

# Fund Conditionality—A Provisional Update

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## Introduction

The Fund's financial assistance supports the adoption and implementation of appropriate policies. These policies need to be adequate to cope with the country's balance of payments problem in a manner that is consistent with the purposes of the Fund (in particular, in the language of the Articles of Agreement, avoiding "measures destructive of national or international prosperity") and that will enable the country to repay the Fund within the designated maturity term (the Articles state that the Fund's resources are made "temporarily available...under adequate safeguards").

Significant unease with the Fund's recent practice of conditionality came to the fore in the late 1990s. Conditionality was, in principle, still ruled by Conditionality Guidelines adopted in 1979, but in some areas—in particular, as regards structural conditionality—practice had diverged significantly from these guidelines. While structural measures were rarely an element in Fund-supported programs until the 1980s, by the 1990s almost all programs included some element of structural conditionality. The expansion of structural conditionality was reflected in increasing numbers of performance criteria, structural benchmarks, and prior actions. These changes were the result of several forces. First, the Fund had, over time, placed increasing emphasis on economic growth as a policy objective, recognizing that demand management may be able to solve an external problem, but does so at high cost and often in an unsustainable way. Second, the Fund became increasingly involved with different groups of countries in which structural reforms were viewed as a central part of the overall policy package (low-income and transition countries). In particular, the design of the Enhanced Structural Adjustment Facility explicitly mandated at least some structural conditionality. Over time, however, the Fund was seen, in some cases, as overstepping its mandate and core areas of expertise, using its financial leverage to promote an extensive policy agenda, and thus short-circuiting national decision-making processes and overtaxing countries' implementation capacity.

A process of reflection on these issues began in 2000 and culminated in the adoption of new Guidelines on Conditionality in September 2002.<sup>1</sup> In parallel, the new facility for low-income countries (the Poverty Reduction and Growth Facility, PRGF), established in 1999, shared some of the objectives of the new guidelines.<sup>2</sup>

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<sup>1</sup> Available on the IMF website at <http://www.imf.org/External/np/pdr/cond/2002/eng/guid/092302.htm>.

<sup>2</sup> See, in particular, "Key Features of IMF Poverty Reduction and Growth Facility (PRGF) Supported Programs," available on the IMF website at <http://www.imf.org/external/np/prgf/2000/eng/key.htm>.

The Fund is in the process of conducting its first review of the new guidelines, which is expected to be completed later this year. It is too early to tell whether programs' record of achieving their ultimate objectives has improved, especially to the extent that these objectives encompass not only immediate outcomes but also issues of medium-term sustainability and growth. However, it should be possible to draw some preliminary conclusions as to whether the practice of conditionality has indeed changed, and, if it has, whether these changes have been accompanied, as had been hoped, by improvements in program implementation. Pending this first review of the guidelines, the evidence available on their implementation and impact is limited.

### **The new guidelines**

The new guidelines emphasize five interrelated principles as key to program effectiveness and implementation, which, in turn, are key to safeguarding Fund resources: national *ownership* of programs, *parsimony* in the application of conditionality, *tailoring* of programs to countries' circumstances, effective *coordination* with other multilateral institutions, and *clarity* in the specification of conditions. These principles interact in numerous ways. Tailoring programs and coordinating with other institutions both contribute to more appropriate program design. Emphasis on national ownership—the member's primary responsibility for designing and implementing policies—should lead to both better tailoring, through greater use of local knowledge, and stronger implementation. Parsimony supports ownership and implementation by creating explicit room for the member to formulate and adapt policies; together with clarity, it also helps the authorities focus on agreed priorities during program implementation. Parsimony and coordination also ensure that the Fund does not exceed its mandate. Finally, clarity of conditions gives the member confidence in the availability of drawings—a crucial condition if the country is to avoid adjustment measures destructive of prosperity, and thus a basic principle of Fund arrangements.

To achieve these objectives, the guidelines emphasize the need to *define program goals clearly*, to ensure the *appropriate breadth of coverage* of conditionality, to apply conditionality at the *right level of detail* and to make judicious use of the different tools of conditionality, and—an overarching goal—to make sure that *the member is ultimately responsible* for the selection, design, and implementation of its economic and financial policies.

#### *Ownership*

Ownership is an essential ingredient for effective policy change. Many of the stipulations in the new guidelines regarding the way conditionality is to be applied are intended to ensure that conditionality supports ownership. In addition, the guidelines provide guidance as to how the Fund should relate to members in the process of designing programs. The implicit model is one in which, beyond the standard that members' policies must meet in order to qualify for Fund support, there is a "policy space" in which members' choices would not affect the Fund's willingness to support the program.

Of course, it is difficult to determine whether the Fund is succeeding in giving members appropriate “policy space.” However, the results of a survey recently conducted in the framework of a review of IMF-World Bank collaboration are fairly encouraging.<sup>3</sup> Three quarters of countries considered that they “largely” or “fully” owned the program supported by the Fund, with a third of countries reporting “full” ownership; and two thirds of countries reported that the Fund was “rather” or “very” flexible in taking the authorities’ views into account during program design, with none considering the Fund “very inflexible.”

### *Program goals*

In terms of goals, the new guidelines—much like the old ones—specify that “Fund-supported programs should be directed primarily toward (a) solving the member’s balance of payments problem without recourse to measures destructive of national or international prosperity; and (b) achieving medium-term external viability while fostering sustainable economic growth.” These are also among the goals of the PRGF, although they are supplemented by “fostering durable growth, leading to higher living standards and a reduction in poverty.”

With the new guidelines’ emphasis on ownership and parsimony, clear specification of program goals has become still more important than it was previously. A necessary corollary of encouraging country ownership is selectivity in determining which programs meet the criteria for Fund financial support, and clear specification of program goals is crucial in this regard. Clear and circumscribed goals are also essential if measures critical to achieving the program’s objectives are to be identified with confidence. The upcoming review of the guidelines will consider whether Fund-supported programs are, indeed, sufficiently clear in their identification of goals.

### *Breadth of coverage of conditionality*

Parsimony in the breadth of coverage of conditionality is a clear requirement of the new guidelines. Conditions must be either of critical importance for achieving the goals of the member’s program or necessary for the implementation of specific provisions of the Fund’s Articles of Agreement. Reflecting the need to safeguard Fund resources, all measures that meet this test are expected to be subject to conditionality; otherwise, it would be possible for the program to veer seriously off track without an interruption of drawings. The criticality test pertains regardless of whether a measure is within or outside the Fund’s core areas of responsibility. However, because critical measures for the Fund-supported program are likely to be within the Fund’s core areas, conditions will typically be within the Fund’s core areas of responsibility. Conditions outside these areas may need more detailed explanation of their critical importance.

Consistent with these expectations, there is some evidence that conditions in programs supported by arrangements in the General Resources Account (GRA) have become more

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<sup>3</sup> “Strengthening IMF-World Bank Collaboration on Country Programs and Conditionality—Progress Report,” available on the IMF website at <http://www.imf.org/external/np/pdr/cond/2004/eng/022404.htm>.

heavily focused on fiscal and financial policies.<sup>4</sup> This is especially true for countries that have experienced serious financial crises, with most of the conditions set to reduce vulnerabilities in the financial sector. Although financial conditions generally account for about one-quarter of all conditions in stand-by programs, this ratio is over 50 percent for emerging market economies in crisis. Measures range from implementing new accounting systems in line with international accounting standards to privatizing state banks.

In contrast to conditions in GRA-supported programs, conditions in PRGF-supported programs are more heavily weighted toward the fiscal sector, with a number of conditions emphasizing the need for improved allocation of expenditures to address poverty concerns. This is consistent not only with the objectives of the PRGF but also with the requirement for Heavily Indebted Poor Countries (HIPCs) reaching their decision and completion points to monitor the spending of additional resources flowing from debt relief on poverty-related needs.

Determining which actions are critical to the success of a program remains a key challenge. Some would argue that the Fund remains too heavily engaged in areas that are not macro-critical. In certain areas, macro-criticality is relatively easy to establish—for instance, where the fiscal position is significantly affected (e.g., utility price adjustments, pension reform, and new systems for taxing petroleum products) or where there is a direct and significant impact on the growth potential of the economy,(e.g., efficiency gains in public companies, privatization, and trade policy changes). At the same time, it is also still possible to point to conditions that appear to be far removed from macro-criticality.

Conversely, in some individual cases, streamlining of the areas covered by conditionality may have gone too far. IMF Executive Directors have sometimes argued that areas critical to the success of the program were not subject to conditionality (e.g., structural fiscal measures in revenue administration or public procurement). Ex post assessments have also sometimes pointed to areas that were identified only in hindsight as critical to program goals.<sup>5</sup>

#### *Level of detail of conditionality and conditionality toolkit*

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<sup>4</sup> Lessons from the Real-Time Assessments of Structural Conditionality, available on the IMF website at <http://www.imf.org/external/np/pdr/cond/2002/eng/assess/032002.htm>. This analysis was based on arrangements approved between September 2000 (when “streamlining” efforts began as part of the process that would lead to the adoption of the new guidelines) and November 2001.

<sup>5</sup> Ex post assessments are conducted for countries that have had a longer term program engagement with the Fund, and were initiated in response to the findings of the Fund’s Independent Evaluation Office that, in some cases, prolonged use of Fund resources reflects failures in the design and implementation of programs and/or hinders the development of domestic institutions. Ex post assessments have been done for about 15 countries so far.

The new guidelines also encourage fewer and less detailed individual conditions: within a given area, conditions are to be applied parsimoniously, and all conditions must be of critical importance to the program's objectives. At the same time, conditions must be clear, so as to permit the country to know in advance what it must do in order to qualify for Fund financial support, and to encourage a focus on the critical actions. There is inevitably some tension between these objectives. Parsimony and ownership argue for allowing for different measures to achieve the same objectives, while the need for clarity suggests that measures should be specified precisely.

Different tools are available to specify conditionality in a given area, and the guidelines specify how each of these is to be used, in an attempt to achieve the right balance. The tools consist of performance criteria (PCs), structural benchmarks, program reviews, and prior actions.<sup>6</sup>

The guidelines specify that in addition to being objectively monitorable, PCs must be by themselves "so critical [...] that purchases or disbursements under the arrangement should be interrupted in cases of nonobservance." Structural benchmarks, too, must be of critical importance. They are appropriate when monitoring the implementation of a measure requires judgment or when the measure's "non-implementation would not, by itself, warrant an interruption of purchases or disbursements under the arrangement." The latter is consistent with the requirement of critical importance because, as explained in the operational guidance on the guidelines, benchmarks may be used for "key components of a broader reform measure that is judged to be critical (e.g., steps in a tax reform or privatization program)," even if the individual measure subject to a benchmark represents but a relatively small step. Program reviews can be used to monitor overall progress in a given area, and thereby give the country more flexibility in how it achieves this progress, but at the cost of a loss of clarity as to what the Fund will or will not consider to be an adequate basis for drawings.

Although there are clear pitfalls in merely comparing numbers of conditions, it is interesting to consider whether streamlining has been reflected at this most basic level. Preliminary indications from the first phase of the "streamlining" initiative (2000-2001) were that the number of structural conditions had not declined among GRA recipients, although focused structural benchmarks were replacing individual performance criteria, thereby providing the authorities more leeway in achieving a specific objective, in line with the new guidelines.<sup>7</sup> In PRGF countries, preliminary evidence suggested that the number of conditions had declined. For both GRA and PRGF, information on the total number of conditions and its distribution between PCs, benchmarks, and prior actions will be updated for the forthcoming review.

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<sup>6</sup> Indicative targets are another tool of conditionality, but are used mainly in the area of quantitative macroeconomic conditionality.

<sup>7</sup> "Lessons from the Real-Time Assessments of Structural Conditionality," previously cited.

The guidelines also encourage use of outcomes-based conditionality and floating tranches, either of which would allow the authorities greater choice in the exact specification and sequencing of reforms, taking account of potential implementation difficulties. Although floating tranches are used in the HIPC Initiative, there has been little experimentation with these instruments in Fund arrangements. The forthcoming review will examine why, including whether the use of floating-completion-point triggers under the HIPC initiative holds lessons for floating tranches more generally.

The guidelines also specify that prior actions are to be used sparingly, specifically “when it is critical for the successful implementation of the program that such actions be taken to underpin the upfront implementation of important measures.” The operational guidance makes clear that “prior actions are to be applied parsimoniously” and states that “staff should be guided by the experience that implementing prior actions has not been shown to increase the likelihood that other subsequent measures under the program will be successfully implemented.”

It is not clear at this stage whether the use of prior actions has, indeed, diminished. Some have argued that prior actions remain useful in allowing countries with weak track records to demonstrate ownership, or in screening out programs with weak ownership. The forthcoming review will examine evidence in support of this argument.

One area where progress has been made is in specifying more clearly the areas on which program reviews will focus. The impression of mushrooming conditionality during the 1990s was driven, in part, by the inclusion of wide-ranging and detailed policy agendas in letters of intent, often with no indication of the more limited set of measures to which Fund financial support was tied. The new guidelines specify that letters of intent should clearly distinguish between the conditions on which Fund support depends and other elements of the authorities’ policy program, and that detailed policy matrices covering the broader agenda should be avoided unless the authorities consider them necessary to express their policy intentions.

## **Conclusion**

The Fund’s review of conditionality over the past few years has recognized that there are several interrelated principles for successful design and implementation of Fund-supported programs. These include national ownership of reforms, parsimony and tailoring in the choice and application of conditions, and effective coordination with other multilateral institutions. Early streamlining efforts suggest that some things have changed, but there likely remains room for improvement in the implementation of the new guidelines; and it is also possible that the forthcoming review of the initial experience will reveal areas of fundamental tension, where the initial expectations of what could be achieved through streamlining may have been overoptimistic. Only time will tell whether macroeconomic benefits have also been achieved.