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New IMF Conditionality Guidelines

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Summary

The International Monetary Fund (IMF) recently revised the guidelines for the design of conditionality in its loans. Conditionality requires a borrower country to adhere to various macroeconomic and other policy “conditions” when it borrows funds from the IMF. It is an inherent feature of all IMF lending. Four guiding principles are at the core of the revised IMF guidelines: national ownership of the reform program, parsimony and clarity in the application of program-related conditions, tailoring of programs to the member’s circumstances, and effective coordination between the IMF and other multilateral institutions. This report provides background on the issues, summarizes the principles underlying the new guidelines, discusses the criticisms they respond to, and assesses their likely effectiveness. This report will not be updated.

Background

Since the creation of the IMF, conditionality has been an integral part of IMF lending. Conditionality is described as “the link between financing from the Fund and implementation of policies by countries that make use of Fund financing.”¹ It refers to the macroeconomic “conditions” that the IMF requires from borrower countries. Over the last twenty years, and especially since the financial crises of the 1990s, IMF conditionality has come under increasing criticism.

One major criticism is that its conditionality focuses too heavily on stabilization of the economy in crisis and not enough on creating policies for longer term economic growth. As the IMF began lending to very poor countries, through structural adjustment loans, it expanded the types of conditions to include removing protectionist trade policies and implementing market-based resource allocation policies. Concerns arose that the IMF

¹ “IMF Conditionality” Press Briefing by Masood Ahmed, Deputy Director, IMF Policy Development and Review Department, March 21, 2001.

was designing and enforcing conditionality in areas outside of its core competencies of macroeconomic policy, fiscal policy, and monetary and exchange rate policies.²

Critics have also called IMF conditionality too intrusive and not essential to the actual success of the IMF program. This trend can be seen in the number of IMF programs that remain uncompleted. For example, in the 1970s and 1980s the IMF made many loans to African countries, that were unable to comply with IMF conditionality and eventually ceased payment on the debt. Some remain in default to this day.

Current completion rates for IMF programs are very low. From 1973 to 1997 only 35% of IMF loans were fully disbursed.³ Between 1993 and 1997, the IMF approved 141 arrangements to be disbursed in numerous tranches (installments), pending the completion of conditionality requirements. Of these loans, only 16.3% were completely disbursed. While in some cases, the IMF did not disburse funds regardless of country compliance with its conditionality, the excessively poor completion rate implies either a failure of the IMF policy guidance, or a mismatch between the IMF's stated country reform agenda and capabilities and/or the policy goals of the recipient country.

Criticism of IMF conditionality evolved in the wake of the 1990s East Asian financial crisis. Prior to the East Asian crisis, most financial crises could be traced to imbalances in a country's current account. A current account crisis could be due to weakening domestic economic fundamentals such as price stability, fiscal deficits, or savings rates.⁴ In a current account crisis, the IMF's usual mix of policy conditions of fiscal austerity and structural reform seem appropriate and likely to restore economic confidence.

Many analysts, however, agree that the Asian crisis was due not to fundamental imbalances in the current account, but rather the capital account. Large increases in the volatility and magnitude of global capital flows and the prominent role of sovereign debt as a primary source of capital to emerging market economies has left many developing countries captive to international capital markets. A decrease in global liquidity or increased risk aversion among international investors can lead to decreased capital flows to developed countries, and the subsequent collapse of a country's currency and macroeconomic fundamentals. Weakening fundamentals do not necessarily reflect internal structural economic problems, but rather the rapid cut-off of foreign capital.⁵ The

² See William Easterly, What did Structural Adjustment Adjust, *Working Paper No. 11, 2002* Center for Global Development, Washington, DC, for a critical assessment of the IMF and World Bank's experience with structural adjustment loans.

³ Graham Bird, The Completion Rate of IMF programs: What We Know, Don't Know and Need to Know" *The World Economy*, Issue 6, Vol. 25, pg. 833-47.

⁴ Capital Account Crisis and Credit Contraction, Masaru Yoshitomi and Kenichi Ohno, May 1999, ADBI.

⁵ Guillermo A. Calvo, Capital Flows and Capital-Market Crises: The Simple Economics of Sudden Stops, *Journal of Applied Economics*, Vol. 1, No. 1, November 1998, pp. 35-54.

applicability of IMF policies for capital account crises can be questioned. Many stress the negative effects of austerity packages on countries experiencing a capital account crisis.⁶

In addressing these criticisms, the IMF on September 25, 2002, approved new guidelines for the design and implementation of conditionality in Fund-supported programs.⁷ The document includes sections describing the principles, modalities, and methods for internal review of the new guidelines. The document also includes a staff statement that discusses the principles of the guidelines in greater detail. This is the first revision to IMF conditionality since 1979 and is the result of a two-year review. The review was initiated by IMF Managing Director Horst Kohler and responded to substantial internal and external criticism of the IMF's use of conditionality in its lending.

Congress also played an important role in pressing for changes in the IMF's use of conditionality. During the 1998 appropriations process, Congress established the International Financial Institutions Advisory Commission (IFIAC) to recommend policy on the IMF and other international financial institutions. Presenting its report to Congress in March 2000, IFIAC proposed abandoning IMF conditionality and replacing it with mandatory preconditions of good economic policies and robust financial institutions. In a crisis situation, the "pre-qualified country" would receive automatic support.⁸ The Commission also concluded that conditionality supported inadequate policy options in developing countries, and proved burdensome and ineffective in promoting long-term economic reform.^{9 10}

The IMF acknowledged that the reasons for balance of payments difficulties vary across countries and the IMF along with the member country must design a unique program of "conditions" for each national applicant. The principles of the new guidelines and the criticisms that led to their inclusion will now be discussed.

Country Ownership of Fund-Supported Programs

Ownership refers to country officials assuming responsibility for a program of economic reforms, based on the mutual understanding between the country officials and the IMF that the economic reforms are in the best interest of the country. Demand for increased country ownership represents probably the most significant change in the new guidelines. It is a reform created to legitimize conditionality in the eyes of the member country and the international community, many of whom have criticized the IMF for

⁶ Stiglitz, Joseph. *Globalization and its Discontents*, New York: W. W. Norton & Co. 2002.

⁷ *International Monetary Fund Guidelines on Conditionality* available at [<http://www.imf.org/External/np/pdr/cond/2002/eng/guid/092302.htm>].

⁸ See CRS Report RL30635, *IMF Reforms and the International Financial Advisory Committee*, by J.F. Hornbeck.

⁹ *Report of the International Financial Institution Advisory Commission*. Submitted to the U.S. Congress and U.S. Department of Treasury, March 8, 2000, pg 7-8.

¹⁰ A criticism of the Meltzer Report is that under this arrangement, many developing countries would be ineligible for IMF assistance. While not all critics agree with the Meltzer Report in abolishing conditionality in its entirety, many agree that fundamental flaws existed in the IMF's conditionality policies and a new approach was warranted.

insisting on increasingly pervasive conditions requiring more and more structural reform of the domestic economy. By harmonizing interests between the member country and the IMF in advance, country ownership is expected to circumvent this problem.

But it is a complex issue. A prominent hindrance to program completion is weak political capacity in many borrower countries. The governments of numerous countries have crafted and promised significant economic reforms, only to fail in passing reform legislation through the domestic bureaucracy or in bowing to pressure from labor unions, opposition parties or special interest groups to abandon the conditionality program. It is this internal opposition, according to many analysts, that makes conditionality necessary, even if country officials and the IMF agree on the reform program. While government officials may be in full support of the reform program, there have been many occasions where the reforms have been undermined by opposition parties or special interests within the country. Constraints at the international level can increase the leverage of the incumbent government and strengthen the bargaining power of the government vis-a-vis special interest groups and opposition parties.¹¹

In the new guidelines, the IMF acknowledges that a country's capacity and ability to implement reforms is a determining role in program success. The new guidelines stress that the IMF will provide a range of policy options and plans and will provide technical assistance to help countries that do not have an administrative capacity strong enough to implement reforms by themselves. In this way, greater flexibility is allowed in harmonizing the often country-specific components of IMF packages.

Parsimony in Conditionality Formulation and Clarity in its Implementation

By parsimony, the IMF means that conditions in its assistance programs "should be limited to the minimum necessary to achieve the goals of the Fund-supported program or to monitor its implementation and that the choice of conditions should be clearly focused on those goals." The two goals of Fund-supported programs are the solving of balance of payments problems and support of sustainable economic growth. Conditions that are not of "critical importance" for achieving these two goals are to be avoided.

The guidelines also state that program-related conditions should be clearly distinguished from other reforms taken by the member country in both IMF documents and the member country's documents. This is to avoid confusion between broad economic and political reform agendas and the actual conditions and criteria required for continued access to IMF resources.

While these parsimonious reforms appear sensible, in practice it can be quite difficult to ascertain what conditions are actually "necessary" to move toward the agreed upon outcome. Nonetheless, these major reforms are deemed an essential response to a growing body of criticism that the IMF's conditions are too broad, too intrusive, and require policy

¹¹ See Robert D. Putnam, "Diplomacy and Domestic Politics: the logic of Two-level Games." *International Organization* 42, 1987: 427-460 and James Raymond Vreeland *The IMF and Economic Development* Cambridge University Press, Forthcoming 2003.

conditions that fall outside of the IMF areas of speciality and aim to correct this in future loans.

Tailoring Programs to Country Realities

The IMF, through its experience with multiple types of international financial crises, has recognized that while balance of payments problems may appear similar across countries, the underlying rationales for the imbalances vary and the type of lending the IMF approves must reflect the specific needs of the country to resolve those problems.

For example, countries with sound and robust economic institutions might require only short term lending to restore investor confidence. A minimum of conditions would apply in such cases. In other countries, such as those receiving loans under the Poverty Relief and Growth Facility (PRGF), the IMF's concessional loan facility, the goal of IMF lending is stimulating growth through market-oriented Structural Adjustment Loans (SALs), which entail a more extensive use of conditionality. Finally, there are transition economies that are trying to introduce a competitive market through privatization and deregulation, yet maintaining sound and stable macroeconomic fundamentals. To respond to these different types of crises, different policy measures must be used. The new guidelines acknowledge that each financial crisis has its own unique causes. The guidelines also stress that a member's past performance in implementing economic reforms is considered when the IMF designs its conditionality.

Coordination Between the IMF and Other Multilateral Development Agencies

In general, there has been increasing collaboration between the IMF and World Bank. These include the Poverty Reduction Strategy Papers (PRSP), the Financial Sector Assessment Program (FSAP), and work to combat international money-laundering. These reforms and others, generally targeted at increasing the effectiveness and governability of developing country's national institutions, have become known as second generation reforms.¹² In light of the recent financial crises, second generation reforms have risen on the agendas of both institutions and have come to dominate their respective agendas. To prevent competing or duplicitous conditionality between the two agencies, the guidelines call for the application of a "lead agency" framework between the two agencies. The new guidelines also allow the IMF to draw on the advice of other international organizations in the design of conditionality. This is very important since in many developing countries there are both IMF and World Bank assistance programs. Cross-conditionality, where IMF's resources would be subject to decisions taken by other international organizations will not be permitted.

In countries where both agencies have operations, IMF and World Bank staff are expected to design a harmonized country strategy, identify key reform areas and implement a strict division of responsibilities in promoting the reforms, with one of the

¹² First generation reforms are fiscal and macro-economic reforms. For more on first and second generation reforms see Moises Naim "Latin America: The Second Stage of Reform" *Journal of Democracy* 5(4) October, 1994.

agencies assuming a “lead” position for each of the reforms.¹³ The staff statement reiterates the IFI’s interest in second generation reforms by identifying the following reforms as policy issues where increased cooperation would be beneficial: elements of financial sector work, public sector reforms, and issues of transparency, governance, corruption and legislative reform, trade policy, and debt management.

Cooperation between the IMF and the World Bank has itself been the subject of significant criticisms. Many commentators have accused both the IMF and World Bank of “mission-creep,” in allowing their activities to expand beyond their mandate. The IFIAC noted this and proposed the IMF be pared down solely to the agenda laid out in its Articles. This argument has also been made for the World Bank.¹⁴

The Likely Effectiveness of the New Guidelines

The effectiveness of the new IMF-authored guidelines will not be known at least for a few years, until a significant number of loans are designed under the new framework. Regardless, the formal statement of revising IMF conditionality is generally viewed as a positive step in the reform process. The principles underlying the new guidelines appear very sensible, open only to minimal and technical criticisms.

Experience has shown that IMF programs are bound to fail if they do not have the full support of the borrower country; are overburdened with cumbersome and extraneous conditions; and try to offer a “cookie-cutter” approach to economic reform in crisis-prone economies. By requiring the IMF to prove that future conditions overcome these problems, the new guidelines could lead to more effective and clearly designed loans. If future IMF loans continue to exhibit the same features, the ability of the IMF to intervene effectively and reduce the susceptibility of developing economies to financial crisis will continue to be questioned and support of the IMF might diminish. The new guidelines are an effort by the IMF to “lock-in” reform and are therefore an important part of turning criticism of the IMF into a constructive new policy agenda.

¹³ See *Strengthening IMF-World Bank Collaboration on Country Programs and Conditionality* at [<http://www.imf.org/external/np/pdr/cond/2001/eng/collab/082301.pdf>] and *Strengthening IMF-World Bank Collaboration on Country Programs and Conditionality - Progress Report* August 19, 2002 at [<http://www.imf.org/external/np/pdr/cond/2002/eng/collab/081902.pdf>].

¹⁴ Jessica Einhorn, “The World Bank’s Mission Creep” *Foreign Affairs*, September/October 2001.