IMF conditionalities, liquidity provision and incentives for fiscal adjustment*

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Abstract

This paper proposes a model to study how conditional lending and immediate liquidity provision affect incentives for fiscal adjustment in a country facing the risk of sovereign default. Conditional lending provides explicit incentives for fiscal adjustment but immediate liquidity provision is more effective in reducing liquidation costs. For some parameters, immediate liquidity provision induces fiscal adjustment and debt repayment, while conditional lending does not (and vice-versa). Incentives for fiscal adjustment are concave in the fraction of lending that is provided under conditionalities. Therefore, the best strategy for an international lending of last resort might be a balance between immediate liquidity support and conditional lending. A large cost of tight fiscal policy shifts the balance towards immediate liquidity provision.

JEL Codes: F33, F34, H63.

KEYWORDS: IMF, conditionality, fiscal adjustment, liquidity provision, sudden stop.

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