

Cooperation between European Governments and the IMF: Conditionality Impact on Employment within the EU

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Abstract

Conditional lending by the International Monetary Fund (IMF) is a main anxiety causing issue when national governments turnelsewhere for financial assistance. As it is wellknown, the IMF's austerity measures have had negative effects on some social and economic aspects. At the same time, one of the most important social issues is assumed to be job security, given that the employment rate has a notable influence both on GDP and on local market competitiveness.

Hence, this paper aims to identify the relevant impact of and aspects related to the IMF measures proposed to the EU Member-States and their sway on the employment rate. The cross-country fixed effects panel data estimation approach has been employed to assess the effects of attached conditionality on employment between 2001 and 2012. In addition, the research process investigates the IMF program's sway on youth employment.

The findings are based on about 200 observations and argue that participation in IMF programs has increased economic growth both on total and youth employment; however, budget deficit sway on youth employment was more noticeable in non-program countries. The research results are robust enough and may be useful for both EU governments and the representatives of the IMF, as they highlight the effectiveness of conditional lending specifically on employment in observed states.

Keywords: *European Union, IMF programs, conditionality, employment.*

JEL classification: F33, G28, J20

Introduction

The Global Financial Crisis (GFC) has affected almost all countries of the world, either directly or indirectly. The GFC latter has created many problems, both theoretical and practical. Particularly, before 2008-09 it was considered that monetary policy was a sufficient tool for short-term macroeconomic stabilization. Therefore, fiscal policy played a restricted role in the stabilization process. However, both developed and developing countries have used fiscal stimulus to mitigate the effects of the turmoil, despite numerous studies that have been conducted unveiling the pitfalls of this fiscal policy in a short-term period (IMF,

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2013). At the same time, the GFC has underlined prerequisites for a strong global financial architecture. The IMF has attempted to capture the mentioned role of global regulator and crisis preventer by doubling its size and proposing governance and quota reforms. The latter has been launched to tackle undergoing critique towards its gradually rising conditionality, inefficient policies, low compliance, and serving for interests of major share-holder countries (Bird, 2001; Stiglitz, 2004; Dreher, 2009).

The GFC has penetrated the EU states, damaging economies and contributing to insolvency problems of such developed countries as Spain, Greece, Ireland, and Portugal. Dornean and Sandu (2013, p. 36) note that the GFC propelled EU expenditure growth was mostly caused by budget deficits and high unemployment rates. At the same time, Isărescu (2009, p. 2) highlights that the causes of the crisis need to be searched not only at the macrolevel, but at microlevel as well. Hence, the study of Romanian export orientated Small and Medium Enterprises (SME) unveils that they need financial assistance to overwhelm the negative impact of the GFC (Androniceanu and Drăgulănescu, 2012, p. 368). Being impaired, the governments could not solely withstand the damaging effects of the crisis, and to mitigate the effects of the crisis, many EU states turned to the IMF for financial assistance. Particularly, amid crisis eight European states have claimed IMF support, though Bulgaria and Croatia have both abstained from turning to the IMF; they have been under programs since the 2000s, thus those two countries are presented as well for further analysis.

This was first time since 1990 that the IMF financed developed countries like EU Member-States, which led to unprecedented collaboration between the IMF and the EU (Lütz and Kranke, 2010, p. 5). But there is no consentaneous opinion as to whether the collaboration and IMF measures have improved the situation in the affected countries. Moreover, the measures were considered austere and fueled public protest against the IMF, like in Romania and Greece. Particularly, IMF loans come with conditionality, which is explained as measures to assure stable growth and repayment of the debt (Polak, 1991, p. 3). Yet, after the reforms, the IMF bases only on country ownership, which means that the country itself should propose desired programs and write the letter of intent with mid-term targets. The latter, in case of IMF approval, should be implemented by domestic authorities with the mentioned time span and deadlines. Generally, economic reform programs by the IMF demand reduction in government spending, budget deficit curtailment, a good track of debt service, preserving foreign exchange reserves, etc. However, these programs have side effects. In particular, Heise and Lierse (2011, p. 32) note that reductions in government spending have been achieved by cutting welfare-state spending and by ubiquitous public layoffs. They highlight that Romania cut social benefits by 15%, and Greece reduced unemployment benefits by 22%. Moreover, a recent study conducted by Kentikelenis et al. (2014) highlights that IMF financial assistance to Sierra Leone, Guinea, and Liberia to fight Ebola has contributed to emigration of health personnel and a decrease in employment. The results of this study are based on the

assumption that the IMF's goal to keep government spending low often demands caps on wage-bill, which affects adequate remuneration of healthcare personnel and which entails emigration of mentioned staff (Mckoll, 2008 cited Kentikelenis et al., 2014). Before March 2014, Romanian authorities had been maintaining tight control over public employment with a one for one system, even after substituting one for a 7 replacement rule. In the aftermath of mentioned policy, public employment reduced in the second half of 2013 by 6,500 according to the IMF's first and second reviews of stand-by arrangements (2014, p. 12).

Thus, the total employment rate of EU-28 was 65.7%, while in 2013 it was just 64.1%. Unemployment since 2008 has been gradually increasing from 7.0%, becoming 10.8 in 2013. To this end it must be taken into consideration that IMF programs, apart from payment problems, do seek to improve income distribution. This study investigates the IMF's conditioned lending impact on employment within the EU using a fixed effects panel model. The data is unbalanced and includes the period between 2000 and 2012, where IMF lending has been considered as a dummy variable to estimate whether the Fund's programs affect employment.

1. Literature review

Participation in an IMF program is a joint decision by the two negotiating sides: the IMF board and the government of the potential participant country. Hence, conditionality is based on the outcome of a bargaining process (Conway, 2003, p. 1). Meanwhile, there is a large divergence in the literature about the effectiveness of and compliance to the conditionality. There are even such opinions among observers that the number and scope has increased to such a degree that it is undermining the sovereignty (Santiso, 2004, p. 75). Yet, other researchers note that the Fund has announced ownership as a precondition for sustaining reforms (Drazen and Isard, 2004, p. 2).

First, empirical studies linked to compliance with IMF conditionality were published in the 1980s. Particularly, Haggard (1985, p. 517), who was examining Extended Fund Facility (EFF) during 1974-1984, reports that 16 out of 30 were cancelled. Another study, covering 347 IMF programs examined in the period of 1979-1997, notes that completion rate is 60% (Edwards, 2001 *cited* Dreher, 2009, p. 248). The same 60% rate of compliance finds Lamdany (2009, p. 139) at the same time highlighting that compliance and effectiveness of arrangements are higher in the core area of IMF competency. Recent evidence from Latin America's conditional lending shows that unemployment rates are higher in countries which turned to the Fund for assistance (Brown, 2009, p. 436). Another critique towards the IMF comes from the EU, especially from Lane (2012, p. 58), who claims that the Fund has just copied its standard practices for Greece, Portugal, and Ireland.

Along with criticism of IMF conditionality, one could find a considerable body of literature underlining the need and advantages of conditional lending. To this end, Martin (2006, *cited* Lamdany, 2009, p. 134) stresses the importance of

structural conditionality as a tool for donors, and Drazen (2002, p. 39) claims that it should be considered an instrument while evaluating governments' commitment to sustainable growth.

Many scholars have estimated the sway of IMF structural conditionality on different economic indicators, such as economic growth, poverty, public deficit, inflation, and employment. Both in general and in this particular case the evidence and opinions are quite divergent. Particularly, Przerowski and Vreeland (2000, p. 403), using a dynamic bivariate probit model with partial observability, find that IMF programs lower growth rates for as long as countries remain under a program. Yet, Dreher (2006, p. 781) points out that the literature has not made an attempt to separate empirically the channels of influence of IMF programs on growth. Furthermore, by using pooled time-series cross-section regression he provides evidence that compliance with IMF conditionality does increase growth rates once the sample selection is considered.

Concerning the topic in hand, a more direct and relevant study has been conducted by Vreeland (2002, pp. 134-136). Particularly, Vreeland employing a dynamic version of the Heckman selection model, has explored the effects of IMF programs on labor and finds that the Fund's programs have negative distributional consequences. However, recent crisis has served as a reason for changes in the Fund's lending policy, which assumes that the IMF conditionality regime utilizes policy outside of the neoliberal framework (Christiansen, 2013, p. 11). Hence, to understand which indicators could have influence on the employment rate, we have based on the formula offered by Choudhry *et al.* (2010, pp. 162-164). The authors have explored the correlation between employment, the unemployment rate, and the crises using a cross-country panel estimation approach.

Thus, the next section will discuss the model employed, which contains the main features of the two aforementioned studies and aims to quantify the relationship between IMF programs and employment within the EU.

2. Data, baseline model and some econometric investigations

Most of the first wave of IMF-supported programs in 2008-09 were for emerging Europe countries. The IMF provided front-loaded, flexible, and high levels of financing for many emerging European countries. In most EU countries - including in Hungary, Latvia, and Romania - this financing was provided in conjunction with the EU, while Poland has a Flexible Credit Line arrangement with the Fund. In addition, in 2010-2013 facing insolvency problems, four members of Euro-area - Greece, Ireland, Portugal, and Cyprus - turned to the IMF for assistance (IMF, 2013). In order to have an entire picture of IMF conditionality since 2001, Bulgaria and Croatia have been employed in the analysis as under-program countries because they have applied to the Fund's support in 2004 and 2003 respectively. Hence, the sample countries are EU-28 states, from which only ten countries (EU-10) have turned to the IMF for assistance since 2001. This estimation is done with an unbalanced panel data to fully utilize the available information for the period 2000-2012 which allowed us to make 200 observations.

Therefore, this section has used the cross-country fixed effects panel data estimation approach to assess the relationship between IMF conditional lending and employment rate. The study has based on the following baseline model for estimation, suggested by Choudhry *et al.* (2010):

$$EMP_{it} = C + IMFloan_{it}\beta_1 + Z_{it}\beta_2 + \varepsilon_{it} \quad (1)$$

where, EMP_{it} represents total employment rate (calculated on 15+ age population) in country i at time t and is considered as the dependent variable. While in the alternative model described variable is *youth employment rate* (calculated on 15-24 age population) in order to understand the IMF conditionality effects on the most vulnerable age group amid crises. $IMFloan_{it}$ is representing a key explanatory variable, and, being dummy variable, it takes value 1 if it has received financial assistance from the IMF since 2001 and 0 otherwise. The results show that IMF loans as a dummy variable were not significant, ergo we decided to construct two models: one with the countries under the program, another with countries not participating in the program. Z_{it} is a vector of control variables, and ε_{it} is the error term. Data on explanatory, control variables, and their description can be found in Table 1.

Table 1 Data description and sources

Variable	Description	Source
Employment rate, 15+	Employed labor force/total population above 15	WB WDI
Employment rate, 15-24	Employed labor force/total population between 15-24	WB WDI
IMF loan	Dummy variable; 1 if the country has taken loan from the IMF after 2001, 0 if not	IMF MONA
Real growth	Real growth of GDP in constant prices	IMF WEO
Investment	Ratio of total investment in current local currency and GDP in current local currency	IMF WEO
Inflation	Annual percentages of average consumer prices are year-on-year changes	IMF WEO
Public expenditures	Total expenditure consists of total expense and the net acquisition of nonfinancial assets and is calculated as a ratio with GDP	IMF WEO
Budget deficit	Net lending (+)/ borrowing (-) is calculated as a ratio revenue minus total expenditure and GDP	IMF WEO
Public debt	General government gross debt as a percentage of GDP	IMF WEO
CAB	Current account balance as a ratio of GDP	IMF WEO
Income taxes	General government taxes on income as a percentage of GDP	EUROSTAT
Income and social taxes	General government total receipts from taxes and social contributions as a share of GDP	EUROSTAT

Control variables have been employed by studying previous literature (e.g. Vreeland 2002) and taking into consideration the macroeconomic indicators which are being influenced by IMF conditionality. Hence, among our control variables are real economic growth, inflation rate, total investments, income tax, public debt, and budget deficit. Income tax data is taken from Eurostat, while data on the remaining control variables has been drawn on from the IMF World Economic Outlook October, 2013 database.

For sensitivity analysis and robustness check, and apart from the basic model for estimation, *panel least squares*, we have also employed the generalized linear models (GLM), which has achieved the same output, so the estimations are precise. Table 2 shows the correlation matrix of the chosen variables.

Table 2 Correlation matrix of dependent and independent variables

	EMP	CAB	EG	PD	PE	BD	INF	INV	IT	IST
Employment (EMP)	1									
Current account balance (CAB)	-0.15	1								
Economic growth (EG)	0.07	-0.36	1							
Public debt (PD)	-0.31	0.1	-0.44	1						
Public expenditures (PE)	-0.29	0.08	-0.5	0.75	1					
Budget deficit (BD)	0.07	-0.16	0.49	-0.52	-0.75	1				
Inflation (INF)	0.19	-0.12	0.19	-0.27	-0.34	0.2	1			
Total investment (INV)	0.3	-0.71	0.5	-0.62	-0.49	0.51	0.16	1		
Income taxes (IT)	0.43	0.13	-0.01	0.2	0.21	-0.1	-0.22	-0.09	1	
Income and Social Tax (IST)	-0.23	-0.13	-0.12	0.54	0.67	-0.1	-0.13	-0.15	0.36	1

The low correlations of the dependent and independent variables suggest that multicollinearity could not cause problems in our estimations.

3. Research results and analyses

First of all, we checked whether unit root is present in the model. The Dickey-Fuller unit root test for employment has shown that time-series are non-stationary. In order to eliminate probability of pseudo regression in our model, we have considered *first difference of employment rates* (D-Employment) as a dependent variable. Launching the same test for this new dependent variable, we found out that time-series do not include unit root, hence they are stationary.

Table 3 Impact of IMF conditionality on total employment rate

Dependent variable: First difference of total employment rate			
Variables		Model 1	Model 2
Economic growth	Coefficient	0.215***	0.207***
	SE	0.027	0.030
Public debt	Coefficient	0.017*	0.019**
	SE	0.009	0.009
Budget deficit	Coefficient	0.053*	0.058*
	SE	0.029	0.030
Inflation	Coefficient	-0.116***	-0.125***
	SE	0.037	0.040
Investment	Coefficient	0.127***	0.134***
	SE	0.037	0.039
Income taxes	Coefficient	0.089***	0.088***
	SE	0.031	0.031
Constant	Coefficient	-6.702***	-6.787***
	SE	1.409	1.420
IMF participation (dummy)	Coefficient		-0.185^
	SE		0.302
Number of observations		107	107
Periods included		11	11
R-square		0.685	0.686
Durbin-Watson stat		2.018	2.025

Note: SE-standard errors. * Significant at 10%, ** significant at 5 %, *** significant at 1 %, ^ Significant at 55%

After neutralizing non-significant time series from panel regression (cross-section fixed effect with unbalanced data), the following output for D-Employment has been obtained (See Table 3).

Model 1 describes the relationship between independent variables and D-Employment of EU-10. Meanwhile, Model 2 has inserted IMF participation as a dummy variable. The inclusion of IMF participation does not change the sign and significance of the key explanation, and the results remain quite consistent. In addition, to check the sensibility of the models, they are estimated by employing GLM; the results have passed the sensibility test, which allows us to claim that the model is robust enough to make conclusions. In addition, the Durbin-Watson statistic is 2.02 in two models, which assumes no autocorrelation in error terms. This states that panel least squares gives a precise estimation. Furthermore, *redundant fixed effects tests* show the presence of fixed effects in our model, proving that the test statistics are significant. Hence, fixed effects coefficients (CX=F) for corresponding countries differ and estimation should be considered. Ergo, the regression function is as follows:

$$D(EMP) = 0.207 * EC + 0.019 * PD + 0.058 * BD - 0.125 * INF + \\ + 0.134 * INV + 0.088 * IT - 0.185 * IMFP - 6.786 + [CX = F] \quad (2)$$

Strong positive correlation has been revealed between economic growth and employment, while inflation has a negative effect on employment. The main area of IMF conditionality, budget deficit, correlates with employment positively, which means to implement IMF measures by cutting budget deficit entails a decrease in employment. On the other hand, IMF lending increases gross public debts, which in turn positively correlates with the dependent variable. This assumes that, during the observed period, an increase in public debt leads to rising employment, even if it is not readily noticeable. It is perhaps obvious that the IMF participation (IMFP) dummy variable is not significant, however it can be left in our model due to its nature. The coefficient of IMFP is negative, which concludes that, in general, IMF conditionality has influenced the employment of EU-10 negatively.

Furthermore, the data for EU-28 countries has been collected to estimate separately the EU-10 (under-program countries) main indicators' sway on total employment and on youth employment between 15-24 ages. Respectively not under-program countries' indicators impact on employment during the 2001-2012 is estimated. The estimations are made based on balanced panel data; Croatia has been excluded due to limitations in data availability. Thus, four impact models have been estimated (see Table 4).

Table 4 Impact of main macroeconomic indicators on total and youth employment

Variables		EU-9	EU-18	EU-9	EU-18
		Model 1-D(EMP)	Model 2-D(EMP)	Model 3-D(YEMP)	Model 4-D(YEMP)
Economic growth	Coefficient	0.224***	0.153***	0.267***	0.188***
	SE	0.027	0.017	0.045	0.040
Public debt	Coefficient		0.010***	0.014**	
	SE		0.002	0.006	
Budget deficit	Coefficient		0.125***	0.147***	0.320***
	SE		0.022	0.045	0.061
Inflation	Coefficient	-0.084***	0.077**	-0.078***	0.277***
	SE	0.023	0.032	0.038	0.074
Investment	Coefficient	0.093***		0.102**	
	SE	0.024		0.045	
Income taxes	Coefficient		-0.029**		-0.355**
	SE		0.012		0.142
Income and social contribution tax	Coefficient	0.095***			
	SE	0.030			
Constant	Coefficient	-5.571***	-0.375*	-3.666***	3.436*
	SE	1.173	0.237	1.279	1.844
Number of observations		96	228	96	228
Periods included		12	12	12	12
R-square		0.627	0.493	0.534	0.431
Durbin-Watson stat		1.923	1.935	1.871	2.224

Note: SE-standard errors. * Significant at 10%, ** Significant at 5 %, *** Significant at 1 %

Some indicators have been eliminated due to their significance in order to obtain solid results. Hence, we could make only general conclusions, and it is not advisable to compare the coefficients of the independent variables. Meanwhile, all four models have been tested by additional estimation through GLM, which unveils that the obtained results are precise. Because of the unit root existence revealed by Levin, Lin, and Chu tests, as dependent variables are chosen first differences of total employment and respectively youth employment instead of their real value. Durbin-Watson tests show that coefficients are close to two, which assumes absence of autocorrelation between error terms. All four models have been tested for fixed effects availability, and only Model 4 has fixed effects, which should be taken into consideration while making forecasting.

From Model 1 and Model 3, where dependent variables are first differences of total employment and youth employment (D(EMP) and D(YEMP)) respectively, it could be observed that economic growth impact is stronger in youth employment than in total. The result confirms the findings of Perugini and Signorelli (2010, p. 167), considering youth employment is most vulnerable during a crisis. Furthermore, the results show that Public debt and Budget deficit explanatory variables are not significant for model 1, while in Model 3 their impact on youth employment is positive and recognizable. This argues that the IMF condition to reduce budget deficit has had negative effects on youth employment.

By comparing Models 1 and 2 could be revealed stronger relationship between economic growth and total employment in Model 1. This assumes that economic growth supports an increase in employment in countries under IMF conditionality. Meanwhile, inflation negatively impacts employment in Models 1 and 3, but positively in Models 2 and 4. The latter may have been conditioned with IMF measures to curb the inflation in program-participant countries, which perhaps has caused negative effects on the labor market.

In general terms, the findings argue that participation in IMF programs has increased economic growth influence both on total and youth employment, yet budget deficit sway on youth employment is more noticeable in non-program countries.

Conclusions

On one hand, IMF conditionality is quite a controversial issue, while there is no agreement about its measures and sway on the countries. On the other hand, decreasing employment in the EU results in social dissidence in many EU Member-States. Considering the Fund's intervention and financial assistance provided to many Member-States, the study has attempted to shed a light on the impact of IMF conditionality on employment among EU-states.

Hence, the empirical part of this study investigates the effects of IMF conditionality on the employment rate during the period 2001-2012 in the EU member-states. The model employed for estimation is a cross-country fixed effect panel data, and the method is least squares with ordinary coefficient covariance. To

achieve the goal, the calculations were made in two ways. For the first attempt, the ten EU countries were chosen which from 2001-2013 were under the IMF programs. In this case, IMF participation was input as a dummy variable in the model. The results reveal that *IMF participation had negative influence* on the countries in the observed period. Then, the EU-27 countries were divided into the following two groups: EU-9 program participants and EU-18 non-participants. It is estimated that the same explanatory variable sway on youth employment is the most vulnerable during the crisis. Findings claim that the economic growth relationship for total employment and youth employment is stronger in program-participant countries. Ergo, during the crisis period, it may cause lower employment rates; however, after a crisis, recovery may be faster than in non-program countries. Thus, the IMF conditionality's sway is controversial, as it entails on one hand lower employment during crisis, strengthening the correlation between economic growth and employment, but on the other hand may support fast recovery of employment. The main and general conclusion that can be drawn is that the *IMF conditionality affects employment in both the short and middle term, while strengthening the improvement of employment rates in the long term.*

The nature of the problem and the availability of the data resulted in some constraints during the investigation, which makes the issue more difficult to quantify. In addition, while having only the EViews pack on hand put an additional pressure, as there are no sophisticated tests to check the robustness of our model. Yet, to obtain robust results we have estimated the model by GLM as well, which shows the same output. The stationary and autocorrelation have been eliminated to produce more precise output. Nevertheless, through some restraints we find that our findings are strong enough to be considered seriously, and at the same time they support further investigation in this area.

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