The modalities of International Monetary Fund conditionality – further considerations[1]

by B T Thoka

Introduction

The International Monetary Fund (IMF) has, since its establishment in 1944, evolved into a major actor in the international economic and financial arenas. This development can be attributed largely to the global economic shocks of the 1960s, 1970s and 1980s and more recently to the major financial crises of the 1990s. In tandem with these changes, the role and responsibilities of the IMF as an international financial institution have consequently expanded considerably and in so doing, inspired vigorous debate and discussion among policy makers, IMF member countries and academics.

A major issue of contention is the appropriate scope and intrusiveness of IMF conditionality. There are two prominent issues at the core of the debate and discussions: one is the issue of the ownership of Fund-supported programmes and the other, the issue of streamlining or simplifying IMF conditionality.

A recent IMF response was the publication of an IMF *Staff Paper*, titled "The modalities of conditionality – further considerations." The authors of the paper accept that conditionality should be simplified and greater ownership be assumed by member countries receiving IMF support. The paper proposes two approaches which would incorporate the aforementioned issues, namely outcomes-based conditionality and floating tranche conditionality. Both approaches are distinct, albeit related concepts.

This paper begins by giving a historical overview of the evolution of IMF conditionality from its simple origins to a complex set of instruments utilised for the purpose of monitoring compliance. Next it summarises outcomes-based conditionality and floating tranche conditionality. Then the relationship between programme ownership and conditionality and also the process of streamlining conditionality are reviewed. The paper ends with a broad overview of some unresolved issues and summarises South Africa's position in the ongoing debate.

Overview of conditionality

The formulators of the IMF's original Articles of Agreement concurred that the key function of the IMF would be to monitor and maintain the Bretton Woods's par value exchange rate system, and lend money on a revolving basis to member countries facing short-term payment imbalances.[2] The concept of conditionality was not mandated in these Articles of Agreement. The first "conditional" IMF loan, the Stand-by Arrangement, was introduced in 1952. A Stand-by Arrangement was initially conceived as an agreement between a member country and the IMF, allowing the member country access to a certain portion of its quota if it maintained certain policy targets within a relevant time period.[3] Peru became the first recipient of a Stand-by Arrangement in 1954.

The Stand-by Arrangement underwent several modifications up to 1957 when leading IMF theoretician, Jacques Polak, published an article titled "Monetary analysis of income formation and payments problems." This article significantly influenced the IMF to formally adopt policy-based conditionality as the basis for the IMF's lending

1 This paper originated as a briefing report submitted to the senior management of the Research Department of the South African Reserve Bank (SARB). The report emanated in part as a response to a request by Dr C D R Rustomjee, IMF Africa Group 1 Constituency Executive Director, that the SARB should submit comments on an IMF Staff Paper titled "The modalities of conditionality – further considerations". These comments were submitted and considered by the IMF's Executive Directors.

The author would like to thank his colleagues in the Research Department for their comments and contributions. The views expressed in this paper are those of the author and do not necessarily reflect those of the South African Reserve Bank.

2 *Dell, S. 1981. On being grandmotherly: the evolution of IMF conditionality.* Essays in International Finance, *No 144 (October). Schadler, S. et al. 1995. Experience under Stand-by and Extended Arrangements. Part 1: Key issues and findings.* Occasional Paper *No 128. International Monetary Fund, Washington, DC.*

3 *Spitzer, E. 1969. Stand-by Arrangements: purposes and form, in Margaret G de Vries and Keith Horsefield (eds.)* The International Monetary Fund 1945-1965: twenty years of international monetary cooperation. *Vol. II. Washington, DC, International Monetary Fund.*

The IMF defines the Stand-by Arrangement (SBA) as a non-concessional loan designed to address short-term balance-of-payments problems and is the most widely used facility of the IMF. The length of an SBA is typically 12-18 months. Repayment is normally expected within 27 months to 48 months, unless an extension is approved. Surcharges apply to high levels of access.

operations. Polak argues that the basis upon which an IMF loan should be granted ought to involve linking the restoration of balance-of-payments imbalances to monetary, fiscal and exchange rate policies. In other words, the IMF should not focus solely on the balance of payments to restore stability, but consider how other policies such as monetary, fiscal and exchange rate policies could be adjusted. Paraguay was allocated the first such loan arrangement in 1957.

4 *Dell, S. 1981. On being grandmotherly: the evolution of IMF conditionality.* Essays in International Finance, *No 144 (October).*

Stand-by Arrangements were expanded subsequent to the Paraguay loan arrangement. Member countries were guaranteed access to larger portions of their quota and the Stand-by Arrangement remained active for a longer time. Dell observes that these larger loans required more "justification", meaning more conditionality.[4] As a result of this development, the IMF decided to incorporate the practice of conditionality explicitly into its Charter. The First Amendment to the Articles of Agreement on 28 July 1969 outlines the IMF's position with respect to conditionality.

5 *Polak, J. 1991. The changing nature of IMF conditionality.* Essays in International Finance, *No 184 (September). Princeton, New Jersey. International Finance Section, Department of Economics, Princeton University.*

Initially, IMF loan programmes were stabilisation programmes which attempted to solve temporary balance-of-payments problems by focusing on monetary, fiscal and exchange rate policies. IMF programmes later turned into structural adjustment programmes which address chronic balance-of-payments shortfalls and low production growth. In addition, though economic growth and poverty alleviation were not explicit goals of the IMF at its inception, both have evolved into central goals in many of the IMF's recent lending facilities.[5] Stand-by Arrangements continued to be the dominant loan vehicle until the international economy experienced major shocks throughout the 1970s, 1980s and 1990s.

These shocks were the oil price increases of the 1970s, the ensuing Third World debt crisis of the 1980s and the financial crises in Mexico, Russia and Asia in the 1990s. All these events gave rise to the emergence of new loan programmes with different purposes and, of course, the expansion of the scope of conditionality. These included the Extended Fund Facility (EFF) established in 1974, and the Structural Adjustment Facility (SAF) established in 1986 to provide balance-of-payments assistance on concessional terms to low-income developing countries. The terms of the SAF constitute conditionality. The Enhanced Structural Adjustment Facility (ESAF) replaced the SAF and was established in 1987 to provide resources to low-income members undertaking strong three-year macroeconomic and structural adjustment programmes. These facilities are known as extended arrangements. All facilities focused on quantified targets such as ceilings for bank credit extensions, the budget deficits, foreign borrowing, external debt arrears and international reserves. The ESAF was reorganised in 1999 into the Poverty Reduction Growth Facility (PRGF) with the objective to foster durable growth, in this way raising standards of living and reducing poverty. The facilities introduced during the 1980s and 1990s reflected the IMF's commitment to fashioning these lending windows so that they would address both macroeconomic and structural reforms.

In 1978 the Second Amendment of the Articles of Agreement came into effect. This amendment includes two important changes: firstly, the establishment of the right of members to adopt exchange rate arrangements of their choice and secondly, with specific regard to conditionality, the expansion of the IMF's surveillance responsibilities. For example, IMF Article IV Consultation Country Mission teams were charged with expanding their evaluations of a country's economic and development prospects by including greater attention to structural problems. This focus led the IMF to consider structural issues and include structural policy conditions in its programmes.

The key components of structural policy conditions in IMF-supported programmes are the instruments used in monitoring compliance with such programmes. There are four such instruments:

- Performance Criteria (PC). The primary purpose of the PC is to provide a direct link between programme implementation and the disbursement of IMF resources. When a recipient country meets a specified criterion on a set date, the IMF disburses the necessary funds. However, if this does not occur, funds are not disbursed unless the IMF issues a waiver. Waivers are issued only when significant exogenous factors obstruct the programme.

- Prior actions. These are the policy measures a member country agrees to take before an IMF agreement is put into effect.

- Structural benchmarks (SBMs). SBMs serve as indicators that facilitate the evaluation of the progress of policy implementation.

- Programme reviews. These are similar to SBMs in that they also assess the implementation of policies. The difference is that they focus specifically on those policies that do not comply with performance criteria.

Efforts by member countries to achieve satisfactory compliance with IMF programmes have inadvertently led to the IMF placing greater reliance on prior actions. Goldstein states that the result has been the proliferation of "... more wide-ranging and detailed structural policy conditions." [6]

Many of the less-developed member states, particularly those in sub-Saharan Africa, expressed strong concerns about the form and substance of conditionality. They argued that the IMF was overstepping its mandate and core area of expertise, using its financial leverage to promote an extensive policy agenda and short-circuiting national decision-making processes. A further concern was that IMF conditionality had evolved to become unduly pervasive and had consequently detracted from the implementation of desirable policies by undermining the recipient member country's ownership of programmes. These concerns were expressed internally in the IMF and externally, and have been incorporated into the Executive Board's ongoing discussions on conditionality. One of the IMF's responses has been to publish a *Staff Paper* which proposes two approaches to conditionality. At the core of these proposals are two central concepts: the streamlining of conditionality and programme ownership. These proposals are discussed in the following section.

Outcomes-based and floating tranche conditionality [7]

Outcomes-based conditionality

The first proposal is referred to as outcomes-based conditionality. As the name suggests, greater emphasis is placed on the required results or outcomes. The paper suggests that this approach would make the availability of IMF financing conditional on the achievement of specified outcomes, such as bank recapitalisation, improved tax enforcement and the liberalisation of foreign exchange markets. In this instance, less emphasis is placed on the *steps* toward outcomes. The main argument for this approach is that it would give the recipient country greater flexibility in choosing the appropriate method of achieving the agreed objectives and thus of enhancing ownership.

6 *Goldstein, M. 2000. IMF structural conditionality: how much is too much? Paper presented at the* NBER Conference on Economic and Financial Crisis in Emerging Market Economies. *Woodstock, Vermont: USA.*

7 *The modalities of conditionality – further considerations. IMF* Staff Paper. *2002. IMF, Washington, DC.*

8 *The modalities of conditionality – futher considerations. IMF* Staff Paper. *2002:8. IMF, Washington, DC.*

Examples of financial institutions which have initiated outcomes-based conditionality are the Asian Development Bank (ADB) and the Inter-American Development Bank (IADB). The former introduced the Programme Cluster Approach (PCA) in 1999. The latter approved a pilot project for Guarantee Disbursement Loans in 2000.[8]

Outcomes-based conditionality has two main benefits. Firstly, the member country would be responsible for the design of policies to achieve desired goals. Hence the country would bear the risk of success or failure. As the design of policies would be the country's responsibility, this approach would enhance ownership by ensuring that the authorities and the IMF would agree only on the objectives of the programme. Secondly, IMF funds would only be disbursed when certain goals had been attained, and incentives would be provided for both the IMF and the country to formulate appropriate policies.

This approach has several risks. Firstly, it has the potential to create uncertainty about the availability of IMF funds, since the agreed policies may not necessarily lead to the envisaged results. Secondly, there may be significant lags in the reporting of data on outcomes, particularly for the real sector and the trade accounts. The data may also be subject to frequent revisions, making timely monitoring and disbursements problematic. Finally, programme objectives are influenced not only by policies under the control of the recipient country, but also by exogenous factors which might lead to the destabilisation of programmes or the non-attainment of goals.

Floating tranche conditionality

Current IMF-supported programmes have specific deadlines. The majority of member countries believe that these rigid schedules have placed severe constraints on their choices, as well as straining their implementation capacity. In response to this concern, the *Staff Paper* suggests floating tranche conditionality as the second alternative proposal. The authors claim that programmes could be designed to allow for greater flexibility in the timing of the implementation of structural reform measures, thus increasing the scope for greater ownership. This may be achieved through the use of floating tranche conditionality for structural measures. Under this approach, the availability of a loan disbursement would not be tied directly to any specific date. Instead, the disbursement would become available upon the completion of certain agreed structural reforms.

9 *Operations Evaluation Department. 1999.* Higher Impact Adjustment Lending (HIAL): initial evaluation. *World Bank, Washington, DC.*

For this proposal, the IMF has taken into account a review of the experience with a form of floating tranche conditionality, namely the Higher Impact Adjustment Lending (HIAL), which the World Bank introduced in the Africa region in 1995. This approach had two objectives. Firstly, it afforded governments more freedom in the timing of agreed reforms, thus increasing ownership. Secondly, the approach sought to reduce pressure on the World Bank to disburse funds when conditions were not met. These objectives were to be achieved through the disbursement of multiple tranches. The further benefits of this approach are highlighted in a study[9] conducted by the Operations Evaluation Department of the World Bank in 1999. This study found that the HIAL initiative was associated with positive policy outcomes in terms of fiscal adjustment and interest rate policy. In addition the HIAL participants had a clear edge over non-participants in achieving lower inflation, improved current-account balances, stabilised foreign exchange reserves, faster economic growth rates and a sustainable debt path.

Programme ownership and streamlining conditionality

Ownership and conditionality

The IMF has acknowledged in principle that programme ownership should feature as a major component in conditionality. A major problem, though, is that the relationship between programme ownership and conditionality remains complex. This is largely because of the difficulty in reaching consensus on the definition of ownership. This observation is supported by the presence of various definitions of programme ownership offered in the literature on IMF conditionality.

The IMF defines ownership as "... a willing assumption of responsibility for an agreed program of policies, by officials in a borrowing country who have the responsibility to formulate and carry out those policies, based on an understanding that the program is achievable and is in the country's own interest." [10]

Boughton proposes that one way of addressing this lack of conceptual consensus would be to provide a clear distinction between programme ownership by a member country and the policies imposed by the IMF. Such an exercise, he points out, poses three important challenges, particularly if the IMF's definition is accepted. Firstly, ownership is not directly observable. As a result, any efforts to discern ownership are reduced to highly subjective observations. Secondly, ownership must be understood as a dynamic process involving "... dialogue, negotiation, and signalling" that could strengthen ownership over time. Thirdly, ownership may include several potential owners. Therefore ascertaining the degree of ownership remains a difficult task, for ownership cannot be allocated solely, for example, to the Central Bank, Ministry of Finance or other key ministries.[11]

10 *International Monetary Fund, 2001.* Strengthening country ownership of Fund-supported programs *(5 December).*

http://www.imf.org/external/np/pdr/cond/2001/eng/strength/120501.htm (accessed 15 May 2002).

11 *Boughton, J. and Mourmouras, A. 2002. Is policy ownership an operational concept?* IMF Working Paper. *April 2002. IMF, Washington, DC.*

Streamlining conditionality

The principle of simplifying, or streamlining, IMF conditionality has been accepted by the IMF, member countries and other interested observers. After a meeting on 29 April 2001, the IMF's International Monetary and Financial Committee (IMFC) endorsed the need to implement a new approach to conditionality by reducing the often numerous conditionality requirements on a member country. The committee's communiqué states that streamlining conditionality shifts "... the presumption of coverage from one of comprehensiveness to one of parsimony". Goldstein has long urged the IMF to re-examine the issue of streamlining conditionality.[12] Goldstein and other observers agree that IMF funds should not be disbursed without conditions. Rather, their concern has been about the sharp rise in the number of conditions attached to programmes. Goldstein suggests eight approaches that may be applied to the streamlining of conditionality:

- Structural preconditions;
- collaterised IMF lending;
- the definition of conditionality in terms of outcomes instead of structural policies or benchmarks;
- placing restrictions or penalties on foreign-currency borrowing;
- greater recourse to international standards;
- leaner structural conditionality within present arrangements;
- allowing the IMF to borrow in the private capital market; and
- establishing a clear division of responsibility with the World Bank and more outsourcing of structural conditionality in non-core areas.[13]

12 *Goldstein, M. 2000. IMF structural conditionality: how much is too much? Paper presented at the* NBER Conference on Economic and Financial Crisis in Emerging Market Economies. *Woodstock, Vermont, USA.*

13 *For an elaboration of the eight approaches see Goldstein 2000, p. 20-23.*

Unresolved issues

On 17 April 2002, in the Managing Director's report to the IMFC, the IMF announced its commitment to addressing the issues of streamlining conditionality and enhancing ownership. With respect to the proposed approaches, namely outcomes-based conditionality and floating tranche conditionality, the Executive Directors were more inclined to shift towards outcomes-based conditionality. However, the Executive Directors cautioned that the scope of floating tranche conditionality "... was likely to be limited because most policy conditions in Fund-supported programs must be implemented in a timely manner to be effective".[14]

14 Managing Director's Report to the International Monetary and Financial Committee. *17 April 2002. IMF. Washington, DC.*

The IMF's decision to revisit the issue of conditionality has been applauded in most academic and non-governmental circles. Conditionality, irrespective of any proposed changes, will remain a dominant feature in future IMF lending programmes. Though the re-evaluation of streamlining conditionality and programme ownership is clearly an important starting point in this discussion, a great deal still has to be accomplished. Questions will continue to arise about both issues, particularly regarding the measurement of conditionality and a consensual conceptualisation of programme ownership. For instance, what instruments or methods are available to determine whether conditionality is in fact an obstacle to programme objectives? Or what is the appropriate degree of conditionality? Ownership, as stated earlier, poses various problems of its own.

In the ongoing discussions on conditionality there is consequential oversight, namely the role of external financiers in IMF-supported programmes. Little is mentioned in the IMF's reports or publications about the considerable influence these financiers may have in determining the adoption and implementation of any changes in the substance and form of conditionality.

External financiers include creditor states, multilateral organisations and private financial institutions. The IMF provides only a fraction of the necessary funds to support its lending programmes and depends on external financiers to supplement these programmes. The relationship between external financiers and the IMF is aptly summarised by Polak: "... a key component of any Fund arrangement was that the resources provided by the Fund together with those from the World Bank, aid donors, commercial banks, and other sources, would cover the country's projected balance-of-payments gap. In the absence of an integral financing package, the Fund could not be confident that the degree of adjustment negotiated with the country would be sufficient. To this end the Fund sought financing assurances from other suppliers of financial assistance. In the second half of the 1980s, however, commercial banks began to exploit this approach. No longer afraid of becoming victims of generalized debt crisis, the banks began to realize that they could insist on favourable terms for themselves by blocking a country's access to Fund credit (and to other credit linked to a Fund arrangement)."[15]

15 *Polak, J in Gould, E. 2001. Money talks: the role of external financiers in influencing International Monetary Fund conditionality. Paper presented at the 2001* Annual Meeting of the American Political Science Association, *San Francisco, 30 August – 2 September 2001, p. 29.*

Gould elaborates on this relationship by quoting a former IMF Executive Director who referred to the expansion of IMF conditionality as "mission push". In other words, external financiers have "pushed" the expansion of IMF conditionality.[16] She states that the IMF gauges the success or failure of its programmes by the volume of funds received from external financiers. Furthermore, to ensure access to supplementary funding, the IMF adopts revisions to policy programmes which in effect detract from its intended objectives.[17]

16 *Polak, J in Gould, E. 2001. Money talks: the role of external financiers in influencing International Monetary Fund conditionality. Paper presented at the 2001* Annual Meeting of the American Political Science Association, *San Francisco, 30 August – 2 September 2001, p. 29.*

17 *Moe, T. 1984. The New Economics of organization.* American Journal of Political Science, *28: 739-777.*

A further complication is the variety of external financiers, all with different interests, who provide financing and in this way make demands on the IMF to include individual specific terms in their IMF conditionality arrangements. Gould points out that "... creditor states finance for political ends" whereas "... private financial institutions finance for profit ..." and "... multilateral organisations finance for policy ends".[18]

18 *Gould, E. Money Talks: The role of external financiers in influencing International Monetary Fund conditionality. Paper presented at the 2001* Annual Meeting of the American Political Science Association, *San Francisco, 30 August – 2 September 2001, p. 32.*

Given the above description of the relationship between the IMF and external financiers, it seems prudent to encourage greater participation by these financiers in discussions on conditionality.

South Africa's position

South Africa is not engaged in any of the IMF's lending facilities. The country's position on the issue of conditionality is intimated through contributions to discussions and debates on the restructuring of the IMF and the International Financial Architecture (IFA). During these deliberations, key South African spokespersons have strongly advocated the need for structural changes within the IMF, changes which would promote the interests of what are called the less-developed countries. South Africa therefore clearly supports the position of reviewing the IMF's policies on conditionality.