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An Analysis of IMF Conditionality

Ariel Buira

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PREFACE

The *G-24 Discussion Paper Series* is a collection of research papers prepared under the UNCTAD Project of Technical Support to the Intergovernmental Group of Twenty-Four on International Monetary Affairs (G-24). The G-24 was established in 1971 with a view to increasing the analytical capacity and the negotiating strength of the developing countries in discussions and negotiations in the international financial institutions. The G-24 is the only formal developing-country grouping within the IMF and the World Bank. Its meetings are open to all developing countries.

The G-24 Project, which is administered by UNCTAD's Macroeconomic and Development Policies Branch, aims at enhancing the understanding of policy makers in developing countries of the complex issues in the international monetary and financial system, and at raising awareness outside developing countries of the need to introduce a development dimension into the discussion of international financial and institutional reform.

The research carried out under the project is coordinated by Professor Dani Rodrik, John F. Kennedy School of Government, Harvard University. The research papers are discussed among experts and policy makers at the meetings of the G-24 Technical Group, and provide inputs to the meetings of the G-24 Ministers and Deputies in their preparations for negotiations and discussions in the framework of the IMF's International Monetary and Financial Committee (formerly Interim Committee) and the Joint IMF/IBRD Development Committee, as well as in other forums. Previously, the research papers for the G-24 were published by UNCTAD in the collection *International Monetary and Financial Issues for the 1990s.* Between 1992 and 1999 more than 80 papers were published in 11 volumes of this collection, covering a wide range of monetary and financial issues of major interest to developing countries. Since the beginning of 2000 the studies are published jointly by UNCTAD and the Center for International Development at Harvard University in the *G-24 Discussion Paper Series.*

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AN ANALYSIS OF IMF CONDITIONALITY

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Abstract

IMF conditionality was introduced in the 1950s as a means to restore members' balance-of-payments viability, to ensure that Fund resources would not be wasted and to ensure that the institution would be able to recover the loans it extended to member countries. For several decades, until the early eighties, Fund Conditionality centred on the monetary, fiscal and exchange policies of members. Over the last 20 years, while the resources of the Fund declined as a proportion of world trade, the number of Fund programmes increased steadily, and conditionality underwent substantial changes, expanding the scope of conditionality into fields that previously had been largely outside its purview. As the number of conditions increased, the rate of member country's compliance with Fund supported programmes declined, and reviewing and streamlining conditionality became inevitable.

Experience and the Fund's own studies show that programme success is closely related to ownership, and that ownership cannot be externally imposed. It must result from internal analysis and discussion, leading to the conviction by domestic actors that compliance with the programme is conducive to the attainment of their own objectives. Conditionality can neither substitute nor offset a lack of ownership.

This paper reviews the origins and purpose of conditionality, as well as its nature and evolution over time. It looks into the reasons for increased conditionality during the 1980s and 1990s and reviews the recent IMF debate on conditionality and on the proposed changes in Fund practices. It distinguishes between short-term imbalances that result from excess demand and structural disequilibria and the new type of financial crises associated with short-term capital movements, asking whether different problems call for different conditionality. The paper also discusses how the economic and social costs of adjustment may be minimized and whether Fund resources are sufficient to enable it to comply with its mandate.

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AN ANALYSIS OF IMF CONDITIONALITY

Ariel Buira

Institutions are not ... created to be socially efficient; rather they, or at least the formal rules, are created to serve the interests of those with the bargaining power to create new rules.
(Douglas C. North, Nobel Lecture, 1993)

I. Introduction

Conditionality is perhaps the most controversial aspect of IMF policies. Among the traditional criticisms of Fund conditionality are that it is too short-run oriented, too focused on demand management and does not pay adequate attention to its impact on growth and the effects of programmes on social spending and on income distribution. In particular, fiscal and monetary policies – the core of programmes – are seen as too restrictive and have a strong deflationary impact to the point where the essence of the correction of the external payments imbalance came from sheer deflation.

More recently, following the sharp rise in conditionality that had been observed in the 1990s, criticisms of Fund conditionality have also tended to centre on its loss of focus, on imposing an excessive number of structural conditions, trying to do too many things at the same time, and on expanding Fund influence beyond its area of competence. The Meltzer Report (2000) states "detailed conditionality (often including dozens of conditions) has burdened IMF programmes in recent years and made such programmes unwieldy, highly conflictive, time consuming to negotiate, and often ineffectual."

Similarly, the Council on Foreign Relations Task Force Report (1999) finds that "Both the Fund and the Bank have tried to do too much in recent years, and they have lost sight of their respective strengths. Both need to return to basics … (The Fund) should focus on a leaner agenda of monetary, fiscal and exchange rate policies, and on banking and financial sector surveillance and reform."

Feldstein (1998) considers that "The Fund should resist the temptation to use currency crises as an opportunity to force fundamental structural reforms on countries, however useful they may be in the long term unless they are absolutely necessary to revive access to international funds" adding that "The fundamental issue is the appropriate role for an international agency and its technical staff in dealing with sovereign countries that come to it for assistance. It is important to remember that the IMF cannot initiate programmes but develops a programme for a member country only when that country seeks help. The country is then the IMF's client or patient, but not its ward. The legitimate political institutions of the country should determine the nation's economic structure and the nature of its institutions. A nation's desperate need for short-term financial help does not give the IMF the moral right to substitute its technical judgments for the outcome of the nation's political process."

II. Some unresolved questions on conditionality

Apart from the numerous economic policy issues to which conditionality gives rise (to be discussed below), there are political and philosophical questions that have yet to be fully and openly addressed by the Fund and other international financial institutions (IFIs). Some such questions are:

1) Can programme ownership by a country be made compatible with externally imposed conditionality? Can externally imposed policies or values become internalized in recipient countries?

2) Is conditionality compatible with democracy?

3) To what extent is IFI conditionality power without responsibility?

4) Should economic policy decisions that affect all be taken outside the domestic political process?

5) Are the transparency and accountability of governments, which the IFIs consider essential to good governance, compatible with conditionality?

6) When conditionality is coercive, can governments be held domestically accountable and responsible for the effects of policies imposed from outside? Are governments accountable to, their electorate, or to some external institutions wherein they are under-represented? (Buira, 2002)

7) Since the political viability of an adjustment programme is related to the depth of a crisis, to the actions of the government and to the amount and timeliness of external support, when can inadequate financial support by the international community be considered responsible for its failure?

8) Governments and IFIs are prepared to intervene in the affairs of third counties, but are they prepared to take political responsibility for the policies or measures they sponsor?

9) Since the majority of programmes are not completed successfully what, if any, are the consequences for the staff and for the Fund of imposing programmes that fail more often than not? (See 3 above.)

10) Should liberalization of the markets take place before liberalization of the state?

III. The origins of conditionality

When the IMF was established as an institution for monetary cooperation there was no reference to conditionality. Indeed, the concept of conditionality is not written in the Fund's original Articles of Agreement. This concept was introduced only several years later in an Executive Board decision in 1952, and much later incorporated in the Articles as part of the First Amendment.

Writing in January 1944, before the Bretton Woods Conference, Lord Keynes described the views of the United States government on the future character of the IMF as follows: "In their eyes it should have wide discretionary powers and should exercise something of the same grandmotherly influence and control over the central banks of member countries, that these central banks in turn are accustomed to exercise over the other banks within their own countries". The United States delegation was well aware that as the countries of Europe embarked on their postwar reconstruction, the United States would be the only substantial net creditor to the Fund for some time to come. On the other hand, the United Kingdom negotiators were under explicit instructions from Churchill's War Cabinet that a deficit country should not be required to introduce "a deflationary policy, enforced by dear money and similar measures, having the effect of causing unemployment; for this would amount to restoring, subject to insufficient safeguards, the evils of the old automatic gold standard" (Moggridge, 1980: 143). Lord Keynes believed that as a result of the Anglo-American discussions on this and related matters, "the American representatives were persuaded of the unacceptability of such a scheme of things, of the undesirability of giving so much authority to an untried institution, and of the importance of giving the member countries as much certainty as possible about what they had to expect from the new institution and about the amount of facilities which would be at their disposal" (Moggridge, 1980: 404–405). He further believed that he had gained agreement for the view that the Fund should "be entirely passive in all normal circumstances, the right of initiative being reserved to the central banks of the member countries."

As explained in Annex 1, the link between a member's policies and the access to Fund resources (which had been rejected at the time of the establishment of the Fund) was adopted by an Executive Board decision in 1952. In 1969, during the time of the First Amendment, these links were incorporated in Article I Section (v) and Article V Section 3(a) of the Articles of Agreement. The amendments by which conditionality was introduced into the Articles began with the reference to the "temporary" use in Article I. Thus the fifth purpose of the Fund was amended to read:

"To give confidence to members by making the Fund's resource *temporarily* available to them under adequate safeguards, thus providing them with opportunity to correct maladjustments in their balance of payments without resorting to measures destructive of national or international prosperity."

The last sentence of Article I was changed to read:

"The Fund shall be guided in all its *policies and* decisions by the purposes of this Article."

The italicized words are additions that were introduced in the First amendment. These conceptual additions were reflected and given operational content by the two subsections added to Article V Section 3, entitled "Conditions governing use of Fund resources":

"(c) A member's use of the resources of the Fund shall be in accordance with the purposes of the Fund. The Fund shall adopt policies on the use of its resources that will assist members to solve their balance of payments problems in a manner consistent with the purposes of the Fund and that will establish adequate safeguards for the temporary use of its resources."

"(d) A representation by a member under (a) above shall be examined by the Fund to determine whether the proposed purchase would be consistent with the provisions of this Agreement and with the policies adopted under them, with the exception that proposed gold tranche purchases shall not be subject to challenge."

The new subsections state that the Fund must have policies based on the principle of conditionality and that all representations made by members in connection with requests to use Fund resources beyond the reserve (gold) tranche must be consistent with those policies.

IV. The nature and purposes of conditionality

Conditionality may be defined as a means by which one offers support and attempts to influence the policies of another in order to secure compliance with a programme of measures. It is a tool by which a country is made to adopt specific policies or to undertake certain reforms that it would not otherwise have undertaken, in exchange for support. Within the context of the IMF, conditionality refers to policies a member must adopt to secure access to Fund resources. These policies are intended to help the member country overcome its external payments problem and thus be in a position to repay the Fund in a timely manner, thereby ultimately assuring the "revolving character" of Fund resources. (Fund resources that are made available to a member are repaid over a stipulated period of time which is normally within three to five years.) The assurance is to be derived from the adoption by the member of certain corrective measures or policies which, in the judgment of the Fund, will allow it to restore the balance-of-payments position and to repay the Fund, thereby ensuring that the same resources will be available to support other members in future. Under Article V Section 3(c) of the Agreement, the Fund must examine the member's representation to determine that the requested repurchase would be consistent with the Articles of Agreement and the policies on the use of Fund resources.

The Articles also provide that requests for reserve tranche purchases, i.e. drawings that will raise Fund holdings of a member's currency up to 100 per cent of quota, may be considered as automatic and will not be subject to challenge. Additionally, the Fund's attitude to those drawings that raise currency holdings up to 125 per cent of quota – the first credit tranche – is generally a liberal one, provided that the member is making a reasonable effort to solve its problems. Since 1955, the conditionality applied on the use of Fund resources increases when drawings go beyond the first credit tranche, i.e. when Fund's holdings of a members currency rise beyond 125 per cent of the member's quota. These are referred to as drawings in the upper credit tranches and require substantial justification.

At the heart of conditionality lies a process of negotiation. The Fund will seek to use its superior financial position, its financial strength to offer support in exchange for a government commitment to effect particular changes in the member country's policies. Thus, the larger the country, the stronger its financial position, the more numerous the financing alternatives are made available to it; the better the quality of its economic team, the less likely it will have to accept conditions it does not agree to. Other things being equal, the greater the asymmetry in power between the country and the Fund – the greater the country's need – the more likely it is that conditionality will lead to an imposition of policies.

Is conditionality intrusive? When a country freely approaches the Fund for support, the relation would appear to be a voluntary one, similar to that prevailing in any contract among equals. However, governments are not normally monolithic. There are often differences of view and tensions to be found within them, particularly between the "spending ministries" charged with the development of the countries productive potential, i.e. the public works, transportation, health, education, industry and defense on the one hand and on the other the financial authorities charged with the macroeconomic and financial management of the economy, in particular the ministry of finance and the central bank. Note that the differences between the finance minister and others may not be merely technical, or solely related to economic policy matters. They may also reflect different political interests and views. The intervention of outside forces such as the IFIs, which offer financial incentives in exchange for the adoption of certain policies, may tip the balance in favour of the "financial" view. This argument suggests that, although a country may not have to enter into a dialogue with the Fund; when it does, in so far as external elements seek to influence the outcome of the domestic policy discussion, conditionality is intrusive.

Considering that governments often harbour policy differences within, the support of the Fund for its natural allies holding the "financial" view raises the issue of programme ownership; i.e., who owns the programme? Is it owned by the government as a whole or simply by the finance ministry? Does the Fund seek to further its own views by supporting its allies? In the latter case is the programme seen by the rest of the government as an external imposition? Could the finance ministry include certain issues in the Letter of Intent to the Fund to gain political leverage domestically and to favour some political interests over others?

Is conditionality coercive? The answer would appear to depend on the circumstances prevailing in each case. For instance, a country with good access to international financial markets, and generally good macroeconomic fundamentals (e.g. China, Mexico or the Republic of Korea) will be in a strong negotiating position vis-à-vis the Fund. It will thus not be compelled to accept unpalatable conditions in exchange for financial support. On the other hand, if the same country is in the midst of a deep financial crisis, with a low level of international reserves and no access to external credit from other sources, it may be compelled to accept conditions that in better circumstances it would have considered politically unacceptable. Too often, however, countries refuse to turn to the Fund unless compelled by circumstances to do so. Within broad limits, conditionality is a relation of power. On this relation, Paul Volcker has stated: "When the Fund consults with a poor and weak country, the country gets in line. When it consults with a big and strong country, the Fund gets in line" (Volcker and Toyoo Gyoten, 1992).

Thus, the answer to whether conditionality may be considered coercive appears to depend on the asymmetry of power between the member and the Fund, and is largely determined by the country's need and its access to alternative sources of finance (Collingwood, 2001). The answer is found by asking questions like: What choices does the country have? What are the real options available to the country at the time? Often a country facing a balance-of-payments crisis will not be able to obtain any external financial support from markets or other IFIs unless it first reaches an agreement with the Fund. This was the situation in Argentina during the period February to September 2002. It is coercive if the cost of not accepting the conditionality is so much higher. A country has no choice but to accept conditions and is obliged to do things it would not otherwise do, and particularly because it prefers strongly to avoid the costs of default.

At best, conditionality is a form of paternalism, by which a country is guided towards its own good, rather like a parent or a teacher guides a child in its own best interests. This may often be the case in programmes associated with the HIPC initiative where certain states lack the technical knowledge and/or the financial resources to pursue good policies, and where the IFIs have both the expertise and resources to assist the country.

The Fund has no particular expertise on poverty reduction or developmental strategy – issues that are within the Bank's primary purview. However, perhaps to show it has a social conscience, the Fund has been unwilling to remove itself from these issues. The Fund should probably withdraw from them and keep itself within its original simplified mandate by giving advice and technical assistance within in its areas of competence.

At worst, conditionality implies the imposition on a country of a mixture of policy agenda that contain elements that are unnecessary to overcoming the payments crisis. These elements may have been suggested by a third party and may not be in the country's best interest. At best, a well focused, limited and technically sound conditionality may make a valuable contribution to the restoration of the country's external viability, particularly when the economic programme is "owned" by it. However, there are a number of related political issues that merit careful consideration.

V. Does conditionality safeguard Fund resources?

We have seen that conditionality was introduced and is justified as a means to ensure the "revolving character" of Fund resources. Conditionality also means a lack of trust in the country's own judgment by those who "know best". Consequently, the use of the resources provided by external sources such as the IFIs must be monitored to ensure these are not wasted. On the one hand it would seem that the purpose of conditionality is to tie the hands of governments of recipient countries, particularly countries in political transition, as was the case of Brazil and Turkey which have undergone strict conditions and careful supervision to ensure that the resources received are used as intended so that they will be repaid on schedule. On the other, some proponents of conditionality argue that the mere fact that the country is in balance-of-payments difficulty shows its inability to manage its own affairs without getting into more difficulties.

Further, when one considers the experience of other creditors – i.e. commercial banks, bond holders and project lending by development finance institutions that do not normally require the adoption of an adjustment programme by debtor countries – one may well wonder whether conditionality is in fact required to protect the "revolving character of the Fund's resources" or whether it is the debtor countries' own desire to protect their creditworthiness that secures repayment to the Fund. After all, conditionality ends when the programme it underpins ends, while repayments fall due at a later date, over an extended period of 3 to 5 years after the date of disbursements in the case of stand-by arrangements and of 4 to 7 years in the case of EFF loans.

Fund resources should be preserved for the benefit of all member countries. However, the emphasis placed on "preserving the revolving character of Fund resources" can be carried too far and give rise to a conservative bias in their administration – one that gives priority to the goal of achieving a prompt external adjustment to permit a prompt recovery of the resources lent by the Fund – over the objectives of the Fund as written out in its Articles of Agreement. It must be recalled that these include the "promotion and maintenance of high levels of employment and real income and to the development of the productive resources of all members as primary objectives of economic policy" (Article I section (ii)). Although the Articles do not provide any indication as to the speed and nature of the adjustment to be followed, by this and the additional statement of "providing (members) with opportunity to correct maladjustments in their balance of payments without resorting to measures destructive of national and international prosperity", Article I section (v) clearly suggest that the priority of the founding fathers is the protection of the levels of economic activity and, consequently, that deflationary adjustment is to be avoided to the greatest extent possible.

Nevertheless, countries that are recipient of Fund programmes often perceive them as unduly restrictive. In their view, the "preservation of the revolving character" seems to take first priority. This is compounded by the limited Fund financing in support of the adjustment programme and the optimistic nature of the assumptions frequently made by the Fund staff regarding the availability of external financing. However, constructing the programme around an unduly optimistic assumption on the amount of external financing available to the country, and the limited amount of financing to be made available by the Fund may undermine the viability of the programme and may prove contrary to its purpose, which refer explicitly to the maintenance of high levels of employment and to providing members with the opportunity to correct maladjustments in their balance of payments without resorting to deflationary adjustment.

One may wonder whether this apparent "creditor bias" in programme design gives rise to the restrictive, short-term nature of the Fund-supported programmes that are so frequently criticized by developing country members. Could it also lead to the repeated use of resources by some members that could not successfully complete the required adjustment during the life of the programme?

The availability of resources is a major determinant of the nature and speed of the adjustment process undertaken by a country. A country with access to unlimited financing would not have to adjust, and if it were to do so, would be able to postpone adjustment for years. The United States, as a reserve currency country, has this advantage as long as holding dollars as reserve assets remains attractive. Moreover it may choose, among the different adjustment paths available, that which is more palatable and less costly in economic and political terms. However, a country undertaking adjustment with low reserves and very limited financing available to it, may of necessity, be compelled to adopt very severe, short-term programmes. These measures conflict with the goal of maintaining high levels of activity and compel the country to sacrifice some of its longer-term development goals by resorting to a "trade-off" between adjustment and financing of imbalances. The Fund's role would be to seek a "golden rule" – a mix of measures and financing that fosters the necessary adjustment – while avoiding the severe recessionary and destructive aspects of under-financed programmes (in some cases, the Fund resources may be constrained by unpaid borrowing). Since well-financed programmes would be much more attractive than more severe ones, they would encourage the early correction of imbalances.

Since the harshness of a programme and, consequently, its viability largely depend on the amount of financing available, the reduction in the resources of the Fund introduces a bias for the adoption of increased conditionality and for more severe, shorter-term adjustments. The rate of success under such terms is bound to diminish. The decline observed in total Fund resources over time, when measured as a proportion of international trade or of GDP, would appear to have required, and has been associated with, stiffer and more demanding conditionality.

Moreover, as countries become more open to trade and capital movements, they also become more vulnerable. Most member countries, including emerging market economies, when faced with difficulties do not have significant access to other sources of external finance. Additionally, the new type of financial crisis, associated with the capital account and the volatility of capital flows, calls for much larger amounts of support than the more traditional one resulting from trade or current account imbalances.

Table 1

THE SIZE OF THE FUND AS A PROPORTION OF INTERNATIONAL TRADE AND GDP, 1944–1998

	1944	*1965*	*1970*	*1990*	*1998*
Ratio of quotas/imports	0.58	0.57	0.15	0.14	0.06
Ratio of quotas/GDP	0.04	0.02	0.02	0.01	0.01

Source: Calculations based on IFS data.

Could the decline in Fund resources be related to the observed hardening of conditionality? More pointedly, can an undue hardening of conditionality be avoided, in view of the relative decline in Fund resources? The decline in Fund resources suggests that these were probably insufficient to allow for the provision of adequate support to member countries, without the conditionality under which it makes its resources available. This leads to the question of: Should adjustment programmes be constructed around access to Fund resources? Should conditionality be determined by the availability of resources when these have diminished sharply over time? Or, in keeping with its purposes and nature as an institution for international cooperation, should Fund resources be increased in line with needs, in view of the expansion of international trade and the volatility of capital movements? If the answer to this last question is yes: Why have quota increases not kept pace with these trends? The majority of Fund member countries usually favour quota increases, which, nevertheless, would require an 85 per cent majority under the weighted voting system. What countries limit the increase in Fund resources? Is the growing schism between creditors and prospective debtors relevant for the analysis of trends in the size of the Fund and the evolution of conditionality?

Since the late-1970s no industrial country has resorted to Fund support because they find unacceptable its conditionality. The last such occasion was when Italy and the United Kingdom requested Fund assistance under the (lower conditionality) Oil Facility. Indeed, these countries have developed a network of swaps, monetary cooperation arrangements and other sources of balance-of-payments support. As a result, only developing countries and economies in transition have resorted to Fund support in the last 24 years. This is not to ignore that in a number of cases large, systemically or strategically important countries (among others Brazil, Mexico, Russia, the Republic of Korea and Turkey) have received financial support far in excess of their quota access under Fund policies. But such exceptional support is neither transparent nor predictable, since it is not available to all Fund members, and at times comes with conditions imposed by countries that contribute to the financial rescue package (Feldstein, 1998).

Occasionally, references are made to the "catalytic role of the Fund", as justification for its limited financing to members. This is a strange argument for the Fund to put forward because there is no reference to a "catalytic role" in the Fund's Articles. Nevertheless, the argument that a member's access to the Fund's resources in the upper credit tranches is regarded by potential creditors, and others, as an endorsement of the country's policies and is sufficient to induce additional private capital flows could be acceptable if, in fact, it assured that financing from the markets were forthcoming. Unfortunately, this is not the case. While the Fund did play a role in inducing capital flows to Latin America in the debt crisis of the 1980s, empirical studies of the catalytic effect conclude that there is little evidence to support its existence in the 1990s (Bird and Rowlands, 1997).

Unfortunately, as is often the case when the conclusion of negotiations of a Fund programme does not bring forth market financing in sufficient amounts, the programme may be under-financed to allow an adjustment that is not sharply contractionary. Indeed, as pointed out by Bird and Rowlands, "Structural adjustment is unlikely to succeed if starved of finance. The Fund appears to have assumed, perhaps on the basis of partial and, in the event, unrepresentative evidence, that finance would come from elsewhere, catalyzed by its own involvement. In practice the catalytic effect was largely unforthcoming and IMF programmes showed an increasing tendency to break down. Significantly, the likelihood of breakdown appears to vary inversely with the amount of finance provided by the Fund" (op. cit.: 984), adding that "The premise of a universally positive catalytic effect will lead to inappropriate conditionality and will have adverse consequences for its effectiveness" (op. cit.: 988). However, it must be admitted that often other IFIs condition their financial support to countries which have an agreement with the Fund. This practice gives rise to what is referred to as "cross conditionality" and greatly strengthens the Fund's negotiating position; it is not the usual meaning of the "catalytic effect".

At times, some observers, particularly those in creditor countries take the view that the hardships of adjustment that result from poor policies are in some sense deserved. The Articles do not make a play with morality by which those who err fall from grace and are punished. As an institution for monetary cooperation, the role of the Fund is to assist countries overcome payments difficulties "without resorting to measures destructive of national and international prosperity". In any event, questions could be raised regarding the morality of punishing the population of a whole nation, particularly the poor and the unemployed who invariably bear the brunt of adjustment, for the failings of a government or for exogenous factors such as downturns in terms of trade, for international recessions, changes in the markets appetite for developing country assets and contagion.

The argument that conditionality is essential to secure repayment and thus "preserve the revolving character of Fund resources" is further weakened by the high failure rate of Fund programmes. As shown in table 2, less than half of the Fund-supported programmes are successful in the sense of full implementation of the programme. Indeed a recent Fund study by Mussa and Savastano found that if one considers the disbursement of 75 per cent or more of the total loan as the test to measure of compliance with Fund policy conditionality, less than half (45.5 per cent) of all Fund-supported programmes over the period 1973–97 would meet the test (Mussa and Savastano, 2000). Further, with the increase in structural conditionality observed in the 1990s, the rate of compliance declined markedly after 1988 and more so in 1993–97 when only 27.6 per cent of 141 arrangements could be considered in compliance.

When the rate of compliance of programmes falls below half, and all the more when it falls to less than a third, it can be argued that the whole rationale and relevance of conditionality have become questionable. Despite the very low rates of programme success or compliance, members have continued to repay the Fund loans. This should be taken as evidence that the traditional argument underpinning conditionality is of dubious validity (table 2).

If conditionality as currently practised is not effective in "preserving the revolving character of the Fund's resources", should it revised? Since conditionality gives rise to many problems and has a number of negative features, the answer is yes. In terms of preserving the Fund's resources, it is worth considering whether the outcome would be any different from that of today if the Fund's attitude to requests to use its resources were more liberal, i.e. one similar to that currently prevailing for drawings under the *first credit tranche* where all that is required for access to it is for the member to "make reasonable efforts to solve its problems" (IMF, 1963). First credit tranche programmes are characterized by low conditionality. They are essentially developed by the member country and are thus owned by it. These characteristics are what contribute to the authorities' commitment to the programme. Since the amount involved is a small, phasing and performance clauses are not required in stand-by arrangements that do not go beyond the first credit tranche. Nevertheless, for more significant access to Fund resources it would be helpful to members to have some indicative objectives or targets to guide them in the application of their programme.

The 1979 Guidelines on Conditionality underscored the need to limit performance criteria to the minimum required to assure policy implementation. The current Managing Director of the

Table 2

THE DECLINING RATES OF COMPLIANCE WITH FUND PROGRAMMES

(Percentage of IMF loan actually disbursed under each arrangement. Distribution by quartiles)

	(1)	*(2)*	*(3)*	*(4)*	*(5)*	*(6)*	*(7)*
All arrangements	*x<0.25*	*0.25=<x<0.5*	*0.50=<x<0.7*	*0.75=‹‹1.0*	*Fully disbursed (x=1.0)*	*(4)+(5) 0.75=<x*	*Number of arrangements*
1973–1977	36.5	7.1	5.9	5.9	44.7	50.6	85
1978–1982	19.4	16.1	10.5	12.9	41.1	54.0	124
1983–1987	12.9	15.8	19.4	7.9	43.9	51.8	139
1988–1992	17.5	15.1	20.6	14.3	32.5	46.8	126
1993–1997	27.0	19.1	26.2	11.3	16.3	27.6	141
Full period (1973–1997)	21.6	15.3	17.6	10.7	34.8	45.5	615
of which:							
Stand-By	23.1	13.4	15.0	9.5	39.0	48.5	441
EFF	33.3	22.2	19.0	15.9	9.5	25.4	63
SAF/ESAF	9.0	18.9	27.0	12.6	32.4	45.0	111

Source: IMF, *Transactions of the Fund, 1998.*

Fund has clearly seen the wisdom of these principles and the need to review and streamline conditionality, particularly structural conditionality. In light of the sharp fall in programme compliance (table 2), his decision must be seen as very timely and should be supported by member countries because the Managing Director will undoubtedly meet resistance and will need to overcome the entrenched habits of a number of staff members.

VI. The new guidelines on conditionality

The Executive Board had approved the new guidelines on conditionality on 20 September 2002. These are a very commendable guidelines aimed at improving the effectiveness of conditionality, essentially by recognizing the central importance of:

1) national ***ownership*** of programmes, implying the need for involvement of the member in the formulation of the programme and the authorities assumption of responsibility for its implementation;

2) ***parsimony*** in the application of conditions, i.e. reducing the number of conditions and focusing on those measures that are considered to be essential to overcoming the problem and critical to the success of the programme;

3) ***tailoring*** the programme to the member's circumstances, i.e, recognizing and addressing the factors behind the balance-of-payments problem, while allowing the policy adjustments and the mix of adjustment and financing to reflect the member's preferences and circumstances;

4) ***clarity*** as to what essential aspects of the programme must be complied with, and what additional measures are contemplated whose non-observance will not constitute a breach of the agreement and impair the country's ability to draw Fund resources.

In substance, however, the new Guidelines are not very different from the previous ones that had been in force since 1979. In fact, although the word "ownership" was not in use then, Guideline 4 stipulated that: "In *helping members to devise adjustment programmes*, the Fund will pay due regard to the domestic, social and political objectives, the economic priorities and the circumstances of members, including *the causes of their balance-of-payments problems*."

As regards the number and content of conditions, Guideline 9 stated "Performance criteria will be *limited to those that are necessary* to evaluate implementation of the programme with a view to ensuring the achievement of its objectives. Performance criteria will normally be confined to (i) *macroeconomic variables* and (ii) those necessary to implement specific provisions of the Articles or policies adopted under them. Performance criteria may relate to *other variables only in exceptional cases* when they are essential for the effectiveness of the member's programme because of their macroeconomic impact".

Why were they revised? In practice, the guidelines had been ignored by the Fund staff in response to external pressures and to the views of some high Fund officials. These officials believed that when a country came to the Fund for balance-of-payments assistance, they should avail themselves of the opportunity to push for reforms in a wide range of matters, many of them structural, presumably because these reforms would be of benefit to the country. The approval of the new guidelines constituted an attempt to re-focus conditionality by establishing a presumption that every condition included has to be justified. It is an implicit recognition that the previous approach had resulted in over-burdening programmes with conditions which led to a high rate of programme failures. Thus, to the extent that conditionality had become dysfunctional, it had to be revised.

By proposing the new guidelines, Management expresses a renewed concern with promoting programme ownership as a key to success and seeks to give a new orientation to programme design. The new approach would establish the presumption of parsimony and restrict the number of conditions or performance criteria contained in a programme to those considered critical for its success. The new guidelines reflect an attempt on the part of Management to reform the Fund's operating procedures. It is an attempt to foster a new attitude among the staff with a view to attaining a higher rate of programme success. The intention "is to change the mindset with which the staff, management and Board consider whether certain structural measures should be covered under conditionality, shifting from a presumption of comprehensiveness to a presumption of parsimony, and thus putting the burden of proof in each case on those that would argue for the inclusion of additional measures under conditionality." (IMF, 2001a)

As stated in the new guidelines, Fund supported programmes should be directed primarily toward the following macroeconomic goals:

(a) solving the member's balance-of-payments problems without recourse to measures destructive of national or international prosperity; and

(b) achieving medium term external viability while maintaining sustainable economic growth.

The "new" approach to conditionality is a very welcome one. It seeks to address many of the weaknesses and shortcomings of previous practice that gave rise to failures and complaints. To be successfully implemented, the new approach will have to overcome considerable inertia within the staff. Operating procedures form part of deeply entrenched habits and it would be difficult to change one part of a self-sustaining system without modifying its other components. It may take a year or two before being certain that inertia has been overcome and the approach of the new guidelines fully adopted. After all, since in the past the guidelines on conditionality were disregarded, the proof of the pudding is in the eating.

Take for instance stand-by arrangement with Turkey of January 2002. The two-year programme contains 5 performance criteria for 2002 and indicative targets for 2003. It had no less than 37 structural conditions: in the areas of fiscal policy (2), public debt management (1), banking reform (10), public sector reform (16) and on enhancing the role of the private sector (6). Conditions included 18 prior actions, some of which were required for stand-by approval and others for the completion of subsequent reviews. Such wide-ranging conditionality gives the impression of a lack of clarity as to what is really critical to the success of the programme. Moreover, if all these conditions are not met, will the Fund suspend financial support? A programme with 42 conditions (5 performance criteria and 37 structural conditions) cannot give the impression of parsimony and of addressing the macroeconomic critical issues, but rather of a wide-ranging micromanagement and lack of focus.

Is the Fund again resorting to micromanaging the economy? Are several of the imposed conditions simply a mapping out of detailed steps to reach a policy outcome? This raises the question whether the practice of conditionality is keeping up with the agreed new policies. Are all the above conditions really essential to correct Turkey's payments imbalance? If not, are the same problems of lack of compliance with the guidelines observed in the past to be expected? It would seem as though when faced with difficulties in the implementation of a programme, the Fund sought to gain credibility by resorting to the introduction of additional conditions.

There is, moreover, an additional structural problem that the Fund has not yet addressed. This relates to the mix between adjustment and financing.

As the size of Fund resources has declined and on average, quotas have fallen to below 1 per cent of GDP, and to the equivalent of 3.7 per cent of current payments, the question arises whether the financial support by the Fund to its members under access policies will suffice to meet the items a) and b) of the new guidelines mentioned above. In particular, can the Fund provide sufficient resources to sustain a mix of adjustment and financing which would allow members to undertake an adjustment process that is non-deflationary, i.e. non-destructive of national and international prosperity? Given the small size of quotas, the answer to this question will most likely be negative.

A particular difficulty arises in the case of those countries with open capital accounts. Because of capital volatility, a loss of confidence may give rise to large, sudden capital outflows, irrespective of whether this being a result of domestic policy errors or of exogenous developments. While access limits appear to have been abandoned on an "ad hoc" basis in dealing with capital-account crises in those countries of systemic importance, this practice is discretionary and discriminatory since it does not apply equally to smaller countries, nor does it help them resolve the more traditional type of payments imbalances. Moreover, it is not transparent as it does not allow members to know beforehand the amount they might receive from the Fund.

The problem of the limited size of the Fund is aggravated by the fact that quota formulas generally underestimate the size of developing economies; hence the distribution of quota shares short-changes developing countries. Consequently, their share of a small Fund is made even smaller than it would be if quotas were a fair reflection of the size of their economies.

As the 1979 Guidelines on Conditionality stated, conditionality is to be non-discriminatory. An equal treatment is to be given to all member countries. However, since conditionality is ultimately the result of a negotiation, there is little question that the larger, systemically important countries with access to financial markets and are represented by strong economic teams generally have a more favourable negotiating position and can get a better deal than small, low-income countries. Indeed, the financial situation of the country at the time of the negotiation is a major influence on the outcome of the negotiation.

Moreover, the strategic, economic and political importance of a particular country, which translates into the political support of the major powers, can and does influence the negotiating position of a country vis-à-vis the Fund. (Do geopolitical considerations have a bearing in the negotiating position of Argentina and Turkey?) Of course, very large, or strategically and politically very important countries like Brazil, China, Egypt, India, Mexico, and Russia are always a special case (Killick et al., 1998).

IMF staff members have had to learn that some countries are more equal than others. But few have taken their objection to political pressures to the point of resignation as did D. Finch, the former Director of the Exchange and Trade Relations Department who resigned when pressed to reduce conditionality for political reasons (Financial Times, 1987).

Are the conditions and policies required to obtain the financial support of the Fund always essential to the resolution of a country's payments problem and in the country's best interest or can they be influenced by the political and/or commercial interest of others? At the time of the its financial crisis, the Republic of Korea was required to open up certain services, i.e. the bank and insurance services, to foreign investment and to liberalize the imports of certain industrial products, including Japanese cars in exchange for financial support. Was this liberalization on the part of the Republic of Korea required to overcome her payments problems? Did it in any way respond to third-party interests? Eminent economists such as Feldstein (op. cit.) and Stiglitz have expressed their doubts in this regard.

While most Fund policy prescriptions on a fundamental issue are generally sound, bringing stability to a high inflation economy will help restore confidence and improve the climate for investment and growth. However, it is not always clear that all conditions included in Fund programmes, particularly the proliferation of structural conditions in recent years, are required to deal with the imbalance at hand, are timely and unquestionably to the benefit of the country. Moreover, it may be argued that in certain cases the Fund recommendations have been mistaken i.e., was the rapid liberalization of the capital account and financial markets in emerging market economies propounded in the 1990s always to the benefit of recipient countries or did it help precipitate financial crisis? Bhagwati believes it did (Bhagwati, 1998).

In the same way there is more than one model of market economy and of capitalism (i.e. compare the Asian model with those prevailing in France, Germany and the United States) since development economics is not an exact science and the political and cultural traditions of countries differ, there is more than one model of development. Compare, for instance, the role of the state in industrial policy in China or in South-East Asia with that in the United States. However, the political values and development perspectives of IFIs are implicit in the programmes they support and generally favour approaches which are in conformity with the current views of their major shareholder, irrespective of the views of the member country on the matter. This does not favour commitment to the programme by the authorities.

VII. Excess demand and structural imbalances

When industrial countries face a recession, they normally pursue expansionary fiscal and monetary policies to stimulate the recovery of demand. The Germany, the United Kingdom, the United States and other countries have recently done so. With the exception of a few high savers in Asia, emerging market economies are unable to pursue similar expansionary policies to stimulate their economy. Given the volatility of financial markets, they are normally obliged to adopt restrictive fiscal and monetary policies to protect their reserves lest they trigger confidence crisis. These restrictive policies aggravate the contraction of domestic and international economic activity. Should the Fund provide financial support to emerging market economies with sound foundations to allow them to avoid contractionary policies? Here is a case where Fund support could make all the difference and where Article I Section (v) on the purposes of the Fund assures that "To give confidence to members by making the general resources of the Fund temporarily available to them under adequate safeguards, thus providing them with opportunity to correct maladjustments in their balance of payments *without resorting to measures destructive of national and international prosperity".*

Should a country undergoing a balance-of-payments crisis and deep recession, (unemployment stands at around 20 per cent in Argentina), be required to *balance the fiscal accounts at depressed levels of activity* as a condition for Fund support? Is this consistent with the purposes of the Fund; or will it exacerbate the downturn? As fiscal revenues decline with economic activity, an economy in recession will normally run a fiscal deficit. Should the Fund distinguish between the cyclical and the structural component of a deficit to avoid pushing the economy deeper into recession? Should the Fund provide support to a well-constructed programme that would secure fiscal balance at a modest but positive growth rate?

The conditionality prescribed for the use of Fund resources requires that the member adopt an adjustment programme to deal with the external imbalance. This means that the Fund requires that the member adopt measures to restore a sustainable balance between aggregate demand for, and the aggregate supply of resources in the economy. The policies adopted for this purpose and the particular policy instruments chosen to do so should vary with the nature and size of the imbalance, but since the most frequent case is that of an imbalance arising from an unsustainable expansion of aggregate demand, the traditional Fund programme relies on a demand management approach, i.e., essentially a reduction of aggregate demand to restore external balance.

This usually entails the limitation of public expenditures and the increase in public sector revenues in order to reduce or eliminate the expansionary impact of public sector financing requirements and the limitation of domestic credit expansion. While this is of course the right approach to deal with excess demand, fiscal adjustments required by Fund programmes are often unduly severe and consequently have an unnecessarily restrictive impact on economic activity and growth. This is often the result of the underestimation of the impact of reduced public expenditure on private sector activity and investment. Moreover, cuts in expenditure tend to focus on investment and social expenditures – such as health and education that benefit the poorer sectors of the population – which undermines the potential for future growth. The reason behind this trend is that governments find these expenditures easier to cut than wages and other current expenditure. Additionally, the deflationary impact of lower levels of public expenditure may also be compounded by the limitation of net domestic credit to the private sector that programmes usually entail in order to limit aggregate expenditure.

Deflationary policies are suitable for dealing with excess demand, and may restore external balance. However, they are not likely to increase supply or to overcome production imbalances. Nor is demand management always the best way to deal with imported inflation. Other measures may be required for those purposes. For example, the adoption of supply-oriented structural measures may be successful where large price and cost distortions have to be corrected, as in the case of many economies in transition. However, in the experience of other countries, the introduction of structural measures in Fund programmes has been rather less successful than was expected (see section below on: The rise and fall of structural conditionality). More generally, the analysis of the effect of Fund programmes on member countries shows that while most strengthen the current account and consequently reduce the overall imbalance on the external accounts, which is consistent with the view that the essence of conditionality is deflation, their impact on growth and inflation is not statistically significant.

Not all imbalances are the result of excess demand arising from expansionary policies. Consequently, a traditional demand management approach is not one appropriate to deal with structural problems where new investment and a reallocation of productive resources are required to improve the supply response of the economy. For instance, consider the investments and the period of time required for the development of domestic energy resources, whether hydroelectric or an oil field that will reduce future imports. Moreover, since structural adjustments for such a development project will normally require greater amounts of financing over an extended period of time than sheer demand management, the type of adjustment policies to be followed will often give rise to policy differences and tensions between the Fund and the member country.

Additionally, the pace and the economic and social cost of adjustment largely depend on the total amount of financing available: the greater the financing available, the more this likelihood will allow the country to extend the adjustment process over a longer period. Thus the nature of the imbalance, the amount of support and the duration of the adjustment process will be issues for discussion and negotiation between the authorities of the member country and the Fund. The answers, given by the Fund to these and other questions, as they embedded in the programme frequently determine whether the conditionality applied in a particular case is seen as either appropriate or too severe; and consequently whether the authorities will be committed to the success of the programme. The adjustment of an imbalance is not simply an economic problem, but one that will usually have significant social and political repercussions. Its success requires the political commitment of the authorities. It often involves technical and political trade-offs and calls for fine political judgments that are known to and should be made by the authorities.

VIII. Capital account crises

In a world of increasingly integrated financial markets and high capital mobility, the loss of market confidence in a country or in a currency may give rise to a massive capital outflow, causing a severe financial crisis that has international repercussions. Mexico in 1995, Indonesia, Thailand and the Republic of Korea in 1997, to be later followed by Argentina, Brazil, Russia, Turkey and Venezuela, to name only the best-known cases. Abrupt confidence reversals of this sort have created a new kind of problem for emerging market countries and for the Fund itself. At the outbreak of the Mexican crisis, the Fund's Managing Director characterized it as "the first financial crisis of the twenty first century", thus implying that it called for a different response from the IMF. However, the Fund response has been similar to that given to any other balance-of-payments crisis except that in some cases it has been quicker and support larger than in the traditional case. The problem with this approach is that it implies that the crisis should be allowed to erupt and thereafter should be resolved by an economic programme backed by large-scale financial support. Implicit in it is the belief that a loss of confidence is invariably caused by poor policies on the part of the affected country and can thus be reversed by strong adjustment measures. These assumptions are questionable. Sudden shifts in short-term capital often appear to be as much the product of weak fundamentals as of speculators' desire for profit and their often-incorrect interpretation of national or international events. In other words they may resemble more closely the type of crisis modelled by Obstfeld (Obstfeld, 1986 and 1995) than the more traditional payments crises modelled by Krugman (Krugman, 1979).

It is widely recognized in the literature, including Fund papers, that capital flows to emerging markets are often volatile for reasons that may have little relation to country risk. Among the reasons that may affect capital flows are:

1) Exogenous and unanticipated changes in financial conditions in industrial countries that are unrelated to their policies can have a severe destabilizing impact on capital-importing countries. For instance, a tightening

of monetary policy that gives rise to higher interest rates (as when P. Vickers raised interest rates in the United States in 1982 which had pushed the United States into recession and detonated the Latin American debt crisis) and/or to exchange rate fluctuations may sharply increase the cost or reduce the availability of financing to developing countries.

2) The pro-cyclical nature of capital flows. Capital tends to flow out of industrial countries when economic activity is at low levels and to return to these countries when the economic and business prospects are favourable. Thus markets tend to undermine the creditworthiness of emerging market economies.

3) Information asymmetries and contagion effects characterize financial markets. Country risk perceptions often respond to "herding" behaviour rather than serene analysis, but once a run is underway the self-fulfilling nature of speculative attacks can make it much more risky for the investor to resist than to join the bandwagon. Recent episodes of financial market turbulence show that a country may lose its creditworthiness overnight leave the authorities little time to react. In a number of cases this sudden loss of confidence may be unjustified. However, there can be no question that the bandwagon effect can abruptly reduce liquidity across the board, disrupt the economies of capital-importing countries and destabilize the economies of a group of countries or a region. The case of the Argentine crisis is the most recent example of this phenomenon.

The current Fund approach to financial crises seems to imply that the best way to deal with these is to let them run their course; then to try to restore confidence by an abrupt change in economic policies coupled with substantial financial support. This approach is unsatisfactory because crises inflict very great damage on the affected country over a very short time. One need not look beyond the sharp contraction of GDP, the fall in consumption, investment and employment, and the wave of bankruptcies and banking crisis that ensue to realize that every effort should be made to find a less destructive and costly approach to the solution of problems of this kind. This would be more in line with the purposes of the Fund as contained in Article 1 of the Articles of Agreement which is "to give confidence to member countries, by making the resources of the Fund temporarily available to them, thus providing them with the opportunity to correct maladjustments in their balance of payments without resorting to measures destructive of national and international prosperity".

Because the flow of capital is crucially dependent upon the confidence of international investors, timely and ample financial support may prevent a crisis. Therefore, the Fund should be ready to act very quickly, at the outset of a speculative attack, before the country falls prey to a financial crisis, rather than coming in after the crisis to pick up the pieces. This would not preclude any exchange-rate or fiscal adjustments that may be required under the circumstances, but would simply allow these to take place in an orderly manner.

The key to the approach suggested is to sustain confidence by the timely provision of a large amount of financial support and thereby avoid the panic and its very costly sequel, the overshooting of exchange and other markets and the recession that takes place as a result of the loss of confidence in the currency. While the creation of the Contingent Credit Lines (CCL) in the Fund appears to recognize the validity of this argument, no country has resorted to it despite several financial crises in the three years since its establishment. This would seem to indicate that it has failed the test of the market. Members may feel that Fund support is not sufficiently certain, nor timely and sufficiently large to be able to protect them from a speculative attack that would trigger off a crisis. Given the small size of quotas, financial support that is little more than a normal day's trading in the exchange market, as in the Mexican case, is not likely to impress the financial market. The CCL could therefore be redesigned the correct its shortcomings and to render it operational (Buira, 1999).

IX. The rise and fall of structural conditionality

While conditionality has been the subject of much discussion over the life of the Fund, it is important to note its evolution and the changes it has been subjected to over the last twenty years.

The Fund and the Bank have modified their lending policies over time to keep in step with changing international economic conditions and evolving economic orthodoxies. In fact, in the 1980s and 1990s, a significant increase in the number of conditions can be observed. "The average number of (IMF) conditions rose from about six in the 1970s to 10 in the 1980s (figures 1 and 2). In the Bank's case the average number of conditions rose from thirty two in 1980–83 to fifty six by the decade's end" (Kapur and Webb, 2000). The number of conditions continued to rise during the 1990s and was focused on structural conditionality.

The number of structural policy commitments – prior actions, structural benchmarks, conditions for programme reviews and performance criteria – in Fund programmes reached its peak during the Asian crisis. At their highest, the programmes with the Republic of Korea included 94 structural conditions; with Thailand, 73; and with Indonesia, 140 structural policy undertakings! In addition, there were of course, a number of other traditional quantitative performance criteria to be met within the fiscal, monetary and on the exchange system. Since there was no ranking as to their importance, trying to keep track of so many commitments and variables could overwhelm the authorities of any country; and must have become a nightmare for those developing countries in the midst of a crisis. Needless to say that conditionality herein had gone too far. Moreover, the programme results (table 2) soon confirmed that this approach had become dysfunctional.

Let us now consider the factors behind this explosion of conditionality. Since the early 1980s, as the Thatcher and Regan doctrines gained ascendancy in the United Kingdom and the United States, both countries adopted a more neo-liberal economic stance and increasingly favoured policies aimed at reducing the role of the state: the reduction or elimination of subsidies, market liberalization, and privatization of public enterprises. These views, which were to be translated into a new type of structural conditionality, were superimposed on the more traditional macroeconomic conditionality. According to Michel Camdessus, the goals included "financial market operations organized around objective financial criteria, transparency in industrial conglomerates and in government business relations more generally, the dismantling of monopolies, and the elimination of government-directed lending and procurement programmes". Although the above watchwords did not describe the history of any industrial country, they reflected the vision of a global market system that was increasingly being advocated since the seventies by the United States business and government sector.

The reasons for the change in the conditionality of the IFIs were not, however, purely ideological. It is a combination of several other factors, among which:

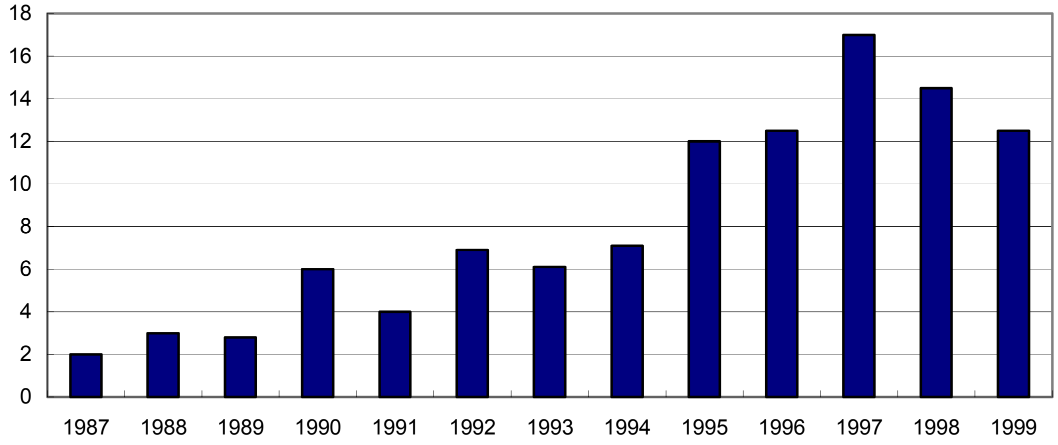
1) The limited (declining in relation to demand) financial resources of development finance institutions which reflected a policy shift in major industrial countries away from the provision of public financing to developing countries, in favour of a policy aimed at the "graduation" of middle income countries to private financing, that had started during the late seventies. This meant that programmes and loan requests had to give prominence to purely economic and financial results to satisfy financial markets.

2) The rise of supply-side economics, the precursor of structural adjustment, in the United States. While this theory was initially resisted by many developing countries in the early eighties, the policy makers of these countries had over time become convinced that there was no alternative to increased reliance on market financing. Moreover, as structural conditionality seemed to match what financial markets required to have confidence in borrowers, it was gradually accepted.

3) A conversion of national authorities in a number of developing countries to the new economic orthodoxy as "technocrats", usually economists who trained in the United States and favoured market liberalization and

Figure 1

AVERAGE NUMBER OF STRUCTURAL CONDITIONS PER PROGRAMME YEAR,[a] 1987–1999

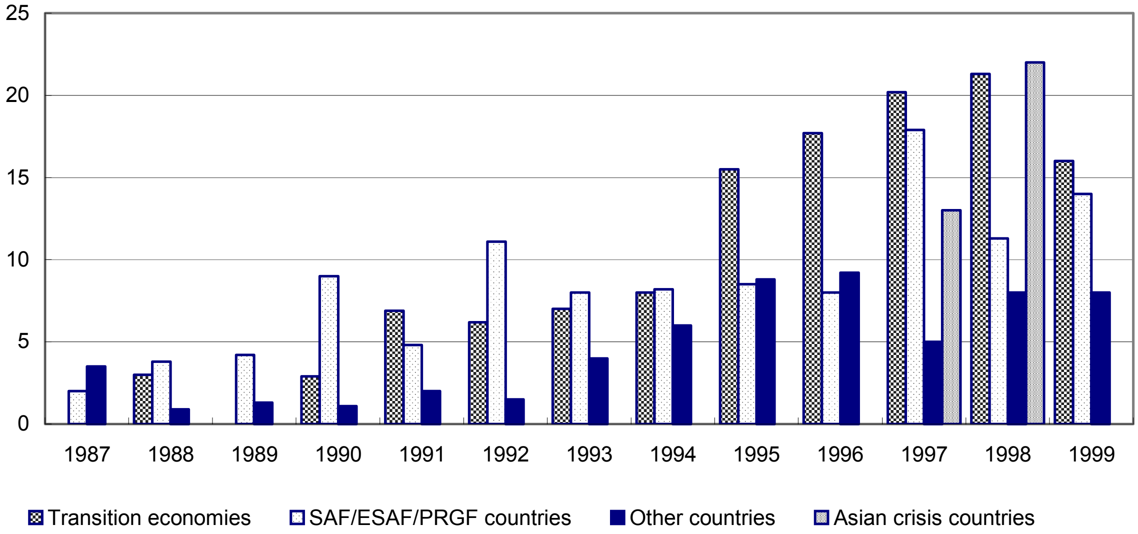


Source: International Monetary Fund, MONA database; and country papers.

[a] Total number of structural performance criteria, benchmarks, prior actions, and conditions for completion of review stand-by, EFF, and SAF/ESAF/PRGF-supported programmes, adjusted for differences of programme length.

Figure 2

AVERAGE NUMBER OF STRUCTURAL CONDITIONS PER PROGRAMME YEAR BY TYPE OF COUNTRY,[a] 1987–1999



Source: International Monetary Fund, MONA database; and country papers.

Note: ***Transition economies***: as defined in the *World Economic Outlook*, covering former centrally planned economies in Eastern Europe, FSU countries and Mongolia. ***SAF/ESAF/PRGF countries***: countries with SAF/ESAF/PRGF-supported arrangements, excluding transition economies. ***Other countries***: residual group, encompassing programmes in countries that do not fall into any of the other categories. ***Asian crisis countries***: Indonesia, Republic of Korea, and Thailand.

[a] Total number of performance criteria, prior action, conditions for completion of review, and structural benchmarks per programme, adjusted for differences in programme length.

a smaller role for the state, gained ascendancy in many developing country governments.

4) The Brady Plan that conditioned external debt reductions to policy adjustment programmes emphasizing changes in economic structures as well as macroeconomic balances.

5) The criticism of Fund programmes by developing country representatives as too restrictive and demand oriented and insufficiently concerned with economic growth, led the Fund to put emphasis on the structural changes "required" by long term growth. This became apparent in the Structural Adjustment Facility (SAF), created in 1986, which required applicant low-income countries to submit a three-year programme "to correct macroeconomic and structural problems that have impeded balance of payments adjustment and economic growth." The Extended Structural Adjustment Facility (ESAF), which was established a year after included similar requirements (IMF Decision No. 8240 - (86/56)SAF March 26, 1986.) See Selected Decisions and Selected Documents of the IMF, Washington, DC, December 31, 2000).

6) The revised Article IV giving the Fund expanded surveillance responsibilities in missions to members that made the staff and Board more aware of structural issues, particularly when these appeared to have a bearing on balance of payments problems.

7) The major structural problems faced by the economies in transition and the far-reaching transformations these countries required in order to establish market economies.

8) The emergence of the Asian crisis, which led to the proliferation of norms and standards in a number of fields.

   Kapur (2000) comments that "There is an understandable skepticism that rich countries are long on norms when they are short on resources, and the increasing resort to norms of governance even as development budgets decline is perhaps not entirely coincidental. As long as the cold war was on, "crony capitalism" in Indonesia was not considered a problem. Nor was it a problem while the East Asian "miracle" was being trumpeted. But when the Asia crisis of 1997–98 erupted, norms of corporate governance were strenuously advanced to deflect attention from broader issues of the nature and quality of international financial regulation."

9) The tendency of major countries to ask the Fund to include certain structural issues of interest to them in programme conditionality despite the injunction in the Fund's Articles (Art XII Section IV) that members "refrain from all attempts to influence any of the (Fund) staff in the discharge of (their) functions." Goldstein (2000) cites the programmes of the Republic of Korea and of Indonesia as programmes as cases in point

In addition to fulfilling an instrumental role in triggering disbursements, compliance with performance clauses or targets also has a double confidence building role: from the country to the financial markets and from the institution to its major shareholders.

As Kapur, Lewis and Webb (1997) had pointed out "multiplying the number of reforms per loan appeared to increase the reform mileage … that could be gotten from limited policy loan money". However, the result of the proliferation of conditions left a lot to be desired: First, there was a loss of transparency and increased uncertainty as to programme compliance on the part of the countries and their access to Fund financial support, i.e., Would a country that had met, say 47 out of 60 policy commitments, (performance criteria, prior actions and structural benchmarks) be considered in compliance and allowed to disburse? Second, as a general rule, the greater the number of conditions in a programme the less likely it was that the authorities felt a strong commitment to and ownership of the programme, a fact that diminished the chances of successful programme completion. Third, the high and increasing proportion of programme failures gave rise to questions as to the point of having ever more comprehensive and ambitious programmes that were not complied with.

The analysis of programme compliance since the seventies suggests there is an inverse relation between the number of performance criteria and programme success. The reasons for this appear obvious: the greater the number of performance criteria, structural benchmarks and other targets, the greater the chance that some will not be met. Thus, more modest and more realistic programmes, centred on certain key issues, those critical to economic performance and the achievement of the programme objectives, are more likely to command political support and ownership by the authorities than much broader ones, thereby improving their chances of success.

By the mid 1990s, faced with the failure of structural policies to secure objectives such as higher rates of growth, the reduction of poverty and an improved distribution of income, the IFIs re-discovered the role of government and aimed to improve governance in member countries, particularly through increased transparency, greater accountability and the reduction of corruption. For this both the Fund and the Bank encouraged reform of public institutions by adding governance-related conditions, including cutting expenditure on arms, the strengthening of civil society and the rule of law to the traditional macroeconomic issues.

X. Conclusion

Conditionality was not always a characteristic of the Fund. It was introduced in the 1950s, as a means to restore members' balance-of-payments viability and to ensure that Fund resources would not be wasted; that the institution would be able to recover the loans it extended to member countries. The practice of conditionality was incorporated as a requirement into the Agreement only in 1969, as part of the First Amendment of the Articles. For several decades, until the early eighties, Fund Conditionality centred on the monetary, fiscal and exchange policies of members.

Over the last 20 years, while the resources of the Fund declined as a proportion of world trade, the number of Fund programmes increased steadily. Not surprisingly, the conditionality contained in programmes experienced substantial change. On the one hand the scope of conditionality was substantially expanded into fields that had been largely outside its purview. Thus, conditionality was expanded well beyond the traditional fields of monetary and fiscal policy and issues related to the exchange system to also encompass structural change in the trade regime, pricing and marketing policy, public sector management, public safety nets, restructuring and privatization of public enterprises, the agricultural sector, the energy sector, the financial sector, and more recently to issues of governance and others in which the expertise of the Fund is limited.

As the number of conditions, particularly structural conditions, increased gradually during the 80s, and rapidly during the 90s, the rate of member country's compliance with Fund supported programmes showed a parallel and no less remarkable decline. Programmes that were successfully completed programmes or were in compliance, fell from the rate of over 50 per cent in the late seventies and early 80s, to below *thirty* per cent in the nineties if compliance is defined as that which permitted the disbursement of over 75 per cent of the loan, and to only *sixteen* per cent if the test of compliance is the full disbursement of the loan. The decline in the relative size of the Fund in relation to needs must have also contributed to the hardening of conditionality.

As a result of the very low rates of programme compliance, it would be very difficult to argue that conditionality restores external balance and secures the repayment of loans, or that it is needed to ensure the revolving nature of Fund resources. It may however, serve the purpose of obtaining certain policy changes desired by creditor countries. Moreover, as compliance declined, the credibility of Fund programmes had been eroded and their catalytic character is increasingly questionable, a fact that has obvious implications for the size of the Fund.

As conditionality had become dysfunctional, its review and streamline became inevitable. In this regard the initiative of the Managing Director to address the very high rates of programme failure is both necessary and welcome The Board has also recognized the nature of the problem. Experience and the Fund's own studies show that programme success is closely related to ownership, and that ownership cannot be externally imposed. It must result from internal analysis and discussion, leading to the conviction by domestic actors that compliance with the programme is conducive to the attainment of their own objectives. Since conditionality cannot compensate for lack of programme ownership, it can only be seen as helpful to the extent that it fits in with the member's goals and is seen by the authorities as a road map to their own purposes. What makes for a successful programme is the authorities' commitment to its objectives. Conditionality can neither substitute nor offset a lack of ownership.

This suggests that the role of the Fund staff should be more akin to that of an external advisor or consultant who can assist the authorities develop their own programmes, by helping them in the identification of available paths and policy options, when they have the conviction to pursue objectives consistent with the Fund's mandate. Programmes, however detailed, are likely to fail when the authorities accept them without conviction as the price they must pay for external financial support in times of need. On the other hand, when the authorities and more broadly, the society are committed to certain policy objectives, these can be attained without the doubtful "benefit" of very detailed conditionality.

Although the Managing Director appears determined to streamline conditionality, the inertia prevailing as a result of many years practice, among a generally very competent and dedicated staff, may take time to overcome. However, as shown by the new Fund policies toward capital account liberalization, change is under way.

The review of conditionality should lead to increased participation of members in programme design in order to secure greater ownership and transparency. Programmes developed by the authorities, preferably in broad consultation with social forces, do not require a multitude of performance criteria, structural benchmarks and prior actions to secure compliance. The Fund's attitude to its members should be a more liberal one, of greater trust, akin to what is currently required for drawings under the first credit tranche. The Fund should need no more than a reasonable programme focused on the essentials, usually centred on the Fund's core areas of competence: fiscal, monetary and exchange rate policies. Provided the member shows its clear understanding of the issues and a commitment to a sound programme, Fund support should be made available. Some flexibility as to the measures to be adopted and their timing should be allowed to permit the member to respond to changing circumstances. This approach should serve members better and safeguard Fund resources more effectively than the onerous conditionality practices of the 1990s that resulted in such poor programme compliance.

In addition, the changing conditions of the international scene and the recurrence of financial crises call for a review of the role of the Fund, the nature and character of its operations, and the adequacy of its resources. The Fund's own governance and accountability and members contributions and participation in decision-making should also be reviewed.

Annex 1

In the discussions in Atlantic City in June 1944, prior to the Bretton Woods conference, the delegates from the United States had raised the issue of requiring member countries that requested financial support, to give certain policy undertakings to the Fund who would decide whether the currency purchase was consistent with the purposes of the Fund. This notion was strongly rejected. Virtually all other countries believed that access to Fund resources should be automatic and unchallenged. Moreover, these countries believed that Fund intrusion in their internal affairs would be intolerable. Within the prescribed limits, the decision to purchase foreign currency in exchange for the country's own currency could not be challenged; the role of the Fund should be strictly limited. By the time of the Conference, the two amendments that had been proposed by the United States delegation had been dropped. Thus the issue appeared to have been settled, and since it was not then raised by the United States delegation, it was not discussed any further. Consequently, the original Articles contained no statement that the Fund had to adopt policies on the use of its resources. A member country was therefore entitled to make purchases provided that "it represents that it is presently needed for making in that currency payments which are consistent with the provisions of this Agreement." (Article V Section 3(a))

Even in the United States' view, the Fund was not to interfere in member country's domestic policies. A valuable insight into this thinking by the United States is provided in a statement by White in October 1943: "The Fund's facilities should not be used to finance either a flight of capital or the issue of foreign loans by a country which could not afford to undertake foreign lending. Again, the Fund would be justified in intervening where a country was using its quota for rearmament. On the other hand, it would not be justified in the case of an unbalanced budget. In general the Fund would intervene only in extreme cases of violation of qualitative rules, and would bear the burden of proof." (Horsefield, 1969)

As Article IV Section 5(f) of the original Articles of Agreement stated, as long as the Fund was assured that a change in par value of a particular member's currency was necessary to correct a fundamental disequilibrium," it shall not object to a proposed change because of the domestic social or political policies of the member proposing the change." This wording makes it clear that the intention of the Agreement as a whole was to preclude Fund interference with domestic policies having social objectives such as the subsidization of food or other essential consumption goods for the protection of low income groups". (Dell, 1981)

While the United States had lost the battle to give the Fund supervisory functions, they would not agree to the use of Fund resources without certain additional safeguards. "The Europeans had the best of the argument, perhaps, but it was the United States that had the resources, and it was the resources that counted, specially in the immediate aftermath of World War II" (op. cit.). After a number of years of very limited Fund operations, it was the need to obtain the financial support and cooperation of the United States that in 13 February 1952, the Executive Board was persuaded to accept a proposal by the Managing Director to embody the United States concept of conditionality by which:

"… the task of the Fund is to help members that need temporary help, and requests should be expected from members that are in trouble in a greater or lesser degree. The Fund's attitude towards the position of each member should turn on *whether the problem is of a temporary nature and whether the policies the member will pursue will be adequate to overcome the problem within such a period. The policies, above all, should determine the Fund's attitude." (*Decision No.10 (52/11) para. 1; italics used for emphasis.)

And additionally "considering especially the necessity for ensuring the *revolving character of the Fund's resources, exchange purchased from the Fund should not remain outstanding beyond the period reasonably related to the payments problem for which it was purchased from the Fund. The period should fall within an outside range of three to five years.* Members will be expected not to request the purchase of exchange from the Fund in circumstances where the reduction of the Fund's holdings of their currencies by an equivalent amount within that period cannot reasonably be envisaged." (op. cit., para. 2)

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