

From Grandmotherliness to Governance

The Evolution of IMF Conditionality

IMF conditionality has evolved steadily over the years. It continues to evolve. Recent developments have produced both a fresh approach and new challenges.

Harold James

ON FIRST sight, there is something unchanging, even eternal, about the dilemmas presented by IMF conditionality. But that appearance is deceptive. During the 1990s, an old debate took a new and highly political turn. There are two elements to the current debate about conditionality, which comprises the policy requirements that the IMF places on its program lending. First, there is a long-standing and inherent difficulty in the implications of lending that is not strictly on market terms—that is, on loans made other than on the basis of trust or specific securities. That debate clearly affects not only the IMF but also lending by any international financial institution. Second, a new element is provided by the dramatic political changes that followed the collapse of communism and their coincidence with a global communications revolution and greatly increased financial interdependence (the bundle of issues popularly known as “globalization”).

John Williamson’s analysis in the early 1980s appears as apt today as it did then: “The traditional criticisms, which initially stemmed primarily from left-wing elements in borrowing countries, were that the IMF adopts a doctrinaire monetarist approach, that it is insensitive to the individual situations of borrowing countries, that it imposes onerous conditions, that it is ideologically biased in favor of free markets and against socialism, and that it overrides national sovereignty and perpetuates dependency. Until recent years, the IMF did not respond to such criticisms. Its aloofness seems to have aggravated the critics . . . and misgivings spread even to the U.S. Congress.”



Origins

But such problems are not unique to the IMF's operations. They are inherent in any attempt to subject lending to a conditionality. The League of Nations programs for Hungary and Austria in 1922 and 1923, for instance, raised exactly the same issue, and the criticisms of them as excessively harsh and intrusive on national sovereignty precisely prefigure later debates. The external control imposed on politically fragile states emerging out of the postwar breakup of the multinational Hapsburg Empire was so extensive and tough that it constituted a deterrent to embarking on similar programs in other states. Instead, countries attempting to stabilize their currencies in the mid-1920s turned to the less "political" capital markets, with the result that, as a general principle, the League's conditionality was counterproductive. A reaction against the experience of the League made some of the architects of the Bretton Woods system, particularly John Maynard Keynes, desire a more automatic Fund. But the principle of conditionality—Keynes called it in a memorable phrase "being grandmotherly"—soon reasserted itself in the lending of the new institution.

For the IMF, conditionality became an increasingly sensitive issue in the 1960s and, above all, in the 1970s for the following reasons. First, because quotas were not raised in line with the dramatic expansion of world trade (see chart on facing page), higher levels of lending in relation to quotas were required, with consequently increased conditionality. Second, the expansion of capital markets, which had been completely unanticipated at the time of the Bretton Woods conference of 1944, offered an alternative source of capital. The result was that conditionality applied only to some debtor countries, and the concept of countries "graduating from" the IMF became increasingly popular. Here, however, the skittishness of markets soon produced some unpleasant surprises. Before the outbreak of the 1982 debt crisis, many finance ministers and bankers had considerable confidence that the IMF was irrelevant to all except the poorest countries. Similar beliefs gripped the markets before the 1997 outbreak of the Asian crisis. Third, conditionality became more complex in order to avoid unintended consequences in programs. Previously, for instance, because of the pressure exerted by powerful political and civil service lobbies, fiscal conditions had often led to big cuts in government investment but very little reduction in government consumption. As a result, economic prospects worsened. Programs therefore began to specify elements in public spending—public sector pay guidelines, investment levels, and the like. Such an expansion of activities inevitably brought the IMF into the political domain.

Guidelines

These problems were only partially addressed in the guidelines on conditionality, which were approved by the IMF Executive Board in 1979. The performance criteria

specified in IMF programs should be as few as possible: Section 9 of the guidelines stated that they would be "normally confined to (i) macroeconomic variables, and (ii) those necessary to implement specific provisions of the Articles [the IMF's Articles of Agreement, or charter] or policies adopted under them." Performance criteria would 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." In practice, however, the concept of a macroeconomic impact is both quite vague and quite inclusive.

The elaboration of additional ("exceptional") details intended to ensure that the macroeconomic criteria would be observed inevitably drew the IMF into domestic political debates. The shape of IMF programs emerged in discussions between IMF officials and national civil servants and politicians. Without the latter's cooperation and involvement, a country's program stood no chance of being realized, but

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officials often found it hard to convince their compatriots of this. On occasion, therefore, they used an argument about external pressure as a way to shelter programs from criticism or domestic political debate.

The extent to which such an exercise in shifting political responsibility increases or decreases domestic political stability is contentious. Examples can be found for both sides of the argument—on the one hand, to show that dependence on external discipline strengthens state authority, and, on the other, to demonstrate how it may erode politically responsible behavior. In the post-Second World War reconstruction of Germany and Japan, which was a conceptual model for IMF activities during 1956–63 when Per Jacobsson was Managing Director, there is no doubt that blaming the allied policy and the military authorities for the economic difficulties that initially accompanied liberalization took the strain off weak and vulnerable political structures and greatly facilitated economic revival. Both the German currency reform of 1948 and the Japanese financial reform of 1949 (the Dodge Plan) were initially unpopular, and their substantial benefits became apparent only after a considerable delay. In the meantime, it was helpful for economic reformers to have the occupation authorities as a kind of benevolent dictator imposing political stability. Weak governments like to be able to reduce the domestic pressure applied by interest groups and political parties by pointing to the need to respond to an alternative pressure coming from the outside. In the course of

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the 1960s, the IMF became accustomed to being used in this way as an external whipping boy or scapegoat. In the 1970s, even quite large and powerful industrial countries, such as the United Kingdom, saw the value of the IMF in this regard.

Changing role of IMF

This view was sustainable as long as the IMF remained—as it had been conceived at Bretton Woods—an institution that would not interfere with national sovereignty. C. David Finch, former Director of the IMF's Exchange and Trade Relations Department, expressed this concept succinctly. The IMF, he said, “has not been established to give guidance on social and political priorities, nor has its voting system been designed to give it the moral authority to oversee priorities of a noneconomic nature. Its functions have to be kept narrowly technical if it is to be effective in the exercise of its role as a promoter of the adjustment process. For this purpose, the Fund has to accept that the authorities of a country are the sole judges of its social and political priorities.”

In the 1990s, this view of the IMF and its role changed dramatically. In large part, this was a consequence of reflections on the collapse of communism and on the links between political and economic reform. In the 1980s, many political scientists believed that economic reform was more easily achieved by authoritarian regimes. The experience of Central Europe, in particular, completely reversed the general understanding of the link between economic liberalization and political democratization. In the new picture, only a country whose government was sustained by a deep reserve of legitimacy would be able to bear the pains associated with adjustment.

This change had repercussions for the concept of conditionality. If there was less room for a benevolent authority in imposing economic reform, this would also mean questioning the traditional role assigned to the IMF. Instead, the issue of “ownership” became central.

New consensus

The collapse of the centrally planned economies or (in the case of China) their movement toward the market was the last stage in creating a new consensus about economic policy, frequently but misleadingly referred to as the “Washington consensus.” The consequence has been an increasing homogeneity of political outlook, as well as of the economic order. Indeed, one key insight is that the two are linked: that economic efficiency depends on a functioning civil society, on the rule of law, and on respect for private property.

The post-cold war world has a quite different politics. There is no longer a lineup of East versus West, in which pro-Western regimes automatically obtain support, regardless of their levels of efficiency and competence and probity. Rather, the international community is adopting a much more

interventionist stance in which the logic that associates economic and political change is taken more seriously. The result has been the forcing of a much quicker pace of economic reform in some countries (for example, Egypt, which until the early 1990s largely resisted attempts to liberalize); the disintegration of the political order in others (the collapse and defeat of Mobutu's Zaïre); and the descent into the status of

international pariah for others. The striking change in this area is that there is no longer an acceptance of domestic political inefficiency, corruption, or oppression.

Governance issues

The most visible product of the new political environment is the concern of the Bretton Woods institutions with “governance.” In August 1997, a new set of guidelines promulgated by the IMF's Executive Board instructed the staff that, in policy advice, the IMF “has assisted its member countries in creating systems that limit the scope for ad hoc decision making, for rent seeking, for undesirable preferential treatment of individuals or organizations.” The IMF suggested that “it is legitimate to seek information about the political situation in member countries as an essential element in judging the prospects for policy implementation.” At the same time, these guidelines also preserved the nonpolitical vision of Bretton Woods, requiring the IMF's judgments not to be influenced “by the nature of the political regime of a country.” In particular, recognizing an obvious danger, they specify that “the IMF should not act on behalf of a member country in influencing another country's political orientation or behavior.”

The IMF's interest in governance was already reflected in a number of very high profile decisions in 1996–97. Conditionality has come to the fore in each of four completely new areas. First, military spending had never been a topic of explicit discussion by the IMF in the era of the cold war. Since 1993, however, it has been discussed in the IMF's *World Economic Outlook* reports as a major problem of misallocation of resources. In a number of cases, notably those of Pakistan and Romania, it became a central element in IMF discussions. Second, corruption is explicitly addressed: in Africa, but also in Indonesia. Third, so also is democracy addressed, although there is no reference to democracy in the IMF's Articles of Agreement (unlike those of the European Bank for Reconstruction and Development). Fourth, especially in response to the Asian crisis, a critique developed of a feature that had previously been regarded as a linchpin of Asia's economic success—the concept of “trust,” or of “strong informal networks”—and that was now relabeled and condemned as “crony capitalism.” This criticism was linked to the attack on corruption, and “a stable and transparent regulatory environment for private sector activity” was laid out as the solution.

There had been some consideration of human rights issues in the past: in Poland, whose membership application was held up in the 1980s after the imposition of martial law and the internment of political dissenters; or, more discreetly and subtly, in South Africa in the 1980s, where apartheid was attacked as an inefficient labor practice. But the scale of the discussion of political issues in the mid- and late 1990s is novel. The gradual extension of the IMF into these areas is an immediate result of the new consensus about economic practice and of a new world political order that it has helped to produce. But it reflects something more profound—a realization increasingly shared throughout the world that the world economy, and world institutions, can be a better guarantee of rights and of prosperity than some governments, which may be corrupt, rent-seeking, and militaristic. Economic reform and the removal of corrupt governments are preconditions both for the effective operation of markets and for greater social justice. Indeed, these two results, far from being contradictory as some critics imagine, are complementary.



Harold James is Professor of Modern History at Princeton University and the author of a number of books, including *The International Monetary System Since Bretton Woods* (New York: Oxford University Press and *International Monetary Fund*, 1996).

Fresh challenges

The new approach will produce greater global prosperity and stability. By helping to provide markets with better information, ensuring greater transparency, and limiting the irrational destructiveness of financial crises, the IMF can help markets operate more efficiently. But questions arise concerning the degree to which the IMF can be “even-handed” in its treatment of all its members. One of the most fundamental issues is the political counterpart to the criticism expressed by Paul Volcker, former Chairman of the U.S. Federal Reserve System, of IMF economic programs: “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. When the big countries are in conflict, the Fund gets out of the line of fire.” Addressing the issues of military expenditure, corruption, and undemocratic practices is easier for international institutions in the cases of small countries, or even politically isolated countries. But it is likely to be hard and controversial in large states with substantial military and economic potential—for instance, China or Russia. Discussion of such issues inevitably plays a major role in domestic politics. In Russia, this kind of criticism of international institutions is made by opposition politicians such as Grigory Yavlinsky. They explain the problems and failures of Russian reform programs by an unwillingness of the international community to go far enough in attacking corruption and in imposing reform from the outside. In other cases, conditionality will be interpreted as a blatant attempt to impose Western values in the hope of restraining or even crippling potential competitors (a

criticism frequently voiced, for example, by Mahathir Mohamad, the Prime Minister of Malaysia).

Second, there is the question of the IMF’s institutional capacity for implementation. Some recent programs and statements also go into such issues of economic organization as the dismantling of cartels, the improvement of accounting practices, and banking supervision. On the one hand, it is easy to see the macroeconomic effects of the organizational or structural flaws criticized by the IMF. On the other hand, correcting them takes the IMF into completely new areas in which it has no previous experience. It is clearly experienced in fiscal affairs and in advising on central bank policy, but not in wide-ranging reforms of the financial sector or in accountancy. The detailed reorganization of corporate balance sheets in order to ensure greater transparency—which is incidentally also a problem in many industrial countries—is a less appropriate task for international institutions than for private sector consultants and accountants. The gains, after all, will directly benefit the companies undertaking the reforms.

Third, and most fundamentally, this process of adding new expectations could create a dangerous momentum of its own. Part of the recent discussion in the U.S. Congress on an IMF quota increase involved the issue of whether to integrate environmental and labor standards into IMF programs. Many of the IMF’s member countries rightly feel that economic reform programs must be responsive to social and humanitarian concerns. But the amplitude of such an agenda may produce an expectations trap. The more the IMF is seen to extend its mandate, the more it will be expected to undertake, and, inevitably, the greater the challenge it will face in trying to live up to the demands. The IMF will need to resist institutional overstretch: to ensure that its mandate is limited, clearly defined, and subject to realistic assessment of results. **F&D**

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