International Monetary Fund Involvement in Lower Income Countries: Helpful or Hurtful?

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Abstract:

Are countries better or worse off economically after receiving IMF loans? Critics of this organization argue that its loans are harmful to countries in a variety of ways. The ways they argue its involvement is harmful include, most notably, the critiques of the debt spiral and conditionality. Proponents counter that the IMF accomplishes its goals of international economic stability through economic maintenance for lower income countries, which helps the countries in the long term (about 5 or more years out). This paper examines the IMF's loans in several countries, ranging from low to high income from 1996-2020 and analyzes whether countries that received larger IMF loans were better off economically. I find that IMF loans create a "sugar rush" in countries, giving them momentary help and momentary relief, but contrary to the belief of proponents, not providing as much help in the long term.

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The International Monetary Fund is an international organization that seeks to ensure the stability of the International Monetary System and the global economy. Created in the wake of World War II at the Bretton Woods Conference, they were created as an international lender of last resort – the financial institutions that countries could go to for financial assistance when no other lenders were capable or willing to help them out. This was seen as an important global economic safety feature, since countries defaulting on their loans would have a domino effect on global economy. Essentially, if one country goes down, it is possible that every country could get caught in a financial debt crisis. The IMF seeks to promote financial stability in a number of ways: giving loans to countries that may be about to enter financial crises (lending), watching over member countries' economies with economic surveillance, and "modernization" of countries' policies and institutions with capacity development (IMF, 2020). To go about all this, they "regularly monitor global, regional, and national economic developments" (IMF, 2020).

Prior to the collapse of fixed exchange rates in 1973, the IMF was less active in giving loans; now lending is one of its main pillars (Masters and Chatzky, 2020). The International Monetary Fund gives out loans to countries in an effort to help those countries avoid financial crisis; ultimately to avoid a global financial collapse. Loan conditionality occurs when countries that take out loans are required to make significant economic reforms. Policies associated can include reduced government spending, cuts in funding to human capital (like hospitals and schools).

Country governments typically go to the IMF when they are no longer capable of paying off debt or they are unable to continue funding foreign imports, both signs of a looming currency collapse (Masters and Chatzyky 2020). Weiss (2010) explains that two main functions of the

IMF are crisis control and surveillance of the global economy, and it has been named by some as a global "financial firefighter" (*Economist* 2011). Some scholars have argued that IMF loans have a positive impact on countries, with one recent study finding that countries who implement the IMF's policies see an increase in average GDP growth rate (Hackler, Hefner, and Witte 2020).

However, critics have argued that the development policies required as part of receiving an IMF loan are especially onerous for low income countries (Stiglitz 2020), and citizens in some of these recipient countries do view their past loan experience in a very negative light. When I went to Jamaica in 2018, I met a local tour guide named Duka Brown. Duka argued that the massive loans from the IMF were not helpful for lower developed countries. In fact, the loans put the countries in awful situations, which included "debt spirals" and "conditionality". He explained that the loans' interest rates were so high that the IMF knew Jamaica would never be able to pay it, and that the majority of the money the country made off of tourism had to be immediately given back to the IMF. He also told me about how programs meant to fund hospitals and schools were cut, leaving only private hospitals for tourists and extremely dilapidated schools for children. He even showed us that the desks there in the school were from his time as a student.

I seek to test whether IMF loans have positive impact on a country's economy by examining a global dataset which includes countries who received IMF loans as well as ones that do not, and analyze both the short- and long-term growth rates of countries. I test whether countries that take out larger loans have slower or faster growth than countries with smaller loans (or those with no loans at all).

The Economic Role of a Financial Firefighter

Typically, the main countries the IMF loans to are ones already heading towards financial collapse. IMF loans are intended to thwart and mitigate the effects of financial crises. But it is important to note the near state of collapse when evaluating IMF helpfulness, because the countries the IMF is trying to help are often in dismal situations at best. These crises the IMF intends to thwart include any temporary strain on a bank or group of banks, including but not limited to a collapse (Dobler, 2016). Countries can get into a variety of bad economic situations that lead to them seeking help from the IMF. These types of situations can include collapses in any of their economic sectors, local sicknesses crippling the workforce, war, or, in more recent circumstances, a global pandemic that crushes the economy worldwide. For example, Egypt recently requested a $4.8 billion loan because of their collapsing tourism and energy sectors (Fahim 2012). They then requested another loan this year in response to Covid-19 (APNews 2020). While most IMF lending has been directed to low income countries, the IMF also played a major role in bailing out economies during the European debt crisis, such as Greece, Portugal, Ireland, and Iceland (Masters and Chatzky 2020).

While some countries go to the IMF when faced with a looming crisis, others might be using this organization as cover to put into place necessary but politically unpopular economic reforms. A comparative case study by Vreeland (2002) on Uruguay found that Uruguay's leader used IMF conditions to help counter domestic opposition that sought to block his proposed economic liberalization reforms.

Even a country that *wants* but does not *need* an IMF loan, however, is likely facing economic trouble which requires reform. In other words, even the "best case" scenario means that the IMF is lending to countries that are likely to be experiencing declining or weak economic growth.

If we assume that IMF loan recipients start out in a poor financial situation, the next question is whether IMF loans ultimately help or hurt those countries, which is a hotly debated topic. Conway finds that the programs substantially raises economic growth and increase government surpluses (Conway 1994), but that the improvement in the economy occurs several years after they receive the loan, not immediately (Atoyan and Conway 2006). Essentially, the loans did not help the countries in real time but created improvements in economic growth several years down the line.

Many studies find that the IMF is helpful because it accomplishes its core goals (like global economic stability and increasing countries' reserves). Research like Dreher and Walter (2010), finds that IMF involvement significantly reduces the likelihood of a crisis through management of the global economy, and that the policy of currency devaluation can be helpful in mitigating macroeconomic risks long-term. Khan (1990) similarly finds a strong correlation between IMF involvement and macroeconomic stability as well as economic growth. The conditionality agreements that accompany IMF loans may also help these countries develop resilience, as countries who have had IMF help do undergo crises are more likely than countries without IMF help to adjust their exchange rate in response to the crisis (Dreher and Walter 2010). In other words, a recent study by Hackler, Hefner, and Witte finds that countries who implement the IMF's policies see an increase in average GDP growth rate. IMF loan recipients become more financially adaptive and flexible following their loan, which puts them on better financial footing in the future (2020).

In a recent case study, the IMF found that its loan recipients were better able to increase their international reserves and signs of debt (IMF 2019). Furthermore, the IMF article examines the effects its involvement has had in the lower developed country of Jamaica. Increases in net

reserves and lowered public debt serve, in the eyes of the IMF, as two signs of progress in Jamaica. The article sees Jamaica as a total case of success. But a local source and the research of countless anti-IMF scholars suggests otherwise. Finally, Gylafson found that IMF involvement typically decreases a country's debt and helps them pay off existing loans (1987). Which goes to show that lowering public debt and paying off existing loans just serve as signs of an IMF loan, *not* necessarily success or economic improvement in that country.

Other scholars have a more mixed assessment of IMF lending. Eke and Kutan (2009) notes that each country has its "own characteristic in responding to the news [of IMF bailout]," and that the effectiveness of IMF loans may rest more on a recipient country's commitment to reform, their current policies, and the presence or absence of external economic shocks. Similarly, a report by the IMF notes that loan effectiveness is limited by a persistently weak global economy (IMF Strategy, Policy, & Review Department 2019).

Theory: The Main Criticisms of IMF Lending

Critics, however, argue that IMF loans can be detrimental, especially to developing countries. These scholars focus on the danger of debt spirals as well as the problems that can arise from loan conditionality. One of the biggest problems associated with IMF loans is the debt spiral, which is the phenomenon that poor countries who take out IMF loans are unable to pay them back. They take out more loans when they are unable to pay existing loans, causing a government to lose money in interest instead of reinvesting money into their economies. Sachs (1997) remarked that the IMF's policies can create a "rip-roaring economic downturn" in their attempts to solve currency crises. Perkins (2004) ruthlessly exposes how the debt spiral forces countries to extract resources from their economy instead of reinvest. While he worked in the

private sector rather than a government or intergovernmental agency like the IMF, he explains how he took part in pressuring low development countries to say yes to loans that would only be able to be repaid through this exploitation of their natural resources. When countries' institutions are too weak to use the loans to reinvest into their economy, they can get caught in the vicious cycle of a debt spiral, which has grave consequences for the country *and* global economy. Essentially they are forced to default on their loans and have to get out more loans to pay off previous ones, resulting in a cycle that is very hard for them to break.

Greece is a recent example of this. Showcasing the perils of the debt spiral, Greece was in a state of crisis after having to default on multiple IMF loans. Having been a recipient of numerous loans over the years, it had to default on a 1.6-billion-euro loan in 2015. This left them in danger of a "Grexit" (McMurray, 2015). This is a perfect example of a country that thought IMF help would pose a solution, when it really created bigger problems by giving the country more loans than they could handle.

Stiglitz (2002) argues that a lot of this issue of debt spiral relates to the "one-size fits all" nature of IMF loans and their resulting conditionalities. He points out that, although the IMF does come through on many of their promises (crisis prevention, better trade, nominally better health care, amongst other things), it is still "not working for the world's poor". It is not responsive enough to the needs of the nations in which it is involved. In fact, the nature of conditionality is a major critique of IMF involvement. There are two main problems associated with conditionality: cutting of government funds and the way capital moves in and out of the country too freely.

To help the markets, the IMF requires loan recipient countries cut government funds and revenue for programs like poverty reduction and human capital programs. However, these

welfare spending policies are often instrumental at helping a country improve their human capital. When the countries are unable to invest in reducing their poverty and improving human capital, they are left with sick, uneducated, and unproductive workforces, which in turn depresses their economic growth potential. A considerable literature has linked human capital to economic growth (for a small sample of this research, see Barro 2001 and Krebbs 2003), thus, any required cuts to these programs are also likely to undermine a country's growth potential.

And many times, IMF conditions also cut education, healthcare, and bureaucracy with few cuts to a country's military (IMF Conditionality). Dijkstra finds IMF involvement to be harmful in countries like Nicaragua, Bolivia, and Honduras, echoes the criticisms of conditionality by saying "that there [is] also limited country ownership with respect to the contents of the strategies" (2010, 451).

A second harmful aspect of conditionality is that it makes it too easy for capital to move in and out. This can lead to risky investment and less oversight. While cutting bureaucratic red tape can allow local businesses to emerge, when there is *too* little oversight, this can trigger problematic boom and bust cycles (IMF 2019). IMF loan conditions are especially intended to help lure foreign investment, which can heighten this continual economic crisis risk for developing countries. According to Best, "As developing countries have become more integrated into the global economy, they have become more vulnerable to sudden changes in exchange rates and capital movements—all of which can derail an IMF adjustment loan or a World Bank program" (2012, 679).

While debt spirals and conditionality agreements can create problems for loan recipients, these criticisms at least assume the IMF actually successfully deploys a loan and establishes reform. However, Eke & Kutan (2009) found that in Eastern European countries, the "IMF fails

to meet its main objective of providing temporary assistance", that "only 21% of the programs in transition economies… were successfully completed" (16). As a result, "IMF programs do not influence GDP growth rates… in their desired directions" (22). The wealth of research on debt spiral and conditionality, in addition to my personal interview with a local Jamaican leads me to believe that these loans are not working. I therefore hypothesize that:

H1: Countries that receive larger IMF loans, will see slower growth after 1 year or more.

Methodology

To empirically test the aforementioned hypothesis, I conducted a cross national statistical analysis. My data set will include all countries that the World Bank collects economic data on, and range from 1996-2020. For each year, I collect data on the GDP growth and IMF loan size for each country. I also include controls for human capital and corruption.

Dependent Variable

The dependent variable is whether a country sees positive or negative GDP growth from the countries given IMF loans. According to the IMF, GDP, or Gross Domestic Product, "measures the monetary value of final goods and services—that is, those that are bought by the final user—produced in a country in a given period of time (say a quarter or a year)" (IMF 2020). GDP is a quintessential way to test whether or not low-income countries are experiencing the desired economic benefits of IMF help because higher values mean greater growth. "GDP is an accurate indicator of the size of an economy and the GDP growth rate is probably the single best indicator of economic growth" (Picardo 2020).

Independent Variable

My independent variable is the size of a country's IMF loan, taken directly from the IMF website (IMF 2020). Linked under *References*, the website shows the loan year with members, dates, and amounts in US dollars. I collect this data for every year for every country that has received IMF help from 1996-2020. Countries that received no IMF loans in a given year receives a 0.

Control Variables

I will be using the information from the World Bank's human capital index to control for human capital. This includes the "knowledge, skills, and health that people invest in and accumulate throughout their lives". Human capital relates to the idea that a well-educated and healthy workforce would contribute more readily to a great economy than the opposite.

As Collier (2007) points out, poor governance is a major factor that can prevent a country from achieving stable economic growth. For this reason, I will also be using the Worldwide Governance Indicators data from World Bank (World Bank 2020). It accounts for the following six dimensions of governance: voice and accountability, regulatory quality, political stability and absence of violence, rule of law, government effectiveness, and control of corruption (World Bank 2020). Similar to human capital, a country with less corruption, accountability, and rule of law in its government would be more able to readily make use of IMF loans, while a country with more corruption or less accountability might more quickly misuse and or funnel the money elsewhere. We are controlling for these elements to give a fair shake to the IMF and acknowledge that these countries were not in ideal shape in the first place in several aspects.

Finally, since high and low income countries have different potential growth trajectories, I coded two dichotomous variables to identify whether a country is for high-income or low-income. This classification is based on to the World Bank's definition (World Bank 2020).

Statistical Analysis

I downloaded all this data into Stata and created separate spreadsheets for each variable. Since IMF loans are likely to take a while to go into effect, I lagged my dependent variable by 1 year and by 5 years to see whether a previous IMF loan help or hurt future growth rates. Since my dependent variable is pretty much continuous, I use an OLS regression to analyze the data.

Results

After doing the regression in Stata, I find that my results for the lag after one year were significant, just not in the direction I had anticipated. The results showed that the loans not only do not immediately hurt the countries, instead they actually *help* the countries after that first year. Since IMF loans are a sudden influx of financial capital, which may help stimulate the economy in the short term, this seems to make sense. The loans help the countries a year later because loans help in the short term, but often contribute to long term difficulties.

Table 1: Country growth rate at different time periods
(OLS Regression)

	GDP Growth 1 year out	GDP Growth 5 years out
IMF Loan (in $10,000 USD)	.0001** (0.000)	0.000 (0.000)
Human Development Index	-5.749*** (1.685)	-7.164*** (1.655)
Political Stability	.009 (0.229)	-.173 (0.207)
Rule of Law	-.851* (0.438)	-.257 (0.366)
Control of Corruption	.400 (0.388)	-.058 (0.335)
High income	.493 (0.438)	.726* (0.424)
Low income	-1.266* (0.649)	-1.14* (0.644)
Constant	7.638*** (1.174)	8.186*** (1.127)

F	14.40***	11.86***
R-Squared	0.046	0.05

Note: Robust Standard Errors clustered on country in parenthesis *p < .10, **p<.05, ***p<.01

However, it is important to note that they don't necessarily help the countries long term. In the 5-year results, we did not see the IMF loan size benefitting the countries. While it is good to be hesitant about discussing a null finding, it may be that IMF loans provide something like a "sugar rush" for the countries; loans have a small short-term impact with less evidence of a long-term impact. It helps in the moment, but it seems that the results are lost before we get a chance to see a local impact, which could help explain the effect on Duka in Montego Bay.

Ultimately, it seems that other factors are probably more important to helping these countries. Lower human development seems to reduce growth rates, which does run counter to traditional human capital arguments. However, it could be that this variable is highly correlated with country income level, since countries with higher income levels tend to also have high HDI ratings. This correlation could be confusing the analysis. Similarly, the results suggest a surprising finding that better rule of law also reduces GDP growth go down. Again, this could be correlated with country income level, as high income countries also tend to have better rule of law.

Conclusion: Directions for Future Research

Perhaps it is not the amount, but the type of loan and the structural adjustment that is a more important part of the story. The conditions they are expected to follow post loan reception could be significant. Future research should consider the nuances instead of just analyze the money. Researching things like the conditionality of a loan and or loan type could reveal more than loan size did. One thing to consider in why we see short term growth is the possibility that these are countries that would have seen slow growth even without the IMF's involvement. It

may just be that the countries have deeper seated issues. But, to be clear, the loans themselves do not seem to be doing any direct damage.

It could be that some loans are more beneficial than others. This is why I suggest that future projects look at what the loans consisted of rather than the amount. There are three different types of loans that the IMF gives out: Extended Credit, Rapid Credit, and Standby Credit. It could be that some loans help certain types of countries more effectively.

As previously stated, it could be that it is innate factors in the countries causing a lack of GDP growth. A deep dive into the similar aspects (beyond being lower development countries) that these poorer countries share could also shed some light onto why we see this phenomenon of stunted growth.

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