

AN ANALYSIS OF IMF CONDITIONALITY

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**Paper prepared for the
XVI Technical Group Meeting of the
Intergovernmental Group of 24
Port of Spain, Trinidad and Tobago
February 13-14, 2003.**

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(Draft)

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

Introduction

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

Following the sharp rise in conditionality observed in the 1990s, criticisms of Fund conditionality have also tended to center on its loss of focus, on imposing an excessive number of structural conditions and trying to do too many things at the same time, of expanding Fund influence beyond its area of competence. The Meltzer Report (2000, p7, 8, 43) states "detailed conditionality (often including dozens of conditions) has burdened IMF programs in recent years and made such programs unwieldy, highly conflictive, time consuming to negotiate, and often ineffectual."

Similarly, The Council of Foreign Relations Task Force Report (1999, p.20) 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."

Martin Feldstein (Foreign Affairs, vol.77, No3, 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 programs but develops a program 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.

This paper will review the origins and purpose of conditionality, its nature and evolution over time and consider whether conditionality is required to safeguard Fund resources. It will look into the reasons for increased conditionality during the 1980s and 1990s review the recent IMF debate on conditionality and the proposed changes in Fund practices. It will distinguish 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 will discuss 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. However, a number of issues related to conditionality that merit careful consideration, are listed below but not addressed in this paper.

Some Unresolved Questions on Conditionality

Apart from the numerous economic policy issues to which conditionality gives rise, there are a number of important political and philosophical questions that have yet to be addressed fully and openly by the Fund (and other IFIs) such as:

- 1) Can program 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? Can governments be held domestically accountable and responsible for the effects of policies imposed from outside? Who are governments accountable to, their electorate or some external institution in which they are under-represented? (See Buira, A. 2001).
- 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) Since the political viability of an adjustment program is related to the depth of a crisis, 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?

- 7) Governments and IFIs are prepared to intervene in the affairs of third countries, but are they prepared to take political responsibility for the policies or measures they sponsor?
- 8) Since the majority of programs are not completed successfully, what if any, are the consequences for the staff and for the Fund of imposing programs that fail more often than not? (See 3 above)
- 9) Should liberalization of the markets take place before liberalization of the state?

The Nature and Purposes of Conditionality

Conditionality may be defined as a means by which a party offers support and attempts to influence the policies of another in order to secure compliance with a program of measures; a tool by which a country is made to adopt specific policies or to undertake certain reforms that it would not have undertaken, in exchange for support.

In the context of the IMF, conditionality refers to the policies a member is expected to follow in order to secure access to the resources of the Fund, i.e. to the conditions that have to be met for gaining access to the financial resources of the Fund. These policies are intended to help ensure that the member country will overcome its external payments problem and thus be in a position to repay the Fund in a timely manner.¹

Therefore, the rationale of conditionality is to restore a viable external position as a means to ensure the “revolving character” of Fund resources; i.e., that the resources made available to a member by the Fund will be repaid over a stipulated period of time, normally three to five years. The assurance is said 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 enable the member to repay the Fund, thereby ensuring that the said 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

¹ See Appendix I on The Origins of Conditionality

to 125 per cent of quota, referred to as 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 member's 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 available to it and the better the quality of its economic team, the less likely it is that it will have to accept conditions it does not like. 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, say public works, transportation, health, education, industry, as well as defense on the one hand and the financial authorities charged with the macroeconomic and financial management of the economy on the other, 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, related to economic policy matters, but may also reflect different political interests and views. The intervention of outside forces, such as the IFIs offering financial incentives in exchange for the adoption of certain policies may tip the balance in favor of the "financial" view. The above 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 program ownership; i.e., who owns the program? 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 program 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 favor 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, (say Korea, China or Mexico) will be in a strong negotiating position vis-à-vis the Fund; thus it will 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. However, too often, 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, Paul and Toyoo Gyoten, 1992"Changing Fortunes", New York, Times Books)

Thus, the answer to whether conditionality may be considered to be 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 (See Collingwood). 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, i.e., consider the situation of Argentina in the period February-September 2002.

Conditionality can be said to be coercive when the cost of not accepting the conditionality is so much higher that, it has no choice but to accept conditions making the country do things it would not do otherwise, particularly as countries have a strong preference for avoiding the costs of default.

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

The Fund, however, has no particular expertise in the fields of poverty reduction or developmental strategy, fields that are the Bank's primary responsibility. However, the Fund has been unwilling to remove itself from these fields, perhaps to show it has a social conscience. The Fund should probably withdraw from this field and stick to its original simplified mandate, giving advice and technical help in its own areas of competence.

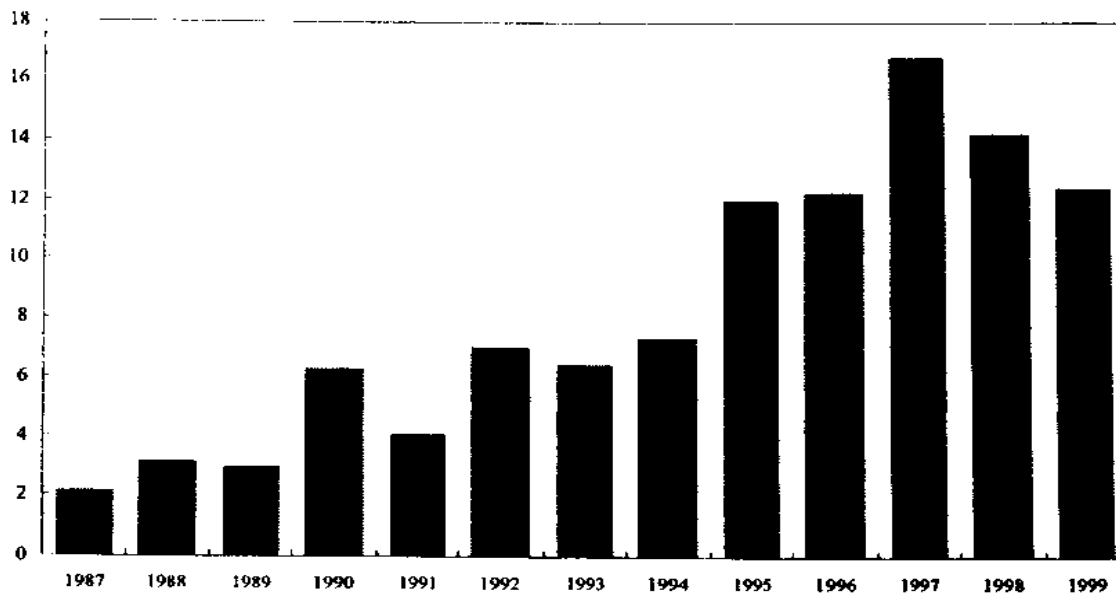
At its worst, conditionality implies the imposition on a country of an alien policy agenda that contain elements that are not necessary to overcoming the payments crisis and that may have been suggested by a third party, but may not be in the country's best interest. At its best, well focused, limited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

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 to which it has been subject over the last twenty years.

The Fund and Bank have modified their lending policies over time, in step with changing international economic conditions and the 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 ten in the 1980s (See Figures 1 and 2). In the Bank's case the average number of conditions rose from thirty two in 1980-3 to fifty six by the decade's end." (Kapur and Webb, 2000 pp3-4) The number of conditions continued to rise during the 1990s, with the increase centered in structural conditionality.

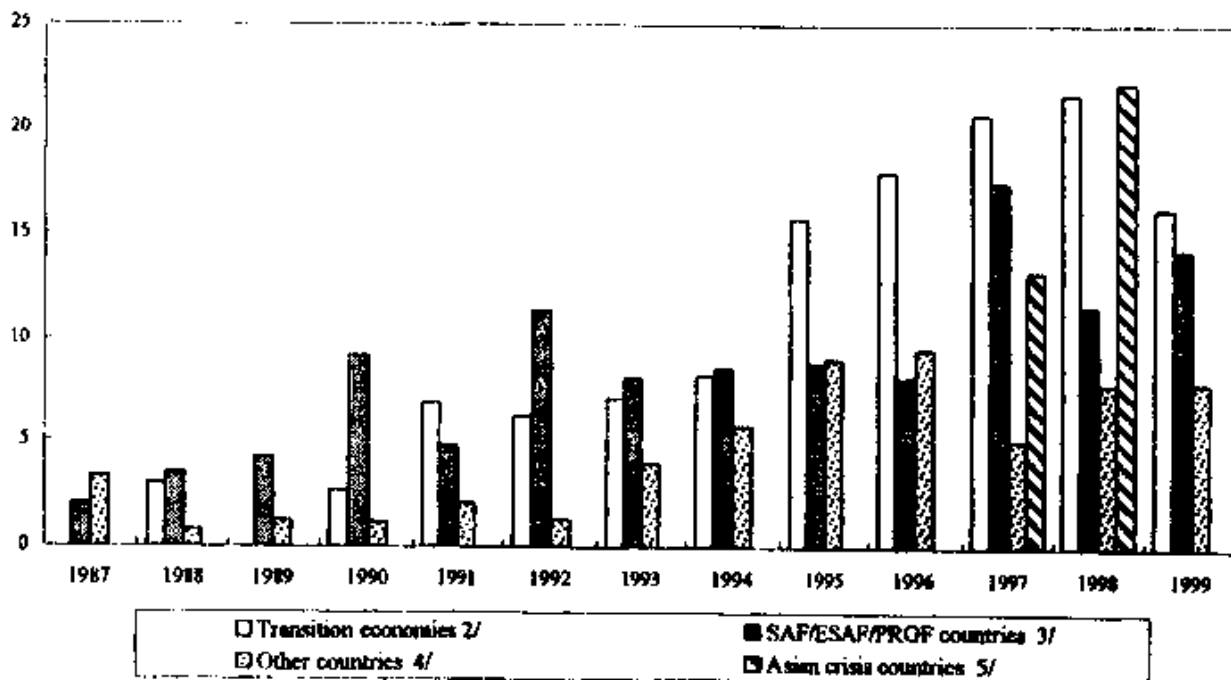
Figure 1. Average Number of Structural Conditions per Program Year ^{1/}



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

^{1/} Total number of structural performance criteria, benchmarks, prior actions, and conditions for completion of review in stand-by, EFF, and SAF/ESAF/PRGF-supported programs, adjusted for differences of program length.

Figure 2 Average Number of Structural Conditions per Program Year by Type of Country 1/



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

1/ Total number of performance criteria, prior actions, conditions for completion of review, and structural benchmarks per program, adjusted for differences in program length.

2/ As defined in the World Economic Outlook, covering former centrally planned economies in Eastern Europe, FSU countries, and Mongolia.

3/ Countries with SAF/ESAP/PRGF-supported arrangements, excluding transition economies.

4/ Residual group, encompassing programs in countries that do not fall into any of the other categories.

5/ Indonesia, Korea, and Thailand.

The number of structural policy commitments (prior actions, structural benchmarks, conditions for program reviews and performance criteria) in Fund programs peaked during the Asian crisis.² At their highest, the programs with Korea included 94 structural conditions; with Thailand, 73, and with Indonesia, 140 structural policy undertakings! In addition to these there were of course, a number of other, traditional quantitative performance criteria to be met: fiscal, monetary and on the exchange system.

As well as 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 and Webb pointed out “multiplying the number of reforms per loan appeared to increase the reform mileage ...that could be gotten from limited policy loan money” (1997, page 552).

However, the result of the proliferation of conditions left a lot to be desired:

Firstly, there was a loss of transparency and increased uncertainty as to program 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?

Secondly, as a general rule, the greater the number of conditions in a program the less likely it was that the authorities felt a strong commitment to and ownership of the program, a fact that diminished the chances of successful program completion.

Thirdly, the high and increasing proportion of program failures gave rise to questions as to the point of having ever more comprehensive and ambitious programs that were not complied with.

The analysis of program compliance since the seventies suggests there is an inverse relation between the number of performance criteria and program

² Kapur 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.” See D. Kapur, “Processes of Change in International Organization” paper prepared for UN/WIDER n.d.

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 programs, centered on certain key issues, those critical to economic performance and the achievement of the program 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 at improving the governance in member countries in particular through increased transparency, greater accountability and the reduction of corruption. To this effect, 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 ones. 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 of a developing country in the midst of a crisis. To say that conditionality had gone too far appears as simply as a matter of common sense; moreover, the program results (Table 2) soon confirmed that this approach had become dysfunctional.

Does Conditionality safeguard Fund resources?

Conditionality was introduced and is justified as a means to ensure the “revolving character” of Fund resources.³ Conditionality necessarily signifies a lack of trust in the country’s own judgment by those who “know best”, consequently, the use made of the resources provided by external sources such as the IFIs, is to be monitored to ensure that these are not wasted. On occasions, it would appear that the purpose of conditionality is to tie the hands of governments of recipient countries, particularly in cases of political transition such as Brazil and Turkey, through strict conditions and careful supervision, to ensure that the resources received are used as intended, so that they will be repaid on schedule. Some of the proponents of conditionality would argue that the mere fact that the country is in balance of payments difficulties shows that it is unable to manage its own affairs without getting into trouble.

However, considering 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 program 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

³ See Appendix I On the Origins of Conditionality

all, conditionality ends when the program which it underpins ends, while repayments fall due at a later time, 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.

There can be no question that the resources of the Fund should be preserved to 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 purposes of the Fund as contained in the Articles of Agreement. Recall 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” (See Article I section (ii)). In fact, while the Articles do not provide any indication as to the speed and nature of the adjustment to be followed, by establishing the above as Fund objectives and the further statement of purpose 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 with Fund programs, often perceive these to be unduly restrictive, as the “preservation of the revolving character” seems to take first priority. This is compounded by the limited Fund financing in support of the adjustment program and optimistic nature of the assumptions frequently made by the staff regarding the availability of external financing. However, constructing the program around an unduly optimistic assumption on the amount of external financing available to the country, and a limited amount of financing to be made available by the Fund, may put at risk the viability of the program and may be contrary to the purposes of the institution, which refer explicitly to the maintenance of high levels of employment and to providing members with opportunity to correct maladjustments in their balance of payments without resorting to deflationary adjustment.

One may wonder whether this apparent “creditor bias” in program design gives rise to the restrictive, short-term nature of the Fund supported programs, 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 program?

The argument that conditionality is essential to secure repayment and thus “preserve the revolving character of Fund resources” is weakened further by the high failure rate of Fund programs. As shown in Table 2, less than half of the

Fund supported programs are successful in the sense of full implementation of the program. Indeed a recent Fund study by Mussa and Savastano found that if you consider the disbursement of 75 per cent or more of the total loan as the test measure of compliance with Fund policy conditionality, less than half (45.5 per cent) of all Fund supported programs over the period 1973-97 would meet the test. (See Mussa M. and Savastano M. "The IMF Approach to Stabilization" IMF Working Paper 104, Sept.13, 2000). Furthermore, with the increase in structural conditionality observed in the 1990s the rate of compliance declined markedly after 1988 and dramatically in 1993-97 when only 27.6 per cent of 141 arrangements could be considered in compliance.

When the rate of compliance of programs falls below half, and all the more when it falls to less than a third, it can be argued that the whole rationale and the relevance of conditionality have become questionable. Note that despite the very low rates of program success or compliance members have continued to repay the loans received from the Fund; this should be taken as evidence that the traditional argument underpinning conditionality is of dubious validity. (See TABLE 2-The Declining Rates of Compliance with Fund Programs).

Table 2. The Declining Rates of Compliance with Fund Programs

Percentage of IMF Loan Actually Disbursed under Each Arrangement, distribution "by quartiles

	(1) x<0.25	(2) 0.25=<x<0.50	(3) 0.50=<x<0.75	(4) 0.75=<x<1.0	(5) Fully Disbursed (x=1.0)	(6) (4)+(5) 0.75=<x	(7) Number of
All Arrangements							
Arrangements							
1973-77	36.5	7.1	5.9	5.9	44.7	50.6	85
1978-82	19.4	16.1	10.5	12.9	41.1	54.0	124
1983-87	12.9	15.8	19.4	7.9	43.9	51.8	139
1988-92	17.5	15.1	20.6	14.3	32.5	46.8	126
1993-97	27.0	19.1	26.2	11.3	16.3	27.6	141
Full period (1973-97)	21.6	15.3	17.6	10.7	34.8	45.5	615
<i>of which</i>							
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)

The New Guidelines on Conditionality

As approved by the Executive Board in September 20, 2002, the new guidelines are a very commendable effort aimed at improving the effectiveness of conditionality, essentially by recognizing the central importance of:

- 1) national ownership of programs, implying the need for involvement of the member in the formulation of the program 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 program,
- 3) tailoring the program 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 are the essential aspects of the program that must be complied with, and what are the additional measures contemplated whose non-observance does not constitute a breach of the agreement that will impair the country's ability to draw Fund resources.

However, in substance, 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 at the time, recall that guideline 4 stipulated that: "In helping members to devise adjustment programs, 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, recall that the 1979 Guidelines on Conditionality underscored the need to limit performance criteria to the minimum required to assure policy implementation. Guideline 9 stated: "Performance criteria will be limited to those that are necessary to evaluate implementation of the program 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 program because of their macroeconomic impact". The current Managing Director of the Fund has clearly seen the wisdom of these principles and the need to review and streamline conditionality, particularly structural conditionality. In the light of the sharp fall in program compliance, (Table 2) his decision must be seen as very timely.

Why were the guidelines revised? In practice, the 1979 guidelines had been increasingly ignored by the staff in response to external pressures and to the views of some high Fund officials that felt 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 in the belief that these reforms would be of benefit to the country.

The approval of the new guidelines constitutes 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 an over-burdening of programs with conditions, which led to a high rate of program failures. Thus, to the extent that conditionality had become dysfunctional, it had to be revised.

By proposing the new guidelines, Management displays a renewed concern with promoting program ownership as a key to success and seeks to give a new orientation to program design. The new approach would establish the presumption of parsimony and restrict the number of conditions or performance criteria contained in a program 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, an attempt to establish a new attitude among the staff with a view to attaining a higher rate of program 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." (Quote taken from "Conditionality in Fund-Supported Programs-Overview" SM/01/60 page 15.)

As stated in the new guidelines, Fund supported programs 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 fostering sustainable economic growth.

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

Take for instance, the stand-by arrangement with Turkey of January 2002. The two-year program contains five performance criteria for 2002 and indicative targets for 2003 and 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 include 18 prior actions, some 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 program. Moreover, if all these conditions are not met, will the Fund suspend financial support? A program with 42 conditions (5 performance criteria and 37 structural conditions) cannot give the impression of parsimony and of keeping to the macroeconomic critical issues, but rather of wide ranging micromanagement and lack of focus.

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

Let us assume, for the time being, that the new Guidelines on Conditionality will be faithfully applied. Note however, that a major structural problem remains, that the Fund has not yet addressed. This relates to the mix between adjustment and financing.

Adjustment and Financing: The Shift in the Balance

The availability of resources is a major determinant of the nature and speed of the adjustment process undertaken by a country. At the extreme, 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, i.e., the US, as a reserve currency country has this advantage as long as holding dollars as reserve assets remains attractive. Moreover, it may choose among different adjustment paths available, the one that is more palatable and less costly in economic and political terms. On the other hand, 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 programs that enter into conflict with the goal of maintaining high levels of activity and be compelled to sacrifice some of its longer term development goals. Thus, there is often a "trade-off" between adjustment and financing of imbalances. The role of the Fund would be to seek a "golden rule", a mix of adjustment and financing that fosters the necessary adjustment while avoiding the severe recessionary and destructive aspects of under financed programs. (In some cases, the Fund may be constrained by previous unpaid borrowing) Since well-financed programs would be much more attractive than more severe ones, they would encourage the early correction of imbalances.

Since the harshness of a program and consequently, its viability are largely dependent on the amount of financing available, the reduction in the resources of the Fund introduces a bias for the adoption of increased conditionality and more severe, shorter term adjustments. The decline observed in total Fund resources over time, measured as a proportion of international trade or of GDP, would appear to have required and been associated with stiffer, more demanding conditionality.

From time to time references are made to the “catalytic role of the Fund” as a means of justifying its limited financing to members. Since there is no reference in the Articles to a “catalytic role”, this is a strange argument for the Fund to make. 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 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. (See Bird and Rowlands 1997)

Unfortunately, as is often the case, when the conclusion of negotiations of a Fund program does not bring forth market financing in sufficient amounts, the program 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. page 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. page 988) However, while it must be admitted that often other IFIs condition their financial support to countries having an agreement with the Fund, a policy that gives rise to what is referred to as “cross conditionality” and greatly strengthens the Fund negotiating position, this is not the usual meaning of the “catalytic effect”.

At times, some observers, particularly in creditor countries, take the view that the hardships of adjustment that result from poor policies are in some sense deserved. It may be appropriate to note that the Articles do not envisage a morality play in 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 to 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.

Table 1-The Size of the Fund as a Proportion of International Trade and GDP

<u>Year</u>	<u>1944</u>	<u>1965</u>	<u>1970</u>	<u>1990</u>	<u>1998</u>
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

Based on IFS Data

Could the decline in Fund resources be related to the observed hardening of conditionality? Or more to the point, can an undue hardening of conditionality be avoided in view of the relative decline in Fund resources? The declining trend of Fund resources suggests that these were probably insufficient to allow it to provide adequate support to member countries without a hardening of the conditionality under which it makes its resources available. This leads to the question: Should adjustment programs 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 increase in line with needs, in view of the expansion of international trade and the volatility of capital movements?

If the answer to the previous question is in the affirmative, one should enquire: Why have quota increases not kept pace with these trends? Recall that the majority of Fund member countries usually favour quota increases, however these increases call for an 85 percent 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?

Finding conditionality unacceptable, since the late 70s no industrial country has resorted to Fund support. The last such occasion was when Italy and the U.K. 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.

As the size of the Fund has declined and on average, quotas have fallen to the equivalent of 3.7% of current payments, the question arises whether the financial support that can be provided by the Fund to members under access policies, will be sufficient to sustain a mixture of adjustment and financing that allows 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 is likely to be generally negative.

Moreover, note that as countries become more open to trade and capital movements, their vulnerability to a loss of confidence increases, giving rise to large, sudden capital outflows, irrespective of whether this is 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 countries of systemic or strategic importance. Killick⁴ considers that countries such as Brazil, China, India, Egypt, Korea, Mexico, Russia and Turkey are always a special case.⁵ This ad hoc access policy 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 what the amount of support is that they may receive from the Fund. Moreover, at times, such assistance comes with questionable conditions imposed by countries that contribute to the financial rescue package. (See Feldstein 1998)

The problem of the limited size of the Fund is aggravated by the fact that quota formulas generally underestimate the size of developing country economies and therefore the resulting distribution of quota shares shortchanges developing countries. Thus 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 and therefore 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 strong economic teams generally have a stronger 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.

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 her financial crisis, Korea was required to open up certain services like banking and insurance to foreign investment and to liberalize the imports of certain industrial products, including Japanese cars in exchange for financial support. Was this liberalization required to overcome her payments problems? Did it in any way

⁴ (See Killick 1998)

⁵ The staff has had to learn that some countries are more equal than others. But few staff members have taken their objection to political pressures to the point of resignation as D. Finch, the former Director of the Exchange and Trade Relations Dept. who resigned when pressed to reduce conditionality for political reasons. (See FT of March 21, 1987” IMF Silent on Resignation”)

respond to third party interests? There has been a tendency of major countries to ask the Fund to include certain structural issues of interest to them in program 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." M. Goldstein cites the Korean and Indonesian programs as cases in point (M. Goldstein, "IMF Structural Programs, p.68, I.I.E. Washington D.C., Dec. 2000.) Eminent economists such as M. Feldstein, (Op.cit.) and J. Stiglitz have expressed related concerns.

While most Fund policy prescriptions on a fundamental issue are generally sound i.e., 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 programs, 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? J. Bhagwati believes it did. (See "The Capital Myth: The Difference Between Trade in Widgets and Dollars" Foreign Affairs, May-June 1998, pp7-12).

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, as the US, the UK, Germany, and others have done recently. With the exception of a few high savers in Asia, emerging market economies on the other hand, are not able 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 for fear they may trigger a confidence crisis. By pursuing these policies, they aggravate the contraction of domestic and international economic activity. Should the Fund provide financial support to emerging market economies with sound fundamentals, in order to allow them to avoid contractionary policies? This seems a case where the Fund support could make all the difference. Recall that Article I Section (v) on the purposes of the Fund reads: "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 facing a balance of payments crisis and a deep recession, (unemployment stands at around 20 percent 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 simply 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 program 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 program to deal with the external imbalance. This means that the Fund requires 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 to this purpose and the particular policy instruments chosen 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 program 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 programs 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, undermining the potential for future growth. The reason for this trend is that governments find those 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 programs 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 suitable 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. 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 programs has been rather less successful than was expected. (See section on The Rise and Fall of Structural Conditionality below). More generally, the analysis of the effect of Fund programs 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.

Obviously, not all imbalances are the result of excess demand arising from expansionary policies and consequently, a traditional demand management approach is not the appropriate one for dealing 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 time lag required for development of domestic energy resources, whether hydroelectric or an oil field, that will reduce future imports. Moreover, since structural adjustments will normally require greater amounts of financing over an extended period of time than demand management alone, 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, since the pace of adjustment and its economic and social costs largely depend on the total amount of financing available, the greater availability of financing would 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. Consequently, the answers given by the Fund to these and other questions, as embedded in the program, frequently determine whether the conditionality applied in a particular case is seen as appropriate or as too severe and whether the authorities will be committed to the success of the program. 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 should be made by the authorities.

Capital Account Crises

In a world of increasingly integrated financial markets and high capital mobility, the loss of market confidence in a country or currency may give rise to a massive capital outflow, causing a severe financial crisis that has international repercussions. Mexico in 1995, Indonesia, Thailand and Korea in 1997, to be later followed by Russia, Brazil, Venezuela, Turkey and Argentina, 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 too often, it assumes implicitly that the crisis should be allowed to erupt and should then be resolved by an economic program backed by large-scale financial support. Implicit in it is the belief that a loss of confidence is 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 appetites for profit and their often-incorrect interpretation of national or international events. In other words they may resemble more closely the type of crisis modeled by M. Obstfeld (1986, 1995) than the more traditional payments crises modeled by P. Krugman (1979). The timing of Fund support is of the essence, since a crisis may be prevented.

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 others, reasons that may affect capital flows include:

- 1) Exogenous and unanticipated changes in financial conditions in industrial countries can have a severe destabilizing impact on capital importing countries unrelated to their policies. For instance, a tightening of monetary policy that gives rise to higher interest rates (as when P. Volcker raised interest rates in the US in 1982 pushing the US into recession and detonating 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 favorable. Thus markets tend to undermine the creditworthiness of emerging market economies.

- 3) Financial markets are characterized by information asymmetries and contagion effects. 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 leaving 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.

Failing to prevent their occurrence by large and timely support, 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: “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 in 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 CCL in the Fund would appear to recognize the validity of the above argument, the fact that despite the occurrence of several financial crises in the three years since its establishment the CCL has not been resorted to by any member country indicates it has failed the test of the market. Members may feel that Fund support is not sufficiently certain, nor timely and large enough to protect them from a

speculative attack leading to 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. Therefore, the shortcomings in the CCL design should be corrected in order to make it operational. (See A. Buirá 1999 "An Alternative Approach to Financial Crises").

Conclusion

Conditionality was not always a characteristic of the Fund. It was introduced in the 1950s, as a means of restoring members' balance of payments viability and ensuring 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 centered 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 programs increased steadily. Not surprisingly, the conditionality contained in programs experienced substantial change. On the one hand the scope of conditionality was substantially expanded into fields that had been largely outside its coverage. 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 programs showed a parallel and no less remarkable decline. Successfully completed programs or programs in compliance, fell from rates of over one half in the late seventies and early 80s to below *thirty* percent in the nineties, when compliance is defined as that which permitted the disbursement of over 75 per cent of the loan and to rates of only *sixteen* percent 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 program compliance, it would be very difficult to argue that conditionality restores external balance and secures the repayment of loans and that it is needed to ensure the revolving nature of Fund resources. Moreover, as compliance declined, the credibility of Fund programs has been eroded, and their catalytic character is increasingly questionable, a fact that has obvious implications for the size of the Fund.

If conditionality as currently practiced is not effective for the purpose of "preserving the revolving character of the Fund's resources", should it be 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 today's if the Fund's attitude to requests for use of its resources were a more liberal one, say similar to that prevailing currently for drawings under the *first credit tranche*, where all that is required for access to resources is that the member itself "make reasonable efforts to solve its problems." (Annual Report of the Executive Directors 1963, page 16). Note that first credit tranche programs are characterized by low conditionality, are essentially developed by the member country, and thus are owned by it, a circumstance that contributes to the authorities commitment to the program. Since the amount provided by the Fund is a small one, 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 benchmarks to guide them in the application of their program over time.

As conditionality had become dysfunctional, its review and streamlining became unavoidable. In this regard the initiative of the Managing Director is both necessary and welcome to address the very high rates of program failure. The Board has also recognized the nature of the problem. Experience and the Fund's own studies show that program 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 program is conducive to the attainment of their own objectives. Since conditionality cannot compensate for lack of program ownership, it can only be seen as helpful to the extent it fits with the member's goals and is seen by the authorities as a road map to their own purposes. What makes for a successful program 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 programs, 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. Programs, 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 wide ranging and 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 program design in order to secure greater ownership and transparency. Programs 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 program focused on the essentials, usually centered 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 program, Fund support should be made available. 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 program compliance.

As Fund resources have declined steadily over the last half century in relation to all relevant variables (trade, GDP, capital flows), and in the absence of other sources of finance, the mix between adjustment and financing, which is a major determinant of program success, has shifted toward less financing and more severe adjustment. Obviously, this discourages countries from resorting to the Fund at an early stage of their imbalances, must contribute to the lack of program ownership, and lead to a high-rate of program failures.

The changing conditions of the international economy and the recurrence of financial crises call for a review of the resources of the Fund, the nature and character of its operations. The Fund's own governance and members' contributions and participation in decision-making should also be revised in order to secure the adequacy of its resources to the role it is called to play in the avoidance of recessionary adjustment, or in the words of Article I Section V, "to correct maladjustments in their balance of payments without resorting to measures destructive of national or international prosperity".

Appendix I

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 did not appear in the original Articles of Agreement. This concept was not to be introduced until 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 US 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 US delegation were well aware that as the countries of Europe embarked on their post-war reconstruction, the US would be the only substantial net creditor to the Fund for some time to come. On the other hand, the UK 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. Vol.25 p.143)

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, Vol.25, p.404-405)

Keynes believed 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. These concepts were to be incorporated in Article I Section (v) and Article V Section 3(a) of the Articles of Agreement in 1969, at the time of the First Amendment. 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 words in italics are the additions to the text 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". Specifically, the addition reads:

(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 the resources of the Fund beyond the reserve (gold) tranche must be examined and found to be consistent with those policies.

In the discussions in Atlantic City in June 1944, prior to the Bretton Woods conference, the US delegates had raised the subject of requiring member countries that requested financial support, to give certain policy undertakings to the Fund and it 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 they felt 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. Thus, by the time of the Conference, since the two amendments that had been proposed by the US delegation had been dropped, this matter appeared to have been settled and since it was not even raised by the US delegation, it was not discussed further. Consequently, the original Articles contained no statement that the Fund had to adopt policies on the use of its resources and thus the member country was 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 US conception, the Fund was not to interfere in member country's domestic policies. A valuable insight into US thinking to this effect is provided by 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, p.69)

As Article IV Section 5(f) of the original Articles of Agreement stated, as long as the Fund was satisfied 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, p.6)

While the US had lost the battle for giving 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 US that had the resources, and it was the resources that counted, specially in the immediate aftermath of World War II". (op.cit.)

Therefore, it was the need to obtain the financial support and cooperation of the US that in February 13, 1952, after a number of years of very limited Fund operations, that the Executive Board was persuaded to accept a proposal by the Managing Director embodying the US 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 emphasis added.

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)

Appendix II

The Rise of Structural Conditionality

Consider the factors behind this explosion of conditionality. Since the early 1980s, as the Thatcher and Reagan doctrines gained ascendancy in the UK and the US, both institutions adopted a more neo-liberal economic stance and increasingly favored policies aimed at reducing the role of the state, the reduction or elimination of subsidies, of market liberalization and privatization of public enterprises. These views were to be translated into a new type of structural conditionality, which aiming at these goals, was superimposed on the more traditional macroeconomic conditionality. According to M. 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 programs" Although the above characterization does not describe the history of any industrial country, it reflected the vision of a global market system increasingly advocated by the US business sector and government since the seventies.

But the change in the conditionality of the IFIs appears as the result of the combination of several other factors, among which:

- 1) the limited (declining in relation to demand) financial resources of development finance institutions reflecting a policy shift of major industrial countries away from the provision of public financing to developing countries and in favor of a policy aimed at the “graduation” of middle income countries to private financing, that had started during the late seventies. This signified that programs 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 US. While initially resisted by many developing countries in the early eighties, policy makers in these countries became convinced over time 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 US trained economists who favored market liberalization and 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 programs emphasizing changes in economic structures as well as macroeconomic balances.
- 5) The criticism of Fund programs by developing country representatives as too restrictive and demand oriented and insufficiently concerned with economic growth, led the Fund to place emphasis on the structural changes “required” by long term growth. This became apparent in the SAF, created in 1986, which required applicant low-income countries to submit a three-year program “to correct macroeconomic and structural problems that have impeded balance of payments adjustment and economic growth.” The ESAF established one year later, included similar requirements. (IMF Decision No.8240-(86/56)SAF March 26, 1986.) See Selected Decisions and Selected Documents of the IMF, Washington, D.C. Dec. 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 lead to the proliferation of norms and standards in a number of fields.

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