External Comments and Contributions on IMF Conditionality

September, 2001

International Monetary Fund
Washington DC 20431

The IMF, as part of its review of conditionality, solicited comments from the public through its website. In seeking comments from the public, the staff made available the papers discussed by the Executive Board on March 7, 2001, the PIN summarizing that discussion, and several background papers on the terms and practice of conditionality. This section, contains the full text of comments and contributions received through June 30, 2001. It excludes some attachments and submissions that did not address issues related to conditionality.

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Should the IMF Abandon Conditionality?

ABSTRACT

The IMF pretty much argues that all is well with the conditionally contained in the programs it supports and sees no reason to change it. The recent report by the International Financial Institution Advisory Commission in stark contrast argues that conditionality doesn't work and should be abandoned. Which of them is right? The answer is neither of them. Undoubtedly, IMF conditionality has its shortcomings. But careful analysis of these allows us to draw some conclusions about how it should be reformed. Conditionality should be retained but it needs to be redesigned and redirected.

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Graham Bird is Professor of Economics at the University of Surrey in England and Director of the Surrey Centre for International Economic Studies. He is also Visiting Professor of International Economics at the Fletcher School, Tufts University. He has written widely on the IMF and has recently completed a major research project on the catalytic effect of IMF programs.

The conditions attached by the IMF to the loans it makes to some of its client countries - developing countries and transitional economies - have been the focus of close attention in the aftermath of the East Asian financial crisis. Some observers have seen IMF conditionality as overly intrusive and as going well beyond what the IMF has a 'moral right' to expect. The implication is that countries turning to the Fund are losing their national sovereignty over the design of economic policy and are being cajoled into pursuing policies that reflect the preferences of the Fund's major shareholders – in other words the richer economies of the world. Although the Fund has staunchly defended conditionality on the grounds that 'on balance' it works, and that without it borrowing countries might squander the resources supplied to them, the recent report of the International Financial Institution Advisory Commission (IFIAC) chaired by Alan Meltzer, has launched a stinging attack on conditionality, claiming that it is 'unwieldy, highly conflictive, time consuming to negotiate and often ineffectual'. Not surprisingly in the light of this assessment, the Commission recommends that conditionality should be abandoned. But should it?

The question can only be satisfactorily answered by undertaking a measured assessment of the available evidence. Unfortunately, neither the IMF nor the IFIAC do this. Instead, their assessments are partial and biased. The policy conclusions they draw are therefore inappropriate. A fuller analysis suggests that while the Fund is wrong to argue that conditionality is basically fine just as it is, (or, if anything, should be extended to include capital account liberalisation) the IFIAC is also wrong to be so negative about it. IMF conditionality may need to be modified and re-directed but it should not be abandoned altogether.

This article attempts to provide a brief but balanced evaluation of the evidence relating to the effectiveness of IMF conditionality. It then goes on to draw some inferences about how conditionality should be reformed. A number of principles are identified which should underpin this reform.

DOES IMF CONDITIONALITY WORK?

As noted above, to this question the IMF answers 'yes' and the IFIAC answers 'no'. They cannot both be right! Or can they? Perhaps the question is too simply stated and the answer more nuanced. There are numerous academic studies examining the effects of IMF programmes and looking at whether they work. What do they tell us? First of all, they tell us that it is a very difficult question to answer, largely because while we know what actually happened in countries that adopted Fund programmes, we can never know for sure what would have happened if an agreement had not been reached. Although there are sophisticated ways of trying to make a good stab at it, we can never precisely define the so-called counter-factual. This immediately means that we can have only limited confidence in the results that emerge.

However, things are not quite as bad as they may seem. Different studies have used different ways of trying to overcome the problem of the counter-factual; for example, some have used a control group of non-programme countries to compare with those that adopted programmes, some have tried to simulate the performance of economies under different combinations of policies representing those favoured by the Fund and those not favoured by the Fund, others have looked at individual countries in-depth to assess the impact of IMF conditionality. Although none of these is ideal, results that are robust across the different methodologies may be

reasonably secure. We can have greater confidence in results that turn up again and again than those that seem to be specific to one study or one methodology.

So, what is the consensus? Judged in terms of their effect on the balance of payments, the Fund is right. Fund programmes do seem to be associated with a statistically significant improvement in the current account of the balance of payments or the overall balance of payments. In this sense, IMF conditionality works. Since the IMF is primarily a balance of payments institution, its programmes seem to be delivering something quite important. Countries come to the Fund when they have severe balance of payments problems and IMF conditionality appears to contribute to the resolution of these problems.

But let's not get too carried away. Fund programmes have other objectives as well, in terms of encouraging economic growth, raising investment and reducing inflation. How do they do when judged against these objectives? Not so well. Indeed, the consensus is that they have little significant impact on these variables and may even lead to a fall in investment and economic growth, lasting for up to three years.

This has knock-on consequences. Evidence suggests that it is countries that are relatively poor and that have low rates of economic growth that are more likely to turn to the Fund for assistance. At the same time, an objective of the Fund, as established in its Articles of Agreement, is to provide only *temporary* assistance. The idea is that Fund programmes help to improve economic performance in ways that make future use of Fund resources unnecessary. But if they fail to encourage economic growth will this happen? Again the evidence shows that many developing countries keep on coming back to the IMF; they are Fund recidivists. Indeed,

some countries are almost permanently under an IMF programme. Thus in the period 1980-96, the following countries spent ten years or more in the Fund: Argentina, Bangladesh, Bolivia, Central African Republic, Congo, Costa Rica, Côte d'Ivoire, Egypt, Guinea, Haiti, Honduras, Jamaica, Kenya, Madagascar, Malawi, Mali, Mauritius, Mexico, Morocco, Mozambique, Niger, Panama, Philippines, Senegal, Somalia, Sri Lanka, Togo, Uganda and Uruguay. Judged against these criteria, IMF conditionality does not seem to work.

But again, is this a reasonable conclusion to draw? A lot should surely depend on whether programmes are implemented. It is important to know how the effects of the programmes vary with the degree of implementation. Is it the case that countries that fully implement agreed programmes enjoy economic success and graduate away from the Fund, while those that fail to implement a programme remain unsuccessful and end up back negotiating another one? If so, we could conclude that conditionality is basically well designed and that what we need to do is to focus on why it is not always implemented. If not, it would be a fairly damning indictment of the basic design of IMF conditionality. What is the point of making loans conditional on the pursuit of specific policies if it makes no difference whether these policies are pursued or not.

The problem is that we do not yet know whether implementation makes a difference. What we do know is that the majority of IMF programmes remain uncompleted. Over 1993-97 sixty-five percent of programme loans were not fully disbursed. In relation to this, we also know that conditionality is frequently not fully implemented. Thus studies examining the effects of IMF programmes on key policy variables such as the size of fiscal deficits and, in particular, the rate of monetary expansion, which form the hard core of IMF conditionality, usually fail to come up with any statistically significant connection. The principal impact seems to be on the real

exchange rate where conditionality does seem to lead to significant devaluation - suggesting one reason why the balance of payments improves. But again, does the degree to which conditionality is implemented make a difference to final outcomes and the likelihood of a country coming back to the Fund? We just do not know. Indeed, only a handful of researchers have examined this fundamental question, and while some argue that implementation does matter, others have discovered no significant relationship between implementation and outcomes. At present we have the uncomfortable situation where the Fund claims that on balance its programmes work, but at the same time the policies through which they are supposed to work are often not affected.

It is therefore premature to offer any definitive answer to the question 'does conditionality work?' Both the IMF and IFIAC are jumping the gun. So do we simply have to be patient and wait for more research to be done? No. While there are certainly important questions about conditionality that still need to be answered, we can make use of what we do already know to help redesign conditionality. After all we do know that IMF programmes have only muted effects on a range of economic out-turns, that they exert little impact on key policy variables, that they are frequently not completed and that many developing countries have to keep coming back to the Fund. These are the facts of the matter and they give us something to work on. How then might IMF conditionality be redesigned in light of them?

REDESIGNING IMF CONDITIONALITY

Crucial factors relate to the breadth and depth of conditionality and the 'ownership' of IMF programmes. Conditionality has expanded quite dramatically over the last twenty years or so.

There are now many more conditions per programme that a country has to meet before it is eligible to draw on loans from the Fund than there used to be. In 1997, each programme on average had sixteen so-called performance criteria, compared with ten in 1993. This may be explained in a number of ways that we shall not explore, but it also has a number of implications that we shall. First, with more conditions, it is more probable that a country will fail to comply fully with all of them. There is simply more that can go wrong and indeed more scope for disagreement between the Fund and a government. Second, conditionality becomes more intrusive, and national sovereignty over policy design is more heavily eroded. Countries become more reluctant to turn to the Fund - allowing problems to mount to crisis proportions before they do - and more keen to pull out of programmes as soon as the opportunity arises. Third, if there is no proportionate increase in the resources available from the Fund, the financial rewards per condition fall, further reducing the incentive to comply. Moreover, why worry about non-compliance if you can simply negotiate another programme, as the degree of recidivism implies.

If countries feel that they are having conditions imposed upon them and are reluctantly having to accept conditionality because of their desperate need for foreign exchange, they are unlikely to be committed to the programme. The very fact that we talk about 'IMF programmes' is indicative. For as long as programmes are perceived in this way by governments, their success will be limited. There is lots of evidence, in many contexts, that ownership matters because it positively influences commitment to reform. So why not give governments a free hand to write their own conditions? The problem here of course is that it is government policies that often contribute to the circumstances in which countries turn to the IMF in the first place; the Fund cannot simply rubber-stamp any set of government policies. How can this dilemma be overcome?

The answer has a number of dimensions. First, conditionality needs to be flexible; one size does not fit all. Different circumstances warrant different degrees and types of conditionality. For countries with a good track record of economic management and with a well thought-out strategy of reform, conditionality could be minimal or light. It could then be cranked up if domestically favoured policies failed. For countries with a poor record of reform, conditionality could be heavier from the outset. Although, alternatively, the Fund could be more selective and say 'no' more often. It could decide not to offer support to countries that it perceived as being uncommitted to economic reform, and perhaps thereby create an incentive for such countries to get their act together before turning to the IMF.

Second, conditionality needs to make a sharper distinction between mandatory conditions - actions that are required in order to get access to a loan - and advice that is non-mandatory. The Fund can still make recommendations and argue its corner but it should seek to persuade rather than coerce. There should be a genuine dialogue about policy reform. There is little doubt that over the years the IMF has made a significant contribution to economic management in client countries and elsewhere by educating domestic policy-makers in the science of economic management through discussion and advice as opposed to conditionality. But the Fund is frequently accused of being arrogant and of having the attitude of 'we know what's good for you'. The balance should be shifted away from mandatory conditions to non-mandatory advice. At the same time, there should be stiffer penalties for failing to follow mandatory conditions that are initially agreed upon. Cancelling a programme is not much of a penalty if another programme can quickly replace it.

Third, since there is evidence produced by the IMF itself that countries turning to it are not characterised by relatively rapid monetary expansion, since again the evidence shows that conditionality exerts no significant effect on future monetary expansion, and since furthermore monetary contraction will tend to exacerbate the adverse effects of IMF programmes on economic growth, there is a strong argument that conditionality should no longer place so much emphasis on monetary variables. Exchange rate policy seems to be much more susceptible to Fund influence and is more likely to assist in both correcting balance of payments deficits and in encouraging economic growth. Fiscal policy can then be used to deal with the potentially inflationary consequences of devaluation. Where structural conditions are deemed to be of fundamental importance for the success of a programme these should not simply be added to conventional demand-side conditionality. It is in part the rise of structural conditionality that has led to the overall increase in conditionality mentioned earlier. Mandatory conditions should relate to policy variables that are easy to define and control and should be capable of being monitored. Other price-based policies, apart from the exchange rate, may pass this test.

Finally, IMF adjustment programmes will not work if they are starved of the necessary financial support. Where structural reform is needed, this is likely to take time. But with a slower speed of adjustment, more financing will be required early on. Without this, countries will be forced to adopt adjustment programmes that focus on reducing domestic aggregate demand. But why should demand contraction solve structural problems? It won't. Indeed, what it will do is increase the probability of programmes failing and of governments abandoning them, which is what the record shows.

The IMF claims that an important objective of its programmes is to mobilise international capital, both private and public, with the implication that it does not need to provide so much financial support itself. Conditionality is supposed to catalyse others to lend. It doesn't. This is hardly surprising when so many programmes break down and when agreeing a programme with the Fund is a reasonable indicator that future programmes will be required which in themselves signal future economic distress. If conditionality were to be more successful, there is good reason to believe that the catalytic effect of IMF programmes could be made to work, but this requires the sorts of changes articulated above. For the catalytic effect to be real rather than imaginary, implementation needs to improve and recidivism needs to fall. In other words, conditionality needs to be made to work better.

ASSESSING THE POLICY ALTERNATIVES

The IMF sees nothing wrong with its conditionality. It claims that it works and has lobbied to increase it to incorporate capital account liberalisation and domestic financial supervision and regulation. However, this represents an ill-judged assessment of the evidence, which in turn gives rise to inappropriate advice for reform. Although conditionality may work to improve the balance of payments, in many other ways it does not work. It does not encourage investment or growth, it is frequently not implemented, it is associated with a high rate of recidivism and it does not catalyse others to lend.

The IFIAC emphasises these failures and recommends that IMF conditionality should be abandoned. This advice is wrong-headed as well. Conditionality offers a potentially important way of assisting many countries in the world. If Fund lending were to be retained but

conditionality were to be abandoned there would be no way of dealing with the moral hazard problem. Countries might be enticed to pursue policies that would give them access to Fund finance but would have little incentive to use this finance to support necessary but unpopular policies of macroeconomic stabilisation and economic reform. While there is an argument for low conditionality - in circumstances where liquidity is needed more than adjustment, for instance where temporary external shocks have occurred, or where domestic economic policy is already well designed - there is a strong argument against no conditionality.

The IFIAC is aware of this moral hazard problem and therefore combines its recommendation that the IMF should abandon conditionality with a recommendation that it should also discontinue lending to developing and emerging economies except in short-term emergency conditions. But where would this leave many of the Fund's client countries? They would not be able to count on private capital flows. Part of the reason for the Fund to lend to them is precisely that private capital markets sometimes do not. Furthermore, they would not be able to rely on additional bi-lateral official flows; foreign aid. It is widely acknowledged that the pattern of lending by the multi-lateral agencies is less affected by political variables than is bi-lateral aid. Moreover, properly used, IMF conditionality offers a potentially important way of influencing private and public capital flows.

Substituting IMF conditionality with World Bank conditionality is also unlikely to be a satisfactory alternative. Not only are there legitimate debates about the policies of economic liberalisation that the Bank tends to favour, but there are also reasons to doubt whether the Bank would be as well equipped as the IMF to help design policies directed towards stabilising the macroeconomy. Moreover, private markets might be expected to pay even less attention to

World Bank conditionality than they do its IMF counterpart. While it is reasonable to examine institutional design and the division of labour between the Fund and the Bank, it is unreasonable to assume that all the problems associated with IMF lending to developing countries could be overcome simply by passing this role – lock, stock and barrel – over to the World Bank.

To abandon IMF conditionality would be to throw out the baby with the proverbial bathwater. It is ironic that the IFIAC reserves some of its greatest hostility for the Fund's longer term concessionary lending facility. This has recently been renamed the Poverty Reduction and Growth Facility and has undergone reforms that at least in part seek to address the spirit of those suggested here by emphasising the importance of ownership. The rhetoric is changing and the reality may follow.

IMF conditionality should not be abandoned at this time. However, its deficiencies should be clearly identified. While awaiting the results of further research into the effects of IMF programmes, conditionality should be redesigned on the basis of what we already know in an attempt to improve its usefulness in developing countries and countries in transition.

From: Calvo-Gonzalez,O
Sent: Friday, May 18, 2001 6:19 PM
To: 'conditionality@imf.org'
Subject: comments

Dear Sir/Madam,

Following your requests for comments on the review of conditionality currently being undertaken at your institution, I would like to make three comments.

1. I do not think that the interpretation of the Board of Governors by which conditionality is still "essential" (Public Information Notice, 21 March 2001) is warranted by the IMF research that you have put up on your website (and elsewhere). The consensus of that technical research could be summarised as follows:
- If the recipient government is not committed to reform, conditionality does not enhance the likelihood of the adoption of reform
- If the recipient government is committed to reform, conditionality may contribute to securing the continuation of the reform programme. The emphasis is on the word MAY. The mechanism through which this may take place is, according to Dollar, Svensson et alia, because it provides the recipient government (committed to reform, remember) with a commitment technology, a way to lock-in the reform path by making the reforms costly to undo
Hence, I fail to see why conditionality is "essential". What is essential to improve the likelihood of repayment is the adoption of reform, and that is proven by IMF research not to be causally related to conditionality.

2. This second block of comments relates to the IMF research as such, rather than about the interpretation of the Board. I am puzzled by the belief that conditionality may enhance the position of pro-reformers by providing a commitment technology. I do not think this logic is watertight. After all, to make a policy-move credible means to make its reversal costly to undo. I do not see how conditionality can give more credibility to pro-reformers. At best, it could be argued that donors may convince pro-reformers to sequence their reform programmes in a different order so as to undertake those reforms that would prove more difficult to undo early rather than late, but that is far from arguing that conditionality can lend credibility to the recipient government.

I also find that the research paper "Conditionality in Fund-Supported Programs-Policy Issues" pays insufficient attention to the issue of the heterogeneity of preferences within the recipient governments (i.e., the fact that most governments are coalition governments of some sort, which may have different views about the reform programme).

Related to this issue of coalitions is also the importance of "sovereignty and independence" as a crucial variable in the political market. A pro-reform government which is accused of selling out the country by the opposition (or by other members of the coalition) may be prompted to renounce its reform agenda as a way of placating those nationalistic fears. This outcome would be less likely if aid is not seen as conditional, since the connection between the reform programme and loss of national sovereignty could not be exploited by anti-reform elements. At times, unconditional aid may help provide pro-reformers at the helm of a government with much needed oxygen to maintain their reformist drive.

The role of large amounts of aid as part of a stabilisation programme may be important in ensuring the credibility of the programme, but this credibility stems from the amounts at the disposal of the government to, say, defend a parity. It is irrelevant whether the aid is conditional or not.

Of course, this emphasises the importance of figuring out the degree of commitment to reform of the recipient government (or majority faction).

3. Finally, let me end with the following quote:

" [S]uch [reform] programs can only succeed if there is the will to succeed in the countries themselves. [...] The Fund does not impose conditions on countries; they themselves freely have come to the conclusion that the measures they arrange to take -even when they are sometimes harsh- are in the best interests of their own countries."

This quote, by now popularised by Harold James book is by Per Jacobsson. These words of the then IMF Mg Dir were pronounced in an interview to the Spanish tv on 23rd June 1959.

A study of the IMF sponsored Spanish Stabilisation Plan in 1959 shows many of the features highlighted on point 2 above: a coalition government divided in which loss of sovereignty is an issue and in which pro-reformers do not want conditionality to tie their hands, but rather want some degree of flexibility so as to overcome anti-reform resistance; though, crucially, IMF management were convinced of the intentions of the pro-reformers and of their relative position of strength and hence provided aid, devoid of many strings, that helped underwrite the implementation of the Stabilisation Plan.

Of course, the quote also gives rise to a the following question: since we are apparently coming full circle (James was struck by how "modern" Jacobsson sounds), one may wonder how come did we get it so wrong with conditionality in the interim?

Yours faithfully,
Oscar Calvo-Gonzalez

Oscar Calvo-Gonzalez
Economic History Department

From: Axel Dreher
Sent: Monday, April 23, 2001 8:38 AM
To: conditionality@imf.org
Subject: Conditionality Review

Dear Sir,

I would like to comment on your review of conditionality guidelines. First, I guess that the planned changes are a big step into the right direction. However, there is one additional critisism I would like to raise. As we have shown recently (Dreher and Vaubel, 2001), credit from the IMF contributes to politcal business cycles in the countries receiving its loans. Credits are higher one year before and one year after elections and lower in election years than otherwise. I think that this misuse could be prevented, if countries which have abused IMF money in the past were excluded from further ressources for some time. The common practice of negotiating new arrangements after break-downs should therefore come to an end.
In my opinion the ex-ante conditionality proposed by Vaubel during the eighties and the Meltzer Commission recently wopuld be an important step. Therefore, not only the Contingent Credit Lines but all IMF facilities should include this type of conditionality.

Sincerely,

Axel Dreher
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Axel Dreher
Universität Mannheim
Lehrstuhl für Volkswirtschaftslehre

"IMF CONDITIONALITY"

Summary of the Paper

External contribution to the IMF's Review of Conditionality

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June 26, 2001

IMF policy conditionality is a multi-faceted instrument, which has been seen as fulfilling a number of different functions during the past 50 years (i.e. since its inception in the early 1950s). These functions include: the protection of limited IMF resources (to guarantee their revolving nature); the provision of valuable commitment technology to member countries; and the mitigation of moral hazard concerns brought about by IMF support during external crises. IMF conditionality has also been the subject of intense debate and, often, criticism, since the 1980s, with respect to both its *content* (i.e. the kind of policies recommended by the Fund) and its *design* (i.e. its scope, credibility and timing).

This paper contributes to the on-going debate on the design of IMF conditionality, and to the closely related one on reforming the International Financial Architecture, from an analytical perspective. We do so by presenting a stylised conceptual model of the IMF, which highlights the basic role of conditionality as a *contract* between the IMF (i.e. the Principal) and the country receiving balance of payments support during an external crisis (i.e. the Agent). This baseline model is then extended to capture some of the key functions which have been attributed to IMF conditionality, in order to assess their robustness and mutual compatibility.

The main results obtained in this paper are as follows. First, two of the basic functions which can be identified with IMF conditionality contracts (namely, the protection of Fund lending during a crisis and the provision of commitment technology to the recipient country) are mutually compatible, if the capital outflow which triggers the crisis is not too large. Second, IMF bail-outs can lead to debtor moral hazard if the Fund's commitment/bargaining power is limited. Conditionality can be used to reduce the incidence of this

type of moral hazard only if it is applied before crisis-events (i.e. *ex-ante*), and in exchange for greater post-crisis lending. Third, if the crisis is large, ex-post private sector involvement (PSI) in the form of debt-relief is a pre-condition for effective conditionality. Depending on the Fund's attitude to PSI, and on the severity of investor moral hazard, the IMF may find it optimal to pre-commit before a crisis to maximise PSI if a crisis occurs, even though this may be ex-post sub-optimal. Also in this case therefore the Fund's ability to provide credible pre-commitments is crucial to avoid moral hazard.

The paper is structured in four main parts. In the first part (section 2 of the paper), the baseline model of the paper is presented. This is a three-player two-period model. The players are a debtor country, foreign investors and the IMF. Foreign investors can precipitate an external crisis in the second period of the 'game', by suddenly pulling out their capital. This can generate debt-default and overhang if the amount of external debt (i.e. the initial capital inflow) is relatively high. In our set-up, the Fund has resources at its disposal (e.g. made up of quota contributions), and it employs them to maximise adjustment effort in the recipient country if a crisis occurs, via a conditionality contract. The IMF is also constrained to "lend under adequate safeguards", and to minimise the size of its bail-outs.

These assumptions imply that IMF bail-outs can avoid sharp post-crisis reductions in recipient consumption and inefficient debt-overhang by means of the provision of conditional liquidity. Conditionality gives the Fund incentives to intervene (given that it 'buys' adjustment effort), and it also enhances the Fund's ability to be re-paid after a crisis. However, if the crisis is particularly large (i.e. if pre-crisis external debt is high), conditional lending cannot avoid default, and some form of debt-relief is required.

The following three sections of the paper draw out some of the implications of the baseline model of IMF conditionality, extending it in a number of directions. The first extension shows how the presence of the IMF and its provisional of conditional liquidity can act as a source of valuable *commitment technology* to the debtor country. This is the case both *ex-post* (once a crisis has occurred) and *ex-ante* (when foreign capital flows into the country). Whilst ex-post the IMF has incentives to extract all of the value of this commitment technology via the conditionality contract (due to its incentives to minimise transfers to the debtor and increase reform effort), ex-ante the debtor may benefit from the external restraint provided by the Fund, due to the reduction in inefficient credit-rationing this brings about. In this sense, there can be *ex-ante debtor ownership* of IMF conditionality.

The following two extensions of the paper explore the interaction between IMF interventions and *moral hazard*, on both the debtor's and the investors' side. *Debtor moral hazard* (i.e. excessive risk-taking on the part of debtors before an external crisis) can only arise if the Fund's ability to commit to leave

no rents to the agent as part of its crisis-intervention is limited. If this is the case, the Fund's bail-outs reduce the incentives for the debtor to engage in costly crisis-prevention activities by effectively providing some unconditional liquidity support, and thereby causing moral hazard.

To solve debtor moral hazard the IMF needs to complement its traditional ex-post conditionality with an ex-ante contract, i.e. a commitment to a larger ex-post bail-out in exchange for more pre-crisis reform efforts by the debtor. If the severity of debtor moral hazard is limited, then such an ex-ante contract can eliminate debtor moral hazard. Ex-ante conditionality is analogous to pre-qualifying countries for IMF support before a crisis has occurred (e.g. as proposed by the Meltzer commission), with one key difference: ex-ante conditionality does not imply that countries which do not accept an ex-ante contract will not be supported by the Fund. To the contrary, ex-ante contracting is efficient (form the IMF's perspective) precisely because the Fund cannot credibly commit to stand-by in the event of a crisis, if a country has not pre-qualified for crisis support. In this sense ex-ante conditionality is more similar to the Contingent Credit Line facility, which complements other IMF facilities.[1]

An additional consideration to bear in mind on the issue of debtor moral hazard is that ex-ante conditionality can mitigate (and possibly eliminate) this concern only by committing some of the IMF's resources ex-ante, without the protection of traditional ex-post conditionality. This may compromise the IMF's ability to "lend under adequate safeguards", which may in turn lead to the presence of an institutional bias on the part of the Fund in favour of ex-post conditionality, implying that the intensity of ex-ante contracts is too low and that crises are too frequent.

The last extension of the model presented in the paper examines the issue of *Private Sector Involvement* (PSI) in crisis-resolution and the related question of *investor moral hazard*. This extension shows that PSI can be an essential component of IMF-led crisis resolution packages, enabling efficient IMF bail-outs to take place. Even a "PSI-averse" IMF, i.e. one which seeks to maximise external debt-repayment following a balance of payments crisis, will therefore demand some PSI if the capital outflow which triggers the crisis is large. A "PSI-tolerant" IMF (i.e. one which trades-off reform inducement with the joint minimisation of PSI and of the size of the bail-out), has incentives to increase the extent to which PSI takes place, to enhance the effectiveness of its conditionality. However, this still leaves some rents to investors, compared to a situation without IMF intervention, if investors suffer from co-ordination failures.

[1] Note also that ex-ante conditionality does not imply that countries' eligibility for support if a crisis has occurred should be evaluated on the basis of *results* rather than *actions*. Conditioning on results (or outcomes) is only optimal if adjustment effort cannot be observed, and it is not related to the issue of when to offer the conditionality contract (i.e. whether to offer ex-post or ex-ante conditionality contracts).

This insurance effect of the IMF's crisis interventions in favour of foreign investors can generate investor moral hazard, if the crisis-event is sufficiently disruptive and if the probability of the crisis taking place is sufficiently sensitive to ex-ante capital inflows. If both of these conditions are satisfied, the IMF will have ex-ante incentives to commit to a "tough" PSI policy if a crisis takes place, even though this partially compromises the effectiveness of its ex-post conditionality (and is therefore ex-post sub-optimal). This will deter excessive ex-ante capital inflows, and therefore reduce the likelihood of a crisis. On the other hand, pre-commitment to a tough PSI-policy also implies that ex-ante credit-rationing increases, which may hurt the debtor country.

The paper concludes by highlighting a number of trade-offs which emerge from our analytical modelling of IMF conditionality, and which need to be considered when thinking about how to optimally reform the International Financial Architecture. These include the trade-offs between:

- the mitigation of investor moral hazard and the relaxation of ex-ante credit rationing;
- debtor ex-post program ownership and the possibility of debtor moral hazard;
- ex-ante conditionality (i.e. crisis-prevention) and ex-post conditionality (i.e. the need to lend under adequate safeguards); and
- efficient crisis resolution (from the Fund's perspective) and the reduction of rents to foreign investors (to mitigate investor moral hazard).

All of these issues need to be considered by the Fund when assessing proposals for reform of its conditionality practices. One of the aims of this paper has been to provide a comprehensive analytical framework which can be used to support this assessment.

IMF Conditionality*

DRAFT - COMMENTS WELCOME

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Abstract

This paper presents a principal-agent model of IMF conditional lending, in the aftermath of a "capital-account" liquidity crisis. We show that traditional ex-post conditionality can be effective in safeguarding the Fund's resources, allowing for the provision of efficient emergency lending and reducing inefficient ex-ante credit rationing if the capital outflow which triggers the crisis is not excessive.

We apply the baseline model to analyse the issues of debtor moral hazard and private sector involvement (PSI), which have characterised the recent debate on reforming the International Financial Architecture. We show that debtor moral hazard is only a concern if the IMF cannot commit to make the post-crisis participation constraint of the debtor country binding, and that it can only be resolved via ex-ante conditionality (or pre-qualification). Attempts to reduce debtor moral hazard may however compromise the Fund's ability to safeguard its resources ex-post.

We also show that PSI in the solution of balance of payments crisis is a central determinant of the effectiveness of both crisis prevention and resolution efforts on the part of the IMF. PSI may be an enabling condition for efficient crisis resolution, and may therefore be imposed even by a "PSI-averse" IMF. Moreover, there are conditions under which it is optimal for the IMF to ex-ante precommit to a tough, and ex-post sub-optimal, PSI policy, in order to mitigate investor moral hazard.

The purposes of the IMF are:

[...] (v) To give confidence to members by making the general resources of the Fund temporarily available to them under adequate safeguards, thus providing them

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with opportunity to correct maladjustments in their balance of payments without resorting to measures destructive of national or international prosperity.

IMF Articles of Agreement, Article I

1 Introduction

Conditionality is the practice by which the International Monetary Fund (IMF, or Fund) makes its financial assistance to member countries contingent on the implementation of specific economic policies. According to Article I(v) of its Articles of Agreement (quoted above) one of the purposes of the IMF is to intervene in support of member countries which are in a position of external disequilibrium (i.e. do not have sufficient foreign exchange to purchase imports or to service their external debt). When it does so the IMF typically negotiates a program of adjustment with the recipient country as a pre-condition for the initial dispersal of resources, and it makes the release of its funds contingent on the implementation of these reforms. This practice is known as *conditionality*.[1]

This paper models IMF conditionality from a contractual perspective, employing a principal-agent framework to capture both the stylised macroeconomic features of situations of balance of payment disequilibrium which warrant intervention by the IMF, and the nature and potential effectiveness of this intervention. In doing so we aim to bring together the various rationales for conditionality which have been put forward since the inception of this practice in the 1950s, and to analyse their mutual consistency and interaction. This analysis is of direct relevance to the current debate on the International Financial Architecture (IFA), which has been triggered by the large international financial crises of the mid to late 1990s (i.e. most notably the Mexican and East Asian crises), and which has brought a renewed interest by researchers and policy-makers on possible reforms of IMF crisis lending and of its conditionality practices.

The main results presented in this paper are as follows. First, two of the basic functions which can be identified with IMF conditionality contracts (the protection of Fund resources and the provision of commitment technology to the recipient country) are mutually compatible, if the balance of payments disequilibrium (or capital outflow) which triggers IMF intervention is not too large. Second, IMF bail-outs can lead to debtor moral hazard if the IMF's commitment power are limited. Conditionality can be used to reduce the incidence of this type moral hazard only if it is applied before the crisis (following "selectivity" procedures), and in exchange for greater post-crisis IMF loans. This may however compromise the ability of the Fund to safeguard its resources after the crisis, and may therefore introduce an institutional bias in favour of traditional ex-post conditionality. Third, if the crisis is large, ex-post private sector involvement (PSI) in the form of debt-relief is a pre-condition for effective conditionality. Depending on the IMF's attitude towards PSI and on the severity of investor moral hazard, the IMF may find it optimal to pre-commit before a crisis to maximise PSI if a crisis occurs. This may in turn re-introduce

[1] Appendix A provides some information on the practice of IMF conditional lending, decribing the nature and historical use of IMF financial facilities which are subject to conditionality.

inefficient credit constraints ex-ante.

This paper proceeds as follows: the rest of this introduction consists of a brief review of existing literature on conditionality, and of the approach taken in this paper; sections 2 presents the baseline model of IMF conditionality, and Sections 3 to 5 apply this model to three issues respectively: conditionality as commitment technology, debtor moral hazard, and PSI. Section 6 concludes.

1.1 Existing work on IMF conditionality

Much has been written about IMF conditionality. This has been mostly about the *content* of conditionality, i.e. the type of policy changes demanded by the IMF as part of its financial assistance programs, and the effectiveness of the IMF's approach to stabilisation and adjustment (see e.g. Williamson (1983) and Shadler et al. (1995)). Work on the rationale and design of conditionality contracts (which is the subject of this paper) however has been relatively scarce, especially at a formal level.

Papers which deal with (or comment on) the contractual aspects of conditionality can be broadly divided into three categories, which partially reflect three different stages in the evolution of the international monetary system, and which therefore place emphasis on three different potential rationales for IMF intervention: the Bretton Woods era (or *conditionality as a safeguard*); the debt crisis of the 1980s (or *conditionality as commitment technology*); and the capital-account crises of the mid- to late 1990 (or *conditionality as moral-hazard containment*).

Conditionality as a safeguard.

The traditional and core view of IMF conditionality, as implicitly stated in the Articles of Agreement of the Fund and applied during the Bretton Woods era (and, to a large extent, beyond), is that by linking its financial support to policy changes, the IMF safeguards its resources, and guarantees their revolving nature.[2] This is because conditionality can ensure that adjustment to a balance of payment disequilibrium will take place and that the temporary relief offered by the Fund's intervention will not lead to delays in the implementation of necessary adjustment policies. This in turn implies that the recipient country will be in a position to repay the Fund in due course (see e.g. Guitian (1981); IMF (2000a)). Conditionality therefore can be seen as acting as a substitute for the collateral which is typically employed in domestic loan contracts to discipline the behaviour of the borrower.

The ability to safeguard its lending via conditionality is often seen as a unique privilege of the Fund relative to private suppliers of liquidity,[3] which enables it to intervene at times of crisis

[2]The IMF's resources are made up of its members' quotas. The Fund therefore functions like a credit cooperative, making its resources available to members on a temporary and revolving manner. See Appendix A for more detail on the IMF's lending practices.

[3]This argument has been made by a number of authors (e.g. Sachs (1989b) and Rodrik (1996)), who argue that the IMF may be advantaged relative to private creditors in imposing and enforcing conditionality on a number of grounds: political neutrality (i.e. which makes the commitment not to extract an excessive share of the benefits of reform credible); informational advantage (e.g. lower costs in monitoring the implementation of conditionality); higher leverage relative to private creditors due to cross-conditionality practices (whereby other donors link their

and prevent actions which are otherwise optimal for the debtor country, but which may have a negative externality on other IMF members.[4] *Conditionality as a safeguard* may therefore go hand in hand with *conditional lending as a bribe*, which is used by the Fund to induce recipient countries to adopt policies which have a public good component.[5]

Conditionality as commitment technology.

A second rationale for conditionality emerged in the wake of the debt-crisis of the 1980s,[6] following the realisation that high level of sovereign debt may lead to inefficient outcomes due to *debt-overhang*.[7] This refers to the fact that a sovereign with a high level of external debt may face sub-optimal incentives to invest and achieve higher future incomes because of the large proportion of future output gains which need to be transferred to external creditors. This can in turn reduce debt repayment, leading to a Debt Laffer curve. Two solutions to exit such debt traps have been identified in the literature: fresh liquidity (or debt rescheduling) and/or debt relief (see e.g. Diwan and Rodrik (1992)). These solutions may however not be available if debtors cannot precommit to policies which increase future output in exchange for favourable recontracting of their debt obligations (e.g. commit to invest rather than consume additional lending). Conditionality can represent the mechanism which allows debtors to commit to efficient policies, increasing the incentives to adopt these policies by means of the extra finance made available by the IMF,[8] thus allowing for an efficient exit from a debt-overhang situation (which may or may not require debt-relief). In the absence of conditionality and debt restructuring an inefficient outcome may persist (for high levels of external debt) and/or ex-ante credit-rationing may take place (Fafchamps (1996)).

Conditionality as moral hazard reduction.

A third and more recent interpretation of conditionality is associated with the debate on the new International Financial Architecture (IFA)[9] and on the potential need for an international

financial support to the implementation of IMF programs).

[4] This is what Article I(v) refers to as "measures destructive of national or international prosperity", and which, depending on specific circumstances, may imply sharp ("competitive") depreciation of the exchange rate, significant output falls (e.g. recessions) or default on external debt.

[5] Masson and Mussa (1995) make arguments along these lines.

[6] This was precipitated by the default of Mexico in the summer of 1982, and led to the IMF playing a key role in debt rescheduling and (eventually) relief efforts, with conditionality at the center of its interventions (see Guitian (1995)).

[7] This was articulated by a number of authors, in particular Sachs (1989a) and Krugman (1988).

[8] Alternatively, conditionality may be seen in this context as a mechanism which guarantees to the debtor that creditors will not extract an excessive share of their future output by delegating the debt-relief (or rescheduling) management to an impartial organisation like the IMF (Claessens and Diwan (1990); Fafchamps (1996)); or as a mechanism which screens high productivity countries from low productivity ones, and allows creditors to target debt-relief on the former (Marchesi and Thomas (1999)).

More generally in these contexts conditionality can be seen as an "external agency of restraint" (Collier (1997)) which allows policy makers to adopt policies which would otherwise be time-inconsistent.

[9] Eichengreen (2000) dates the start of this on-going debate to a speech made by Rubin (the then U.S. Secretary of the Treasury) in February 1998. Much of the recent discussion on IFA (e.g. Eichengreen (1999), Eichengreen (2000), Jeanne (2000) and Goldstein (2000)) centers around the issue of investor and debtor moral hazard reduction, emphasising the need for reforms of IMF lending (including conditionality) and of arrangements for

Lender of Last Resort in a world with high and volatile international capital flows, which may leave countries exposed to "runs" and liquidity crises even if their fundamentals are sound (in a fashion similar to the classic Diamond and Dybvig (1983) banking model).[10] Some commentators have argued that, given the scale of the financial flows involved, IMF bail-outs in these circumstances may lead to a problem of moral hazard, and excessive ex-ante risk-taking by both creditors and debtors (see for instance the IFIAC (or Meltzer) report (2000)). Given the risk and potential implications of moral hazard, it has been argued that conditionality should (and can) be seen as a mechanism to limit debtor moral hazard and introduce *co-insurance*, by imposing an additional cost onto countries which face a capital-account crisis and which are bailed-out by the Fund (Guitian (1995); Fischer (1999)).[11] In this context conditionality could therefore be seen as a substitute for "penal rates" at which the domestic Lender of Last Resort should lend according to the standard Bagheotian doctrine.

1.2 Approach and Structure of the Paper

As the survey of the relevant literature presented above shows IMF conditionality is a multi-faceted instrument, which is frequently "assigned" different roles by commentators (and, arguably, by the Fund itself). The purpose of this paper is to provide a stylised model which can encompass these roles, and shed light on whether they are internally and mutually consistent.

We do so by presenting a stylised principal-agent model with the following building blocks: (i) external disequilibrium is due to capital inflows, which can trigger a "sun-spot" crisis (e.g. partially unrelated to fundamentals) by suddenly withdrawing from the debtor country;[12] (ii) the model follows some of the literature on sovereign debt, starting from a recognition that debt contracts between sovereigns cannot be enforced, and that willingness to pay rather than ability to pay determines the amount of debt-repayment (see e.g. Eaton and Fernandez (1995)); (iii) the model assumes that the IMF is the only potential supplier of conditional liquidity in the immediate aftermath of a crisis (see the arguments put forward in section 1.1 for why this might be so); (iv) hidden action or information aspects of conditionality contracts are not modelled,

private-sector-involvement (PSI) in crisis resolution.

[10] Much has been written on this issue in the wake of the Mexico crisis of 1995, and of the East Asian crisis of 1997/1998. Relevant work includes Radelet and Sachs (1998) and Chang and Velasco (1999) (who argue in a favour of a "country-run" interpretation of the crises), Dooley (2000) and Corsetti, Pesenti and Roubini (2000) (who favour a "moral-hazard" interpretation for the crises) and Fischer (1999) and Giannini (1999) (who discuss the issue of international lending of last resort).

[11] According to this line of argument, the cost due to conditionality presumably derives from the conflict of priorities between the IMF and the recipient government, which implies that under conditionality the recipient adopts policies which it would have not adopted otherwise.

[12] In other words the balance of payments crisis we consider as the trigger for IMF intervention is not a Krugman-style *current-account crisis* (as in Krugman (1979)), which is typicall driven by over-expansionary policies and/or negative external shocks, but a *capital-account crisis*, of the kind seen in Mexico and East Asia in the 1990s. We focus on capital-account crises to make our analysis directly relevant to the current debate on IMF reforms, but the set-up we put forward is adaptable to a more traditional current-account crisis (i.e. the fundamental constraints on Fund intervention are the same).

for simplicity;[13] and (v) the model is real, in the sense that there is no exchange rate, and a crisis does not manifest itself as a sharp currency depreciation but rather as a sudden reversal of foreign capital flows, possibly followed by debtor default.

In the next section of the paper we employ these building blocks to construct an agency model of conditionality, where a principal (the IMF) offers a conditional liquidity contract to an agent (the debtor) following a crisis event. As in standard principal-agent models, the principal designs the contract to trade-off the maximisation of reform effort with the minimisation of bail-out transfers. We shows that this contract can avoid the occurrence of a inefficient liquidity crunch and of debt overhang if the capital outflow which triggers the crisis is not too large. The use of conditionality also allows the IMF to lend under "adequate safeguards" (i.e. recover its bail-out at the end of the crisis period), by tying the provision of the bail-out to the implementation of income-increasing reforms.

Sections 3 to 5 then proceed to draw out some of the implications of the baseline model. Section 3 shows how the presence of the IMF and of its provision of conditional liquidity can act as a source of commitment technology for the debtor both ex-post (once a crisis has occurred) and ex-ante (when foreign capital flows into the country). Whilst ex-post the IMF has incentives to extract all of the value of this commitment technology with his contract (given its incentives to minimise transfers to the agent), ex-ante the debtor may benefit from the external restraint provided by the Fund, due to the reduction in inefficient credit rationing.

Section 4 and 5 address the currently topical issue of whether apparently efficient IMF bail-outs can induce 'moral hazard'. We show in section 4 that debtor moral hazard (i.e. excessive risk-taking on the part of the debtor) can only arise if the Fund's ability to commit to make the agent's participation constraint bind ex-post is limited. If this is the case, the IMF ex-post contract will be characterised by some slippage in the implementation of reforms (i.e. there is ex-post program 'ownership'), which will in turn induce the debtor to reduce ex-ante crisis prevention efforts. To solve debtor moral hazard the Fund needs to complement its ex-post bail-out with ex-ante conditionality, i.e. the commitment to higher ex-post bail-outs in exchange for more pre-crisis effort on the part of the debtor. Section 4 shows that if the incidence of IMF ex-post discretion is limited, ex-ante conditionality is able to restore first-best ex-ante efforts.

Section 5 examines the role for so-called Private Sector Involvement (PSI) in balance of payments crises. It shows that PSI can be an essential component of IMF-led crisis resolution packages, enabling efficient IMF bail-outs to take place. Even a PSI-averse IMF, i.e. one which seeks to maximise debt repayment, will therefore demand some PSI if the capital outflow is large. A PSI-tolerant IMF (i.e. one which trades-off reform inducement with bail-out and PSI

[13] This is the case also in the "moral hazard" extensions of the model that we present in Sections 4 and 5, where we follow the recent literature on international financial architecture and use the term "moral hazard" rather loosely, to refer to a situation where an agent does not spontaneously adopt an efficient level of "effort" from the point of view of a principal (as opposed to a hidden-action model where first best effort is not attainable because of a combination of asymmetric information, noise and agent risk-aversion).

It would be relatively straightforward to introduce hidden action and information considerations in the model we present below, but doing so would not add particularly significant insights about the nature of IMF conditionality.

minimisation) has incentives to increase the degree of PSI, but it would still leave some rents to investors relative to a no-IMF benchmark (as long as in the absence of the Fund investors cannot co-ordinate on an efficient debt-relief offer). This insurance for investors can generate an investor moral hazard problem, if the crisis is sufficiently disruptive and sufficiently sensitive to ex-ante capital inflows. If this is the case, the Fund will face incentives to pre-commit to a tougher, and ex-post sub-optimal, PSI policy, in order to deter excessive capital inflows.

Section 6 concludes by summarising the main results obtained in this paper, and highlighting the variety of trade-offs which can be identified between the different possible functions of IMF conditionality.

2 The Baseline Model

2.1 Set-up

Consider the following three-player and two-period model. The players are a group of foreign investors, a recipient (or debtor) country and the IMF. The two periods are an investment period ($t = 1$) and a potential crisis period ($t = 2$).

At $t = 1$ the investors lends an amount k to the recipient country, which is assumed exogenous in this baseline model, and which we endogenise in the next section of the paper. We assume that k is consumed by the debtor country, and there is no reserve accumulation or investment.[14] At $t = 2$ a "crisis" may occur, with probability γ, which causes all creditors to 'panic', inducing them to demand k back from the debtor country at the beginning of the period. The probability of crisis is also assumed to be exogenous in this baseline model, and is endogenised in the extensions we present in Sections 4 and 5. Both in the baseline model and in the endogenous-crisis extensions however we assume that probability of the crisis occurring is not directly related to the investors' prospects for debt-repayment, and that the crisis takes place for reasons which are outside the model (e.g. investor "panic"; "contagion"; or a sudden interest-rate reversal working against the debtor country).

The recipient country faces a choice of adjustment effort (e_t) at both $t = 1$ and $t = 2$. More effort leads to more output $y(e_t)$ (i.e. $y'(e_t) > 0$), but at a cost $c(e_t)$. The standard assumption of convexity of the cost function is made (i.e. both $c'(e_t)$ and $c''(e_t)$ are positive). In this context effort can be thought of a supply-side measure (e.g. price liberalisation, or a reduction in taxation/tariffs) which increases domestic output but also implies a political economy cost for the policy makers in the recipient country.[15]

If a crisis occurs at $t = 2$, the country can choose whether to repay k (which is demanded

[14] This is analytically equivalent, in our set-up, to an assumption that foreign capital is invested by the recipient country at $t = 1$, and that its returns are fully wiped out in the event of a crisis (e.g. because of early project termination).

[15] Alternatively, $y(e_t)$ can be though of as the production of tradeables, e_t as the relative price of tradeables to non-tradeables, and the function $c(e_t)$ as describing both the domestic production function of tradeables and non-tradeables and the policy-makers' preference with respect to these two goods. See Appendix C.1, which outlines a model which defines effort e_t along these lines.

back by the creditor) or default. If it repays, it suffers a $(1+\lambda)k$ fall in consumption, where λ (which lies between 0 and 1) reflects the deadweight loss associated with sudden capital outflows. This may be due to early project liquidation - as in banking models - or to the cost due to sudden foreign exchange scarcity or sharp falls in absorption.[16] We assume that the λ loss applies at the beginning of the $t = 2$ period (i.e. when investors demand their capital back), but not at its end. If the debtor defaults it suffer a direct sanction $p(y(e_2))$ which is increasing in its domestic production level.[17,18]

If the crisis does not occur, k is not demanded back by the investor, and the debt is serviced by the debtor at $t = 2$ (and thereafter). For simplicity the world interest rate is fixed at 0, so that debt-servicing does not imply any transfer of resources from debtor to creditor.[19]

The IMF has resources at its disposal, and can intervene to bail-out the debtor country if a crisis occurs at $t = 2$.[20] IMF intervention consists of a conditional loan b, which is dispersed at the start of $t = 2$ (i.e. when the λ-loss applies) if three requirements are fulfilled by the recipient country: it implements a pre-specified second-period effort level e_2; it repays k in full at the beginning of the period $t = 2$; and it repays b at the end of the period. The latter two conditions imply that the IMF requires that the debtor country does not default on its external debt as a pre-condition for its lending, and that the Fund *needs* to lend under "adequate safeguards", making sure it is repaid at the end of $t = 2$ (we expand on both of these points below). By the end of the period $t = 2$ the deadweight loss λ on capital outflows does not apply, so that the cost of repaying the amount b equals $-b$. This implies that an IMF bail-out leads to a net transfer of λb to the debtor.

The utility functions of the recipient country and of the IMF are as follows:

[16] This effect could be modelled explicitly, by for instance introducing risk-aversion, or allowing for price stickiness, which does not allow the debtor country to produce more tradeables when hit by a crisis to compensate for the sudden scarcity of foreign exchange. The set-up presented here can be therefore though of as a reduced form of a more complex model, which preserves its essential features (i.e. a sudden outflow of foreign capital is costly) but is more tractable. Appendix C.1 outlines a model with price-stickiness which micro-founds the presence of a liquidity cost λ.

[17] This follows the standard assumption of "gun-boat technology" in the sovereign risk literature (see e.g. Eaton and Fernandez (1995)).

[18] The penalty rate p is inclusive of the dead-weight loss λ. The penalty received by the creditor therefore equals $\frac{p}{1+\lambda}y(e)$.

[19] The incentives for the creditor to invest k with an interest rate of 0 are made explicit in the extension with endogenous capital, and relate to capital depreciation in the investor country.

[20] We do not allow the IMF to intervene before the crisis. This assumption is relaxed in the debtor moral hazard extension of the model (Section 4).

We also do not model why the IMF has access to financial resources. We simply assume the existence of a quota-funded IMF as an instrument of international monetary co-operation, which acts a source of emergency reserves (which is in an efficient risk-pooling activity for member states if the shocks which trigger external crises are idiosyncratic) and as a promoter of international economic linkages (see the IMF's utility function in the main text).

- Recipient utility (U_t^R, for $t = \{1, 2\}$):

$$U_1^R = y(e_1) - c(e_1) + k$$

$$U_2^R = \begin{cases} y(e_2) - c(e_2) & \text{if there is not a crisis} \\ y(e_2) - c(e_2) - p(y(e_2)) & \text{if there is a crisis and default} \\ y(e_2) - c(e_2) - (1+\lambda)k + \underbrace{\lambda \min(b,k)}_{\text{if the IMF intervenes}} & \text{if there is a crisis and no default} \end{cases}$$

- IMF utility:

$$U^{IMF} = y(e_2) - b$$

The IMF's utility function is underpinned by the assumption that the Fund is concerned about the production level of the recipient country (which may, for instance, contribute to global stability and/or international trade), and that it also seeks to minimise the use of its resources (to maintain their revolving nature).[21] Note that we are assuming that the Fund is not directly concerned with the consumption level in the recipient country, and does not directly seek to minimise the dead-weight loss induced by a crisis. However, as we show below, the presence of a crisis allows the IMF to intervene (i.e. a crisis gives leverage to the Fund) and reduce inefficiency in the process, even though none of the efficiency gains are passed on to the recipient country. In section 4 we relax the latter assumption, and allow for some rents from Fund intervention to be appropriated by the recipient.

The following assumptions on functional forms are made in what follows, for the sake of tractability: $y(e_t) = e_t$; $p(e_t) = pe_t$, with $p \in (0, 1)$; and $c(e_t) = \frac{1}{2}e_t^2$.

Figure 1 summarises the timing of the game. As the figure shows, we assume that the realisation of the crisis is known before the actual outflow of k or the levying of the penalty $p(e_2)$, which allows the recipient country to set e_2 according to whether it wants to default on its debt or not. The figure also illustrates the fact that the IMF's bail-out takes place just after e_2 is set, which allows the Fund to enforce the conditional liquidity contract (see Section 2.3 below for further discussion of this point).

As it is shown below this set-up can convey the basic rationale for IMF intervention: by providing valuable balance of payment support and granting debtor countries "time to adjust" (i.e. allowing them to avoid the additional λ-cost associated with a sudden capital outflow), the Fund can induce income-increasing reforms, avoid unnecessary demand-side adjustment (i.e. an excessive fall in consumption) and, depending on the level of debt, avoid inefficient debt-overhang. The scope for efficient intervention by the IMF hinges on the interaction between conditionality and the size of the capital outflow, as the results presented below illustrate.

[21] Note that this assumes that the IMF does not care about first period output. This assumption is made for simplicity and is innocuous, given that we are ruling out IMF intervention before a crisis in the baseline model.

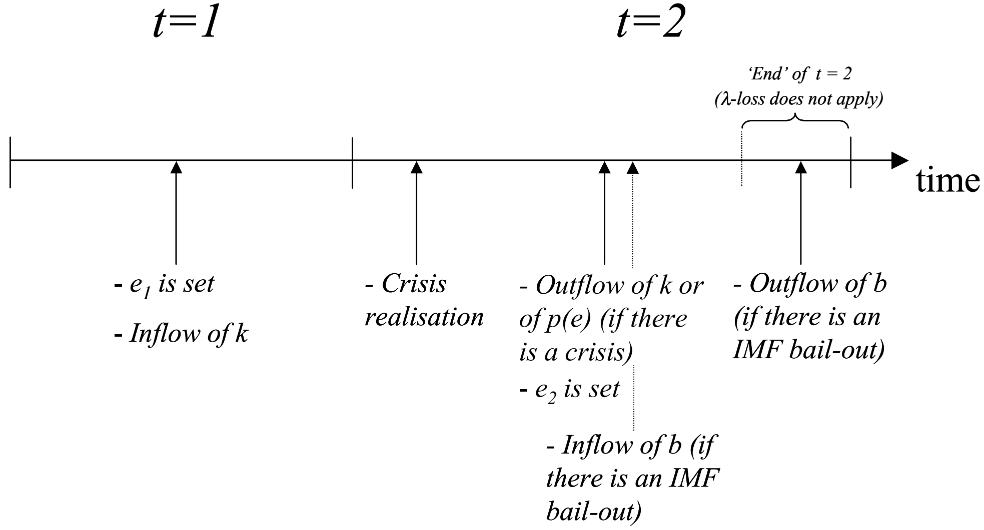


Figure 1: The timing of the game.

2.2 The equilibrium without the IMF

At $t = 1$ the recipient maximises its utility relative to e, and therefore sets $e_1^* = 1$ (from the following FOC: $\frac{\partial U_1^R}{\partial e_1} = 1 - e_1 = 0$), which is independent of the level of capital inflow k given the assumption of quasi-linearity.[22]

At $t = 2$ if the crisis does not occur the same level is chosen for e_2. If a crisis occurs the debtor faces a choice between defaulting and paying the debt. This yields the following optimal level for e_2:

$$e_2^* = \begin{cases} 1 & \text{for } k < k^D \ (\textit{repayment equilibrium}) \\ 1 - p & \text{for } k \geq k^D \ (\textit{default (or debt-overhang) equilibrium}) \end{cases}$$

where $k^D = \frac{p(1-\frac{p}{2})}{1+\lambda}$, with $\frac{\partial k^D}{\partial p} > 0$ (i.e. the likelihood of default falls with the size of the default penalty).

Therefore, if the level of external debt is high enough, the recipient finds it optimal to default on its external debt and reduce national output (or withdraw from external trade), and suffer the penalty $p(e)$. This corresponds to a situation of *debt overhang* (as in Sachs (1989a)), where high levels of external debt induce a country to reduce adjustment effort and therefore production. For low levels of k, the recipient finds it optimal to repay the debt, and run a current account surplus equal to $(1 + \lambda)k$ at the start of $t = 2$, by reducing consumption.

[22] Throughout the paper we write variables with a superscript $*$ to denote optimal levels in the absence of IMF conditionality, and with superscript c to indicate optimal levels chosen by the IMF.

The equilibrium utility level obtained by the recipient at $t = 2$ is as follows:

$$U_2^{R,*} = \begin{cases} \frac{1}{2} - (1+\lambda)k & \text{for } k < k^D \\ \frac{(1-p)^2}{2} & \text{for } k \geq k^D \end{cases}$$

2.3 The equilibrium with the IMF

As set out above, the IMF can intervene if a crisis occurs at $t = 2$. The IMF's incentive to supply emergency funds derives from the ability to offset the deadweight loss λk with its bail-out and, therefore, obtain some leverage on the recipient country to induce it to adopt an optimal level of adjustment.[23]

IMF intervention consists of *conditionality*, that is, the offer of a bail-out b in exchange for a given second period effort level e_2. We assume here that the IMF can enforce the optimal contract $\{b^c, e_2^c\}$ in a time-consistent fashion, i.e. it can guarantee that the agent will exercise effort e_2^c in exchange for the (net) transfer λb^c (as long as the individual rationality constraint is satisfied). In our set-up this is equivalent to assuming the choice of e_2 by the agent can be observed by the Fund and is not reversible, and that the Fund has access to full commitment technology (and hence has all the bargaining power). If this is the case, the principal can enforce optimal conditionality by relying, for instance, on a linear contract which specifies b as a function of e_2, and which therefore delegates the choice of e_2 to the agent. By meeting the appropriate incentive compatibility constraint, such a contract ensures that e_2^c is set by the agent, and b^c is transferred by the principal.

In practice reform implementation is a gradual and cumulative process, and only a share of the IMF's bail-outs is dispersed at the outset of a reform program, and additional tranches of b are released depending on the level of e_2. That is, the IMF solves the incentive-provision problem which would be caused by front-loading the bail-out in the absence of the agent's commitment to a given level of e_2 by staggering its lending (see Appendix A). This gives rise to a trade-off between the early dispersal of bail-out funds (which is more effective in preventing excessive demand-side adjustment and, therefore, in meeting the agent's participation constraint) and the provision of incentives to change policies. We abstract from this trade-off in our modelling, by effectively 'compressing' the timing of the liquidity-reform contract and assuming that reforms demanded by the IMF can be implemented before liquidity is provided.[24]

We do however allow for the imperfect enforcement of the IMF contract due to limited commitment power on the part of the Fund, which is arguably a more policy-relevant reason for why the optimal conditionality contract may not be fully enforceable. We introduce this feature in Section 4 of the paper, in the context of our discussion of debtor moral hazard.

[23] Note that the adjustment that we are allowing for here is both an explicit supply-side adjustment (i.e. a change in e, or "expenditure-switching") and an implicit demand-side one (i.e. a reduction in absorption, or "expenditure-changing"), which is given by the change in consumption (= income - debt repayment) relative to a no-crisis outcome.

[24] This is analytically equivalent to assuming that b^c is released in tranches (e.g. according to an optimal linear contract) as e_2 is increased up to e_2^c, over a time horizon during which the additional 'liquidity' value of the bail-out (i.e. λ) applies in full.

The IMF is subject to three constraints in its intervention. One is a standard individual rationality constraint for the recipient country, which in this case implies that the cost to the recipient country of implementing the level of effort demanded by the IMF rather than e_2^* *and* the cost of having to repay k fully for all values of k (i.e. even for $k \geq k^D$) needs to be outweighed by the benefit of receiving the bail out at the outset of the crisis. We express this constraint as $U_2^R(e_2, b, -k) \geq U_2^{R,*}$ where $U_2^R(e_2, b, -k)$ indicates recipient utility when it exercises second-period effort e_2, receives b at the beginning of $t = 2$ (and repays it at the end of the period), and pays back k at the beginning of $t = 2$.

The second constraint is based on our assumption on the legal framework under which the IMF operates (as reflected in its Articles of Agreement), and in particular on the need for the Fund to lend "under adequate safeguards". This means that the IMF needs to be sure that the recipient country faces appropriate incentives to repay the bail-out at the end of period 2, i.e. $\frac{p}{1+\lambda}e_2 \geq b$ in our set-up (assuming the Fund has access to the same penalty technology as private creditors, and noting that the penalty faced by the recipient for not paying the Fund is scaled down by $1 + \lambda$, given that it is levied at the end of period 2). We define this as the "Adequate Safeguards Constraint" (ASC).

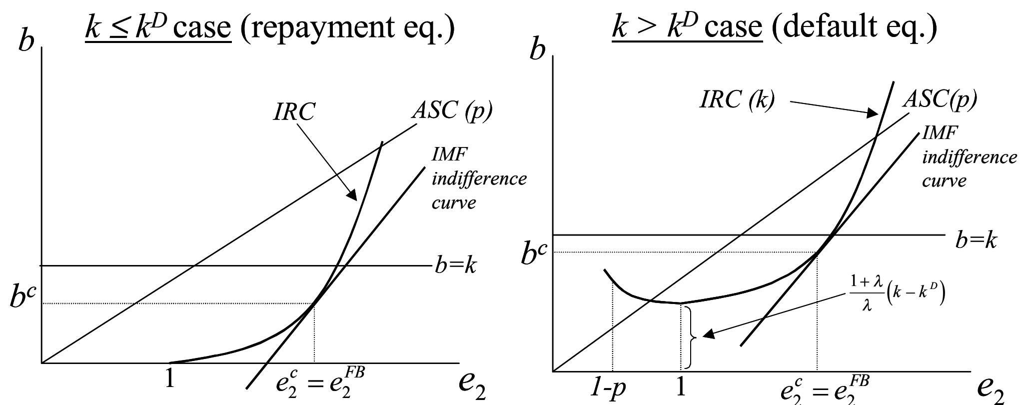
The third constraint is a "no net transfers constraint", which implies that the size of the bail-out cannot exceed the initial capital outflow suffered by the debtor country (i.e. $b \leq k$). This is a technical constraint which is employed to reflect the fact that any b in excess of k does not benefit the recipient (given that it does not provide any liquidity relief), and therefore cannot be optimal for the IMF (since it cannot be used to induce additional effort).

Formally, IMF intervention consists of a conditional bail-out package (e_2, b) which solves the following program:

$$\begin{aligned} \max_{e_2,b} U^{IMF} &= e_2 - b \\ s.t. &: U_2^R(e_2, b, -k) \geq U_2^{R,*} \text{ (IR constraint) (IRC)} \\ &: b \leq \frac{p}{1+\lambda}e_2 \text{ (\textit{adequate safeguards} constraint) (ASC)} \\ &: b \leq k \text{ (\textit{no net transfers} constraint)} \end{aligned}$$

Figure 2 describes the IMF base-line conditionality program, plotting the Fund's indifference curve in (b, e_2) space and the three constraints under which it optimises (i.e. the IRC, the ASC and the $b = k$ schedule). The figure illustrates the fact that making IRC binding is always optimal for the Fund (i.e. first-best conditional effort is at the tangency of the IMF's indifference curve and the IRC) and that a binding $b \leq k$ constraint and/or a binding ASC lower the intensity of conditionality relative to the first-best and can ultimately provoke the collapse of the contract. This is shown formally in Proposition 1, which describes the properties of the solution to the IMF's conditionality program, and is also illustrated in Figure 3 below.

Proposition 1 *The intensity of IMF conditionality is a function of the level of capital outflows which precipitate the balance of payments crisis.*



IMF utility increases as one moves South-East (i.e. towards a higher effort level and a lower bail-out), and its indifference curve has a slope of 1.

The IRC is a convex function of e_2, given that the cost of e_2 is quadratic, and always binds at the optimum, since the IMF has incentives to minimise b. The unconstrained optimum (first-best effort) is at the tangency of the IMF's indifference curve and IRC.

Higher levels of b are necessary to satisfy IRC if $k > k^D$, given that if this is the case the recipient finds it optimal to default on sovereign debt in the absence of IMF intervention, and needs to be compensated for not doing so. This is why, in this case, the IRC lies above the x-axis and its position is a function of k.

The additional two constraints faced by the IMF are also shown on this graph: the ASC constraint, which is flatter (and therefore harder to satisfy) the lower is the penalty for default p; and the $b \le k$ constraint. Both of these constraints are shown as slack in this graph (i.e. b^c lies below both of them), implying that effort is at its first-best level.

Figure 2: The IMF's baseline conditionality program (first-best case).

For high values of k *(i.e.* $k > k^H \equiv (1+\lambda)k^D$*) no conditionality can be imposed by the IMF (i.e. the IR and "no net transfers" constraints cannot be jointly satisfied).*

For lower values of k *(i.e.* $k \leq k^H$*), three cases can be identified depending on whether the "no net transfers" constraint and the "adequate safeguards" constraint bind:*

(i) neither the "no net transfer" nor the "adequate safeguards" constraints bind if $k^D \geq \frac{\lambda}{2}$ *and for* $\frac{\lambda}{2} \leq k \leq k^M$*, where* $k^M = k^H - \frac{\lambda^2}{2}$*. If this is the case the IMF is able to induce first-best conditionality, characterised by:*

$$\begin{aligned} e_2^c &= 1+\lambda \equiv e_2^{FB} \\ b^c &= \begin{cases} \frac{\lambda}{2} & \text{for } k \in [\frac{\lambda}{2}, k^D) \\ \frac{\lambda}{2} + \frac{1+\lambda}{\lambda}(k-k^D) & \text{for } k \in [k^D, k^M] \end{cases} \end{aligned}$$

For other values of k *or if* $k^D < \frac{\lambda}{2}$*, the IMF can only impose second-best conditionality (i.e.* $e_2^c < 1+\lambda$*). In particular we have:*

(ii) For p *high enough (i.e.* $p \geq \bar{p} \equiv \frac{2\lambda}{1+\lambda}$*) the "adequate safeguards" constraint is always slack,* $b^c = k$ *and the IMF imposes the following level of conditional effort:*

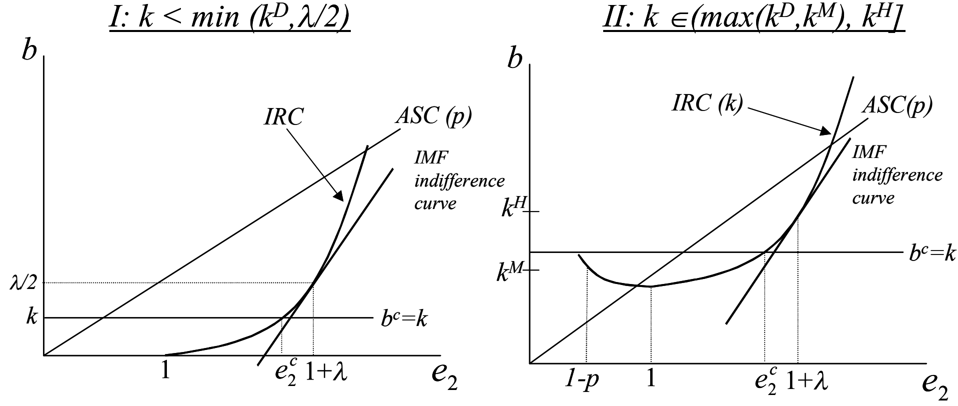
$$e_2^c = \begin{cases} 1+\sqrt{2\lambda k} & \text{for } k < \min(k^D, \frac{\lambda}{2}) \\ 1+\sqrt{2\,(k^H - k)} & \text{for } k \in [\max(k^D, k^M), k^H] \end{cases}$$

(iii) For $p < \bar{p}$ *the "adequate safeguards" constraint binds in the case* $k \geq \max(k^D, k^M)$ *for high enough* k*. This implies that there exists a* $\hat{k}^H(p) \in (\max(k^D, k^M), k^H)$ *such that for* $k > \hat{k}^H(p)$ *conditionality collapses. For* $k \leq \hat{k}^H(p)$ *we have one of two cases, depending on the value of* p*: if* $p \in [\hat{p}, \bar{p})$ *(where* $\hat{p} \equiv \frac{2\lambda(1+\lambda)}{1+2\lambda(1+\lambda)} < \bar{p}$*), we have that* e_2^c *and* b^c *are given by the values in case (ii) above; if* $p < \hat{p}$*, both* e_2^c *and* b^c *are lower than the corresponding levels in case (ii) at* $k = \hat{k}^H(p)$*, and converge to those levels for lower values of* k*.*

Proof. *In Appendix B.* ■

Proposition 1 shows the IMF is able to "bribe" the country experiencing a balance of payments crisis to exert more adjustment effort and, where relevant, not default on its foreign debt, as long as the level of external debt is not too high. The "bribe" consists of provision of foreign exchange to the debtor country at a time of crisis, which in turn partially derives to the IMF from the fact that it can impose conditionality to safeguard its bail-out, and prevent default on its own lending. We elaborate on this point in the next section of the paper, where we discuss the role of the contract as ex-post commitment technology for the debtor country and as an enabling conditions for efficient debt rescheduling.

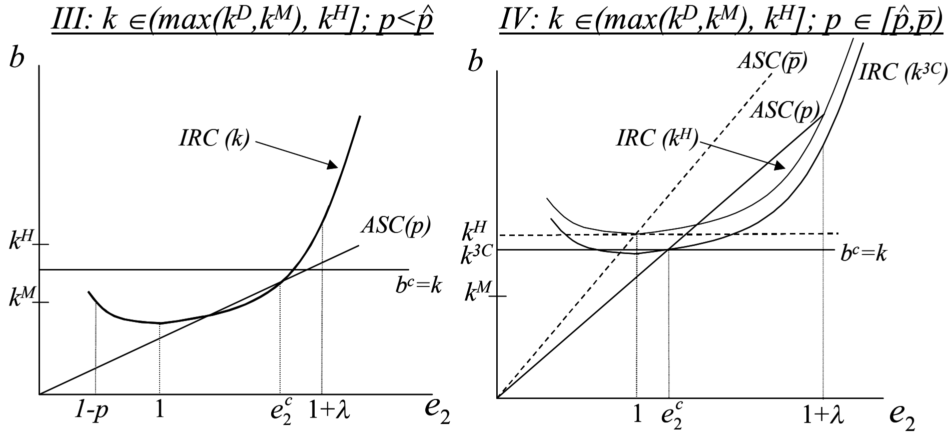
Conditionality is at its first best (i.e. $e^c = 1+\lambda$; $b^c < k$) if the crisis is of an intermediate size and if the penalty p is sufficiently high relative to λ so that $k^D \geq \frac{\lambda}{2}$ is satisfied (see Figure 4 and Figure 5). The first-best effort level reflects the one-to-one trade-off faced by the IMF between extra effort by the recipient and additional bail-out funds, which induces it to optimally increase e_2 relative to the recipient's optimum ($e_2^* = 1$) in accordance with the marginal effectiveness of its bail-out in increasing the recipient's utility (which is given by λ). The first-best conditionality



Panels I and II illustrate case (ii) of Proposition 1, where the $b = k$ constraint is always binding.

Panel I shows the case of excessively low k, which decreases the leverage of the Fund, and forces it to accept an effort level which is below the first-best one.

Panel II illustrates the case of high k (but not high enough to lead to a collapse of conditionality), where the Fund needs to settle for second-best effort given its inability to compensate the recipient for both not-defaulting on debt and choosing first-best effort.



Panels III and IV depict case (iii) of Proposition 1, which describes the optimal IMF contract for high values of k ($k > max(k^D, k^M)$) and relatively low values of p ($p < \bar{p}$).

Panel III shows the weakening of conditionality relative to case (ii) if the penalty rate p is particularly low (namely $p<\hat{p}$). If this is the case the IMF needs to weaken conditionality further relative to the case (ii), *and* conditionality collapses "earlier" (i.e. for lower threshold values of k).

Panel IV shows the corresponding case for $p \in (\hat{p}, \bar{p})$. If this is the case as long as conditionality can be imposed, the effort level is equal to case (ii). However conditionality collapses earlier than under case (ii), namely for $k < k^{3C}$ (see Proof of Proposition 1). The panel shows the equilibrium where $k = k^{3C}$.

Figure 3: Second-best IMF Conditionality (cases (ii) and (iii) of Proposition 1).

contract can be decentralised with a linear "tranching" contract of the form $b = \alpha_0 + \alpha_1 e_2$, where the IMF optimally sets $\alpha_1^c = 1$.

If the crisis is either too small or too large, or if the $k^D < \frac{\lambda}{2}$ is not satisfied, second-best conditionality needs to be accepted by the Fund. The second-best cases (i.e. cases (ii) and (iii) of Proposition 1) are illustrated in Figure 3 and in Figure 4 (which assumes $p \geq \bar{p}$ for simplicity). Under second-best conditionality the intensity of the "tranching" contract is therefore lower than under the first-best ($\alpha_1^c < 1$).

Conditionality is weakened relative to the first-best if capital outflow is too small (e.g. $k < \frac{\lambda}{2}$) because if this is the case the benefits deriving to the recipient from the IMF bail-out are relatively small, thereby reducing the leverage of the Fund in imposing extra reform effort. In this case, $b^c = k$, so that the Fund is effectively "financing the run" with its resources.

Conditionality is also not at its first best if the crisis is "too large" (e.g. $k > k^M$) since if this is the case the IMF is unable to compensate the recipient enough for not defaulting on the debt. For particularly high levels of capital outflows (i.e. $k > k^H$) the IMF cannot impose any conditionality, and therefore does not intervene. Allowing for some debt relief mitigates this conclusion, and always enables conditionality to take place, as it is shown in Section 5.

In the high-k second-best cases, the levels of the parameters λ and p interact to determine the intensity of conditionality and the extent to which the IMF is "financing the run". In particular, if the default penalty is too low, the ASC will bind for high k and conditionality will collapse for values of k below k^H (see Figure 5).

As Figure 5 shows, the Fund prefers high values of p relative to λ (as in Area I of the graph), to be able to exercise first-best conditionality and not be constrained by the ASC. This is because high levels of λ increase the debt-repayment costs due to the IMF conditionality package for the debtor, which makes it harder for the Fund to meet the agent's participation constraint in the cases where the bail-out is not fully covering the initial capital outflow (i.e. $b^c < k$). High levels of p on the other hand make it easier for the IMF to meet the agent's participation constraint, and to protect its lending at the end of $t = 2$.

Throughout the rest of the paper, and in particular in Sections 3 and 5, we restrict the values of the parameters p and λ to be in Area I of Figure 5 (i.e. so that both $p \geq \bar{p}$ and $k^D \geq \frac{\lambda}{2}$ are satisfied). This allows us to focus on one specific form of ex-post IMF conditionality, enhancing the tractability of the extensions of the baseline model we consider in the following sections of the paper.

The following three section of the paper employ the baseline model developed here to assess the role of the IMF in both crisis resolution and prevention, and evaluate the various functions performed by IMF conditionality. In the next section of the paper we draw out the implications of the baseline conditional liquidity contract as a source of valuable commitment technology for the debtor country. In Sections 4 and 5 we extend the baseline model to be able to examine the issue of moral hazard, and to allow for the possibility of PSI (in the form of debt relief) in the crisis resolution package designed by the IMF.

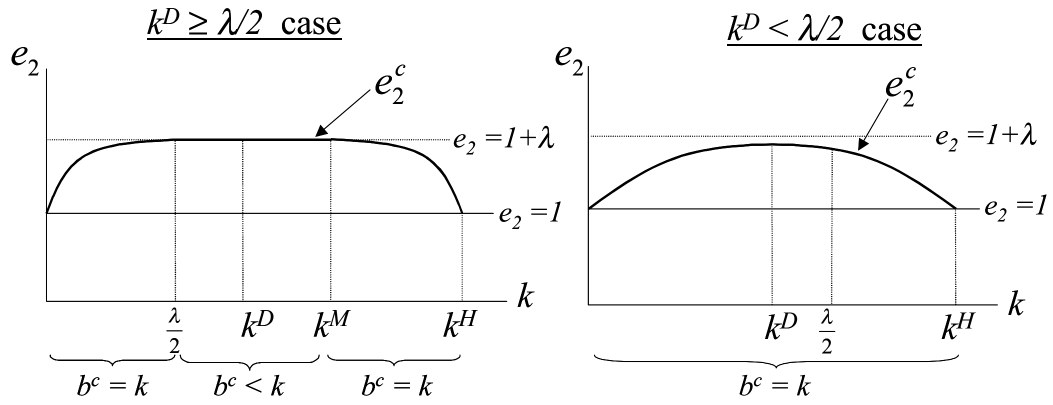


Figure 4: The intensity of IMF conditionality as a function of capital outflows k.

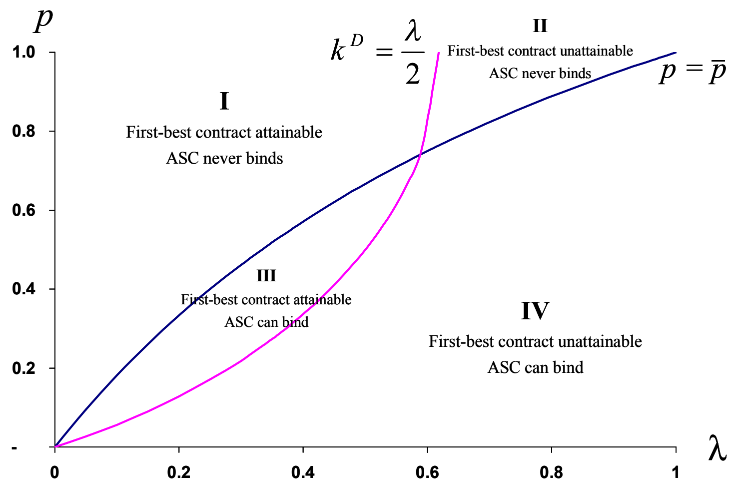


Figure 5: Illustration of the role of the penalty rate p and the liquidity cost λ in determining the nature of IMF Conditionality.

3 IMF Conditionality as Commitment Technology

In this section of the paper we focus on the role of the IMF as an external agency of restraint which is capable of constraining the policies of the debtor country and remove sub-optimal discretionary equilibria. We highlight two roles of IMF conditionality as commitment technology: an ex-post one, which affects the efficiency of crisis resolution; and an ex-ante role, which has an impact on capital inflows before a crisis takes place. Both of these roles are direct by-products of the baseline IMF conditionality presented in the previous section, and their presence does not rely on the Fund explicitly seeking to act as an agency of restraint.

We firstly introduce the idea of IMF conditionality as a source of ex-post commitment technology. This role of IMF conditionality is implicit in the modelling we have presented so far, and the main purpose of the next sub-section is to isolate and clarify the main effects of the baseline IMF contract, and to show their relationship with the issue of debtor ex-post commitment.

The second commitment role of conditionality highlighted in this section requires us to slightly extend the modelling presented so far, by endogenising capital inflows at $t = 1$. This enables us to examine issues of credit-rationing, and to introduce a framework which we also use in Section 5 of the paper, to analyse the issue of Private Sector Involvement (in the form of debt-relief) and investor moral hazard.

Both of the roles of IMF conditionality we discuss in this section have been noted, and to some extent formalised, in the literature on sovereign debt and conditionality.[25] The main objective of this section of the paper is therefore to restate these results in the context of the agency framework introduced here, and to show that our baseline model is capable of encompassing them. In the following two applications of the baseline model (in Sections 4 and 5) we extend the model in original directions, addressing issues which are more topical in the context of the current debate on reforming the IFA.

3.1 Ex-post Commitment, Ownership and Safeguards

The model of conditionality presented in the previous section interprets IMF conditional bail-outs as contracts for liquidity, in the context of a balance of payments crisis. In our baseline model the IMF is assumed to have a comparative advantage relative to private investors with respect to both the imposition of conditionality (i.e. the ability to monitor and contract upon e_2) and in the provision of emergency liquidity (i.e. in the form of the bail-out b). In this sub-section we show that the first property of the contract (i.e. conditionality) can be interpreted as a source of post-crisis commitment technology which can benefit the donor, relative to a no-IMF state of the world, if the Fund restrains from extracting all the rents from its intervention.

It is possible to isolate the role of conditionality by initially considering an IMF bail-out without conditionality, i.e. the provision of unconditional liquidity following a crisis. A default-averse

[25] Sachs (1989b) notes the importance of IMF conditionality as a source of commitment in debt restructuring negotiations, and Claessens and Diwan (1990), Diwan and Rodrik (1992) and Fafchamps (1996) formalise this insight. Fafchamps (1996) also comments on the potential role of IMF conditionality in mitigating inefficient credit rationing ex-ante.

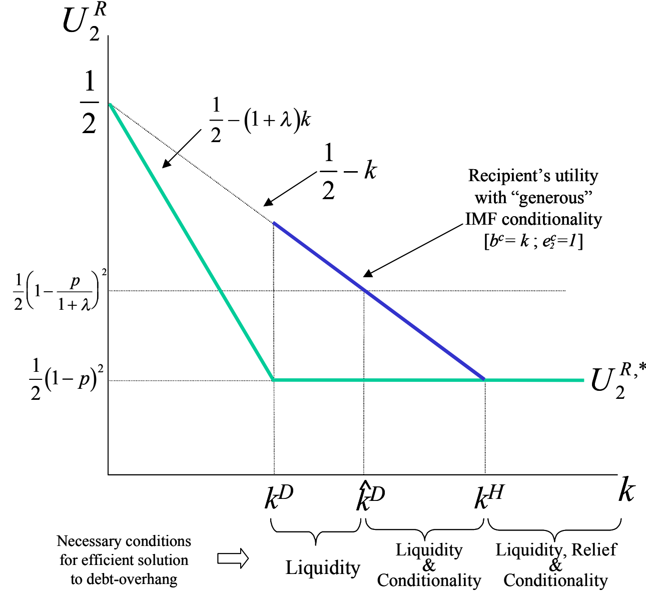


Figure 6: Debtor's utility as a function of external debt k and of the IMF's bail-out policy.

IMF which is subject to an 'adequate safeguards' constraint, in the absence of conditionality is able to avoid default and debt-overhang by providing an unconditional bail-out b equal to k, as long as $k \in [k^D, \hat{k}^D]$, where $\hat{k}^D = \frac{p}{1+\lambda}\left(1 - \frac{p}{2(1+\lambda)}\right) \in (k^D, k^H)$. $\hat{k}^D$ is the value of external debt which makes the debtor indifferent between repayment and default at the end of $t = 2$ (i.e. when the liquidity cost λ does not apply).

As long as $b = k < \hat{k}^D$, the IMF is therefore able to intervene under adequate safeguards, without the need to impose conditionality. And the fact that $\hat{k}^D > k^D$ implies that, by acting as a pure liquidity provider, the IMF can increase the range of values of debt k for which default does not occur in equilibrium.[26] This increases debt repayment and makes the debtor country better off, relative to the no-IMF outcome (see Figure 6). It also increases IMF utility (i.e. $e_2 - b$) relative to a no bail-out alternative, given that reform effort equals 1, rather than $1 - p$, and the funds provided by the IMF are always below p (given that $\hat{k}^D < p$). The IMF faces therefore incentives to provide an unconditional bail-out, as long as default is the equilibrium outcome otherwise.

Liquidity without conditionality therefore can improve the efficiency of the interaction between private investors, the debtor and the IMF (all three parties are better off).[27] The absence

[26] This effect is due to the fact that the marginal benefit to the debtor of a reduction in the liquidity 'tax' λ is larger if the country is repaying its debt as opposed to defaulting, given that in the latter case the country reduces its exposure to the tax by distorting its production. Therefore, if λ is driven to 0 (i.e. which is the case if $b = k$) a higher value of the debt k is required to equalise debtor utility in the debt-repayment and default equilibrium respectively.

[27] If investors are sufficiently patient within the $t = 2$ period, they may be willing to provide the unconditional liquidity themselves, rendering IMF intervention unnecessary for $k < \hat{k}^D$. Our assumption of "investor panic"

of conditionality does not however allow the Fund to maximise the efficiency of crisis resolution and nor does provide it with enough flexibility to maximise its own utility.

The first effect is clear from the fact that $\hat{k}^D < k^H$: there is a range of debt (namely $k \in (\hat{k}^D, k^H)$ for which liquidity plus conditionality can avoid default and sub-optimal effort, whilst unconditional liquidity cannot. In this range of k the debtor would like to be able to pre-commit, after a crisis has occurred, to repaying the entirety of the debt and set $e_2 = 1$, in exchange for a bail-out equal to k (which is equivalent to a debt stand-still until the end of $t = 2$). However, if e_2 cannot be observed by the Fund and therefore conditionality cannot be imposed, the debtor has incentives to renege on the promise of full debt repayment at the end of $t = 2$, and minimise the cost of default by setting $e_2 = 1 - \frac{p}{1+\lambda}$ (and obtain utility $U_2^R = \frac{1}{2}\left(1 - \frac{p}{1+\lambda}\right)^2$ - as shown in Figure 6). Anticipating this, the Fund would not release the unconditional $b = k$ bail-out.

By making the bail-out conditional on reform effort, the IMF can solve this commitment problem, and allow for efficient debt-rescheduling to take place. By doing so the Fund is also able to lend under adequate safeguards, and prevent debtor default on the bail-out. This implies that in this range of k ($k \in (\hat{k}^D, k^H)$), the conditional bail-out contract displays a circular logic: the provision of emergency liquidity allows the Fund to impose conditionality (i.e. additional reform effort), which in turn protects IMF resources and enables the bail-out to take place.

From the debtor's perspective, the most attractive conditional liquidity package which solves its commitment problem is one which sets $b^c = k$ and $e_2^c = 1$, i.e. it reschedules all of the debt repayment, and it allows for efficient domestic production (from the debtor's point of view). As long as $k < k^H$, the debtor is better off than under the no-IMF outcome (see Figure 6), and it therefore benefits from the commitment technology provided by IMF conditionality (i.e. there is "ownership" of the program).[28] The IMF is also better off relative to the no-conditionality outcome: it earns $1 - b$, which is greater than $1 - p$, given that the maximum value for the bail-out, k^H, is lower than p.

There is however a second role of conditionality, in the form of debtor rent-extraction, which is present in the baseline contract described by Proposition 1. If the IMF is not concerned about leaving any rents to the debtor country in a crisis-situation, then it will use the ability to contract upon e_2 both to maximise the range of k for which default can be avoided under adequate safeguards (i.e. provide commitment technology to the debtor), *and* to extract rents from its intervention (i.e. by increasing e_2 and -when possible- decreasing b, relative to the "ownership" package described above).[29] If this is the case, the debtor is effectively indifferent

once a crisis hits is effectively equivalent to a high-impatience assumpion, which rules out this form of private sector involvement, and forces the IMF to act as a sole provider of both emergency lending and conditionality. Allowing for private contributions to the provision of bail-out funds (which, for example, might be necessary if the IMF is resource-constrained) may give rise to issues of IMF moral hazard. That is, the IMF might not face sufficiently strong incentives to monitor and enforce its conditionality adequately if it is not the sole provider of the bail-out (see Rodrik (1996) for an argument along these lines).

[28] We explore the debtor moral hazard implications of a "generous" IMF, which leaves rents to the debtor country, in the next section of the paper.

[29] As Proposition 1 shows, the IMF finds it optimal to depart from a policy of full debt rescheduling ($b^c = k$)

between IMF intervention or default, and "ownership" of the program is therefore limited.[30] The ability to condition on e_2 therefore allows the Fund both to provide valuable commitment to debtor and to extract the value of this commitment via demanding higher reform efforts.

For $k > k^H$ conditionality collapses, given that the IMF cannot provide enough incentives to the recipient not to default on its external debt. If this is the case, there is a need for a debt relief to avoid default and enhance the efficiency of crisis resolution (we elaborate on this point in Section 5). Three ranges for the values of external debt can be therefore identified in terms of required components of the debt-overhang resolution package: for $k \in (k^D, \hat{k}^D)$ unconditional liquidity is required; for $k \in (\hat{k}^D, k^H)$ conditional liquidity is necessary; and for $k > k^H$ both conditional liquidity and relief are required.[31] These ranges are also illustrated by Figure 6.

3.2 Ex-Ante Commitment Technology

3.2.1 The equilibrium with endogenous capital without the IMF

To model the ex-ante (i.e. pre-crisis) effects of IMF conditionality we endogenise period 1 investment k. This enables us to analyse the efficiency properties of the equilibria with and without IMF intervention, focusing on the issue of credit-rationing.

To endogenise period 1 capital inflows k we specify a function which describes the return to foreign investors of holding their capital at home, rather than investing it abroad. We assume that the total capital stock in the investor country equals S, that k indicates the amount of capital invested abroad, and that aggregate domestic returns are given by a quadratic function of the following form, $f(S-k) = (1+S-\alpha)(S-k) - \frac{(S-k)^2}{2}$. The domestic return function displays diminishing marginal returns, thereby inducing investors to transfer some of their capital abroad. α is a parameter which measures the relative attractiveness of holding capital abroad, and which we restrict to lie between 0 and S.[32]

The returns from holding capital abroad are given by the rate of interest (which we assume to be fixed at 0) and by the probability of a crisis, followed by a default. If no crisis occurs, or if default is not the post-crisis equilibrium (which is the case for $k \leq k^D$ in the absence of IMF intervention), the marginal product of capital held abroad equals 1, and optimal investment behaviour is given by $k^* = \alpha$ (i.e. the investor keeps capital at home until the rate of return f' equals 1, and invests the rest abroad).[33]

If a crisis can occur ($\gamma > 0$) and default is the post-crisis outcome ($k > k^D$) the marginal

for $k \in (k^D, k^M)$, as long as the $k^D > \frac{\lambda}{2}$ condition holds. Note that $\hat{k}^D > k^M$ so that in the range of k where conditioning on e_2 is required to avoid default, the IMF captures the rents from its intervention by increasing e_2 above 1 (rather than by reducing b below k).

[30] The investors' participation constraint is slack in the baseline conditionality model, implying that they benefit from IMF bail-outs. As we show in Section 5, the IMF has incentives to make both the debtor's and the investors' IRC bind only if investor moral hazard is significant.

[31] This effect is present also in Claessens and Diwan (1990) and Diwan and Rodrik (1992).

[32] In what follows we assume that S is high enough (namely $S > k^D + \frac{1}{1+\lambda}$), to ensure that all the cases we characterise can occur in equilibrium .

[33] $f'(S-k) = 1$ yields $1 + S - k^* = 1 + S - \alpha$, which implies $k^* = \alpha$.

product of k is given by $1-\gamma$, and therefore the optimal investment level is given by $k^* = \alpha - \gamma$ (which equalises marginal returns from holding capital abroad or at home).

Equilibrium capital flows to the debtor country are therefore as follows:

$$k^* = \begin{cases} \alpha & \text{for } \alpha < k^D \\ k^D & \text{for } \alpha \in [k^D, \gamma + k^D] \\ \alpha - \gamma & \text{for } \alpha > \gamma + k^D \end{cases} \tag{1}$$

so that, in equilibrium, defaults occurs only for $\alpha > \gamma + k^D$.

This equilibrium, which is sub-game perfect, displays credit rationing (as in Fafchamps (1996)) in the sense that the level of investment is sub-optimal (i.e. below α) for $\alpha \geq k^D$. Proposition 2 below describes its efficiency properties.

Proposition 2 *In the absence of IMF intervention credit rationing occurs in the sub-game perfect equilibrium of the game if $\alpha \geq k^D$. This is ex-ante Pareto inefficient if the following two conditions hold:*

(i) $\gamma < \frac{1}{1+\lambda}$

(ii) $\alpha \in \left(k^D, k^D + \frac{1}{1+\lambda}\right)$

For $\alpha \geq k^D + \frac{1}{1+\lambda}$ credit rationing is an equilibrium outcome but it is not ex-ante inefficient.

Proof. For the equilibrium with credit rationing to be ex-ante inefficient we require the expected two-period utility of the debtor to be lower than in a counter-factual situation where it can precommit to always repay the creditor in a situation of crisis, and therefore receives the unconstrained amount $k^* = \alpha$.

Comparing expected utilities we obtain the following condition for inefficiency:

$$\frac{\alpha - k^*}{\alpha - k^D} > \gamma(1+\lambda) \tag{2}$$

where k^* is given by equation (1). For $\alpha \in (k^D, k^D + \gamma)$ we have that $k^* = k^D$ so that an inefficiency results if and only if $\gamma < \frac{1}{(1+\lambda)}$. For $\alpha > k^D + \gamma$, we have that $k^* = \alpha - \gamma$, which implies that expression (2) holds if and only if $\alpha < k^D + \frac{1}{1+\lambda}$, which also requires the condition $\gamma < \frac{1}{1+\lambda}$ to hold. ■

Proposition 2 shows that the sub-game perfect equilibrium (SPE) of the creditor-debtor game is inefficient if two conditions (one on the probability of a crisis taking place and one on the relative productivity of international capital investment) hold. If these conditions are satisfied, the debtor's expected utility would be higher if it were able to credibly precommit not to default on its external debt if a crisis occurs.[34] This is because the loss from the lower level of foreign capital inflows due to credit-rationing outweighs the benefit of being able to default on this debt if a crisis takes place.

It is convenient to interpret the benefit of discretion to the debtor (i.e. the benefits which arise from the ability to default) as the expected value of a put option. Given this interpretation,

[34] In the absence of commitment technology (e.g. such as IMF conditionality) this is not possible, given that default is ex-post optimal for high enough levels of capital ($k > k^D$).

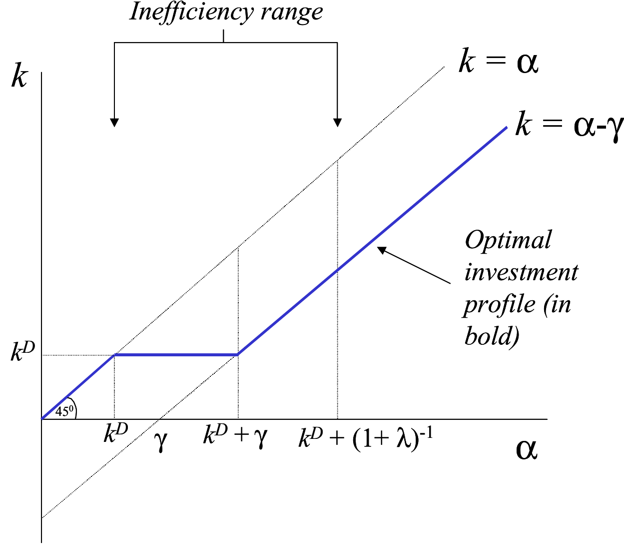


Figure 7: The investment equilibrium without the IMF (for $\gamma < \frac{1}{1+\lambda}$).

the two conditions identified by Proposition 2 determine when the value of the put is lower than the benefit from commitment (i.e. the additional inflow of capital in period 1), implying that the SPE of the investors-debtor game is inefficient. This is the case if the probability of crisis γ (i.e. the probability of being able to exercise the option) is relatively low;[35] and if the profitability for investors of lending to the debtor country α is sufficiently high so as to generate costly credit rationing (i.e. $\alpha > k^D$), but also not high enough as to increase the expected value of the option beyond the value of commitment (i.e. $\alpha < k^D + \frac{1}{1+\lambda}$). This second effect arises because as α increases so do period-1 capital inflows, which in turn increases the value of the option of being able to default on debt if a crisis occurs. That is, the debtor payoff in the debt-repayment equilibrium, which decreases with k^*, can be interpreted as the "stock price" which determines the value of the put, implying that higher capital inflows raise the value of the option.[36]

Figure 7 illustrates the nature of the equilibrium with endogenous capital without the IMF, and the inefficiency range of α.

3.2.2 The equilibrium with endogenous capital with the IMF

As shown in the previous section the presence of the IMF avoids default for all levels of capital below $k^H \equiv (1+\lambda)k^D$, as long as $p > \overline{p}$. This has the direct effect of reducing credit rationing

[35]The condition for γ is also equivalent to the condition for the optimality of imposing capital controls: if $\gamma(1+\lambda) > 1$, the debtor country would like to minimise the inflows of capital at $t = 1$, and therefore any credit rationing is efficient, from its perspective.

[36]This effect can also be seen by reference to Figure 6, which displays the (fixed) benefit of defaulting once a crisis has occurred (i.e. the strike price of the put) and the utility obtained under the debt-repayment outcome (i.e. the underlying stock price). This shows that the value of the default put and the stock price are inversely related.

by stimulating capital flows ex-ante, which are now given by:

$$k^{*,IMF} = \begin{cases} \alpha & \text{for } \alpha < k^H \\ k^H & \text{for } \alpha \in [k^H, \gamma + k^H] \\ \alpha - \gamma & \text{for } \alpha > \gamma + k^H \end{cases}$$

The enhanced level of capital flows in turn reduces the range of values for which a Pareto inefficient outcome realises (potentially eliminating it), as shown in Figure 8, and described by the following Lemma.

Lemma 1 *In a situation where the debtor-creditor relationship is characterised by Pareto inefficiency (see Proposition 2), IMF conditionality has the following impact:*

- *it eliminates the inefficiency for* $\gamma \in \left[\frac{1-\lambda p(1-\frac{p}{2})}{1+\lambda}, \frac{1}{1+\lambda}\right)$
- *if* $\gamma < \frac{1-\lambda p(1-\frac{p}{2})}{1+\lambda}$*, IMF conditionality reduces the range of* α *for which the ex-ante equilibrium is inefficient to* $\alpha \in \left((1+\eta)k^H, k^D + \frac{1}{1+\lambda}\right)$*, where* $\eta \equiv \frac{\gamma\lambda}{1-\gamma(1+\lambda)} > 0$*.*

Proof. The presence of the IMF eliminates credit rationing for $\alpha \leq k^H$. For $\alpha \in (k^H, k^H + \gamma)$, IMF intervention enhances capital flows, affecting the efficiency comparison between commitment and discretion relative to the no IMF case. For this range of α the expected utility comparison between commitment and discretion (equation (2) now yields the following inequality as a condition for inefficient credit rationing:

$$\alpha > \left(1 + \frac{\gamma\lambda}{1-\gamma(1+\lambda)}\right) k^H \equiv (1+\eta)k^H > k^H$$

where $\eta \equiv \frac{\gamma\lambda}{1-\gamma(1+\lambda)} > 0$ (given that $\gamma < \frac{1}{1+\lambda}$, from Proposition 2). This condition is consistent with $\alpha < k^H + \gamma$ iff $\gamma < \frac{1-\lambda p(1-\frac{p}{2})}{1+\lambda} < \frac{1}{1+\lambda}$.

For $\alpha > k^H + \gamma$, the efficiency comparison is the same in the IMF and no IMF cases. Inefficient credit rationing therefore characterises the IMF case if $\alpha < k^D + \frac{1}{1+\lambda}$. This is consistent with $\alpha > k^H + \gamma$ also iff $\gamma < \frac{1-\lambda p(1-\frac{p}{2})}{1+\lambda}$. Therefore if the latter condition holds IMF intervention cannot prevent inefficient credit-rationing for $\alpha \in ((1+\eta)k^H, k^D + \frac{1}{1+\lambda})$. ■

The IMF, by intervening with a conditional bail-out and maximising its objective function can therefore provide commitment technology to the recipient, allowing it not to suffer from ex-ante inefficient credit-rationing by providing it with a credible "promise" to repay its external debt. Some inefficiency may however remain since credit rationing persists also with the presence of the IMF, implying that the value of the commitment never to default (which the IMF cannot supply) may still exceed the expected value of the "discretion put".

As Lemma 1 shows the IMF eliminates the inefficiency if γ is not excessively low or if α does not lie within a given intermediate range (which is narrower than the corresponding range in the no-IMF scenario). If γ is particularly low, the expected value of the ability to default is relatively small, implying that there is a range of α for which the value of commitment exceeds

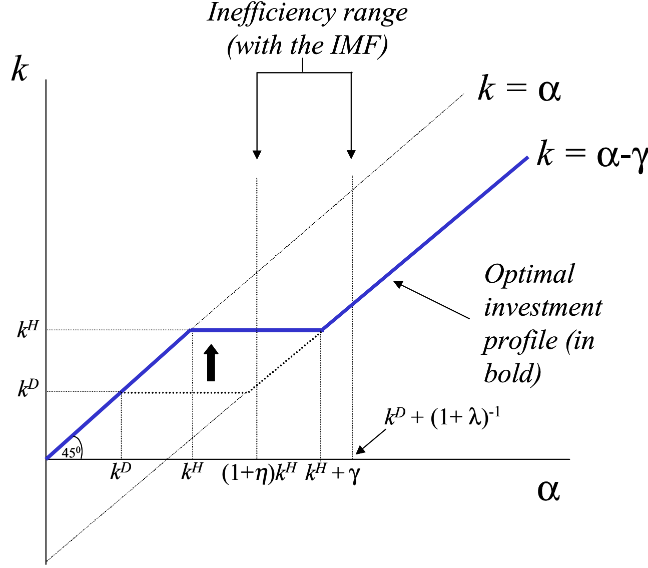


Figure 8: The investment equilibrium with the IMF (for $\gamma < \frac{1-\lambda p(1-\frac{p}{2})}{1+\lambda}$).

the expected value of the default put option, also in the presence of the IMF. As in the no-IMF case, this occurs if α is sufficiently high so as to generate costly credit rationing, but not high enough so as to increase the expected value of put beyond the value of commitment.[37]

The efficiency properties of the IMF-equilibrium are summarised in Figure 8.

This sub-section has therefore shown the IMF conditionality can enhance the efficiency of debtor-investor interaction, by limiting the negative impact of sovereign risk on capital inflows and mitigating the consequences of the debtor's lack of commitment power. In contrast to the case of the provision of ex-post restraint by the Fund analysed in Section 3.1, the IMF does not extract all the benefits from its provision of ex-ante commitment technology to the debtor. In this sense, program "ownership" is restored from the debtor's point of view, even though the debtor's ex-post participation constraint binds.

As our modelling has highlighted, the Fund is able to act as an effective agency of restraint by guaranteeing higher debt-repayment to foreign investors, thus reducing the impact of ex-ante credit-rationing. The benefits of higher capital inflows brought about by the presence of the IMF may however have cost associated with them. If investor moral hazard and the risk of excessive lending is a concern (given its impact on the probability of a crisis occurring), the Fund may wish to reduce its role as a guarantor of foreign investment when a crisis hits, and mitigate capital inflows via a tougher position on Private Sector Involvement (PSI). We take up

[37] Note that at the value of α where credit rationing sets in (i.e. $\alpha = k^H$) the expected benefits of discretion exceed those of commitment, given that the latter are small (i.e. the credit rationing is limited) whilst the former reflect the value of being able to default on relatively high amounts of debt ($k \geq k^H$), and are therefore relatively large. Commitment is therefore valuable only if debt is strictly higher then k^H (namely, $k > (1+\eta)\,k^H$).

this issue in Section 5 of the paper.

4 IMF Conditionality and Debtor Moral Hazard

The issue of "moral hazard" is frequently discussed in the context of the IMF and of its crisis interventions. Some commentators argue that the IMF, by providing insurance to both debtors and investors in a crisis situation, can induce moral hazard, i.e. insufficient crisis-prevention efforts on the part of the debtor ("debtor moral hazard") and excessive ex-ante investment on the part of the creditors ("investor moral hazard"). In this section we extend the baseline model introduced in section 2 in order to address the issue of debtor moral hazard, and we devote the next section of the paper to the analysis of PSI and investor moral hazard.

4.1 Debtor Moral Hazard: Extended Set-up

In the standard insurance principal-agent model moral hazard refers to a situation where a risk-averse agent who purchases insurance from a principal against some negative realisation and who can exercise some (costly and unobservable) effort to reduce the probability of the "bad" event taking place, does not spontaneously apply the first-best level of effort. The solution to the moral hazard problem (in the context of insurance) is to make the agent's payoff depend on the realisation of the negative event, to elicit at least second-best effort (i.e. co-insurance takes place in equilibrium).

The baseline model of crisis and conditionality used in this paper needs to be augmented in a number of directions to produce a moral hazard framework. In this extension we add some properties of a moral hazard situation, but not all of them. In doing so we offer a model which captures some of the basic features of the recent moral hazard debate on the role of the IMF (e.g. IMF bail-outs can lead to a sub-optimal probability of crises), but where first-best effort can be restored in equilibrium with an appropriate conditionality contract, so that, strictly speaking, there is not a moral hazard problem.

The two features we add to the baseline model are as follows. Firstly, we assume that the probability of crisis is endogenous, and a function of the agent's (or debtor country) first period effort.[38] In particular we assume that $\gamma(e_1) = \bar{\gamma} - \delta_e e_1$, where $\delta_e \geq 0$ and $\bar{\gamma} \leq 1$.[39] The agent (i.e. the debtor country) therefore has some control over the probability of the negative event (i.e. the crisis) taking place, and a moral hazard situation may occur if it provides sub-optimal crisis-prevention effort.

[38] In the following section of the paper we introduce investor moral hazard considerations using a similar reduced-form approach, and assuming that γ is a function of k (capital inflows at $t = 1$) rather than of e_1. In both this and the next extension we abstract from the *direct* effect of the presence of the IMF on the probability of crisis (as opposed to indirect effects, via e_1 and k). This may be negative (i.e. the presence of emergency IMF lending enhances the probability that investors do not suffer capital losses - see e.g. Lane and Phillips (2000)), but it may also be positive (e.g. if the bail-out partially finances the run - see Zettelmeyer (2000)).

[39] Additional parameter restrictions, which are made explicit below, are necessary to ensure that $\gamma \geq 0$ in equilibrium.

The second feature we add is that there is a level of unconditional funds (βk, where $\beta \in (0,1)$) which the IMF always transfers to the debtor country in a situation of crisis. This may be due to "global stability" considerations, which effectively force the IMF to intervene even in the absence of conditionality; or to an assumption that the Fund is constrained not to extract all of the rents of its intervention from the debtor, for "political-economy" reasons (e.g. some ex-post program "ownership" needs to be granted to the debtor).[40] The assumption that βk is released unconditionally is equivalent to one that the optimal IMF contract is not fully implemented by the recipient and that there is some unpunished 'slippage' (e.g. $1 \leq e_2 < e^c$). It can therefore be thought of as the outcome of IMF discretion (i.e. lack of full commitment/bargaining power).

This second assumption is also necessary for a debtor moral hazard model to be developed: without it (e.g. as in the baseline model) the IMF makes the individual rationality constraint of the agent bind when it intervenes (i.e. it supplies the lowest feasible level of bail-out funds), thereby not providing any "relief" to the debtor country from the occurrence of crisis and therefore not reducing the incentives for the agent to avoid the crisis ex-ante. In addition, given the binding IRC assumption, the IMF cannot use ex-post (or traditional) conditionality to incentivise ex-ante efforts to prevent the crisis, since it cannot lower the debtor country's payoff relative to its outside option (i.e. repaying the debt without bail-out or defaulting).[41] If on the other hand, as we assume in this section, the IMF leaves the debtor country's participation constraint slack following a crisis, the debtor country will face reduced incentives to avoid the crisis ex-ante, implying that the Fund's intervention causes some debtor moral hazard.

We also make the two following simplifying assumptions in this extension, in order to focus the analysis on the issue of debtor moral hazard: the penalty rate p is "high enough", so that default is not an option for the debtor country if a crisis occurs;[42] and the debtor country knows the level of external debt k before setting its first-period effort level e_1, implying that it can set it as a function of the cost a crisis.

4.2 Ex-ante Conditionality

In the absence of IMF conditionality, the debtor country sets e_1 to maximise its expected utility, and always sets $e_2 = 1$ (given the assumption of high p). The optimal level of e_1 (defined as $\bar{e}_1$) is therefore as follows:

$$\bar{e}_1 \in \arg\max e_1(1 - \frac{e_1}{2}) + k + \frac{1}{2}(1 - \gamma(e_1)) + \gamma(e_1)(\frac{1}{2} - (1+\lambda)k + \lambda\beta k)$$

[40] Appendix C.2 explicitly derives the presence of βk unconditional transfers from an assumption of IMF "altruism". Alternatively, βk could be derived as the outcome of a bargain between the IMF and the recipient country, which allows both parties to do better than their outside option, and which therefore would leave some rents to the recipient.

[41] That is, IMF conditionality cannot act as co-insurance, as implicitly suggested by Fischer (1999).

[42] This is equivalent to assuming that $k \leq k^D$. It implies that the debtor always repays βk at the end of $t = 2$, so that the net impact of the IMF's unconditional loan on the debtor's utility equals $\lambda\beta k$.

where βk is the level of unconditional bail-out provided by the IMF in the event of a crisis. This yields:

$$\bar{e}_1(k, \beta) = 1 + \delta_e(1 + \lambda(1 - \beta))k$$

which is decreasing in β and increasing in k. For $\beta > 0$ "moral hazard" therefore sets-in, lowering the level of first period effort below its first-best level $e_1^{FB}(k) = 1 + \delta_e(1 + \lambda)k$ (which corresponds to the case of $\beta = 0$).

How can the IMF mitigate this moral hazard effect? One direct way would be to commit not to release βk unconditionally after a crisis, and instead commit to offer a conditionality contract of the form modelled in the base-line model of this paper, which makes the IRC binding (and which would therefore induce first-best first-period effort). Ex-post this is however not credible, given the assumption of limited IMF commitment power introduced in this section, and would not be a sub-game perfect outcome. *Ex-post* conditionality therefore cannot avoid moral hazard.

Another instrument to mitigate moral hazard which does not rely on the IMF's ability to commit to be "tough", is an *ex-ante* conditionality, that is conditionality on the first-period effort level. This would consist of an offer by the IMF of a *higher* bail-out in the event of a crisis (i.e. $b^c > \beta k$) in exchange for a (higher) level of first period effort e_1^c.[43] This contract is similar to an insurance contract, where the premium paid by the recipient is in the form of higher crisis-prevention efforts.[44] It is also closely related to the "selectivity" or "pre-qualification" proposals put forward by a number of commentators recently (e.g. Collier (1997), the IFIAC/Meltzer report (2000)), and partially adopted by the Fund with the introduction of a new facility (the Contingent Credit Line (CCL)) in 1999.[45]

The optimal ex-ante conditionality contract (e_1^c, b^c) is derived from the following program:[46]

$$\begin{aligned} \max_{e_1,b} E(U^{IMF}) &= \gamma(e_1)(e_2 - b) + (1 - \gamma(e_1))e_2 \\ s.t. \quad &: \quad E(U^R(e_1, b)) \geq \bar{U}^R(\beta) \text{ (IRC } (\beta)\text{)} \\ &: \quad b \in [\beta k, k] \end{aligned}$$

where $E(U^R)$ is the expected two-period utility of the recipient, and $\bar{U}^R(\beta)$ is the reservation two-period expected utility of the recipient, obtained by setting $e_1 = \bar{e}_1$ and receiving βk if a crisis takes place. As in the baseline model, we assume that the Fund does not directly benefit

[43]This requires us to assume that the IMF is able to commit not to abuse the trust of the debtor country ex-post (i.e. if a crisis takes place), which is a more reasonable assumption to make than the one of "commitment to be tough" (i.e. never releasing βk unconditionally), given the institutional nature of the Fund.

[44]Given risk-neutrality, the agent is not benefitting from insurance *per se*, but from the additional net transfer received from the IMF in period 2, which is traded-off with extra effort in period 1. Note that of course the IMF could make this transfer in period 1, thus directly purchasing a higher e_1. We do not allow for this because it would violate the Fund's Articles of Agreement, whilst ex-ante conditionality is consistent with them (i.e. the transfer from the IMF to the recipient occurs only in the event of balance of payments disequilibrium and is in the form of a loan).

[45]See Appendix A for a description of the CCL.

[46]The "adequate safeguards" constraint does not apply given our assumption of a sufficiently high p.

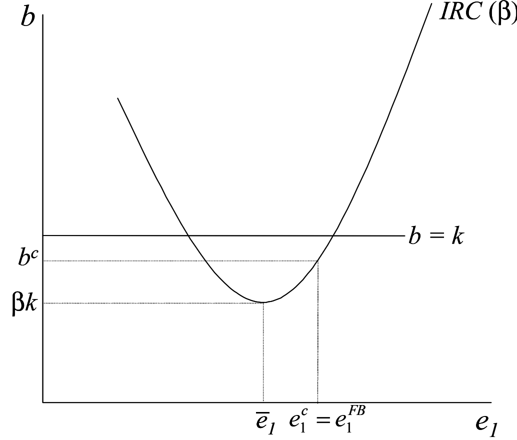


Figure 9: The ex-ante conditionality program

from first period reform efforts.[47] Given this assumption, the IMF's objective with ex-ante conditionality therefore boils down to the minimisation of its expected bail-out $\gamma(e_1)b$. Note also that a restriction on the level of k is needed to ensure that, in equilibrium, the probability of crisis is non-negative. This restriction is made explicit in Proposition 3 below.

Figure 9 illustrates the IMF's ex-ante program, showing its formal similarity with baseline ex-post conditionality (see Figure 2). Also in this case we can plot the agent's IRC in (b, e) space, focusing here on first–period effort, and show how higher (expected) bail-out funds can purchase higher effort. In Figure 9 we show a situation where the $b \leq k$ constraint does not bind, so that first-period effort can be restored to the first-best via ex-ante conditionality, as stated by Proposition 3.

Proposition 3 describes the properties of the optimal ex-ante conditionality contract.

Proposition 3

(i) For k low enough (i.e. $k \leq k^T(\beta) \equiv \frac{2(1-\beta)(\bar{\gamma}-\delta_e)}{\delta_e^2(\beta^2\lambda+2(1+\lambda)(1-\beta))}$*), we have that* $b^c \leq k, \gamma(e_1^c) \geq 0$ *and the IMF can apply first-best ex-ante conditionality, which is as follows:*

$$
\begin{aligned}
e_1^c &= e_1^{FB}(k) = 1 + \delta_e(1+\lambda)k \\
b^c &= \beta k \left(1 + \frac{\lambda \delta_e^2 \beta k}{2\gamma(e_1^c)}\right) > \beta k
\end{aligned}
$$

(ii) If $k \in (k^T(\beta), k^U(\beta)]$*, then ex-ante conditionality can only elicit second-best effort by the agent and the* $b \leq k$ *constraint binds. Therefore:*

$$
\begin{aligned}
e_1^c &= e_1^{SB}(\beta, k) \in [\bar{e}_1(\beta, k), e_1^{FB}(k)) \\
b^c &= k
\end{aligned}
$$

[47] Allowing for this would be straightforward but would not allow us to focus exclusively on the moral-hazard prevention role of conditionality, which is the aim of this extension.

$k^U(\beta)$ is given the condition $\gamma(\bar{e}_1(\beta,k)) = 0$, which yields $k^U(\beta) = \frac{\bar{\gamma}-\delta_e}{\delta_e^2(1+\lambda(1-\beta))} \geq k^T(\beta)$. At $k = k^U(\beta)$, we have $e_1^c = \bar{e}_1(\beta,k)$. Values of k higher than $k^U(\beta)$ are ruled out because of the non-negativity constraint on $\gamma(e_1)$.

Proof. See Appendix B. ■

Figure 10 illustrates the results given in Proposition 3. The left hand panel plots the two threshold schedules of k highlighted in the Proposition: $k^T(\beta)$, below which first-best ex-ante conditionality can be imposed; and $k^U(\beta)$, which gives the upper bound on acceptable values of k (to satisfy the non-negativity constraint on γ), and is also the locus of values of k such that no conditionality is imposed by the Fund (i.e. $e_1^c = \bar{e}_1$). The right hand panel plots the corresponding values of first-best effort, with and without ex-ante conditionality, for a given value of β. Conditional effort departs from first best for $k > k^T(\beta)$, and it converges to the no-conditionality level at $k = k^U(\beta)$.

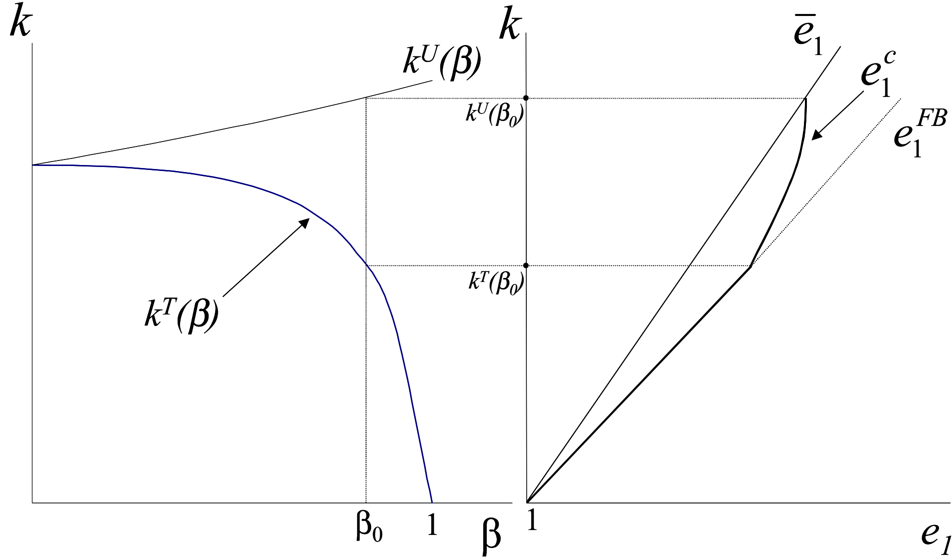


Figure 10: Ex-ante conditionality equilibria.

Proposition 3 shows if k, the capital inflow at $t = 1$, is sufficiently low relative to the degree of IMF ex-post support (measured by β), ex-ante conditionality can restore first-best effort in the pre-crisis period by means of a higher bail-out in the event of a crisis. However if k is relatively high, the $b \leq k$ constraint binds, and the IMF needs to settle for second-best ex-ante conditionality. This is because high level of capital inflows in the first period imply a greater wedge between $\bar{e}_1$ and e_1^{FB}. Given the increasing cost of incremental effort for the debtor, this implies that $b^c(k)$ under first-best ex-ante conditionality is strictly convex in k, so that there is a level a threshold level of k (defined here as $k^T(\beta)$) beyond which $b \leq k$ binds and the IMF can only impose second-best conditionality. This threshold level of k is decreasing in β, which measures how 'close' the IMF already is to the $b \leq k$ constraint in the second period, and it

tends to 0 as β tends to 1 (see Figure 10).

An implication of this result is that "important" (or high-β) countries (i.e. those which receive more unconditional support from the IMF in the event of a crisis) are subject to less intense ex-ante conditionality ceteris paribus, and that their ex-ante policy may still be characterised by moral hazard in spite of the IMF ex-ante intervention. IMF discretion (which is measured by β) therefore acts as a budget constraint on the Fund's debtor moral hazard prevention activities, making first-best pre-crisis effort unattainable, for large enough levels of external debt.

Second-best conditionality converges to the no-conditionality outcome as k increases further beyond $k^T(\beta)$. This is due to the fact that high levels of capital inflows increase the agent's first-best period effort also in the absence of conditionality, lowering the probability of a crisis taking place. If k is high enough, the agent finds it optimal to drive this probability to 0, implying that the IMF's unconditional bail-out βk never materialises and that the Fund has therefore no incentives to apply ex-ante conditionality.

Proposition 3 also reveals that the IMF does not go beyond imposing the agent's first-best level of effort in period 1 (i.e. the level which is optimal for the agent if $\beta = 0$). This is because the purpose of ex-ante conditionality as we have modelled in this extension is to minimise the expected use of IMF resources at $t = 2$.[48] Expected bail-out minimisation implies the maximisation of expected recipient utility *net of the IMF bail-out* (given the presence of the binding IRC(β)), which by definition is achieved by setting $e_1 = e_1^{FB}$. The IMF only departs from imposing ex-ante first-best effort if it faces a binding budget constraint, due to the $b \leq k$ restriction.

4.3 Discussion

This section of the paper has examined under what conditions the presence of the IMF can induce "moral hazard" on the part of the debtor country. We have shown that this takes place if the IMF cannot commit not to intervene in the event of a crisis where no ex-post conditionality is agreed (or, alternatively, if it inflates bail-outs or allows for program-slippage under ex-post conditionality, thus not making the agent's constraint binding). If this is the case, ex-ante conditionality can be used to eliminate (or at least reduce) debtor moral hazard.

Our modelling of pre-qualification is in contrast to some of the current discussion of this issue in the context of the IFA debate, where selectivity is seen as incompatible with Fund lending to non-prequalified countries and a justification for Fund inaction when a crisis hits these countries (e.g. as in the "pre-qualify and stand-by" approach advocated by IFIAC (2000)). In our model *ex-ante conditionality is motivated by the inability of the Fund to credibly stand-by in the event of large crises.* In this sense it is more consistent with current Fund practice, where ex-ante facilities (such as the CCL) co-exist with traditional ex-post lending.

[48] Additional motives for the Fund to impose ex-ante conditionality would be present if the Fund was directly concerned with reform effort at $t = 1$, or if the IMF faced an opportunity cost from a crisis outcome which exceeded the cost of releasing unconditional bail-out funds. The latter can be introduced by assuming that the Fund earns a reservation utility if a crisis does not take place. This is the approach we follow in the next section of the paper, to analyse the issue of investor moral hazard.

The discussion of ex-ante conditionality presented in this section also points to a potentially important trade-off between traditional ex-post conditionality and ex-ante contracts. The Fund will face a trade-off between these two, at the margin, given the presence of a common budget constraint, which is due to the fact that overall IMF lending b cannot exceed capital outflows k. An increase in ex-ante conditionality (i.e. the promise of additional unconditional funds if a crisis occurs) lowers the availability of funds for ex-post conditionality, which is needed to induce higher reform efforts and, where relevant, avoid outright default, during a crisis.

This financial trade-off may imply a choice for the Fund between crisis prevention and the minimisation of the expected recourse to its funds on the one hand, and the safeguarding of its lending ex-post via conditionality on ex-post effort on the other. If the Fund is constrained to maximise the extent to which its loans are repaid by debtor countries (e.g. because of its Articles of Agreement), it will face a bias in favour of ex-post conditionality. This in turn could lead to a sub-optimally high probability of crises taking place, and an excessive recourse to Fund bail-outs.

5 IMF Conditionality and Private Sector Involvement (PSI)

One of the more controversial issues in the current debate on how to reform the international financial architecture is the one of investor 'moral hazard' and of the appropriate degree of "private sector involvement" (PSI)[49] in crisis-resolution (see, e.g., Lane and Phillips (2000) and Eichengreen (2000)). Many commentators (including the IMF) recognise that investor behaviour and incentives have a significant bearing on both crisis prevention and crisis resolution, and that the moral hazard induced by IMF intervention is a two-sided issue (i.e. involving investors as much as debtors).

In this section we introduce the possibility of PSI in the form of debt-relief.[50] That is, we allow investors to forgive some of the debt which the country owes to them following a crisis realisation. This might be done directly, if investors are able to co-ordinate their actions, or via the IMF, in the context of an IMF bail-out package. In what follows we firstly analyse the no-IMF benchmark level of PSI; we then examine the IMF's ex-post optimal PSI-policy, i.e. the extent of PSI which the IMF favours following a crisis occurrence; and, thirdly, we allow for investor moral hazard, and model under what circumstances the IMF might want to depart from its ex-post optimal PSI policy to mitigate investor moral hazard ex-ante.

Throughout this section we will denote debt repayment as k^r, whilst k, as above, denotes the level of capital inflows at $t = 1$, and therefore the maximum debt repayment investors can demand if a crisis takes place. We also introduce a new variable ψ, which measures the extent of PSI which occurs after a crisis. Debt-repayment is therefore negatively related to ψ (i.e. $\frac{\partial k^r(\psi)}{\partial \psi} < 0$).

[49] This is sometimes referred to as 'burden-sharing' or private sector 'bail-ins'.

[50] We use the terms (debt) relief and PSI interchangeably in what follows. Other forms of PSI, which we do not consider here, are collective action clauses (to allow atomistic investors to co-ordinate when offering a debt-restructuring package), debt stand-stills, and debt rescheduling (which is partially discusssed in Section 3.1).

5.1 PSI without the IMF

Without IMF bail-outs investors collectively have incentives to forgive all debt beyond k^D. This is because in the absence of debt-relief and for $k > k^D$, default takes place, and debt-overhang sets in. If this is the case, repayment by the debtor takes the form of the "gun-boat" penalty $\frac{p}{1+\lambda}e_2^*$, so that $k^r = \frac{p}{1+\lambda}(1-p) \equiv (1-\bar{\psi})k^D$, where $\bar{\psi} \equiv \frac{p}{2-p} > 0$. $\bar{\psi}$ therefore denotes the maximum level of PSI investor can suffer from in the event of a crisis. If, on the other hand, the investors forgive all debt above k^D, they can induce both $e_2 = 1$ and the full repayment of k^D, so that $k^r = k^D > (1-\bar{\psi})k^D$. If this is the case, $\psi = 0$.[51]

Relief on all debt beyond k^D is therefore a Pareto efficient outcome, given that it removes the tax on effort present with debt-overhang (i.e. it induces efficient domestic production) and it raises debt-repayment (as in the classic model by Sachs (1989a)[52]). It however may not occur if there are multiple creditors who fail to co-ordinate and grant relief collectively. Depending on whether investors can effectively co-ordinate, the no-IMF benchmark level of the PSI variable is therefore either 0 or $\bar{\psi}$.

In the rest of this section of the paper, where we consider the IMF's optimal PSI policy, we assume that investors cannot co-ordinate their debt-relief offer, so that $\psi = \bar{\psi}$ in the absence of the IMF.

5.2 PSI with the IMF

We next consider the possibility of debt-relief in the context of IMF conditionality. In our set-up the IMF can effectively decide how much debt relief to grant to the debtor country, by making its bail-out conditional on both the effort exercised in the second period and the amount of capital repaid to the creditor (which may be below k). The optimal IMF contract therefore specifies three variables: e_2^c, b^c and ψ^c.

In offering this three-variable contract the IMF needs to satisfy both the debtor and the investors' participation constraint. The latter can be represented by the following condition: $\psi \leq \bar{\psi}$ (Investors' IRC), given our assumption that the investors are not able to collectively negotiate the efficient level of debt relief (i.e. set $\psi = 0$). We assume that if both IRCs are met, the contract is accepted by both parties and, in particular, the investors restrain from demanding any further debt-repayment and/or applying the gun-boat penalty pe_2.

We consider in what follows three cases for the IMF's PSI-policy. The first two relate to two possible attitudes of the Fund's toward PSI (PSI-aversion and PSI-tolerance), and allow us to identify two benchmark cases for the Fund's PSI policy. The third case, which we examine in the next sub-section, allows for investor moral hazard, and explores its implications on the Fund's optimal ex-ante PSI policy.

In both this and the next-subsection we restrict our attention to the cases where initial

[51] This does not imply that PSI is minimised, given that negative values of ψ are also possible, as it is shown below.

[52] The insight that it is preferable to set a fixed level of external debt rather than a variable income-dependent (and therefore distortionary) one is forcefully argued by Keynes (1919).

investment k is above k^D, which implies that the IMF has some flexibility in the determination of its PSI-policy (i.e. for $k \leq k^D$, the investor recovers the entirety of its initial investment, even in the absence of the IMF, so that there is no PSI).

5.2.1 PSI-aversion

The first possibility we consider is that the IMF is *PSI-averse*, and that its preferences are lexicographic in debt relief (i.e. in the amount of un-paid debt): the IMF first minimises PSI, and then maximise its utility function, as specified in Section 2 (i.e. $U^{IMF} = e_2 - b$).[53]

These preferences imply that relief is only optimal for $k > k^H$, and that debt-repayment k^r therefore equals $\min((1 - \underline{\psi})k^D, k)$, where $\underline{\psi} = -\lambda$. This is because, when $k > k^H$, limiting debt-repayment to k^H allows for some conditionality to be imposed (in particular, $e_2^c = 1$ and $b^c = k^H$, from Proposition 1(ii)), which gives the Fund utility of $1 - k^H$. This is higher than $1 - p$, the level obtained in the no-relief (and therefore no-conditionality) outcome. In addition, for $k > k^H$, the combination of conditionality and debt-relief implies a lower level of un-paid debt than the alternative (i.e. $k - (1 - \underline{\psi})k^D$ rather than $k - (1 - \bar{\psi})k^D$).

A PSI-averse IMF therefore maximises re-payment to the creditors, and allows for debt-relief only to the extent to which this enables it to be in a position to exercise some conditionality. This has the effect of reducing the extent to which PSI takes place after crises, relative to a situation with no IMF lending: PSI occurs only for high levels of debt ($k > k^H$), and debt-repayment is always higher than in the no-IMF benchmark (as long as $k > k^D$). A relief-averse IMF therefore does not make the investors' IRC bind ($\psi^c < \bar{\psi}$), and it minimises PSI, setting $\psi^c = \underline{\psi} < 0$. Given that the debtor country is effectively indifferent relative to the IMF's bail-out (its IRC binds), this implies that most of the efficiency gains from the IMF's provision of emergency lending are appropriated by the foreign investors.

5.2.2 PSI-tolerance

An alternative possibility for the attitude of the IMF vis-à-vis debt relief is what we term here *PSI-tolerance*. A PSI-tolerant IMF trades-off PSI minimisation with its other two objectives of promoting reform effort and minimising its bail-outs, after a crisis has occurred. It therefore maximises the following function:

$$U^{IMF} = e_2 - b - (k - k^r(\psi))$$

If this is the case IMF finds it optimal to set $\psi^c = 0$, i.e. set $k^r = k^D$, just like in the no IMF debt-relief equilibrium described above, when investors were able to co-ordinate their actions after a crisis.

This result can be seen by considering the Fund's utility as a function of ψ, in the range $k^r(\psi) \in [k^r(\bar{\psi}), k^r(\underline{\psi})]$ (which ensures that the investors' IRC is met). It is possible to express

[53] It is possible to interpret a PSI-averse IMF as one which is 'captured' by foreign investors, and whose main concern is therefore the recovery of their capital.

U^{IMF} solely as a function of ψ, by replacing e_2 and b with their optimal levels as a function of debt repayment $k^r(\psi)$.[54] $U^{IMF}(\psi)$ is therefore as follows (after some simplification):

$$U^{IMF}(\psi) = \begin{cases} e^c(k^r(\psi)) - k & \text{for } k^r(\psi) \in (k^M, k^r(\underline{\psi}) \equiv k^H] \\ 1 + \frac{\lambda}{2} - (k - k^D) + \frac{k^D}{\lambda}\psi & \text{for } k^r(\psi) \in (k^D, k^M] \\ 1 + \frac{\lambda}{2} - k + (1-\psi)k^D & \text{for } k^r(\psi) \in (\frac{\lambda}{2}, k^D] \\ e^c(k^r(\psi)) - k & \text{for } k^r(\psi) \in [k^r(\bar{\psi}), \frac{\lambda}{2}] \end{cases} \tag{3}$$

which assumes that $k > k^H$ and $k^r(\bar{\psi}) < \frac{\lambda}{2}$.[55]

This implies that the IMF's marginal utility relative to the level of PSI ψ is:

$$\frac{\partial U^{IMF}}{\partial \psi} = \begin{cases} \frac{k^D}{\sqrt{2(k^H - k^r(\psi))}} & \text{for } k^r(\psi) \in (k^M, k^r(\underline{\psi}) \equiv k^H] \\ \frac{k^D}{\lambda} & \text{for } k^r(\psi) \in (k^D, k^M] \\ -k^D & \text{for } k^r(\psi) \in (\frac{\lambda}{2}, k^D] \\ -\frac{\lambda k^D}{\sqrt{2\lambda k^r}} & \text{for } k^r(\psi) \in [k^r(\bar{\psi}), \frac{\lambda}{2}] \end{cases} \tag{4}$$

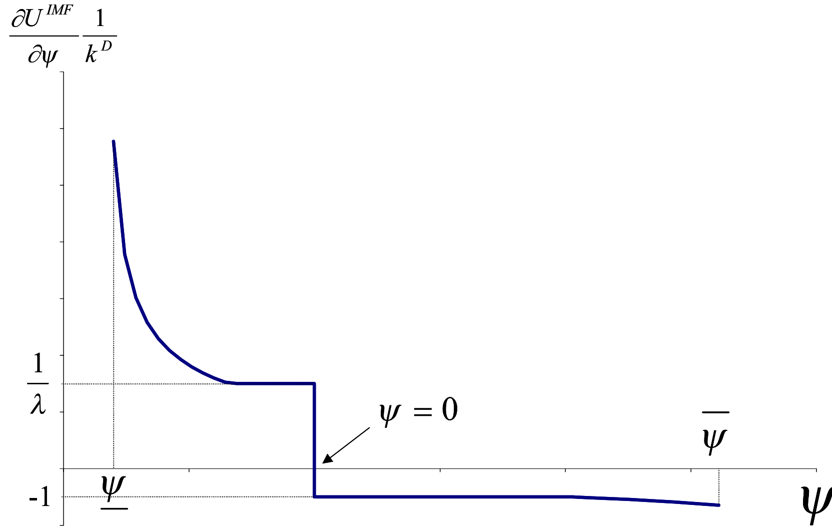


Figure 11: The IMF's marginal benefit from PSI

This shows that the IMF's marginal utility of PSI is positive for $k^r(\psi) \in (k^D, k^H]$, i.e. for $\psi \in [\underline{\psi}, 0)$, and it is negative for $\psi > 0$ (see Figure 11). A PSI-tolerant IMF therefore finds it optimal to set $\psi^c = 0$. This is so because for $k^r(\psi) \in (k^M, k^H]$ any increase in debt-relief implies a one-to-one reduction in the level of the bail-out (given that $b^c = k^r(\psi)$ in that range), but also

[54] These are given by the solutions for e_2^c and b^c in Proposition 1, substituting $k^r(\psi)$ for k (i.e. relaxing the assumption implicit in Proposition 1 that all foreign debt is repaid).

[55] If the first condition is not met, the $k^r \leq k$ constraint will bind for low enough k, limiting the range of $k^r(\psi)$ which the IMF can consider.

If the second condition does not hold, there are only three ranges of $k^r(\psi)$ which need to be considered for the purposes of computing $U^{IMF}(\psi)$, given that the investors' IRC rules out the fourth.

has a positive impact on adjustment effort (which is decreasing in $k^r(\psi)$ in that range), therefore leading to a positive net marginal impact of PSI for the Fund. In the range $k^r \in (k^D, k^M]$ on the other hand, reform effort is unaffected by the amount of debt-relief (given that it is at first-best anyway) but bail-outs are reduced by more than one-to-one in response to any given debt relief (i.e. $\frac{\partial b^c}{\partial k^r(\psi)} = \frac{1+\lambda}{\lambda}$, from the debtor's IRC), again implying a positive marginal impact of PSI. Any PSI beyond $\psi = 0$ however has a negative marginal utility, given that its negative impact on the intensity of reform effort and on the level of debt-repayment.

The optimal PSI policy for a relief-tolerant IMF is therefore to set $\psi^c = 0$, which allows it to implement first-best conditionality, i.e. $e_2^c = 1 + \lambda$ and $b^c = \frac{\lambda}{2}$. This also allows the Fund to fully relax the "adequate safeguards constraint" (ASC), ensuring that the recipient of the bail-out never has an incentive to default on the IMF, even for low values of p.

This combined conditionality/PSI contract leaves no rents to the investors if their outside option is one of co-ordinated debt-relief (i.e. their IRC binds). If, on the other hand, investors are unable to co-ordinate their debt relief effort, IMF intervention effectively reduces PSI, and leads to a positive gain for investors, which is exactly equal to the reward from being able to co-ordinate.

5.3 PSI and Investor Moral Hazard

The previous section has shown how the nature of ex-post conditionality and the IMF's attitude towards debt-repayment affect the Fund's PSI policy. Another consideration which is likely to play a significant role in shaping the IMF's PSI policy, and which is currently attracting considerable attention in the IFA debate, is the one of investor moral hazard. Like in the case of debtor moral hazard (see Section 4), this can be interpreted as referring to a situation where pre-crisis investor behaviour leads to a sub-optimal probability of a crisis taking place. This section explores the implications of the presence of moral hazard on the part of foreign investors on the IMF's optimal PSI policy. We assume in what follows that the IMF is relief-tolerant, and that its ex-post optimal PSI policy is therefore to set $\psi^c = 0$. We also assume however that the IMF is able to pre-commit ex-ante (i.e. before a crisis) to any PSI policy, even if this is ex-post sub-optimal. The purpose of this extension is to understand whether and under what circumstances the IMF might want to deviate ex-ante from its ex-post optimal PSI policy.

5.3.1 Investor moral hazard: extended set-up

For an investor moral hazard situation to arise we need to make two additions to our basic set-up, in a similar fashion to the debtor moral hazard extension modelled in Section 4. Firstly, the probability of crisis occurring γ needs to be a function of capital inflows before a crisis. Secondly, the IMF needs to find a crisis event costly, so that it is concerned with mitigating investor moral hazard.

Endogenous crisis and capital inflows We endogenise investment (i.e. foreign capital inflows in period 1) as in the analysis of credit rationing presented in section 3.2. The only

difference we introduce here is that the probability of crisis is a function of investment behaviour, according to the following linear function:

$$\gamma(k) = \bar{\gamma} + \delta_k k$$

where $\bar{\gamma} > 0$ and $\delta_k > 0$.[56] This is intended to capture, in reduced form, the fact that the higher the level of foreign indebteness of a given country, the more likely it is they it will be subject to a sudden and unexpected balance of payments crisis.[57]

Given the domestic production function introduced in section 3.2, and our earlier assumption that PSI is maximised (i.e. $\psi = \bar{\psi}$) if a crisis occurs without IMF intervention, optimal foreign capital inflows at $t = 1$, $k^*(\psi)$, and debt repayment if a crisis takes place, $k^r(\psi)$, are given by the following functions (in the absence of IMF bail-outs):

$$k^*(\bar{\psi}) = \begin{cases} \alpha & \text{for } \alpha < k^D \\ k^D & \text{for } \alpha \in [k^D, \hat{\alpha}(\bar{\psi})] \\ \hat{k}(\bar{\psi}) & \text{for } \alpha > \hat{\alpha}(\bar{\psi}) \end{cases} \Rightarrow k^r(\bar{\psi}) = \begin{cases} k^* & \text{for } \alpha \leq \hat{\alpha}(\bar{\psi}) \\ (1-\bar{\psi})k^D & \text{for } \alpha > \hat{\alpha}(\bar{\psi}) \end{cases} \quad (5)$$

where $\hat{\alpha}(\psi) = \bar{\gamma} + (1 + \delta_k(1+\psi))k^D$ and $\hat{k}(\psi) = \frac{\alpha - \bar{\gamma} + \delta_k(1-\psi)k^D}{1+2\delta_k}$.

Relative to the optimal investment schedule with fixed probability of crisis (see equation (1)), capital flows are now less sensitive to the productivity of foreign investment if default is the ex-post outcome in the event of a crisis (i.e. $\frac{\partial k^*}{\partial \alpha} < 1$ for $\alpha > \hat{\alpha}(\bar{\psi})$); and the threshold level of productivity of foreign investment above which investors are willing to accept a capital loss in the event of a crisis (defined as $\hat{\alpha}(\bar{\psi})$ here) is higher. Investors therefore internalise some of the 'moral hazard' due to their behaviour, and lend capital to the debtor country more prudently.

Both the optimal investment function ($k^*(\psi)$) and the repaid investment function ($k^r(\psi)$) can be generalised as a function of the IMF's choice of the PSI variable ψ if a crisis takes place, as long as $\psi \in (0, \bar{\psi})$.[58] This is the case given our assumption that the IMF is be able to commit, before a crisis, to any (ex-post) PSI policy, which allows it to therefore affect ex-ante investment and the probability of a crisis taking place.

In particular, $\hat{\alpha}(\psi)$ is a positive function of PSI (i.e. the lower PSI, the less likely is it that investment will be constrained at k^D); and $\hat{k}(\psi)$ is negative function of PSI (i.e. the lower PSI, the higher the level of capital flows for a given value of α).

Figure 12 summarises the optimal investment schedule at $t = 1$, as a function of the productivity of foreign investment α and the level of PSI if a crisis takes place.

[56] In equilibrium the following condition needs to hold to ensure that $\gamma(k) \leq 1$ for $\alpha \in [0, 1]$:

$$\bar{\gamma} \leq 1 - \frac{\delta_k k^D}{1 + 2\delta_k}$$

[57] We do not seek to model this process in detail here. We introduce it as a simple reduced form relationship, to enable us to provide a stylised model of investor moral hazard.

[58] Negative values of ψ imply that investors recover more than k^D in the event of a crisis (as it is the case with a relief-averse IMF). If this is the case, the investment is rationed relative to the no-crisis benchmark for values of α greater than k^D. We do not consider the case of IMF relief-aversion in this extension, and therefore restrict ψ to be non-negative.

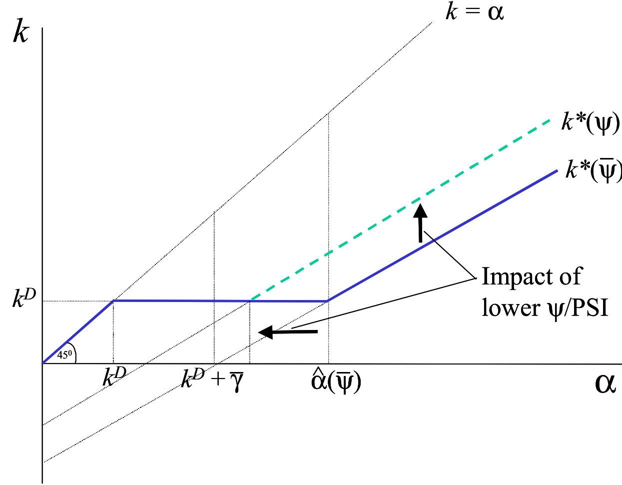


Figure 12: Optimal capital flows at $t = 1$ as a function of PSI.

Costly Crisis The second addition we make to our baseline set-up here is to assume that the IMF always prefers a no-crisis outcome to a crisis one. In the debtor moral hazard case this was the case because of the presence of a level of unconditional bail-out funds βk which the IMF had to disperse in the event of crisis (and which also generated the debtor moral hazard problem); here we assume, for simplicity, an exogenous loss to the IMF from a crisis, which takes the form of a reservation utility $\overline{U}$, which the IMF earns if a crisis does *not* take place.

We set $\bar{U}$ to be higher than the IMF's maximum utility if a crisis takes place (i.e. which is obtained by setting $\psi^c = 0$, $e_2^c = 1 + \lambda$ and $b^c = \frac{\lambda}{2}$), so that the IMF always finds a crisis costly, no matter the effectiveness of its crisis-resolution. This implies the following restriction:

$$\bar{U} > \bar{U}\min \equiv 1 + \frac{\lambda}{2} + \frac{(1+\delta_k)k^D + \bar{\gamma} - \alpha}{1 + 2\delta_k}$$

Why is there Investor Moral Hazard ? The fact that the Fund (i.e. the principal) always finds a crisis costly, and that foreign investors (i.e. the agent, in this set-up) have some control over the likelihood of a crisis taking place, generates a moral hazard setting (in the sense discussed in the case of debtor moral hazard): the agent may not autonomously choose an efficient level of investment from the principal's point of view.

As in the case of debtor moral hazard, the potential for inefficient agent behaviour is generated by the presence of IMF 'insurance': it is the Fund inability (or unwillingness) to make the agent's participation constraint bind which is at the root of the moral hazard problem. In the debtor's case this was by assumption (i.e. in section 4 we assumed that the Fund could not commit not to transfer βk unconditionally if a crisis took place). In the case of investor's moral hazard the investors' IRC may be slack because of the Fund's ex-post incentives to increase debt repayment relative to the no-IMF benchmark, to be able to obtain the most favourable combination of debtor reform effort and bail-out. This increases the investors' utility in a crisis

situation, inducing an increase in ex-ante capital inflows, which in turn increases the likelihood of the crisis occurring.

As we show below, given both the ex-ante and ex-post impact of its PSI policy, the IMF may find it optimal to accept an inferior crisis resolution outcome and commit to make the investors' IRC bind ex-post, in order to deter capital inflows at $t = 1$, and reduce investor moral hazard. As the next sub-section shows, the IMF will have incentives to depart from ex-post optimum PSI ($\psi^c = 0$) and pre-commit to a positive level of ψ if the crisis is sufficiently costly and if the impact of capital inflows on the probability of crisis is relatively high.

5.3.2 The IMF's optimal choice of PSI

The IMF's PSI program consists of the maximisation of its expected utility at $t = 1$ with respect to the PSI variable ψ, subject to both the debtor's and the investors' IRCs. As shown above, in the case of the relief-tolerant IMF, any choice of ψ (as long as the IMF can commit to it ex-ante, and that it respects the investors' IRC) uniquely determines the optimal levels of effort level and the bail-out at $t = 2$ if a crisis takes place. This allows us to express the Fund's ex-ante utility uniquely as a function of ψ, and also to ignore the constraints associated with ex-post conditionality, since these are met by the optimal baseline conditionality contract implied by ψ.

Formally, defining as $V(\psi)$ the IMF's expected utility at $t = 1$, the IMF ex-ante program is as follows:

$$\begin{aligned} \max_{\psi} V(\psi) &= (1 - \gamma(\psi))\bar{U} + \gamma(\psi)(U(\psi)) \\ s.t. &: \psi < \bar{\psi} \text{ (Investors' IRC)} \end{aligned} \tag{6}$$

where $\gamma(\psi)$ is short form for $\gamma(k^*(\psi))$, and $U(\psi)$ denotes the Fund's utility if a crisis occurs, and optimal (ex-post) conditionality is implemented with debt-repayment equal to $k^r(\psi)$. The latter is given by equation (3), omitting the IMF superscript for notational simplicity. $k^*(\psi)$ and $k^r(\psi)$ are given by equation (5), substituting ψ for $\bar{\psi}$.

A first step to note for the solution to this program, is that we can restrict our attention to values of positive values ψ, given the assumption of IMF PSI-tolerance, which implies that the ex-post optimum ψ is 0. The only reason for the IMF to depart from this level is to reduce the probability of a crisis occurring by increasing ψ, which implies that any level of ψ less than 0 has to be sub-optimal ex-ante.

A second simplification of the program is to note that optimal solution for ψ depends on the value of α, the productivity of investing abroad for the investor at $t = 1$.[59] It is possible to incorporate the effect of different values of this parameter on the IMF's optimal choice of ψ by amending the investors' IRC, i.e. limiting the range of possible values of ψ^c. If $\alpha > \hat{\alpha}(\bar{\psi})$, then any value of ψ^c lower than $\bar{\psi}$ has an impact on ex-ante investment behaviour and on the probability of crisis. If however $\alpha \in [\hat{\alpha}(0), \hat{\alpha}(\bar{\psi})]$, then the choice of ψ by the IMF has

[59] Note that the IMF's program is uninteresting if $\alpha < \hat{\alpha}(0)$ given that if this is the case $k^*(\psi) < k^D$ always, and the Fund's PSI policy cannot affect ex-ante capital flows. This in turn implies that the ex-ante optimal level of PSI coincides with the ex-post optimum, i.e. $\psi^c = 0$. We therefore restrict our attention to cases where $\alpha \geq \hat{\alpha}(0)$.

an impact on ex-ante capital flows only if $\psi^c < \hat{\alpha}^{-1}(\alpha)$, i.e. if PSI is low enough, relative to α, so that ex-ante investment reacts positively to the level of PSI chosen by the Fund. If ψ is above this threshold value, ex-ante investment remains constrained at k^D (i.e. the investor prefers to avoid the risk of default), and the IMF's PSI policy is not capable of affecting the probability of the crisis occurring. Given that the only reason why a relief-tolerant IMF might wish to depart from its ex-post optimal policy of $\psi^c = 0$ is to reduce the probability of a crisis taking place by increasing PSI, values of ψ above $\hat{\alpha}^{-1}(\alpha)$ can be ruled out as solutions to the IMF's ex-ante program. The range of possible optimal values of ψ can therefore be narrowed to $\psi < \min(\bar{\psi}, \hat{\alpha}^{-1}(\alpha)) \equiv \hat{\psi}$. Accounting for the implications of IMF relief-tolerance noted above, the range of possible values of ψ^c is therefore $\psi \in [0, \hat{\psi}]$.

Given the above restriction on the possible values of ψ, it is straightforward to derive that $V(\psi)$ is convex in ψ, i.e. $V''(\psi) = 2\gamma'(\psi)U'(\psi) > 0$, as long as $k^r(\bar{\psi}) > \frac{\lambda}{2}$ (which implies that $U''(\psi) = 0$).[60] This is because both $\gamma'(\psi)$ and $U'(\psi)$ are negative for $\psi \in [0, \hat{\psi}]$.[61] This in turn implies that there is no interior solution to the IMF's ex-ante program and that, depending on parameter values, the IMF will either choose to set $\psi^c = 0$ (i.e. follow its ex-post optimal PSI policy) or to set $\psi^c = \hat{\psi}$ (i.e. pre-commit to increase PSI to deter capital inflows and, if α is high enough, make the investors' IRC binding).[62]

Substitution of the values for these corner solutions into (6) reveals that $V(\hat{\psi}) > V(0)$ (i.e. $\psi^c = \hat{\psi} > 0$) if the following condition holds:

$$\delta_k^2(1-\mu)\bar{U} > F + \frac{(1+\delta_k)\,\delta_k^2}{1+2\delta_k}(2-\hat{\psi})k^D \qquad \text{(C (PSI))}$$

where $\mu \equiv \frac{1+\frac{\lambda}{2}}{\bar{U}}$, and $F \equiv \frac{\delta_k(\alpha-\bar{\gamma})}{1+2\delta_k} + (1+\delta_k)\bar{\gamma} > 0$.

C (PSI) shows that the IMF finds it optimal to commit to increase PSI relative to its ex-post optimal level if *both* δ_k and $\bar{U}$ are sufficiently high - i.e. the level of capital inflows

[60] The condition $k^r(\bar{\psi}) = \frac{p(1-p)}{1+\lambda} > \frac{\lambda}{2}$ is necessary to set $U''(\psi) = 0$ (see equation 4). If this is not satisifed, we have $V''(\psi) = 2\gamma' U' + \gamma U''$, which, for U'' negative enough, might be negative. If this is the case, there might be an interior solution to the ex-ante IMF program, which would still imply the possibility of a departure from the ex-post optimal PSI policy of setting $\psi^c = 0$. The main policy implication of this analysis of investor moral hazard and PSI would therefore be unaffected.

[61] In particular, $\gamma'(\psi) = -\frac{\delta_k^2}{1+2\delta_k}k^D$. $U'(\psi)$ is given by equation (4).

[62] The reason why no interior solution exists to the IMF's ex-ante PSI program can be seen by considering the marginal benefit and marginal cost to the IMF of increasing PSI relative to 0 and moving towards $\hat{\psi}$. The first derivative of the Fund's ex-ante utility is as follows:

$$V'(\psi) = -\gamma'(\psi)(\bar{U} - U(\psi)) + \gamma(\psi)U'(\psi)$$

The first term of this expression can be interpreted as the marginal benefit of increasing ψ above 0: the reduction in the probability of a crisis times the opportunity cost of a crisis. This is positive and increasing in ψ, given that $U'(\psi) < 0$ and $\gamma''(\psi) = 0$. The negative of the second term is the marginal cost of increasing ψ: the expected loss in utility if a crisis occurs. This is decreasing in ψ, given that $U'(\psi)$ is constant and $\gamma(\psi)$ is decreasing in ψ. Therefore, when deciding whether to depart from its ex-post optimum of $\psi^c = 0$, the IMF is faced with an increasing marginal benefit schedule, and a decreasing marginal cost one: if it is beneficial to increase ψ above 0 it is therefore always optimal to do so as much as possible (i.e. make the investors' IRC bind, whenever possible).

has a sufficiently high impact on the probability of crisis, and the crisis is sufficiently costly. In particular $\bar{U}$ needs to be strictly higher than $\bar{U}_{\min}$ for *C (PSI)* to be satisfied. Defining $\Delta\bar{U} = \bar{U} - \bar{U}_{\min}$, *C (PSI)* implies $\Delta\bar{U} > \frac{1+\delta_k}{1+2\delta_k}\left[\frac{\delta_k\alpha+(1+\delta_k)\bar{\gamma}}{\delta_k^2} + (1-\hat{\psi})k^D\right] > 0$. Figure 13 illustrates the ratio $\frac{\Delta\bar{U}}{\bar{U}_{\min}}$ as a function δ_k, showing how for low values of δ_k, $\bar{U}$ needs to be considerably higher than the maximum utility earnt by the IMF in a crisis situation (i.e. $\bar{U}_{\min}$) for the Fund to find it optimal to depart from its ex-post optimal PSI policy.[63]

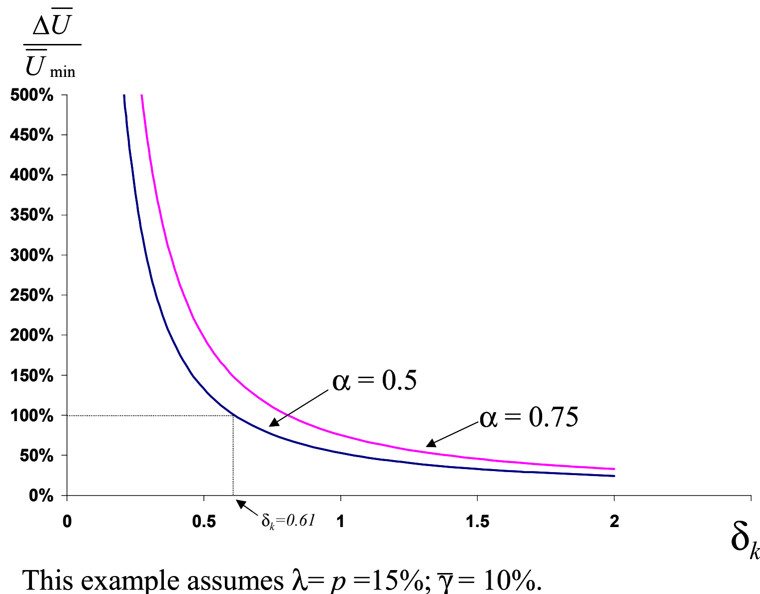


Figure 13: Thresholds values for $\frac{\Delta\bar{U}}{\bar{U}_{\min}}$ as a function of δ_k (the IMF optimally sets $\psi^c = 0$ if $\frac{\Delta\bar{U}}{\bar{U}_{\min}}$ is below the threshold value, and $\psi^c = \hat{\psi}$ if it is above it).

5.4 Discussion

This section has discussed the role of PSI in both crisis prevention and resolution. It has shown that, ex-post (i.e. after a crisis), the extent to which PSI takes place has an impact on the form of ex-post conditionality, and on the IMF's 'returns' from conditionality. In the presence of high levels of external debt, PSI is a pre-condition for effective crisis resolution. At lower levels of debt ($k < k^H$), a PSI-tolerant IMF finds it optimal to allow for some PSI as part of its conditionality, in order to enhance the effectiveness of crisis resolution.

Ex-ante (i.e. before a crisis), expected PSI affects the inflow of foreign capital and, in the presence of 'investor moral hazard' considerations, the probability of a crisis taking place.

Given this role of PSI, this section of the paper has identified some key drivers which can be expected to affect the level of PSI included in the Fund's overall conditionality package following a crisis. These include the attitude of the Fund to PSI (i.e. aversion vs. tolerance), its ability

[63] The restriction on $\bar{\gamma}$ stated in footnote 56 is satisfied for all the parameter values plotted in Figure 13.

to credibly commit before a crisis to an ex-post sub-optimal level of PSI, the investors' outside option (which is a function of their ability to act collectively following a crisis) and, finally, the seriousness of the concern for investor moral hazard. We have shown that a relief-tolerant IMF with access to commitment technology has incentives to commit to maximise PSI ex-ante, if investor moral hazard is strong and if investors are relatively weak. If one of these two conditions does not hold (or if the IMF is not credible in its promises), PSI will be at its ex-post optimum. If the reason why maximum PSI is not attainable is either lack of commitment power on the part of the Fund or the ability of investors to co-ordinate following a crisis, then investor moral hazard may not be mitigated in equilibrium.

The discussion of PSI presented in this section also raises distributional and efficiency considerations with regard to the Fund's post-crisis intervention. Ex-post (i.e. following a crisis) debtor countries are indifferent to the Fund's choice of conditionality contract (including its PSI component) given that their IRC always binds. Investors are of course not indifferent, and their welfare is maximised by a PSI-averse IMF (i.e. one which sets $\psi^c = -\lambda$). Any choice of PSI above this level, implies a utility transfer from the investors to the IMF. If the IMF's and the investors' utility is weighed equally from the point of view of global welfare, this enhances efficiency.[64]

Ex-ante on the other hand, the ex-post optimal PSI policy followed by a PSI-tolerant Fund might be sub-optimal. If debtors benefit from the commitment technology afforded by IMF conditionality in terms of a reduction in inefficient credit-rationing (see Section 3.2), a more lenient PSI policy might benefit both debtors and investors in expected utility terms, offsetting the benefits to the Fund of higher PSI ex-post. If the IMF is concerned about the issue of ex-ante credit-rationing (and if investor moral hazard is not too much of a concern) the Fund may in fact find it optimal to set $\psi^c < 0$, thus increasing the ex-ante utility of both debtors and investors.[65]

6 Conclusion

This paper has presented an agency framework to analyse IMF conditional lending, which can account for both a standard interpretation of IMF conditionality (e.g. as applied until the debt crisis of the 1980s) and for a more contemporary approach to conditionality, which stresses the implications of conditionality on debtor-commitment, debtor-moral hazard, and PSI. We have shown that "conditionality as a safeguard" of limited IMF resources can be compatible with "conditionality as commitment technology", and it can relieve inefficient ex-ante credit

[64] This is clear from the expression for the Fund's marginal utility from PSI (see Figure **11**). Lowering ψ below 0 has a marginal cost for the Fund of at least $\frac{k^D}{\lambda}$, which is always greater than the investors' marginal benefit of lower ψ (i.e. -$\frac{\partial k^r(\psi)}{\partial \psi} = k^D$).

[65] For instance, if the IMF's ex-ante utility includes a term for credit rationing, i.e. $V(\psi) = (1-\gamma(\psi))\bar{U} + \gamma(\psi)U - (\alpha - k^*(\psi))$, then the condition for $\psi^c = \hat{\psi}$ (C (PSI)) is harder to satisfy, given that it includes an extra δ_k term on the right-hand side.

rationing.

We have also described a context in which the IMF can induce debtor moral hazard, because of its inability to pre-commit to extract all the rents from its efficient crisis intervention. This moral hazard can only be mitigated via ex-ante conditionality (or pre-qualification). However, especially in the presence of strict IMF budget constraints (which may be partially due to its inability to commit to limited ex-post bail-outs), moral-hazard reduction may have to be traded-off with less effective safeguards on IMF loans. If the IMF is constrained to lend under adequate safeguards, it may bias its intervention towards crisis resolution rather than crisis prevention, leading to a sub-optimally high probability of crisis.

We have also shown that PSI is a central component of IMF's rescue packages. PSI can be an enabling condition for effective crisis resolution, and it determines the IMF's return from intervening in a crisis. The optimal level of PSI if a crisis occurs may however lead to excessive ex-ante capital inflows, generating an investor moral hazard problem. This implies that the Fund may find it optimal to commit to a tougher stance of PSI ex-ante, to reduce capital inflows.

A general theme which has emerged throughout this paper is that are conflicts between the various functions which IMF conditionality can fulfill. For instance, between the mitigation of investor moral hazard and relaxation of inefficient ex-ante credit rationing; between debtor program ownership (or the transfer of efficient ex-post commitment technology) and the presence of debtor moral hazard; between ex-ante conditionality (crisis-prevention) and ex-post conditionality (lending under adequate safeguards); and, finally, between efficient crisis resolution (from the Fund's perspective) and transferring rents to foreign investors (which has implications for investor moral hazard).

This variety of trade-offs shows that designing the appropriate IMF conditionality contract is a complex issue and that policy-makers need to be aware of the potential pitfalls of a partial-equilibrium analysis when considering possible reforms of the International Financial Architecture.

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A IMF Lending Practices[66]

Strictly speaking, the IMF does not lend money to its members. It instead allows members which are experiencing external disequilibrium to purchase foreign exchange from the IMF's usable resources (made up of the quota contributions of members whose currency is sufficiently strong) using their own currency, which needs to be "re-purchased" within the timeframe imposed by the Fund. The IMF can draw on its quotas to support these operations (which are currently at about \$300bn, following a 45% increase in 1999), and on Agreements to Borrow additional funds with a number of its members.[67]

The rationale for the IMF's lending practices originates with the desire of the architects of the Bretton Woods system to establish an institution through which creditor countries could support debtor countries in their adjustment efforts, and eliminate (or at least reduce) their temptation to resort to measures which could compromise or damage international cooperation[68]. The practice of conditionality emerged soon after Bretton Woods, after an initial debate on whether access to IMF funds should be "automatic" or "managed" (Friedman (1983)). Conditionality was introduced in 1952, with the establishment of Stand-by Arrangements, to "balance the safeguards for the Fund with assurance to the member of the availability of resources" (IMF (2000b), p. 36).

The current conditionality practices (as set out in the 1979 Guidelines on Conditionality) combine the phasing of lending and the use of quantitative performance criteria for "upper tranche credit", that is credit in excess of the first 25% of the member's quota (which is instead subject to very light conditionality). The standard vehicle of conditional lending is the Stand-By Arrangement (SBA), which is intended to implement the IMF's mandate by providing limited (given the presence of access limits) and temporary assistance to countries experiencing cyclical external disequilibrium. After the fall of Bretton Woods and the first oil shock, with current account deficits becoming more pronounced, the IMF introduced an additional lending facility (the Extended Fund Facility (EFF)), which was intended to facilitate adjustment to more structural external disequilibrium, and is therefore longer (see Table 1). Both SBAs and EFFs are subject to a basic rate, which is based on the interest on risk-free assets in industrial countries (the SDR rate), plus a modest surcharge.[69]

In the 1980s these two facilities were supplemented by the Structural Adjustment Facility and Enhanced Structural Adjustment Facility (subsequently renamed the Poverty Reduction and Growth Facility (PRGF)) for concessional lending to low-income countries. More recently, to deal with the larger and more rapid capital-account crises of the 1990s, the IMF introduced a the Supplementary Reserve Facility (SRF), which is larger than SBAs but subject to higher ("penal") charges, and a Contingent Credit Line (CCL), intended to deal with "contagion"-induced capital outflows, and which is subject to "ex-ante conditionality" (or pre-qualification). The SRF was first used to finance the assistance package to Korea (in December 1997), which was 20 times its quota, and has subsequently been used for Russia (1998),

[66]This section is mainly based on IMF (2000a), IMF (2000b) and Boughton (2000).

[67]The General Agreement to Borrow (of 1962) was resorted to in July 1998, to support an EFF to Russia, and a New Agreement to Borrow was set up with 23 lending countries in 1998, and used later that year to help finance a Standy-by to Brazil.

[68]Such as competitive depreciations and foreign trade restrictions, which had characterised the inter-war years after the collapse of the Gold Standard.

[69]E.g. in January 2001 the SDR rate was at 4.4%, and the basic IMF rate at 5.1%.

Brazil (1998), Turkey (2000/2001), and Argentina (2000/2001). No IMF member has so far used the CCL. The features of these IMF facilities are summarised in Table 1 below, which incorporates some of the recent modifications introduced by the Fund following a Review of its facilities undertaken in 2000.

Figure 14 plots the commitments made by the Fund since 1950, both in monetary terms (in 2000 US$) and in terms of number of programs. IMF lending picked up during the Suez Crisis, and also following the collapse of the Bretton Woods system, with large packages to Italy and the UK in the late 1970s. The largest financial interventions by the IMF have however occurred since the 1980s, following the debt crisis of 1982, the Mexico crisis of 1995, and the Asian and Russian crises of 1997-98.

Overall 80% of the IMF's "loans" since 1950 have been SBAs. Since the 1990s however 13% of programs have been EFFs and 35% PRGFs.[70] In terms of monetary commitments, the IMF estimates that 40% of its lending in the 1990s has been for "capital-account crises", 20% for transition economies and the remaining 40% for more "traditional" current-account disequilibria (IMF (2000b)). No industrial country has resorted to IMF lending since 1983.

Facility	*ati al*	*t*	*a*	*cc li it ta*	*ay t i*	*tal t*
Stand-by Arrangement	Cyclical disequilibrium	1-2 years	asic rate*	100% annually	3.5-5 years	8 (quarterly)
Extended Fund Facility	Structural disequilibrium	3 years	asic rate*	300% cumulati e	4.5-10 years	12 (semi-annual)
Supplementary Reserve Facility	Capital-account disequilibrium	Short	asic rate ith surcharge**	one	2-2.5 years	2
Contingent Credit Line	Contagion	Short	asic rate ith surcharge***	one (but need to prequalify)	2-2.5 years	2
PRGF	Concessionary	ong	0.5% p.a.	140% o er 3 years	5.5-10 years	10 (semi-annual)

* There is a surcharge for large loans (greater than 200% of quota).
**Currently set at 3%, rising to 5% for delayed repayment.
*** Currently set at 1.5%, rising to 3.5% for delayed repayment.

Table 1: IMF Lending Facilities

B Omitted Proofs

B.1 Proof of Proposition 1

Proof. It is convenient to solve the IMF's program by assuming at first that only the IRC binds (which is always the case, since it is optimal for the IMF to make it bind to minimise on transfers), and check whether the "no transfers constraint" and the "adequate safeguards" constraint are satisfied by the solution of the simpler program.

The IRC gives the following condition for the optimal level of bail-out b:

$$b^c = \frac{U_2^{R,*} - e_2 + \frac{(e_2)^2}{2} + (1+\lambda)k}{\lambda} \tag{7}$$

[70] For the purpose of this classification, used by the IMF in its annual report, SBAs and EFFs include SRFs.

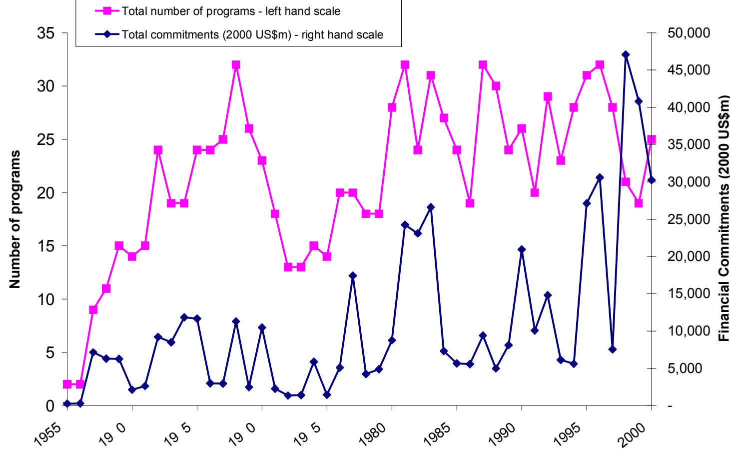

Figure 14: IMF Financial Commitments since 1955

Substituting into the IMF's objective function and optimising w.r.t. e_2 gives the following first order condition:

$$1 + \frac{1 - e_2}{\lambda} = 0$$

which delivers the first best level of conditionality $e_2^c = 1 + \lambda$. Plugging this back into equation (7) and substituting for the appropriate value of $U_2^{R,*}$ (depending on whether k is above or below k^D) yields the values for b^c given in Proposition 1(i).

Two conditions can therefore be identified for when the $b^c \leq k$ constraint binds: $k < \min(\frac{\lambda}{2}, k^D)$ (which follows directly from the unconstrained solution for b^c); and $k \geq \max(k^D, k^M)$. This second condition derives from the unconstrained solution for b^c for $k > k^D$. This is greater than k for $k > k^M$ (as straightforward calculation reveals). Comparing k^M and k^D shows that $k^M > k^D$ iff $k^D > \frac{\lambda}{2}$. If this is not the case $k > k^M$ is satisfied whenever $k > k^D$ is satisfied, so that the $b \leq k$ constraint binds for all k.

The values for e given in Proposition 1(ii) are obtained from equation (7) by imposing $b = k$, and applying the relevant value for $U_2^{R,*}$. For $U_2^{R,*} = \frac{1}{2} - (1 + \lambda)k$ (which is the case for $k < k^D$), this yields the following quadratic in e_2:

$$e_2^2 - 2e_2 + 1 - 2\lambda k = 0$$

where the optimal root is $1 + \sqrt{2\lambda k}$ which is less than the first best level $1 + \lambda$ given that $k < \frac{\lambda}{2}$. For $U_2^{R,*} = \frac{(1-p)^2}{2}$ the IRC yields:

$$e_2^2 - 2e_2 + 1 + 2k + (1 - p)^2 = 0$$

which gives the following optimal root, $e_2 = 1 + \sqrt{p(2 - p) - 2k} = 1 + \sqrt{2\left(k^H - k\right)}$ which is less than $1 + \lambda$ for $k > \max(k^D, k^M)$. For $k > (1 + \lambda)k^D \equiv k^H$ the determinant of this expression is negative, i.e. no conditionality can be imposed by the IMF.

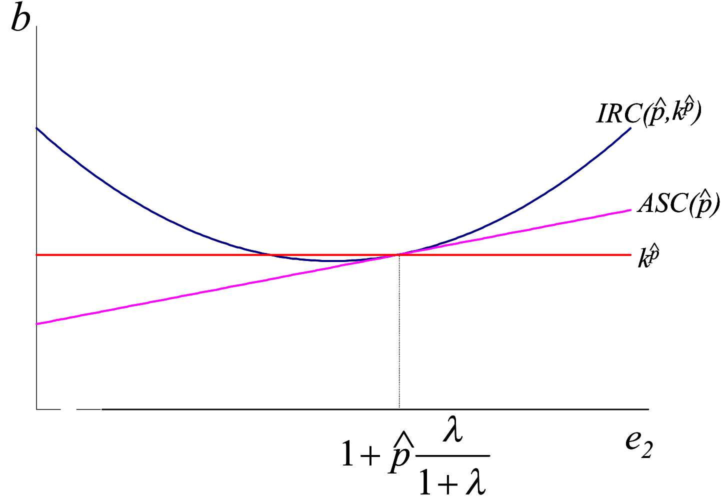

Figure 15: Conditionality at $p = \hat{p}$ and $k = k^{\hat{p}}$.

Turning now to the "adequate safeguards" constraint, this never binds for $p \geq \bar{p} = \frac{2\lambda}{1+\lambda}$, which is given by making ASC binding for $k = k^H$. For lower values of p, ASC will bind for k high enough (but always above $\max(k^D, k^M)$ as straightforward comparison of the ASC with the solution for (e_2, b) obtained ignoring the ASC shows) and conditionality will collapse or be weakened for k "too high".

To determine how conditionality needs to be adapted to satisfy the ASC consider the case where all three constraints bind and ASC is tangent to IRC. This is the case for $p = \hat{p} < \bar{p}$, where $\hat{p}$ is obtained by jointly satisfying $e_2 = 1 + \frac{\lambda}{1+\lambda}p \equiv e_2^t$ (ASC-IRC tangency condition), $e_2 = 1 + \sqrt{p(2-p) - 2k}$ (assuming $b \leq k$ binds), and $k = \frac{p}{1+\lambda}e_2$ (from a binding ASC), and equals the value given in Proposition 1.

This implies that at $p = \hat{p}$, there is a value of k ($k = k^{\hat{p}} \equiv \frac{\hat{p}}{1+\lambda}(1 + \frac{\hat{p}\lambda}{1+\lambda}) < k^H$) such that for $k > k^{\hat{p}}$ conditionality collapses (i.e. it is not possible to meet all three constraints), and for lower values of k the solution for conditionality is the same as the one obtained ignoring the ASC, and given in case (ii) of this Proposition (see Figure 15).

For $p < \hat{p}$, conditionality collapses "earlier", i.e. for $k > k^{AS}$, where k^{AS} is given by the tangency of IRC and ASC (i.e. $k^{AS} = \frac{e_2^t(1 - \frac{e_2^t}{2} + \frac{\lambda}{1+\lambda}p) - \frac{(1-p)^2}{2}}{1+\lambda} < k^{\hat{p}}$). At $k = k^{AS}$ the bail-out b is less than the capital outflow k (i.e. the $b \leq k$ constraint is slack), which implies that conditionality is lowered relative to the level implied by ignoring the ASC. This is so because lowering k relative to $k^{\hat{p}}$ and towards k^{AS} implies that the IRC shifts downwards by more than k in (b, e_2) space, which in turn implies that at the tangency with ASC $b < k$. As k is lowered below k^{AS} the level of e_2 under conditionality converges to the level obtained ignoring the ASC.

For $p \in (\hat{p}, \bar{p}]$ conditionality can be implemented for values of k above $k^{\hat{p}}$. In this case conditionality collapses for $k > k^{3C}$, where $k^{3C} \in (k^{\hat{p}}, k^H]$ is given by the value of k for which all three constraints bind. For $k \in (\max(k^D, k^M), k^{3C}]$ conditionality can be imposed, and its solution is the one obtained ignoring the ASC. ■

B.2 Proof of Proposition 3

Proof. Part (i) follows from the maximisation of the IMF objective function, after substituting for b from the (binding) IR constraint. This shows that the minimisation of $\gamma(e_1)b$ is equivalent to maximising $\frac{E[U^R(e_1,\beta=0)]-\overline{U}^R}{\lambda}$, and that therefore $e_1^c = e_1^{FB}$, as long as $b \leq k$ does not bind.

The value of b^c is then obtained by replacing e_1^{FB} for e_1 in the IRC, substituting for $\overline{U}^R$, and solving for b. This yields:

$$\gamma(e_1)b^c = \beta k \left(\gamma(\overline{e}_1) - \frac{\lambda\delta_e^2\beta k}{2}\right)$$

which simplifies to the expression for b^c given in the Proposition.

The value of k^T is then obtained by equating the solution for b^c with k. Differentiation of k^T w.r.t. β shows that $\frac{\partial k^T}{\partial \beta} < 0$.

(ii) From part (i), $k \geq k^T(\beta)$ implies that the $b \leq k$ constraint binds, and the conditional effort level is therefore lower than e_1^{FB}. In this case e_1^c is given by substituting k for b in the IRC and solving for e_1. This yields the following solution: $e_1^c = e_1^{SB}(\beta, k) = 1+\delta_e k+\sqrt{\left[2(\bar{\gamma}-\delta_e) - \delta_e^2 k(2+\lambda(1-\beta))\right](1-\beta)\lambda k}$, which equals e_1^{FB} for $k = k^T(\beta)$, and lies below it for higher values of k.

Equating $e_1^{SB}(\beta, k)$ and $\bar{e}_1(\beta, k)$ yields $k = \frac{\bar{\gamma}-\delta_e}{\delta_e^2(1+\lambda(1-\beta))} \equiv k^U(\beta)$, which is increasing in β. This is the same value of k obtained by setting $\gamma(\bar{e}_1(\beta, k))$ to 0.

Imposing $\beta = 0$ shows that $k^U(0) = k^T(0)$. Given that $k^U(\beta)$ is increasing in β and $k^T(\beta)$ is decreasing in β, this implies $k^U(\beta) \geq k^T(\beta)$.

Finally, differentiation of $e_1^{SB}(\beta, k)$ w.r.t. k shows that $\frac{\partial e_1^{SB}(\beta,k)}{\partial k} \geq 0$ for $k \leq k^U(\beta)$. This implies that if $k < k^U(\beta)$, then $\gamma(e_1^c) > 0$. ■

C Micro-foundations

C.1 Derivation of the nature of adjustment effort and of the liquidity cost λ

This appendix outlines possible micro-foundations for the presence of a liquidity cost of sudden capital outflows (defined as λk in the main text), and for the presence of a policy conflict between the developing country and the IMF.[71]

We firstly introduce some additional notation.[72] Namely, we define as m the level of imports, as n the production of non-tradeables and as x the level of production of exports. e, as in the main text, refers to effort, and can also be thought of as the exchange rate between exports and non-tradeables ($\frac{p_x}{p_n}$). We assume that the debtor country can produce both exports and non-tradeables, according to the following production functions:

$$x = x(e) = e$$

[71] This set-up partially follows Fafchamps (1996).

[72] We omit time subscripts for notational simplicity.

and

$$n = n(x(e)) = 1 - \frac{e^2}{4}$$

These functions imply a concave production possibility frontier between n and x, and that the choice of effort e by the policy makers determine both the production of exports and non-tradeables. We assume that exports can be exchanged one-for-one with imports (i.e. the external exchange rate is 1), and that inflows (outflows) of foreign capital, are used to buy imports. That is, $m = x + k$.

The debtor country earns utility from the consumption of non-tradeables and imports, according to the following quasi-linear function, $U^R = m - \frac{m^2}{4} + n$, which implies, in terms of effort e:

$$U^R(e) = (e + k)\left(1 - \frac{e+k}{4}\right) + 1 - \frac{e^2}{4}$$

Maximising w.r.t. e we obtain the following first order condition:

$$\begin{aligned} 1 - \frac{e}{2} - \frac{k}{2} - \frac{e}{2} &= 0 \\ &\Rightarrow \; e^* = 1 - \frac{k}{2} \end{aligned}$$

The solution for e^* shows that the greater the availability of foreign capital the lower is the production of exportables, given the increased ability to purchase imports. This implies a the lower is the price of tradeables to non-tradeables, or an appreciation of the real exchange rate (which is given by e).

Turning now to the situation described in the baseline model, consider an inflow of k at $t = 1$, and the possibility that at $t = 2$ a crisis might take place. Assume now that the level of e can only be changed at the end of each period t, and that at the end of $t = 1$ the debtor sets $e = 1$ (which is optimal if the probability of γ is low enough).[73] If a crisis then occurs, and e is sticky in the short-run (i.e. it can only be changed at the end of $t = 2$), the debtor needs to pay k back to the investor without being able to change e to produce more tradeables (which would be efficient given the higher marginal utility of imports associated with a negative capital outflow).[74] Comparing the utilities associated with the sticky-prices scenario ($\bar{e} = 1$) and the flexible price scenario ($e^* = 1 + \frac{k}{2}$), both with an outflow of $-k$ we obtain:

$$\begin{aligned} \Delta U &= (e^* - \bar{e}) + \frac{1}{4}\left[(\bar{e} - k)^2 - (e^* - k)^2 + \bar{e}^2 - (e^*)^2\right] \\ &= \frac{k^2}{8} > 0 \end{aligned}$$

Relating this result to the baseline model in the main text, we have that $\lambda k = \frac{k^2}{8}$, that is $\lambda = \frac{k}{8}$. This shows that the liquidity cost associated with a sudden crisis can be micro-founded, and that it is

[73] The optimal level of e will in fact be slighly above 1 to reflect "insurance" against the probability of crisis. Allowing for this, as opposed to assuming $e = 1$, would not add particular insights to the analysis, but would complicate the algebra significantly.

[74] This is consistent with the possibility of debt-overhang setting in (which we allow for in the main text), if we assume that the penalty in case of default is paid at the end of $t = 2$, when domestic prices can be varied.

a function of k (which is intuitive, and which is a feature we abstract from in the reduced-form model presented in the main text).

The policy conflict described in the text between the IMF and the debtor can also be introduced in this extended set-up by assuming, for instance, that the IMF attaches less utility to the debtor's consumption of non-tradeables than the debtor himself (e.g. which could be because the IMF wants to promote global trade, or because the debtor has political-economy reason to favour the non-tradeable sector), e.g.

$$U^{IMF} = (e+k)\left(1 - \frac{e+k}{4}\right) + (1-\omega)\left(1 - \frac{e^2}{4}\right)$$

where $\omega > 0$.

This yields, $e^{*,IMF} = \frac{e^*}{1-\frac{\omega}{2}} > e^*$. The model in the main text reproduces this policy conflict by assuming that the IMF want to maximise e, which is locally consistent with this.

C.2 Derivation of unconditional transfer level βk in the moral hazard extension

The assumption that the IMF cannot commit not to transfer a level of unconditional funds βk following a crisis can formalised by assuming the following IMF utility function:

$$U^{IMF} = \underbrace{e_2 - b}_{\text{standard}} + \underbrace{\left(\hat{\beta}\Delta U^R(e_2, b) - \left(\Delta U^R(e_2, b)\right)^2\right)}_{\text{additional "altruism" term}}$$

where $\Delta U^R(e_2, b) = U^R(e_2, b) - \overline{U}^R$. This revised utility function implies that, up to a point, the IMF benefits from leaving some rents to the recipient when intervening ($\Delta U^R(e_2, b) > 0$), and not making the recipient's IRC binding.

The definition of $\Delta U^R(e_2, b)$ implies:

$$b = \frac{\overline{U}^R - \Delta U^R - e_2 + \frac{e_2^2}{2} + (1+\lambda)k}{\lambda}$$

which in turn implies

$$\frac{\partial U^{IMF}}{\partial \Delta U^R} = -\frac{1}{\lambda} + \hat{\beta} - \Delta U^R$$

Setting $\frac{\partial U^{IMF}}{\partial \Delta U^R}$ to zero we obtain the optimal level of rents ΔU^R which the IMF wants to leave to the recipient:

$$\Delta U^{R*} = \hat{\beta} - \frac{1}{\lambda}$$

which is positive (i.e. IRC is slack) as long as $\hat{\beta} > \frac{1}{\lambda}$.

Substituting for ΔU^R and b^c in the IMF objective function we finally obtain $e_2^c = 1 + \lambda$ (assuming that the $b \leq k$ constraint and ASC do not bind), as in the baseline case. This implies that the optimal bail-out level is increased by $\frac{\hat{\beta}-\frac{1}{\lambda}}{\lambda}$ relative to the binding IRC case, which measures the level of unconditional

[1] See, for example, T. Killick, Aid and the Political Economy of Policy Change, 1998, London, ODI.
[2] See P. Collier, "Conditionality, dependency and coordination", ch. 12 of C.L. Gilbert and D. Vines eds. (*op.cit.*).
[3] Evidence for ineffectiveness is actually weak for IMF lending, but stronger for World Bank lending, where fungibility is a more serious issue. See S. Devarajan and V. Swaroop, "The implications of foreign aid fungibility for development assistance", ch. 7 of C.L. Gilbert and D. Vines eds., *The World Bank Structure and Policies*, 2000, Cambridge, Cambridge University Press.
[4] Documented in IMF, "Structural conditionality in Fund-supported programs", 2001, Washington DC, IMF.
[5] The evidence in IMF (*op. cit*.) does not suggest that multiple conditionality results in any proportional decline in compliance.
[6] *Report of the International Financial Institution Advisory Commission*, Washington DC, US Government Printing Office, 2000.
[7] The principles involved are discussed in some detail in G. Federico (2001) "IMF Conditionality" External contribution to the IMF's Review of Conditionality.
[8] A. Lerrick and A. Meltzer, "Default without disruption", *Financial Times*, 10 May 2001.
[9] See Federico (2001).

IMF Conditionality

Christopher L. Gilbert and David Vines*

1 Introduction

Conditionality is the requirement that, in return for IMF adjustment lending, countries adopt policies specified in an agreement with the IMF, as part of an adjustment program.

The simplest way to think of conditionality is as follows. If a country suffers from a financial crisis, in the form of capital withdrawal, and reneges on the required capital repayment then it will suffer from default costs. If, instead, it does permit the capital to be withdrawn, then it will need to embark on an enforced adjustment process. The latter course of action will produce a deadweight adjustment loss, in the form either of project liquidiations or of unplanned falls in absorption. A successful IMF program involves a loan to a crisis country of sufficient funds that it chooses not to default, as the consequence of being able to repay the withdrawn capital without incurring such high deadweight adjustment costs. This adjustment lending postpones the default risk to such time as the new loans fall due, but also transfers the default risk to the IMF.

The time gained by postponing repayment may be sufficient to ensure that repayment is feasible – this could be the case if the crisis was caused purely by contagion. Typically, however, repayment, and avoidance of further crises, will require that the country adjusts policies and/or institutions. The adjustments will involve costs, and there is a problem that, reinforced by IMF adjustment lending, countries may seek to avoid incurring these costs. This is a moral hazard problem, which arises *after* the agreement of an IMF program. The IMF needs to impose conditions to ensure repayment and avoidance of future costs, so as to mitigate this moral hazard problem.

We can thus think of conditionality as the IMF's response to the moral hazard problem which arises *afte*r crisis adjustment lending has been made to a country.

Is it possible to envisage the private sector take over the IMF's crisis lending role? There are two strong arguments that lending of this sort is best performed by a multilateral public sector organization. First, the coordination problem among private sector organizations (presumably banks) would make rescue slow and cumbersome, whereas what the markets actually require in crisis situations is speedy and definitive programs. Second, neither banks nor foreign governments have the legitimacy to seek institutional or policy change as a precondition for lending. The IMF's status as a membership organization is what allows it to undertake conditional lending. This will be important in what follows.

This note considers, in turn, three aspects of the conditions associated with IMF programs which could helpfully be addressed. First, we discuss the need to separate the conditions imposed by the IMF from those imposed by the World Bank. Second, we examine the potentiality of introducing

some ex-ante conditionality. Third, we consider the possibility of standstills, and "private sector involvement", in the process of crisis resolution.

2 Narrowing the Scope of Conditions: Separating the Roles of the Fund and the Bank

Conditionality has come under wide-ranging attack recently years, as being (a) ineffective (b) insufficiently respectful of countries' sovereign rights.[1] Our view is that conditionality can be effective, and that ownership issues arise partly because it is effective. Nevertheless, effectiveness requires that conditions applied have the right scope and focus. Inappropriate conditions will either (i) cause immediately ineffective outcomes, or (ii) endanger domestic support, gradually leading to ownership problems, which will eventually cause outcomes to be ineffective. In this section we discuss the scope of IMF conditionality.

The view that conditionality is largely ineffective is a dated one which derives from examination of the experience of the nineteen seventies and eighties. We believe that, over that period and for a particular set of reasons, the scope and focus of IMF conditions became misaligned with the IMF's objectives. Most importantly, those decades were colored by now absent Cold War imperatives.[2] In addition, developing country debt problems may have put a premium on disbursements over performance during the nineteen eighties. Those events are now history, and we believe that the IMF has learnt from the historical experience. [3]

The last fifteen years have seen an escalation in the scope and range of conditions attached to IMF loans. [4] Many governments and commentators see IMF conditions as having become increasingly intrusive into a wide range of domestic policy-making areas, and it is possible that this perception will weaken compliance. It is suggested that this expansion in conditionality was due to concerns that IMF programmes were paying insufficient attention to countries' growth prospects, and that the expansion in lending to poor and to ex-Communist countries resulted in the increased prominence of structural conditions. Such multiple conditions may be unrelated to the purposes of IMF lending, may jeopardize IMF monitoring, [5] and may also compromise governmental ownership. Over-ambitions and excessively intrusive conditions should therefore be avoided.

To make the necessary distinctions, it is useful to distinguish between short term crisis stabilization lending and longer term structural lending. Since crisis alleviation and prevention are a central element of the IMF's brief, the Fund will necessarily wish to be confident that governments adopt policies which ensure, so far as is possible, that crises are solved and do not recur. This form of lending will inevitably involve conditions on macroeconomic policies and may also involve conditions on financial regulation and structural adjustment. Avoidance of crisis recurrence is a limited objective and will be consistent with a wide variety of policies in other areas of the economy.

Longer term growth, development and poverty reduction objectives will typically imply different and more extensive conditionalities than those implied by stabilization. Many of these concerns

are primarily World Bank responsibilities. This is not to imply that the Fund should ignore those government policies which do not directly impinge on macroeconomic stabilization, but rather that it should require only that stabilization policies should not significantly exacerbate anti-poverty, pro-environment and other such policies. (It may also be and that governments which act in blatant disregard of these broader objectives might disqualify themselves from Fund assistance). The implication is that Fund assistance should imply a different, and in practice narrower, set of conditionalities than is appropriate in the case of Bank assistance. Of course, there will continue to be areas of policy in which Bank and Fund concerns overlap, and it is important that the two institutions coordinate effectively on these issues.

A major implication of the foregoing is that, if the Bank and the Fund are to distinguish their conditionalities, and perhaps also the extent to which ownership is important, they must first define better their objectives and better focus their activities. The nineteen nineties saw a tendency for “mission creep” on behalf of both organizations, encouraged by an “all hands on deck” view during the Mexican and then the Asian financial crises. We agree with the Bank’s current position that it is important that its primary development and poverty reduction concerns be insulated from short-term crisis imperatives. The concomitant of this view is that the Fund’s stabilization objectives should not be muddled with the Bank’s concerns with sustainable development and policy relief. The fact that both sets of objectives are commendable does not imply that both should be embraced by the two institutions – specialization will bring advantages.

A decision by the IMF to limit the scope of the conditions it applies in stabilization lending to those directly related to the likely success of stabilization policy does not imply that the IMF should cease to be involved in longer term structural policies aimed at promotion of growth. The IMF is, of course, in a position to advise governments on all aspects of policy, and this is an important function, which draws on knowledge and experience across the entire range of countries. There is merit in governments themselves making proposals on these issues within a government-IMF discussion framework. But lending of this sort should be distinguished from stabilization lending and should be coordinated by the World Bank, and other multilateral development agencies. This is not to detract from the importance of coordination between the two institutions. It should be recognized that, in certain cases, this may result in the Bank and Fund taking different views on whether lending is appropriate. A decision to reduce the budget deficit may have negative microeconomic, or growth, or poverty-reduction, implications. Cooperation between the Fund and the Bank is necessary on such issues, which is different from each institution being responsible for the other institution’s outcomes.

Issues of reform ownership are in some ways less critical for the Fund than for the Bank. It is obviously desirable that governments and their citizens feel responsible for any set of reforms. At the same time, crisis lending will only be effective to the extent that it is speedy. This may leave little time for education. There are many instances in which the finance ministry and central bank have been willing to commit to reforms despite resistance among the officials and/or institutions most directly concerned. It is in just these circumstances that the Fund will see a formal

agreement on loan conditions as particularly valuable. But it would be substantially more problematic for the Bank to lend on a development assistance program which fails to command the support of those who will be required to implement it. Delay on a dam or pipeline project until a consensus is attained will push both costs and benefits into the future, and as such, may have little impact on project profitability. Delays of providing assistance during a financial crisis my massively increase the costs arising out of the crisis.

3 A Limited Role for Ex Ante Conditionality

Up to this point we have considered only *ex post* conditionality. The Meltzer Report[6] has raised the important issue of whether conditionality should be *ex ante,* of whether countries should obtain better IMF assistance, after a crisis, if they have met certain *ex-ante* tests before any crisis occurred. We now consider this important issue.

The Meltzer Report suggests that countries would be required to prequalify for any form of post-crisis support from the IMF. On this proposal, Fund support would be *entirely* limited to countries which had adopted appropriate macroeconomic and regulatory policies prior to any crisis, and which had been deemed by the IMF to have done this. It is argued that this would both improve the effectiveness of IMF support and increase domestic ownership of policy reform. The prequalification proposal suggests an insurance model for IMF support.

We doubt whether the prequalification requirement is either practicable or desirable:

a) There is a danger that countries may consider pre-qualification for IMF support as an admission that they are potentially vulnerable to crisis. The countries which are most vulnerable to "unanticipated" crises may therefore fail to apply for pre-qualification.
b) The pre-qualification decision will inevitably be based in part on political considerations.
c) There is a danger that pre-qualification might be seen as a guarantee of potentially unlimited IMF support. For this reason, the Meltzer Report sought to impose limits on the support which would be available even to pre-qualified countries. However, limits of this sort may reduce the effectiveness of Fund lending.
d) There is a danger that pre-qualified countries may subsequently (perhaps after a change in government) adopt ill-advised policies which the Fund would not wish to underwrite. Equally, a country which has as yet failed to qualify may be hit by a crisis despite having exemplary policies. In this case, the Fund may consider support to be highly desirable, but nevertheless would be prevented from offering such support.
e) The Meltzer Report envisaged that non-qualifying countries would not get support. In the case of a perceived risk of contagion, support would be limited to qualified countries at risk. It is far from obvious that, *ex post*, this would be the lowest cost method of limiting contagion.

For all these reasons, our view is that the attempt to move entirely from *ex post* to *ex ante* conditionality would seriously limit the flexibility of the IMF is responding to crises, and at the

same time may reduce the effectiveness of Fund support. We view this proposal as well-intentioned but misconceived.

Nevertheless, we believe that there is merit in some degree of *ex-ante* conditionality. This, as Meltzer argues, is because reliance only on *ex-post* conditionality can induce countries to take less trouble to avoid crises, knowing that there will be IMF assistance to mitigate the bad effects of crises. In designing the IMF's operating rules, we should aim for a situation in which one can be confident, after a crisis, more will be lent to countries with a better policy framework than to other countries with poor frameworks. This will imply that other countries will have tougher *ex post* conditionality imposed after a crisis occurs, since, with lower IMF loans, more contractionary fiscal and monetary policies will be required. If countries knew that a less extreme, and less contractionary outcome would be imposed by the Fund in the event of a crisis in countries with a good policy environment, then there would be incentives for such a good policy environment to be established. That would reduce the probability of crises.[7]

This *ex-ante* conditionality would effectively guard against a second form of moral hazard. As we discussed in Section 1, *ex-post* conditionality is necessary to ensure that countries keep to agreed policies, after a crisis has occurred and an IMF loan has been obtained. That guards against a problem of moral hazard which arises after an IMF loan has been granted. But *ex-ante* conditionality may help to guard against countries doing too little to avoid a crisis, before any crisis has occurred, in the knowledge that relief will be available from the IMF once any crisis has occurred. Such *ex-ante* conditionality might thus guard against a form of moral hazard which arises in an on-going way, even before any IMF loans have been made.

Further discussion is required on the form such an arrangement might take. The arrangements should not limit the ability of the Fund to respond to any crisis as it sees fit, but at the same time should have the implication that the conditions imposed on countries for assistance would be less demanding if their policy environment had been judged satisfactory. They might also have the implication that the likelihood of assistance, in the event of crisis, would also be increased.

Note that the Meltzer proposal for limiting the conditionalities imposed by the IMF entirely to *ex- ante* conditionality is subject to another difficulty: it would also inevitably reduce the number of countries which obtained IMF support. This may be seen as an advantage to the extent that IMF support thereby becomes more effective. However, it raises the important question of what can be done for countries which the IMF feels unable to support, and by whom. Furthermore, in that the IMF is a membership organization, there is a serious danger that if its lending comes to be limited, either by explicit decisions or in terms of practical outcomes, in such a way as to exclude a significant group of countries, these countries are likely to see little merit in continuing active support and involvement in the organization. We believe that the long term viability of the Bretton Woods organizations depends on their being as inclusive as possible. In our view, it is misleading to see the IMF only as a type of loan guarantee organization for emerging market countries which should operate in terms of strict actuarial and profitability conditions - the IMF's capacity to educate governments with regard to appropriate structures and policies is in large

measure due to the authority deriving from its inclusive membership structure. This implies an inevitable tension, which the Executive Board must manage, between the efficiency of the Fund's lending and the inclusiveness of its programmes. The compromise proposal suggested above would mitigate this problem.

4 Private Sector Involvement and a Role for Standstills

The discussion in the first Section assumed that the consequence of IMF involvement is that that countries would avoid default. We now examine whether this requirement should be relaxed and so whether there should be Fund programs which involve allowance for, and endorsement of, partial debt default.

In recent crises, the Fund has been unable to impose any such payments standstills. But we know that standstill mechanisms are essential in the context of corporate restructuring and bankruptcy procedures: they force creditors to share in the burden of crisis. Such burden sharing serves efficiency objectives as well as equity objectives: it enables debt overhangs to be removed. In the context of international crises standstill mechanisms would also be helpful: they would bail-in foreign private sector creditors. This would force them to share the burdens of countries in crisis. It would thereby remove international debt overhangs, of the kind which are still crippling Indonesia and Thailand, three years after the Asian crisis began. Yet there are as yet no proposals for international standstill mechanisms that look even remotely feasible.

Standstill mechanisms would be helpful in reducing problems with what has been discussed in previous sections. Standstills would lower the need for very large loans by the IMF as part of crisis-resolution policies, loans which in a world of very high capital mobility are possibly more than the IMF can be in a position to afford. If standstills were part of *ex post* crisis resolution, they would also make it less necessary for the IMF programmes to include conditions which involved extremely contractionary monetary and fiscal policies, since the standstills would make possible a longer period of adjustment.

Standstills would help to reduce a further form of moral hazard, that by *creditors*. It has been suggested that lenders, knowing that there will be IMF assistance to mitigate the bad effects of crises, take less trouble to carefully assess the risks in loans. What is necessary is knowledge that after a crisis, there is the possibility of loss by creditors. This would clearly be helpful in reducing such creditor moral hazard. That is to say, if creditors knew that even in the presence of IMF crisis-resolution adjustment programs, capital loss was possible, then more care would be taken in lending. That too would reduce the probability of crises.

In a recent intervention, Lerrick and Meltzer have suggested that the IMF exercise a international lender of the last resort function by standing ready to buy emerging market debt at a price below its potential value once restructured.[8] This proposal could be used as the basis for a private sector involvement, or standstill mechanism, if, instead the borrowing country were to stand ready to purchase the debt, at a price laid down by the IMF. The country would borrow the necessary

funds from the IMF, and would be due to repay them to the IMF, as part of its adjustment programme. Such a proposal would put a floor on the price of emerging market debt, thereby preventing catastrophic collapse. But since the floor would be a price of less than 100 per cent, the existence of this scheme would expose lenders to risk, and thus stem lender moral hazard, as required. We regard this as a useful proposal, provided it is seen as one element in the Fund's armoury – it will be appropriate in countries where debt overhang is the major problem (Turkey in 2001) but less so in countries where macroeconomic performance is the problem (Argentina in 2001).

However, emerging market default insurance is currently available within the financial system. The amended Lerrick and Meltzer proposal is in one sense equivalent to the IMF undercutting the private sector by enabling borrowing countries to provide an alternative to this insurance. Why should it do this?

Furthermore, intervention by the IMF in this way would raise the probability that borrowers would not repay in full when faced with crisis, rather than, as assumed in the first Section, seeking to utilize the Fund to avoid default. The effect of the amended Lerrick and Meltzer proposal, or some other like, would be to allow some degree of default by borrowing countries at a time of financial crisis, without suffering from a default penalty.[9] Why should the IMF make this possible?

It makes sense for the IMF to make this possible, in competition with any private sector insurance, if it has a comparative advantage, but not otherwise. The source of comparative advantage is the ability of the IMF to persuade borrowing governments to adopt appropriate policies, in the way discussed in the previous Sections.

This suggests a possible institutional arrangement in which the IMF might move towards the possibility of standstills, or private sector involvement in crisis resolution, in association with the kind of *ex ante* conditionality discussed in the previous Section. We envisage that governments may apply to the IMF for debt insurance. The IMF would only approve applications from countries which it considers have suitable institutional frameworks and have adopted satisfactory macroeconomic policies. However, once approval has been granted, countries would be permitted, in the event of crisis, to repay creditors at less than 100 per cent value, and the IMF would be contractually committed to provide assistance to the countries to do this, in the circumstances listed in the contract documents. These documents would be publicly available and so would be known by the markets. Lenders would thus know to what risk they were exposed. Governments would demonstrate their commitment to the approved policy environments through their agreement with the IMF to a framework of policies. Access to the scheme might involve an agreed fee. Countries could with withdraw, and no longer pay the fee, if they no longer wished to participate in the arrangement.

5 Conclusions

a) Policy conditionality is the IMF's main weapon in controlling the moral hazard which is an inevitable by-product of crisis lending. The IMF and its members should resist well-intentioned demands that it drop or relax loan conditionality. Instead, it should aim to reduce the perceived costs of participation in IMF programs by focusing conditionality on measures which are essential to program success.
b) There is an important distinction between crisis stabilization lending and structural lending which will typically have longer term objectives. In crisis lending, conditions should be focused narrowly on policies which will impact directly on the success of macroeconomic stabilization. Structural lending will generally depend upon greater policy preconditions, but the appropriate policies can be discussed and evolved on a joint basis through policy dialogue involving government and agencies. A narrower focus in IMF stabilization lending implies that IMF and World Bank concerns will become more distinct. This may imply that one institution will lend to a country when another will be unable to do so.
c) The proposal that the IMF should move entirely to *ex ante* conditionality through a pre-qualification procedure would severely limit the IMF's operational flexibility, and may reduce the effectiveness of Fund programmes. However, there is considerable merit in establishing an institutional arrangement which provides countries with the incentive of easier access to IMF support, in the event of crisis, if they have adopted satisfactory policies and institutions .
d) We see merit in the proposal that the IMF provide default insurance on emerging market debt, but believe this is best linked to the move towards *ex ante* conditionality. Countries with suitable policies and institutions might qualify for a status which would enable them to repay outstanding debt at less than full value in the event of crisis. They would demonstrate commitment by specific agreements on policies with the IMF, and would possibly increase their contributions to the IMF, for this service.
e) We regard the membership structure of the IMF as crucial to its authority and influence. The Executive Board should be aware of the danger that some proposals aimed at increasing the efficiency of IMF lending may reduce its inclusiveness and, in the long term, undermine its authority. In this note, we have attempted to frame proposals which will increase inclusiveness.

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[1] See, for example, T. Killick, Aid and the Political Economy of Policy Change, 1998, London, ODI.
[2] See P. Collier, "Conditionality, dependency and coordination", ch. 12 of C.L. Gilbert and D. Vines eds. (*op.cit.*).
[3] Evidence for ineffectiveness is actually weak for IMF lending, but stronger for World Bank lending, where fungibility is a more serious issue. See S. Devarajan and V. Swaroop, "The implications of foreign aid fungibility for development assistance", ch. 7 of C.L. Gilbert and D. Vines eds., *The World Bank Structure and Policies*, 2000, Cambridge, Cambridge University Press.
[4] Documented in IMF, "Structural conditionality in Fund-supported programs", 2001, Washington DC, IMF.
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[8] A. Lerrick and A. Meltzer, "Default without disruption", *Financial Times*, 10 May 2001.
[9] See Federico (2001).

From: Joseph P. Joyce
Sent: Monday, May 14, 2001 2:08 PM
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Subject: comments on conditionality

COMMENTS ON CONDITIONALITY

The IMF's series of papers on conditionality provide an overview of the record of conditionality in recent decades and raise a number of conceptual issues. One aspect of conditionality that merits further investigation is the role of conditionality in those cases where there are a series of Fund-supported programs and a record of incomplete compliance with the programs' conditions.

Mussa and Savastano have pointed out that many Fund-supported programs are not completed, as measured by the ratio of actual credit disbursed vis-a-vis the amount originally committed. In the paper "Conditionality in Fund-Supported Programs-Policy Issues," the authors note that most program interruptions have been due to factors outside the Fund's control, including a lack of commitment. Moreover, it is well-known that many countries have entered into a series of Fund programs over time. This raises the issue of whether an uncompleted program and the conditionality associated with it does have, or should have, any effect on the planning of new programs.

These questions can be framed in both positive and normative terms. First, it would be useful to document the linkages among a specific country's programs, either through case studies or other forms of empirical analysis. Does incomplete program compliance lead to the use of more prior conditions in future programs? If partial completion is due to a breakdown in a particular area, such as monetary policy, do future programs attempt to remedy the weakness by including structural measures, such as policies designed to enhance central bank independence or its capabilities? Establishing the record of these interactions would clarify what interdependencies, if any, exist across programs.

Similarly, these issues can also be analyzed in terms of the design of optimal policies. Would compliance be enhanced if the design of conditionality over successive programs were contingent on past performance? A perception by a government that future programs may be affected in some way, such as the use of more prior actions or performance criteria, may affect its willingness to complete an existing program. On the other hand, an inflexible linkage that ignored the reasons for program interruption would be inappropriate in some circumstances, such as the occurrence of a shock after the inception of the program. There would be little point in penalizing a country when a program is rescheduled after the Fund and the country agree that the original program is inadequate in view of the new circumstances.

Policy design may also benefit from an analysis of the reasons for non-compliance with past programs. A lack of political support from within a country may reflect tensions over the impact on income distribution that some structural measures may entail. Future programs could explicitly address this problem, through provision of social support programs or other measures that might mitigate the effect of the initial policy change. As suggested above, structural measures designed to strengthen institutions would be appropriate if there was a

record of non-compliance with conditionality in particular areas, such as tax collection by fiscal authorities or financial regulation by the central bank.

Such explicit "feedback loops" among the conditionality of programs could affect the perception of program ownership. Before a new program is initiated it might be useful for an explicit review of the reasons for non-compliance with previous programs. If these breakdowns were based on particular areas of political dissension or institutional weakness, then it would be in a country's interests to institute policies that specifically address these issues in order to raise the degree of program compliance and obtain more of the committed credit.

Finally, the paper on "Structural Conditionality in Fund-Supported Programs" discusses the possibility that there may be "synergy" in conditionality, i.e., that extensive conditionality may create a "critical mass that facilitates progress in related areas" and thus improve compliance. The empirical results reported in that paper do not provide support for that view (nor the opposite view that extensive conditionality hinders implementation). However, it may be instructive to investigate whether such relationships prevail over time across a country's different programs. Structural conditionality in one program may have a long-term "payoff," and increase a country's ability to comply with other policy measures in future programs. This opens the possibility of "sequencing" structural conditionality, similar to the sequencing of capital account liberalization.

The International Monetary and Financial Committee at its last meeting emphasized that the objective of streamlining conditionality is to make it more effective. The review of conditionality in the context of a country's past experiences with IMF programs would be consistent with the Fund's commitment to streamline and focus conditionality. The suggestions for further analysis outlined above would provide a fuller understanding of the impact of conditionality over time, and how successive programs could respond to any deficiencies in the past and make conditionality more effective.

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THE BRETTON WOODS INSTITUTIONS IN THE XXI ST CENTURY

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INTRODUCTION

There are three dimensions to the economic relations between States (or international economic relations): trade, money and investment. These relations can be co-operative, conflicting or non-existent. In the latter case, the State retrenches to an inward-looking economic policy of isolationism and protectionism. Conflicts – of any sort – are unavoidable; however, the existence of a rule-based framework for the resolution of international economic conflicts can help promote co-operation. If such a framework does not exist, or if it is not respected, economic conflicts will either lead to the deterioration (or rupture) of economic relations between the States involved or will turn into a political conflict with the possibility of severance of diplomatic ties or, even worse, of a military backlash. There are three dimensions to the economic relations between States (or international economic relations): trade, money and investment. These relations can be co-operative, conflicting or non-existent. In the latter case, the State retrenches to an inward-looking economic policy of isolationism and protectionism. Conflicts – of any sort – are unavoidable; however, the existence of a rule-based framework for the resolution of international economic conflicts can help promote co-operation. If such a framework does not exist, or if it is not respected, economic conflicts will either lead to the deterioration (or rupture) of economic relations between the States involved or will turn into a political conflict with the possibility of severance of diplomatic ties or, even worse, of a military backlash. Co-operative international economic relations, i.e., institutional international co-operation in the field of money, trade and investment, are a relatively recent phenomenon. Their origins can be traced back to the Bretton Woods system which was designed in the 1940s. This system foresaw the establishment of three international organizations: the International Monetary Fund (IMF) for the purposes of international monetary co-operation; the International Bank for Reconstruction and Development (IBRD) for the purposes of international development assistance (investment); and an International Trade Organization (ITO) for the purposes of international trade co-operation. However, while the IMF and the IBRD came into existence in the 1940s, the fate of the ITO – which should have played the role of the necessary 'third leg' of the Bretton Woods system - was quite different. Though a charter for the International Trade Organization was concluded in Havana in 1948, the project for its creation died because of the rejection by the US Congress. Instead, the General Agreement on Tariffs and Trade (GATT) was signed in 1947 and entered into force (through a Protocol for Provisional Application) in 1948. Only in 1995 did a 'permanent' international trade organization - the World Trade Organization or WTO - finally come into existence.[1]

[1] An excellent historical account of the ITO (in the context of the Bretton Woods system), GATT and WTO is provided by John Jackson in Chapter 2 of his book "The World Trade Organization: Constitution and Jurisprudence," published by the Royal Institute of International Affairs, London, in 1998 (Chatham

A primary objective of the Bretton Woods system was to win the peace and to preserve it. Both John Maynard Keynes of the UK and Harry Dexter White of the US referred in their proposals to the need to "win the peace." The Bretton Woods system was conceived with the bitter memories of high unemployment, hyperinflation, recession and fluctuating exchange rates still fresh. The inter-war period had not been properly handled by the international community. In particular, the harsh reparations policy towards Germany had proven to be very damaging. The disastrous experience of hyperinflation in Germany in 1923, in an economy already overburdened with onerous war debts and reparations as well as high unemployment, created enormous popular discontent. This paved the way for the rise of National Socialism, with its dire consequences for the German nation. Keynes' argument that the reparations policy towards Germany after World War I was not a way of winning the peace[2] was sadly confirmed by history.

As we wave farewell to the XXth century, we can reflect upon the last 50 years of international economic co-operation with a sigh of relief. To some extent, we have won the peace, as Keynes and White proclaimed in their proposals. However, the challenges that the Bretton Woods institutions face in the XXIst century are very different from the challenges these two institutions – the Fund and the World Bank - confronted when they started operations in Washington DC in May 1946. Such challenges, particularly the ones encountered by the International Monetary Fund, constitute the focus of my paper. The paper is divided into four sections. The first section deals with the genesis of the Bretton Woods institutions. The second section analyses the changing nature of the IMF: from being primarily an international monetary institution (with a rather narrow mandate: exchange rate stability, convertibility) to becoming an international financial institution (with a broader mandate, encompassing monetary issues, but also other financial issues: payment systems, banking and capital markets, financial crises, etc.). The third section surveys the main functions, policies and activities of the IMF, in particular surveillance and conditional financial support. The fourth section covers the controversial issue of whether or not the IMF should adopt a formal international lender of last resort role and suggests the need to extend surveillance to financial supervision and regulation. The final section is a short reflection on what development role, if any, should the IMF adopt.

1. THE BRETTON WOODS INSTITUTIONS IN HISTORICAL PERSPECTIVE

House Papers). Despite the provisional character of GATT, it proved to be, nevertheless, a rather permanent institution, playing a significant role in international trade for almost five decades. Jackson points out (at pp. 15-16) that the Bretton Woods conference was held under the jurisdiction of ministries of finance, while trade was under the competence of different ministries. However, he also notes that "the 1944 conference is on record as recognising the need for a comparable institution for trade, to complement the monetary institutions."

[2] In *The Economic Consequences of the Peace* (cited by Arminio Fraga, "German Reparations and Brazilian Debt: a Comparative Study", Princeton Essays in International Finance, No. 163, July 1986, at p. 2) Keynes had forcefully argued that the reparations payments discussed in Versailles were far too high. He also argued that postwar prosperity required not only a lower level of reparations and a cancellation of inter-Ally indebtedness incurred during the war.

THE KEYNES AND WHITE PLANS

> *Perhaps the most difficult question is how much to decide by rule and how much to leave to discretion.*
> John Maynard Keynes, "Proposals for an International Currency (Clearing) Union", February 11, 1942, paragraph 15.

In order to understand the historical rationale of the Bretton Woods institutions, it is important to trace back the original proposals of the two men who drafted their foundations: Harry Dexter White and John Maynard Keynes.

Harry Dexter White joined the staff of the US Treasury in 1934 and resigned on May 1, 1946, to take up the post of US Executive Director of the Fund. He died in 1948. John Maynard Keynes (later Baron Keynes of Tilton) combined a multifaceted career with the position, from July 1940 until his death on April 21, 1946, of Honorary Advisor to the British Treasury. Both men firmly believed that the economic distress of the inter-war period could be avoided after the end of World War II only by international economic co-operation. Their proposals were drafted in 1941 and 1942, negotiated in 1943, and adopted at the International Monetary and Financial Conference of the United and Associated Nations in Bretton Woods, New Hampshire, in July 1944. Delegates from 45 nations (including the Soviet Union, which, nevertheless, never became a signatory)[3] as well as representatives of international organizations attended the conference. As acknowledged, the world was still in war in July 1944. At that time, the Soviet forces to the east of Germany had not reached the Polish border, and to the west the Allies, following the Normandy landings, were engaged in a sanguinary struggle whose outcome was by no means certain. The Allied forces in the Pacific were still involved in the slow process of subjugating islands and advancing along the northern coast of New Guinea. A full year of desperate battle lay ahead. And yet, the delegates to Bretton Woods were talking about, and indeed were erecting a framework for, future international economic co-operation. The setting up of the International Monetary Fund was the primary focus of the conference, while the World Bank was - in the words of some commentators[4] – something of an 'afterthought'.

White's proposal was greatly influenced by the experience of the Great Depression in the USA. Following the stock market crash in 1929, the USA entered a catastrophic economic period. Between 1929 and 1932 industrial production contracted by 47% and

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[3] At a meeting of the General Assembly of the United Nations in 1947, the Soviet representative charged that the Bretton Woods Institutions were merely 'branches of Wall Street' and that the Bank was 'subordinated to political purposes which make it the instrument on one great power.' The incident is recalled by Edward S. Mason and Robert E. Asher, *The World Bank since Bretton Woods*, The Brookings Institution, Washington DC, 1973, at p. 29, f.n. 46.

[4] See, e.g., Edward S. Mason and Robert E. Asher, *The World Bank since Bretton Woods*, The Brookings Institution, Washington DC, 1973, at p. 2.

the national income by 52%. By March 1933 there were at least 14 million unemployed.[5] The prime objective of White's proposal was the establishment of a mechanism - 'a stabilization fund' in his own words - that would ensure the stability of currencies and avoid the recurrence of competitive devaluations and of the restrictions on payments, as well as the setting up of a 'bank for reconstruction and development.' In the introduction to his plan, entitled 'Preliminary Draft Proposal for a United Nations Stabilization Fund and a Bank for Reconstruction and Development of the United and Associated Nations' and dated April 1942,[6] he stated:

> "No matter how long the war lasts nor how it is won, we shall be faced with three inescapable problems: to prevent the disruption of foreign exchanges and the collapse of monetary and credit systems; to assure the restoration of foreign trade; and to supply the huge volume of capital that will be needed virtually throughout the world for reconstruction, for relief, and for economic recovery. If we are to avoid drifting from the peace table into a period of chaotic competition, monetary disorders, depressions, political disruptions, and finally into new wars within as well as among nations, we must be equipped to grapple with these three problems and to make substantial progress toward their solution."

Keynes' proposal was inspired by a different set of events: an analysis of Britain's post-war prospects. Demand for imports would rise with the end of wartime austerity, while Britain's future capacity to export would be cut because of the wartime conversion of industries to military manufacture and the difficulties of reconversion.[7] To avoid the recurrence of a major slump in the UK at the end of World War II, Keynes proposed the establishment of an international clearing union, aimed at avoiding balance of payments imbalances through a set of rules governing the overdrafts on the Union accumulated by debtors (such as the UK) and the positive balances acquired by creditors (such as the USA). Keynes' plan was entitled: 'Proposals for an International Currency (or Clearing) Union.[8]' Keynes spelt out his concerns for the UK economy after World War II: " This [an international clearing union] would give us, and all others, the great assistance of multilateral clearing, whereby (for example) we could offset favourable balances due to the United States or South America or elsewhere. How indeed can we hope to afford to start up trade with Europe (which will be of vast importance to us) during the relief and reconstruction period on any other terms?[9]" Keynes further regarded that an international

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[5] See J. Keith Horsefield, *The International Monetary Fund 1945-1965, Volume I: Chronicle*, International Monetary Fund, Washington DC 1969 at p.5.

[6] This proposal is reproduced in J. Keith Horsefield, *The International Monetary Fund 1945-1965, Volume III: Documents,* International Monetary Fund, Washington DC 1969, at pp. 37-82 (though it omits the Articles for the Bank). The final version of Mr. White's plan was issued by the US Treasury in printed form on July 10. 1943, and is reproduced in pp. 83-96 of the same book.

[7] See Harold James, *International Monetary Cooperation since Bretton Woods*, International Monetary Fund and Oxford University Press, 1996, at p. 35.

[8] The fourth draft of his proposal (of 1942) is reproduced in J. Keith Horsefield, *The International Monetary Fund 1945-1965, Volume III: Documents,* International Monetary Fund, Washington DC 1969, pp. 3-18. The final draft which was issued by the British Government in April 1943 as a White Paper (Cmd. 6437) is reproduced in pp. 19-36 of the same book. The title of the final British draft dropped the word currency and was simply entitled: "Proposals for an International Clearing Union."

[9] See paragraph 10 of his proposal, repr. in Horsefield.

currency (clearing) union – which in his original plan also included the creation of a new international currency that he named bancor - would support other international policies regarding, e.g., trade (whose importance was also emphasized by White), investment and development,[10] though he did not design a specific institutional framework to deal with such other issues.

While the British proposal focused mainly on the work of the International Monetary Fund, which Keynes referred to as the International Currency (or Clearing) Union, the US proposal focused both on the establishment of an stabilization fund and a bank for reconstruction and development. Harry Dexter White was the central figure in the birth of the World Bank,[11] though Keynes and other UK experts eventually became major enthusiasts for the Bank, acknowledging that loans from creditor countries to debtor countries in the early post-war period were essential to avoid economic chaos and that without them no international monetary plan could have a fair start.[12] The World Bank[13] or more properly speaking, the International Bank for Reconstruction and Development, had – as its name indicated – two main goals, though the 'development' goal would eventually become the primary one. The sequencing of these two goals was summarised by Lord Keynes in his opening remarks at the first meeting of the Bretton Woods Commission on the Bank:

> "It is likely, in my judgement, that the field of reconstruction from the consequences of war will mainly occupy the proposed Bank in its early days. But, as soon as possible, and with increasing emphasis as time goes on, there is a second primary duty laid upon it, namely to develop the resources and productive capacity of the world, with special reference to the less developed countries."[14]

However, when the war was over, it was the Marshall Plan rather than the World Bank that played the major role in the reconstruction and recovery of war-torn European economies. As acknowledged, US Secretary of State George Marshall unveiled the "European Recovery Program" (which became known as the Marshall Plan) in his famous Harvard commencement speech in June 1947, where he announced a program of

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[10] See paragraph 54 of his proposal, repr. in Horsefield.

[11] Indeed, as Mason and Asher recall, "the Bank was esentially a U.S. proposal." See Edward S. Mason and Robert E. Asher, *The World Bank since Bretton Woods*, The Brookings Institution, Washington DC, 1973, at p. 13

[12] See Harold James (1996) at p. 52.

[13] Nowadays, the name World Bank is given both to the IBRD and to the World Bank Group. The World Bank Group comprises five institutions: the International Bank for Reconstruction and Development (set up in 1944, the original Bretton Woods institution), the International Development Association (set up in 1960 to deal with the world's poorest countries), the International Finance Corporation (set up in 1956, as the private-based arm of the World Bank Group), the Multilateral Investment Guarantee Agency (set up in 1988 to provide insurance against political risk) and the International Centre for the Settlement of Investment Disputes (set up in 1966 for the resolution of investment conflicts).

[14] See Edward S. Mason and Robert E. Asher, *The World Bank since Bretton Woods*, The Brookings Institution, Washington DC, 1973.

massive financial assistance to Europe.[15] The Marshall Plan, which was supervised by the US Economic Cooperation Administration (ECA) also created the Organisation for European Economic Cooperation (OEEC) and contributed to the establishment of a multilateral system of European payment: the European Payments Union (1949-1950).

2. THE ROLE OF THE INTERNATIONAL MONETARY FUND

The **goals** of the IMF as defined in the first of the Articles of Agreement are as follows:

(i) To promote international monetary cooperation through a permanent institution which provides the machinery for consultation and collaboration on international monetary problems.

(ii) To facilitate the expansion and balanced growth of international trade, and to contribute thereby to the promotion and maintenance of high levels of unemployment and real income and to the development of productive resources of all members as primary objectives of economic policy.

(iii) To promote exchange rate stability, to maintain orderly exchange arrangements among members, and to avoid competitive exchange depreciation.

(iv) To assist in the establishment of multilateral system of payments in respect of current transactions between members and in the elimination of foreign exchange restrictions which hamper the growth of world trade.

(v) To give confidence to members by making the Fund's resources available to them under adequate safeguards, thus providing them with the opportunity to correct maladjustments in their balance of payments without resorting to measures destructive of national or international prosperity.

(vi) In accordance with the above, to shorten the duration and lessen the degree of disequilibrium in the international balances of payments of members. smoothly functioning payment systems, promotion of international monetary cooperation,

This broad enumeration of goals has allowed the institution to survive over the years, adjusting and readjusting its role in response to diverse economic circumstances. While the initial emphasis was on a rather narrow monetary role, since the demise of the par value regime in the 1970s, the emphasis has turned to a rather broader financial role.

2.1. THE IMF AS AN INTERNATIONAL MONETARY INSTITUTION

The International Monetary Fund began operations in Washington D.C. in May 1946. The **par value** regime, often referred to as the Bretton Woods regime, meant that the value of currency was defined in terms of gold or alternatively in terms of the US dollar of July 1, 1944, which had a fixed gold value (one ounce of gold was equal to $35). Article IV, Section 1(a) of the Articles of Agreement stated:

[15] "In 1946, the Western European trade deficit with the United States had been $2,356 million, and in 1947 it rose to $4,742 million. It is first year of operation (April 1948-June 1949), the ERP made $6,221 million available, and then $4,060 million in 1949-50 and $2,254 in 1950-51." See Harold James (1996) at p. 74.

> "The par value of the currency of each member shall be expressed in terms of gold as a common denominator or in terms of the United States dollar of the weight and fineness in effect on July 1, 1944."

The IMF's mandate was to maintain the good order of this predictable and "stable" international monetary system, by enforcing rules about adjustment in international monetary relations and by providing temporary resources to deal with short-term balance of payments problems.

In the beginning of the 1970s the par regime was abandoned. The world-wide change from fixed to floating exchange rates 1973 triggered the second amendment to the IMF's Articles of Agreement (1978), which allowed members to choose their exchange arrangement and to determine the external value of their currency. Following this second amendment, Article IV, Section 2(b) stated:

> "Under an international monetary system of the kind prevailing on January 1, 1976, exchange arrangements may include (i) the maintenance by a member of a value for its currency in terms of the special drawing right or another denominator, other than gold, selected by the member or (ii) cooperative arrangements by which members maintain the value of their currencies in relation to the value of the currency or currencies of other members or (iii) other exchange arrangements of a member's choice."

MONEY, MONETARY SOVEREIGNTY AND INTERNATIONAL MONEY

The starting point of any discussion on international monetary cooperation is the concept of money. Money is a commonly accepted medium of exchange or means of payment. Money is also unit of account and a store of value. Money is fundamental for the regular functioning of an economy; money oils the wheels of an economy. Without money, without a means of payment and a unit of account, trade relations will revert to barter (exchange of goods for other goods).

The power to issue money, the power to issue currency,[16] has been typically considered an attribute of sovereignty, of the sovereignty of the Nation State.[17] However, in recent years, this sovereign power (typically a monopoly) has been eroded by a number of considerations:

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[16] Though money is a broader concept that the definition of currency – notes and coins in circulation – in my discussion I will be generally referring to money and currency indistinctly. It is also worth noting that the definition of money is a dynamic (from commodities such as gold, silver or even cigarettes to paper money) and constantly expanding concept (being 'virtual money' that latest development).

[17] "That the State's sovereignty includes its power to issue and regulate money has traditionally been accepted in international law. The Permanent Court of Justice stated that 'it is indeed a generally accepted principle that the State is entitled to regulate its own currency.' *Serbian and Brazilian Loan Cases*, judgement of 12 July 1929, Publications of the Court, Series A, Nos. 20-1 at p. 44, cited in F.A.Mann, *The Legal Aspect of Money,* 1992, at p. 44.

1) The choice of exchange regime. Under a fixed exchange rate system, a national central bank only enjoys control over monetary monetary policy if it is the central bank which sets monetary policy for the whole area. In the case of a currency board agreement (e.g., Argentina, Hong Kong, Estonia), monetary sovereignty is greatly reduced. In the case of dollarisation (e.g., Panama), monetary sovereignty is eliminated.
2) The degree to which a currency is a good store of value. While it is generally accepted that countries with 'hard' currencies (easily tradable and a good store of value because of scarce risk of depreciation vis-à-vis other currencies) enjoy monetary sovereignty, the same cannot be predicated about countries with 'soft' currencies.
3) The creation of a monetary union. The transfer of monetary powers from the national to the supranational arena signifies a surrender of monetary sovereignty. This factor helps explain the emotional discussion in the United Kingdom with regard to European Monetary Union.
4) The process of money creation. Private banks keep their position in the money supply process by issuing deposits. The state has the monopoly over the issue of currency only. Checking accounts are part of the money supply. (M1 is equal to currency in circulation plus bank deposits). This characteristic of bank liabilities provides the rationale for many monetary and banking laws and regulations.

At the international level there has been a conspicuous absence of a central authority with the ability to monopolise the issue of currency. Keynes included in his proposals the establishment of an international currency, that he called 'bancor', which would have been a true medium of exchange. White referred in his proposals to a unit of account, that he called 'unitas' which was only a unit of account, not a medium of exchange. In the end no new international unit of account was adopted in Bretton Woods. Instead, the 1944 Bretton Woods agreement stressed the importance of the US Dollar, thus satisfying the US negotiators, who privately favoured a postwar world economy centered around the dollar.[18] Since it is highly unlikely that such a world authority – with powers to issue an international currency - may come around in the near future, one has to conclude that the supply of currencies at an international level will remain a highly competitive business. However, regional blocs are likely to emerge.

The IMF took a limited step towards the establishment of an international unit of account with the creation of the Special Drawing Rights. In 1969, the First Amendment to the IMF Articles of Agreement authorised the IMF to create Special Drawing Rights (SDRs) in order to increase international liquidity. SDRs are international reserve assets allocated through various issues.[19] The SDR is also the unit of account of the IMF. However the use of the SDR is rather restricted. To begin, holders of SDRs are only prescribed holders. In addition, the frequency and size of SDR allocations has been rather

[18] See Harold James (1996) at p. 46 and 50.

[19] Until January 1, 1999, the value of the SDR was determined on the basis of the US $, Japanese Yen, DM, FF and Sterling £. With the introduction of the Euro, the IMF replaced currency amounts of DM and FF with equivalent amounts of Euros, based on the fixed conversion rates announced on 31 December 1998.

limited, with the last allocation in 1981. Over the years, several proposals to 'harden' the SDR (so that it could become a medium of exchange) have also been unsuccessful.

CONVERTIBILITY

The requirement of convertibility according to the IMF Articles of Agreement only extends to current account convertibility, i.e., to the unrestricted access to foreign exchange to conduct trade in goods and services.[20] Whether convertibility will also be extended to capital account convertibility in the XXIst century remains a matter of controversy. Both White and Keynes favoured the control of capital movements. Capital movements in the 1920s and 1930s (in particular short-term capital flows) were considered a fundamental ill of the inter-war economy. According to Keynes: "It is widely held that control of capital movements, both inward and outward, should be a permanent feature of the post-war system (…). If control is to be effective, it probably involves the machinery of exchange control for all transactions, even though a general open licence is given to all remittances in respect of current trade[21]" White stated that the reduction of the necessity and use of foreign exchange controls should be one of the purposes of his proposed stabilization fund. ("Foreign exchange controls usually constitute an interference with trade and capital flows"). He noted that each member country should "subscribe to the general policies of permitting foreign exchange trading in an open, free and legal market, and to abandon, as rapidly as conditions permit, all restrictions or controls by which various classes of foreign exchange transactions have been prohibited or interfered with." However, he also pointed out that, in practice, there are situations "that make inevitable the adoption of controls" on movements of capital and on movements of goods.[22] The final wording of Article VIII (2) (a) of the IMF Articles of Agreement stated: "[N]o Member shall, without the approval of the Fund, impose restrictions on the making of payments and transfers for current international transactions." Thus, IMF members were to avoid restrictions on current account but remained free to impose restrictions on capital account.

In recent years, a number of voices within the Fund, as well as outside it, have advocated the need to extend convertibility to capital account. However, following the recent financial crises in East Asia – which have arisen from capital account problems (huge private capital flows) – controls on short-term capital flows are in vogue again. Controls on short-term capital inflows, as in Chile, have been appraised on the grounds that they are subject to lesser volatility than countries with unrestricted capital mobility; if speculators cannot bring money into the country, then capital will not flow out when

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[20]Current account convertibility relates to the absence of restrictions in transactions involving the trade in goods and services and is deemed to be a necessary condition for a country to be integrated efficiently into the world trading system. Capital account convertibility relates to the absence of cross-border controls or equivalent taxes and subsidies on international capital transactions; nowadays the most advanced economies all have open capital accounts. Capital account convertibility is more problematic, particularly in the case of developing countries and transitional economies. Prudential controls on foreign capital flows, such as tax on short-term capital inflows, are sometimes considered to be appropriate. In addition, controls on short-term inflows and outflows might also be appropriate in countries with weak financial systems.

[21] See paragraph 45 of Keynes' 1942 proposal, repr. in Horsefield, supra note at p. 13.

[22] See White's 1942 proposal, repr, in Horsefield, supra note, at p. 47 and 63.

market sentiment changes. Given these recent developments and taking into account the fact that many economists question the wisdom of free capital flows,[23] it is unlikely that capital account convertibility will be adopted by the Fund – through an amendment to the Articles of Agreement – in the near future.

2.2. THE IMF AS AN INTERNATIONAL FINANCIAL INSTITUTION

The worldwide change from fixed to floating exchange rates, known as the abandonment of the Bretton Woods [exchange] regime, also signified a more profound change in the nature of the IMF: the shift in emphasis from being primarily an international monetary institution focusing on issues such as exchange rate stability and convertibility, to becoming an international financial institution with a broader array of responsibilities, encompassing not only monetary issues, but also other issues such as payment systems, banking and capital markets and financial reform. The Fund played a leading role in the sovereign debt restructuring of the LDC countries in the 1980s (a financial role), in the transition to market economies of formerly communist countries (a financial and advisory role) and in the financial crises in the 1990s (a financial role). In the ensuing paragraphs I will elaborate on how these changes have influenced (or should influence) the redefinition of the three main functions of the Fund: surveillance, conditional financial support and technical assistance.

3. THE MAIN FUNCTIONS AND ACTIVITIES OF THE INTERNATIONAL MONETARY FUND

3.1 SURVEILLANCE

Surveillance can be defined as the appraisal of a country's macroeconomic and structural policies and performance from an international standpoint. Surveillance is a regulatory or jurisdictional function, which has traditionally focused on the assessment of the exchange arrangements, the exchange rate and the balance of payments.[24] Surveillance entails a judgement on the part of the Fund, and as with any judgement, a degree of discretion is always involved. In the case of surveillance, the exercise of this 'judgement' is particularly complex, because of the interconnectedness between domestic and foreign economic policy, the interdependence amongst countries and the political and social consequences of some sensitive economic decisions.

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[23]See, e.g., Stanley Fischer et alii, "Should the IMF Pursue Capital Account Convertibility?" Princeton Essays in International Finance No. 207, May 1998.

[24] "The focus of obligation on the part of members centers on the point and the terms of intersection of their national economies with each other – that is the balance of payments, the exchange rate and the exchange regime." Manuel Guitián, "The Unique Nature of the Responsibilities of the International Monetary Fund," IMF Pamphlet Series no. 46, 1992, at p. 11. See also p. 8.

The Fund mainly carries out surveillance through its so-called “Article IV consultations,” though there is also multilateral surveillance, with the publication - by the Fund - of a world economic outlook twice a year.

In accordance with Article IV of the IMF Articles of Agreement, IMF staff hold annual bilateral meetings with members country. According to Article IV, Section 1:

> “Each member shall:
> (i) Endeavor to direct its economic and financial policies toward the objective of fostering orderly economic growth with reasonable price stability, with due regard to its circumstances;
> (ii) Seek to promote stability by fostering orderly underlying economic and financial conditions and a monetary system that does not produce erratic disruptions;
> (iii) Avoid manipulating exchange rates or the international monetary system in order to prevent effective balance of payments adjustment or to gain an unfair competitive advantage over other members; and
> (iv) Follow exchange policies compatible with the undertakings of this Section.”

When an ‘Article IV consultation’ takes place, a Fund staff team (called an IMF ‘mission’) visits the country to collect information about macroeconomic policies, national accounts, institutional developments, prices, wages and other issues. Following the review of these policies, the Fund team holds discussions with the authorities regarding the effectiveness of their economic policies as well as prospective changes for the domestic economy and the member’s balance of payments positions. At the conclusion of these discussions, and prior to the preparation of the staff’s report to the Executive Board, the IMF mission often provides the authorities with a statement of its preliminary findings. Once the IMF’s Executive Board has discussed the staff report, they forward a summary of the discussion to the country’s government. The conclusions of the report are only published if the country consents to do so.

The exercise of surveillance needs to adapt itself to global changing circumstances. Indeed, every two years, the IMF reviews the principles and procedures that guide its surveillance, as originally set out in a 1977 Executive Board decision. This changing character implies that the judgement made by the Fund regarding the economic policies of a given country needs to take into account the needs, problems and structural weaknesses faced by that country. While surveillance in the past has typically focused on the jurisdiction over exchange arrangements of members, surveillance nowadays needs to take into account other issues, often involving the workings of the private sector (‘micro’ issues), such as good governance (both political and corporate governance), legal and institutional reform, bank restructuring, financial reform, etc., in addition to its traditional ‘macro-economic’ assessment. In particular surveillance should be strengthened to increase the Fund’s ability to detect incipient financial tensions. I further discuss this issue below when I talk about the *de facto* lender of last resort role of the IMF in the resolution of international financial crises.

3.2 CONDITIONAL FINANCIAL SUPPORT

IMF's financial assistance (support to members experiencing balance of payments problems) is conditional on the adoption and implementation of adjustment policies. Conditionality is the set of policies and procedures developed by the Fund to govern the access to and the use of its resources by member countries. These resources exist for the benefit of the entire membership and are finite; hence their use need be temporary and consistent with Fund objectives. The logic behind the conditionality requirements is that a country with external payments problems is spending more than it is taking in. Unless economic reform takes place, it will continue to spend more than it takes in.

IMF resources are quota subscriptions (the 'capital base' of the Fund) plus borrowed money (general arrangements to borrow, GAB, and other specific programs). On joining the Fund each member contributes a certain sum of money called quota subscription as a sort of membership fee (25% of the subscription has to be paid in SDRs or other currencies acceptable to the Fund and the rest in the member's own currency). The richer the country the higher the quota (e.g., the US, has the largest quota).[25] Quotas are expressed in SDRs (Special Drawing Rights, First Amendment to the Articles of Agreement). The quotas form a pool of money that the Fund can draw from to lend to members in financial difficulty. They are also the basis to determine how much a country can borrow from the Fund and they determine the voting powers.

The word conditionality did not appear in the original Articles of Agreement.[26] It was first used in the 1964 IMF Annual Report, though two decisions of 1952 already anticipated the concept. The word conditionality does not have a precise legal meaning.
An Executive Board decision of 2 March 1979 contains the principles applied to the use of Fund's resources. These principles have been often referred to as the "guidelines on conditionality." These guidelines spell out the policies and procedures that govern the access and use of Fund's resources by its members, and can be summarised in the following terms: Along with the request for a loan the potential borrower presents to the IMF a plan of reform (a "program") outlined in a letter of intent, undertaking some fiscal, monetary and exchange rate polices. The specifics of the program are selected by the member, not by the Fund. The Executive Board judges the sufficiency of the reform

[25] The initial formula for the determination of quotas – first estimated by Raymond Mikesell - was a rather unscientific exercise. See, e.g., Ariel Buira, "Reflections on the International Monetary System," *Princeton Essays in International Finance*, No. 195, January 1995, at pp. 31-33. Buira claims (at p. 33): "It is certainly understandable that the lack of equity and rationality in the quota criteria continue to cause controversy and mistrust among members today, just as it did fifty years ago."

[26] Article V,section 3(a) refers to the conditions governing the use of the Fund's general resources:

> "The Fund shall adopt policies on the use of its general resources, including policies on stand-by or similar arrangements, and may adopt special policies for special balance of payments problems in a manner consistent with the provisions of this Agreement and that will establish adequate safeguards for the temporary use of the general resources of the Fund."

measures and whether the IMF can reasonably expect payment. The performance criteria selected by the member are monitored through periodic reviews. The availability of instalments in upper credit tranches (phasing out) is made conditional on the member's observance of performance criteria.

The language of conditionality would certainly have been described by Keynes as "Cherokee." Keynes derided the language used in the American drafts (a language that in many instances was adopted in the final version of the Articles of Agreement) as "Cherokee" in contrast with the "Christian English" of his own writings.[27]

The purpose of IMF conditionality is to serve as a substitute for collateral. Banks require collateral in commercial lending. Conditionality operates as a substitute for collateral in lending to sovereign borrowers. The importance attached by countries to IMF conditionality goes beyond the importance they attach to the fulfilment of other obligations undertaken as members of international organizations. This is because IMF conditionality can signal policy credibility to the markets. The existence of an IMF program encourages private investment into the country. Being in arrears to the IMF brings a country into the status of an 'economic pariah.' This explains why countries are ready to tighten their belt (and the belts of their citizens) in order to get and maintain an IMF program. The eagerness to get or maintain a program may also help explain why, in some instances, specific measures in a program have been proposed, without a full awareness or analysis of their potentially negative social implications.

The interpretation of conditionality is not independent of the international economic regime in place.[28] Indeed, the notion of conditionality has been relaxed over the last two decades, through the establishment of less strict facilities and new procedures. Today there is 'strict conditionality' (regular facilities) co-existing with 'low conditionality' or relaxed conditionality' (an issue which raises concerns in terms of the need for non-discriminatory treatment of IMF members).

REGULAR FACILITIES ('STRICT CONDITIONALITY')

Member countries use the general resources of the IMF by making a purchase (drawing) of other members currencies or SDRs with an equivalent amount of their own currencies. The IMF levies charges on these drawings and require that members repurchase (repay) their own currencies from the IMF with other members currencies or SDRs over a specified time.

The regular facilities[29] that the Fund offers to its members are stand-by and extended arrangements, which are not technically loans, but purchase and repurchase agreements.

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[27]See Harold James (1996) at p. 54. Keynes also complained about the predominance of lawyers on the American side of the negotiating table. He observed (loc.cit.) that "lawyers seem to be paid to discover ways of making it impossible to do what may prove sensible in future circumstances."

[28] See, e.g., Manuel Guitián, "Conditionality: Past, Present and Future," *IMF Staff Papers*, December 1995.

[29] A bit of "Cherokee" language is needed here: Reserve Tranche (previously gold tranche) is the name given to the excess of a member' s quota over the Fund' s holdings of the member's currency. A reserve tranche can be drawn up at any time, with no charge and no expectation of repayment. Credit Tranches or

Stand-by arrangements give members the right to draw up specified amount of IMF financing (for an annual 100% and a cumulative 300% of its quota) during a prescribed period. They typically cover a 12-18 month period (although they can extend up to 3 years). Repayments are to be made within 3 to 5 years. Drawings are phased out quarterly and the release of the next 'credit tranche' is made conditional upon meeting agreed performance criteria.

Extended arrangements (EFF) provide assistance to members for longer periods (3 to 4 years) and repayment of the currencies they have drawn are to be made with 4 and half to 10 years of the drawing. They are designed to rectify balance of payment difficulties that stem from structural problems and require a longer period of adjustment.

THE RELAXATION OF CONDITIONALITY

Conditionality has been relaxed over the years through the creation of new facilities and the adoption of new procedures. I will classify these 'low conditionality' mechanisms into concessional facilities, special facilities, accelerated procedures and exceptional (or emergency) facilities.

1. **Concessional Facilities**. In order to help the poorest countries in their process of development the IMF has developed concessional lending facilities: SAF, ESAF and PRGF. These facilities are made available in the form of loans (as opposed to the regular facilities, which rely upon purchase and repurchase of currencies).

    - Structural Adjustment Facility (SAF). The SAF was established in 1986 to provide low income countries with concessional loans in support of medium-term macroeconomic adjustment policies and structural reforms. The member develops with the help of the Fund and the World Bank a medium term policy framework for a 3 year period. Loan disbursements are made annually. The applicable rate of interest is 0.5% and repayment is due in 5 and a half to ten years. In November 1993, the IMF's Executive Board agreed that no new commitments would be made under the SAF.

    - Enhanced Structural Adjustment Facility (ESAF). The ESAF was established in 1987 and enlarged in 1994. ESAF arrangements have provided financial support to low income member countries facing balance of payments problems. Loans are disbursed semi-annually at an interest rate of 0.5% and repayment is due in 5 and a half to 10 years. Countries with ESAF programs are e.g., Burkina Faso, Ivory Coast, Ghana, Gambia, Kenya, Mozambique, Tanzania, Uganda, Bangladesh, Nepal, Pakistan, Sri Lanka, Bolivia, Honduras, Nicaraguan Albania, Cambodia, Mongolia, Vietnam. Almost all

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upper credit tranches are typically subject to conditionality through stand-by arrangements. IMF credit is made available in segments of 25% of a member's quota (these segments are called tranches). For drawings in the first credit tranche, members must demonstrate reasonable efforts to overcome their balance of payments difficulties.

countries receiving ESAFs fall under the HIPC category: Heavily Indebted Poor Countries.

- In November 1999 the IMF transformed its ESAF into the more positively named Poverty Reduction and Growth Facility or PRGF and "expanded the facility's objectives to support programs that substantially strengthen balance of payments positions and make them sustainable, while fostering durable growth.[30]" Uganda became the first recipient of the new facility on 10 December 1999.

2. **Special Facilities**. The word "special" (introduced by the Second Amendment to the Articles of Agreement, Article V, Section 3(a) provides for "low conditionality" in the case of balance of payments problems. Accordingly, a number of low conditionality special facilities have been designed over the years to cope with specific balance of payments problems.

   - The so-called "oil facility" in 1974 was designed to help members finance deficits related to oil import price increases following OPEC's decision in 1973. Only two conditions were required: (a) to consult with IMF on balance of payments needs; (b) to avoid enacting restrictions on international transactions.

   - Compensatory and Contingency Financing Facility (CCFF). It provides financing to members to cover shortfalls in export earnings and/or excesses in cereal import costs that are temporary and arise from events beyond their control. Countries which are commodity exporters have used the CCFF. The so-called buffer stock financing facility (not used since 1984)was similar in nature to the CCFF.

   - In April 1993, the IMF launched the so-called "Systemic Transformation Facility," to help former communist countries in Eastern Europe and the states of the former Soviet Union in their transition to market- based economy. These countries temporarily suffered sharp drops in exports and permanent increases in import costs, particularly for energy products, because of the shift to market prices, thus creating severe balance of payments problems. Both the performance criteria, the phasing out and the terms were relaxed. The STF was used by 20 countries from 1993 to 1995. It was designed to pave the way for these countries to move to regular IMF facilities.

3. **Accelerated Procedures**.

   - In September 1995 [following the Mexican crisis] the IMF adopted an "Emergency Financing Mechanism," that is a set of accelerated procedures to facilitate rapid Executive Board approval of IMF financial support in response to crises in a member's external account that require an immediate IMF response. This Emergency Financing Mechanism is not a new facility, but rather the adaptation of existing facilities (stand-by arrangements) to accelerated procedures

[30] See IMF Survey of 10 January 2000, Vol. 29, No.1, at p. 1.

so as to facilitate rapid Executive Board approval of IMF financial support in response to crises in a member's external account that require an immediate response.[31] The emergency financing mechanism was adopted in the approval of the stand-by arrangements for Korea (SDR 15.5 billion, about $21 billion), for Indonesia (SDR 7.3 billion, about $10.1 billion) and Thailand (SDR 2.9 billion, about $3.9 billion).[32] In these Asian bail-outs, as well as in the Mexican one, the guideline that members can only draw up a specified amount of IMF financing in proportion to the member's quota (typically an annual 100 percent and a cumulative 300 percent of its quota) was not followed. The Korean stand-by arrangement is equivalent to 1,934 percent of Korea's quota, the Indonesian one to 490 percent of Indonesia's quota, and the Thai one to 505 percent of Thailand's quota. The Emergency Financing Mechanism as a procedure is reminiscent of the workings of the lender of last resort role of the central bank (LOLR) at the national level: it is the speed, the immediacy of the availability of liquidity assistance that makes the LOLR particularly suited to confront emergency situations.

4. **Exceptional (or Emergency) Facilities**.

- In December 1997 the IMF adopted the Supplemental Reserve Facility as a new facility intended to provide financial assistance to a member country experiencing exceptional balance of payments difficulties due to a large short-term financing need resulting from a sudden and disruptive loss of market confidence reflected in the pressure on the capital account and member's reserves. The SRF is clear step in the formalisation of the role of the IMF as International Lender of Last Resort. The Supplemental Reserve Facility (SRF) is intended "to provide financial assistance to a member country experiencing exceptional balance of payments difficulties due to a large short-term financing need resulting from a sudden and disruptive loss of market confidence reflected in pressure on the capital account and member's reserves."[33] Assistance under the facility is available when there is a reasonable expectation that the implementation of strong adjustment policies and adequate financing will result, within a short period, in an early correction of the balance of payments difficulties. In order to minimise moral hazard, a member using resources under this decision is encouraged to seek to maintain participation of creditors, both official and private, until the pressure on the balance of payments ceases. A member should also be aware - I would add - that not all countries will be bailed out. (Indeed Russia was not bailed out). Financing

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[31]M. Guitián argues in "Conditionality: Past, Present and Future," *Staff Papers,* Vol. 42, No. 4, International Monetary Fund, December 1995, that the interpretation of conditionality is not independent of the international economic regime in place.

[32]See *IMF Survey* of December 15, 1997 for the approval of the Korean arrangement, *IMF Survey* of November 17, 1997 for the approval of the Indonesian stand-by arrangement, and *IMF Survey* of September 17, 1997, for the approval of the Thai stand-by arrangement.

[33]See *IMF Survey*, 12 January 1998, at p. 7. This facility has at the international level some of the features that Thornton and Bagehot described for the LOLR at the domestic level. It should be noted that both Thornton and Bagehot wrote their important contributions to the understanding of the LOLR in the nineteenth century, when crises were mostly confined to the national arena.

under the SRF is made available in the form of additional resources under a stand-by arrangement. Countries borrowing under the SRF are expected to repay within one to one and a half years of the date of each disbursement. During the first year from the date of approval of the SRF, borrowers pay a surcharge of 300 basis points above the rate of charge on IMF loans (which averaged 4.7 percent in 1997). This rate increases by 50 basis points at the end of that period and every six months thereafter until the surcharge reaches 500 basis points.

- In April 1999 the IMF adopted the Contingent Credit Line (CCL). The CCL takes the form of an addition to the Supplemental Reserve Facility established in December 1997. The CCL is intended for members that are concerned with potential vulnerability to contagion, but are not facing a crisis at the time of commitment. The CCL is another step in the formalisation of the international lender of last resort of the IMF, an issue which I explore in Section 4 below.

3.3 TECHNICAL ASSISTANCE

The third main function performed by the IMF is technical assistance, a task which has grown in importance in recent years. Technical assistance and training in banking and monetary policy, foreign exchange, fiscal policy and statistics has become a major function of the International Monetary Fund in the 1990s, particularly in the transition from centrally-planned economies to market economies in the formerly communist countries of Eastern Europe and the Former Soviet Union.

4. SHOULD THE IMF ADOPT AN INTERNATIONAL LENDER OF LAST RESORT ROLE?

The fear that a domestic conflict can expand - by contagion - to other countries has led to the emergence of the International Monetary Fund as a *de facto* international lender of last resort. Proposals to entrust the IMF with such a role as well as proposals to create an international bankruptcy court were first debated in 1995, following the Mexican crisis sparked by the devaluation of the peso at the beginning of the Zedillo Administration.[34]

[34]See J. Sachs, "Do We Need and International Lender of Last Resort," paper presented to the Study Group on Private Capital Flows to Developing and Transitional Economies at the Council of Foreign Relations on October 5, 1995. Sachs argues that international bankruptcy procedures modeled upon Chapter 9 and Chapter 11 of the US Bankruptcy Code would be the best response to cope with Mexican-type crises. Sachs' proposals, which include the reorganization of the IMF to act as a kind of international bankruptcy court rather than as a lender of last resort to member governments, overlook important legal and constitutional aspects, including *inter alia* the difficulties of enforcing international law and the differences in national legislations regarding insolvency law and liquidation procedures. For instance, at the EC level - where a coherent degree of harmonization has been achieved in other banking aspects - a proposed directive on the reorganization and winding-up of credit institutions is still the subject of much controversy. A bankruptcy procedure for developing countries analagous to Chapter 11 of the US Code is also recommended in a report published by B. Eichengreen and R. Portes in 1995, under the title of "Crisis? What Crisis? Orderly Workouts for Sovereign Debtors", CEPR. See also the Group of Ten Working

The crises in Thailand, Indonesia and South Korea re-ignited this debate in 1997, as the International Monetary Fund provided - through stand-by arrangements - emergency liquidity to these countries. A bail-out package was deemed necessary to restore confidence and to renew access to funding in the international capital markets.[35] For better or worse, the IMF appears to be emerging as a *de facto* international lender of last resort. In this scenario, I would like to make a number of suggestions.

First, should the IMF "formally" adopt such an international LOLR role, it should be accompanied by enhanced surveillance. Domestically, the lender of last resort role justifies regulation. It then follows that any degree of international protection justifies strengthening international banking rules[36] and enhancing surveillance of domestic bank supervisory and regulatory policies. In fact, this increased surveillance and enhanced transparency in banking and financial matters is needed even if the IMF were not to adopt an international lender of last resort role. Article IV of the IMF Articles of Agreement could be revised or creatively re-interpreted to allow for greater and closer surveillance over financial systems and their supervision and regulation. Such a mandate would entail the need to hire a new team of economists, analysts and lawyers with expertise in banking and finance. In the interim period, the IMF could rely upon external consultants to supply those skills and retrain part of its staff to be able to examine issues related to the functioning of the financial sector and capital flows and the demands of bank soundness (ensuring full awareness of market views and perspectives).

The IMF should also develop an internal rating system for countries' banking and financial systems akin to the CAMEL system in the USA, which is a composite rating that takes into account capital adequacy, asset quality, management competence, earnings and liquidity. The information (about banks) in the USA is provided to the authorities through on-site examinations and reporting requirements. The IMF ratings that I propose would also be composite ratings and would be based upon the results of "micro" Article IV consultations as suggested above.[37] Whether these proposed ratings should be published (like private ratings from rating agencies) or not (like CAMEL ratings or "macro" Article IV consultations) is debatable. The benefits of publication are probably outweighed by the costs of publishing explicit IMF ratings, as such publication could

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Party's Report on "The Resolution of Sovereign Liquidity Crises", May 1996, and P.Kenen (ed.) "From Halifax to Lyons: What has been done about crises management?" *Essays in International Finance*, Princeton, October 1996.

[35] The techniques adopted in the last twenty years to deal with international financial crises have shifted from debt rescheduling to debt restructuring and debt reduction, and from these restructuring techniques to bail-outs, though the IMF surprised world capital markets by not bailing out Russia in the summer of 1998 (this non bail-out has been referred to by some policy-makers as a 'moral hazard shock').

[36]The Core Principles for Effective Banking Supervision, adopted by the Basle Committee on Banking Supervision in September 1997, are a step in this direction.

[37]Arminio Fraga – current Central Bank Governor in Brazil - has indicated that the IMF should act as "the permanent auditor of countries, who should voluntarily submit themselves to examination in order to lower their borrowing costs." See A.Fraga, "Crises Prevention and Management: Lessons from Mexico" at p. 54, in P. Kenen (ed.), "From Halifax to Lyons: What has been done about crises management?" *Essays in International Finance*, Princeton, October 1996. Fraga also proposes that Article IV consultations be supplemented by quarterly reviews to enhance the credibility of the data released under the IMF's initiatives on better disclosure of country data (i.e., the special and general data dissemination initiatives).

potentially increase the incentives for countries not to tell the truth or, at least, to be less open with the Fund, thereby changing the relationship between the IMF and its members. Unpublished IMF composite ratings on countries' banking and financial systems would, on the other hand, provide the IMF with valuable information for its lending decisions without any of the drawbacks of publication. Because there is no collateral in international sovereign lending (conditionality serves a substitute for collateral), the decision to support a troubled country needs to be based upon the best possible information.

Should the IMF surveillance function extend to micro prudential supervision, it would be logical to ask whether the IMF should also adopt a regulatory role (currently carried out *de facto* by the Basle Committee on Banking Supervision. The IMF is, to some extent, better suited than the Basle Committee to adopt that role, because it is a formal international organization (as opposed to the Basle Committee, whose existence is not formalised by an International Treaty), with a large membership comprising developing and developed countries (as opposed to the Basle Committee, which comprises only the expanded G-10 countries), and with strong communication ties with ministries of finance, central banks and other representative governments in countries all around the World (the members of the Basle Committee are central banks and supervisory agencies from the G-10 countries). The IMF, through its surveillance function, already exercises a regulatory or jurisdictional function over its members.

From a practical point of view, it has been argued that if the problems are of illiquidity, what the country needs is quick cash upfront.[38] Stand-by arrangements are relatively too long (1 to 3 years, with repayment to be made within 3 to 5 years), and somehow unsuitable for emergency liquidity crises, as drawings are typically phased out quarterly and the release is made conditional upon meeting agreed performance criteria. A short-term lending facility is better suited to offset crises or emergencies in the capital account of the balance of payments. (In a way, the IMF has already given a step in this direction through the approval of the Contingent Credit Line in April 1999 and the Supplemental Reserve Facility in December 1997 and through the adoption of the so-called Emergency Financing Mechanism in September 1995). The obvious problem with these emergency facilities is that given the magnitude of capital flows today, the IMF would only be able to engage at any given time in a limited number (very few) of 'bail-out' packages, thus raising questions of possible discriminatory treatment of members.

There are other problems and disadvantages with international bail-outs.[39] First, they give rise to moral hazard incentives: investors' folly, reckless bank lending, irresponsible

[38]M. Feldstein in an article published in the *Financial Times* on 5 March 1998 ("Trying to do too much") claims that if the purpose of the IMF packages for Korea, Thailand and Indonesia was "to act as a lender of last resort in order to stop financial panics and the runs by creditors, the IMF's funds would have had to be available for immediate disbursal, not held back until these countries demonstrated their willingness to carry out major structural reforms."

[39]See R. Lastra, "Lender of Last Resort, an International Perspective," *International and Comparative Law Quartely*, Volume 48, Part 2, April 1999, at pp. 359-361.

policies, delays in policy change, etc. Though the moral hazard is not created by the bail-out *per se*, but by the precedent it constitutes and by the expectations it generates, particularly on creditors). Second, other techniques to deal with crises may prove more efficient and less costly than bail-outs; for instance, what appeared to settle the issue in South Korea in December 1997 was the agreement between Western banks and Korean banks as to the restructuring of the Korean debt (rolling it over). Third, any commitment of funds in advance might not only give rise to moral hazard incentives but also be insufficient to contain a crisis when massive financial assistance is needed. Unlike domestic central banks, the IMF cannot print money and, thus, cannot lend freely. Neither in the Mexican nor in the Asian bail-out packages did the IMF provide the funds alone. The IMF acted as a leader or coordinator in the design of the packages (akin to the role of the lead bank in a syndicated loan), but the support of national governments - in particular of the US Government - was essential. Indeed, if what people want in a crisis is US dollars, one could argue that the Fed is also assuming a quasi international LOLR role! Fourth, bail-outs may be inequitable if they allow investors to "escape" when they should take a hit for their bad decisions. If investors are not hit for their bad decisions then the burden of such decisions shifts to taxpayers, since IMF funds are ultimately taxpayers' money.[40] Fifth, the financial crises in South East Asia are a good stimulus for reform; the moral hazard of an international LOLR may allow bad policies to remain in effect much longer. At the end of the day, the final response must be at the domestic level: reforming the domestic financial sector and strengthening its institutional framework. Sixth, as I have already mentioned, stand-by arrangements of the magnitude of Mexico and Korea stretch IMF resources, which are finite, impeding the alternative use of those resources for other purposes. Finally, given the recurrent nature of financial crises,[41] and the difficulties to predict and prevent the next crisis, one might wonder if today's solution (i.e., a bail-out package) might be a good response for tomorrow's crisis. Let us hope we do not end up with an International Deposit Insurance Fund!

The management of financial crises, which is an important element in the new international financial architecture, needs to emphasise preventive *ex ante* measures, such as early warning systems, and better data dissemination, rather than *ex post* protective measures, such as the provision of emergency liquidity assistance, whose efficacy is limited by the finite nature of IMF resources, given the magnitude of private capital flows nowadays. The involvement of the private sector ('bailing in' private investors) in the prevention and resolution of financial crises should also be fostered.

[40]However, in principle, the country which receives a stand-by arrangement is expected to pay back to the Fund the amount received plus a rate of interest in a timely fashion.

[41]As C. Kindleberger, *A Financial History of Western Europe*, 1984, at p.273, reminds us:
"The record [in financial markets] shows displacement, euphoria, distress, panic and crises occurring decade after decade, century after century."

5. WHICH DEVELOPMENT ROLE FOR THE IMF?

Prosperity, like peace is indivisible. We cannot afford to have it scattered here or there among the fortunate or to enjoy it at the expense of others. Poverty, where it exists, is menacing to us all and undermines the well-being of each of us.
US Treasury Secretary, Henry Morgenthau, Inaugural Adress, Bretton Woods, July 1, 1944.

Nowadays the IMF is fundamentally an international financial institution. This character does not preclude a development role for the institution. The question we should ask ourselves is not whether the IMF should have a development role or not, but rather: which development role should it have in the XXIst century? In my opinion, it should be a residual development finance role, focused on the poorest countries (those which typically fall under the category of heavily indebted poor countries or HIPC). Such a role has two main components: debt relief to HIPC countries[42] and financial support (typically concessional) to those countries that do not enjoy access to international capital markets.[43] Financial support to the poorest countries should also include, in some instances, 'lending to arrears,' i.e., providing financing to those countries that have outstanding financial obligations to the IMF.

The position and reputation of the IMF in the international financial community makes it a particularly suitable actor in the process of financing development in the poorest countries. This process requires the active involvement of both the World Bank and the IMF. Poverty alleviation is a daunting task, but one that that international community 'cannot afford' to neglect, in the words of Morgenthau.

CONCLUDING REMARKS

The Bretton Woods institutions, the International Monetary Fund and the International Bank for Reconstruction and Development, were set up in Bretton Woods in 1944 in a context of war and with the memories of hyperinflation, depression, high unemployment and fluctuating exchange rates still fresh. This paper has focused on the changing role of the IMF and some of the challenges this institution faces in the XXIst century. Despite

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[42] A commitment to provide increased debt relief for the poorest countries was endorsed by the Governors of the World Bank and the IMF at their September 1999 Annual Meetings in Washington DC.

[43]The IMF should not provide development finance to the better-off developing countries. Indeed, it can be argued that countries which can access private capital markets do not need financial support from international financial institutions (World Bank and others). This point is developed by Dani Rodrik in his 1995 NBER Economic Paper, "Why is there Multilateral Lending?". Rodrik differentiates between multilateral lending related to humanitarian considerations (concessional lending) and other multilateral lending not related to such considerations. He points out (at p.3) that "during the early 1990s less than a quarter of gross disbursements from multilateral sources was concessional."

the abandonment of the par value regime in the 1970s, the importance of the IMF has remained undiminished. Over the last two decades, the IMF's mandate has been broadened: from being primarily an international monetary institution to becoming an international financial institution, encompassing not only monetary issues but also other financial issues (capital markets, payments systems, etc.). The IMF played a leading role in the sovereign debt restructuring of the LDC countries in the 1980s, in the transition to a market economy of formerly communist countries in the early 1990s and in the resolution of financial crises in Mexico and Asia in the mid to late 1990s, though its handling of such crises has been the subject of much controversy. I argue in this paper that the domain surveillance should extend beyond macro-economic policies. In particular, the IMF's surveillance function should be extended to [micro] prudential financial supervision, through a creative re-interpretation of Article IV of the Articles of Agreement and through the development of unpublished composite ratings to measure the safety and soundness of countries' financial systems. The changing notion of conditionality is also surveyed in the paper. Today 'strict conditionality' co-exists with 'relaxed conditionality,' thus raising concerns in terms of the need for non-discriminatory treatment of members. The wisdom of the provision of emergency financial support, i.e., the wisdom of granting the IMF with an international lender of last resort, is also questioned in my paper, given the finite nature of IMF resources and the magnitude of private capital flows nowadays. Finally, I suggest that the IMF should play a development finance role (debt relief and concessional financial support) in the case of the World's poorest countries that do not enjoy access to private international capital markets.

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26.07.2001

IMF review of conditionality

Comment by Paul Löwenthal[1]

1. The discussion in IMF is restricted to two problems and three solutions.

Problems are (P.1) the all-too large number and, sometimes, ambition of conditions that are imposed upon borrowing governments and (P.2) the disproportion between (ever more likely) non-commitment and its sanction.

Proposed solutions are (S.1) concentrate on IMF's own, financial, competence; (S.2) change conditions into result requirements, to be evaluated more synthetically (parsimony) in the course of the program and, either sanctioned in proportion of the shortcoming, or gratified according to achievements; (S.3) shift public aid from micro-management (projects) to macro-management (fiscal support programs and governance-related conditionalities).

2. The two operational problems that are mentioned widely understate what is at stake. We should add the following ones.

P.3 : Perverse effects: long-term domestic consequences of macro-financial squeezes, inmizerizing-growth effects of export-led strategies focusing on natural resources and cheap labor, backward redistribution, a.s.o.

> *Example:*
> For a country to be accepted in HIPC II, it must (i) comply with macroeconomic equilibrium and stability requirements, (ii) suffer unbearable debt charges, in other words, be in good *and* bad health. Fiscally, it means both a quasi-equilibrium and high financial burden – hence a forceful overhead burden on other, i.a. social, missions.

P.4 : Limits of competence, in a technical sense. Specialists of money and finance or, at best, macroeconomics, IMF staff and Board orient and evaluate policies in all the fields of economic and social policies, incl. industrial strategy, labor-market, social provision, a.s.o. We will not comment on this issue, which seems to be gradually recognized – at least by the World Bank.

P.5 : In contrast with alleged technicity and professionalism, uniformity of – ideologically conditioned – policy stances, irrespective of institutional, structural, or cultural specificity, local relations of power, their preference for a fiscal pattern or concern for environmental protection – not to speak of national sovereignty as to their socio-political regime.

P.6 : Limits of competence, in a legal sense. Concerned with policies but forcing upon structural and systemic options, IMF conditionalities in structural adjustment or poverty reduction programs are interfering with politics, though lacking the corresponding legitimacy. (P.4) and (P.6) are connected but different. The former relates to policies' contents (decision making), the latter to formal politics (decision-taking)

Let us be clear: the point is not to dispute the legitimacy of an inference in national domestic affairs by an international institution, whenever backed by international law, but the legitimacy of IMF as an political decision-taker, sharp. This because of their own legal structure and, more so, because their unwillingness (i) to assume international law, (ii) to account for their policies before such political bodies as the UN economic and social committee.

3. With these problems in mind, the suggested solutions call for the following remarks.

S.1 : Division of tasks between institutions could well call for a concentration by IMF on its original, monetary and financial, missions. Hence on precise policy issues. But "real" economic and social consequences are foreseeable and choices must be made – which cannot be but socio-political.

S.2 : Evaluating achievements is intended to enhance local governments' responsibility in their own policies – but evades the Fund's own responsibility (P.6).

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S.3 : Going over to governance-related conditionalities and macro-management, conflicts with the restrictive, technical view of S.1 and 2. Having criticized the latter, I accept the present suggestion, but provided IMF (i.a.) to be giving the legitimacy it is lacking (P.6).

Example:

Fiscal support programs have clear advantages. A unique negociation between local authorities and its donors permits a global view of national policies, coherence in foreign aid, an equilibrium between foreign and national efforts, and ownership by the local government. But the system has its drawbacks.

(i) It widens the gap between decision takers and stakeholders. Decentralization, if any, and consulting (a government biased subset of) civil society do not warrant a co-responsibility by the local people involved. The fact is, in all-too numerous cases of socially avert, however formally legitimate, governments there is a negative correlation between ownership by the government and by the people…

(ii) Negociation on the public budget means an increased ingerence in its political stance leading to an international tutorship that is likely to be felt as neo-colonialism.

4. The crux of aforementioned criticisms is the pretension to separate policies from politics, the latter being left with local authorities. Clearly, IMF was not originally designed to take or impose political options, and that it lacks competence to do so, in both technical and legal sense, in its present institutional building. But *there is no such thing as a non-political policy, and one cannot escape political "games" without evading political legitimacy*, i.e. democracy and its implications: accepted governance, people's participation in the countries – compliance with international law and political accountability by IMF.

5. The clue to a relevant institutional adjustment, thus to an adequate reform of conditionalities, is in the acceptance of (i) the primacy of international law, (ii) the legal status of human rights.

Once agreed upon, i.e., ratified by a sufficient number of countries, the UN Declaration on human rights and its complementary treatises (on women, children, workers, prisoners, handicapped persons, a.s.o., and on the environment) are no longer moral statements or political projects: they are law. Even if they still lack *exequitur* and justiciability.

This is obvious for the European-continental tradition, rooted in a *jus gentium* that is itself the basis of international law. For their lawyers, human rights *are* rights (P.Klein 2000, in appendix). It is not obvious for the Common-law based anglo-saxon legal model, which is more or less consciously followed by international institutions. But the latter should not be allowed to evade norms to which their members are committed. And this does not mean (as IMF officials have said) adding a mission to the statutory ones, but complying with a legal constraint.

6. Although non-operational in the present state of affairs, the following tracks should be followed towards other, more meaningful solutions.

S.5 : Ratification and commitment with international treatises, including their embodiment in conditionalities. Complying with international law cannot be considered an interference in sovereign States' domestic affairs.

S.6 : Accountability of the Fund itself (as of World Bank) before the relevant international institutions: United Nations and international Courts.

S.7 : Institutional reform that make room for the required competence, in terms of both full-scope professionalism (policy) and legitimity (politics).

7. Attached, you find the preliminary program of a conference on conditionalities that is to be held at Université catholique de Louvain (Louvain-la-Neuve, Belgium) on 0ctober 4-5, 2001. We should gladly welcome IMF-Staff members and make room for them in the first-day panels.

Attachments

- Pierre KLEIN, *International Financial Institutions and Human Rights*.
- Preliminary program, Conference on Conditionalities, Université catholique de Louvain.

INTERNATIONAL FINANCIAL INSTITUTIONS AND HUMAN RIGHTS[1]

by

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Some aspects of the activities of international financial institutions have given rise to a good deal of controversy, and have been subject to often intense criticisms in the last few years. This is in particular the case for the two vocationally universal organisations created in the framework of the United Nations system by the Bretton-Woods agreements, the International Monetary Fund (IMF) and the International Bank for Reconstruction and Development (IBRD), the latter, with other institutions, now a part of what is known as the World Bank group[2]. According to the terms of its Articles of agreement, the objectives of the IMF are to favour international monetary cooperation and exchange stability, to help Member States solve their balance of payments issues by providing them with the resources of the Fund in return for appropriate guarantees and to "facilitate the expansion and balanced growth of international trade, and to contribute thereby to the promotion and maintenance of high levels of employment and real income and to the development of the productive resources" of the Member States[3]. The objectives of the IBRD supplement the Fund's actions and help Member States to rebuild and develop their territories by facilitating productive capital investment, and encouraging private investments abroad with the help of guarantees and private loan and investment participation, or by supplying financial means taken from its own capital[4]. However, the calling into question which these organisations have been submitted to are in reality less targeted towards their functions and missions than towards their way of operating. Stringent criticism has thus been formulated since the 1960's regarding the IBRD and the IMF's loan policy. This criticism related most particularly to the loans agreed by the Bank to South Africa and Portugal when the *apartheid* policy of the former State and the colonial policy of the latter had already been condemned several times by the General Assembly of the UN. This body had repeatedly called on the United Nations system's financial institutions to abstain from giving any form of aid to those two States for as long as they maintained these policies[5]. The UN and the Bank had then entered into open conflict, before a truce was agreed between these two organisations in 1967[6]. Loans from the World Bank or the IMF constituted an indirect support for such totalitarian regimes which was from then on frequently condemned.

The "conditionality" policies followed by the two specialised agencies also attracted a good deal of criticism. Both gradually attached various conditions to the loans they agreed with their Member States, the general objective of which was to ensure better health to the economy of their beneficiaries through "structural adjustment policy" (SAP) [7]. Of course, the terms of these loans – and

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[1] Translation from an article published in *Revue belge de droit international*, 2000.

[2] In addition to the IBRD, this group includes the International Finance Corporation (IFC), the International Development Association (IDA), the International Centre for the Settlement of Investment Disputes (ICSID), as well as the Multilateral Investment Guarantee Agency (MIGA); for additional information on these, see a.o. Ibrahim F.I. SHIHATA, *The World Bank in a Changing World,* Dordrecht/Boston/London, Nijhoff, 1991, pp. 7-14.

[3] Article 1 of the Agreement on the International Monetary Fund, 27 December 1945 ; 2 U.N.T.S. 41.

[4] Article 1 of the Agreement on the International Bank for Reconstruction and Development, 27 December 1945; 2 U.N.T.S. 135.

[5] See a.o. resolutions 2105 (XX) of 20 December 1965 and 2184 (XXI) of 12 December 1966.

[6] See on this controversy the report of the Secretary-General of the UN on consultations with the IBRD, doc. A/6825, reproduced in (1967) U.N..J.Y. 120-147, and Samuel A. BLEICHER, "U.N. v. I.B.R.D. – A dilemma of functionalism", (1970) *International Organisation* 36 and seq. and Paulette PIERSON-MATHY, " L'action des Nations Unies contre l'apartheid (III)" (The action of the United Nations against apartheid), (1971) Rev. belge D.I. 148- 198.

[7] On the setting up of this policy by the IMF, see a.o. Erik DENTERS, "The IMF in the 1990s: Structural adjustment through cooperation", in Subrata Roy CHOWDURY, Erik DENTERS and Paul DE WAART (Editors), *The right to development in international law*, Dordrecht/Boston/London, Nijhoff, 1992, pp. 366 and seq.; Jean-Marc SOREL, "Sur quelques aspects

the relevant policies – are subject to negotiations between the organisations and the borrowing States and are at the end of the day freely accepted by these States who commit themselves to respect them in a "letter of intent" addressed to the organisation[8]. Nevertheless the very limited margin for manoeuvre which most of the States concerned are in reality reduced to allowed the IMF and the World Bank to dictate often drastic economic policy to these States. The elements of these policies (which include in many cases the reduction of public spending and the role of the State in the economy, as well as cutting back on imports) sometimes had important – and negative - repercussions in several countries, in the social field, in particular putting at risk the access of significant layers of the population to various essential services [9].

These situations expose two kinds of infringements of human rights – indirect in both cases, as they are not an immediate consequence of acts of the relevant organisations themselves. In the first case, the loans agreed by the financial institutions contribute to allowing political regimes with little or no concern for the respect of human rights to maintain themselves and continue with their policy; in this case it is essentially civil and political rights which are negated. In the second, the SAP often results in a reduction of the population's standard of living and the restriction of access to certain services, therefore leading to infringements of economic and social rights[10].

In legal terms, understanding these "perverse effects" of the action of the World Bank and the IMF raises fairly complex issues connected to the determination of the legal obligations which bind these two institutions in this field[11].

Both organisations have always restricted the debate to their own legal order. But we will see that beyond the rules specific to the organisations, mapping out their competences and regulating their functioning – and even their interpretation by the two relevant institutions is subject to caution – (I), there exist more general standards of international law which require them to ensure that the policies they follow or "lay down" do not infringe on human rights (II).

I. – THE "CONSTITUTIONAL LIMITATIONS" ARGUMENT DOES NOT PREVENT THE TAKING INTO ACCOUNT OF THE HUMAN RIGHTS SITUATION IN THE BORROWING COUNTRIES BY INTERNATIONAL FINANCIAL INSTITUTIONS

The international financial institutions have constantly justified the practices described above by sheltering behind the constitutional framework which was put into place for their action, by arguing that the latter imposed on them to only take into account economic considerations in the pursuit of their activities. This argument was strongly put forward in situations where criticism was levelled against loans being granted to regimes with a poor regard for human rights (1). While this argument did not prevent these organisations from giving a certain amount of importance to the achievement of economic and social rights, their practice in this area is however limited and their approach restrictive (2).

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juridiques de la conditionnalité du FMI et leurs consequences" (On certain legal aspects of the conditionality of the IMF and their consequences), (1996) E.J.I.L. 43 and 53 and seq.

[8] See on this Jean-Marc SOREL, *loc.cit.* (n.6), pp 47 and 60. As the author points out, the relationship between the Fund and the Member State does not however take on a conventional aspect (*ibid.*, pp.46-49).

[9] See a.o. the statement made in the report of the Secretary General of the United Nations listing the "Main conclusions of the research work carried out by the organisations of the United Nations on the mains trends and economic and social policy in the world and on the new issues which are appearing", Doc. E/1990/81, 14 June 1990, p. 18, as well as the report by El Hadji GUISSE on the achievement of economic, social and cultural rights subject to the Sub-Committee for the prevention of discrimination and the protection of minorities of the United Nations Human Rights Committee, Doc. E/CN.4/Sub.2/1997/8, para 65. For a specific case study, see the contribution of Gérard NIYUNGEKO in (1999) Rev. belge D.I. 8-18.

[10] See a.o. the papers produced by the SAPRIN (Structural Adjustment Participatory Review International Network), a network composed of several hundreds of organisations (NGOs, trade unio,ns, lobby groups) which assesses the impact of SAPs in the countries where they are applied; these texts are available on the internet (http:/www.igc.org/dgap/saprin/index.html).

[11] In this article we shall only deal with the obligations of the international financial institutions themselves, excluding issues of conflicting obligations and responsibility which the implementation of SAPs in Member States are likely to raise; on this, see the contribution of Laurence ANDRE and Julie DUTRY in (1999) Rev. belge D.I. 58-85.

1. – *Banning of political activity : no basis for an argument*

Based on the principle of speciality (a), the use of the ban of political activity by financial institutions to justify their refusal to take into account the civil and political rights situation in countries receiving their financial aid is in itself highly objectionable (b).

a) *Political activity and the principle of speciality*

The "constitutional" argument is founded on the principle of speciality of international organisations. In virtue of this principle, these organisations, "secondary" subjects of international law, are only endowed with competences of attribution – those conferred on them by the States which created them – and cannot pretend to exercise authority in other areas than those attributed to them initially[12]. This principle has a specific practical application in the United Nations system, where the functionalist approach has resulted in a sharing out of tasks between the UN, figurehead political organisation, and the specialised institutions, in charge of more "technical" missions in areas as wide-ranging as health, civil aviation, culture or finance. The – theoretical – exclusion of the "political" from the activities of the specialised institutions is in itself a principle firmly grounded in the functioning of these bodies[13].

As vocationally economic organisations, these financial institutions are thus required to circumscribe their activities to this sole area. None but economic criteria should guide their actions and decision-making, excluding all other considerations, and in particular political aspects. This requirement is stated particularly clearly in the constitutive act of the IBRD. Article IV, section 10 of the agreement establishing the Bank provides that

> "the Bank and its officers shall not interfere in the political affairs of any member; nor shall they be influenced in their decisions by the political character of the member or members concerned. Only economic considerations shall be relevant to their decisions, and these considerations shall be weighed impartially […]"[14].

It is mainly on this provision that the Bank based itself to provide legal arguments in the controversy – mentioned earlier – which opposed it to the UN regarding the loans it had agreed with South Africa and Portugal[15].

As the former legal counsel to the International Monetary Fund put it with respect to the provisions of the Articles of agreement of the IMF to which the same scope has been given,

> "Noneconomic considerations, particularly of a powerful moral character, may make decisions on some occasions appear, to some and even many members, to be applications of the maxim *dura lex sed lex* (hard law, but law)"[16].

But the wording itself of the constitutive act does not give the choice of adopting another guideline, which may in any case turn out to be perilous:

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[12] Charles CHAUMONT, « La signification du principe de spécialité des organisations internationales » (The meaning of the principle of speciality in international organisations), in *Mélanges Henri Rolin,* Paris, Pedone, 1964, pp. 58-59.

[13] For further reading and a critical commentary, see Pierre KLEIN, "Quelques réflexions sur le principe de spécialité et la 'politisation' des institutions spécialisées" (Some thoughts on the principle of speciality and the 'politicisation' of specialised institutions), in Laurence BOISSON DE CHAZOURNES and Philippe SANDS (Editors), *International Law and Nuclear Weapons and the International Court of Justice*, Cambridge, Cambridge University Press, 1999, pp. 79-91.

[14] *Loc.cit.* (n.3). This prohibition is not stated as completely in the IMF statutes ; see however Article I *in fine* and Article IV, Section 3, b) (*loc.cit.*, n.2).

[15] See the arguments put forward by the IBRD legal counsel in his letter of 5 May 1967 addressed to the UN Secretariat, reproduced in annex to the report quoted earlier of the Secretary-General, pp. 134 and seq.

[16] Sir Joseph GOLD, *Political Considerations are prohibited by Articles of Agreement when the Fund considers requests for the use of resources*, IMF Survey, 1983, p. 148.

> "The swimmer who goes out too far may seem to be waving but is drowning. The Fund that swims out too far, even in a moral cause, will risk drowning. It will have lost the full confidence of its members. It will be less able to promote universal prosperity. That task is the Fund's moral cause"[17].

This reading of the abovementioned provisions of their constituent acts has consequently led the Bank as well as the Fund to follow a constant policy of not taking into account the civil and political rights situation in Member States when deciding on agreeing to a loan.

The World Bank's practice has however been somewhat modified in this respect. Indeed, since the beginning of the 1990s, its management bodies tend to admit the taking into account, in the decision-making process, of non economic considerations – and in particular of the situation prevailing in a State in the area of human rights - insofar as these aspects have a more general influence on the capacity of the State in question to ultimately face up to the obligations which will result from the loan agreement that the Bank would have accepted to agree with it:

> "violation of political rights may […] reach such proportions as to become a Bank concern, either due to significant direct economic effects or if it results in international obligations relevant to the Bank, such as those mandated by binding decisions of the United Nations Security Council"[18].

Consequently, if the human rights situation in a State which solicits financial aid from the World Bank deteriorates to such an extent that internal troubles and tensions develop which may affect the general functioning and the economic activity of the relevant country, or may lead to the adoption of sanctions by the United Nations Security Council, the Bank could refuse to agree to the requested loan. The taking into account by the Bank of the civil and political rights situation in a Member State remains therefore limited and, in practice, the exception. As an example, the reasons put forward by the Bank for the suspending of loans to Myanmar decided in 1998 are of a strictly technical nature (failure to reimburse instalments due to be paid)[19] and in no way refer explicitly to the massive human rights violations committed in this country and denounced by many organisations[20]. In addition, the legal framework reference remains the same: the prohibiting of political activities set out in Article IV, Section 10 of the constituent act of the Bank is in no way called into question. This is only insofar as they affect economic factors – or, in a limited way, are an issue in terms of international legality in a sufficiently significant way to lead to the application of sanctions by the Security Council – that massive human rights violations could influence the decisions of the organisation. This development turns out to be based on a larger interpretation – although still measured – of the terms "economic considerations" contained in Section 10[21].

b) *An erroneous interpretation of the constituent instruments*

This general approach lays itself open to two kinds of criticisms: an "internal" one, linked to the interpretation of the notion of "political affairs" which is found in the Articles of agreement of the Bank, and an "external" one, concerning the general legal framework in which the Bank's activities take place. At this stage only the first one will be developed, as the other refers back to more general issues which will be dealt with later[22].

If the opposition made by the financial institutions authorities between economic and political considerations is not subject to controversy insofar as it arises directly from the terms of their constituent instruments, this is however certainly not the case for the inclusion of the issue of the respect of human rights in the "political" field . It seems difficult to contest that this last issue has been

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[17] *Ibid.*

[18] Memorandum of the legal counsel of the World Bank of 21 December 1990, Sec. M91-131. See also the contribution of Ibrahim SHIHATA in (1999) Rev. belge D.I. 86-96.

[19] See the information available on the internet website of the Bank (http://www.worldbank.org).

[20] See a.o. resolution 52/137 adopted by the United Nations General Assembly on 12 December 1997, as well as the report from the ILO Commission of Enquiry on forced labour in Myanmar, Geneva, 2 July 1998.

[21] See sp. Ibrahim F.I. SHIHATA, *The World Bank in a Changing World*, vol. II, Dordrecht/ Boston/ London, Nijhoff, 1995, p. 561.

[22] See *infra*, section II.

more and more solidly grounded in international law for now over half a century. The International Law Institute established in its 1989 resolution on the "Protection of human rights and the principle of non intervention in the domestic concerns of States" that the obligation to respect human rights "is a duty for all States with regard to the international Community as a whole"[23], in virtue of the customary and conventional regulations which have proliferated in this field over the last 40 or 50 years. A State cannot therefore uphold that this issue is one of "national competence" or "internal affairs"[24].

More or less significant or systematic violations of human rights can of course be part of State policy - there are enough historical examples. It does not however constitute an element of "political orientation" in a State which section 10 of the Bank's statute prohibits it to take into account in the carrying out of its activities. This provision echoes the principle of sovereign equality and its corollary, the principle of non intervention in internal affairs of State. In this way, its aim is to protect the Member States against the infringements which international financial institutions would be likely to make on their "reserved area" by possibly penalising the political choices of the State requesting financial assistance by refusing to grant them this aid. But the "political orientation" which is ensured by many international instruments is normally understood to encompass the options chosen by a State for the management of common interests in social, economic and cultural fields, or in a wider sense, for the development of a human society[25].This freedom of orientation, which is indirectly recognized by the IBRD's Articles of agreement[26], does not include that of infringing on the international obligations of the State. In no international instrument will one find the statement or the presumption according to which the freedom of choice of States – which constitutes one of the essential aspects of sovereignty, a fundamental principle of international law – includes that of not complying with their international commitments[27].

Bizarre as it may seem, this is the result of the interpretation upheld by the World Bank, which seems to believe that the practice of human rights violation is integrated in the choice of political orientation of the State committing this violation, and should therefore benefit from the protection of international law. On the contrary, these human rights violations are obviously not a part of the State's policy, which is determined freely and the choice of which is protected by international law, but may only be seen as an infringement of the international obligations of the State, which is in itself contrary to international law[28]. The issue of the respect of human rights is primarily a legal issue, not a political one. In this respect, it is treading the wrong path for financial institutions to set aside its taking into account in pursuing their activities in relation with Member States[29].

It is obvious that this question belongs to a larger issue which is the legal framework within which are integrated the activities of the financial institutions. Once agreed that the issue of non respect of human rights by a Member State does not belong to the political sphere, inside which their constituent

[23] *A.I.D.I* (1990) .338.

[24] *Ibid.*

[25] See for example the setting out of the principles of sovereign equality, of self-determination and non intervention in resolution 2625 (XXV) of the United Nations General Assembly (Declaration on Friendly Relations).

[26] This reading of the IBRD statute can be confirmed by the confrontation of this text with Article I of the Agreement establishing the European Bank for Reconstruction and Development (EBRD), which specifies that the objective of this organisation is to contribute "to the progress and economic reconstruction of the Central and Eastern European Countries *which are committed to respect and put into practice the principles of pluralist democracy, of pluralism and of market economy* […] (Agreement of 29 May 1990, text reproduced in (1990) I.L.M. 1077; our italics). The opposition between the two instruments on this point – that the doctrine has shown up (see sp. Ibrahim SHIHATA, *The European Bank for Reconstruction and Development*, Dordrecht/Boston/London, Nijhoff, 1990, p. 2) – shows that it is the free choice of the Member States in terms of political and economic orientation that section 10 of the IBRD's statute aimed to protect.

[27] See more generally on this point NGUYEN Quoc Dinh, Patrick DAILLIER and Alain PELLET, *Droit International Public* (International public law), 6th edition, Paris, L.G.D.J., 1999, p. 431, para. 280.

[28] See already Olivier CORTEN and Pierre KLEIN, *Droit d'ingérence ou obligation de réaction?* (Right to interfere or obligation to react?), 2nd ed. Brussels, Bruylant, 1996, pp. 91 and seq.; see also for its thematic similarity, on genocide, Linos-Alexandre SICILIANOS, *Les réactions décentralisées à l'illicite – Des contre-mesures à la légitime défense* (Illicit decentralised reactions – From counter-measures to self-defence), Paris, L.G.D.J., 1990, p. 478.

[29] See already the general affirmation by Marc COGEN according to which « there is no legal contradiction between the classical doctrine on prohibition of political activities and the doctrine of human rights" ("Human rights, prohibition of political activities and the lending policies of Worldbank and International Monetary Fund", in Subrata Roy CHOWDURY, Erik DENTERS and Paul DE WAART, op. cit. (n. 6), p. 396).

instrument prohibits the interference of financial institutions, it remains to be seen whether international law requires them to take into account in their decisions other international obligations than those arising from their own constitutions. We will return to this in the second part of the study, after having examined the position of the financial institutions with regard to the negative effects that the structural adjustment programmes which the borrowing States are compelled to respect may have on economic and social rights inside these States.

But before examining this issue, it should be noted that in practice the relevant organisations do not present a very coherent picture of the meaning they attach to the obligation of abstaining from all interference in the internal affairs of their members.

On the one hand, because of their understanding of what is "political", and because of the prohibition of imposing specific requirements on the borrowing States in this field appear singularly changeable. Since the beginning of the 1990s, the Bank's insistence on the notion of "good governance"[30] could in many respects illustrate this "double discourse". This concept of "good governance" is essential political. Whether a State has satisfied —or not— to the criteria listed in the documents of the Bank (among others the absence of discrimination in the policies followed by the relevant State, transparency, the representativeness of the Government and the absence of corruption[31]) will be subject to assessments which are obviously riddled with value judgements and an appreciation which, it appears, will always be in the end political. But the fears of seeing the organisation "entangl[ed] in political issues that typically extend beyond its mandate"[32], so present in debates on civil and political rights, seem here to suddenly disappear.

On the other hand, one cannot but observe that the structural adjustment programmes implemented by the borrowing States at the invitation of the financial institutions ultimately turn out to be considerably more intrusive in the "internal affairs" of these States than any other requirement relating to the respect of civil and political rights. As one author observes "the adjustment loans bear witness to the Bank's wish not only to be an important source of financing, but also to play a determining role in the decision-making process of the developing countries […]"[33]. The analysis made by Danilo Türk of the SAPs in his report on the achievement of economic, social and cultural rights presented to the United Nations Sub-Committee on the prevention of discrimination and the protection of minorities is no different[34]. The paradox can hardly be overlooked, as by making them "political" the relevant organisations include in the "reserved domain" of the States issues which are unanimously considered as not belonging therein (the civil and political rights situation), whereas they simultaneously push with all their weight on the orientation of economic and social policy of their Member States, an orientation traditionally considered as relating in the first instance to the "internal affairs" of the States.

The position of the financial institutions in this area seems therefore marked by a far-reaching ambiguity: on the one hand, they declare they have to base their action solely on economic considerations and as they cannot intervene in the internal affairs of the Member States, they cannot take into account the (non) respect of civil and political rights inside these States with regard to the decisions they make on the granting of loans. Yet on the other hand they base themselves on criteria of which some are intimately linked to a political judgment ("good governance") to make these decisions, and their loans carry with them conditions which weigh heavily on the power of the beneficiary States to continue to determine in all sovereignty the options they intend to privilege to ensure their economic, social and ultimately political development. As we will now see, the position of the financial institutions regarding the taking into account of economic and social rights in the statement of their policies and their decision-making process is also characterised by internal contradictions, which if they are less obvious, are nonetheless just as real.

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[30] See esp. the memorandum "Issues of 'Governance' in Borrowing Members : The Extent of their Relevance Under the Bank's Articles of Agreement", doc. Sec. M91-131 of 21 December 1990.
[31] See a.o. Ibrahim F.I. SHIHATA, op.cit. (n. 1), pp. 84 and seq.
[32] Ibrahim F.I. SHIHATA, op.cit (n. 20), p. 561.
[33] Graham HANCOCK, *Les nababs de la pauvreté* (Poverty Nabobs), Paris, Laffont, 1991, p. 56.
[34] Doc. E/CN.4/Sub.2/1992/16 of 3 July 1992, paras 42 and 44.

2. – *The limited taking into account of social and economic rights by international financial institutions*

If the idea which the financial institutions have now created for themselves of their role with regard to economic and social rights is at right angles to the approach just described on the respect of civil and political rights by the borrowing States (a), it is nevertheless true that the taking into account by these organisations of the impact of their programmes and policies on the economic and social rights' situation in the relevant countries remains limited (b).

a) *The achievement of economic and social rights as an aspect of the mandate of the financial institutions*

The difference in tone between the discourse of the financial institutions with regard to respectively political and civil rights, and economic and social rights, can be found in particular in the discourses and policies of the World Bank. As much the organisation itself as its most eminent officials insist on the central place occupied by the achievement of economic and social rights in the Bank's objectives[35]. As soon as development becomes the main objective of the organisation's activities, it has by the nature of things put the emphasis on the achievement of rights which are in the end simply concrete applications of this objective. The principal guidelines of several projects it is financing bear witness to this concern: programmes for the fight against poverty, education, health are a few illustrations[36]. As stressed by the Bank's legal counsel, the evolution is all the more interesting that "[t]he Bank's operations have covered numerous diverse issues including population, education, health and social security, *even though none of these issues are specifically mentioned in the Articles of Agreement*"[37]. It is therefore a dynamic interpretation of the mandate entrusted to the Bank in 1945 which justifies the actions it undertakes in these different fields. But in reality, the pursuit of these general objectives does not exclude the Bank's policies leading to serious infringements of economic and social rights.

c) *A discourse partially contradicted by practice*

A closer examination of the World Bank's practices exposes the limits of the taking into account of the economic and social rights in its activities. These limits are perceived in the framework of the functioning of the inspection panel instituted in 1993 as a supervisory body of the activities of the Bank, as well as the maintaining of the structural adjustment programmes in many countries.

According to the resolution establishing it, the World Bank inspection panel may be informed of a request for an inspection by a person or group of persons declaring that "its rights and interests have been or may be directly affected by an action or an omission of the Bank arising from the non respect by the Bank of its policies and operational procedures regarding conception, evaluation and/or achievement of a project financed by the Bank"[38].

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[35] See more generally the contribution of the World Bank to the Vienna Conference on human rights of 1993, doc. A/CONF.157/PC/61/Add. 19 of 10 June 1993.

[36] See a.o. Ibrahim F.I. SHIHATA, op. cit. (n. 1), pp. 97 and 109 and seq.

[37] Ibrahim F.I. SHIHATA, op. cit. (n. 20), p. 557; emphasis added.

[38] Para 12 of resolution nº93-10 of 22 December 1993; text available on the internet site of the World Bank (http://www.worldbank.org/html/ins-panel). For further details, see a.o. Daniel D. BRADLOW and Sabine SCHLEMMER-SCHULTE, "The World Bank's new inspection panel: A constructive step in the transformation of the international legal

The texts which the Panel can apply in exercising its supervisory authority are in reality different documents internal to the World Bank (circulars, directives, etc.) through which the main guidelines and procedures decided on by the governing bodies of the organisation are brought to the attention of the staff [39]. These texts aim in certain cases at ensuring the respect of the basic rights of persons who risk being practically affected by the project, but a number of them also possess a totally different objective[40]. This is however the only "applicable law" before the panel — although the wording is somewhat misleading, as this instance is not a jurisdiction[41] — , to the exclusion of all other rules of international law. In other words, if the achievement of certain economic and social rights does figure among the missions of the Bank, the fact that pursuing a project financed by this organisation should infringe on these rights in such a way as to prejudice local populations does not in itself enable the panel to conclude to the irregularity – and even less the illegality – of the incriminated activities. Once again, only the yardstick of the organisation's own regulations can assess the legality of its actions.

The continuation of structural adjustment programmes, despite their negative effect on the enjoyment of economic and social rights by the populations of the States subject to it, raises even more pressing questions as to the reality of the commitments of the financial institutions to ensure the achievement of these rights. The main line of discourse in this respect remains that these programmes are essential, as in the middle term they will enable to improve the economic situation of the borrowing country, and therefore to improve its population's living conditions[42]. The unavoidable and immediate negative effects of the SAPs should therefore be accepted as, although they imply a regression in the field of economic and social rights, this would only be temporary, and necessary to the more effective enjoyment of these rights in the future. The report produced by the World Bank for the fiftieth anniversary of the Universal Declaration of Human Rights declares that "the difficulty of the policies should not be mistaken for their necessity. Countries that do not adopt a broad mix of outward-oriented progrowth policies risk being left behind in an increasingly global economy, with the poor suffering the most severe consequences"[43]. The argument is not entirely convincing. As M. Lucas writes on the identical arguments put forward by the IMF, "the defenders of the IMF like to point out [that] the position of the States concerned would be worse off without the Fund's intervention. [But a] doctor is required to act professionally with his patients. Therefore it cannot be argued in his defence that the patient would have died without his intervention"[44].

It is true that the World Bank's practices, as the IMF's, have also evolved in this field. The negative effects of the SAPs have effectively lead the two organisations to add social measures to them, in order to reduce these consequences. Social "safety nets" have thus been set up in several countries where SAPs were implemented[45]. However, in several cases these efforts are not sufficient compared with the scope of the negative effects these programmes have had on economic and social rights[46]. As D. Türk wrote in his report mentioned earlier, "the structural adjustment process continues to have formidable effects on human rights and on the capacity of legal systems to fulfil their obligations to

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order" (1994) Z.A.Ö.R.V. 392 and seq.; Louis FORGET, "Le 'panel d'inspection' de la Banque Mondiale" (The inspection panel of the World Bank), (1996) A.F.D.I. 645 and seq.

[39] Ibrahim F.I. SHIHATA, op. cit. (n. 20), p. 281.

[40] For example, the instruments mentioned in the communiqué dated 23 October 1997, on the inspection of a project for a power station in India, were the following : directives on the involuntary movement of population, environmental impact studies, indigenous populations, the participation and consultation of affected populations, and the supervision of the Bank (text available on the internet site of the World Bank : http://www.worldbank.org/html/ins-panel/press39.html).

[41] Memorandum by the President of the World Bank on the inspection panel, Doc. R93-122/2 of 10 September 1993.

[42] See a.o. Ibrahim F.I. SHIHATA, op. cit. (n. 20), p. 570.

[43] *Development and human rights : the role of the World Bank*, Washington D.C., World Bank, 1998; text available on the internet site of the World Bank (http://www.worldbank.org/html/extrdr/rights).

[44] Michaël LUCAS, « The International Monetary Fund's conditionality and the International Covenant on Economic, Social and Cultural Rights : An attempt to define the relation », (1992) Rev. belge D.I. 133.

[45] See a.o. the report *Development and human rights* mentioned above, p. 8, as well as a concrete example in the granting in June 1998 of a loan of 300 million dollars to Malaysia to lessen the social consequences of the Asian crisis (press release nº 98/1826/EAP, http://www.worldbank.org/html/extdr/Extme/1826.htm).

[46] See for example, on the situation in Ghana, *Les programmes d'ajustement structurel (P.A.S.) et les droits humains* (Structural adjustment programmes (SAPs) and human rights), Brussels, GRESEA, 1997, p. 18.

ensure the respect of these rights"[47]. In any case, it seems once again from this aspect of the policy of the international financial institutions that the respect of economic and social rights is not something they feel firmly constrained to achieve, including in the execution of the programmes they "impose" on the borrowing States.

In the end, in all the situations which have been described, the international financial institutions only take into account human rights insofar as they can link this issue to the "economic considerations" which must, according to the terms of their constituent instruments, constitute the only criteria for their decisions in the management of their activities. However, it will now be argued that general international law is imposing obligations on these organisations which go beyond those stated in their constitutions.

II. GENERAL INTERNATIONAL LAW IMPOSES OBLIGATIONS ON INTERNATIONAL FINANCIAL INSTITUTIONS TO TAKE INTO ACCOUNT THE IMPACT OF THEIR POLICIES AND THEIR DECISIONS ON THE HUMAN RIGHTS SITUATION IN THE BORROWING COUNTRIES

The principle according to which the activities of international organisations are governed in the first instance by their own regulations (constituent instrument, secondary law, subsequent practice of the organs) which constitute what is known as the legal order of these organisations is unanimously accepted[48]. However, this does not mean that the provisions of their own legal order are the only legal framework of the activities of intergovernmental organisations. These legal orders are not in fact autonomous, but appear more as "sub-systems" within the international legal system, by which they are validated. This shows that beyond the obligations their own rules impose, intergovernmental organisations are subject to general international law. As the International Court of Justice put it in the case of the *Interpretation of the Agreement of 25 March 1951 between the WHO and Egypt,* "international organisations are subjects of international law and, as such, bound by any obligations incumbent upon them under general rules of international law, under their constitutions or under international agreements to which they are parties"[49].

In consequence, the approach centred on the limits which are imposed by their constituent instruments on the organisations concerned, and on the speciality principle, does not appear here either as an appropriate way to deal with the issue. The issue is not in fact to find out whether the financial institutions are able to deploy activities to ensure the protection of human rights – which would indeed raise difficulties with the speciality principle - , but more simply to find out if in the achievement of their mission, these organisations will see their freedom of action curtailed by certain rules of international law other than those of their own legal order, and more particularly by the international standards for the protection of human rights. The real question here is the "transverse" application of this type of standard to the activities of the organisations concerned, and not some sort of wish to extend abusively the scope of their competence[50]. However, we will see that international law imposes on intergovernmental organisations specific obligations of due diligence, which must lead them to take into account the consequences of their acts or abstentions for other subjects of law (1). This obligation of due diligence imposes specific duties on international financial institutions, including in the field of human rights (2).

1. – *International law imposes on intergovernmental organisations an obligation of due diligence*

[47]Loc.cit. (n. 33), p. 12, para. 41. See also resolution 1991/27 of the Sub-Committee (quoted in part in ibid. , n. 19).
[48] See more generally, Henry G. SCHERMERS and Niels M. BLOKKER, *International Institutional Law*, 3rd ed., The Hague/Boston/London, Nijhoff, 1995, p. 708, para 1141.
[49] Advisory Opinion of 20 December 1980, I.C.J. Rep. (1980) 89 and 90, para. 37.
[50] See more generally on this Pierre KLEIN, *La responsabilité des organisations internationales dans les ordres juridiques internes et en droit des gens* (The responsibility of international organisations in internal legal orders and in international law), Brussels, Bruylant, 1998, p. 345.

It is true that the policies followed by the international financial institutions do not in themselves infringe on any international standard. As I. Shihata puts it , "[a] loan agreement to a country accused of violating such [basic human] rights does not in itself violate any human rights rules, or for that matter, condone violation of such rights"[51]. The situation is no different for the SAPs, as their execution is finally ensured by the borrowing countries themselves. The absence of direct responsibility of the international financial institutions in one or the other case does not mean that they are not likely to see their responsibility engaged in some other respect. Among the obligations that "general international law" imposes on intergovernmental organisations, is the obligation of due diligence which customary international law traditionally imposes upon States.

Understood in its initial meaning, this principle boils down to "every State's obligation not to allow knowingly its territory to be used for acts contrary to the rights of other States"[52]. Its meaning was gradually extended in order to cover the activities taking place on the territory of the State by persons other than its agents or organs, and to include acts committed to the detriment of subjects of international law other than States – in particular individuals - , and, in certain cases, acts contrary to international law committed by nationals of a State outside its territory[53]. Currently, we can affirm that the obligation of due diligence imposes in a general way on its holder to ensure that the activities which take place under its control do not infringe on the rights of another subject of international law.

Originally linked to the exercise of territorial competence, the obligation of due diligence has subsequently acquired a wider scope which enables and justifies its applicability to international organisations. This is of course the case in situations where an organisation exercises control over a territory [54], but also, more generally for activities which take place under their authority or which are undertaken by Member States on the basis of the authorisation of an organisation. As L. Condorelli put it regarding the mandates given by the Security Council to UN Member States to ensure the respect of decisions taken by the Council in the framework of Chapter VII of the Charter, "[the] UN should […], in this case, ensure that the use of force by States (even by regional organisations) takes place in the stringent respect of all relevant rules", and first among these the legal standards of armed conflicts[55]. The author continues by stressing that "it arises that possible infringements [carried out by another subject of international law, and not the UN] could expose an omission – infringement of an obligation of take all necessary measures of prevention – which would then, this time, be perfectly attributable" to the UN[56]. The fact that the violation of international law is not directly attributable to an intergovernmental organisation obviously does not prevent the illicit fact from "revealing" a wrongful abstention by the organisation – in this case the non fulfilling of an obligation of due diligence– likely to engage its own responsibility.

2. – *The obligation of vigilance imposes on financial institutions to act in such a way that their decisions do not produce any negative consequences on the human rights situation in the borrowing States*

The reasoning described above is also valid for international financial institutions. The general obligation of due diligence imposes on them to ensure that the activities undertaken under their

[51] Ibrahim F.I. SHIHATA, op.cit. (n. 20), p. 563.
[52] Corfu Channel case, I.C.J. Rep. (1949) 22.
[53] On the evolution of the extent of the obligation of due diligence, see esp. Jean SALMON, *Responsabilité internationale* (International Responsibility), T. II, 6th ed., Brussels, P.U.B., 1996-7, PP. 181-183. As examples, one could mention among the texts imposing obligations of due diligence on States regarding activities taking place outside their territory Article VI of the Treaty of 27 January 1967 on the principles governing the activities of States in matters of exploration and use of outer space, as well as Article 139 of the UN Convention of 10 December 1982 on the law of the sea.
[54] This could include control of the headquarters district as well as the temporary administration of a State's territory; these two hypotheses are pointed to by F.V. Garcia-Amador in his first report to the International Law Commission on State responsibility II Y.I.L.C. (1956) 191, para 88. See among others to the same effect Antonietta DI BLASE, « Sulla responsabilità internazionale per attivita de l'ONU », (1974) Riv. D. I. 256 and C.F. AMERASINGHE, *Principles of the Institutional Law of International Organizations*, Cambridge U.P., 1996, p. 247.
[55] Luigi CONDORELLI, « Le statut des Forces de l'ONU et le droit international humanitaire » (The statute of UN Armed Forces and international humanitarian law), (1995) Riv. D.I. 906.
[56] Ibid.

supervision – and, *a fortiori*, at their initiative, as is the case for structural adjustment programmes – do not infringe on international law, or, more specifically, on the rights of other subjects of international law. The policies upheld by the World Bank in various fields have indeed integrated for several years this concern for vigilance with regard to certain of the potentially negative effects of the use which would be made of the sums it loans, in particular regarding the environment. An *Operational Manual Statement* (OMS, nº 2.36) adopted in May 1984 provides among other things that the organisation "will not finance projects that contravene any international environmental agreement to which the member country concerned is a party […]"[57]. This very specific wording enables officials to have clear decision-making criteria at their disposal by referring to the international commitments of the Borrowing State. Even if no World Bank text imposes the same precaution regarding international instruments for the protection of human rights agreed by the borrowing State, it has an identical duty in this area in virtue of the general obligation of due diligence mentioned earlier. There is in point of fact no legal reason for which this limitation would be valid in the field of environment only. The Bank, as the IMF, should on the contrary, in virtue of the general obligation of due diligence binding upon them under international law – as upon all international organisations – ensure that their activities, and, more particularly the loan agreements they conclude with their Member States should not lead or contribute to a violation of international law, and more particularly of the standards of protection of human rights[58]. To quote the words of the *Operational Manual Statement* nº 2.36, these organisations should not "finance projects which contravene the international obligations contracted by the Member State concerned in the field of human rights". As we know, in practice these two organisations are far removed from this guideline, the logic of which seems elementary…[59].

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In conclusion, the issue of the situation of the international financial institutions with regard to the rules of protection of human rights cannot be envisaged in the sole legal framework of these entities, within which these standards in any case appear to be envisaged with a questionable bias (according to which the respect of human rights is a political consideration). Beyond this basic legal framework, general international law has a vocation to be applied in a "transverse" way to the activities undertaken by these institutions in their field of statutory competence. In particular, they are subject to an obligation of due diligence which imposes on them to ensure that the activities undertaken under their supervision do not infringe on the rights of other subjects of international law, including individuals. They must therefore ensure that the programmes and policies they incite their Member States to adopt as conditional to the granting of loans do not affect the rights, as much civil and political, as social and economic, of the local populations, rights which these borrowing States have committed themselves to respect at the international level.

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[57] Text reproduced in Ibrahim F.I. SHIHATA, op. cit. (n. 1), p. 140.

[58] See already the arguments put forward by Marc Cogen, who however considered this issue more from the angle of the obligations bearing on the representatives of the Member States making up the decision-making bodies of the international financial institutions (loc.cit. (n. 6), p. 389).

[59] The breaches of the Pact on economic, social and cultural rights which the implementation of the SAPs by the States party to this instrument have been clearly exposed by the United Nations Human Rights Committee (see the report mentioned earlier by D. TÜRK, para. 56 and n. 39).

Translation from French

Contribution to discussion on IMF conditionality

Our contribution reflects the view that discussions on debt relief should go hand-in-hand with a review of policies.

Thus it is worth remembering the main conclusions of the IMF Executive Board at the end of its meetings in June and November 1994.[1] The case of Madagascar, as illustrated in a recent study by the Economic Research Center of the University of Antananarivo and the John F. Kennedy School of Government (Harvard University),[2] shows that the problems mentioned by the Board in 1995 hold true to this day.

1. The Board's main conclusions in June and November 1994

These meetings were devoted to examining the "three-pronged conditionality" of the IMF. The improvements in question focused on the external and financial sectors, namely: increasing official reserves, and strong efforts to correct fiscal imbalances. The disappointing results applied to external and domestic objectives alike:

- Externally speaking, payment arrears continued to accumulate, and export performance weakened;

- Domestically, the Board noted that developments in the domestic economy were generally less impressive, and in particular, inflation had not been brought under control.

In view of this limited results, the Board asked the following key question: did the three-pronged approach place excessive emphasis on achieving a short-term balance of payments adjustment, subordinating domestic goals of longer-term growth and better living standards to that of external equilibrium?

The examination of demand management policy design, in light of this fundamental realization, led to the following conclusions:

- The programs included no reliable medium-term budget scenarios;

- The high (even excessive) interest rates served to delay the private investment response;

- The credit ceilings were too rigorous.

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[1] IMF Survey, August 7, 1995, p. 233-236.

[2] Madagascar, The Financial Sector on the Cusp of the 21st Century: Status and Guidelines. This study was funded by USAID, under contract CAER II No. 40, Nov. 2000.

These restrictive demand management measures did not succeed in controlling inflation, particularly when the "programs (…) attached too high a priority to building reserves and preserving competitiveness." Accordingly, the question of anchors was rightly [blank] by the board.

On this subject, two senior staff members from the IMF's Exchange and Trade Relations Department wrote in 1991 that the IMF is increasingly concerned by the fact that a policy focused on maintaining the real exchange rate is liable to deprive an economy of a nominal peg unit and to rekindle inflation, particularly if the country applies a market-oriented financial policy. The authors went on to say that when a policy aims at maintaining a real exchange rate, it is in order to preserve competitiveness and safeguard its balance of payments; but the risk incurred in this instance is that the real rate will be too low—it is in fact difficult to determine the real optimal equilibrium rate, particularly on account of the numerous domestic and external shocks to which it is exposed—and that a nominal depreciation would be primarily reflected in a general increase in prices. The authors noted that this increase could then trigger a further exchange rate depreciation in the case of a policy focused on maintaining the real exchange rate—a depreciation which could usher in an inflationary spiral, followed in turn by further depreciations.

These considerations by the IMF Executive Board inter alia raise issues pertaining to "adjustment and growth" and "adjustment and financing," and they also pose questions with respect to the choice of policy and exchange regime.

However, it would appear that the Board's recommendations and the research conducted within the IMF have been overlooked by the various program missions that have visited Madagascar in turn.

2. Inflation and exchange policy in Madagascar, 1990-99

The following passages are taken from Chapter 5 of the abovementioned study. They assess the effectiveness and scope of the monetary and exchange policies pursued during the period under consideration. The analyses address the following issues in turn: (i) inflation and the exchange rate; (ii) the floating of the FMG; and (iii) the compatibility of monetary and exchange policy objectives with other adjustment objectives.

2.1 Inflation and exchange rate

The inflation rate jumped during 1994 and 1995, reflecting the first two years of the "free float" of the FMG. In fact, these rates were 39 percent in 1994 and 49.1 percent in 1995, as opposed to 10 percent in 1993. The root cause of this upswing in inflation is still a matter of debate.

In 1995, Fund staff put forward the same argument as the one contained in the text in question. They maintained that the rise in prices in 1994-95 was primarily attributable to the Treasury's increased borrowing requirements: "It was realized that these requirements, together with government lending for the import of rice, had amounted to fully one half of

the total money creation in Malagasy francs in 1994. This provided impetus to the nascent view in Antananarivo that general subsidies for basic necessities were not an appropriate way to extend a social safety net, and that it would be more effective to curb inflation through a reduction in monetary growth than to try to mitigate its consequences."[3]

Now, the monetary data (Table 1, below) do not appear to bear out this argument. In fact, they show that in 1994, net foreign assets increased by 3.7 percent, while foreign exchange adjustments (other net items) increased by 87.4 percent, and accounted for almost 57 percent of the increase in M2. The claims on government increased by only 1.4 percent. In 1995, net foreign assets increased by a further 64 percent, while foreign exchange adjustments increased by 102.7 percent, although claims on government declined by 3.1 percent.

The opposing view is derived, for instance, from the conclusions in the study by J. Herrera, who argued that official explanations, in focusing on lax monetary policy and fiscal management, have greatly underestimated the impact of the FMG's depreciation on inflationary drift.[4]

The econometric estimates in this study revealed that in Madagascar, in contrast with other African countries, shifts in the exchange rate have a proportionally greater impact than shifts in the money supply or shifts in credit; in fact, a 10 percent appreciation in foreign exchange leads to a 3 percent increase in inflation, whereas a comparable rise in the money stock will cause a 2.5 percent increase in inflation…"[5]

The same conclusions are also implicit in "monetarist analysis of price formation in Madagascar" [6]as performed by Central Bank staff. It tends to show that inflation is monetary in the long term, but in the short term, the results of the tests of short-term price dynamics have shown that the money supply has no immediate impact on prices; conversely, the depreciation of the exchange rate, neutral over the long term, becomes a highly significant variable;

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[3] IMF Article IV report, April 1995.

[4] J. Herrera, "Dépréciation du taux de change et inflation à Madagascar" [Exchange rate depreciation and inflation in Madagascar], January 1996, Project MADIO, p. 4.

[5] Ibid., pp. 19-20.

[6] "Une analyse monétariste de la formation des prix à Madagascar" [Monetarist analysis of price formation in Madagascar], Rabeantoandro Joé—Economie de Madagascar, Revue No. 3, October 1998, pp. 81-104.

Table 1: Madagascar, Monetary Survey

(in billions of FMG, end-of-period)

	1993	1994	1995	93-94 change in %	94-95 change in %
Net foreign assets	360.3	373.7	616.3	3.7	64.9
Foreign liabilities	-242.1	-169.8	-156.6	-29.9	-7.8
Net domestic assets	1446.7	2135.7	2257.6	47.6	5.7
Net credit to the government	825.3	837.1	811.3	1.4	-3.1
Net credit to the economy	1079.7	1356.5	1563.7	25.6	15.3
Other items (net)	-458.3	-57.9	-117.4	87.4	102.7
Money supply	1564.9	2339.5	2717.3	49.5	16.1
Currency in circulation	378l7	614.5	758.7	62.3	23.5
Demand deposits	659.3	986.5	1083.6	49.6	9.8
Time deposits	507.7	507.8	590.4	0.01	16.3
M2	1545.7	2108.8	2432.7	36.4	15.4
Foreign exchange deposits	19.2	230.7	284.6	1100.6	23.4

Source: Central Bank

2.2 Floating the FMG

Since the Bretton Woods system came to an end, the instability and lasting misalignment of exchange rates have been a cause for international concern. Furthermore, the choice of exchange regime is clearly one of the crucial issues involved in the current debate surrounding the reform of the international financial and monetary system.

Exchange rate instability is recognized to be greater in the current system than in the Bretton Woods system. In order to minimize the constraints in this situation, the floating of the three main currencies in the system (dollar, yen, and deutsche mark—replaced by the euro), is supervised by the G-7. With respect to management of the dollar, we have seen inter alia the Plaza Agreements in 1985 and the Louvre Agreements in 1987, etc. In addition to these special agreements, the exchange rates for these currencies figure regularly in the agendas of G-7 meetings, where the discussions may include certain elements of economic policy coordination.

On the occasion of a conference organized by the committee on the future of the Bretton Woods institutions in 1994, Mr. Lawrence Summers, U.S. Deputy Treasury Secretary, justified this practice, emphasizing that "[A]fter the drastic misalignments of the 1980s that culminated in the crash of 1987, no responsible government official would recommend that exchange rate movements be left entirely to market forces."[7]

Transposed to Madagascar, this international debate on the choice of exchange regime raises questions as to the efficiency of the interbank exchange market (MID), established by decree in 1994, and the compatibility of exchange policy objectives with other adjustment objectives.

2.2.1 Efficiency of the MID

To assess the efficiency of the MID, we must first determine whether the variations in the CMP (weighted average exchange rate) reflect the variations in supply and demand.

We accordingly tested the relationship between the rates of increase in the CMP and the supply of foreign exchange. On the MID, unmet offers are negligible, whereas unmet bids are sizable. Accordingly, in the tests, "supply" is considered equivalent to the volume of transactions, as sellers are virtually assured of having their orders executed.

The tests show that the rate of growth in the CMP is negatively correlated with the rate of growth in the volume of transactions; however, this latter variable is not significant.

[7] IMF Survey of 8/15/94, p. 250.

Unmet bids account for over 90 percent of "best offer bids," which means the buyers are ready to pay any price. Demand is therefore inelastic, which is simply a reflection of the inelasticity of imports.

There is thus a tendency toward continuous depreciation of the FMG in the medium-term, as well as exchange rate instability.

Furthermore, exchange rate instability in the short term creates insecurity in trade and investment. It introduces an element of uncertainty into calculations of the profitability of investments, and consequently acts as a damper on investment, whether in the export sector or in production for the domestic market.

Instability is also fostered by the following factors: (i) interventions by the Central Bank as a buyer of foreign exchange, as it must honor debt service; (ii) irregularity in disbursements of balance of payments assistance; (iii) seasonal behavior of export revenues; (iv) narrowness of the market; (v) a shortage of liquidity, and a lack of instruments for speculation and coverage against exchange risks.

Second, the efficiency of the MID should be assessed in relation to the quest for an equilibrium exchange rate. The "Centre for the Study of African Economies" (CSAE) (Oxford University) undertook research to describe foreign exchange auction systems in various African countries, such as Ghana, Uganda, Ethiopia, Nigeria, and Zambia.[8] The econometric tests included microeconomic assumptions (on the behaviors of auction participants) and macroeconomic assumptions (equilibrium exchange rate). The results of these studies generated conclusions that would be useful in improving the conduct of exchange policy and liberalizing the financial sector in these countries.

However, such research is not available in regard to Antananarivo's MID. Here, determining exchange rate objectives is based on measurements of the real effective exchange rate as performed by staff of the Bretton Woods institutions. This method is simplistic and thus highly questionable.

2.2.2 BOP impact of monetary and exchange policies

It has been pointed out that monetary and exchange policies in effect during the period under consideration focus on BOP objectives. This is entirely as one would expect with IMF-supported programs, as the theoretical assumptions underlying these programs is the "monetary approach to balance of payments" theory, according to which inflation is always monetary and the behavior of domestic credit has a direct impact on balance of payments.

First, however, the equations used in the monetary approach to balance of payments have not been confirmed by empirical studies of African economies. It is clear that the assumptions

[8] CSAE, Research Summary, 1999, p. 80.

used in this approach require a great deal of enhancement in order to take account of the actual functioning of African economies.

In particular, one of the "initial assumptions" in this approach, formulated in the 1960s, is the hypothesis of a zero balance of capital. Now, in the case of a country like Madagascar, this balance is negative, in view of the burden of debt.

Second, the data show that BOP sustainability in these countries results from debt relief measures, not from demand management policies, such as a restrictive credit policy.

In Madagascar, the research (chapter 4 of the study) points to a steady accumulation of arrears during the period under consideration, "mopped up" by several trips to the Paris Club.

Finally, this "debt empowerment" was belatedly understood by the Bretton Woods institutions. The latter took the initiative in support of the severely indebted poor countries (HIPC) in 1996.

2.3 Compatibility of monetary and exchange policy objectives with other adjustment objectives

2.3.1 Monetary objectives and growth target

The monetary policy implemented during the period under consideration, particularly after the introduction of floating for the FMG, was therefore dictated by the IMF's assessment, where inflation was said to be connected with lax monetary policy and fiscal management.

It consisted of a highly restrictive credit policy, based on combined manipulation of the Central Bank of Madagascar's lead interest rate [*taux directeur*] and the rate applicable to the required reserves. The implicit reasoning underlying this approach is as follows: an increase in the lead rate entails an increase in the lending rates of banks, followed by a decline in credit and the money stock, and finally followed by control over inflation.

However, the tests performed on the various links in this reasoning indicate inter alia that this monetary policy remains a "base money" policy, rather than an indirect management policy based on interest rate management. In fact, the tests show the behavior of credit to the economy responds far more to manipulation of the reserve requirement rate than to manipulation of the lead rate.

Now, the manipulation of the lead rate has in fact resulted in a considerable increase in interest rates. The lead rate was 6 percent from 1990 to 1993; it peaked at 33 percent (corresponding to a repo rate of 40) between April 1995 and July 1996. These excessive interest rates strike us as "arbitrary" and "pointless" for several reasons. For one thing, the management of the lead rate does not apply to a financial market in any meaningful sense, because such a market does not yet exist. This explains why these high rates were not followed by banks, and why credit behavior remains determined rather by "base money" than by the level of the lead rate. For another thing, the rate levels (particularly during the period 1994-96) were inconsistent with the anticipated profitability of firms.

These excessive rates thus created high capital costs and had a further weakening effect on firms. The first incompatibility to note, therefore, is between monetary objectives and investment/growth objectives.

2.3.2 Multiplicity and compatibility of objectives

This monetary policy at first seems subordinated to the pursuit of exchange policy objectives. Thus, during the period 1994-95, the restrictive credit policy was aimed at "defending the FMG." Generally speaking, these exchange policy objectives included a quest for competitiveness and "reserve floors." In addition to the above-mentioned constraints on investment and growth, subordinating monetary policy to exchange rate objectives may also create the following contradictions:

- (a) The reserves objectives, dictated primarily by the constraint of debt, may contradict the exchange rate and liquidity objectives. In fact, the Central Bank's purchases on the MID may depreciate the exchange rate, create instability, and increase banking system liquidity;

- (b) Furthermore, it is no easy task to reconcile the goals of competitiveness (attempting to depreciate the currency) and of domestic inflation.

Taking account of the multiplicity of these objectives, the monetary and exchange rate policy pursued during the period under consideration resembles a system with "N" unknowns, but with "N-I" equations. In other words, it is a system with several objectives (inflation, exchange rate, international reserves, etc.) and essentially just one instrument (interest rate manipulation)—or to put it another way, it is a system without solutions. In short, this policy is a perfect illustration of the incompatibility identified by "monetarist theory," i.e., the problems involved in seeking to determine simultaneously the quantity and price of money.

Finally, this policy has resulted in a decline in M2/GDP (financial intensity) and M3/GDP (depth). All in all (and taking account of R. Levine's analysis[9] on the linkages between financial development and economic development, mentioned in Chapter 1), it is also reasonable to raise the issue of the compatibility between monetary and exchange policy and future growth. In the final analysis, it is also possible to question the compatibility between adjustment and growth.

The recommendation consistent with the foregoing analysis is as follows; instead of having rates administered by a "non-market" (the MID), we suggest a return to a managed float, as conducted before 1994, with the following suggestions for improvement:

- The intended objectives should be announced in general terms in order to help firms to have confidence in their planning;

[9] Journal of Economic Literature, October 1997.

- The enhanced staffs of the Central Bank should estimate medium-term and long-term equilibrium rates, [10] in order to clarify the direction of the float.

In support of this recommendation, we might add the following comments:

(1) One of the main points raised by the first external assessment of the ESAF had to do with the sequencing of reforms.[11] A free float would be premature in this instance. It would have to be preceded by a package of reforms, inter alia including measures to strengthen the financial system with concomitant efforts to obtain external debt relief.

(2) This conclusion is increasingly shared by various authors commenting on the choice of exchange regime in developing countries. Thus, in a recent IMF paper on this subject, Paul Masson wrote that "it is unlikely that (…) a perfectly free float (…) is going to be desirable (…). Sustainable free-floating regimes require deep foreign exchange markets, and developing countries typically lack this feature."[12] (In the case of the MID: oligopolistic structure, narrowness of the market, shortage of liquidity, a lack of speculative instruments and market-makers).

(3) By way of information on the various possible options, we find in the new classification which the IMF has used since April 1999 to describe exchange regimes in effect in 185 countries, that as at December 31 1999, fixed exchange rate regimes were the most common, being in effect in 90 countries; 44 countries used a managed float; while an independent float was in effect only in 51 countries, 28 of which were implementing Fund-supported programs.

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April 1

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[10] These staffs could rely on the estimation model prepared by Ghana for the EAGER project, in the context of the study entitled, "Ghana—Monetary, Fiscal, and Exchange Rate Policy" produced by AIRD, under the direction of Dr. Dirck Stryker.

[11] Cf. CSAE, Research Summary, op. cit., p. 79.

[12] IMF Survey, No. 9, of May 15, 2000, p. 149.

Contribution aux discussions sur la conditionnalité du FMI

Cette contribution part de l'idée que les discussions sur l'allégement devrait être accompagnées d'un examen des « policies ».
A cet effet, il semble utile de rappeler les grandes lignes des conclusions du CA du FMI à l'issue de ses sessions de juin et de novembre 1994[1]. Le cas de Madagascar, tel qu'il ressort d'une récente étude réalisée par le Centre d'études économiques de l'Université d'Antananarivo et le John F. Kennedy School of Government de l'Université de Harvard[2], montre que les problématiques soulevées par le CA en 1995 restent d'actualité.

1.Les grandes lignes des constats du CA en juin et novembre 1994

Ces sessions étaient consacrées à l'examen de la « conditionnalité à trois volets » de l' institution. Les améliorations constatées relevaient, principalement, des secteurs extérieur et financier, à savoir : augmentation des réserves officielles et déséquilibre des finances publiques fortement corrigé. Les résultats décevants concernaient aussi bien les objectifs externes qu'internes :

- Sur le plan externe, les arriérés de paiement continuaient de s'accumuler, et les performances à l'exportation étaient faibles ;
- Sur le plan interne, le CA a noté que, d'une manière générale, « l'évolution a été moins remarquable », et en particulier, l'inflation n'a pas été maîtrisée.

Au vu de ces résultats mitigés, le CA s'était posé la question fondamentale suivante : Il « s'était demandé si l'on n'a pas trop insisté dans la stratégie à trois volets sur l'ajustement à court terme de la balance des paiements, subordonnant les objectifs intérieurs d'amélioration du niveau de vie et de croissance à plus long terme à celui d'équilibre extérieur ».

L'examen de la formulation des mesures de gestion de la demande, à la lumière de ce constat fondamental, a abouti aux constats suivants :

- Les programmes ne comportaient pas de scénarios budgétaires à moyen terme et fiables ;
- Les taux d'intérêt élevés, « sinon excessifs », ont eu pour effet de différer la réponse des investissements privés ;
- Les plafonds de crédits ont été trop rigoureux.

Ces mesures restrictives de gestion de la demande n'ont pas permis de maîtriser l'inflation, notamment « lorsque les programmes attachaient trop d'importance à la constitution de réserves et au maintien de la compétitivité ». En conséquence, la question des « points d'ancrage » a été, à juste titre par le CA.

A ce sujet, deux responsables du Département des relations de change du FMI écrivaient en 1991 : Le FMI « est de plus en plus préoccupé par le fait qu'une politique axée sur le maintien du taux de change réel …risque de priver une économie d'une unité nominale de rattachement et de relancer l'inflation, en particulier si le pays pratique une politique financière libérale. Lorsqu'une politique vise le maintien d'un taux de change réel, c'est pour préserver la compétitivité et préserver sa balance des paiements, mais le risque couru dans ce cas est que le taux réel soit trop faible – il est en effet difficile de déterminer le taux réel d'équilibre optimal, notamment en raison de nombreux chocs intérieurs et extérieurs auxquels il est exposé – et qu'une dépréciation nominale se traduise principalement par une

[1] Bulletin du FMI du 7 août 1995, p.233 à 236
[2] Madagascar, Le secteur financier à l'aube du 21ème siècle : Etat des lieux et orientations. Cette étude a été financée par l'USAID, sous le contrat CAER II n°40, nov. 2000

hausse générale des prix. Cette hausse peut alors déclencher une nouvelle dépréciation du taux de change dans le cas d'une politique axée sur le maintien du taux de change réel, dépréciation qui peut être la cause d'une spirale inflationniste, suivie à son tour de nouvelles dépréciations ».

Ces constats du CA soulèvent, entre autres, les problématiques relatives aux couples « ajustement et croissance » et « ajustement et financement », et celle relative au choix de la politique et du régime de change.

Il semble, cependant, que les recommandations du CA et des études réalisées au sein même de l'institution n'aient pas été prises en compte par les différentes missions de programme qui se sont succédées à Madagascar.

2. Inflation et politique de change à Madagascar de 1990 à 1999.

Les passages suivants sont extraits du Chapitre 5 de l'étude précitée, et constituent une appréciation de l'efficacité et de la portée des politiques monétaire et de change mises en œuvre au cours de la période étudiée. Les analyses portent successivement sur i) l'inflation et le taux de change ; ii) le flottement du FMG ; iii) la compatibilité des objectifs des politiques monétaire et de changes et des autres objectifs de l'ajustement.

2.1. Inflation et taux de change

Des sauts de taux d'inflation ont été enregistrés pendant les années 1994 et 1995, correspondant aux deux premières années de fonctionnement du flottement libre du FMG . En effet, ces taux ont été, respectivement, de 39% et de 49.1%, contre 10% en 1993. L'explication de ces « sauts » fait l'objet d'un débat.

Les services du FMI ont défendu, en 1995, la même thèse que celle du texte. Ils ont soutenu que la hausse des prix de 1994-1995 était surtout attribuable aux besoins d'emprunt accrus du Trésor : "Il est apparu clairement que ces besoins d'emprunt, en venant s'ajouter aux prêts consentis par l'Etat pour financer les importations de riz, expliquaient pour moitié la création monétaire totale en francs malgaches en 1994. Cette constatation est venue conforter une opinion qui commençait à apparaître à Antananarivo, à savoir qu'il vaut mieux éviter d'accorder une protection sociale en subventionnant l'ensemble des produits essentiels, et qu'il est plus efficace, au lieu d'essayer d'atténuer les conséquences de l'inflation, de ralentir cette dernière en réduisant la croissance monétaire"[3].

Or, les données monétaires (Tableau 1, ci-dessous) ne semblent pas confirmer cette thèse. Elles montrent, en effet, que, en 1994, les Avoirs extérieurs nets(AEN) se sont accrus de 3.7%, et les ajustements de devises (Autres postes nets) de 87.4%, et ont contribué à près de 57% à la croissance de M2 ; les créances sur l'Etat ne se sont accrues que de 1.4%. En 1995, les AEN ont encore progressé de 64% et les ajustements de devises de 102.7%, tandis que les créances sur l'Etat ont baissé de 3.1%.

La thèse opposée à celle du texte découle, par exemple, des conclusions de l'étude de J. Herrera, selon lesquelles « les explications officielles, en se centrant sur le laxisme de la politique monétaire et de la gestion des finances publiques, ont largement sous-estimé l'impact de la dépréciation du FMG sur la dérive inflationniste »[4].

[3] Rapport du FMI, au titre de l'article IV, avril 1995.
[4] J. Herrera, « Dépréciation du taux de change et inflation à Madagascar »- janvier 1996- Projet MADIO, p.4

Les résultats des estimations économétriques de cette étude montrent, en effet, que « à Madagascar, en contraste avec le cas d'autres pays africains, les variations du taux de change ont un impact proportionnellement plus important que les variations de la masse monétaire ou les variations du crédit. En effet, une appréciation des devises de 10% se traduit par un accroissement du taux d'inflation de 3% tandis que une hausse comparable de la masse monétaire provoquera une hausse de 2.5% du taux d'inflation.. »[5]

Les mêmes conclusions sont, également, implicites dans « l'analyse monétariste de la formation des prix à Madagascar »[6], réalisée par les services de la Banque centrale. Elle tend à montrer que l'inflation est monétaire à long terme, mais, à court terme, les résultats des tests de la dynamique à court terme des prix ont montré que l'offre de monnaie est sans impact immédiat sur les prix ; par contre, la dépréciation du taux de change, neutre sur le long terme, devient une variable très significative ;

Tableau 1 : Madagascar, Situation monétaire (1993-1995)

(en milliards de FMG; fin de période)

	1993	1994	1995	Var 93-94 en %	Var 94-95 en %
Avoirs extérieurs nets	360,3	373,7	616,3	3,7	64,9
Engagements extérieurs	-242,1	-169,8	-156,6	-29,9	-7,8
Avoirs intérieurs nets	1446,7	2135,7	2257,6	47,6	5,7
Crédit net à l'Etat	825,3	837,1	811,3	1,4	-3,1
Crédit net à l'Economie	1079,7	1356,5	1563,7	25,6	15,3
Autres postes nets	-458,3	-57,9	-117,4	87,4	102,7
Masse monétaire	1564,9	2339,5	2717,3	49,5	16,1
Circulation fiduciaire	378,7	614,5	758,7	62,3	23,5
Dépôts à vue	659,3	986,5	1083,6	49,6	9,8
Dépôts à terme	507,7	507,8	590,4	0,0	16,3
M2	1545,7	2108,8	2432,7	36,4	15,4
Dépôts en devises	19,2	230,7	284,6	1100,6	23,4

Source : Banque centrale

2.2. Le flottement du FMG

Depuis l'effondrement du système de Bretton Woods, l'instabilité et le désalignement durable des changes sont l'objet de préoccupations internationales. De plus, dans le débat actuel sur la réforme du système financier et monétaire international, le choix du régime des changes apparaît comme un des volets importants.

Il est reconnu que l'instabilité des changes est plus grande dans le système actuel que dans celui de Bretton Woods. Afin de minimiser les inconvénients de cette situation, le flottement des trois principales monnaies du système, à savoir le dollar, le yen et le mark allemand (remplacé par l'euro), est dirigé par le G7. En ce qui concerne la gestion du dollar, il y eut, par exemples, les « Accords du Plaza » en 1985, les « Accords du Louvre » en 1987, etc…Outre ces accords particuliers, les cours mutuels de ces monnaies figurent régulièrement dans les ordres du jour des
réunions de ce G7, dont les délibérations peuvent inclure certains éléments de coordination de politique économique.

[5] - idem – p.19-20
[6] Une analyse monétariste de la formation des prix à Madagascar- Rabeantoandro Joé – Economie de Madagascar, Revue n°3, Octobre 1998, p. 81-104

A l'occasion d'une conférence organisée par la “Commission sur l'avenir des institutions de Bretton Woods”, en 1994, M. Lawrence Summers, Sous-Secrétaire du Trésor des Etats-Unis, justifiait cette pratique en soulignant “qu'après les énormes distorsions des années 80, qui ont culminé avec la crise boursière de 1987, **aucun dirigeant responsable ne peut recommander d'abandonner entièrement l'évolution des taux de change au jeu des forces du marché”[7].**

Transposé à Madagascar, ce débat international sur le choix du régime des changes conduit à soulever des questions sur l'efficience du marché interbancaire des devises (MID), créé par décret en 1994, d'une part, et sur la compatibilité des objectifs de la politique de change et des autres objectifs de l'ajustement, d'autre part.

2.2.1 Efficience du MID

Evaluer cette efficience revient, en premier lieu, à répondre à la question de savoir si les variations du CMP (cours moyen pondéré) reflètent celles des variations de l'offre et de la demande .
A cet effet, on a testé la relation entre les taux de croissance du CMP et de l'offre de devises. Sur le MID, les offres non satisfaites sont négligeables, alors que les demandes non satisfaites sont importantes. Ainsi, dans les tests, l'offre est assimilée au Volume des transactions, les vendeurs étant pratiquement sûrs que leurs ordres seront exécutés.

Les tests révèlent que le taux de croissance du CMP est négativement corrélée avec celui de Volume des transactions, mais cette seconde variable n'est pas significative.

Les demandes non satisfaites sont, à plus de 90% des demandes « au mieux », ce qui signifie que les acheteurs sont prêts à payer à n'importe quel prix. La demande est, donc, inélastique, ce qui n'est que le reflet de l'inélasticité des importations.

Il en résulte une tendance à la dépréciation continue du FMG, à moyen terme, et une instabilité des cours.
On peut rappeler que l'instabilité des changes crée à court terme une insécurité dans les échanges et des investissements. En effet, elle rend incertains les calculs de rentabilité des investissements, et limite en conséquence ces derniers, aussi bien dans le secteur d'exportation que dans la production pour le marché domestique.

L'instabilité est, en outre, alimentée par les facteurs suivants : i) les interventions de la Banque centrale qui est acheteuse de devises car elle doit honorer les services de la dette ; ii) l'irrégularité des déboursements des aides à la balance de paiement ; iii) la saisonnalité des recettes d'exportation ; iv) l'étroitesse du marché ; v) le manque de liquidité, et l'absence des instruments de spéculation et de couverture contre les risques de change.

En second lieu, l'efficience du MID devrait être évaluée en relation avec la recherche d'un taux de change d'équilibre. Le « Centre for the Study of African Economies »(CSAE), de l'Université d'Oxford, a entrepris des recherches pour caractériser les systèmes d'adjudication des devises dans différents pays d'Afrique, tels que le Ghana, l'Ouganda, Ethiopie, Nigeria, et la Zambie[8]. Les tests économétriques intègrent des hypothèses aussi bien micro-économiques (sur les comportements des participants aux adjudications) que macro-économiques (taux de
change d'équilibre). Les résultats de ces études ont permis de tirer des leçons pour améliorer la conduite de la politique de change et de la libéralisation du secteur financier dans ces pays.

[7] Bulletin du FMI du 15/08/94, p. 250.
[8] CSAE, Research Summary, 1999, p.80

De telles études n'existent pas en ce qui concerne le MID d'Antananarivo. La détermination des objectifs de taux de change s'appuie, ici, sur des mesures du taux de change effectif réel(TCER) réalisée par les services des institutions de Bretton Woods. Cette méthode est très discutable, car simpliste.

2.2.2 Impacts des politiques monétaire et de change sur la balance des paiements

Il a été souligné que les politiques monétaire et de change, en vigueur au cours de la période considérée, visent des objectifs de balance de payement. Il ne peut qu'être ainsi s'agissant des programmes soutenus par le FMI, étant donné que le présupposé théorique de ces programmes est « l'approche monétaire de la balance des payements »(AMBP), selon laquelle l'inflation est toujours monétaire et l'évolution du crédit domestique a un impact direct sur la balance de payement.

En premier lieu, cependant, les équations de l'AMBP n'ont pas été confirmées par les études empiriques se rapportant à des économies africaines. Il est évident que les hypothèses de ladite approche doivent être sérieusement complétées pour tenir compte du fonctionnement réel de ces économies.
En particulier, on peut rappeler que l'une des « hypothèses initiales » de cette approche, formulée dans les années 60, est l'hypothèse d'un solde nul des capitaux. Or, dans le cas des pays comme Madagascar, ce solde est négatif, compte tenu du poids de la dette.

En second lieu, les faits montrent, en effet, que la soutenabilité de la balance des paiements de ces pays résulte des mesures d'allégement de la dette, et non pas des mesures de gestion de la demande, dont la politique restrictive des crédits.
Dans le cas de Madagascar, il a été montré (chapitre 4 de l'étude) une accumulation continue d'arriérés pendant la période considérée, « épongée » par plusieurs passages devant le Club de Paris.

Enfin, cette « autonomisation de la dette » a été tardivement comprise par les institutions de Bretton Woods. Celles-ci ont pris l'Initiative en faveur des pays pauvres très endettés (IPPTE) en 1996.

2.3. Compatibilité des objectifs des politiques monétaire et de change et des autres objectifs de l'ajustement :

2.3.1 Objectifs monétaires et objectif de croissance

La politique monétaire mise en œuvre au cours de la période étudiée, notamment après l'instauration du flottement du FMG, a été, donc, dictée par le diagnostic du FMI, selon lequel l'inflation est liée « au laxisme de la politique monétaire et de la gestion des finances publiques ».

Elle a consisté en une politique très restrictive du crédit, s'appuyant sur la manipulation à la fois du taux directeur de la Banque centrale et du taux de réserves obligatoires. Le raisonnement implicite à la base de cette approche est le suivant : Une hausse du taux directeur entraîne celle des taux débiteurs des banques, suivie par une baisse des crédits et de la masse monétaire, et enfin par une maîtrise de l'inflation.

Les tests qui ont été effectués sur les différents chaînons de ce raisonnement ont fait ressortir, notamment, que cette politique monétaire reste une politique de « base monétaire », plutôt qu'une politique de gestion indirecte, basée sur la gestion des taux d'intérêt. En effet, les tests montrent que l'évolution des crédits à l'économie répond beaucoup plus à la manipulation des taux des réserves obligatoires qu'à celle du taux directeur.

Or, la manipulation du taux directeur s'est traduite par une hausse considérable des taux d'intérêt. Le taux directeur a été de 6% de 1990 à 1993 ; il a culminé à 33%, auquel correspond des taux de pension de 40, entre avril 1995 et juillet 1996. Ces taux d'intérêt excessifs apparaissent, donc, « arbitraires » et « inutiles » à divers égards : D'une part, la gestion du taux directeur ne se réfère pas à un véritable marché financier, dans la mesure où celui-ci n'existe pas encore ; ce qui explique que ces taux élevés n'ont pas été suivis par les banques, et que l'évolution des crédits restent déterminée plutôt par la « base monétaire » que par le niveau du taux directeur ; d'autre part, les niveaux des taux, notamment au cours de la période 1994-1996, étaient sans commune mesure avec la rentabilité anticipée des entreprises.

Ces taux excessifs ont, ainsi, entraîné des coûts élevés du capital et ont davantage fragilisé les entreprises. La première incompatibilité qu'il faudrait soulever est, donc, celle entre les objectifs monétaires et les objectifs d'investissement et de croissance.

2.3.2 Multiplicité et compatibilité des objectifs

Cette politique monétaire apparaît, d'abord, subordonnée à la poursuite des objectifs de la politique de change. Ainsi, pendant la période 1994-1995, la politique restrictive des crédits visait la « défense du FMG » ; on peut rappeler que, d'une manière générale, sont inclus dans ces objectifs de la politique de change la recherche de la compétitivité et des « planchers de réserves ». Cette subordination de la politique monétaire aux objectifs de change peut impliquer, outre les contraintes mentionnées ci-dessus sur l'investissement et la croissance, les contradictions suivantes :

- d'une part, les objectifs de réserves, dictés principalement par la contrainte de la dette, peuvent être en contradiction à la fois avec les objectifs de change et de liquidité. En effet, les achats de la Banque centrale sur le MID peuvent déprécier le taux de change, créer une instabilité, et augmenter la liquidité du système bancaire ;
- d'autre part, la conciliation des objectifs de compétitivité(recherche d'une dépréciation de la monnaie) et d'inflation intérieure est un exercice difficile.

Compte tenu de cette multiplicité des objectifs, la politique monétaire et de change pratiquée au cours de la période étudiée ressemble à **un système à n inconnues, mais à (n-i) équations**, c.a.d. à plusieurs objectifs (inflation, change, réserves internationales…), et pratiquement un seul instrument (la manipulation des taux d'intérêt), autrement dit, **un système sans solutions**. En résumé, cette politique est une parfaite illustration de l'incompatibilité soulignée par la « théorie monétariste », à savoir **la difficulté à vouloir déterminer à la fois la quantité et le prix de sa monnaie.**

Enfin, la même politique s'est traduite, également, par une compression de M2/PIB(« intensité financière ») et de M3/PIB(« profondeur »). Au total, et en se référant à l'analyse de R. Levine[9] sur les liens entre le développement financier et le développement économique (rappelé dans le chapitre 1), la question de compatibilité la politique monétaire et des changes et **la croissance future** peut donc, aussi, être posée, et, en dernière analyse, celle entre l'ajustement et de la croissance.

La recommandation cohérente avec l'analyse précédente est la suivante : à la place de taux administrés par un non – marché(le MID), il est proposé de revenir au **flottement dirigé**, pratiqué avant 1994, avec les propositions d'amélioration suivante :
- les objectifs visés doivent être annoncés dans des termes généraux afin d'aider les entreprises à avoir confiance dans leur prévision ;

[9] Journal of Economic Literature, oct. 1997

- les services renforcés de la Banque centrale devraient estimer les taux d'équilibre à moyen et long termes[10], pour éclairer la direction du flottement.

A l'appui de cette recommandation, on peut ajouter les considérations suivantes :

1) L'un des principaux points soulevés par la première évaluation externe du FASR est la séquence des réformes[11]. En l'occurrence, le flottement libre est ici prématuré. Il aurait dû être précédé d'un **« package » de réformes** incluant, entre autres, le renforcement du système financier et un allégement conséquent de la dette extérieure.

2) Cette conclusion est de plus en plus partagée par différents auteurs qui s'expriment sur le choix du régime de change dans les pays en développement. Ainsi, Paul Masson, dans une récente étude du FMI sur cette question, conclut « qu'un flottement pur n'est sans doute pas opportun dans ces pays. Pour être viable, un flottement pur exige un marché de changes actif, ce qui n'est généralement pas le cas dans les pays en développement.. »[12] (dans le cas du MID : structure oligopolistique, étroitesse du marché, manque de liquidité , d'instruments de spéculation, et de market-makers).

3) A titre d'information sur les **diverses options possibles**, on peut relever dans la nouvelle classification utilisée, depuis le mois d'avril 1999, par le FMI pour décrire les régimes de change en vigueur dans 185 pays que, au 31 décembre 1999, les régimes de change fixes demeurent les plus courants, étant en vigueur dans 90 pays ; 44 pays appliquent des régimes de flottement dirigé ; le « flottement indépendant » n'est en vigueur que dans 51 pays, dont 28 pays appliquant des programmes soutenus par le FMI.

Andrianomanana Pépé
Directeur du Centre d'Etudes Economiques
avril 01

[10] Ces services pourraient s'inspirer du modèle d'estimation élaboré pour le Ghana par le projet EAGER , dans le cadre de l'étude intitulée « Ghana, Monetary, fiscal, and exchange rate policy » , réalisée par AIRD, sous la direction du Dr. Dirck Stryker.
[11] Cf. CSAE, Research Summary, op.cit., p.79
[12] Bulletin du FMI, n°9, du 15 mai 2000, p.149.

From: dani rodrik
Sent: Wednesday, April 25, 2001 6:49 PM
To: conditionality@imf.org
Subject: comment on "Trade Policy Conditionality in Fund-Supported Programs"

The IMF's staff paper on "Trade Policy Conditionality in Fund-Supported Programs" is so utterly misinformed about the actual empirical evidence on the consequences of trade liberalization that one does not even begin where to start.

I shall restrict myself to a brief comment on footnote 5, which cites the usual list of sources on the trade liberalization-growth linkage. The footnote refers to my critique of this literature (in a joint paper with F. Rodriguez), but states that my challenge is based on "technical grounds."

This is an incredible piece of obfuscation. The Rodriguez-Rodrik critique is in fact a very simple one: The studies cited in the footnote have taken variables quite unrelated to trade policy (such as black market premia, policy instability, or geography), have chosen to call them trade policy, and then demonstrated a link between these and growth. The staff may find this a "technical" argument, but I am sure the EDs, given a chance, would realize that one hardly needs advanced training in econometrics to recognize its import and relevance.

The footnote goes on to refer to "many individual country studies which show that well designed and implemented trade reforms have been a crucial element of long term sustainable growth." Two points about this. First, few country studies have in fact been able to identify the effects of trade liberalization separately from the macro stabilization and other reforms that typically accompany it. The inadequacies of the NBER-World Bank-OECD country studies were in fact the reason researchers began to run cross-country regressions in the first place. Second, note the qualification "well designed and implemented." Presumably the ones that failed or did not produce results were not well designed and implemented. The reasoning is conveniently circular.

When ideology substitutes for analysis, the result is bad policy. The Executive Board deserves better than this.

Dani Rodrik
Professor
Kennedy School of Government
Harvard University

A comment on reforming IMF's conditionality

International University of Japan, International Finance Group

May 18, 2001

1. We want to comment on two issues discussed in the summary paper, "Conditionality in Fund-Supported Programs - Overview," one concerning the issue of "ownership of sound policies" and the other that of a need to distinguish conditionalities needed in different circumstances and for different puposes.

2. The issue of policy ownership should be at the center of the argument of streamlining conditionality. We fully support the spirit underlining the Interim Guidance Note on Streamlining Strucutural Conditionality, shifting the emphasis of conditionality from comprehensiveness to parsimony.

3. We feel, however, that the paper does not clearly differentiate two very different types of conditionality: the conditionality that is a part of a structural reform program to be implemented in the long run and the conditionality that may or may not be necessary for a country to overcome the temporary pressure on its currency and foreign exchange reserves. The analysis of the paper on conditionality in the latter situation does not seem to be adequate, particularly in the context of highly integrated global capital markets. Imposing inappropriate conditionality in the midst of a currency crisis could damage the credibility of a government to control economic situation and worsen the effect of such crisis on the economy.

From: TN Srinivasan
Sent: Sunday, May 20, 2001 6:22 PM
To: conditionality@imf.org
Subject: Comment onTrade Policy Conditionality in Fund-Supported Programs

I am pleased that the paper refers in footnote 5 to "a large body of evidence that trade liberalization and trade openness increase the growth of income and output". You might have cited also a paper of David Dollar and Aart Kraay "Trade, Growth and Poverty " and a special study of WTO on Trade, Environment and Growth. You refer to the critique of Rodrik and Rodriguez of this evidence. While they have a valid point that trade policy proxies in some of the studies are not ideal and that econometrically identifying the effects of trade policy when other policies also change at the same time is not simple, their alternative of cross country regressions is no better in addressing the problem. The reason is that there is no theoretical justification for presuming the effect of trade policy changes on growth would be the same across all countries even if controls for other variables. This is why nuanced country studies, such as the NBER studies, with a common analytical framework that allows for country differences to be reflected are more satisfactory. Rodrik and Rodriguez did not convince many with their criticisms of these studies.

I am convinced of the beneficial impact of trade liberalization and openness on growth. BUT I AM NOT CONVINCED OF THE CASE OF CONDITIONING IMF SUPPORT OR ITS CONTINUANCE ON TRADE LIBERALIZATION. STRICTLY SPEAKING AUTARKY IS CONSISTENT WITH "A VIABLE EXTERNAL POSITION AND HIGH DEGREE OF RESOURCE USE", WHICH, ALONG WITH MACROECONOMIC STABILITY, YOU LIST AS THE OVERALL OBJECTIVES OF FUND-SUPPORTED PROGRAMS. PUT ANOTHER WAY, MAINTAINING FULL EMPLOYMENT OF RESOURCES AND A VIABLE BALANCE OF PAYMENTS IS CONSISTENT WITH MANY ALTERNATIVE TRADE POLICY REGIMES INCLUDING A LIBERAL ONE. ADDING MACROECONOMIC STABILITY AS A THIRD OBJECTIVE DOES NOT REDUCE THE APPROPRIATE REGIME TO JUST ONE, VIZ. LIBERAL ONE.

From: Lynda Marquez
Sent: Tuesday, May 15, 2001 1:13 PM
To: conditionality@imf.org
Subject: Message from Tom Willett

Sirs:

The IMF's review of conditionality is to be warmly welcomed as is the decision to invite outside comments. The focus of the Managing Director and Executive Director on the desirability of streaming conditionality is widely supported by international monetary specialists and the staff papers prepared for the review give an excellent background for considering issues of implementation.

I think most outside experts support the philosophy laid out in the Managing Director's Interim Guidance Note on Streamlining Structural Conditionality. I would encourage a narrow interpretation of the Fund's core areas. I especially applaud the idea that Letters of Intent should make a clearer distinction between conditionality criteria and the country's overall policy program. As the staff documents suggest, there are many areas where the Fund can offer valuable policy advice without making this part of conditionally.

I have little disagreement with the content of the staff documents. They are informative and accurately describe the broad state of relevant research. They do not, however, highlight an important area of concern to many experts. As is documented in the staff reports, the success rate of Fund programs is low. What is given insufficient attention in my judgement is that as a result of this, the credibility of IMF programs has become increasingly called into question. This is of special concern because conventional wisdom emphasizes the importance of the IMF seal of approval as a catalytic agent to favorably influence private capital flows.

If Fund programs are not credible than they cannot be expected to have such favorable catalytic effects. There have been only a few studies of the catalytic effects of the Fund programs to date and these have failed to find the positive effects generally assumed. These results may not hold up to the use of improved techniques, but the fact remains that the credibility of IMF programs is being much more widely questioned today than in the past and the Fund's own review of experience with the Asian crisis notes that the Fund's projection were much too optimistic about the effects of Fund programs on private capital flows. Thus I believe that a major priority needs to be given to improving the credibility to IMF programs.

This of course will not be easy. It will require saying no much more often to programs that have a low chance of success. This in turns requires developing a stronger technical capability at the Fund to access the degree of ownerships of programs by the government and the chances of the government being able to effectively implement these policies. It also requires a greater willingness to take the heat of saying no to the initiation of Fund programs. To outside observers there is a seeming puzzle about the behavior of the IMF. Its record of

suspending and terminating programs for non-compliance suggests that it is a tough policeman, but this contracts with its record of agreeing to programs that often seem to have low probabilities of success to outside observers. This is an issue that I believe deserves serious attention.

Sincerely,

Thomas D. Willett
Horton Professor of Economics
Claremont Graduate University
and
Claremont McKenna College

From: Nancy C. Alexander
Sent: Friday, June 29, 2001 5:58 AM
To: conditionality@imf.org
Subject: comments
Short Comment on Conditionality

To the IMF:
1. TRANSPARENCY AND PARTICIPATION. The IMF has become a far more transparent institution in recent years. Whereas the World Bank and its borrowers do not disclose any adjustment-related documents with the exception of PRSC (on a case-by-case basis), the IMF (since the Asian crisis) has urged most of its borrowers to disclose the LOI. This is significant.

[We understand that the forthcoming revision in the World Bank's information disclosure policy may lack any presumption in favor of disclosure of SAP documents (the Letter of Development Policy; the Letter of Sector Policy; the Memorandum and Report of the Presdent). Hence, there may continue to be a vacuum regarding public information about over a third of all World Bank lending. World Bank lending advances the policies prescribed by the IMF. The collective control of information by the IFIs and their borrowers precludes broad-based ownership of SAP-related policies.]

While the IMF has made progress, there are worrisome trends. For instance, much of the meat of the LOIs has migrated to the IMF Reviews, which are not in the public domain. There is growing pressure for compliance with ROSC, which have a strong western bias. And, the stronger emphasis on "prior actions" makes some aspects of the LOI obsolete on arrival. Furthermore, if, following its March 2001 review of conditionality, the IMF cedes more of the domain of structural conditionality to the World Bank, then the universe of undisclosed information will expand. Information that might have been available to the public through the LOI will not be available at all.

We believe that, in releasing the PRSP to the public PRIOR to review by the Boards of the IMF/WB, the institutions set an important precedent. We believe that PRGF Arrangements, PRSCs, SAPs, and other loan instruments should be subject to the same high standards. After all, if these documents are "owned" by the country, domestic constituencies should (at a minimum) provide their informed consent for policies. Adjustment measures which, if disclosed, could jolt the market are the exception - not the rule. And, in some cases, one could make the argument that market behavior should be jolted.

There is a double standard with respect to disclosure. There are arduous G7-led efforts (SDDS, etc.) to disclose information that the markets want and a paucity of effort to disclose information that citizens need for informed participation in their own societies.

One can make the case that, in many cases, citizens lack the capacity to participate in certain macroeconomic decisions. However, when they do not have the information to participate, their capacity withers even further. Experts underestimate the capacity of citizens to provide informed input because information about key policy questions is often provided in English and obfuscated through the use of technical jargon.

It is especially problematic that parliaments and congresses which have jurisdiction over budgetary decision-making should be deprived of involvement -- or even informed consent -- with respect to the decisions taken by the Executive Branch and the IMF.

Citizens are being encouraged to monitor budgetary expenditures. However, they are seldom involved in determining the budgetary envelopes or in decisions about intra-sectoral (as opposed to inter-sectoral) transfers of resources. This derogates the rights of citizens.

The policy trade-offs implicit in the IMF's anti-deficit/pro-surplus and pro-reserve account biases should be subject to parliamentary and citizen scrutiny and debate.

As a public institution, we believe that the IMF should be aware of the way that it facilitates short-circuiting of open and consultative processes in borrowing countries. While borrowing governments can and do abuse the public trust, it is inappropriate for the IMF to facilitate that process.

2. DUPLICITY, FLEXIBILITY AND ACCOUNTABILITY.

Many citizens' groups feel that it is duplicitous for their governments (with urging of the IMF/WB) to invite public participation in framework documents, such as the PRSP. They feel this way because, while the PRSP puts some of the "cards on the table." Many "cards" remain below the "table" as the PRGF is negotiated in a "shadow" process -- a manner cloaked in secrecy. Why should Senegalese NGOs invest their valuable time and energy in the PRSP only to discover that all manner of targets (e.g. VAT rates, privatization revenues, tariff levels, deficit targets) have been established a priori through PRGF negotations? Such a process can also alienate parliaments/congresses from the Executive and polarize political parties and factions. It is a recipe for disillusionment and unrest.

The PRSP is a misconceived initiative in the sense that one document cannot serve two masters: creditors and citizens. Clearly, the interests of these constituencies dovetail, but they are not the same. As countries descend into receivership, citizens know that their rights migrate to the creditors and that borrowers must, by all accounts, tell the creditors what the creditors need to hear. As the Bank's John Page told us in an unguarded moment, "The PRSP is a compulsory process wherein the people with the money tell the people who want the money what they need to do to get the money."

Unlike the PFP, the PRSP need not include the macroeconomic policy matrix. Although the IPRSP must include the matrix, the PRSP need not. In this sense, the PRSP is less reliably transparent than the PFP. At least with the PFP, the public knew which macroeconomic and structural policy commitments their government had made to the IMF and World Bank.

The PRSP gives the appearance of transferring ownership from the IFIs to the borrowers. In effect, it diminishes the potential liability and accountability of the IFIs while ceding little, if any, power to the borrower. As many observers have noted, there is little divergence in terms of policy prescriptions between the PRSPs and the PFPs. (Note the cases of Albania, Benin and Honduras.) Participation without policy flexibility on the part of the IFIs becomes a charade.

When the PRSP was launched, the institutions wrote (Operational Issues paper, 12/99) that they had a "steep learning curve" to traverse in order to formulate macroeconomic and poverty-related policies in an iterative way. This admission was encouraging. We looked for the IFIs to initiate a rigorous internal learning process. Such a process is not, at present, in evidence. Most disappointingly, early evidence shows that the design of impact assessment efforts by the IFIs which, ideally, could facilitate such reflection, is biased. As an anonymous U.S. Treasury Department official commented, they appear to be ideology masquerading as analysis, since potential downsides of policy prescriptions are downplayed, if not ignored.

Furthermore, impact assessment instruments study, rather than involve people. This is an understandable trend. Since information about prospective reforms are not frequently disclosed to

citizens, how could citizens participate in analyzing the impacts of secret reforms and trade-offs implicit in different sets of secret reforms?

It would be heartening to see the IMF engage in open and more objective processes of formulating its policy prescriptions in an iterative way. For instance, the IMF could encourage the preparation by domestic constituencies of "economic options papers," that could stimulate debate and analysis of different sets of policies and, hence, facilitate consensus-building.

3. EQUAL TREATMENT. Increasingly, we see a double standard practiced with respect to low-income and middle-income borrowers. As a public institution, the IMF should facilitate an upward harmonization of policy formulation and implementation standards.

4. IMF AS GATEKEEPER. The IMF's responsibility as gatekeeper is exercised in a problematic way. Because Ethiopia does not "come to heel" by expanding its treasury bill market, should the IMF facilitate the collapse of external assistance to that country? Does such action serve the development interests of Ethiopia or the IMF's more intimate constituencies? Should aid to Honduras hinge on privatization of electricity? Even if it should, should the IMF be the sole arbiter of decisions that can spell life or death for governments that are basically in receivership? Creditors are always coercive; that goes with the territory. However, citizen sentiment can vary from apathy to outrage when the IMF has a veto over wide-ranging policies backed by popular will and parliamentary mandate.

4. NGOs ARE NOT THE ENEMY. Open and participatory processes are very messy. By their nature, participants speak different languages and pursue different interests. Too often, the IMF -- rather than the borrower and its domestic constituencies -- has become the referee and arbiter of domestic policy processes. As Devesh Kapur, Richard Webb, Barry Eichengreen and others have described so eloquently, conditionality has spread and permeated nearly every area of governance.

Citizens' groups experience an outmigration of power and an enhancement of responsibility for compensating for market "imperfections" and for the erosion of state-provided services. Too often, the IFIs facilitate the socialization of private debt in ways that have a massive negative impact on populations. All too often, the IFIs, as public institutions, champion the private sector as a solution for all ills when, objective reality is far more complicated. The U.S. Treasury's trumpeting of the "productivity" theme will, no doubt, serve this myth well. Even if the private sector always possessed the magic bullet, why should the IFIs override public sentiment and veto domestic will?

Global public sentiment is polarizing and taking to the streets. The IMF and its shareholders -- including the G1, G3, G8 -- would be well served if they sat at more tables with respect for the public trust as well as private interests. [The "public trust" is construed here as extending beyond the finance ministry.] Ultimately, until there is more equal power sharing among players in the development and finance games, polarization is likely to increase. "Participation" in the context of current power sharing arrangements seems to be having a backlash effect because it smacks of tokenism.

Nancy Alexander
Globalization Challenge Initiative

INSTITUTO LIBERTAD Y DESARROLLO DEL ECUADOR (ILDE)[1]

REFERENCE: **COMMENTS ON CONDITIONALITY IN FUND SUPPORTED PROGRAMS: AN OVERVIEW**

Germán Cárdenas[2]**, Executive Director**

I would like to make a few brief comments on the above-referenced matter.

(1) Within the context of Ecuador and the globalized economy, it is important to stress that:

(a) macroeconomic stability is key; (b) sectoral policies are key; (c) the agricultural sector is key; (d) openness to trade and private investment is also key; (e) education, health, nutrition and family planning are key to sound economic development and the promotion of more equitable economic growth to reduce poverty; (f) finally, protection of the environment through clean production technologies is also key in the light of the Free Trade Area of the Americas.

> Therefore, we believe that conditionality should address all of these issues and the intervention of the IMF should be based on the track record of a particular country as far as compliance with previously agreed to conditionality in stand-by arrangements. That is, how compliant has this country been in the enforcement of agreed to conditionality, including structural reforms?

(2) The increase in conditionality over the last 20 years, in the case of Ecuador, has been due to the fact that economic growth needs to be an explicit policy objective of the GOE to reduce poverty levels. Thus, the supply-side of the economy must be strengthened and structural reforms to achieve this goal have to be designed so that the country's ability to deliver on its macroeconomic policy objectives become more efficient[3]. However, Ecuador has only completed one stand-by arrangement with the IMF, in the last 20 years. Compliance with IBRD sector loans has also been lax.

(3) Ecuador's development strategy must redefine the role of the state, enhance private sector-led growth, strengthen the delivery of basic public services, protect the poor from the impact of the recession, achieve macroeconomic adjustment through improvement of fiscal and financial public sector management and implementing key structural reforms for sustainable development and poverty reduction.

(4) We therefore feel that both the IBRD and the IMF should act together – the IMF at the macro level and the IBRD at the sectoral level – to collaborate in implementing the GOE's Letter of Intent, where specific conditionality would be chosen by the GOE for each institution.

(5) Finally, the environmental impact of macroeconomic adjustment and structural reform should also be taken into account.[4]

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[1] See Attachment I.
[2] Former IBRD Alternate Executive Director, 1980-82.
[3] See Attachment II.
[4] See Attachment III.

ATTACHMENT I

THE LIBERTY AND DEVELOPMENT INSTITUTE OF ECUADOR (ILDE) Error! Bookmark not defined.

A. INTRODUCTION AND COUNTRY OVERVIEW

ILDE is a non-profit, non-governmental organization (NGO) which aims to actively participate in the promotion and implementation of a sustainable socio-economic and political development agenda in Ecuador.

At present, Ecuador is at a critical juncture in its development path, where it must move away from its older import-substitution development strategy to a more export-oriented one, based on a market economy, private investment, a reduced role for the state and modernization and privatization of state-owned enterprises. This phase of Ecuador's development process requires the interaction of a comprehensive set of political and economic players, long term continuity, low public visibility and very high technical and administrative complexity. The political costs implicated by the transformation of the economy and thus, the losses for specific interest groups are quite high. A major challenge during this process requires the transformation of the middle strata of the public bureaucratic sector, the target group through which the implementation of macro development strategies depends in the long run. Macroeconomic reform in Ecuador is fragile and lacks deep support of the Ecuadorian population because the benefits of these reforms have not as yet been fully realized and because there has been limited progress on social, environmental and democratic reforms.

The multilateral development institutions coincide in the importance of providing better opportunities and access to social services to the poor, and in the importance of social development policies and in improving developing countries' effectiveness in social investment and protection of the environment. Thus, a successful development strategy for Ecuador must be based on growth with equity. The next five years will be a period of encouraging and helping to implement major structural reforms in the social sectors, including protection of the environment and implementing reforms that strengthen democracy as well as deepening and consolidating economic liberalization measures.

Finally, there is increasing awareness in Ecuador that a country's economic and social reform process cannot be accelerated and deepened without more progress in strengthening the ability of democratic institutions to govern with greater coherence and credibility. Reforms that support 'good governance', including constitutional reforms, and improve the ability of democratic institutions to formulate and implement social and economic reforms are urgently needed.

B. OBJECTIVES OF THE NECESSARY ECONOMIC AND SOCIAL REFORMS

(1) Social Policy Reform

Development and initial implementation of a coherent social policy reform agenda including in education, housing, health, nutrition, protection of the environment, social security, municipal development and decentralization and the elimination of poverty. Five of the elements that must be applied in the agenda are:

(a) Targeting of government subsidies and expenditures to the poor.
(b) Cost recovery and greater efficiency in the implementation of social sector expenditures.

(c) Rationalizing the respective roles of the public and private sectors, with the public sector practicing a more normative role.
(d) Decentralization of the administration and provision of social services.
(d) Privatization, i.e. increased reliance on private for profit and not-for profit entities for the delivery of services.

(2) Economic Reform

Continued support of stabilization and structural adjustment with the aim of completing implementation of the present Administration's (and those following) macroeconomic reform agenda and the attainment of a sustainable development strategy for Ecuador. In this area, the following four points should be given priority:

(a) Achievement of policy and institutional reforms to benefit the creation and growth of micro, small and medium-scale enterprises, to permit mobilization of savings and greater access to credit, technical assistance and training services. Including land titling programs, in urban and rural areas with specific projects for the Indian population.
(b) Reform and enforcement of private property rights as a necessary condition for economic growth and improvement of Ecuador's investment climate.
(c) Preparation of a policy and legal framework for accession to NAFTA or the FTAA.
(d) Promotion and generation of internal savings through the adoption of tax reforms and also, reform of the pension and social security systems.

(3) Environmental Reform

Adoption and implementation of a sustainable development strategy for Ecuador in which unsound environmental practices, which discriminate against the poor, reduce economic efficiency and waste budgetary resources, are reduced or eliminated through:

(a) Reduction and eventual elimination of policies (taxes, subsidies, quotas, and public projects) that distort well-functioning markets or exacerbate market failures.
(b) Correction or mitigation of market failures through interventions that improve the functioning of the market or result in outcomes superior to those of the free market.
(c) Internalization of environmental, social, and other side effects of public projects and sectoral and macroeconomic policies.
(d) Costing externalities produced by the urban and industrial sectors that contaminate and destroy the country's environment.
(e) Protection of the environment through enforcement of existing regulations and adoption of reforms or additional measures in areas where environmental policy is lacking or absent.

(4) Democratic Reform

Achievement of Ecuadorian consensus on measures and strategies for strengthening democratic processes, including constitutional reforms, in order to address the political fractionalization which has impeded progress in social and economic development.

CENTRE FOR ENVIRONMENT CONCERNS

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Comments on Background Papers on Conditionalities

It is to be recognised that the dialogue with civil society is being held in the background of the failure of the policies imposed by IMF on poor countries in the form of conditionalities. As such this exercise of interaction with civil society should not end as an exercise to legitimise the conditionalities. In stead, this should result in evolving of alternative framework that will genuinely address the problems faced by the poor countries.

In this context we offer some comments on the background papers on conditionality. Hope it will merit your attention.

The link between the approval or continuation of the Fund's financing and the implementation of specified elements of economic policy by the country receiving this financing—is a salient aspect of the Fund's involvement with its member countries. This link is considered to be two sides of a common response to external imbalances. This implies that successive tranches of financing are delivered only if key policies are on track. Even more important implication of this conditionality link is that these conditionalities are the solutions to the problems faced by the countries. This is highly questionable.

The problems faced by different countries differ though they ultimately result in the BOP crisis. So the solutions to these problems should also be as varied and diverse. But the IMF has a single set of conditionalities to stabilise the situation. In stead, funding by the IMF should be based on the needs of the respective countries, and the policies to be taken up should be the prerogative of the countries, and the link between the funding and conditionalities should not be there.

Further, experience of the various countries that had accessed funding from IMF with the accompanying conditionalities is that these conditionalities instead of saving the countries further pushed them into more severe problems. This shows that the set of policies based on the conditionalities imposed by the IMF do not hold answer to the problems faced by the countries. There is need to look beyond or away from the policy orientation on which IMF’s conditions are based. In other words there are more than one answers to the problems faced by the poor countries and it is not logical or justified to force a single set of policies in the form of conditionalities on these countries.

Another important issue related to this is that most of the BOP related problems faced by the poor countries are because of the exogenous conditions which are beyond the control of these countries. In fact these conditions should be examined rather than imposing a cure all prescriptions on them. These exogenous conditions include the protectionist barriers erected by the developed countries, and the new international trade regime (WTO) which rules are framed in such a way that these poor countries are always in debt bondage. If IMF is serious about saving the poor countries from recurring debt it should seriously consider about addressing itself to these issues.

While the IMF’s discussion document on Conditionality recognises tensions between the desire to cover aspects of policy central to program objectives and the importance of minimizing intrusion into national decision-making processes, it does not recognise other alternatives. A specific set of conditionalities are imposed with the belief that these would solve the imbalances besetting the poor countries. But the experience show that these conditionalities instead of solving the problem they

further accentuated them. These conditionalities in no way ensure that the financial conditions of the poor countries will improve enabling them repay the funds borrowed from IMF. Instead, The sovereign guarantee should address the element of repayment. Imposition of conditionalities amount to violating the sovereignty of the countries. The adoption of principle of parsimony in limiting performance criteria to the minimum number needed to evaluate policy implementation is no answer to the violation of sovereignty of the member countries. IMF should do away with conditionalities and respect sovereignty of the member countries. The countries should be left free to choose the type of policies that they want to follow in their own interest.

The explicit purpose of the structural conditionalities was said to be "the alleviation of structural imbalances and rigidities" in low-income developing countries, "many of which [had] suffered for many years from low rates of economic growth and declining per capita incomes." In the discussion note it was stated that the Fund has over time placed increasing emphasis on economic growth as a policy objective, with the recognition that raising growth on a sustainable basis requires strengthening the supply side through structural reforms. In other words the Fund recognised that there is one and only one set of policies which could take the poor countries on development path. The hitherto experience shows that this is not correct and there are various paths to development given the concrete conditions of the countries. It is fraught with dangerous implications to constrain the choices of policies available to the poor countries.

Also, when the policies imposed by IMF failed to produce desired results the Fund did not take the responsibility for that, but further burdened the poor countries with even more retrograde policies. If the IMF thinks that its policies are sure remedies for the ills faced the poor countries it should not have insisted on sovereign guarantee or on the converse it should not have imposed its own set of conditionalities. But unfortunately it imposed both these without taking any responsibility for the outcome. It is highly despicable.

These days ownership of policies by the national governments has become the watchword. This has only added to the problems. Before this new policies as imposed by IMF were being implemented as the programme funding goes on. But now the poor countries are made to follow the set of policies even before the funding started as an indicator of the national government's ownership of these policies. These days the poor countries in need of external funds claim the ownership of these policies. This ownership does not arise from their understanding of its correctness but from their understanding that without this claim they cannot please the Fund establishment.

The signing of the Letter of Intent by the prospective countries is a case in point. Though the Fund claims that " an LOI is not a commitment to the Fund, but a statement of the policies the authorities intend to implement", in fact the LOI presents the full sweep of the authorities' policy program that in advance mirror the conditionalities being imposed by the Fund. The following passage from the discussion document clearly show the Fund's stance: " A solution would be either to limit the LOI to those policies that are being monitored by the Fund, or ensure that LOIs include a section that delineates precisely which aspects of the authorities' program actually constitute conditionality. Moreover, it may be desirable simply to end the practice of including detailed matrices of policy actions in LOIs; in most cases, the Fund's financing hinges on only a small subset of the measures in such matrices". Once the conditionalities are done away with there would be no need for these elaborate LOIs.

The Fund is more concerned about its policies rather than developing democratic institutions in these poor countries that will evolve policies owned by these countries.

In monitoring the implementation of the conditionalities the distinction between steps and outcomes is blurred. For it steps taken are themselves outcomes of the programme. To quote the discussion document, " One solution to the perception of micromanagement would be to rely to an increasing degree on results-based conditionality: making the Fund's financing conditional on the achievement of specified outcomes—such as bank recapitalization, or improved tax enforcement, or foreign

exchange market liberalisation—rather than on the steps toward those outcomes". In fact measures like bank racapitalisation and foreign exchange market liberalisation are the steps taken to improve the financial condition of the said country. But here the instead of the financial condition these steps are treated as outcomes. This is another instance of the Funds obsession with the correctness of its conditionalities. The monitoring or reviewing of the funding programme should be more concerned about whether the financial condition of the respective countries improved rather than the implementation of a specific policy matrix.

May 18, 2001

To: International Monetary Fund
Re: Conditionality Review
From: Marie Dennis
Director, Maryknoll Office for Global Concerns
Chair, Religious Working Group on the World bank and IMF

Four years ago, in a statement entitled *Moral Imperatives for Evaluating Structural Adjustment and Economic Reform Measures*, hundreds of religious leaders declared:

> **"Economic decisions - by individuals, institutions and governments - involve moral choices and are subject to moral accountability. Our faith traditions insist that public policies be shaped and evaluated according to the standards of God's love and mandate of justice."**

The *Moral Imperatives* statement was a faith-based critique of the economic policy changes required of developing countries to qualify for debt relief or new loans. The statement was rooted in reports from our partners in the global South and our own observations that conditions for many impoverished people around the world were worsening as a result these policies.

In a similar statement last year entitled, *A Moral Assessment of Progress Toward Jubilee,* we addressed the status of economic policy prescriptions attached to debt relief as expressed in the then-new Poverty Reduction Strategy Paper (PRSP) process. There, and in a recently issued (May 2001) statement, *Global Economic Policy and the Restoration of Right Relationships*, we identified concerns that we believe are relevant to the current IMF review of conditionality. Thus we include them here for your consideration.

1. We were told that under the new framework, poverty reduction would in every instance take precedence over economic policy reform. We assume that reforms associated with trade, investment, privatization, monetary policy, financial-market policy, labor-market policy and other measures that have constituted structural adjustment programs will be reevaluated and eliminated if they impede progress toward poverty reduction, even more so if they themselves worsen the situation of people living in poverty.

2. We were told that decisions would be made in a transparent manner and that people in local communities would be participants in the design of national poverty reduction plans. We believe that "participation" must move beyond “consultation” to include real power in decision-making, implementation and evaluation of poverty reduction strategies, including debt cancellation and economic reform measures. Sufficient resources must be made available to local communities to make such participation possible for all levels of civil society.

3. We were told that assessment of the social and environmental impact of policy reforms would be an integral part of decision-making about the suitability of any such reforms prior to and during implementation. We believe that this must include the identification and termination of adjustment programs that have deepened unemployment, lowered wages and job security, destroyed small businesses, undermined food security, increased the burdens on women and undercut government’s ability to protect the environment.

4. We were told that countries emerging from overwhelming debt and poverty would not be held to a rigid model of economic life, but would be able to adapt economic policy decisions to their specific social, cultural, economic and environmental contexts. We insist that this is essential. Policy prescriptions designed and imposed by outsiders are bound to ignore the varied nature of multiple

local realities. The set of policies thus far forming the basis of structural adjustment programs have been a disaster for poor people.

5. We were told that savings from debt cancellation would be used for poverty reduction. We believe the best assurance that debt cancellation will benefit ordinary people lies in the empowerment of local communities to hold their own governments accountable.

Much has been said in the past few years about the need for a Jubilee. Overwhelming evidence has pointed to grave deficiencies of the global economy in protecting the dignity of millions of people and providing for their most basic needs. One significant expression of this concern has been the global effort to address the crushing debt burden exacerbating this reality. But the moral trajectory of the Jubilee imperative goes way beyond the cancellation of debt to emphasize the restoration of right relationships among people (individuals, communities, nations), between human beings and the rest of creation, and between human beings and God. Our inability or unwillingness to eradicate poverty or reach basic accord on how to protect the integrity of creation -- and the ominous specter of pandemic disease, especially among the most impoverished communities -- compel us as people of faith to probe more deeply the meaning of right relationship in our own times.

While we have taken a significant first step toward debt cancellation, the pursuit of right relationships requires that much more be done. This includes a serious examination and revision of economic policy prescriptions that worsen poverty and environmental destruction. We believe that structural adjustment conditionality as currently constituted must end and any economic policy reforms must be chosen through the democratic participation of the citizens of the reforming countries, with special attention to the voices of the poor.

By our faith we are committed to protecting the dignity of each human life and enhancing the integrity of creation. In our reflections on jubilee we have renewed our determination to help make right the unjust relationships between human beings, societies and the rest of creation. We will evaluate all policy proposals and decisions in this light.

Thank you for this opportunity to comment.

Prague, May 16, 2001

Thank you for your confident to our organization. We will try to present our opinion of discuss topics of IMF Executive Board:

1. We think the policy of IMF would be based always on the principle sustainable living. This is the most main criterion of all main ones. It would be supported that projects which are a part of long-term strategies and which consider not short-term economic effects but mainly all life aspects in concrete aera.
2. The government of "a country that lacks a strong commitment to policies needed to achieve a sustainable external position" , has usually another priorities than groups of people which are building a civic society. This people contribute to building a sound society voluntary and in primitive conditions. Their contribution is very often more valuable than bad decisions of good paid politicians. That is way the financial support of IMF would be focused on this group or would be consulted with them at any rate.
3. The Fund can "play a more supportive role in helping countries build ownership of sound policies" only by the support of valuable projects (see point 1), of civic society and of independent media.

We are sorry for our English. We hope our comment is understandable. We are looking forward to our following cooperation.

Sincerely yours

Jitka Herrmannová and Rut Kolínská

Network of Mother Centres in Czech Republic

CENTER FOR ENVIRONMENTAL PUBLIC ADVOCACY/FRIENDS OF THE EARTH-SLOVAKIA

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No. of pages: 2

Re.: Comments on review of conditionality papers

May 19, 2001

We agree with the concern of the IMF that conditions attached to Fund-supported programs are ineffective and in most cases include the promotion of structural reforms that are outside of the institute's mandate. Therefore, we would like to further comment on issues surrounding conditionality as was requested in the letter addressed to us from Mrs. Simonetta Nardin dated May 3, 2001.

It is first necessary to explain that, for more than a year, we have been in communication with the Fund and requesting the release of vital documentation on the activities and operations of the IMF in Slovakia. Such documents we are requesting include:

- complete Article IV Consultations and their supporting documents, including staff reports and staff appraisals;
- Copies of all agreements between Slovakia and the IMF including loan reviews and loan approvals including the conditions attached to such agreements;
- Letters of Intent;
- Memorandum of Economic and Financial policies or Policy Framework Paper;
- detailed summaries of Board discussions of Slovakia's Article IV consultations;
- formal or informal recommendations submitted to the Slovak government as a result of IMF missions to Slovakia over the last couple of years, as well as IMF summaries / evaluations of how these recommendations have been implemented by the Slovak government;
- review of the responses of the Slovak government related to all recommendations of the IMF missions including a review of all measures taken to implement these recommendations, e.g. in legislation, sectoral policies, etc.

These are the very same documents that outline the conditions established by the IMF for Slovakia. As of yet, the IMF has been completely unwilling to release this information to us and therefore we have little ability to effectively participate in a "review of conditionality" when we lack the basic materials to analysis.

This situation indicates two contradictory elements in IMF procedure. First, the IMF agrees that conditions for adjustment programs have a great importance and impact in a country of operation, yet the substance of these conditions are not released to civil society. This means that the IMF effectively disempowers citizens to act on their own behalf.

Second, the IMF continues to ask for feedback from civil society on its operations, yet it will not respond to the request of NGOs to release documentation. This conflict in policy implies a shallow attempt by the Fund towards transparency when in practice the institution remains closed to public oversight.

Nevertheless, although we are unable directly comment on the effects of IMF structural conditions in Slovakia, there are several general comments we can make regarding this review. In reference to a previous point, the IMF should refocus on its original mandate of economic surveillance and short-term lending for countries with immediate balance-of-payment problems. Such short-term lending should not include the type of conditionality associated with conventional structural adjustment programs, but should include measures dealing only with the immediate redress of the balance-of-payments crisis.

The streamlining of conditionalities will not in itself eliminate the negative impacts of IMF policies imposed on countries. On the contrary, such an exercise will result in the more efficient implementation of these policies that have devastated the livelihoods of people around the world. In order to establish a "good set of conditionalities" an entirely new design for the process in which these conditions are formed must be developed. Primarily, the standardized implementation of conditions despite the particular situations of individual countries must be stopped. In addition to this, full public participation is absolutely necessary in order to develop an original approach to each country. This means that conditionality is not decided behind closed doors but is open to public discussion and ultimately agreed upon in the public domain.

In addition to ratifying the process in which conditionality is decided, we make several other recommendations to the IMF:

1. The Fund should consider conducting thorough environmental and social impact assessments of past IMF programs to gain a comprehensive understanding of the effects of conditionalities.

2. The lessons from such assessments must be implemented into new policies.

3. The IMF must establish a strong and binding information policy to ensure transparency in operations and full information for effective public involvement.

4. The IMF must establish a strong and binding policy on public participation to ensure the highest quality of projects, including conditionalities.

The Center for Environmental Public Advocacy welcomes a discussion with the IMF on any of the above issues. Please contact us with further questions or comments.

Sincerely,

Jennifer Kalafut
Economic Program Coordinator

From: Kazimir Karimov
Sent: Monday, July 02, 2001 4:05 AM
To: conditionality@imf.org
Subject: Re: Contacts

Sorry for delay reply, I was outside of Bishkek and returned only on 30 June.
In this connection I send you my general comments concerning Kygyzstan.

Our organization repeatedly undertook efforts on realization transparancy and wide informing of a public. These problems detailed were discussed recently on 9 Economic Forum OSCE in Prague in May of this year, where I took part.

Especially it is necessary to allocate section fiscal trancparency, which is necessary would be more active to introduce in Kyrgyzstan. Here there are many opportunities for the critical remarks and discussions.
The precise maintenance of a transparency in budget-imposition sphere for Kyrgyzstan is a business of the far future. The creation in Kyrgyzstan of a precise legal and administrative basis of management is a very duly step, but it will meet many difficulties. It is desirable to organize a number of seminars with participation of all parties.
The basic wishes:
1. At allocation of means IMF it is necessary to Kyrgyzstan to require of managementof republic to organize wide discussion of the projects with participation of a public.
2. The representatives NGO's should participate in commissions on distribution of the received means and to supervise their movement. It should be by one of conditions for government at allocation of money.

In the whole information is very good and interesting, but the ways of its realization will be various for the different countries.

Prof. Kazimir A. Karimov
President of Environmental Protection
Foundation of Kyrgyzstan

Comments on the IMF staff's review of conditionality

We welcome the opportunity to comment on the review of the IMF conditionality and that comments are considered by the staff and the Board of the Fund.

However, it is difficult to comment on a subject which we think is basically flawed in its foundations. We see a fundamental contradiction between the principle of „ownership" (which in our perception means that the development of a country is designed entirely by the government and the people of that country) and the principle of „conditionality" (which means that certain conditions which are decided by an outside institution have to met). We therefore disagree with the argument that ownership is an essential foundation for conditionality. 100 % country ownership will never be possible vis à vis the presence of (IMF and donors') conditionalities.
We think that this „misunderstanding" is based in the „traditional interpretation" of the IMF that „conditionality is introduced to ensure that the Fund's resources are used for their intended purpose." (IMF, „Conditionality in Fund-Supported Programs – Policy Issues", February 16, 2001). But as the Fund deals with the whole development program of a country (especially those countries who have to design a PRSP) and as the Fund's approval of a program is a clear sign to all other donors (and has thus a leverage effect), conditionality is not restricted to the use of the Fund's resources alone.
It has been agreed that LoI should make a clearer distinction between the countries' own policy programme and the part of the programme subject to the Fund's conditionality. It seems to us that this might be a first step in the right direction as has been outlined above.

Moreover, much of IMF lending is due to financing the repayment of old loans. Especially in the case of overindebted countries (which are not identical to the 41 HIPCs) multilateral debts remain high and are even increasing. Much of these piled up debts goes back to lending for past policy reforms that have not been not led to the intended outcome (balance of payments stability, sustained growth rates, reduced indebtedness) neither to significant poverty reduction.
A review of conditionality should therefore envisage to implement an urgent revision of those reforms. There should be enough flexibility to accept reform programs that are not necessarily based on the traditional IMF recipes. This would be possible if the IMF support is directed towards outcome (or an „outcome conditionality" where the goals but not the ways that lead to them are supported).

Debtor countries have very little influence within the IMF. Therefore, a precondition for a fundamental discussion on conditionality is a reform of the present voting structure towards a more democratic decision taking, where interests of creditor **and** debtor countries are taken into account.

As further improvements we would see the following next steps (this would of course not lead to a solution to the fundamental contradiction between ownership and conditionality):

- the IMF should concentrate on areas of its core expertise, reforms like eg. labour reform should not be conditions of IMF-lending.
- The IMF has significantly increased its surveillance functions and has shifted into devising and monitoring various codes and standards. We think that it is vital for poorer countries that those standards remain voluntary.

- programme documents should be released in draft form in order to be discussed by parliaments and civil society
- staff monitoring reports which go to the Board should be made public
- monitoring mechanisms should not impose additional burdens on government capacity
- processes must be established to effectively reformulate programmes as necessary
- In special situations, eg. financial crisis, there might be a need for a „standstill" of reforms, too hasty reforms may do more harm than help improve the situation.

Karin Kueblboeck, Austrian Foundation for Development Research,
Martina Neuwirth, Jubilee 2000 Austria

Vienna, May 2001

Conditionality and Ownership: A View from the Periphery.

By Ibrahim Haruna Lipumba, Dar es Salaam, May 15, 2001

Introduction.

The increasing transparency of the IMF and its decision to seek opinions from outside the institution on the issues of conditionality is highly commendable. I particularly appreciate the current Managing Director vision to focus and streamline conditionality in order to give greater scope to national ownership of policy reforms. In 1983 conference proceedings on IMF conditionality (Williamson ed.), Mikesell who thought IMF conditionality were not tough enough had a section of his paper titled "Judging IMF Conditionality Packages without seeing them." Letters of Intent that are still not easily available in member country government publications outlets are routinely posted on the IMF website. The PIN on the IMF Board discussion of conditionality and Masood Ahmed press briefing has provided ample information on the thinking that is going on in the Fund. The information and communication technology is providing an opportunity even for us in the periphery to follow discussions in the center with much ease. The IMF website is one of the most easily accessible even in our slow Internet cafes in Dar es Salaam.

The four staff papers on IMF conditionality have ably reviewed the increase in structural conditionality in IMF programs contrary to the instructions of the 1979 Guidelines that wanted IMF staff to reduce the number of conditionality and focus them on measures that are necessary for the attainment of program objectives mainly the improvement of balance of payments and reduction of inflation.

My comments on streamlining and focusing conditionality will relate more to ESAF/PRGF countries. I will not analyze structural conditionality of mega borrowers whose balance of payment problems were mainly related to the liberalization of capital account under a perceived fixed exchange rate regime. I was of course intrigued by the conditionality to remove the Indonesia clove monopoly when in Tanzania the IMF never touched the Zanzibar clove monopoly that caused a large decrease in clove production in Zanzibar which contributed to the increase in clove production in Indonesia.

The Debate is too narrow!

Unfortunately, the views on conditionality that the IMF is seeking are too narrow. They are confined to the link between fulfilling policy conditions of structural nature and access to fund resources and not on the appropriateness in policy conditions in the first place. The conclusions on the link between conditionality and disbursement of funds will dramatically differ depending on whether there is a consensus on policies recommended by the IMF or not. If policies are inappropriate for attaining balance of payments equilibrium with growth, conditionality is outright harmful. On the other hand if policies are correct and will help in attaining government objective of macroeconomic stability

and growth, conditionality may be benign or superfluous in countries where governments own policy reforms and development agenda.
The debate is also narrow for focusing mainly on structural conditionality and leaving aside traditional IMF performance criteria particularly credit ceilings that are usually derived from the Polak (1958) model. If the objective of a Fund program is to attain an improvement in the balance of payments in countries that face structural supply constraints the use of "quantified credit ceiling and other performance criteria are literally indefensible" (Killick 1995, p.144). Does the IMF still require quarterly credit ceilings for a PRGF country such as Uganda that has attained and maintained single digit inflation since 1994, its currency is convertible and exchange rate market determined and the legislation for and practice of Central Bank independence is in place, and has privatized state owned commercial banks?

Rationale for Policy Conditionality.

The rationale for policy conditionality are given in the IMF Articles of Agreement that defines one of the main objective of the Fund is "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 or international prosperity." The policy conditions the IMF attaches to its loans are seen as the "adequate safeguards" this clause refers to. The policy conditions are seen "analogous to the physical or financial collateral that a private lender might demand."(Fischer 2001). Under normal circumstances if the policy conditions are respected the borrowing country balance of payments will improve and will be able to pay back the Fund and therefore safeguard the revolving credit union character of Fund resources. In practice this is largely a myth. Countries repay the Fund even when their balance of payments have not improved because of the implicit and explicit seniority of IMF debt and the dire consequences in terms of access to private capital market and bilateral official development assistance, for those countries that accumulate payment arrears with the Fund. Countries with large debt payment arrears with other creditors have continued to service their IMF debt.

For many poor countries particularly in Africa with continuous or intermittent stabilization and adjustment programs for the past 15-20 years, temporary availability of IMF funds is more of an accounting gimmick. For poor African countries the role of the IMF is not providing temporary funds for a short-term balance of payments crisis but to provide a seal of approval that allows a country to access to bilateral and multilateral official development assistance and to attract foreign direct investment. Even at the beginning of a program the net resource transfer from the IMF rarely accounts for more than 5 percent of a country's total imports of goods and services. Net transfer from the IMF to Uganda as a percentage of that country's imports was the highest in 1992 at 5 percent during 1986- 1997. A similar Tanzania is 4.3 in 1992. For the PRGF countries the role of the IMF is not simply to provide short term balance of payment support for countries implementing aggregate demand reducing policies but more important to assist

a country to put in place an institutional framework for sustainable macroeconomic stability that is indispensable for supporting long term growth and poverty reduction.

Reasons for the increase in the number of policy conditionality.

Prior to the 1980s, the IMF used the argument of political neutrality to justify the use of aggregate monetary variables as performance criteria. C. David Finch (1983), a senior staff member of the IMF in the 1980s argued "The principle of political neutrality has an important bearing on another aspect of the Funds approach, the use of aggregate variables as one of the instruments of control in programs of adjustment. This program evolved in large part from the desire to place as much distance as possible between the sphere of influence of the Fund and specific decisions relating to policy implementation. In the formulation of adjustment programs there is of course, a necessity to undertake specific actions. Measures are often needed to cut specific subsidies, reduce protection, or increase specific prices and taxes. The choice among actions of this character is essentially political, and the Fund has no right to prefer one action over another, provided that the final result is the required recovery of the balance of payments. Consequently it was accepted as a general practice that access to Fund resources should be regulated in accordance with developments in the broadest of macroeconomic indicators, that is global monetary aggregates, which give the needed assurance of continued adherence to the adjustment effort, and not in accordance with the specific measures that lie behind the global developments."

This approach was abandoned in the 1980s. My reading of the Executive Board decision to open the debate and the staff papers do not indicate that the Board want to return to the pre 1980 criteria.

The staff papers have argued that the increase in structural conditionality emanated from first, including growth as an explicit policy objective in Fund supported programs. Second, involvement with low income countries and the former Central Planned Economies of Eastern Europe and Soviet Union where structural and institutional constraints where seen as particularly binding if the objective of faster growth and sustainable balance of payments position had to be attained. Killick (1995) evaluation of IMF programs in general and Lipumba (1994) review of SAF/ESAF programs in particular has shown growth objective has not been taken seriously. Protection of public investment in infrastructure that can crowd in private investment has not informed policy conditionality of IMF programs. The increase in the number of conditionality in ESAF programs is probably a reflection of lack of negotiating power by these countries. The attitude of the IMF staff seem to have been that if a policy is not part conditionality it will not be implemented. All important policies have to be in a package of conditionality in order to be implemented. This attitude has undermined ownership. Using Masood Ahmed example of Mauritania, there were 19 specific structural benchmarks or prior actions associated with the introduction of the value-added tax. Where a government owns the policy reform, there is nothing wrong in discussing in detail the 19 steps needed to be taken in order introduce a value added tax without making them a condition for continuing access to Fund resources and receiving the IMF seal of approval.

Does Conditionality Work?

The IMF Board seems to have avoided the key question of whether conditionality works. Research at the World Bank on "Aid Effectiveness" has concluded that conditionality does not influence the success or failure economic reforms in developing countries. The effectiveness of aid is dependent on economic policies that countries follow. Aid is highly effective in a good policy environment. Good policies include stable macroeconomic environment, open trade regimes, and adequate protection of property rights, efficient government that is capable of delivering high quality social services. Aid with or without conditionality, however, cannot purchase good economic policies. The commitment of national authorities to implementing appropriate economic reforms independent of externally imposed policy conditions is the main determinant of economic success. If the World Bank study conclusions are right, then policy conditionality including those by the Fund should be given a minimum role. The key issue should be how to promote country ownership of reform programs through collaboration with the countries authorities. Effective ownership requires knowledge and capability to design, implement and monitor policy reforms. The IMF in collaboration with the World Bank are in a better position to collaborate with African policy makers in increasing capability and ownership of policy reforms. Policy conditionality do not give confidence to policy makers, they scare them. No body knows this better than the Fund staff.

What should contain in the letter of intent?

The drafting of the Letter of Intent by the Fund staff has been a glaring symbol of lack of ownership in Fund supported programs. In promoting ownership, the Letter of intent should be owned by the authority that signs the document. It should contain at least the macroeconomic program and policies of the country. To clarify on policy conditionality an appendix can be attached to LOI. The policy matrix is useful for the authorities monitoring of policy implementation. In many African governments hard thinking of macroeconomic policy may take place only during analyzing policies that become part of LOI. Its comprehensiveness should not be watered down.

Ownership and Pre-qualification.

For African countries, pre-qualification of countries with proven good policies is a bad idea. Ownership of policy reforms and development programs is a non-binary process. Ownership is process of learning by doing. In 1986, President Museveni was being advised to revalue the Ugandan shilling! The earliest stabilization programs were not fully owned. Overtime Uganda has learned by doing and increased ownership of their policy reforms and development agenda. The taking of risks in supporting growth-promoting reforms in poor countries is an important aspect of the ball game. The Fund can use prior actions in areas that do not require immediate availability of resources to test a government commitment and hence to reforms. Areas in which prior actions are deemed necessary should also be streamlined rather than being left to the whims of

individual staff members. The PRSP process can be seen as prior action for qualifying to debt reduction under enhanced HIPC.

Program Reviews.

The Fund staff should increasingly learn to use transparent language. When the Fund staff is unable to complete a Review it actually means the Review has been completed and the authorities have flunked. The aim of program reviews should not be mainly the assessment of abiding to policy conditionality. It should be a collaborative exercise of reviewing policy implementation with the objective of making necessary corrections where there is slippage in implementation.

Cross Conditionality with the World Bank.

My major worry in this exercise of focusing and streamlining conditionality in the Fund program is shifting structural conditionality to the World Bank. The abuse of conditionality was in many cases worse in the World Bank. I recall when we were embarking on privatization in Tanzania, some official in the Ministry of Finance were not supportive of this policy and undermined its implementation by delaying the provision of office furniture through government tendering system. The World Bank staff threatened to impose conditionality on the deadline for purchasing furniture for the Commission responsible for privatization! Thank God the Bank has realized that conditionality does not work.

If the Bank is honest with its own research, it should be moving towards promoting ownership through collaboration rather than using conditionality. I just hope the Bank will resist increasing the use of structural conditionality that is being transferred from the Fund.

What division of labor does the Fund expect to have with the World Bank? I am worried about the division of labor in Masood Ahmed example of "Mali, where the cotton sector accounts for about a third of the population, in terms of employment, half of the exports, and where there has recently been, because of problems in the organization of the state monopoly that is responsible for the purchase of cotton from farmers and then their export, a major problem in terms of an implicit tax on farmers that account for about 4-percent of GDP, and where, as a result, farmers have cut back on production… dealing with that is critical because not dealing with it has a major impact on the macroeconomic viability and growth prospects for Mali. So we can't work out a meaningful growth and macroeconomic viability scenario for Mali without dealing it."

Cotton is important for the balance of payments and economic growth of Mali. In the streamlined conditionality, will the Fund continue imposing policy conditionality on the cotton sector in its programs with Mali despite the fact that agriculture and cotton are not the IMF's area of competence?

Concluding Remarks.

I strongly welcome the decision to streamline and focus conditionality. The decision to reduce conditionality, if implemented is commendable. The debate need to be further

opened to review the relevance of conditionality in general, the traditional IMF conditionality particularly for PRGF countries that in future may want to have a program with the Fund not for short balance of payments financing but to consolidate macroeconomic reforms and continue enjoying the IMF seal of approval.

Prof. Ibrahim Haruna Lipumba,
Chairman, Civic United Front

Translation from French

Ouagadougou, May 25, 2001

To: Mrs. Simonetta Nardin
Public Affairs Office, EXR

From: Benoît Ouedraogo

Dear Mrs. Nardin:

It wasn't until this morning (i.e., one week after the deadline of May 18, 2001 that you specified to your correspondents) that we received your letter of May 3, 2001, in which you asked us to comment on IMF conditionality.

We appreciate your consideration in inviting us to take part in this consultation process. We are sincerely grateful to you for thinking of us.

To allow us to make a meaningful contribution to the discussion, we would need to have been notified sufficiently in advance, which would have given us the time to do the necessary research and arrive at an informed opinion on this issue, based on a thorough grasp of IMF principles and practices, particularly with respect to conditionality. As that has not been possible, it is not easy for us to offer relevant commentary on the subject.

We have, however, been able to draw some general lessons from what we have read here and there. Our conclusions would be as follows. IMF conditionalities have often been roadblocks standing in the way of efforts to reduce poverty (which is, if anything, exacerbated by these conditionalities); furthermore, they have an alienating effect on the sovereignty of those nations upon whom the conditionalities are imposed. As a result, economic and social policy is set by the IMF and the World Bank instead of by the countries themselves, who thus lose complete control over policymaking. Under the circumstances, the IMF and World Bank come to rule the world order in accordance with a free-market philosophy that crushes the poor. In so doing, they create injustices and inequalities by worsening the poverty of those who are poor to begin with. In our view, these institutions operate in accordance with undemocratic mechanisms that reserve decision-making power for a minority of wealthy states.

As you can see, the information available to us may be incomplete or mistaken, which makes it difficult for us to offer an objective and constructive contribution to the discussion. Perhaps one day we shall have the opportunity to participate in an educational seminar on the IMF; such a seminar would provide us with data and information, which in turn would better enable us to express an opinion on the subject.

We wish you every success in your endeavors.

Benoît Ouedraogo
Director, FONADES projects [National Foundation for Development and Solidarity]
01 BP 523 Ouagadougou 01

(Burkina Faso)
Tel./Fax: (226) 36 10 79
E-mail: fonades@fasonet.bf

Ouagadougou, le 25 Mai 2001

DE : Benoît OUEDRAOGO

Chère Madame,

C'est ce matin seulement que nous avons reçu votre lettre du 03 Mai 2001 qui demandait notre point de vue sur les conditionnalités du FMI, soit une semaine après la date limite que vous avez fixée aux destinataires de votre correspondance (18 mai 2001).

Permettez-moi de vous exprimer notre gratitude pour la considération et la confiance que nous portez en nous associant à la consultation. Nous en sommes très sensibles et vous en disons sincèrement merci.

Pour être en mesure d'apporter une contribution positive à la réflexion, il aurait fallu que nous soyons saisis suffisamment à l'avance, ce qui nous aurait permis de disposer du temps nécessaire pour nous documenter de manière à pouvoir donner à nos avis un fondement solide, basé sur une parfaite connaissance des principes et des pratiques de l'intervention du FMI, notamment en ce qui concerne les conditionnalités. N'étant pas dans ces conditions, il est malaisé pour nous de réagir de façon pertinente.

Ce que nous retenons néanmoins globalement des quelques lectures que nous avons pu faire parfois ici ou là, c'est que les conditionnaltés du FMI bien souvent constitueraient des entraves posées sur le chemin de la lutte contre la pauvreté qu'elles contribueraient au contraire à aggraver. De plus elles seraient souvent aliénantes pour la souveraineté des Etats auxquels elles s'imposent. Dans ce contexte, la politique économique et sociale serait définie par le FMI et la Banque Mondiale à la place des Etats qui en perdraient ainsi complètement la maîtrise. Ces institutions régenteraient ainsi l'ordre mondial selon un schéma libéral qui étouffe les faibles. Elles contribueraient ainsi à créer des injustices et des inégalités en accentuant la pauvreté de ceux qui sont déjà pauvres. D'autre part, elles fonctionneraient selon des mécanismes peu démocratiques qui réserveraient la prise de décision à la minorité des Etats riches.

Comme vous le voyez les informations en notre possession sont peut-être incomplètes, erronées, ce qui nous place dans une situation difficile pour donner une contribution objective et constructive. Peut-être l'occasion nous sera-t-elle un jour donnée de participer à un séminaire d'information sur le FMI qui nous apporterait des informations et des connaissances qui autoriseraient de notre part des appréciations pertinentes ?

C'est en vous souhaitant beaucoup de succès dans votre mission que je vous prie d'agréer, chère Madame, l'assurance de ma considération distinguée.

Benoît OUEDRAOGO
Directeur des projets de la FONADES

Comments on the IMF's Review of Conditionality

1 Overview

Oxfam supports the view that a radical reduction in the number of conditions attached to IMF loans would be a useful step towards creating space for the emergence of nationally owned strategies for development (provided that the streamlining of conditionality does not coincide with an expansion of informal conditions).

A real concern is that the set of papers that make up the Fund's review of conditionality do not give adequate attention to the link between conditionality and poverty. This is part of the institution's ongoing weakness in making the link between the macro and the micro, and the continued perception among many Fund staff that poverty reduction, although a noble aim, is not a priority.

2 Which measures are critical?

The policy assumptions underlying fund conditionality need to be reconsidered, especially now that poverty reduction is a central aim of the Fund. Reviews of effectiveness of past Fund lending have often shown poor results. The 1997 staff evaluation of ESAF indicated that the core objectives, balance of payments stability and growth, were not achieved. In Sub-Saharan Africa both poverty and inequality increased, and in Latin America inequality increased, implying that future growth rates will have to be even greater to achieve targeted levels of poverty reduction. It is unacceptable for the Fund to continue to apply and advise the same reforms now that the IMF's remit has expanded to include poverty reduction.

Impacts on poverty should be given far greater priority in determining where conditionality should be applied. No conditions should be applied which are not essential for the poverty reduction objectives of programmes to be met. A clear statement of the poverty-reducing rationale for reforms should be included in loan and or program documents (if in the former, these should be published). Furthermore, ex ante impact assessments should be carried out to determine the likely impact of economic reforms on poverty reduction. Such assessments should underpin a debate on economic policies tailored to a specific country's needs.

At the 2001 Spring Meetings, the Communiqué of the joint IMFC/Development Committee asked for rapid progress in the area of poverty impact assessments. Over the last months, Fund and Bank staff have moved forward. Concerns remain, however, in a number of areas. Firstly, it seems that the Fund and Bank wish to place responsibility for carrying out assessments on Governments. Whilst building capacity in this area is important, the Fund and Bank should take responsibility for assessing the impact of their own policy recommendations rather than making this a further burden on Governments.

Secondly, the Fund should not pass responsibility for assessing the impact of its policy recommendations onto the Bank. Although the Bank has more expertise in the area of poverty assessments, and although it is important that the Bank provides assistance to the IMF in assessing the impact of its policy recommendations, the IMF should retain the lead role in the analysis of the impact of its own policy recommendations. Thirdly, impact assessments should be made public early and should underpin a national debate around pro-poor economic policies. Finally, impact assessments should be iterative, with prior impact assessments being complemented by ongoing assessments of the impact of reforms on poverty.

A further concern surrounding the conditionality review relates to the lack of a clear message about how conditionality should be derived from priorities within PRSPs. According to the IMF paper Key Features of IMF Poverty Reduction and Growth Facility Supported Programs (16th August 2000) "the main features of PRGF-supported programs can be seen to be drawn from the country's PRSP". Unfortunately, the papers that inform the Fund's review of conditionality do not consider how conditionality within Fund programs might be explicitly linked to PRSP priorities.

3 Trade Conditionality

One area where the impact of conditionality on poverty has been most controversial is in trade liberalization. Whilst trade can be a key ingredient in the kind of pro-poor growth that is needed for rapid poverty reduction in poor countries, it is equally true that rapid, poorly designed, or unreciprocated liberalization can have a profoundly negative effect on poor people's livelihoods.

While access to Northern markets remains restricted, many poor countries have introduced trade liberalization programs under the auspices of IMF and World Bank programs. Liberalization under these programs is not reciprocated, locking poor countries into an unequal bargain. In some cases highly inappropriate liberalization policies have been introduced. This is especially true in agriculture. The removal of trade barriers has left highly vulnerable food producers facing competition from industrialized countries, which spend US$1bn each day on production and export subsidies. In Haiti, the liberalization of rice markets and a resulting flood of subsidized imports from the USA contributed to a wholesale destruction of rural livelihoods. It also undermined food security by creating a dangerous dependence on food imports.

The IMF paper 'Trade Policy Conditionality in Fund-Supported Programs" makes a very uncritical assessment of the impact of trade conditionality. In Oxfam's view, trade liberalization measures should be excluded from IMF (and World Bank) loan conditions. Trade agreements should be negotiated between countries - not imposed by the IFIs on developing nations.

4 Ownership and transparency

Oxfam welcomes the commitment that the Letters of Intent should include a section that delineates precisely which aspects of the authorities program actually constitute conditionality. In addition, staff assessments of program implementation (mission reports) should be made public. National ownership and IMF accountability would be further assisted by releasing program documents in draft form, prior to government and board approval. This is especially true of PRGF programs that support PRSPs. The Fund cannot continue to claim that PRSPs are shaping Fund priorities whilst no broad discussion of PRGF documents is possible until programs and conditionality are finalized.

Oxfam Recommends:

- No conditions should be applied which are not essential for the poverty reduction objectives of programmes to be met. Fund staff should provide the Board with details of how loan conditions are derived from consideration of poverty reduction.

- Fund staff should provide the Board with details of how PRGF conditions are essential for meeting PRSP priorities.

- A clear statement of the poverty-reducing rationale for reforms should be included in loan and/or program documents.

- Rapid progress should be made on implementing poverty impact assessments. The Fund should take responsibility for assessing the impact of its policy recommendations. Impact assessments should be made public early and should underpin a national debate around pro-poor economic policies. Impact assessments should be iterative, with prior assessments being complemented by ongoing assessments of the impact of reforms on poverty.

- Trade liberalization conditions should be excluded from IMF loan conditions.

- Staff assessments of program implementation should be made public. Program documents should be released in draft form, prior to government and board approval.

Oxfam International is a confederation of twelve development agencies that work in 120 countries throughout the developing world: Oxfam America, Oxfam in Belgium, Oxfam Canada, Oxfam Community Aid Abroad (Australia), Oxfam Great Britain, Oxfam Hong Kong, Intermon Oxfam (Spain), Oxfam Ireland, Novib, Oxfam New Zealand, and Oxfam Quebec. Please call or write to any of the agencies for further information.

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RESULTS Australia
Submission to the Review of Conditionality on Lending by the International Monetary Fund (IMF)

RESULTS Australia welcomes the opportunity to provide input to the consultation on conditionality on IMF lending. Due to the increased role of the IMF as a source of finance for developing countries, and the use by international donors and lenders of a country's compliance with an IMF program as a basis for providing assistance, it is essential that the conditions on IMF credits make a positive contribution to poverty reduction.

As an overall comment, RESULTS Australia would like to state that conditionality on the use of IMF credit is necessary to ensure that this source of finance will contribute to both economic and social improvements in the borrowing country. However the conditions need to be appropriate and also require accountability by the IMF for how the conditions are developed and their impact.

For instance, it is appropriate that borrowing countries establish basic good governance rules when receiving funding from the IMF and report on the use of the funds lent to them. RESULTS Australia also considers that it is good governance for the IMF be assessed every few years by the donor community, and that its concessional program, the Poverty Reduction and Growth Facility (PRGF), be replenished or not based on that assessment. Current PRGF reserves should serve for direct debt reduction (providing debt relief to more countries or more substantial debt relief to current highly-indebted poor countries), not to build a self-sustaining PRGF.

RESULTS Australia's specific suggestions on the type of conditionality that should apply to borrowing countries are set out below.

A) Monitoring of Poverty Impacts of IMF operations:

IMF interventions, in the best of cases, are evaluated ex-post, with some attention given to social indicators. The two shortcomings of this approach are, of course, that information is not available to make early corrections to programs, and that some of the key social information is often missing.

RESULTS Australia requests that all IMF operations in PRGF-eligible countries be accompanied by mandatory, real-time, public monitoring of basic social service coverage data. This requirement should be expressed in the form of a conditionality.

These indicators are mandatory in most Poverty Reduction Strategy Papers, but are seldom made public in real time, i.e. when corrective action can be taken. They are well defined and include for instance: primary school enrolments, immunisation rates etc. This would therefore not involve much of an additional burden on the borrowing countries, but it would serve as a critical early warning signal.

In many cases, the evolution of basic social coverage is not directly related to IMF loans, but if a negative trend is suspected, all development partners would need to ask themselves whether their operations are contributing to the problem, and to further ask themselves how they can participate in the resolution of the problem.

B) Preventing user fees for basic social services:

The international community, including the IMF, has agreed to clear International Development Goals to be achieved by 2015. All of the goals are dependent on universal or near-universal access to basic social services. While many studies show that user fees deter the poorest from accessing these basic social services, too many poor countries keep imposing user fees. These countries claim they impose user fees to comply with advice from international financial institutions to increase their revenue sources.

This must be actively discouraged, including when services are decentralised at sub-national levels, in the form a specific conditionality. After all, what is the point in receiving extra financial resources from the IMF if it is to result in depriving the poorest from access to the services they most need?

C) Trade taxes as a revenue source:

Frequently, poor countries are told by the donor community and the IMF to open their economies to the world. While in theory this would facilitate increased exports by developing countries and reduce the cost of imports for consumers and local industries, benefits are limited because donor countries maintain their trade barriers, which often discriminate against goods from developing countries. An additional problem with liberalisation by developing countries is that the removal of tariffs on imports (and export taxes in some cases) reduces revenue, which reduces their ability to fund basic social services.

RESULTS Australia therefore proposes that a loan condition be established that would link lowering of tariffs in PRGF-eligible countries to the development of alternative sources of revenue, to support funding of all basic social services.

D) Privatisation:

RESULTS Australia is concerned that a condition applied frequently under IMF loans is the privatisation of public enterprises, including key social services. Given the mixed record of privatisation, RESULTS requests that privatisation be removed as a general condition for IMF loans, and that alternatives be discussed instead, on a case-by-case basis.

E) Disclosure

RESULTS Australia commends the IMF for steps to increase disclosure of its operations, but considers the entire set of conditionalities on IMF loans should be made public. Otherwise neither this nor any future consultation with the general public will be very meaningful.

From: Blaise Salmon
Sent: Saturday, June 30, 2001 6:29 PM
To: conditionality@imf.org
Subject: Submission to Conditionality consultation

RESULTS Canada welcomes the opportunity of providing input to the consultation on conditionality

To begin, RESULTS Canada would like to state that conditionality can indeed be a good thing under many circumstances.

For instance, it is appropriate that borrowing countries establish basic good governance rules when receiving funding from the IMF and report on the use of the funds lent to them. RESULTS Canada thinks that it is good governance that the IMF be assessed every few years by the donor community, and that its concessional program, the PRGF, be replenished, or not, based on that assessment. Current PRGF reserves should serve for direct debt reduction (broadening or deepening of outreach) not to build a self-sustaining PRGF.

This being said, let us now focus on the type of conditionality that should apply to borrowing countries.

A) Monitoring of Poverty Impacts of IMF operations:

IMF interventions, in the best of cases, are evaluated after the fact, with some attention given to social indicators. The two shortcomings of this approach are that information arrives too late for early corrections and that some of the key social information is often missing.

RESULTS Canada requests that all IMF operations in PRGF-eligible countries be accompanied by mandatory, real-time, public monitoring of basic social service coverage data. This requirement should be expressed in the form of a conditionality.

These indicators are mandatory in most PREPS but are seldom made public in real time, i.e. in time for early corrective action to be taken. The indicators are well defined and include for instance: primary school enrollment rates per gender, and immunization rates. This would therefore not involve much of an additional burden on the borrowing countries, but it would serve as a critical early warning signal.

Granted, in many cases the evolution of basic social coverage data is not directly related to IMF loans, but if a negative trend is suspected, it behoves all development partners to ask themselves whether their operations are not inadvertently creating the problem, and perhaps to further ask themselves how they can participate in the resolution of the problem.

B) Banning user fees for basic social services:

The international community, including the IMF, has agreed to clear year 2015 International Development Goals. All of the goals are dependent on

virtually universal access to basic social services. Yet, despite the fact that all studies show that user fees deter the poorest from accessing these basic social services, too many poor countries keep imposing user fees. They impose them because, they say, international financial institutions tell them to increase their fiscal resources.

This must be actively discouraged, including when services are decentralized at sub-national levels, in the form a specific conditionality. After all, what is the point in receiving extra financial resources from the IMF if it is to result in depriving the poorest from access to the services they most need?

C) Fair trade barriers:

Too often, poor countries are told by the donor community and the IMF to open their economies to the world. While on paper this makes sense, in reality we operate in a highly subsidized and protectionist environment, especially in agriculture and textiles, so that LDC products too seldom have a chance to compete due to trade barriers in developed countries.

Worse yet, in the process of liberalization, LDCs loose critical fiscal revenues from tariffs, which reduces their ability to fund basic social services. RESULTS Canada therefore requests that a loan condition be established that would impede lowering of tariffs in PRGF- eligible countries until an alternative source of funding is identified to fund all basic social services.

D) Privatization:

RESULTS Canada is worried with what we perceive as an ideological stance at the IMR supporting privatization at all costs. Given the very thin empirical evidence on privatization, RESULTS Canada requests that privatization be removed from the list of potential conditions for IMF loans, and that alternatives be discussed instead, on a case-by-case basis.

E) Disclosure:

RESULTS Canada commends the IMF for taking the lead in disclosure policy, underlining however that we think the entire set of conditionalities should be made public. Otherwise neither this nor any future consultation with the general public will be very meaningful.

****
Blaise Salmon
President,
RESULTS Canada

Result:Ed, the Educational arm of RESULTS Canada, is pleased to participate in the IMF'S consultative process on conditionality

To begin, Result:Ed would like to state that conditionality can play an important role in setting the adequate background for successful poverty-reduction policies. But conditionality has to be used appropriately.

I) Tracking Impacts on Poverty:

IMF interventions, in the best of cases, are evaluated ex-post. In most cases little attention is given to what happens to poor people as key social indicators are not routinely monitored (except perhaps for PRSP processes) . Furthermore, the information arrives too late for early corrections. This is an instance where conditionality can be useful: all IMF operations in PRGF-eligible countries should be accompanied by mandatory, public monitoring of basic social service coverage data (e.g. school attendance, vaccination) as a real-time indicator of success or failure.

These indicators are already mandatory in most PRSPs but are seldom made public in real time, i.e. when corrective is still possible. The additional onus placed on borrowing countries should therefore be manageable.

It is of course understood that basic social coverage is not a direct function of IMF loans, but key social indicators should inform all development partners.

II) Universal access to basic social services:

The International Development Goals form part of an international consensus. However, too often that consensus is challenged on the ground by the imposition of user fees, often in the name of fiscal responsibility.

Why should the international community tolerate that IMF rescue interventions take place if at the same time the poorest are deprived from access to the services they most need?

This must be actively discouraged, including when services are decentralized at sub-national levels, in the form of a specific conditionality.

III) Appropriate Tariff Revenues:

In a laudable effort to promote growth, all countries are told by the donor community and the IMF to open their economies to the world. The problem is that, in the process of liberalization, LDCs loose critical fiscal revenues from tariffs and this revenue drop reduces their ability to fund basic social services.

Another important element of conditionality should be to impede lowering of tariffs in PRGF- eligible countries until other replacement revenues are made available to fund all basic social services.

IV) Privatization:

There is very few elements of evidence in favor of blanket privatizations. Result:Ed is actually worried that privatization might be somewhat of a fad at the IMF; we therefore request that privatization be removed from IMF loan conditionality and substituted by broader, higher elements of conditionality.

In closing, we would be remiss not to mention two specific points on conditionality. First, while the IMF must be congratulated for taking the lead in disclosure policy, we think it is important to go one step further and make public the entire set of conditionalities for each loan. No consultation with the general public of the type being held presently will be ever very meaningful until everyone can have a close look at the clauses involved.

Second, conditionality should be a two-way street. Yes the IMF should impose conditions and call countries to account. But it is equally appropriate that the IMF be assessed every few years by the donor community, and that its concessional program, the PRGF, be replenished or not based on that assessment. Current PRGF reserves should serve for direct debt reduction (broadening or deepening of outreach) not to build a self-sustaining PRGF.

Again, thank you for the opportunity to provide our views.

Jean-François Tardif

President
Result:Ed

-----Original Message-----
From: Results
Sent: Thursday, June 28, 2001 6:50 AM
To: conditionality@imf.org
Subject: Conditionality in Fund-Supported Programs
Importance: High

28 June 2001

Executive Directors
International Monetary Fund

RESULTS UK is please to respond to your request for comments on the paper "Conditionality in Fund-Supported Programs" to be discussed by the Executive Board. The paper discusses, in part, the curtailment of the scope of policies included under conditionality. Our comments focus on this.

Firstly with regard to privatisation - it seems that the IMF believes privatisation is appropriate within all borrowing countries, although there is little evidence of its benefits. We request that privatisation is removed from the list of potential conditions for IMF loans.

In contrast, we suggest the introduction of new conditionality criteria that will help ensure that IMF interventions benefit very poor people.

We would like to see all IMF operations in PRGF-eligible countries accompanied by mandatory, real-time monitoring of social data such as primary school enrolments, immunisation rates and maternal health outcomes. The ongoing assessment and publication of such data would allow negative trends to become apparent; development agencies would then be able to assess possible causes, including self inflicted ones, and intervene quickly and appropriately. Whilst many IMF loans are not directly related to the social sector we would suggest that they often do have an impact, albeit at a distance.

One such indirect impact is the imposition of user fees for basic social services in many of the Least Developed Countries. Many countries impose user fees in response to demands from the international financial institutions to increase their fiscal resources. This in turn means that poor people are deterred or prevented from seeking and using basic health and educational services with obvious disastrous consequences. We request that the IMF requires LDCs not to impose user fees for basic social services.

Finally, we welcome the move towards greater disclosure which this consultation represents and trust that this will continue with the publication of all conditionalities imposed by the IMF.

Yours faithfully,
Sheila Davie
National Director

RESULTS UK

Translation from French

SOLAGRAL
The Challenges of a Solidary World

The Debate on Reforming International Monetary Fund (IMF) Conditionality

The Contribution of Solagral

Solagral wishes to make the following contribution to the debate on IMF conditionality. Solagral is a French NGO whose mission is to empower the key players in sustainable development of the South, in North-South relations, and in monitoring international negotiations. Its areas of expertise are agriculture, food security, the environment and intellectual property rights, development assistance, and WTO negotiations.

Because of the scope of its activities, Solagral often finds itself incorporating into its analyses the strategies of the Fund and the impact of the conditionality attached to Fund assistance to the peoples of the South. The emphasis of Solagral's contribution is not on the technical debate surrounding the conditionality of Fund programs, but rather on the general principles that should guide the Fund in devising conditionality, and any other donor for that matter, with a view to the sustainable development of the South. Inasmuch as Solagral's activities particularly target the Less Developed Countries (LDCs), this contribution should be regarded first and foremost as it relates to the interests of these countries.

Two observations: The objective of sustainable development and the IMF's influence on LDCs

At present, the dominant paradigm for the South is sustainable development. Starting from the observation that the market alone cannot guarantee that this objective will be met, national and international regulations would appear to be essential, in particular in order to guarantee individual rights and universal access to basic social services (health, education, water, energy). This implies a concerted and transparent dialogue among all the parties involved, with the objective of continually enhancing good governance and ensuring capacity building in government, parliaments, and civil society organizations in the South.

The Fund has a decisive influence in the countries receiving its assistance. This is particularly so in the case of the LDCs. For these countries, indeed, the Fund represents a partner of primordial importance, in the absence of which any development assistance from other donors is marginal if it exists at all. The Fund therefore has an important indirect responsibility in these countries' development.

Given these two observations, it is incumbent on the Fund to give greater consideration to the compatibility of the conditionality attached to assistance with the objective of sustainable development. This can be bolstered by placing emphasis on: (1) the primacy of international law; (2) promoting access to basic social services by vulnerable population groups; and (3) national ownership of the process of formulating conditionality.

Legal framework: the primacy of international law

Every memorandum of understanding (or letter of intent) between the Fund and a country receiving assistance should begin with a preamble on the observance of international law and the international conventions signed by the beneficiary country. Such a preamble should include the following points:

- The Universal Declaration of Human Rights (UDHR);
- Such International Labor Organization (ILO) conventions as the beneficiary country may be party to; and
- The Multilateral Environment Agreements (MEAs) to which the beneficiary country is a signatory.

Such a preamble ensures that the conditionality attached to Fund assistance will be compatible with the beneficiary country's adherence to international regulations. In specific terms, the Fund should be in a position to guarantee that no conditionality stands in the way of promoting the international rights to which the beneficiary country has subscribed.

Contents: Accord equal priority to economic growth and access to basic social services

Conditionality's very contents, and its direct and indirect impact on the people involved, in particular the vulnerable population groups, should be guided by two general principles:

- Strong, stable, and healthy long-term economic growth; and
- Universal access to basic social services in the short term by vulnerable population groups.

The principle of economic growth is essential for combating poverty in the long term. Promoting the access of vulnerable population groups to basic social services, like economic growth, is crucial to the fight against poverty. Indeed, it is also the instrument whereby the individual and collective rights defined within the legal framework of the UDHR, ILO conventions, and MEAs are applied.

The Fund should give equal priority to economic growth and to universal access to basic social services. Conditionality should be judged both in terms of its impact on access to basic social services and in terms of economic growth. The priorities on the social side are particularly important in respect of the structural conditionality pertaining to privatizations and the restructuring of services to the public.

Formulation and implementation: Concerted dialogue between all parties involved with the beneficiary country

A third condition for the sustainable development of the countries of the South is empowerment and governance in the country concerned. This objective quite clearly implies transparent and concerted dialogue between the Fund and the beneficiary populations on the formulation and implementation of conditionality. It implies a dialogue which cannot be limited to an intergovernmental style of negotiations between the Fund and the executive authorities of the beneficiary country, without regard to the strengths or weaknesses of the latter.

- Such a dialogue should substantively involve the legislature: the upper and lower Houses of Parliament, and, where applicable, the Constitutional Council, the Economic and Social Council, or the Supreme Court;
- This dialogue should also be open to civil society organizations so as to enhance the degree to which development assistance strategies are properly adapted to the population groups concerned.

Proposals for the reform of IMF conditionality

- Ensure that any memorandum of understanding between the Fund and a government receiving assistance from it contains a preamble addressing human rights and such international regulations as the beneficiary country may have subscribed to;
- Develop the conceptual tools required to ensure compatibility between conditionality and the promotion of access to basic social services in the short term;
- Guarantee substantive dialogue between the Fund and the legislative bodies of the beneficiary country, as well as Fund participation in the empowerment of civil society organizations.

Le débat sur la réforme des conditionnalités
du Fonds Monétaire International (FMI)
-
La contribution de Solagral

Solagral propose la contribution suivante au débat sur les conditionnalités du FMI. Solagral est une ONG française dont l'objectif est d'appuyer les capacités des parties prenantes au développement durable du Sud, aux relations Nord-Sud et au suivi des négociations internationales.
Ses compétences thématiques sont l'agriculture, la sécurité alimentaire, l'environnement et les droits de la propriété intellectuelle, l'aide au développement, les négociations à l'OMC.

De par son champ d'activités, Solagral est très souvent amenée à prendre en compte dans son analyse la stratégie du Fonds et l'impact des conditionnalités de son aide sur les populations du Sud.
Cette contribution de Solagral ne porte pas sur le débat technique autour des conditionnalités des programmes du Fonds, mais sur les principes généraux qui doivent guider le Fonds dans l'élaboration des conditionnalités, au même titre que tout autre donateur, et ce dans la perspective de développement durable du Sud.
Puisque l'activité de Solagral est particulièrement ciblée sur les Pays les Moins Avancés (PMA), cette contribution doit avant tout se comprendre par rapport aux intérêts de ces pays.

Deux constats : l'objectif de développement durable et l'influence du FMI sur les PMA

Le paradigme dans lequel s'inscrit aujourd'hui le Sud est celui du développement durable. Partant du constat que le marché ne peut à lui seul garantir cet objectif, des régulations nationales et internationales apparaissent indispensable, afin notamment de garantir les droits individuels et l'accès universel aux services sociaux de base (santé, éducation, eau, énergie). Ceci implique un dialogue concerté et transparent entre toutes les parties prenantes, avec l'objectif d'un renforcement continu de la bonne gouvernance ainsi que des capacités des gouvernements, des parlements et des organisations de la société civile du Sud.

Le Fonds a une influence déterminante sur les pays bénéficiaires de son aide. Cela est particulièrement le cas des PMA. Pour ces pays, le Fonds représente de fait un partenaire primordial, sans lequel toute aide au développement des autres donateurs est marginale, sinon exclue. A ce titre, le Fonds a une responsabilité indirecte importante dans le développement de ces pays.

A partir de ces deux constats, la responsabilité du Fonds doit mieux prendre en compte la cohérence entre conditionnalités de l'aide et objectif de développement durable. Cette cohérence peut être renforcée en soulignant (1) la primauté du droit international, (2) la promotion de l'accès aux services sociaux de base pour les populations vulnérables et (3) l'appropriation nationale du processus de formulation des conditionnalités.

Encadrement juridique : le préalable du droit international

Tout protocole d'accord (ou lettre d'intention) entre le Fonds et un gouvernement bénéficiaire devrait être introduit par un préambule portant sur le respect du droit international et des conventions internationales souscrites par l'Etat bénéficiaire. Ce préambule doit inclure les points suivants :

- la Déclaration Universelle des Droits de l'Homme (DUDH),
- les conventions de l'Organisation Internationale du Travail (OIT) qui ont été signées par l'Etat bénéficiaire, et
- le ou les Accords Multilatéraux sur l'Environnement (AME) souscrits par l'Etat bénéficiaire.

Ce préambule permet de garantir le principe de cohérence entre les conditionnalités de l'aide du Fonds et l'insertion du pays bénéficiaire dans la régulation internationale. Concrètement, le Fonds doit pouvoir garantir que toute conditionnalité ne nuit pas à la promotion des droits internationaux auxquels a souscrit l'Etat bénéficiaire.

Contenu : donner une égale priorité à la croissance économique et à l'accès aux services sociaux de base

Le contenu des conditionnalités et l'impact direct et indirect de celles-ci sur les populations concernées et, en priorité, les populations vulnérables, doivent être orientées en fonction de deux principes généraux :

- une croissance économique forte, stable et saine à long terme, et
- l'accès universel aux services sociaux de base pour les populations vulnérables à court terme.

Le principe de la croissance économique est une condition essentielle à la lutte contre la pauvreté à long terme. La promotion de l'accès des populations vulnérables aux services sociaux de base est au même titre que la croissance économique une condition essentielle de la lutte contre la pauvreté. Elle est, de plus, un instrument d'application des droits individuels et collectifs tels que définis dans l'encadrement juridique de la DUDH, des conventions de l'OIT et des AME.

Le Fonds devrait donner une égale priorité à la croissance économique et à l'accès universel aux services sociaux de base. Une conditionnalité doit être jugée à la fois en fonction de son impact sur l'accès aux services sociaux de base et sur la croissance économique.
La priorité sociale est particulièrement importante pour les conditionnalités structurelles relatives aux privatisations et à la restructuration des services publics.

Formulation et mise en œuvre : dialogue concerté avec toutes les parties prenantes du pays bénéficiaire

Une troisième condition au développement durable des pays du Sud est le renforcement des capacités (en anglais *empowerment*) et de la gouvernance du pays. Cet objectif implique très clairement un dialogue transparent et concerté entre le Fonds et les populations bénéficiaires sur la formulation et la mise en œuvre des conditionnalités. Il implique un dialogue qui ne peut se limiter à une négociation de type intergouvernemental entre le Fonds et le pouvoir exécutif central du pays bénéficiaire, et ce indépendamment de la qualité de ce dernier.

- Ce dialogue doit être substantiel avec le pouvoir législatif : les chambres haute et basse du parlement et éventuellement le Conseil Constitutionnel, le Conseil économique et social ou la Cour Suprême
- Ce dialogue doit aussi être ouvert aux organisations de la société civile, pour appuyer l'appropriation des stratégies d'aide au développement par les populations.

Concrètement, le processus de formulation des conditionnalités doit inclure à l'initiative du gouvernement bénéficiaire et du Fonds, un débat avec les représentants de la société civile. Le protocole d'accord doit en suite être soumis au débat parlementaire et à l'avis des autres instances législatives, notamment pour garantir la cohérence entre la politique du Fonds et la politique budgétaire du gouvernement bénéficiaire tel que sanctionnée par le parlement.

Les propositions pour une réforme des conditionnalités du FMI

- Introduire tout protocole d'accord entre le Fonds et un gouvernement bénéficiaire de son aide par un préambule sur les droits humains et les régulations internationales souscrites par le pays bénéficiaire.
- Développer les outils conceptuels nécessaires à la cohérence entre les conditionnalités et la promotion de l'accès aux services sociaux de base à court terme.
- Garantir un dialogue substantiel entre le Fonds et les institutions législatives du pays bénéficiaire ainsi que la participation du Fonds au renforcement des capacités des organisations de la société civile.

Comments on the Review of Conditionality In IMF-Supported Programs

Submitted by:
Carol Welch
Friends of the Earth US
May 18, 2001

Friends of the Earth US (FoE) welcomes the opportunity to provide input on the International Monetary Fund (IMF) Review of Conditionality. We appreciate IMF management's recognition of some of the problems associated with its conditionality, including the number of conditions and the appropriateness of IMF conditionality in structural areas and other areas outside the IMF's mandate and expertise. This review, and the solicitation of public comments, are welcome steps in addressing these issues. However, the crucial issue will be how recommendations and feedback are taken into account by the IMF Board and management, and how this process impacts on the design of future programs.

A discussion of conditionality is also incomplete without a discussion of transparency and ownership. We continue to affirm the need for the IMF and its borrowing governments to become more transparent in the loan negotiation process, open up the loan negotiation process to a wider range of government officials, and to truly include public participation in the formulation of economic strategies and policies. Ultimately, whether conditions are implemented, regardless of the number of conditions, will depend on the authorities' and the public's support of the programs. Greater attention should be paid as to how to design policies that will be broadly supported, than attempting to determine the number of conditions that a given country can tolerate.

Excess Emphasis on Quantity of Conditions

An overall concern with the conditionality review is its over-emphasis on the number of conditions and the categories that they fall under, such as performance criteria versus structural benchmarks, and too little differentiation on the type of conditions and their appropriateness. By looking too much at the numbers of conditions, rather than the overall impact and intent of conditions, the IMF has missed an important opportunity. The IMF should assess more deeply whether its conditions have been appropriate in a given country and to propose criteria by which to judge the appropriateness of its policies in a given country. This question of appropriateness is particular important given the modest performance and anemic improvements in growth in many countries going through high conditionality Fund programs.

Rationale for Structural Conditions

There are many concerns with the appropriateness of some of the Fund's conditions, particularly in the structural area. However, the Board has also made clear that no structural areas should be off-limits to the IMF, a priori. It is crucial, therefore, that the rationale and justification for including structural conditions in programs must be clearly explained in loan documents, namely the Letter of Intent. For example, if energy sector conditions are included in an individual country's loan program, the impact of the energy sector on the economy, by requiring large government subsidies for instance, should be made clear and linked to the overall macroeconomic situation and outlook for this country. These explanations should be included in loan program documents so that the public better understands the IMF and borrower's strategy in a given country. This could also serve to better explain Fund programs more generally. If policies cannot be clearly linked to the macroeconomic health of a country, they should not form part of the IMF's conditionality.

The review of trade-policy conditionality misses an opportunity to think through criteria for trade policy conditions. The appropriateness of trade conditionality depends greatly on the regional situation of a country, world prices, and the openness of other markets, particularly in the developed world. The rationale for trade liberalization should be clearly explained and the links to poverty alleviation made clear. In addition, the appropriateness of trade conditionality should also depend on whether the measures being considered have agreed in multilateral trade fora, namely the World Trade Organization.

Capacity Questions

The IMF's new emphasis on "streamlining" conditionality may not lead to any overall reduction in conditions if the World Bank fulfills its envisioned role in the new Poverty Reduction Support Credit (PRSC) and includes conditions in the PRSC that have in the past been included in the IMF's operations. Many countries face severe capacity constraints in adopting the large number of conditions imposed on them by a variety of multilateral and bilateral donors. The IMF should explicitly consider capacity issues in program design and recognize that some policy changes will necessarily have to be left to a later date. In addition, the IMF appears to lack a strategy for streamlining conditions in middle-income country borrowers, where a World Bank program may not exist.

Follow up and Monitoring:

It is crucial that timely monitoring of conditionality be a part of the IMF's effort at streamlining conditionality. This monitoring should be transparent. It is our understanding that much of this monitoring will take place through staff program reports. Yet it is also our understanding that staff reports for program reviews are not made public. This problem must be rectified, ideally by making these reports public or minimally by releasing the monitoring report as a separate document. A summary, year-end assessment is not a sufficient means of making this important information publicly available. Real-team assessments of how conditions have been decided in country

programs should be public in a timely fashion, as should upstream reviews of upcoming programs.

In general, the Fund has a poor track record for following up on the reviews it has undertaken. The reforms proposed in the external ESAF review received inadequate follow up, with scant attention paid to the six pilot countries designated for enhanced World Bank/IMF collaboration and ex ante identification of vulnerable groups. The PRSP process has since subsumed the recommendations of the external ESAF review, yet valuable experiences that could have been garnered in the six pilot cases, had they been pursued, were lost. It is crucial that recommendations from this review process be carefully monitored and assessed periodically.

Comments on the IMF staff's review of conditionality

By Angela Wood
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April 2001

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Bretton Woods Project monitors the World Bank and IMF in collaboration with a worldwide network of NGOs, researchers and policy makers. It was established by a network of 30 UK NGOs.

Bretton Woods Project welcomes this review. In particular, we support the decision to apply less conditionality in programmes, although we note with concern that conditionality in some of the Poverty Reduction and Growth Facility programmes has increased. We support the intention to encourage greater country ownership of the reform process and believe that widespread involvement in policy decision making is the key to sustainable and appropriate reforms.

Bretton Woods Project also welcomes the Board and staff's desire to consider comments from outside observers. We would like to suggest that to facilitate this process it will be helpful if all submissions are made available on the IMF's website and that the staff and/or Board should publish a paper responding to the generic comments made in these. In particular it will be helpful if the paper could clarify which of these have been adopted or will be given further consideration and explain why others will not be.

Whilst welcoming the review, Bretton Woods Project is concerned that the analysis has stopped short of considering some essential aspects and we appreciate this opportunity to present them to the Executive Board.

The roles of the IMF and its policy advice also need to be considered

Whilst it is important to review the areas in which the IMF will apply its conditionality, this is only one element of the IMF's involvement in member countries. It also has significant involvement through its surveillance, policy advice and technical assistance functions.

Whilst streamlining conditionality may help to ensure programmes are better implemented it does not necessarily mean that the IMF is disengaging from areas which are not core to its remit. Indeed, the staff have indicated that whilst micromanagement of the reform process through structural benchmarks will be cut back technical assistance will increase. Thus it seems somewhat illusory that the IMF is refocusing itself unless it is prepared to streamline its activities in these areas too. To rectify this the Board should provide guidelines to staff clarifying which areas their engagement, particularly technical assistance, should be limited to.

The IMF has significantly increased its surveillance function in the last few years as it has shifted into devising and monitoring various codes and standards. It is vital to ensure that these remain voluntary and do not become an explicit or implicit element of conditionality, we welcome the Board's reiteration of this principle.

This is particularly important at the current time when developing countries are not engaged in the institutions in which these are devised and discussed. Developing countries are particularly sensitive to the fact that these codes and standards are designed for highly developed markets and institutions and are not appropriate for their own current state of development.

In addition, implementing codes and standards places a very considerable burden on developing countries in terms of resources and administrative capacity. Thus, a focus on these may limit the ability to implement reforms in other key areas. We are particularly concerned that this may be the case in the poorest countries where policies and actions to support poverty reduction initiatives should be the priority.

Coherence between review initiatives

It is a significant oversight that the review of the IMF's involvement in governance issues has not been explicitly linked to the review of structural conditionality. As the paper *Review of the Fund's Experience with Governance Issues* notes, governance conditionality has increased significantly in the past few years.

Whilst some areas of governance, such as budget management, clearly are related to the IMF's core expertise, others, such as labour sector reforms, which have significant social costs and are extremely political in nature, are clearly outside the Fund's remit. Especially, given that other institutions exist to deal with labour issues. It is totally inappropriate that the IMF tries to de-politicise such reforms by making them a condition of its lending. Moreover, given the conflict they cause, it suggests that their inclusion in programmes is more likely to cause them to breakdown or be resisted.

We do not agree with the *Review of the Fund's Experience in Governance Issues,* that the current broad, pragmatic approach should continue as it is our belief that the IMF has overstretched itself in this area as the review confirms: "the Fund has developed and applied its instruments for promoting good governance to an extent well beyond what was envisaged at the time of the GN [Guidance Note]".

Thus it should be a priority to revise the 1997 Guidance Note to make more explicit in which areas IMF staff should advise governments and those that should be left to other institutions.

Make the rationale for structural conditions explicit

Whilst it may be difficult to define ex ante all cases in which structural reforms are relevant to the macroeconomic situation, the rationale for their inclusion on a case by case basis should be made explicit and public.

Bretton Woods Project understands that staff have agreed to make "real time" assessments of the rationale for structural reforms for the Board. However, these are not expected to be made public. To build confidence and understanding in the IMF's advice, it is important that stakeholders outside the IMF can also see the rationale for inclusion of structural reforms. This could perhaps be made public in the Letter of Intent alongside the list of IMF performance criteria. Alternatively, and perhaps more appropriately, the staff report and lending documents in which the conditions and rationale are detailed should be publicly disclosed.

In addition, the IMF's objectives, particularly in low income countries are wider than just macroeconomic stabilisation. It is equally important that staff also explain in Letters of Intent (or the PRGF document which should be publicly disclosed) how they expect structural and macroeconomic conditions will impact on poverty reduction and growth objectives.

Appropriateness of reforms

Whilst the review considers the number and types of conditionality, it fails to consider the nature or content of policy reforms.

As the IMF has increased its span of objectives the breadth of reforms have increased from first generation to second generation and beyond. However, reviews of programme outcomes, although given a positive spin by the staff, have, on closer inspection, shown very poor results.

In the case of the 1997 staff evaluation of ESAF, the results indicated that the core objectives – balance of payments stability and growth – were not achieved (although there was a limited increase in growth rates this was not sufficient to reduce poverty levels); moreover, indebtedness increased. In Sub-Saharan Africa both poverty and inequality increased, and in Latin America inequality increased, implying that future growth rates will have to be even greater to achieve targeted levels of poverty reduction.

Given this evidence, it is indefensible that the staff continue to apply and advise the same reforms. The staff should be required to undertake a full review of their policy advice to determine the impacts it has had on poverty levels. It is essential that staff understand the micro impacts of the macroeconomic and structural reforms that they advocate. We appreciate that the staff are taking steps to do so and we hope the Board will publicly support this as a priority for IMF research.

When collaboration is not possible

Given that staff admit that they do not always have the necessary expertise, it is extremely worrying that they propose to continue including structural reforms in programmes when other institutions are not in a position to collaborate even if, as the staff paper suggests, there is informal consultation between them.

A clear example of hasty structural reforms, which worsened the situation and impacted on recovery, was the restructuring of banks in Indonesia in the immediate aftermath of the financial crisis. Whilst in some cases delaying reforms may also delay stabilisation, a worse scenario is the potential for hasty and mis-judged reforms to have a significantly negative impact on an economy.

We urge the Executive Board to make it clear to staff that in such situations they should not proceed with reforms (advise governments or impose conditionality) until a time when partner institutions are ready to proceed. In these cases further consideration should be given to appropriate sequencing and timing of related reforms.

The type of conditionality applied is important

Bretton Woods Project welcomes the commitment to limit the number of conditions in programmes. However, the type of condition imposed is also important. We are concerned that the staff may make increased use of prior actions.

As the review recognises, it is clear that conditionality to induce policy reforms only works in limited situations. Thus the emphasis is now on ownership. Whilst the use of prior actions may appear to signal ownership, it does not necessarily do so. It is a particularly unsubtle form of inducement. Prior actions are a particularly harsh form of conditionality, since actions must be taken before money is provided, which can assist their smooth implementation or ameliorate their negative impacts.

Moreover, the use of prior actions does not signal that staff have faith in a government's intentions, this could lead to negative dynamics in the staff-government relationship. Thus they should be used, if at all, in very limited circumstances. These should be defined clearly by the Board.

Ownership and results based conditionality

If the intention is to move towards an "ownership" approach, then ultimately it should be envisaged that the IMF will impose minimal conditionality – perhaps just in relation to budget management and government transparency - and that disbursements will be made on a pre-agreed basis, preferably in accordance with the budget-cycle.

Whilst this ideal may be some time off, Bretton Woods Project believes that it is essential that further consideration be given to "outcomes" or "ex post" conditionality as a concrete step towards embracing the "ownership" approach. Outcome conditionality sends positive signals to governments that they are in control of the policy formulation and implementation process, which is an essential aspect of ownership and successful reform.

Staff have argued that outcome conditionality is not practical because it is difficult to determine clearly on what basis loan tranches could be released. Bretton Woods Project does not consider that this argument is sufficient to reject outcome conditionality.

Naturally outcomes conditionality will require staff to use their judgement, particularly if objectives have not been achieved, but it is already the case that staff must make judgements when they grant waivers. Moreover, linking lending to objectives is more appropriate in terms of providing the appropriate incentives to both governments and staff. It should not be overly problematic to base a decision to continue funding on visible actions the government has taken to implement reforms and/or to assess ex ante how these will feed through and impact on the economy with regard to the agreed objectives. As is already the case, these judgements will need to be made in discussion with the

government (not just the finance ministry). To ensure consistency and impartiality on the part of staff it will be important to make the rationale for decisions public.

With outcomes conditionality regular staff monitoring will be helpful to ensure reforms do not have unintended negative consequences and to reassure the Executive Board. Although, care should be taken to ensure that monitoring mechanisms do not impose additional burdens on government capacity.

Impact assessments and monitoring outcomes

Staff are likely to develop tools for assessing the impact of programmes in relation to key objectives for PRGF programmes. We welcome these steps and urge that impact assessments should become a required element of the programme formulation process for all countries.

However, the assessment process must be a continuous one in order to adjust programmes if they appear to be going off target. Since staff monitoring documents are not publicly disclosed, it is unknown if staff monitor whether programme objectives are achieved in addition to the implementation of conditions. The perception is that their priority is to monitor implementation of conditions. Obviously this is inappropriate as conditions are simply tools.

Staff monitoring reports which go to the Board should be made public. And processes must be established to effectively reformulate programmes as necessary.

Participation and transparency

We welcome the decision to clarify in programme documents which aspects of the Letter of Intent are conditional for IMF assistance.

National ownership and IMF accountability will also be assisted by releasing programme documents (ie the Letter of Intent) in draft form, prior to government and board approval. It is particularly important that those engaged in the PRSP process are able to determine that PRGF funded programmes are compatible with and based on the PRSP. Whilst this can be assessed once a Letter of Intent has been approved by the Board and made public, by this stage, it is too late for parliaments or civil society to affect the programme should it be found that there is inconsitency.

(RE)FOCUSING IMF CONDITIONALITY

PAPER BY THE NETHERLANDS MINISTRY OF FINANCE AND THE NETHERLANDS CENTRAL BANK

INTRODUCTION

The present discussion on the scope of Fund conditionality stems directly from the criticism the IMF has received with respect to the way it handled the 1997 Asian crisis. Research into Fund-supported programs suggests that the Fund has strayed into non-core areas and indicates that both the number and the level of detail of conditions have increased over time. The wider scope of conditionality could have serious consequences: it may jeopardize the effectiveness of IMF-programs; countries may delay their approach to the Fund; the Fund may be regarded as being insensitive to cultural and social differences among countries; the level of detail and intrusiveness of conditionality is sometimes hard to reconcile with the principle of ownership; it may result in a lack of responsibility of countries. Besides this, involvement of the Fund in areas outside its primary competence could weaken its reputation for professional, non political advice. Programs too detailed carry the risk of program failure, not least because of the above mentioned lack of ownership.

Members of the International Monetary and Financial Committee (IMFC) have acknowledged the need for streamlining Fund conditionality[1]. The Managing Director of the IMF has responded by putting the topic of conditionality high on the agenda. In different speeches he has argued in favor of a more focused IMF[2]. In September 2000 he issued an Interim Guidance note on Streamlining Structural Conditionality[3].

OUR APPROACH TO CONDITIONALITY

In our understanding, the scope of the Fund's conditionality exhibits two dimensions: breadth (core/non-core) and depth (broad/detailed). The confrontation of these two dimensions can be represented as follows:

Depth/breadth	Core	non-core
broad	A	B
detailed	C	D

[1] Communiqué of the IMFC of the Board of Governors of the IMF, Press Release No. 00/54, September 24, 2000

[2] See for example, Towards a More Focused IMF, uncheon Address by Horst Köhler at the International Monetary Conference, Paris, France, May 30, 2000; Address by Horst Köhler to the Board of Governors of the IMF, Fifty-fifth Annual Meeting, Prague, September 26, 2000

[3] Streamlining Structural Conditionality, Letter of the MD to the Heads of Departments and Offices of the IMF, September 18, 2000

Most countries applying for IMF programs have more than once faced non-sustainable balance of payment positions due to external debt overhangs and/or excesses of absorption over output. Maintaining aggregate demand on a sustainable path calls for keeping in control the flows of domestic financing and the rates of monetary and domestic credit expansion[4]. We would therefore put criteria with respect to (among others) the levels of the net international reserves, the net domestic borrowing of the public sector and the net domestic assets of the central bank in matrix cell A[5]. We would put a specific measure identifying how to reach either of these quantitative targets in cell C. With respect to other conditionality taken up in IMF programs, these should in principle be covered by the guidelines and should, almost naturally, be in line with the Fund's mandate. We expect most of the conditions to fall into cell A.

We are mainly interested in the structural component of the IMF's conditionality and the level of detail of conditions in stand-by and extended arrangements[6]. IMF staff defines "structural" in a technical way: everything that is not a quantitative macro-economic performance criterion[7]. Goldstein focuses more on the content: structural conditions are the ones not aiming at the management of aggregate demand but rather at either improving the efficiency of resources use and/or increasing the economy's productive capacity[8]. We feel both definitions fall largely together, taking different perspectives. We prefer the approach brought forward by Goldstein, because it deals with the content of conditions.

MAIN MESSAGES

1 – IMPROVING COMPLIANCE WITH THE GUIDELINES ON CONDITIONALITY

The existing Guidelines on Conditionality were agreed upon by the Executive Board in 1979. The applicability of the guidelines has been reaffirmed by the Board several times, most recently in 1994. While the present guidelines in itself seem adequate and tight, we feel that the way the Fund (not only staff and management but the Executive Board as well) interprets and employs the guidelines should be improved and brought more into line with the spirit in which the guidelines have originally been written. This could be pursued through a number of measures. First, the staff could clarify the macroeconomic relevance for every structural condition (either a performance criteria or a benchmark) in every Fund program as well as the degree in which this condition is critical for the success of the program (see message 4 below). If bringing forward conclusive proof in this respect appears impossible, that specific condition should be left out of the arrangement. This seems to correspond perfectly with what the guidelines say on performance criteria, namely that "[they] will normally be confined to (i) macro-economic variables, and (ii) those necessary to implement specific provisions of

[4] For a more detailed analysis: Manuel Guitán, Conditionality: Past, Present, Future, IMF Staff Papers, Volume 42, No. 4, December 1995

[5] These criteria are also included in the standards for SBA and EFF agreements; see also main message number 4 below

[6] We acknowledge that PRGF-supported programs take a different perspective because of their focus on poverty reduction and economic growth. Conditionality in PRGF-arrangements should reflect these divergent program objectives.

[7] Explained during an Informal Board briefing on the Conditionality Review, December 8, 2000

[8] Morris Goldstein, IMF Structural Programs, paper prepared for NBER Conference on "Economic and Financial Crisis in Emerging Market Economies" (page 4), October 19-21, 2000

the Articles or policies adopted under them.... [they] may relate to other variables only in exceptional cases when they are essential for the effectiveness of the member's program because of their macro-economic impact". Second, a maximum number of structural conditions could be determined; exceeding this number would require invoking an exceptional circumstances clause as well as a separate Board meeting. Moreover, one could even consider demanding a qualified Board majority for approval of exceeding this maximum number of structural conditions.

Finally, we would recommend the Fund to undertake a regular (annual or biennial) review of conditionality, to be discussed in the Board. This would give the Board a tool to assess conditionality policy on a permanent basis, analogous to the biennial review of the Fund's surveillance activities. It would also secure persistent commitment to the guidelines and the spirit in which they have been (re)written.

Although the key to more focussed conditionality seems to lie in stricter enforcement of the existing guidelines, it could additionally be useful to clarify some parts of these guidelines. The messages beneath illustrate the points that could be addressed in the guidelines. Some messages clearly follow the line chosen by Köhler in his Interim Guidance Note, which we largely endorse. Other messages take a different perspective and go into more detail in order to focus the IMF more clearly with respect to conditionality.

2 - THE BREADTH OF FUND CONDITIONALITY: THE MANDATE AND THE CORE AREAS. Conditions in IMF stand-by and extended arrangements should fit the Fund's mandate. However, as the Articles of Agreement of the Fund are formulated in a rather general terms, a more specific definition of the Fund's mandate is called for. In our view the Fund's primary focus should be on macro-economic and financial stability. Therefore, conditions should be limited to and directed at solving the current balance of payments crises (which led the country to apply for assistance by the IMF) and at minimizing the chances of getting into another crisis in the near future. More specifically, the guidelines could explicitly determine that in principle conditions should be limited to the areas of:

- fiscal policy
- exchange rate policy
- monetary policy
- balance of payments issues (including external debt)
- the financial sector (including banking and capital markets).

Conditions within each of these five core areas may either be of a quantitative or of a structural nature.

3 - HOW TO DECIDE ON THE APPROPRIATE STRUCTURAL CONDITIONS IN IMF PROGRAMS. We feel that the guidance note of the MD represents a useful starting point in assessing whether a specific structural condition (detailed or not) should be included in IMF programs. Based on this note, the following decision diagram can be of help to assess whether and how structural conditions should be taken up in an IMF supported program (PC = performance criterion; PA = prior action).

*a. is a structural reform macro-***relevant***?* }**no**} no Fund conditionality

J**yes**J

take up as a condition in IMF program } *b. is this reform* **critical** *for program success?*

J**yes**J — J**no**J

PC or PA — benchmark or indicative target

J — J

c. does this reform fall within **core areas** *of the Fund?*

J**yes**J — J**no**J

own expertise — outside expertise

In order to make this decision tree a useful instrument, an elaboration on what constitutes "macro-relevant" and "critical" is called for.

4 - MACRO-RELEVANCE - CRITICAL. Making decisions on including structural measures in IMF programs operational, calls for some definition of "macro-relevance" and "critical", also to be taken up in the guidelines. In our view a reform measure is macro-relevant if it is focused at one of the underlying problems which (indirectly) resulted in the balance of payments problems and/or the economic imbalances. In addition, a measure is critical for program success if without the implementation of this measure macro-economic stabilization is not to be expected within the period during which a member remains to have access to Fund resources[9]. It is worth noting that the precise interpretation of "macro-relevance" or "critical" is country specific and program dependent. This makes the reasons for including (structural) conditions in IMF programs even more important. The Board should always be in a position to assess their adequacy, appropriateness and need. This set-up could make it necessary for staff to inform the Board in a timely manner (i.e. well before the formal Board meeting). This equally applies to the level of detail of conditions.

5 - DEGREE OF DETAIL OF CONDITIONS. We feel it is important that conditions in IMF programs do not exhibit too large a degree of detail as to endanger ownership and as a result hereof threaten the effectiveness of programs. As we acknowledge that quantitative performance criteria inevitably call for some degree of detail, limiting detail especially applies to structural measures. The guidelines should determine that the IMF must restrict itself to setting conditions at levels as macro and aggregate as possible to reach program objectives and to allow countries to take their own responsibilities. The onus of proof regarding the necessity of certain detailed measures lies (again) with IMF staff. If staff is not able to demonstrate this necessity, it should limit conditionality to a measure less detailed or refrain from imposing such a condition at all.

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[9] This is in line with the original and overall purpose of conditionality in IMF-financed programs: to safeguard the use of Fund resources.

6 - FUND AS A SCAPEGOAT. In day to day operations, national authorities may request the Fund to include specific measures in IMF programs in order to increase their leverage in domestic political discussion. In some cases however, these measures fall into non-core areas of the Fund or are unnecessary detailed. Nonetheless, the Fund has in many cases accepted the role of scapegoat. Taking into account the importance of ownership, the question is whether the IMF should refrain from doing so in the future. We take the position that conditions beyond those that are deemed macro-relevant or critical (with a clear motivation by staff), should only be taken up by other (international) organizations or in national country programs. This is in line with our suggestions above. Member countries must be encouraged to take their own responsibilities within their own legal and judiciary systems. The IMF should not try to substitute for national authorities. If the Fund wants to reflect on issues which fall outside its conditionality mandate, the annual Article IV consultation seems the right way of doing so. Technical assistance can also provide an opportunity to assist members in this respect.

7 - PRIOR ACTIONS AND PERFORMANCE CRITERIA. Analyses of IMF-supported programs show remarkable differences with respect to number and form of conditions in programs. With Goldstein we note that the number of prior actions differs markedly between countries; the number of conditions for specific countries increases as time passes; and in some programs a specific measure (e.g. making privatization of a state run enterprise possible) is listed as a structural performance criterion while in other cases the same measure is a prior action. With respect to the three above mentioned aspects it would be desirable for the Fund to explain the choices it makes in different cases. The principle of equal treatment of members (taken up in the present guidelines) necessitates this. More concrete, staff and management could explain in every program why they consider a specific prior action indispensable (building a track record, ensuring a good program start, some other reason) and motivate why they prefer a prior action to a performance criterion. This seems perfectly in line with the Guidelines on Conditionality. They state that "... member may be expected to adopt some corrective measures ...., but only if necessary to enable the member to adopt and carry out a program consistent with the Fund's provisions and policies." Although this guideline allows some room for interpretation, it is formulated in a restrictive way. We feel that it is important for the Fund to live up to this rule to ensure that countries will not be unduly discouraged to approach the Fund.

8 - ENHANCE OWNERHIP. Limiting both the number and (in both dimensions) the scope of conditions, is helpful in securing national ownership for an IMF program. The concept and the importance of ownership are taken up in the present guideline number 4. We would recommend to accentuate this guideline by explicitly taking up the opportunity for program countries to suggest alternatives for measures proposed by the Fund if they feel that these are more suitable to their domestic situation. On the other hand, IMF staff should also be encouraged to suggest different scenarios addressing economic imbalances. Countries should be offered a real choice with respect to the measures they prefer to implement. This will also take note of the fact that no blue print solutions exist and that reforms are highly country specific. We encourage staff to deal with such alternative scenarios in staff reports accompanying requests for the use of Fund resources.

One other relevant consideration, not necessarily to be addressed in the guidelines, concerns the possible role a national adjustment program could fulfill in the context of a request for an IMF program.

9 - NATIONAL ADJUSTMENT PROGRAM (NAP) AND A FUND PROGRAM. We would recommend national authorities to have in place some kind of national adjustment program approved by the national legislative forces whenever it decides to approach the Fund for its financial assistance. Unlike a PRSP (which is drawn up in the context of a PRGF program), this NAP should not be endorsed by the Board and the country should have absolute freedom with respect to its process and content. The involvement of the IMF in drawing up a NAP should be kept to an absolute minimum. At most, Article IV results could feed into national programs or authorities could use the benefits of technical assistance in setting up these programs. In many cases the Letter of Intent (LOI) or Memorandum on Economic and Financial Policies (MEFP), in most cases written by Fund staff, serve the purpose of a national program. However, a true national program (written by the authorities themselves and accounted for by them in the national parliament) could address a lot of issues that the IMF should not be concerned with. We expect that having in place a national program will strengthen the position of the member state. It will enable the IMF and other international organisations to keep their roles of expert advisers with respect to (structural) measures in line with their mandates. If a country chooses to include in its program structural measures relating to the expertise of (among others) the World Bank, ILO or WTO, these other organisation(s) should monitor their implementation. If macro-relevant, these conditions could be included in the IMF program. This may require more intense co-operation between these institutions and the Fund. It is needless to say that, whether countries have a national program in place or not, an IMF program should always fit the quality standards of the Fund.

The Hague / Amsterdam,
February 2001

From: Dr T K Chakrabarty
Sent: Monday, April 09, 2001 2:03 AM
To: conditionality@imf.org
Subject: small economy

Thanks for entertaining views on conditionalities
I am since 1994 with a break of 2 years placed as Economic Adviser to Governor , Bank of Mauritius . I belong to Reserve Bank of India and hold a post of Director , Research Division of Economic Dept. I am supposed to back to RBI in this year end.

During this period, I had occasions to discuss with some mission teams for article four consultations.

Conditionalities and team approach should be conducive to motivate local authorities to ensure political will for fiscal responsibilities. Fiscal responsibilities should be execised not through universal model of fiscal reforms , but through indigenous model incorporating local structural specificities. The speed of adjusments should not be dictated , but be incorporated by the local authorities.

IMF mission team should encourage local authorities (research wings of monetary and fiscal authorities) to conduct analytical and informative regular studies to know better the dynamics of the economy . IMF would be able to form views based on local reserarch studies also. The research culture helps modern policy implementations and develop country ownership.

Intellectual faculty of the local authorities must be used by IMF team .
IMF should encourage local intiatives to improve macro management for their own social , political and economic objectives.
(IMF Regional Institute should encourage country specific studies exclusivelt by countries officials and academics).
The basic premise is that research culture helps foster own initiatives towards progressive changes .
This leads to feeling of country ownership which is the necessary condition for successful implementations of reforms.
The financial world has changed , has gifted us many crises (own/ imported) . IMF conditionality is being changed . The focus deserves towards fostering country's effective initiatives .
This is entirely personal view.
Thanks

Yours

Dr. Tapas Kumar Chakrabarty
Economic Adviser to Governor
Bank of Mauritius

Streamlining and Focusing Conditionality: The Precondition of Legality.

Conditions linked to the use of IMF financing provide an important mean for imposing main policy guidelines in exchange to the concession of the funds. The misappropriation of the financial resources has become a fundamental issue in recent years. The case of Russia during the Yeltsin government represents the best example, although it is not unique. The achievement of macroeconomic stability and the implementation of structural economic reforms are key elements of the IMF action, but it is also necessary to take into consideration the existence of widespread corruption systems in many parts of the world.

The misuse of the resources supplied by the Fund can be often reduced through a deeper control on their real management, while the illegality connected to bad administrative pratices acts as a serious limit to economic development and needs a more intense approach in order to eradicate it. Therefore, the conditions attached to the use of IMF financing should include the enforcement of appropriate legal frameworks in member countries.

At a basic level, less developed countries and transition economies should focus on the constitution of nation states based on the rule of law. Modern democracies have demonstrated to provide the best environment for economic development and the certainty of right is a fundamental condition for the realization of any kind of economic rapport. The creation of a legal order is particularly necessary in many African and Asian developing countries, in China and in those nations that are experiencing the changement from socialist economy to the market.

At a upper level, the enforcement of international legal standards and of regional agreements allows the diffusion of economic transparency and hinders the action of corruption. The adoption of the International Accounting Standards and the ratification of the international rules against money laundering, as well as the harmonization of national codes and procedures, are required in order to expand good economic practices. Again, Russia is one of the countries where such action is needed, before the illegal system reaches a critical consolidation.

In conclusion, policy implementation linked to IMF financing must absolutely take into consideration the diffusion of corruption and provide the necessary measures in order to stop it, through the enforcement of adequate legal provisions as a precondition for the concession of the funds.

Alessandro Ceresa

Comments on the IMF Paper

"Conditionality in Fund-Supported Programs---Overview"

by Vicente Galbis

1. I would like to thank the IMF for the opportunity to comment on this set of important conditionality papers. My comments are focused on the Overview paper, but they have taken into account the three background papers, as well as the discussion by the Executive Board. While the basic ideas go in the right direction, there is serious danger that a premature implementation could harm the interests of the international community and diminish the effectiveness of conditionality in Fund-supported programs.

2. The main contention is that Fund conditionality has expanded excessively in the structural area since the 1980s and especially in the 1990s. However, none of the papers provides a test of whether the expansion of conditionality reduced or enhanced *the results* of Fund-supported programs. Moreover, the fact that the *rate* of implementation of structural conditions is shown to be constant in relation to the number of structural conditions means that we may have not reached the point of diminishing returns. Again, the fact that compliance with structural conditionality has been less than that of quantitative macroeconomic conditions can be explained by two facts. First, structural conditions have been imposed mainly on transition economies and low-income countries where the general economic situation was worse than in other countries. Second, many of these "structural conditions" (as broadly defined in the papers) were not obligatory (not prior actions, performance criteria, or even benchmarks) but only intentions of the authorities. Logically, we would expect greater compliance with formal conditions than other policies. The papers also attempt to cast suspicion on whether the Fund is adhering to the principle of "uniform treatment" of program countries, by questioning the observed differences in coverage and the rates of compliance in structural conditionality among program countries. But again, the papers do not provide evidence that there was anything wrong with these observed differences, which would seem to have been justified by differences in the situation of the countries.[1]

3. Before the advent of structural conditionality, most Fund-supported programs were short-term (usually one year) and were deficient in two areas. First, implementation could be a mirage. For instance, a government could engineer a cut in expenditures during the program year only to shift them to the year after the program had ended. A central bank could play the same game with regard to conditions limiting domestic credit expansion. In this state of affairs, programs often not only did not have the desired restrictive effect in the medium term, but aggravated cycles of boom and bust observed in many countries. Second, even if the integrity of a Fund-supported program was sustained beyond the short-term period of the program, the lack of structural adjustment meant that the

[1] The principle of "uniform treatment" of countries does not mean that all of them should be treated in the same way. Equal treatment of unequal countries can be the most unequal treatment of all.

application of the program was going to have drastic negative effects on output and make the poverty situation worse. Therefore, the control of the balance of payments and inflation often were at the expense of growth and poverty reduction. The lengthening of the period of Fund-supported programs and the introduction of structural conditionality were the two mechanisms used by the Fund to combat these two difficulties that frequently rendered the *results* of Fund-supported programs unpalatable and even detrimental. Thus, there is no doubt that these two features of Fund-supported programs--appropriate length of the program and structural reform--must be maintained. We all agree, therefore, that the issue is not whether structural reforms will continue to be necessary (they will), but whether it is better to leave these reforms to the discretion of the authorities (the question of ownership); and secondarily, for those policies that may be included in the conditionality of international organizations, which of these organizations should be responsible for their application, the IMF or other international organizations such as the World Bank, the WTO, and others.

4. The papers do not directly address issues of poverty, environment, military expenditures, and socially productive expenditures in education and health. Presumably, expenditures in education and health and the military are included as part of fiscal policies that fall under IMF responsibility. Improvements in the poverty front are indirectly linked to growth (although this relationship is not always certain) and more directly to social safety nets, which are in the area of the World Bank. But there seems to be no specific arrangement at this time to evaluate and impose conditions on environmental policies, which are coming to the forefront in all countries. The Fund must have some way of taking into account the situation in all these areas, because this is crucial to the goals of high quality sustainable growth and poverty reduction that are, or should be, the ultimate justification for Fund-supported programs. Because financial resources are fungible, the Fund should not return to a more primitive age when it could provide balance of payments financing to countries without paying attention to the situation of the country in these other areas. Financing a country under a military buildup, or with unsound environmental policies, is tantamount to promoting its destructive aims; and this is not only economically unjustified, but also morally wrong. The issue again is not whether the Fund should continue to make judgments in these non-core areas, but how it should make these judgments and impose its conditions.

5. The proposition that the IMF should limit its conditionality only to those *individual* policies that are *critical* to the macroeconomic outcome involves a fallacy. Of course, the Fund always (before and after the expansion of conditionality) imposed conditions on individual elements of the policies that were so significant that they could critically affect the macroeconomic outcome, such as an export commodity that was dominant in trade. But this is not the issue. It is easy to identify a single micro condition that can affect the macro outcome, a situation that only tends to affect relatively backward and small countries. What is more difficult to pin down is the situation of many countries that do not have a single policy lever that would critically determine the outcome, yet where a multitude of structural impediments make the outcome of a program doubtful, particularly from the medium to long term sustainability perspective. Thus, a *constellation* of structural conditions can be absolutely crucial—the critical mass--

without any individual condition being critical on its own. In these cases, the Fund will have to continue to judge the relevance of the constellation of multiple, not single, structural conditions to the outcome of Fund-supported programs. Such constellations of measures can of course be very different from country to country because of their different situations. And it is also possible that various different constellations of measures may satisfy the requirements (the critical mass) in any single country. In addition to this general methodological problem, the papers, as well as the discussion of the Executive Directors, point out the difficulty in distinguishing between *crucial* and *relevant* measures. In light of these methodological complexities, the proposed shift to a presumption of parsimony from a presumption of comprehensiveness involves a large role for a priori judgmental views, which may have the effect of increasing the probability of committing errors in the *results* of Fund-supported programs by pre-selecting policies that in hindsight may turn out not to be the crucial ones. This applies to areas of Fund expertise as well as critical non-core areas.

6. The issue of "country ownership" in Fund-supported programs is not much enlightened by these papers. There is a discussion that indicates that causality between country ownership and conditionality runs in both directions, which means they are uncorrelated; and indeed the econometric tests show lack of correlation between the two. But it is unclear what this has to do with the *results* of the programs. At another level, the papers seem to imply that the more country ownership the better. Tautologically, it is true that since the policies of a country cannot be implemented by anyone other than the country itself, the determination of the authorities and the capacity of the country are always crucial. However, the issue is whether the IMF adds or subtracts value to that determination and capacity. From this more pointed perspective, the relationship between the "relevance of the Fund" and "country ownership" is not linear, but has a u-shape form. At one extreme, if the authorities were fully prepared to undertake a good program even without the Fund, the IMF would be irrelevant (except that its financing could ameliorate the costs of adjustment). At the other extreme, if the country were not prepared to undertake any reforms, the Fund would also be irrelevant, since the Fund does not have sanctions to impose its conditions. The Fund is most relevant in the intermediate case, that is, when the authorities' commitment hangs in the balance; in this case, the Fund may make it more probable that, with its participation, the authorities will implement a good program than otherwise, either because of the financial carrot provided to the country or because the authorities can partly point to the IMF as a source of pressure to carry out the necessary policies, or because of the value of critical Fund advice and technical assistance. But, if in addition, in some cases the Fund should somewhat bend the hand of the authorities *in the right direction* so be it. The Fund should not have to apologize for infringing *to an appropriate extent* the so-called sovereign rights, because it was created precisely to prevent the national authorities (on behalf of the community of nations) from carrying out policies that are destructive of national or international prosperity.[2] Nevertheless, it is possible that in some individual cases the excessive detail in Fund conditionality in regard to the implementation process and sequencing could have negative value; this is especially the case if a policy can be

[2] Most international agreements are designed to chip away to a greater or lesser extent the countries' sovereign rights that harm the interests of the country or the international community.

accomplished through various alternative routes and the Fund should insist on doing it in one particular form or sequence that might eventually turn out not to be viable. However, the papers do not contribute evidence that systematic errors were made in this regard. It is worth noting that the number and detail of structural conditions is bound to fall in any case in the coming years because there are no more transition countries in the initial stages of reform and many of the existing transition and low-income countries will henceforth be undergoing less intense second-generation reforms.

7. In principle, in a well-ordered international governance system, the IMF should relegate non-core functions to other international organizations. For instance, the Fund should rely on the World Bank to exercise vigilance and impose conditions on poverty and environmental matters and other structural areas of its immediate concern. Unfortunately, however, the Fund does not now have proper and effective coordination arrangements with other international organizations in the context of Fund-supported programs. The Overview paper notes that improved coordination arrangements between the Fund and the World Bank are now in effect for low-income countries following the introduction of the Fund's Poverty Reduction and Growth Facility (PRGF) and the Bank's Poverty Reduction Support Credit (PRSC) in the context of the Poverty Reduction Strategy Paper (PRSP). This is a good model for such future arrangements, although it remains to be seen if its successful implementation can be carried out rapidly. However, the paper also (but too briefly) notes the fact that no such arrangements have yet been worked out with the World Bank for countries other than the low-income countries. From the point of view of one of the main objectives of the IMF that is to keep order in the international monetary system, this leaves a very serious and crucial gap at this stage in the implementation of the idea of close Bank/Fund collaboration in the context of country programs. For it is in the group of so-called emerging economies--countries with relatively substantial economies and well connected with the rest of the world, especially through capital flows—that the main and most dangerous financial crises are at present taking place from time to time. These crises can be dangerous to the international monetary order through contagion effects on other similar economies, the world capital markets and the exchange rate system. Therefore, the lack of IMF/World Bank coordination in these countries shows how primitive a stage of coordination we are in at the present time from the point of view of managing Fund-supported programs. Moreover, given that the World Bank does not normally have significant operations in non-poor countries nor dedicates substantial resources to analyze their performance even in its crucial areas of responsibility, it would take a significant leap in the World Bank's country focus to start playing its complementary role in relation to the Fund. It is not clear whether this is something that the World Bank is contemplating. In these circumstances, the immediate abandonment by the Fund of structural conditionality would simply leave a vacuum, with no one watching over these other areas. Such coordination arrangements can and should be established over time, but even with good will and imagination on all the parties concerned, it could take a long time to have working arrangements in place. In the meantime, the Fund should continue to impose conditionality in the non-core areas when required by the circumstances of any given country.

8. There are in principle three ways in which the IMF could continue to rely on conditionality on issues crucial to the results of Fund-supported programs outside its core areas of responsibility.[3] First, the Fund could continue to impose its "own conditionality". This would be necessary if some crucial policies were not covered in practice by any other international organization; but it could also result from the application of "overlapping conditionality", where both the IMF and the other relevant organization impose similar conditions. Second, the Fund could rely on other international organizations to impose "complementary conditionality" (this presumes that these other organizations are ready and fully coordinated with the IMF). And, third, it could if allowed recur to "cross-conditionality". At present the Articles of Agreement would seem to preclude the third possibility. However, in practice it is difficult to see how this can be avoided except in a formal sense. If a Fund-supported program requires "complementary conditionality" and the complementary program of the World Bank is not met by the authorities, would this not call for the Fund to be remiss to proceed with its own program? If so, would this not be an indirect form of cross-conditionality? In this case, the only way to avoid formal cross-conditionality would be for the Fund to reintroduce the conditions on its own (with the resulting "overlapping conditionality"). This may have been partly the reason why the Fund had to impose its own conditions outside its areas of expertise even when similar conditions were being imposed by other international organizations. It would seem worthwhile to reinvestigate this whole area. After all, the World Bank and other international organizations sometimes introduce "cross-conditionality" by making some of their programs conditional on the observance of Fund-supported programs.

9. The discussion of the trade-offs between "action-based" and "results" based conditionality reaches the useful conclusion that in practice the Fund has been and needs to be somewhere in the middle. Because ultimately the Fund and the authorities are interested in results, the closer the programs are to results the better, but this desire is tempered by the constraints of the delayed and uncertain effects of policies on results and the need for timely balance of payment financing. However, we should not lose sight of the fact that this issue is most relevant to the treatment of *reviews* in Fund-supported programs. Reviews are the Fund's tool to deal with the inherent uncertainty in the relationships between the policies, the intermediate targets and the results. It is true that reviews can reduce ex-ante assurances to the authorities that financing will be forthcoming. But if a program is rigid, that is, without proper dynamic review when the uncertainties in the instrument/results connection are inherently very great, the Fund could provide full assurances to the authorities only at the expense of increasing the probability of errors in the results. The principle guiding the treatment of reviews should be "better to be imprecise than precisely wrong". Along the same lines, the idea that reviews should not move goalposts but only ensure the implementation of the original program is of doubtful value in cases when it comes to be recognized by both the Fund and the authorities that the original goalposts were faulty, incomplete or inconsistent.

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[3] It is reassuring to note the finding that 70 percent of IMF conditions were applied in its own areas of responsibility.

10. Because Letters of Intent (LOI) and other similar documents are papers from and of the authorities, the IMF should adopt the general principle that the authorities should decide what to include or not in them, besides the conditions of the Fund-supported program. A fortiori, this should also apply to the policy matrices found in these papers, which often provide a much more clear overview of the authorities' intent than the verbal descriptions. In this area, the IMF should limit itself to two obvious requirements. First, all the conditions agreed with the Fund should be covered in a manner acceptable to the Fund. Second, these conditions should be clearly demarcated from the rest of the intended policies. The suggestion for including a separate section encompassing all Fund conditions is a good one. Any other material the authorities see fit to include should not contradict the IMF conditions.

11. An issue not dealt with in the papers is the *stigma* suffered by member countries that apply for Fund resources under conditionality. This stigma is to be expected, because the need to apply for Fund-supported programs means that the country in question has failed to follow good economic policies. But an undesirable consequence of this stigma is that countries try to avoid recurring to the Fund until late in the problem, often in the middle of a full-blown crisis. To remedy this serious problem, the Fund could engineer a set of incentives in terms of rapid disbursements and less conditionality to entice countries to apply for Fund support at an early stage of a probable crisis, when it is easier to deal with. In this regard, the recent proposal by the G-24 for the creation of a new Fund facility with these characteristics--the Cooperative Credit Arrangement (CCA)--deserves consideration by the Fund.

12. To conclude, structural conditions will continue to be critical to the performance of Fund-supported programs. For the time being, and while the mechanisms for close coordination between the IMF and other relevant international organizations are not in place, the Fund should continue with its present practices of evaluating and imposing structural conditions outside its core areas, while basing these conditions on paying increasing attention to the relevant programs of other international organizations. At the same time, the Fund should immediately start to <u>dedicate much more resources to engineering the future coordination mechanisms with other international organizations</u> that will ultimately allow it to transfer structural conditionality outside its core areas to other more appropriate organizations, along the model worked out with the World Bank for poor countries. It must be recognized, however, that this will take substantial time and resources to accomplish both at the Fund and other international organizations, and that its final outcome will not depend only on improvements within the Fund but also within all the other relevant international organizations.

From: Martin Edwards
Sent: Wednesday, May 16, 2001 9:47 AM
To: conditionality@imf.org
Subject: response to review

To Whom It May Concern:

I recently read with anticipation the Fund's extensive review of conditionality. I feel that the proposed changes are commendable, and the tone of the documents reflect a frank acknowledgment that many problems presently exist. However, I have several reservations based on the report as written. For the record, I am a PhD candidate in Political Science at Rutgers University, and I am in the process of writing a dissertation on compliance with Fund Stand-By and EFF programs.

My main concern with the Policy Issues document lies in the discussion of ownership and conditionality. Though the Policy Issues paper does stress the importance of ownership, and it notes that the decisions of national authorities as well as other stakeholders are paramount in establishing whether programs are owned' or not, future work on reshaping conditionality needs to develop these lines of argument much more systematically. In essence, there are three omissions in the existing report which need to be resolved to make conditionality more effective.

First, there is no discussion of what constitutes an "owned" program and how it can be identified ex ante. Following from the discussion of Dollar and Svensson's work, the Fund needs to develop the wherewithal to identify owned programs ex ante. Focusing on "ownership" is simply not enough, for it has two problems. First, it is poorly operationalized. If we accept that one reason governments use conditionality is that they need an external source of discipline to make policy changes at home, then the sample of Fund program states is probably by its very nature comprised of states with questionable ownership. Second, and more important, it may be strategically misrepresentable, a prospect readily admitted in the report on page 54, paragraph 10. If leaders may seek to use Fund conditionality as a lever, then the prospect of successful implementation is uncertain.

Thus, the Fund needs to develop a theoretically informed account of how potentially successful reformers can be identified and promoted. Fortunately, a substantial discussion of the political economy of reform does exist in the political science literature. All that is needed is a more focused appraisal of it.

Second, there is no discussion of what domestic political factors contribute to successful implementation. To be fair, the report does mention the 1997 ESAF review findings about electoral cycles and civil unrest, but there is little else. A huge literature in political science focuses on the effects of institutions such as legislative organization, federalism, regime type, and the number of veto players. Recent work at the Fund (notably by Alesina and coauthors) has focused on how electoral rules and political institutions shape the level and composition of public spending. More work of this type is necessary to uncover what mix of

political institutions allow for better adherence to Fund performance criteria.

Third, there is no discussion of how consideration of domestic institutions, by shaping the prospects of successful implementation, affect the design of conditionality. Recent critiques of the Fund stress its need to be more selective about lending. Of course, while selectivity is a mantra, the exact criteria by which the Fund should become more selective are often not discussed. If we accept the claims above, then it is clear that the basis for future selectivity grows out of a focused appraisal of the links between institutions, performance, and compliance. If the Fund seeks to improve the implementation rate of its programs, which constitutes the sine qua non of successful conditionality, then this necessitates designing prior actions and performance criteria that are both politically viable as well as economically viable.

In essence, to fulfill the promise of making conditionality work, the Fund needs to take the politics of reform as seriously as it does the economics. Only by developing more extensive data collection efforts and more in-depth analyses can the Fund take a state's domestic politics out of the error term' and design adjustment programs that are both more credible and more effective. As cited in the report, excellent research of this type is well underway at the World Bank. The Fund needs to show similar vision in the coming years by developing similar capacities.

Many thanks for the opportunity to comment on these efforts.

Martin S. Edwards
Department of Political Science
Rutgers University

From: Akhtar Mahmood
Sent: Thursday, May 17, 2001 11:29 AM
To: conditionality@imf.org
Subject: Akhtar Mahmood's comment on conditionality

May 17, 2001

To: IMF: Conditionality

From: Akhtar Mahmood

I am writing this in response to an IMF public invitation (www.imf.org).

I am a retired civil servant. Before my retirement, I worked in most of the economic ministries of the Government of Pakistan.

My comments, given below, are based on the three remarkably educative documents on Conditionality published by the Fund on February 21, 2001.

Let me begin by thanking the Fund for giving members of the public like me an opportunity to express their views on a matter as sensitive as Conditionality. I regard this action as an important step forward in the liberating process the Fund began some time ago to make public most of its transactions with its member governments.

I know from personal experience that Conditionality is both necessary and desirable. However, I am not convinced that deviation from an agreed program deserves to end in premature termination of the program and total stoppage of financial support without the Fund having issued a credible and well-argued public warning in advance. Punishment no doubt brings an undisciplined government back to virtue, and sometimes to its fall, but it also inflicts a great deal of undeserved pain on already poor people. I wonder if the Fund ever makes a cost/benefit analysis of its penal policy. Moral hazard is indeed a real problem but it needs to be defined in each specific case before remedial actions are set in motion. Negative action becomes even more hurtful when one recalls the fact that the Fund does not always apply its rules uniformly to all countries.

The Fund documents on Conditionality have placed a great deal of emphasis on the need for ‘ownership’ of adjustment programs, but they have not clarified the difference between ‘ownership’ in the sense of ‘making’ a program and ‘ownership’ in the sense of commitment to implementing a program, one that has been designed by the Fund and accepted by the borrowing country. Secondly, while these documents have acknowledged the existence of factors, such as the following, that compromise the notion of ownership, they have not discussed clearly their implications for the Fund’s penal policy.

- The Fund needs resources for carrying out its operations; it cannot therefore ignorethe wishes of its major shareholders. On the other hand, it is also true that not all members of the Fund always regard the political and economic interests of the

major shareholders as benign. This doubt infects the objectivity of the "Reform" in the eyes of the borrowers and tends to inhibit dedicated implementation.

- Even the literature produced by the Fund has brought out the fact that only a relatively small number of Fund Programs have been implemented fully by the borrowing countries. It has also emerged in various studies that Fund programs, more often than not, fail to meet their objectives of growth, low inflation and sustainable current account balances. I am therefore puzzled as to what exactly is the basis for the intellectual certainty of Fund staff in their dealings with a borrowing country.

- The common perception among national bureaucracies is that Fund staff do not leave much room for the borrowers' bureaucracies to participate in any meaningful sense in the designing of a program. It is therefore not surprising that most civil servants, other than a handful of the chosen few, tend to nullify rather than promote implementation.

- Those who know Pakistan will recall that before the 1990s, the era of Conditionality and elected governments, it had a fairly active Planning Commission. Among other things, the Commission, notwithstanding its many limitations, built up a group of reasonably well-trained economists and engineers that used to act as a useful think tank, at least, for the Government. That body now, as a result of constantly expanding Conditionality and increasingly bad governance, is in a state of permanent coma. All "thinking" is now concentrated in the Ministry of Finance! As far as I know, the Fund has not made any serious effort to encourage the development of the intellectual capacity for "ownership".

The current reform program of Pakistan is spread over 27 pages. The reform program of the Asian Development Bank adds perhaps another 10 pages of instructions. It is true that a large number of constituent elements of these programs are not as compulsory as the "Performance Criteria"; nonetheless, the scope of current "Conditionality" is excessive. It is essential that the Fund evaluate carefully whether in fact it has the resources and skilled manpower to design and monitor Conditionality of the size it is promoting these days. I wonder if any multi-lateral institution, even with the best of will, can cultivate the sensitivity to develop effective programs for all its huge membership. At least I am not aware of any recent study done by an eminent economist and sponsored by the Fund that has attempted to research the institutional structures in Pakistan that make even the best policies go awry. The Fund needs to spend some resources to understand better the institutional and economic structures of Pakistan in order to succeed in recommending effective policies.

Concerning the scope of Fund Conditionality, I further recommend that the Fund work out in as great detail as possible the implication of its programs for growth and poverty in poor countries and discuss them with its members. Experience does not seem to justify the expansion of its Conditionality in the name of growth or poverty alleviation.

Finally, I request policy makers in the Fund to scrutinize their utility functions more carefully to evaluate how far Conditionality is a form of domination.

STRUCTURAL CONDITIONALITY: THE WRONG FOCUS FOR THE IMF[1]

June 19, 2001

1. Introduction

1.1 It is likely that the pending IMF Board consideration of structural conditionality is a somewhat bogus undertaking. A central concern of this consideration seems to be whether or not IMF arrangements contain an excessive number of policy reform conditions. The Board should instead focus on substantive issues relating to the impact on welfare of IMF lending disbursements, not of structural conditions. A crucial question for IMF staff should be to explain why lending arrangements fail, particularly those with good, if not "perfect" structural condition menus. These failures, and there are more than a few, suggest that simply improving structural conditionality is not enough. Too many IMF arrangements reduce welfare and/or contribute to sovereign debt overhang problems. Very few recent arrangements seem aimed at credibly containing international contagion.

1.2 The IMF has intervened in too many countries, usually with too much money over too prolonged periods of time. These excesses are the result of the adoption in the 1970s of a "promote growth" goal. This has been used to rationalize IMF lending interventions into virtually all of IMF developing country members, coupled with a belief that more lending will "buy" more policy reforms, packaged as structural conditions. To economists who have lived through the last 30-40 years of development history these "lend-for-reform" interventions do not appear to have improved things compared to the counterfactual. In particular the international economy seems about as **un**stable now as 30-40 years ago.

1.3 This note argues mainly on the basis of deductive logic and experience[2] that the IMF should change the way it operates. In particular it should drop its "promote growth" goal in favor of its older goal of limiting international contagion caused by temporary negative shocks. In addition the IMF should de-link its lending and policy or structural condition advice. In fact, the IMF should not lend to countries with poor policy milieus, especially if poor policies rather than negative shocks are the cause of economic/financial problems. Poor policy countries are not creditworthy.[3] If the poor policies carry a threat

[1] This note is based on a quite complete understanding of economic theory and its applications to development, and of what the IMF currently does and how it operates. I've worked as a development economist for thirty-seven years, twenty-one of them as a macro/trade country economist in the World Bank. For much of this time I worked with the IMF on country adjustment arrangements/operations, the latest having been Egypt. My CV is on my web page: www.erols.com/rmyers1.

[2] I argue in my paper, Improving Logical Reasoning in the World Bank, that the Boards of the IMF and World Bank accept the results of ludicrously specified empirical (econometric) studies when such studies reach conclusions that people want to believe. The paper is on my web page: www.erols.com/rmyers1.

[3] Morris Goldstein attributes a position similar to this to Walter Baghot (M. Goldstein, page 72).

of contagion, they should be seen as beggar-thy-neighbor policies and treated accordingly.

1.4 There are two country welfare-based reasons why the IMF shouldn't lend in poor policy situations. One is that the lending will "finance" delays in policy reform. The other is that the financing costs of the loans will reduce, or transfer overseas some of any gains from any policy reforms actually undertaken. The IMF should lend only when there is a threat of international contagion, in circumstances where a country's central bank can not by itself offset the impact on the private sector of negative shocks. This would limit the IMF to fewer interventions each year, although the size of callable lending in each instance might have to be considerably larger than most current IMF arrangements.

1.5 Besides lending to offset contagion, the IMF could adopt another, expensive, expertise intensive role involving assessing and publicizing the policy appropriateness of major economies. That is, the IMF could, at regularly specified intervals publicly provide information, now held secret, concerning policy problems in various countries. This would provide information that is relevant to private lenders' assessments of country creditworthiness. In fact, such a creditworthiness assessment is also required if the IMF is to appropriately identify negative economic shocks that can be mitigated with IMF lending. In addition, publicizing regular policy appropriateness assessments for major economies would serve to improve the information flow relevant to private international capital flows. As such it would smooth private capital movements, thus reducing their contagion impact.

1.6 This recommendation for limiting the role of the Fund is based on traditional economic reasoning, tempered with an understanding of some advances in the Economics sub-disciplines of Industrial Organization (principal/agent problems and TFP) and Altruism (subsidies). A very significant assumption that underpins these recommended changes is that permanent solutions are found to the world's current sovereign debt overhang problems. Until and unless these are removed, the IMF will continue to be asked to intervene to attempt to solve sovereign debt overhang problems that it is not equipped to handle. Solutions to sovereign debt overhang problems, which might in their totality be called a Sovereign Bankruptcy System,[4] will require broad-based international agreement. The IMF could be an initiating, and participating party to such an agreement, but it can not provide a solution on its own.

2. Background Considerations

2.1 This note concerns IMF lending arrangements such as Standby, Extended Standby and SAF/ASAF/PRGF) facilities that are accompanied by policy conditions. It is not applicable to the World Bank which might well cease lending altogether and become an international grant-giving institution patterned on the USA's Federal Emergency Management Agency (FEMA: http://www.fema.gov/about/what.htm). The importance of

[4] This is a term used in an excellent booklet entitled, Still Waiting for the Jubilee: Pragmatic Solutions for the Third World Debt Crisis, by David M. Roodman. World Watch paper No. 155, April 2001.

this to the IMF will become clear in the discussion below concerning negative economic shocks.

2.2 Unique aspects of this note are its focus on country creditworthiness and on the need for more private investment in freer market settings. Creditworthiness is a free market private sector concept defined as lending that makes positive contributions to gross domestic product/income, net of the cost of loan servicing and repayment. Country creditworthiness tends to improve when country external debt/GDP ratios fall. Most IMF arrangements do not cause sustained improvements in country creditworthiness. In fact, they frequently make a country's creditworthiness worse, as reflected by raising/maintaining unsustainable external debt/GDP ratios (e.g., Zambia).[5]

2.3 The key component of all IMF arrangements is short term lending of foreign exchange to Central Banks.[6] Such lending is supposed to temporally expand the supply of foreign exchange above what it would have been without the IMF. This increased supply of foreign exchange can be used to target market-determined exchange and interest rates at previous (desirable) levels in order to prevent both declines in welfare and international contagion. Alternatively, the borrowed foreign exchange can be used to increase a country's monetary base, in currency board situations. Either by causing an expansion of foreign exchange or non-inflationary domestic currency the IMF can help mitigate declines in domestic welfare and international contagion.

2.4 Theory suggests that the IMF will operate best in economies dominated by private enterprise and free markets. In such settings IMF lending can change domestic supplies of foreign exchange/domestic currency, without changing the incentive framework, and prevent the unsavory impact of contagion on international employment/unemployment levels. In practice the IMF operates mainly in developing economies where private sectors are small. In addition, domestic markets are non-competitive and dominated by governments and/or monopolies. In such settings IMF lending is at least partially wasted because incentive frameworks are not conducive to maximal growth. Put differently, the incentive frameworks are such that the countries should not borrow. Doing so will reduce welfare below what it would be without borrowing and create financial dependencies. In such settings, lending should only occur after substantial growth in private enterprise and the emergence of more free markets. Without these changes, IMF lending can be seen as somewhat sinister.

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[5] Alternatively the test of successful IMF arrangements could be, as Morris Goldstein says, to "…reduce/dismantle government imposed distortions and/or put in place various institutional features of a modern market economy." (M. Goldstein, p. 5) On these grounds too, IMF arrangements have generally failed. In spite of billions of dollars of lending and years of structural policy conditions private, formal sector investment/productive activities in most major developing economies are still underdeveloped, heavily regulated, highly monopolized and horribly inefficient. In addition, public sector external debt to GDP ratios are generally too high and unsustainable. As such, they prevent the additional borrowing needed to react appropriately to negative economic shocks that would reduce contagion.

[6] IMF lending wasn't considered part of country debt (so called DOD) until about 1978. Before then it was considered a swap or purchase/repurchase of foreign exchange. However, as the IMF's net lending to member countries increased, it began to be included in country debt, albeit frequently as a separate line item.

3. Old Versus New IMF Goals

3.1 The old IMF is distinguished from the new by virtue of different intervention criteria. As Lord Keynes envisaged it, the precipitating incident rationalizing IMF intervention would be a temporary negative shock that reduces the domestic supply of, or increases the demand for, foreign exchange. For large, internationally integrated economies such shocks are likely to have spillover or "contagion" effects into the international economy. (Remember, if it is not likely to spill over it is probably a World Bank concern.) In Keynes' day the primary concern regarding contagion was snowballing unemployment. Current concerns are more diffuse but tend more toward concerns for devaluing exchange rates and declining capital values.

3.2 The old IMF goal of containing contagion was in vogue until the adoption in the 1970s of a "promote growth" goal for each IMF developing country member. The old IMF, the IBRD (World Bank) and GATT (WTO) were founded by economic practitioners who wanted to protect the international economy from downward economic spirals, or snowballing panics that would result from an initial negative economic shock in a large internationally integrated economy. In today's jargon, they wanted to protect against "contagion". Such snowballing panics can occur when a large, internationally integrated economy either experiences a significant negative economic shock or suddenly adopts new beggar-thy-neighbor or excessively nationalistic economic policies.

3.3 The IBRD was established to lend money to help countries affected by negative shocks (WW II). WTO was formed to prevent beggar-thy-neighbor policies (the Great Depression) by engendering mutual agreement to a standard, sensible set of trade (BOP current account) rules. The IMF was originally established to help offset the internationally destabilizing or contagion effects of adverse financial (BOP capital account) movements or capital flight triggered by autonomous economic/financial shocks.

3.4 Such shocks, such as earthquakes or sudden loss of confidence in the domestic currency, assumed to be of exogenous origin, are likely to reverse themselves (i.e., they're temporary) and to occur in relatively appropriate policy settings. In such settings, the country borrows from abroad in order to avoid having to adjust domestic policies and propensities (which are considered to have been okay before the shock). Temporary negative shock cases involve external borrowing but no policy adjustment. The assumption is that the IMF lending, coupled with continued good policies enables the country to recover from the temporary negative shock without having to reduce imports and/or private capital inflows and/or significantly change exchange and interest rates. Mitigating post-shock changes to levels of imports and private capital flow and to exchange and interest rates prevents the contagion.

3.5 The new IMF came about in the 1970s with the adoption of a "promote growth" goal for each developing country, coupled with a belief that lending will "buy" policy reforms that will promote more growth. It can be understood by considering what

countries and the IMF should do in the case of permanent negative shocks such as the rapid depletion of oil reserves or a new government's dramatic policy shift toward socialism. These shocks lower GDP growth prospects and make countries less creditworthy. However, the negative impact on growth can be minimized if affected countries adjust policies but do not borrow from abroad. The permanent shock makes the existing policy milieu inappropriate. However, the IMF should not lend, and the country should not borrow in reaction to a permanent negative shock. Instead the country should improve the policy milieu in order to adjust to permanent negative shocks. Any IMF lending/borrowing worsens country welfare losses and creditworthiness. It may also delay, but not reduce contagion effects.

3.6 There are two important reasons why the IMF should not lend into policy situations made inappropriate by permanent negative shocks. One is that reductions in country welfare due to shocks will be worse if accompanied by borrowing. Countries will have to reduce consumption even further if they borrow in order to transfer overseas the interest/fee costs of borrowing. The other reason, usually much more significant is that lending/borrowing following a permanent shock will likely delay appropriate policy adjustment. This will mean that welfare will decline more than minimally because of lack of appropriate and timely policy adjustment and because of too low or negative economic returns to lending/borrowing because of sub-optimal policy milieus.

3.7 The above suggests that the new IMF violates the economic principle enshrined in the old IMF. That principle is, borrow for a temporary shock, but reform policies without borrowing for a permanent shock. A permanent shock brings about the quintessential new IMF situation: A need for policy adjustment. However, the theoretical economic maxim is that external lending/borrowing in situations of inappropriate policy will **in**appropriately increase external indebtedness and further lower GDP/income growth below what it will be following appropriate policy adjustment alone. In addition, the lending/borrowing may forestall policy adjustment, as it indeed does in cases of temporary negative shocks. The result is reductions in creditworthiness and/or sustained increases in country external debt/GDP ratios.

4. The Impossibility of "Pushing" Policy Reform

4.1 Applying the intervention principles of the old IMF requires that Fund staff quantitatively identify country growth trends or initial country growth conditions, given the existing policy milieu. Following this, the size of shock departures from these trends and the existence of a threat of contagion must be identified. These are difficult and uncertain tasks, but they are required if the appropriate size or amount of lending for IMF arrangements is to be determined. This approach has essentially been abandoned in favor of asking the staff to identify policy shortcomings. Determination of the amount of lending accompanying IMF agreements is now mainly done by administrative/political means. The logic for the switch to a policy focus is opaque but is mixed in with the "promote growth" goal adopted in the mid1970s. In effect the IMF shifted its focus from aiding in the adjustment to shocks and mitigating contagion, to advocating or "buying" policy reforms that might raise the growth trend.

4.2 If policy reforms are to raise the growth trend, they must stimulate more private investment. A fundamental truth of Economics is more growth requires more investment. Following the failure of Socialism/Communism this would be amended to say that greater private investment promotes growth. Following the latest productivity growth revolution, this would be further amended to say that more (relatively fragmented) private investment in competitive market settings promotes efficient, environmentally sympathetic growth. Given the fundamental nature of this relationship one would think that a primary test of IMF growth promoting arrangements would be their impact on fragmented private competitive investment. Unfortunately this is not the case. Instead, most IMF arrangements tend to be assessed according to whether they stimulate implementation of "consensus" menu of policy "improvements". Hence the concern in the new IMF with the correctness and efficacy of IMF structural policy conditions.

4.3 There are several serious problems with this approach, each of which is sufficient to prevent IMF arrangements from achieving policy reform and "promote growth" goals.[7] One is that it is virtually impossible to identify and specify complete and correct growth improving policy milieus.[8] In other words, there is no way of knowing with any certainty which policy frameworks will or won't insure growth in private enterprise and free market competition. A second is that the pace and sequencing of policy reforms are crucial to success, but not properly dealt with in IMF arrangements.[9] Yet a third is that no one has found a way to design IMF arrangements that definitively stimulate governments to adopt better policies. The current IMF approach seems to be expensive but of limited influence. Fourthly and finally, the new IMF appears to be **un**able to separate or distance itself from any country's policy reform process, once it has intervened.[10] This compromises growth in private investment and the emergence of more free, competitive domestic markets.

5. Sovereign Debt Overhangs Distroy IMF Effectiveness

5.1 Regardless of the fiction that IMF arrangements are motivated to improve policies to promote growth, most IMF arrangements are actually mandated by public sector, external debt overhangs and the crises they spawn. International financiers care little about the policy recommendations accompanying IMF arrangements. They focus on the lending and the short-term impact it has in staving off public sector debt defaults. In fact

[7] It is counterintuitive to say that better policies don't promote growth. My argument here is that IMF lending arrangements do not (can not) stimulate better policy atmospheres.

[8] Morris Goldstein (p. 54, etc.) gives some credibility to the contention that there is a "consensus" policy menu that approximates a standard IMF arrangement and that will enhance country growth trends if enacted. I never experienced such a consensus within the Bank regarding one country, let alone within the profession across several countries. Besides this, such a consensus is logically impossible and not empirically testable. This is despite the work by David Dollar, etc.

[9] I addressed this issue in a memo dated June 17, 1991 entitled, "Sachs and Co., Sequencing and Adjustment in Poland and Yugoslavia". I concluded that issues concerning pace and sequencing are important but can not be properly handled by the IMF and World Bank. See the memo on my web page: www.erols.com/rmyers1.

[10] As a friend in the IMF said, "country crises are tar babies."

most IMF arrangements worsen sovereign debt/GDP ratios, thus exacerbating the likelihood of default in the future. The fiction is that IMF policy recommendations will promote growth, causing the GDP denominator to grow faster than sovereign debt, thus lowering the debt/GDP ratio.

5.2 The actuality is that excessively high public sector external debt/GDP ratios and the chaos and uncertainty they cause play a more important role than poor policies in preventing growth in private investment and GDP. Explicit, policy neutral reductions of the debt/GDP ratio, e.g., through defaults or (much better) sovereign bankruptcy procedures[11] will have a much bigger impact on growth in private investment and GDP than policy reforms without reductions in the debt/GDP ratio. Alternatively, policy reforms without additional sovereign debt will have a greater impact on growth in private investment and GDP than will policy reforms accompanied by greater sovereign debt. The major inhibitor of growth in private investment and GDP is excessive sovereign debt, not poor policy atmospheres.

5.3 The pervasiveness of problems related to sovereign debt overhangs force excessive IMF interventions that go beyond its mandate and capabilities. Most IMF arrangements are motivated and dictated by debt servicing crises rather than by growth or contagion considerations. At present there are no alternative international mechanisms/institutions to address these debt overhang problems. This is despite the fact that IMF policy reform arrangements have been of little help. In fact, it is possible that the policy reform focus simply provides a cover for lending that delays but does not ameliorate problems relating to sovereign debt overhangs.

5.4 The current situation forces the IMF to devote much of its staff time and lending resources to sovereign debt overhang problems rather than to promoting growth or reducing contagion. Until and unless independent internationally agreed arrangements/institutions are established to address these problems, IMF arrangements must continue to be misdirected. Worse, the IMF expends considerable resources, e.g., under the aegis of economic research, defending such arrangements even though they will not alleviate sovereign debt overhang problems, alter structural policies appreciably or stimulate the expansion/maintenance of private investment required to achieve the contagion and growth goals.

6. The Need for Domestic Debt (Bond) Markets

6.1 It requires contrived and convoluted theoretical reasoning to defend the proposition that IMF arrangements can be effective in economies that do not have open domestic bond, or debt and asset markets. Theoreticians, including Lord Keynes, assume the presence of domestic debt/asset markets in discussing how to prevent contagion and stimulate growth in private investment and GDP. In addition, such markets, including related, credible bankruptcy procedures, seem essential to fostering buoyant competitive private investment. In spite of this, virtually all IMF arrangements are set in situations without domestic debt/asset markets. Most IMF arrangements are not tailored to succeed

[11] See Roodman, op. cit. pp. 62-73.

in settings lacking domestic debt/asset markets, nor do they contain structural conditions aimed at encouraging the emergence of these markets.[12]

6.2 In a short note entitled, "The Need for Domestic Currency Denominated Debt (Bond) Markets in Developing Countries" on my web page, I enumerate the benefits derivable from the emergence of competitive debt/asset markets. These benefits encompass the goals of the IMF and suggest that developing country governments can achieve the goals of the IMF without borrowing from the IMF if they issue domestic currency debt in freely competitive bond markets.[13] These benefits include: a) increasing and stabilizing household savings/insurance and private investment; b) stabilizing interest and exchange rates; c) mitigating inflation; and d) improving governance. The first (a) occurs primarily because competitive debt/asset markets are a necessary condition for successful reform/development of domestic banking (financial) systems.[14]

6.3 The second (b) recognizes that much of the pressure on developing country exchange rates comes from frustrated household saving/insurance/investment desires. These desires give rise to demand for credible financial assets with appropriate interest rates. As a general rule there are few such financial instruments in developing economies (there are no debt markets), particularly at attractive interest rates. As a result this demand spills over to foreign financial assets. The third, (c) should be obvious to anyone understanding Keynesian economics, while the fourth or improved governance (d) results from a government need to become more accountable to its own people when they are its major creditors. Alexander Hamilton first proposed this governance argument when advocating the sale of bonds by the US Government.

6.4 Government domestic currency bond sales, crucial to the emergence of domestic debt/asset markets in developing economies, have been impeded in part because of crowding out by IMF lending. Like domestic bond sales, IMF lending provides governments with non-inflationary financing for public sector deficits. However, most governments see IMF lending as preferable to domestic bond sales. First, most developing country governments have interest rate myopia. Because of this, they prefer IMF lending because the dollar interest rates are subsidized.[15] Also, such interest costs don't have to appear in the budget.[16] Second, IMF lending enables governments to

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[12] The US Treasury, with financing from USAID, provides consultants who push timidly for debt/asset markets. Accomplishments have been few, slow in coming and mainly limited to the establishment of money markets to help with monetary (not interest rate) policy. At present in Egypt US Treasury/AID consultants are supposed to be helping the Government sell bonds domestically. However, they've been taken off of that task to help the Government borrow in the Eurobond market.

[13] There may be several bond markets. One for government bonds, one for Treasury bills and notes and one for infrastructure bonds.

[14] Whether domestic financial systems can be successfully reformed/liberalized when there are no competitive domestic debt/asset markets, is closely related to whether BOP current account liberalization can be sequenced to successfully occur before, or without, simultaneous BOP capital account liberalization. The latter, and by implication the former, has been the topic of correspondence between myself and Sebastian Edwards and Anne Krueger. They feel that the reforms/liberalization can be sequenced. I feel they must occur together if costly failures are to be avoided.

[15] Devaluations can cause domestic currency interest charges on IMF borrowing to be very high, however.

[16] They are paid by the Central Bank.

maintain control over interest and exchange rates, rather than allowing them to be market determined. In effect IMF lending allows governments to establish an inconsistent or non-market relationship between interest rates and financial asset prices (including foreign exchange). This is a situation that requires continual increases in foreign borrowing and significant but delayed social losses if and when net debt repayment occurs.

7. Does IMF Lending Thwart Growth in Private Enterprise & Competition?

7.1 IMF lending arrangements can't succeed in the absence of vibrant or expanding private enterprise and competitive market activity. Otherwise new IMF lending, and/or the increases in domestic credit that it engenders, will be poorly used, thus worsening welfare and sovereign debt overhang problems. Recognition of this has led to the inclusion of privatization and anti-monopoly structural conditions in recent lending arrangements. Unfortunately, IMF arrangements have not been and are not likely to be successful in expanding private enterprise and competitive market behavior. Because of this, the IMF should eschew interventions until and unless vibrant private competitive activity exists or is emerging as the result of non-lending/borrowing initiatives.

7.2 One reason that IMF lending arrangements won't expand private competitive activity is moral hazard. The IMF, an official body working through member governments is attempting to encourage growth in competitive private enterprise through new government initiatives. Most in the economics profession feel that official/government bodies can not stimulate or encourage more competitive private activity with new, proactive initiatives. Such attempts compromise the private nature of the enterprises that emerge. IMF/government initiatives tend to create cozy relationships between existing private entrepreneurs, thus violating the "arms-length" dictum. With cozy relationships, competition and efficiency suffer and monopolies succeed. Private entrepreneurs see their profits as coming from IMF/government actions rather than from the preferences of consumers.

7.3 Another reason is that growth in private competitive activity is likely to occur because of deregulation or the dismantling of government programs. That is, developing country governments should do less rather than more to stimulate private activity. Dismantling and deregulating will allow more private competitive enterprise to emerge as a result of innate business proclivities.[17] This "hands-off" view is based partly on the belief that most developing country governments now intervene excessively, thus inhibiting private competitive initiatives.

7.4 The problem is that IMF lending and structural conditions then to foster and finance continued or even increased government interventions. For instance, most IMF supported privatization and anti-monopoly structural conditions have resulted in more government intervention that further inhibits private investment and competition. The privatization process has become an expertise intensive revenue-earning process,

[17] The existence of huge, vibrant, competitive informal economies provides evidence that these innate proclivities are both widespread and frustrated by excessive government interventions.

involving protracted negotiations to sell monopoly licenses to operate. The anti-monopoly conditions tend to result in new laws, regulations and intervention criteria that increase government control over existing enterprises and suppress rather than increase freedom of entry. The end result is maintained/increased government intrusions and no improvement in the private competitive investment atmosphere. The primary lesson is that IMF lending agreements should not be rationalized on the grounds that they stimulate more private competitive activity. They don't and can't. Instead, the absence of vibrant, private competitive behavior should be a signal for the IMF not to lend.

8. Zambia: A Case Study in What Not To Do.

8.1 The IMF paper on structural conditions has a declarative "box" on page 80 about a 1999 ESAF arrangement for Zambia. The reason for including this Zambia example is opaque. One possibility is that the 1999 ESAF is being presented as an example of an arrangement with a few, rather than many structural conditions. Another possibility is that the Zambia example suggests that the IMF's doesn't disburse lending until structural conditions are adhered to. Whatever the case, my close familiarity with Zambia, dating back to the late 1960s, and with IMF arrangements there, dating back to 1977, suggest that Zambia is an example of IMF failures. In particular, Zambia demonstrates that sovereign debt overhangs nullify IMF effectiveness.

8.2 The text in the box indicates that there have been nine or ten IMF arrangements in Zambia since the mid-1970s. Taken as a whole, the arrangements can not be said to have been successful. During this time period in Zambia per capita growth has declined significantly and a gargantuan sovereign debt overhang burden has developed.[18] The box text ascribes the lack of success of these Fund arrangements to the fact that "…program implementation was inadequate." The Fund's reaction to non-implementation, apparently considered appropriate by the authors of the box, was to delay or cancel particular lending arrangements but to always be negotiating the next arrangement. The box makes it appear that a sovereign debt overhang problem emerged in the late 1990s when, "…it became evident that Zambia's debt servicing was unsustainable…"

8.3 In fact, the sovereign debt overhang problem in Zambia emerged in 1980. Following an IMF/World Bank/GOZ financial projection exercise, it was obvious that Zambia could not meet its projected external debt service payments for 1981-1983. Zambia could not even meet the debt service payments owed to the IMF since they constituted slightly over 80% of the total.[19] It was clear in 1980 that Zambia had a sovereign debt/GDP problem and that the IMF was very highly exposed. The Fund had no choice but to continue to approve new arrangements in order to roll over Zambia's debt to it.

[18] Even with some debt write off, Zambia's sovereign debt/GDP ratio is over 150%. At one point in the early 1990s, it was over 200%.

[19] The IMF discovered the meaning of the term "exposure" in Zambia in 1980. Following the projection exercise, the then Governor of the Central Bank, at a meeting in Lusaka, looked at the IMF staff and said, "if we aren't going to pay one of our creditors, who do you think we will not pay first?"

8.4 But the arrangements did more than roll over IMF debt. They allowed/encouraged other external lenders to increase their Zambian debt. The Government of Zambia (GOZ) was able to use this borrowed money to substitute for increased tax revenues that would have accrued by encouraging more private investment activity. The additional external lending ratcheted up non-IMF external lending so that the Fund's portion of the total debt, or its exposure, fell. Other lenders were willing to increase lending, despite questionable creditworthiness, as long as Zambia remained in "good standing" with the IMF. "Good standing" essentially came to mean that an arrangement was in place with the IMF, even if Fund disbursements were being delayed or canceled.

8.5 Little attention was paid to the IMF's structural conditions by other lenders. Considerable staff resources were expended to insure that recommended structural conditions were viewed as appropriate within the Fund, but what was important to the international lending community was that Zambia appear to be in "good standing" with the IMF. In particular, it didn't seem to matter that GOZ was implementing the structural conditions in ways that continued to suppress private investment initiatives. Even cancellations of arrangements meant little since the periods until the next agreed arrangement didn't force debt-servicing crises.

8.6 An examination of the numerous Fund arrangements in Zambia over the last twenty-five years demonstrates the problems that occur when the IMF that intervenes willy-nilly to "promote growth" with structural advice. The Government of Zambia utterly ruined the country's policy atmosphere in the decade prior to 1975 with massive socialist interventions that destroyed private investment incentives. The country was not creditworthy by 1975. Then Zambia suffered what was initially interpreted to be a temporary copper price shock. Although there was no danger of contagion, this stimulated the IMF to formulate a continuing set of arrangements, with escalating amounts of lending and structural conditions, aimed at reducing GOZ interventions. By 1980 the IMF was an ineffective captive of circumstances.

8.7 In many respects Zambia is worse off now than it was in 1975. It has one of the world's worst sovereign debt overhang problems. There is such pervasive "adjustment fatigue" that it is virtually impossible to write a convincing story regarding how the private investment atmosphere might be improved. What is clear is that the IMF should not be involved.

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From: Richard Segal
Sent: Wednesday, May 02, 2001 7:52 AM
To: conditionality@imf.org
Subject: Conditionality

Dear Sirs,

I am pleased to see that the IMF is streamlining and in some ways strengthening its approach to conditionality. There are several aspects to this which I believe are crucial, most of which echo your statements and papers.

Other organizations, such as the World Bank and Paris Club, act on your signals as a rule of habit. I believe as a rule of thumb this is OK, but can be harmful if applied inflexibly. If, for example, the IMF and a country agree on most aspects of macroeconomic policy but not all, that should not preclude financial assistance or debt rescheduling talks from other agencies, particularly if the assistance is going to be applied in a completely different and uncontroversial area. Your conditions will be narrow and purposeful, but other agencies will interpret and apply them broadly. How can other agencies - especially the Paris Club - become more independent and begin to set their own conditions and covenants?

How will existing programs be grandfathered? It is impossible to rewrite each existing program to take into account a new philosophy about conditionality. However, this may be unfair to some countries that will be forced to follow more stringent conditions. They therefore have an incentive to move out of compliance, or taken to the extreme, to cancel an existing program, and insist negotiations start completely fresh. This would produce supoptimal policymaking.

It will be important to market participants that you clearly define what is a critical (what we call "bottom of the boat") issue and what is relevant but not critical (what we call "side of the boat" issues), and why they are critical.

It would be interesting if the IMF and/or the countries published an executive summary of a recovery package or monitoring program. At present, key aspects are presented informally and potentially in a noncommittal fashion, anecdotally, or in lengthy documents without prioritization.

sincerely,

Richard Segal
Director
Emerging Market Economics
London

Jakarta May 18, 2001

Ref: Comments on Conditionality

Dear Sir,

I have received the letter from NGO Liason office, dated May 3, 2001 today, May 18, 2001, at 13.00 Jakarta times. It is unfortunately too late in regard to the deadline for comments, which is also today. And because my modem is out of order, I can not see the set of papers on the review the conditionality. Nonetheless, by referring to the IMF publications, Pamphlet Series, No. 45 Fifth Edition: *Financial Organization and Operations of the IMF*, IMF 1998, especially Chapter III, *General Terms and Conditions*, I hereby send you the following comments. In your above letter, it was stated that the IMF Executive Board discussed how to focus and streamline the Fund's conditionality, focussing on:

- where to draw the line between measures that are critical to program objectives and those that are relevant but not critical ;
- how to improve coordination with other agencies on measures outside the IMF's core areas of responsibility;
- what the IMF should do when its financial support is requested by a country that lacks a strong commitment to policies needed to achieve a sustainable external position;
- whether there is scope for results-based conditionality, whereby the IMF would provide only after specific policy results have been achieved (rather than on the basis of progress toward such results);
- and the scope for the Fund to play a more supportive role in helping countries build ownership of sound policies.

It is clear that the reason for the IMF involvement is the balance of payments (BOP) problem of a country. At the present situation of liberal capital account, the free flow of short-term capital is surely at the roots of BOP problems, devastating the exchange rate at the time of exit. From its characters, it is of short-duration. But many of the conditionality on structural adjustment measures are of the long-term. From this point of view, it is of critical importance to have an appropriate coordination with other Bretton Woods Institutions (BWI). As a quick cure for the BOP problem, the country should be allowed to exert a temporary capital control, under the supervision of the IMF. But it is only temporary, and the IMF should be in charge on the time frame of the control. Due to the destroying effects of the massive short term capital outflows from a small economy, which are not well equipped with suitable financial institutions, the liberalization of capital account, especially short term capital, should be applicable to a club of countries, capable of sustaining such a regime. The financial stability of country has become **a global public goods**. Hence if a free flow of short-term capital for a country will entail its financial instability, provoking financial instability for the neighboring countries, free flow of capital should be limited and optional. Free flow of short-term capital with an appropriate volume needed by the economy concerned should be maintained. For this reason, there should be a special survey on the needs of short-term capital for a country, namely for working capital.

The request from a country, which is lacking a strong commitments to policies needed to achieve a sustainable external position should be refused, but after an appropriate dissemination of the information. But, any sustainable external position of a country should not be achieved at the cost of internal position. The burden for achieving sustainable external position, should not be charged upon the general tax-payers. One of the indicators of the efficiency of the loans from the World Bank all over the world is its

low of success rate, namely around 30 percent. It means, if the loans were from private commercial banks, 70 percent of the loans are *non-performing*. But the payment of the *sovereign debt* is demanded 100 percent, except for the countries, eligible for HIPC. Here again, there is an urgent need for coordination between the IMF and World Bank (including the ADB, etc).

The results-based conditionality at the time of crisis is surely anti-social and a killing strategy. It is not feasible, except if the IMF has been closely following and monitoring the policy of the country, and has been giving warning of the danger of the bad policy.

The Fund should be proactive helping countries to build ownership of sound policies. It means that the Fund should be proactive in capacity building on sound policies. For that purpose, the IMF should be supporting the domestic think tanks, at least 3 in numbers. The available local think tanks, could be reliable sources for sound policy formulation. But the Fund must avoid any efforts to minimize the role of domestic think tanks, or even to replace them by expatriate think tanks. The expatriate think tanks should be given a complementary role in policy formulations for a country.

I still have many comments, and after seeing the relevant papers on the conditionality, I will send you, even though the deadline is over. Due to the problem of my modem, I send you this e-mail through a friend's e-mail. Thank you,

Yours truly,

Dr. Djamester Simarmata
PR Indonesia.