially important indirect effects of the IFIs on the shift to economic openness and suggest avenues for future work on the topic.

## THE EVOLUTION OF THE IFIS' APPROACHES TO CONDITIONAL LENDING

In this section I briefly sketch the paths taken by the IMF and the World Bank from their founding in 1944 to their roles at the core of the pro-market "adjustment regime" (van de Walle 2001, pp. 210–234) in the developing world in the 1980s.

The IMF and the World Bank are the products of the plan, spearheaded by American and British officials, for a more open international economic system in the wake of World War II. One of the obligations of IMF membership, built into the institution's Articles of Agreement, is the removal of current account restrictions (Broome 2010; Nelson 2010; Simmons 2000). By encouraging international trade in goods and (increasingly) services, the IMF created the demand for the thing that it supplied—resources to help states with balance of payments problems adjust without resort to exchange restrictions.

In an open international economic system, states can run current account deficits by borrowing from the rest of world. Deficits are not sustainable indefinitely, however. Debtor countries depend on the willingness of the rest of the world to plug the gap between what a state's citizens consume and the domestic resources that can be mobilized to finance that level of consumption. If the capital inflows that finance the current-account deficit dry up, a state finds itself in a payments crisis. Its citizens will have to cut back, perhaps drastically, on their consumption, and it will have trouble paying off maturing debt that was issued in the years before the crisis.

The IMF provided liquidity available to members in order to smooth the adjustment process. Borrowers could stay current on their payments without having to make radical, socially disruptive policy changes to free up resources. If IMF officials thought that the member's balance of payments problems were likely to be protracted, they could approve a revaluation of the country's currency (from 1945 to 1972 currencies were pegged to the U.S. dollar, which was itself pegged to gold at the rate of \$35/ounce).

Conditionality did not become an official part of the IMF's toolkit until the 1960s. An amendment to the Articles of Agreement in 1968 codified the practice that developed in the previous decade: when a member's drawings were small (relative to the amount that the member deposited with the IMF as its "quota") the loan would be free of conditions, but loans in the "upper tranches" (above 25 percent of quota) would be released in segments conditional on the observance of policy targets agreed upon in advance by the IMF's economists and the authorities in the borrowing country (Barnett and Finnemore 2004, pp. 57–58).

IMF conditional lending arrangements involve the provision of resources in exchange for policy commitments by a member country facing a current-account adjustment problem (Ghosh et al. 2005). At the core of the IMF's approach to balance-of-payments problems is the identity describing the components of the current account:  $CA = (S_{priv} - I_{priv}) + (S_{pub} - I_{pub})$ . The identity tells us that a country's current account (CA) is simply the balance of private saving ( $S_{priv}$ ) over private domestic investment ( $I_{priv}$ ) less the government's fiscal balance (IMF 2006, p. 11). The IMF's approach to adjustment is built on the assumption that "balance of payments deficits stem from an excess of domestic absorption over income" (IMF 2003, p. 23). The "classical" IMF loan involves short-run measures to reduce domestic absorption and improve the current account balance by "as much as is required to maintain solvency" (Ghosh et al. 2005, p. 27).

The design of IMF adjustment and stabilization programs was based on a "financial programming" model built in the 1950s and 1960s by staff economists, led by Jacques Polak (who served in various top positions in the IMF from 1947 to 1986). The "Polak model," as it came to be known, enabled the staff members to combine the current account identity with a handful of other behavioral relationships (including the effect of credit growth on the economy on the banking system's balance sheet and the velocity of money) to determine which macroeconomic policies would have to change—and by how much—in order to meet a predetermined balance-of-payments target (Agénor and Montiel 1996, pp. 43–425; Boughton 2010).

The modal IMF lending arrangement into the late 1970s included a target for the level of international reserves, a sizeable reduction in the government's budget deficit, limits on the growth of domestic credit, and (in some cases) an exchange-rate adjustment. All of these conditions aim at turning around an unsustainable current-account position. Fund programs were controversial because they asked borrowers to quickly and simultaneously impose pro-cyclical policies that depressed economic activity (Taylor 1997, p. 148). However, the financial-programming approach said nothing about the underlying structure of the borrower's economy; it offered no suggestion about how much the state should or should not intervene in domestic markets or about the optimal level of openness to international markets.

Like the IMF, the World Bank did not get into the business of promoting market liberalization in its policy-based loans until the late 1970s.<sup>2</sup> The World Bank's activities in the developing world historically focused on providing financing and technical assistance for public infrastructure projects. Its founders believed that "special risks" impeded the flow of private capital to industrializing countries, justifying the existence of an institution that "substitutes its judgment for that of the market" (Gavin and Rodrik 1995, pp. 330–331).

The World Bank could (and did) use *ex ante* conditionality to screen recipients of project lending, but it did not tie project lending to policy commitments; and, until the early 1980s, *ex post* conditional lending of the type practiced by the IMF was limited to 10 percent of the World Bank's portfolio (Babb 2013, p. 276; Woods 2006, pp. 43–46). For thirty-five years the IIF's division of labor was clear: the IMF dealt with macroeconomic stabilization and adjustment, and the World Bank "would deal with development programs and the evaluation of projects" (Woods 2006, p. 44).

In 1981 the World Bank's contribution to balance-of-payments financing in the developing world was negligible, accounting for just 3 percent of developing countries' aggregate current-account deficits (Bacha and Feinberg 1986, p. 334). The debt crisis that erupted the next year spurred the World Bank into motion: it removed the cap on conditional lending from 1982 to the present policy-based loans have accounted for 20–30 percent of the institution's annual disbursements) and began to collaborate closely with the IMF to fill the financing gaps faced by developing countries.

The World Bank's estimate of a borrower's financing need was based on its Revised Minimum Standard Model (RMSM) of capacity output. The RMSM combined elements from the national income accounting identity with a production function and behavioral equations relating the relationship between savings and economic output; the model allowed World Bank staff to calculate how much saving (domestic and foreign) was required to achieve a growth target (Agénor and Montiel 1996, pp. 425–27). The RMSM approach is contractionary in the sense that it recommends policies that privilege saving over consumption.<sup>3</sup> But, like the IMF's macroeconomic model, it contains no parameters pertaining to structural features of borrowers' economies.

This brief overview should make clear that nothing in the IIF's mandates or operational cultures necessitated the use of lending facilities to promote market liberalization. The shift to attaching conditions requiring trade-policy liberalization, privatization of state-owned firms, deregulation of product markets, labor-market flexibility, tax-system reform, and other "structural" measures has its origin in the belief that developing countries needed to move beyond the pernicious cycle of crises → stabilization → adjustment → crisis, toward a more sustainable model built on policies that produce "good growth." The first public reference to "structural adjustment" came in a May 1979 speech by World Bank president Robert McNamara (Kapur, Lewis, and Webb 1997, p. 506); that year, Senegal became the first African country to agree to terms of a World Bank Structural Adjustment Loan (SAL) (Lugauer 1997, p. 166; van de Walle 2001, p. 215). The IMF's 1980 *World Economic Outlook* made reference to "structural problems faced by many countries" that "may require adjustment over a longer period." In 1985 the IMF put into place its own concessional structural lending facility, the Structural Adjustment Fund (SAF).<sup>4</sup>

Structural conditionality expanded throughout the 1980s and into the late 1990s. The average number of conditions in World Bank programs increased from thirty-four in 1980–1981 to fifty-six in 1987–1990 (Dreher and Vaubel 2004, 445–46). International Monetary



Fund loans in postcommunist transition countries and in crisis-stricken East Asian countries in 1997–1998 were larded with structural policy measures. The average number of structural conditions included in IMF programs during the 1996–1999 period topped fifty. In the 1998 Indonesian rescue package, the list of structural policy commitment signed by the country's economic policy team reached 140 items (Goldstein 2003, p. 400).<sup>5</sup>

Scholars suggest different reasons for the proliferation of structural conditions in IFI lending arrangements. In the late 1970s the mainly Keynesian officials that staffed the IFIs, who were willing to countenance some degree of state intervention in markets, were retiring. They were replaced by a new cohort of young economists who received their macroeconomics training in top-ranked American departments that by the 1970s had excised “naïve” Keynesian models of the economy in favor of models built on the assumption of rational expectations. The neoliberal economists that entered the World Bank and IMF were more fervent in their advocacy of the price mechanism and more distrustful of the state's role in guiding economic activity in developing countries (Babb 2013, pp. 272–275; Bacha and Feinberg 1986, p. 340; Chwieroth 2010; Stiglitz 2003; Woods 2006, pp. 51–56). In this view the economic beliefs possessed by the World Bank and IMF economists led them to advocate market-liberalizing measures in addition to the traditional stabilization and adjustment measures attached to conditional loans. The incompatibility of the beliefs of IFI's officials and the economic policy-makers in developing countries created tension in Francophone African countries such as Côte d'Ivoire.

the Bank's more recent economic ideology has seemed not only hostile but inconsistent... Part of Côte d'Ivoire's French-schooled resistance to the Bank's economic prescriptions has been cultural... As in France, the Ivorian official working in economic administration does not have a doctorate; rather, he has professional training from a specialized school or an engineering diploma in one of a variety of disciplines. He does not base his decisions on neoclassical theory. (Pegatienan and Ouagogo 1997, p. 131)

Using conditional loans to press for market-oriented reform was also consistent with the interests of the IFI's main shareholders (namely, the United States). Stone (2011) and Goldstein (2003) document cases in which the United States and other powerful states contravened the IMF's rule prohibiting members from “all attempts to influence any of the [IMF] staff in the discharge of functions” (Article XII, section IV) in order to insert structural conditions that they wanted the borrowing government to carry out. American influence on the design of lending programs could be subtler. Even if the IFIs resist meddling by members in their day-to-day activities, they remain dependent upon the material and symbolic resources that rich and powerful states provide (Barnett and Finnemore 2004, p. 22). International financial institutions respond to changes in their external environments; the market fundamentalism of the Reagan, Thatcher, and Kohl governments of the early 1980s clearly signaled that the institutions should get on board with the new agenda or face marginalization (Lancaster 1997, p. 168; Woods 2006, pp. 47, 142–143, 146).

Finally, the ambiguity of the mandates, the degree of complexity, and uncertainty that IFI staff members confront in crisis-stricken developing countries and entrenched organizational cultures combine to produce a tendency toward organizational expansion (Barnett and Finnemore 2004). Instead of sticking to the narrower goals of stabilization and balance-of-payments support, by the 1980s the IFI's staff members viewed their task as

encompassing macroeconomic stabilization, crisis resolution, crisis prevention, promotion of “sustainable” economic growth, and poverty reduction. By making the task more expansive, the areas of the economy to which IMF and World Bank programs applied widened dramatically. And if (as former IMF chief economist Kenneth Rogoff claims) “fundamentally most people in the Fund believe in markets and market-based solutions to problems” (quoted in Beattie 2011), then conditional loans will be oriented to removing market-impeding distortions across a wide swathe of borrowers' economies.

It is common to assume that the IMF and the World Bank jointly used conditional lending to promote greater liberalization of foreign and domestic economic policies from the early 1980s onward. Take, for example, comments from Joseph Stiglitz, former chief economist at the World Bank and prominent public critic of structural adjustment lending:

The problem was that the IMF was very tied to a particular set of ideologies, models that didn't work in the advanced industrial countries... they said that ideology to developing countries for which it was even less suited... in many of these programs the World Bank and the IMF in the eighties were partners in crime so I don't want to say that not having the IMF there would have solved these problems... the big difference is that the World Bank broke away from that ideology much earlier.<sup>6</sup>

Most of the research reviewed in the next section also rests on the assumption that the IMF and the World Bank promoted similarly market-oriented policy changes in the countries making use of the institutions' resources. The big differences between the two institutions, however, should not be ignored. Adjustment lending was a smaller part of the World Bank's portfolio. And as the Stiglitz quote suggests, the World Bank's agenda veered away from market-oriented structural adjustment in the late 1990s. While the IMF remained focused on macroeconomic adjustment and structural reform, the World Bank's broad mandate to promote “development” drew the institution into a variety of new issues, including the quality of local and national government, corruption, human rights, the impact of development projects on the environment, gendered aspects of project-based lending, and social protection. Research on the IFI's impact on the liberalization of borrowers' policies assumes that any observed positive effect of lending comes through the mechanism of coercion: the IFI's preferred greater liberalization to the status quo policy regime, and used its carrots (material resources) and sticks (policy conditionality) to bring about desired change. To the extent that the World Bank's agenda has drifted away from structural policy adjustment, the coercion model may no longer be applicable.

### Determinants of Market Liberalization in Developing Countries

The first wave of studies of the politics of market liberalization in developing countries involved primarily qualitative evidence from comparisons of reform episodes in one or several countries over time (Haggard and Kaufman 1992; Haggard and Maxfield 1996; Loraux et al. 1997; Mosley, Harrigan, and Toye 1991). The development of large data sets that recorded discrete liberalization episodes (such as Sachs and Warner's [1995] collection of rates of trade liberalization and Grilli and Milesi-Ferretti's [1995] data on the presence of capital controls) or indices that measured the degree of market liberalization paved the way

for a second, quantitatively oriented wave of studies. The focus in the second wave has been comparing the relative importance of different covariates of liberalizing reforms and levels of economic openness. The simple analytical framework developed in Abiad and Mody's (2005) study of financial liberalization is a good starting point for thinking about the factors that shape liberalizing policy change.

We can start by conceptualizing policy change as steps toward closing the gap between the target goal of full liberalization in some policy area ( $P^*$ ) and the current degree of liberalization ( $P_{i,t-1}$ ). The assumption built into this line of research is that economic policy makers embark on reforms because they prefer market liberalization and openness to state intervention and closure (Abiad and Mody 2005, p. 76). Liberalization is constrained however by some resistance to reform, and is affected by stochastic elements ( $\epsilon_{i,t}$ ) such that:

$$\Delta P_{i,t} = \alpha(P^*_{i,t} - P_{i,t-1}) + \epsilon_{i,t}$$

The status quo bias factor,  $\alpha$ , is not fixed over time; in the models of policy reform presented in Alesina and Drazen (1991) and Fernandez and Rodrik (1991), uncertainty over the distribution of gains and losses from reforms among policy-relevant societal groups can induce gridlock; consequently, we should expect status quo bias to be decreasing in the current level of liberalization:

$$\alpha = \theta_1 P_{i,t-1}$$

In Abiad and Mody's framework  $\theta_1 > 0$ , implying that previous reforms reveal information about payoffs from further policy changes to societal actors, paving the way for deal-making and reducing resistance to liberalizing reforms. We can thus rewrite the first equation as:

$$\Delta P_{i,t} = \theta_1 P_{i,t-1} (1 - P_{i,t-1}) + \epsilon_{i,t}$$

Models of policy liberalization also take into account the government's economic beliefs. To capture this, we can include the parameter  $\theta_2 P_{i,t-1}$ , in which  $\theta_2 \in [0,1]$ . When  $\theta_2$  approaches 1, the government is fully committed to market liberalization: when it is close to 0, the government dislikes liberalization and would prefer state intervention and continued barriers between the domestic and international economic realms. Directly observing policy-makers' beliefs is difficult (if not impossible), so researchers have to rely on indirect indicators. The most common indirect measure of beliefs about liberalization is the ideological orientation of the government. Right-wing policy-makers are assumed to be more market-friendly than left-wing counterparts. Many researchers rely on a dichotomous measure of the head of government's partisan orientation. Others use biographical information on top economic policy-makers to indirectly measure economic beliefs. Chwieroth (2007a) and Nelson (2014), for example, code policy-makers as having neoliberal economic beliefs if they hold graduate degrees from highly ranked American economics departments.

Status quo bias and policy-makers' economic beliefs help explain why some countries go further and faster than others in achieving market-oriented reforms, but these elements are less helpful for understanding the global liberalizing trend documented in Figures 19-19's "ebb and flow of liberalization" (Simmons and Elkins 2004, p. 171) that swept many countries pointed researchers to the spillover effect that one country's policy choices could

have on other countries' choices. The mechanism of diffusion-via-learning (Mesequer 2006; Simmons, Dobbin, and Garrett 2006, pp. 795-799) suggests that policy-makers in country  $i$  will press harder for market liberalization if their own country's performance compares unfavorably to a peer country that pursued more extensive reforms ( $PEER_{i,t-1}$ ):

$$\Delta P_{i,t} = \alpha_0 (PEER_{i,t-1} - P_{i,t-1}) + \epsilon_{i,t}$$

The pressure to catch up to the competitor country's level of liberalization presumably increases as the difference between the performance indicator (typically the economic growth rate) of country  $i$  and its peer competitor ( $\theta_3$ ) grows.

Learning is one way in which cross-national policy convergence can take place. Another diffusion mechanism involves policy emulation among members of a group of peer countries: emulation implies that policy-makers adopt reforms in order to "conform to shared norms and appear legitimate" (Henisz, Zelter, and Guillén 2005, p. 876; see also Simmons, Dobbin, and Garrett 2006, pp. 799-801). For example, Brooks and Kurtz (2012) show that capital-account liberalization in Latin America in the 1980s and 1990s diffused through peer groups composed of countries that had imposed similar "advanced" import-substitution development models in the 1950s and 1960s.

The IFIs' contribution to market-oriented liberalization is posited to come through the coercive pressure that they apply to elicit desired liberalizing reforms (Henisz, Zelter, and Guillén 2005; Simmons, Dobbin, and Garrett 2006). Coercion implies that the IFIs, endowed with some resources that give them leverage over prospective borrowers, used their tools to encourage countries to pursue policy changes that they would not have otherwise pursued. By mixing carrots (infusions of hard currency) and sticks (conditions that must be met to access tranches of the loan), the IFIs can "alter the domestic political balance of power in favor of reform" (Henisz, Zelter, and Guillén 2005, p. 875).

The IFIs' individual effects on reform can be tested alongside the other covariates in the baseline specification:

$$\Delta P_{i,t} = \theta_1 P_{i,t-1} (1 - P_{i,t-1}) + \theta_2 P_{i,t-1} + \theta_3 (PEER_{i,t-1} - P_{i,t-1}) + IMF_{i,t} + BANK_{i,t} + \epsilon_{i,t}$$

The question, then becomes how important the coercive effects of IMF and World Bank programs have been compared to other possible determinants of market liberalization. How strong is the association between the IFIs and market-oriented reforms in the recent empirical literature?

### What Are the Effects of the IFIs on Market Liberalization?

My search of the recent (post-2000) literature on the determinants of market liberalization yielded a sample of thirty-one studies that included indicators for lending by one (or both) of the IFIs as a covariate(s). The studies focused on policies pertaining to foreign economic openness and deregulation of domestic markets. Each of the studies is described in Table 20.1.

The evidence for the association between the IFIs and market-oriented policy reforms is mixed. In the table I record whether the coefficient for the IFI variable was in the expected direction and statistically distinguishable from zero in the bulk of the specifications reported by the author(s) of each study in the sample. Less than half (43) of the studies provide unambiguously positive evidence for an association between indicators for the presence of IMF and/or World Bank lending arrangements and policy liberalization. The fact that the studies vary widely in their sampling and measurement strategies militates against rejecting the claim that coercion, expressed through policy-based conditional lending, played an important role in the global trend toward greater market liberalization. Further, only a handful of the studies try to account for the World Bank's influence (6 in total, and only 4 that include Bank and Fund indicators separately in the models).

Privatization of state-owned firms and product market deregulation are the only policy areas in which the evidence for the IMF's contribution to reform is strong.<sup>2</sup> An indicator for IMF influence features in 16 studies of the determinants of banking, capital account, and FDI liberalization; oddly, the association between World Bank loans and any of these outcomes is only explored in one study (Brooks and Kurtz 2007). The Fund's reform-promoting track record is not very strong: 6 of the 17 studies report positive coefficients that can be distinguished from zero, and in the rest of the studies the IMF indicator shows little correlation with the level, or change in the level, of market liberalization.

The tendency to examine the impact of the IMF alone is particularly surprising in the area of trade liberalization. After all, trade was a common target of conditions in World Bank policy-based loans in the 1980s and 1990s: according to Edwards (1997: 46) "almost 70 percent of World Bank adjustment operations contained some trade-policy component, mostly in the form of trade-liberalization conditionality." The study that did examine the role of the Bank in trade liberalization (Brooks and Kurtz 2007) was limited to Latin America and reported a negative but statistically insignificant association. About half of IMF programs between 1993 and 2003 contained trade conditions (20 percent of which were binding performance criteria) (Wei and Zhang 2010: 72). The single study (Wei and Zhang 2010) that directly tests for the effect of trade-related conditionality reports a positive association with trade flows. The other studies of the impact of the IMF on trade liberalization are inconclusive.

### *Sharpening Our Understanding of the IFIs' Contributions to Market Liberalization*

In this concluding section I discuss some problems in the statistical studies and suggest that future work consider mechanisms of IFI influence on policy reform other than coercion-via-conditionality.

The panel studies listed in Table 20.1 compare the average effect of the IFI variable(s), conditioning on indicators for confounding factors, to other covariates. In each year a set of countries are observed under World Bank or IMF agreements; if we had access to a parallel universe in which those same countries were *not* under IFI agreements, then it would be simple to establish the effect of the treatment: we would just compare outcomes

Table 19.1 Studies of the Association between the IFIs and Market Liberalization

Author(s) and Publication Year of Study	Sample	Policy Area(s) of Interest	Testing for Effect of World Bank, IMF, or both?	Key IFI-related findings
Simmons and Elkins (2004)	182 rich and developing countries, 1967–1996	Capital and current account liberalization and retrenchment episodes	IMF (use of credits)	IMF variable is never significant in hazard models of liberalizing shifts; significantly correlated with restrictions on capital account.
Abiad and Mody (2005)	35 rich and developing countries, 1973–1996	Financial liberalization (index)	IMF (program dummy)	IMF covariate is positive in all specifications; significance varies.
Abiad (2013)	91 rich and developing countries, 1973–2005	Financial and capital account liberalization (indices)	IMF (program dummy)	Positive and significant in models of financial liberalization; positive and insignificant for capital decontrol.
Burgoon et al. (2012)	82 rich and developing countries, 1973–2001	Financial liberalization (index)	IMF (program dummy)	Positive, but never statistically distinguishable from zero.
Mukherjee and Singer (2010)	87 rich and developing countries, 1975–2002	Capital account liberalization (index)	IMF (program dummy)	Positive, but insignificant; interaction with welfare spending is positive and statistically significant.
Chwieroth (2007a)	29 developing countries, 1977–99	Capital account liberalization (index)	IMF (program dummy)	Positive and significant.
Chwieroth (2007b)	53 developing countries, 1977–1997	Capital account liberalization (index)	IMF (program dummy)	Switches between positive and negative and is insignificant; interaction with number of neoliberal staff members is positive and significant.
Brooks and Kurtz (2007)	19 Latin American countries, 1985–1999	Trade and capital account liberalization (indices)	World Bank and IMF loan flows (%GDP)	World Bank and IMF are both negative in models of trade liberalization; only IMF is significant; neither IFI variable is significant in models of capital account.

(continued)

Table 19.1 Continued

Author(s) and Publication Year of Study	Sample	Policy Area(s) of Interest	Testing for Effect of World Bank, IMF, or both?	Key IFI-related findings
Biglaiser and DeRouen Jr. (2011)	15 Latin American countries, 1980–2003	General reform index and subindices (trade, capital account, privatization, tax system, and domestic financial market regulation)	IMF (program dummy)	Positive and significant only in models of trade reform.
Brooks and Kurtz (2012)	Latin America, 1983–2007; online appendix has results for larger sample of developing countries.	Capital-account liberalization (index)	IMF (program dummy)	Positive, but insignificant 10 of 11 models reported in article and online appendix.
Joyce and Noy (2008)	53 developing countries, 1983–1998	Capital-account liberalization (onset and various indices)	IMF (new program dummies, distinguish type of loan)	Positively and significantly correlated with liberalization onset dummy; correlation flips between negative and positive for indexes of openness.
Pepinsky (2013)	181 rich and developing countries, 2005–2006 (cross-sectional)	Financial and capital account liberalization (indices)	IMF (program dummy)	For bank liberalization, positive and significant; for capital account, positive and insignificant.
Mukherjee et al. (2014)	85 democratic developing countries, 1975–2007	Capital-account liberalization (index)	IMF (program dummy)	Positive, but statistically insignificant.
Quinn and Toyoda (2007)	82 rich and developing countries, 1955–1999	Change in capital-account liberalization index	IMF (lagged program dummy)	Positive, but statistically insignificant in most models; negative (and significant) in one model.
Brune and Gulsinger (2011)	114 developing countries, 1973–2002	Capital-account openness (index)	IMF (program dummy)	Positive and significant in 5 of 6 reported models.
Pandya (2014)	94 rich and developing countries, 1970–2000	Foreign ownership restrictiveness	IMF (lagged program dummy)	Negative, statistically significant in half of the reported specifications.
Kobrin (2004)	79 developing countries, 1992–2001 (cross-sectional)	Deregulation of FDI inflows	IMF ("obligations" in 1991)	Switches signs, insignificant.
Vadlamannati and Cooray (2012)	148 rich and developing countries, 1992–2009	Deregulation of FDI inflows	IMF (program dummy)	Positive and significant in all specifications.
Milner and Kubota (2005)	179 developing countries, 1970–1999	Tariff rates and closed/liberalized trade dummy	IMF (program dummy)	Coefficient switches signs and is insignificant in tariff rate models; negative, insignificant coefficient in liberalization model.
Frye and Mansfield (2004)	Postcommunist countries, 1990–1998	Trade liberalization index	IMF (program dummy)	Negative and insignificant.
Wei and Zhang (2010)	All developing IMF member countries, 1993–2003	Trade openness (logged real bilateral imports)	Pre- and post-IMF program dummies; trade-related conditions	Trade-related conditionality positively and significantly associated with trade openness.
Weymouth and Macpherson (2012)	104 rich and developing countries, 1981–1997	Trade liberalization (onset)	IMF (= 1 if country accepted IMF credits in year $t$ )	Positive and significant in 3 of 5 reported models.

(continued)



Table 19.1 Continued

Author(s) and Publication Year of Study	Sample	Policy Area(s) of Interest	Testing for Effect of World Bank, IMF, or both?	Key IFI-related findings
Kogut and Macpherson (2011)	Rich and developing (excluding postcommunist) countries, 1981–97	Privatization (onset of third episode)	IMF (= 1 if country accepted IMF credits in year <i>t</i> )	Positive and significant
Brune et al. (2004)	96 rich and developing countries, 1985–1999	Number of and revenues from privatizations	World Bank and IMF loan flows (%GDP)	World Bank covariate is insignificant; IMF is positive and significant for proceeds, negative and significant for no. of privatizations.
Henisz et al. (2005)	71 rich and developing countries, 1977–1999	Market-oriented reforms in telecommunications and electricity industries	Sum of World Bank and IMF credit (%GDP)	Positive and significant for 2 of 4 types of liberalizing reforms.
Zelner et al. (2009)	61 rich and developing countries, 1989–2001	Renegotiations of privatized electricity contracts to reduce investors' income stream	Sum of World Bank and IMF credit (%GDP)	Negative and significant.
Bjørnskov and Potrafke (2011)	19 postcommunist countries, 1990–2007	Privatization index	World Bank projects and IMF programs	IMF is positive and significant in 1 of 4 models; World Bank switches signs and is insignificant.
Doyle (2012)	18 Latin American countries, 1984–1998	Privatization revenues	IMF loan flows (%GDP)	Positive and usually significant; negative when interacted with Left government variable.
Dreher and Rupprecht (2007)	116 countries, 1970–2000	Economic freedom index	IMF (program dummy)	Negative and significant association with overall index; 2 of 5 index sub-components.
Boockmann and Dreher (2003)	85 countries, 1970–1997	Economic freedom index	World Bank and IMF (annual change in stock of credits and number of ongoing projects)	Jointly significant; volume of World Bank credits is negative; number of projects positive (both significant); IMF covariate is insignificant.
Kingstone and Young (2009)	15 Latin American countries, 1976–2004	Structural reform index and sub-components	IMF (program dummy)	Positive and significant correlation with index; 4 of 5 components.

for those countries in the two universes. Living as we do in the universe and not the multi-verse makes our task harder. We have to compare country-year units under and not under IFI agreements, and there may be confounding factors that systematically predispose the "treated" units to be under IFI arrangements—and those confounding factors may also affect policy liberalization. Some of the studies in Table 20.1 attempt to correct for selection bias. Most do so by estimating two-stage selection models, an approach that, in other contexts, has been criticized for yielding unreliable estimates (Gilligan and Sergenti 2008; Simmons and Hopkins 2005). Recent innovations that enable analysts to construct matched units that are observably equivalent but for the treatment (in this case the presence of an IFI conditional lending arrangement) offer a promising fix for the selection problem.<sup>8</sup>

The congruence between concept and measurement is another perennial problem in studies of the determinants of market liberalization in developing countries. The coercion mechanism implies that the IFIs elicit reforms by tying money to policy commitments. Coercion's effectiveness is established by evidence that the borrower adjusted the policies targeted in the loan agreement in order to continue to draw on the IFI's resources (Simmons, Dobbin, and Garrett 2006, p. 791).

A lack of evidence for an association between IMF conditionality and trade liberalization does not disconfirm the coercion mechanism if trade conditions were not included in the loan agreement. The weak association between IMF programs and capital-account decontrol is unsurprising in light of the fact that almost no IMF loans contain conditions related to capital controls (Tomz 2012, p. 703). A number of studies show that IMF programs vary in the extensiveness and content of conditionality (Goldstein 2003; Nelson 2014; Stone 2011), yet only one of the thirty-one studies surveyed in this chapter tests for the effect of the *type* of conditions. Wei and Zhang's (2010) study should serve as a model for future work: not only do the authors record the number of trade conditions in IMF programs, but they also use this information to construct a difference-in-differences estimator (by conditioning on the presence of IMF programs and comparing countries with and without trade conditions) that mitigates the selection-bias problem. Analysts could use the data on labor-market conditionality in IMF programs (1980–2000) collected by Caraway, Rickard, and Anner (2012), for example, to design a study similar to the one set up by Wei and Zhang.

Few of the studies surveyed in this chapter examine compliance with IFI conditionality. The ideal test of the coercive effect of the IFIs on market liberalization would control for borrowers' compliance rates. Compliance with IFI conditionality, however, is hard to measure. Some rely on program completion rates to infer compliance (e.g., Goldstein 2003). By gathering data on the ratio of the funds accessed to the funds promised when the program was signed one can infer that underutilization was due to suspension of the program in response to rampant noncompliance. The problem with this measure is that it might miscode countries that were perfectly compliant and left programs early due to improvement in economic conditions as well as countries that missed one or several conditions and continued to draw down the loan thanks to waivers.<sup>9</sup> Another option is to use the IFI's own assessments of the implementation of structural conditions: Wei and Zhang (2010, p. 80) take this approach in their study. This approach hinges on the assumption that the IFI staff members' judgments reflect dispassionate weighing of the information and are not affected by the incentives to overstate the implementation rate.

Researchers should also be wary of the "perils of pooling" (Blonigen and Wang 2004). The studies in table 20.1 report estimates of the average partial correlation between indicators

for the presence of the World Bank and the IMF and the indicators for the degree of market liberalization. By looking only at the average effect, we might miss big differences in how the IMF's and World Bank's programs have affected different *types* of countries. Variation in the level of economic development of countries under IMF lending arrangements is huge: the per capita GDP level of the poorest country that received a conditional loan after 2008 (Burundi) was \$53,180 less than the per capita GDP of the richest post-2008 IMF borrower (Iceland). Countries vary in their sensitivity to the coercive pressure applied by the IMF and World Bank. It is likely that the richer, larger countries were better able to resist the pressure applied by the IFIs through conditional lending. Grigore Pop-Eleches (2009) argues that when countries whose economic health is integral to the functioning of the global financial system are plunged into crisis, they can count on special treatment from the IMF. The evidence suggests that the IMF is more likely to grant waivers for missed conditions to Turkey than to the Guinea-Bissau. Country classifications developed by the international community of professional investors matter as well; the subset of countries that are classified as "emerging market economies" often have an outside option that countries in the "developing country" classification do not: they can raise funds in the sovereign debt market. We are likely to miss some important differences in the relationship between the IFIs and their borrowers when we look only at the average effects from a sample that lumps all types of borrowers together.

The empirical literature on the IFIs' role in the wave of market liberalization assumes that the effect of the IMF and World Bank comes through the coercive pressure they can apply. Even the most ardent believers that the IFIs have been in the vanguard of market liberalization would be forced, looking at the results of the studies listed in Table 2.01, to admit that the evidence for the coercive effect is weak. But the IFIs' positive contribution to market-oriented reform need not come only through its use of carrots and sticks. One of the obligations of membership in the IMF (which now tallies 188 countries) is the removal of restrictions on current-account transactions. The IMF does not have the coercive tools to enforce the membership requirement, yet as Simmons (2000) and Simmons and Hopkins (2005) argue, there is a high rate of compliance with the obligation (see von Stein 2009). Evidence shows that opening the current account makes it much more likely that a country will open its capital account (Aizenman and Noy 2009).

The IFIs can also indirectly influence market liberalization by affecting the terms in the baseline model sketched earlier in this chapter. The status quo bias is highest when liberalization is in its incipient stages, and with each incremental step toward full liberalization societal resistance declines (Abiad and Mody 2005, p. 76). A number of developing countries have been prolonged users of IPI resources. Thirty-six countries in Bird, Hussain, and Joyce's (2004) data set spent more than half of the years between 1980 and 1996 under IMF arrangements. The research discussed in this chapter does not address the possibility that the IFIs' main effects are additive, nonlinear, and work through the adjustment factor rather than through coercion.

Future work should also consider the possibility that the IFIs' influence on the wave of liberalization came mainly through their efforts to reshape policy-makers' economic beliefs. Both the World Bank and the IMF devote significant resources to research aimed at disseminating lessons about liberalization experiences (Simmons, Dobbin, and Garret 2006, p. 798). They also have important roles in training government officials; based on the data presented in Arezki, Quintyn, and Toscani (2012), the IMF's Institute for Capacity Development (formerly

called the IMF Institute) trained over 2,500 officials each year between 1995 and 2010. IMF-trained officials that gain influence over policy decisions may be more likely to pursue liberalization, whether they are under a loan agreement or not. Arezki, Quintyn, and Toscani (2012) find that IMF programs are more likely to yield structural reforms when a sizeable share of a borrowing country's public servants received IMF training.

There is a large literature in the field of international relations (IR) that focuses on how international organizations like the IMF and the World Bank can serve as the promoters of policy norms. Policy norms, as defined by Park and Vetterlein (2010, p. 4), are "shared expectations for all relevant actors within a community about what constitutes appropriate behavior, which is encapsulated in (Fund or Bank) policy." From this perspective the power of the IFIs to produce policy change extend far beyond their coercive capacities. International organizations like the World Bank and the IMF are "in authority" by dint of the ability, formally delegated by the rules of membership and the mandate guiding the institution, to exert governance in some issue areas; they can also act as "an authority" through the perception that their judgments reflect expert knowledge and are thus legitimate (Barnett and Finnemore 2004, pp. 22–26). International institutions can shape states' policies by setting the standards for what constitutes appropriate behavior in international society (Finnemore 1996).

The quantitative turn in the study of the IFIs' impact on domestic and foreign economic policy liberalization yielded a sizeable set of studies that, taken together, suggest that the IFIs' contribution to policy liberalization was mixed. More research on the indirect effects of the IFIs might reveal the heretofore submerged but important ways in which the IFIs served as drivers of the post-1979 wave of economic liberalization.

## NOTES

1. My calculation, converted from the IMF's currency unit (Standard Drawing Rights) to U.S. dollars, of the total amount approved for disbursal in 210 post-2002 lending arrangements listed in the Monitoring of Fund Arrangements (MONA) database, accessed here: <http://www.imf.org/external/np/pdr/mona/index.aspx>.
2. The World Bank is a multifaceted organization consisting of five separate agencies. The International Bank for Reconstruction and Development (IBRD) and the International Development Association (IDA) are the units that are primarily responsible for lending to developing countries.
3. In the early 1980s the IMF's financial programming model and the World Bank's RMSM were "reconciled" under a common framework by two IMF economists, Mohsin Khan, and Nadeem Haque, seconded to the World Bank by then-vice president Anne Krueger (Kapur, Lewis, and Webb 1997, p. 480; Boughton 2010).
4. The SAF was superseded by the Enhanced Structural Adjustment Facility (ESAF) in 1989, which was itself replaced by the Poverty Reduction and Growth Facility (PRGF) in 1999.
5. Granted, few of those structural conditions were binding "performance criteria" (PCs), violation of which will automatically trigger suspension of further disbursements (unless the borrower requests and is granted a waiver for noncompliance). Structural PCs are far less common than nonbinding structural "benchmarks" in IMF programs; in Nelson's (2014) data set of 466 conditional loans from 1980 to 2000, the average number of structural performance criteria in the loans was 1.45.

6. I transcribed Stiglitz's comments from a BBC radio documentary, available here: [http://www.bbc.co.uk/worldservice/documentaries/2011/01/110109\\_documentary\\_inside\\_the\\_inf\\_stephanie\\_flanders.shtml](http://www.bbc.co.uk/worldservice/documentaries/2011/01/110109_documentary_inside_the_inf_stephanie_flanders.shtml).
7. Privatization and public enterprise reform was the third most common type of structural condition in the sample of IMF programs (1996–1999) analyzed by Goldstein (2009).
8. Statistically driven matching is not an uncontroversial approach; see, for example, the debate between von Stein (2005) and Simmons and Hopkins (2005).
9. Nelson (2014) and Stone (2011) examine the covariates of waivers issued by the IMF.

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## CHAPTER 20

## FOREIGN AID AND DEMOCRATIZATION IN DEVELOPING COUNTRIES

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The emergence of the good governance agenda in the early 1990s brought concerns over institutions, public sector management, and politics more broadly to the fore for the development community. After fading in prominence in the 2000s, the commitment to good governance was recently reaffirmed when the UN Secretary General's High-Level Panel on Development beyond the Millennium Development Goals (MDGs) declared: "We are calling for a fundamental shift—to recognize peace and good governance as core elements of wellbeing, not optional extras" (United Nations 2013). For many bilateral donors belonging to the Organization for Economic Cooperation and Development (OECD), good governance has become equated with democracy, which is viewed as the regime most conducive to addressing powerlessness, providing accountability, and creating legitimate institutions (e.g., DHD 2007; USAID 2013).

However, can donors influence democracy through foreign aid? The existing, primarily statistical scholarship examining the relationship between aid and democracy offers mixed and sometimes contradictory outcomes. On the one hand, aid has been found to demonstrate a positive association with democracy in Africa (Goldsmith 2001), during only the post-Cold War era (Dunning 2004), but only if allocated by traditional OECD donors (Bermeo 2011) or if in the form of U.S. democracy assistance (Finkel et al. 2007). On the other hand, some notable studies have uncovered that aid either exhibits no effect on democracy (Knack 2004) or that it can even exert a negative influence by undermining the capacity of state institutions (Brätting and Knack 2004; Djankov et al. 2008; Moss et al. 2008). Others have argued that aid's impact depends on whether a country has already engaged in economic liberalization (Kalyvitis and Vlachaki 2012) or whether the ruling regime is firmly authoritarian or already engaged in some degree of political liberalization (e.g., Bueno de Mesquita et al. 2003; Dutta et al. 2011; Kono and Monthinda 2009; Morrison 2009).

This article builds on at least three key issues that emerge out of the research-design strategies and findings from this scholarship: First, since foreign aid encompasses a broad