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Prolonged Use and Conditionality Failure: Investigating the IMF Responsibility

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Abstract

Prolonged use of Fund resources has consistently expanded since the 1970s among both low-income and middle-income countries. Overall this phenomenon suggests a lack of effectiveness of Fund supported programs. Such conditionality failure has been explained by the literature by looking both at the characteristics of the borrowing countries and at the lack of credibility of the IMF threat of interrupting financial assistance in case of non compliance with conditionality. In this paper we suggest that such lack of credibility might be attributed to the dual role played by the IMF, which acts at the same time as a creditor and as a monitor (or as an advisor) of economic reforms. We show that the Fund desire to hide its surveillance failures, in order to preserve its reputation of being a good monitor/advisor, may actually distort its lending decisions towards greater laxity in punishing non-compliance with economic reforms. Such laxity may be exacerbated by the length of the relationship between a country and the Fund. Thus we claim that prolonged use of IMF resources is not only a consequence of a lack of effectiveness of adjustment lending but it might itself be a determinant of conditionality failure.

Keywords: IMF conditionality, incomplete information, reputation

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1 Introduction

There exists a large body of evidence documenting an unsatisfactory record of implementation of IMF conditionality by borrowing countries.[1] A large proportion of IMF programs are not successfully completed, with non-completion being not an indicator of graduation from the Fund but rather one of future referrals (or recidivism).[2] Specifically, the IMF has recently come under criticism for allowing some countries to establish long-term relationships, while, according to its original mandate, the Fund could only guarantee temporary assistance.

There has indeed been a natural evolution in the use of IMF assistance towards longer time frames (the original 18 months of a SBA have lengthened to the three years of a PRGF). However, such evolution has not changed the original structure of an IMF arrangement which still maintains fixed time limits. Nevertheless, the vast experience of countries has been to enter a long term relationship with the Fund by signing many consecutive agreements and thus making the time frames of IMF supported programs quite arbitrary.[3]

Prolonged use has a significant effect on the revolving nature of IMF resources, which is measured by the average length of a lending cycle.[4] For example, Jeanne and Zettelmeyer (2001) find that for developing countries about 40% of all the lending cycles initiated since the creation of the IMF were not completed by the year 2000 and that the average length of such incomplete cycles was 18 years.

A report published in 2002 by the IMF Independent Evaluation Office (IEO) deals specifically with the issue of prolonged use and provides a definition of prolonged use based on the concept of "time under arrangements".[5] A country is defined as being a prolonged user if it has been under an IMF arrangement for at least 7 years out of any 10. Using such definition, the report examines trends in prolonged use over the period 1971-2000. It emerges that prolonged use started to build up in the second half of the 1970s and accelerated sharply in the first half of the 1980s, due to the debt crisis. More specifically, 51 countries, out of the 128 countries that made use of IMF resources, meet the definition of prolonged user at some time during that period.

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[1] For a review of this literature see, for example, Joyce (2004b).
[2] According to Mussa and Savastano (1999) only 47% of all IMF programs have been successfully completed.
[3] In particular, on this point, see Vreeland (2003).
[4] Without subsequent programs a lending cycle should be equal to the sum of the program and the repayment period, that is a maximum of 13 years for either an EFF or an ESAF/PRGF and a minimum of 6.5 years for an 18 month SBA.
[5] However, a formal criterion to identify prolonged users has not yet been adopted by the IMF Executive Board, while an "operational definition" of prolonged use would be a key step to investigate such phenomenon and develop a strategy to reduce its diffusion.

In terms of the number of countries most of such expansion was in the use of concessional resources (i.e. by PRGF-eligible countries), but in terms of financial obligations, the expansion in prolonged use of general resources (i.e. mainly by middle-income countries) was greater. In addition, prolonged use is found to be persistent (i.e. countries are generally slow to "graduate" from such use) and, in 2001, the arrangements with prolonged users represented about half of the total number of IMF programs, with a total exposure of about half of the total outstanding obligation to the IMF.

In general, a prolonged use of IMF resources could be justified by thinking of economic adjustment as a multistage process that requires multiple IMF loans to be completed. However, the empirical evidence does not support such optimistic view, since the probability of "graduation" from the IMF by a borrowing country does not appear to be positively related to the number of cumulated lending arrangements. Thus, prolonged use of IMF resources rather suggests a lack of effectiveness of IMF supported programs (i.e. poor programs implementation and flaws in programs design).

In the literature, conditionality failures have generally been investigated by looking at the characteristics of the borrowing countries (the so called "demand-side"). More recently, the possibility that an IMF specific interest may influence the adoption of an IMF program (and in turn its implementation) has also been considered (the so called "supply-side"). Specifically, it has been argued that if the objective of conditional lending is to induce the borrowing country to carry out reforms (which otherwise would not be implemented), the threat of interrupting financial assistance, in case of non compliance, should be credible.[6]

Nevertheless, several obstacles to the punishment of non compliance have been identified by the literature: bureaucratic biases, political pressures, difficulties in monitoring, and the so called "defensive lending". In this paper we propose a novel explanation, based on the contribution by Marchesi and Sabani (2005), according to which it is the repeated nature of the IMF involvement, together with the fact that the Fund acts simultaneously as a lender and as a monitor (and as an advisor) of economic reforms, that weakens the credibility of the IMF threat and produces "defensive lending".[7]

[6] According to Drazen (2002) there exists a conflict of interest between the Fund and its borrowers due to the influence of some private interests in the borrowing government's policy choices. Therefore, with no sanction, the government will not implement any reform

[7] In a different context, this argument has been first applied by Boot and Thakor (1993) to sustain the view that the lender of last resort should not also be responsible for the surveillance of the banks.

Our key idea rests on the circumstance that, since the IMF is not only a lender but also a monitor/advisor of economic adjustments, it is (at least partially) responsible of a borrowing country's bad performance. This for of at least two reasons: either because the Fund has prescribed the wrong reforms, or because it has not been able to detect, as a monitor, some deviations from the prescribed reforms early enough to get the country back on track, by threatening of immediately interrupting its financial assistance. The longer the relationship with the borrowing country, the more disruptive for the IMF reputation the decision not to refinance a country, since this outcome will have been influenced by many past monitoring (counselling) actions.

Therefore, the desire to avoid a loss of reputation as a good monitor/advisor might lead the Fund to exhibit some laxity in interrupting financial programs (when a country is not meeting the agreed conditions) and such laxity will be exacerbated by the length of the relation between the country and the Fund. In conclusion we claim that prolonged use of IMF resources is not only a consequence of a lack of effectiveness of adjustment lending but it might itself be a determinant of conditionality failure.

The paper is organized as follows. Section 2 discusses the possible determinants of prolonged use. Section 3 analyses the effects of prolonged use on the nature and the extent of conditionality. Section 4 investigates conditionality failure by focusing on the so called supply-side factors. Sections 5 and 6 analyse the Fund lending policy when the IMF cares about its reputation either as a good monitor or as a good advisor, respectively. Section 7 contains some policy implications and concludes the paper.

2 Why do agreements continue?

In general, it is reasonable to think of the economic adjustment as a multistage process that requires multiple IMF loans to be completed. Borrowers' problems, in fact, often require structural reforms that might take many years to produce positive effects. Under this interpretation, we would expect to see a gradual improvement and a borrowing country's "graduation", at least after participation in a given number of adjustment lending programs. However, there is some empirical evidence pointing to the opposite conclusion.[8]

Bird et al. (2004), examining IMF programs between 1980 and 1996, find that repeated participation to IMF programs is associated to: (i) larger current account deficits, (ii) lower levels of

[8] It is worth noting that very few studies have explicitly addressed issues related to prolonged use of IMF-supported programs.

international reserves, (iii) less capital inflows, (iv) higher program cancellation, (v) lower terms of trade, (vi) greater debt-service ratios and (vii) relatively more corrupt governments. According to Bird et. al. recidivist nations seem to be caught in a vicious cycle: they start by entering Fund programs out of necessity but then they present a poor record of compliance with these programs and thus a large proportion of IMF programs are cancelled. However, with no penalty for past non-completion, such countries turn soon again to the Fund.

Joyce (2004b) analyses in details the spans of time (i.e. spells) spent under IMF arrangements by a group of emerging countries over the period 1982-2000. He finds that, as the determinants of programs duration are concerned, countries with lower per capita income, exports concentrated in primary goods, landlocked geographic status and autocratic regimes have longer spells. However, such evidence is not surprising, since prolonged use obviously reflects the persistence of economic difficulties. More interestingly, Joyce finds that the average length of each spell is almost three years (but a number of spells in the sample lasts for five years or longer) and that the probability that a spell would end in a given period first rises but then falls, as time passes.

Accordingly, Easterly (2005) finds that, among the top 20 recipients of adjustments loans (from both the IMF and the World Bank), in the period 1980-99, the probability to get a new adjustment loan does not decrease with the number of loans already received (and actually it seems to increase after ten cumulative loans). These results are also confirmed by Knight and Santaella (1997) who, using a bivariate probit model to estimate the approval of an IMF arrangement, for 91 developing countries over the period 1973-1991, find that a dummy variable for past agreements increases significantly the probability to get another agreement.[9]

However, frequent use of IFI loans and lack of graduation may actually take place for reasons controlled neither by the IMF (or the World Bank) nor by the borrowing countries. This could be the case of the countries subject to frequent external shocks, which, inducing a poor macro-outcome, may prevent them from gaining independence from the IFI. Nevertheless, Easterly (2005), in his sample of intensive recipients of adjustment lending, does not find a clear association between macro-shocks and prolonged use of IFI resources. In general, Easterly does not find any statistically significant difference in terms of economic performance (i.e. terms of trade growth and per capita growth) between the top 20 recipients of adjustment loans and the whole sample of developing countries, over both the 1980's and the 1990's. This evidence is then in favour of the

[9] Besides, Conway (1994), estimating the probability to participate to an IMF program for a sample of 74 developing countries over the period 1976-86, using a tobit model finds that the greater the percentage of IMF facility drawn down in the previous year the greater the duration of the current IMF program.

view that prolonged use reflects some shortcomings in the effectiveness of adjustment programs (i.e. conditionality failure).

In fact, a poor program implementation is a key factor underlying the lack of effectiveness of IMF-supported programs and as such, a direct cause of prolonged use. However, in principle, the Fund (and the World Bank) should not grant new loans to countries that had failed to deliver reforms in response to old ones. Thus, if a poor program implementation needs to be blamed, the question turns to how to explain the lack of selectivity by the IMF (and the World Bank) in rewarding compliance with the agreed conditions.[10]

In that respect, it actually seems that prolonged use has actually affected the extent and nature of conditionality, allowing the recipient countries to hide more easily their policy slippages. In the next Section we will present some evidence on prolonged use and its effects on conditionality.

3 Prolonged use and its effects on conditionality

Some empirical studies have found that, controlling for countries' characteristics and their economic performance, the existing debt has a robust and positive impact on new IFI lending. For example, Birdsall et al (2003), analysing a panel of 37 Sub-Saharan countries over the period 1978 to 1998, find that the quality of their economic policy mattered little in explaining multilateral and bilateral net transfers. Donors, especially bilaterals, made greater transfers to countries with high multilateral debt, despite their bad policies. Marchesi and Missale (2004), estimating a dynamic panel of 52 low-income countries for the period 1982 to 1999, find similar evidence. According to their results, while in the case of non-HIPC (other low income) countries, both multilateral new loans and grants decrease as multilateral debt increases, in the case of HIPC such "correction" does not take place. Moreover, HIPC receive more grants from bilateral donors as bilateral debt increases.[11]

This evidence overall suggests that HIPCs have kept receiving large amounts of resources just because of their high indebtedness.[12] Marchesi and Sabani (2005), estimating a dynamic panel of 53 middle-income countries for the period 1982-2001, show that a higher level of IMF debt significantly increases new IMF disbursements.

This empirical evidence, together with that discussed in the previous section seems to suggest that the IFI incentives to punish bad policies (borrowing countries failure to deliver reforms) decrease with the accumulated debt burden and with the number of loans already received.

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[10] Such lack of selectivity of both the IMF and the World Bank is confirmed by the results obtained in the case of foreign aid (see, for example, Burnside Dollar, 2000; Birdsall et al., 2002; Marchesi and Missale, 2004).

[11] Greater net transfers have taken the form of net loans from multilateral organisations and grants in exchange for loans from bilateral institutions.

[12] On this point see also Easterly (2002) and Birdsall et al. (2002).

The above mentioned IEO report (2002) presents some evidence in support of the idea that the persistence of IMF lending affects the extent and nature of conditionality. Its main conclusion are the following: (i) conditionality applied to prolonged users was on average less extensive and softer (less prior actions and performance criteria) than that applied to temporary users; (ii) there was a tendency to some underestimation by the IMF of the technical and political limits to a country's implementation capacity (resulting in over optimism about the feasibility and the effects of conditional reforms); (iii) there was not closer monitoring of performance under programs with prolonged use (as one would have reasonably expected); (iv) IMF officials could generally exercise much more discretion with prolonged users than with temporary users in assessing compliance with the agreed conditions.

In conclusion, all these findings confirm the view that the problem of prolonged use (and recidivism) should be associated with some failure in inducing borrowing countries government to implement policy changes. Specifically, it seems that the very fact of entering a long term relationship with the IMF affects the nature of conditionality towards the adoption of softer and more qualitatively expressed conditions. The monitoring process itself seems to become less intensive, making easier to recipient countries to abscond with policy slippages.

How can we explain this and what could the mechanism behind be? Our conjecture is that the repeated nature of the IMF involvement, together with the fact that it acts simultaneously as a lender and as a monitor/counsellor of reforms, is responsible for such result. However, before explaining and justifying at length our idea (in Section 5 and 6), in the next section we first examine what other supply side factors have been addressed by the literature so far to account for poor program implementation.

4 Conditionality failure

When a government enters an IMF supported program, the Fund makes a given amount of foreign exchange available to the country for the duration of the agreement. The government can draw on these funds at scheduled intervals, provided that it satisfies the conditions specified in the arrangement. The multiple tranches system allows the IMF to deny access to subsequent disbursements if it does not observe compliance with the agreed conditions. For this agreement to work properly, it is essential that the Fund is able and willing to punish non compliance, that is, the threat of early termination of financial assistance must be credible.[13]

[13] The effectiveness of this threat increases if the program suspension undermines the country's long term ability to negotiate new programs with the Fund.

The rather disappointing results of conditionality (as a mean to induce reforms) have brought some authors to investigate on the motivations which could account for the lack of credibility of the termination threat. The main obstacles to punishment of non-compliance are identified by the literature in the existence of bureaucratic biases, political pressures, difficulties in monitoring, and "defensive lending".

According to the international public choice approach (e.g. Vaubel, 1986) the existence of a bureaucratic bias might lead the IMF to try to maximize its power in terms of budget size and influence in the world, without concern for its original mandate. The budget constraint the Fund faces, in fact, is a soft one: the more resources it uses, the more it can demand from its members through increased contributions. According to this view, the IMF would continue to grant new loans to protect its budget despite a lax reform effort.

On the one hand, the Fund must obviously justify the use of its resources. On the other hand, there are several layers of PA problems that might account for a reduced IMF accountability to its members (see Vreeland, 2003). Fund officials might report that policy changes are satisfactory although a program has not been fully implemented, moreover, they may attribute bad outcomes to adverse states of nature independently of a borrowing government's behaviour. Under these circumstances, the threat of interrupting disbursements (when conditions are not fulfilled) becomes not credible and loses its efficacy as an incentive to induce the government to keep on-track.

As reported by Rowlands (1995) the Fund has often been accused of being too much concerned with the interest of international lenders, especially after the 1982 debt crisis. External lenders (specifically the G-7 governments) may exercise some political pressures on the IFI (especially the Fund) to stay involved with the countries they have important economic relations with. This is consistent with the evidence presented, among others, by Copelovitch (2004) who argues that IMF lending decisions are responsive to the interests of large industrial countries.

However, according to Sturm et al. (2004), who estimate a panel model for 128 countries over the period 1972-1998, while mostly economic variables are robustly related to the IMF lending activity, most political variables are non-significant. To the extent that political factors matter (especially elections), they seem more closely related to the achievement of an agreement with the IMF than to

the actual disbursement of an IMF loan.[14] For example, other political variables, like a country's relative size and its trade relations with the US, do not appear to be significant.[15]

Moreover, a similar kind of pressure could also depend on the "gatekeeper" role assigned to the IMF with respect to many other sources of official financing. For example Paris Club creditors have provided reschedules to developing countries conditionally on their adoption of an IMF program.[16] Nevertheless, Marchesi and Sabani (2005), find that IMF disbursements significantly increase only with the lagged value of the IMF outstanding debt, while the impact of both bilateral and multilateral debt (and of the debt share held by private bondholders) is not significant, at least at conventional levels.

Another important problem refers to the existence of difficulties in monitoring compliance with the required reforms (Cordella and Dell'Ariccia, 2001). The policy reforms on which the IMF has progressively focused are more difficult to observe than traditional macro-variables (like, for instance, the rate of inflation and the exchange rate). The budgetary process can be very complex to monitor, and thus governments might succeed in diverting resources to their most preferred use, without incurring in penalties.[17] Furthermore, the quality of monitoring might be undermined by a high IMF staff turnover that limits the accountability of mission chiefs and weakens their relationship with the recipient country's authorities. Such detrimental effects might be particularly relevant for prolonged users of IMF resources, due to the importance of track records and "learning curves" (see the IEO report, 2002). Moreover, in a risky economic environment (for example due to supply conditions, international prices or world interest rates), the ability in monitoring compliance with conditionality would be strictly related to the IMF officials ability to rapidly respond to unanticipated shocks through the necessary policies and targets adjustments.

Finally, as an alternative explanation, some authors have attributed the prolonged use of Fund resources to IMF defensive lending, that is, to the practice of granting new loans to help countries pay off the old ones.[18]

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[14] New governments are more likely to invest their political capital into an IMF-supported adjustment program than governments later in their term because they are more likely to enjoy the outcome of their reforms. For the same reason, the Fund might judge new governments to be more reliable reformers (Sturm et al. 2004).
[15] The relative size of a country may matter to the extent that the contagion risk of a big country's balance of payments deficit is higher (the "too big to fail hypothesis").
[16] Unlike official creditors, private creditors are less dependent on IMF programs as a "seal of approval".
[17] For example, conditions imposed on the composition of public expenditure require the monitoring of audited public accounts which are seldom available on a sufficiently timely basis to implement legitimate penalties (Collier et al. 1997).
[18] See, among others, Collier et al. (1997), Easterly (2002) and Ramcharan (2003).

This practice clearly disrupts recipient country's incentives to live up with the agreed conditions, making the threat of being cut off from IMF financial assistance not credible. The rationale behind that practice rests on the fact that the lender would suffer from inflicting the suspension of disbursements, since that would trigger a macroeconomic crisis, with relative suspension of debt service payments. However, if the country does not adopt policy changes to ameliorate economic conditions, rolling over the debt simply postpones the default crisis. To understand the Fund defensive lending we should then refer either to some "political cost" borne by current IMF officials after a borrower's inability to pay has become public (as current officials have a shorter horizon than the institution they work for) or to the possibility that postponing default might come at a relatively lower pecuniary cost, due to future debt relief program (Ramcharan, 2001, 2003).[19]

The "political cost" argument implicitly assumes that the IMF is accountable (at least to some extent) for a conditionality failure.[20] For example, the most powerful Fund members might refrain from increasing the Fund resources if its reputation is damaged.[21] What is not obvious, and thus needs to be explained, is the reason why the borrower's inability to pay can negatively affect the reputation of the IMF. Our conjecture rests on the dual role played by the Fund, which is at the same time a lender and a monitor/advisor of economic adjustments. Therefore, a borrower's inability to repay might be disruptive for the IMF reputation as far as the latter can be, at least partially, responsible of a country's bad performances. This may happen for of at least two reasons: either because the Fund has prescribed the wrong reforms, or because it has not been a good monitor. More specifically, it has not been able to detect deviations from the prescribed reform-path and/or to get the country back on track by the threat of immediately interrupting its financial assistance.

Therefore, it is reasonable to think that the IMF "prestige", as an institution, and, with it, its ability to maintain and to increase its budget, may depend on its the reputation of being either a good monitor or a good advisor of policy reforms. In the next Section we will consider the case in which the Fund reputation may be related to its ability as a monitor, while in the following one we will describe the case in which the Fund reputation may depend on its ability as an advisor. Obviously the reputation of the Fund may be influenced by these two factors together (and eventually by some others more), however, for simplicity, in this work we will present them separately.

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[19] However, we dismiss the role of such pecuniary costs since the IMF is a senior creditor.
[20] This despite the fact that the attribution of responsibility of such a failure (between the Fund and a country) may be blurred by the existence of asymmetric information.
[21] The Fund can activate supplementary borrowing arrangements (through GAB and NAB) if it believes that its resources might fall short of members' needs.

5 Reputational concern as a monitor

In what follows we formulate analytically our conjecture by sketching the reputational model of conditional lending as was proposed in Marchesi and Sabani (2005).

In the model there are three agents: the borrowing country's government, the IMF and its stakeholders (global taxpayers) to whom the Fund is imperfectly accountable. The economy lasts for two periods. The government, at the beginning of each period, faces an "adjustment option" that requires an indivisible investment. This structure captures the idea that the economic adjustment is a multistage process which requires multiple investments be completed. At the beginning of each period, the IMF is prepared to offer financial assistance in exchange of a precise set of policy reforms it has specified. The investments' payoffs depend on the level of reforms implemented by the government.

We assume that the reforms indicated by the IMF maximize the end of period expected investment payoffs, but, by eliminating economic and other distortions, they also reduce the level of political and economic rents that the government can extract for its private gain.[22]

Thus, conditional on receiving the loan, for the government is never optimal to implement the level of reforms indicated by the Fund. Then, the optimal level of reforms will be implemented by the government only if the IMF is able to monitor efficiently and, in case of some reported deviations, it exercises timely the threat of interrupting current and future disbursements.

The long term nature of the adjustment process gives the IMF more contractual power, since any first period deviation from the agreed conditions could be punished with the interruption of both current and future disbursements. Recognizing this, in our model we assume that, in the first period, if the government were actually facing the alternative between meeting the conditions and renouncing to present and future disbursements, it will always prefer to follow the adjustment path indicated by the Fund.[23]

The structure of our model is complicated by the fact that the IMF can observe only imperfectly compliance with the agreed conditions. More specifically, we assume that the Fund can actually detect, without any uncertainty, whether or not the recipient country has respected its conditions

[22] On this point, among others, see Svensson (2000) and Drazen (2002).
[23] In principle, leaving the IMF may not be particularly costly. However, if either official or private creditors around the world rely on the IMF "seal of approval", then it may be very costly for a government to defect on the IMF. Obviously if the conditions to be implemented are particularly harsh, a country might still decide to exit from the IMF arrangement (see, for example, the case of Tanzania in the 1980s as reported in Vreeland, 2003).

only at the end of the program. During the program, instead, there exists some positive probability that a policy slippage would not be immediately detected by Fund officials.[24] In this case, the government may conclude the first period neither respecting the agreed conditions nor incurring in a suspension. However, the IMF is able to eventually observe the reforms accomplished with no noise and it can make the borrowing country ineligible for the second agreement. If credible, such a threat could, per sé, provide ex ante the government with enough incentives to meet the agreed conditions.

Nevertheless, we argue that this threat is not credible, since the interruption of the financial assistance, at the end of the first period, comes with some "political cost" to the Fund. Specifically, such political costs arise whenever the reputation of the Fund as a good monitor (of compliance with conditionality) is undermined.[25] In that respect we assume that there exists some uncertainty over the IMF ability as a monitor. More specifically, the IMF can be of two types: either a good monitor or a bad monitor. If the IMF is a good monitor, it will discover departures from the optimal reform level, early enough to put the country back on track, with probability ρ_g , if it is a bad monitor the probability would be ρ_b , with $\rho_g > \rho_b$.[26]

At the beginning of the first period, the IMF's type is unknown to everybody, but global taxpayers and the country's government attach a prior probability to the event that it is a good monitor. At the end of the first period, global taxpayers can observe the IMF decision to refinance or not refinance the country, but they can not observe either the realized investment payoffs or the realized reforms. Thus, they can update their beliefs about the IMF ability as a monitor only by looking at the signal given by the "refinancing" decision. This circumstance generates incentives for the IMF to take actions to protect its reputation as a good monitor by exploiting its informative advantage.

The IMF decision not to sign the second agreement conveys bad news for the Fund reputation, since it indeed signals a failure of the Fund in timely detecting some policy slippages and exercising interruption threats. Therefore, at the end of the first period, when it comes to decide whether or not to sign a second agreement with the borrowing country, the Fund will not only look at the expected NPV of the second loan, but also at the impact of such decision on its reputation.

Then, the desire to avoid a loss of reputation as a monitor might lead the Fund to exhibit some laxity (relative to social optimum) in interrupting financial programs which, in turn, may destroy the

[24] Alternatively, we could imagine that the policy slippage is detected but some political pressures prevent IMF officials from intervening.
[25] Since the prestige of the Fund as an institution affects its ability to maintain and to increase its budget such political costs, in our model, it enters the Fund objective function.
[26] For example, the existence of uncertainty over the IMF monitoring ability could be explained by the uncertainty over the ability of the Executive Directors to monitor the activity of Staff Officials.

government's incentives to fully comply with conditionality.[27] Moreover, the greater the laxity, the higher the probability of financing a negative NPV investment in the second period, since the expected outcome of the second period adjustment is likely to depend on the reforms produced in the first period.

In conclusion, persistence of bad outcomes appears to be strictly related to the long term nature of the relationship between the IMF and the country. Therefore, prolonged use of IMF resources may be one of the determinants of a borrowing country's poor economic performance.

6 Reputational concern as an advisor

In this section we present a possible extension of the Marchesi and Sabani (2005) model, which consider the implications of the IMF being an advisor of economic reforms.

When the uncertainty on the IMF's type does not concern the IMF ability to monitor a country's implementation of reforms, but rather its ability to design and suggest a set of reforms tailored to the specific characteristics of the borrowing country, our conclusion would remain the same. The IMF desire to hide its failure in identifying and suggesting the appropriate set of reforms will again distort its lending decisions towards greater laxity.

Let us suppose that the probability of success of the second period adjustment option financed by the Fund is now a function of two arguments: the degree of effort exerted by the government in economic adjustment, and the set of reforms suggested at the beginning of the first period by the IMF. Such set of reforms could either be good, i.e. targeted to the specific needs of the borrowing country, or bad, that is designed without taking into account the actual characteristics of the country. A good set of reforms not only increases the NPV of the second adjustment option, for each level of effort exerted, but increases also the marginal productivity of the effort produced.[28]

We assume that the IMF can be of two types: either a good advisor or a bad one. If the Fund is a good advisor, it will suggest a good set of reforms with probability θ_g, while if it is a bad advisor, this probability would become θ_b, with $\theta_g > \theta_b$. As before, we assume that the economic adjustment reduces the level of political and economic rents that can be extracted by the borrowing country's government for its private gain, but, differently from the previous section, we assume that the

[27] If the IMF supervisory information was observable, the circumstance that the Fund may be self-interested would not cause any problem since it could be forced to take the right actions by its constituency.
[28] The rationale behind this hypothesis rests on the fact that financial assistance becomes more productive in a good policy environment.

government's "hostility" to economic adjustment depends on its type which, at the beginning of the first loan, is unknown to the IMF. A government whose hostility towards adjustment is strong will exert a lower level of effort than a less hostile government. However the quality of the reforms suggested by IMF affects positively the level of effort exerted by each type. Specifically, for each type, the more "country specific" the conditions agreed with the IMF, the greater the effort.

We assume that, at the end of the first period (loan arrangement), the IMF will be able to judge whether or not the reforms suggested suit best the needs of the borrowing country and it will be also able to observe the government's type. Moreover, at this stage, the Fund decides whether to continue lending. Global taxpayers update their beliefs about the IMF quality as a good advisor by actually looking at the refinancing decision (the only event they can observe at the end of the first period).

As before, the IMF wants to protect its reputation and so its willingness to keep on lending will depend not only on the expected NPV of the second loan, but also on the effects of the refinancing decision on its reputation. In this framework, if the suggested reforms are bad, the expected NPV is more likely to be negative, which in turn implies that the decision to stop lending is more likely when the suggested reforms are bad than when they are good. Therefore, the decision to stop lending conveys a worse signal for the Fund reputation than the decision to continue. Again, the desire to avoid a loss of reputation as an advisor might lead the Fund to exhibit a lack of selectivity in targeting financial assistance on those countries that would best utilise resources.

In conclusion, in both the models presented in this Section and in the previous one, the length of the relationship between the IMF and the borrowing country plays a crucial role. It can be argued, in fact, that, when the IMF is a good monitor (or a good advisor), the probability to discover some deviations from the agreed conditions (or to design a package of reforms more tailored to the country's needs) increases with the number of years passed under arrangements, since as time passes the knowledge of the political and economic environment increases. On the contrary, if the IMF is a bad monitor (advisor) the probability to discover some deviations from the agreed conditions will be less dependent of the length of the relationship. Therefore, the decision of interrupt a program becomes increasingly more disruptive for the IMF reputation as time passes and so prolonged use of IMF resources may exacerbate distortions in the IMF lending policy.[29]

7 Conclusions and Policy Implications

[29] We overlook the possibility that fundamental breaks of the political and economic environment will make the IMF decisions less informative as its reputation is concerned.

IMF conditionality specifies policies and structural reforms which borrowing countries must meet in order to obtain an IMF loan. In principle, the Fund can enable governments to implement economic reforms as a result of the leverage it exerts as a creditor. In practice the effectiveness of the conditional lending approach has been limited and numerous empirical studies have shown that a large proportion of Fund programs lasts for too long, has not been successfully completed and presents a high degree of recidivism. In particular, prolonged use of Fund resources (regardless of its specific definition) has consistently expanded since the 1970s among both low-income and middle-income countries and the existing evidence overall suggests that it is linked with a lack of domestic reforms.

A strand of the literature has explained such unsatisfactory record of conditional lending referring to the existence of bureaucratic and political biases and/or monitoring difficulties that might be responsible for the lack of credibility of the IMF threat of interrupting financial assistance when a country is not complying with conditionality.

Our view is that such lack of credibility might be attributed to the dual role played by the Fund, which acts at the same time as a creditor and a monitor (advisor) of reforms. More specifically the IMF desire to hide its surveillance or counselling failures, in order to preserve its reputation, may actually distort its lending decisions towards greater laxity (relative to social optimum) in punishing non-compliance with economic reforms. Moreover, such distortionary incentives (towards excessive lending) may be exacerbated by the length of the relationship between a country and the IMF. In fact, the longer this relationship, the more informative (for the quality of the Fund monitoring and advising) the decision to interrupt a program will be, since this outcome will have been influenced by many past monitoring actions.

An immediate policy implication of our analysis would be that, in order to eliminate distortions in the Fund lending policy, it would be better to separate its responsibility as a lender from that as a monitor (at least in the case of prolonged use). For example, the IMF could be responsible for designing appropriate policy conditions, monitoring and reporting, while, based on such reports, financial support could be decided by a separated intergovernmental body. Nevertheless, it is crucial for this solution to work that the two bodies share the same information about the compliance of borrowing countries with the required conditions.

An alternative proposal would envisage giving back to governments the responsibility for designing and implementing economic reforms. The surveillance function should be limited to the periodical evaluation of the attainment of objectives, rather than to the implementation of particular policy

measures (Collier et al., 1997). In other words, substituting "procedures conditionality" with "target conditionality", the IMF would be less involved in managing reforms at a micro level and, in turn, it would be less responsible for observed disappointing results in the recipient countries. Outcome based conditionality may provide a possible approach that minimize IMF interference. Obviously, there are drawbacks attaining to the difficulties in ascertaining how much of a disappointing result is due to a government's misbehaviour or to some negative shocks, therefore the efforts should be devoted to disentangle the consequences of bad policies from those of external shocks. Collier et al. suggest correcting for this bias by identifying important determinants beyond the government control (e.g. geographical factors and ethno-linguistic fractionalisation).

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