INTERNATIONAL MONETARY FUND

Conditionality in Fund-Supported Programs—Policy Issues

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(In consultation with other departments)

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Contents Pg

Text Boxes

Annexes

I. Introduction

1. Conditionality—the linkage of financing to the implementation of economic policies—is a central feature of the Fund's activities. According to the Articles of Agreement, one of the main purposes 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 the opportunity to correct maladjustments in their balance of payments without resorting to measures destructive of national or international prosperity" (Article I).

2. Conditionality is not intended to infringe on national sovereignty. The Fund's financing is intended to support a member country's own program of economic policies, provided that these are consistent with the purposes of the Fund. In turn, the purposes of the Fund have much in common with the broad policy objectives of individual countries: it is in a country's own interest to pursue policies that will achieve a sustainable external position at a healthy rate of economic growth. But at the same time, the Fund and governments may disagree on the appropriate means and time frame for achieving these objectives. In particular, the Fund's fiduciary responsibility to safeguard the resources entrusted to it and its mandate to discourage beggar-my-neighbor policies may impose certain constraints on the advice the Fund provides to a member on its adjustment program.

3. Particularly in recent years, concerns over the extent of these constraints and their implications for the effectiveness of Fund-supported programs have become increasingly prominent. Some critics have questioned the basic premise of Fund conditionality, arguing that conditional lending, rather than supporting governments' own policy programs, has been used to pressure countries into making policy reforms that otherwise would not have been undertaken or would have undertaken only more gradually.[1] Such conditional financing, these critics argue, is bound to be ineffective because it ignores the role of national ownership in supporting program implementation. Some have expressed concerns that conditionality has been expanding, particularly in connection with the increasing structural content of Fund-supported programs. This expansion has led to questions of whether the Fund's conditionality has been extended beyond the limits of its effectiveness, and whether it has become so intrusive as to weaken national ownership for economic policies and thus defeat its intended purpose. These concerns are underscored by the generally mixed success of Fund-supported programs in meeting their macroeconomic objectives, together with evidence that a lack of commitment by the authorities to program objectives has been an important ingredient of failure in some Fund-supported programs.[2]

[1] See, for example, Killick, 1998, p. 163.

[2] The macroeconomic performance of Fund-supported programs is reviewed in Annex I, and criticisms of conditionality in Annex II.

4. Concerns over the expansion of conditionality have inspired various proposals to curtail it, partly with a view to enhancing ownership. Some have proposed eliminating conditionality in its present form, replacing it with eligibility criteria designed to ensure that the Fund's financing is provided only to countries with good policy environments.[3] Such relatively radical reform proposals are in some ways appealing and have useful elements, but they raise numerous issues regarding their general applicability, which are discussed in Annex III.

5. Short of replacing the entire framework of Fund conditionality, a number of proposals have been made to simplify it. Within the Fund, concerns about the scope and detail of conditionality have given impetus to recent efforts to streamline it. In particular, focusing and streamlining conditionality and strengthening ownership is an essential part of the Managing Director's vision for the institution. The Fund's management set this overall direction after informal consultation with Executive Directors at the July 2000 Board retreat. The International Monetary and Financial Committee welcomed this emphasis in its September 2000 meetings. The general principles of streamlining, within the scope provided by the Fund's existing policies, were embodied in an *Interim Guidance Note on Streamlining Conditionality* issued to staff in September 2000.

6. The present paper is intended as the basis for a Board discussion of principles and issues related to conditionality. The paper focuses on conditionality as a mechanism that links financing and policies, as distinct from the design of those policies themselves. Most of the issues and principles discussed are broadly applicable to both quantitative macroeconomic conditions and to structural conditions, although it is the latter that have generated the most attention recently.[4] The paper addresses the issues raised by the experience with structural conditionality, including the appropriate scope of structural conditionality and the division of labor with the World Bank as well as the modalities of program monitoring. It notes that the boundaries of conditionality and the role of different instruments have become unclear, pointing to a need to clarify the modalities of conditionality. Board discussion of these papers is intended to set the stage for a review of the Fund's *Guidelines on Conditionality* (Box 1).

7. The remainder of the paper is structured as follows. Chapter II discusses the principles of conditionality, including its purposes, the principles of program monitoring, the

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[3] This was, for instance, the approach favored by the Meltzer Commission Report (p. 6) for all but the most unusual circumstances where a crisis threatened the global economy.

[4] An accompanying background paper on *Structural Reforms in Fund-Supported Programs* examines the expanding scope and detail of conditionality over the past decade. Another background paper reviews recent experience with *Trade Policy Conditionality in Fund-Supported Programs.*

Box 1. Guidelines on Conditionality

The Executive Board agrees to the text of the guidelines on conditionality for the use of the Fund's resources and for stand-by arrangements as set forth [below].

Decision No. 6056-(79/38)
March 2, 1979

Use of Fund's General Resources and
Stand-By Arrangements

1. Members should be encouraged to adopt corrective measures, which could be supported by use of the Fund's general resources in accordance with the Fund's policies, at an early stage of their balance of payments difficulties or as a precaution against the emergence of such difficulties. The Article IV consultations are among the occasions on which the Fund would be able to discuss with members adjustment programs, including corrective measures, that would enable the Fund to approve a stand-by arrangement.

2. The normal period for a stand-by arrangement will be one year. If, however, a longer period is requested by a member and considered necessary by the Fund to enable the member to implement its adjustment program successfully, the stand-by arrangement may extend up to but not beyond three years.

3. Stand-by arrangements are not international agreements and therefore language having a contractual connotation will be avoided in stand-by arrangements and letters of intent.

4. In helping members to devise adjustment programs, the Fund will pay due regard to the domestic social and political objectives, the economic priorities, and the circumstances of members, including the causes of their balance of payments problems.

5. Appropriate consultation clauses will be incorporated in all stand-by arrangements. Such clauses will include provision for consultation from time to time during the whole period in which the member has outstanding purchases in the upper credit tranches. This provision will apply whether the outstanding purchases were made under a stand-by arrangement or in other transactions in the upper credit tranches.

6. Phasing and performance clauses will be omitted in stand-by arrangements that do not go beyond the first credit tranches. They will be included in all other stand-by arrangements but these clauses will be applicable only to purchases beyond the first credit tranche.

7. The Managing Director will recommend that the Executive Board approve a member's request for the use of the Fund's general resources in the credit tranches when it is his judgment that the program is consistent with the Fund's provisions and policies and that it will be carried out. A member may be expected to adopt some corrective measures before a stand-by arrangement is approved by the Fund, but only if necessary to enable the member to adopt and carry out a program consistent with the Fund's provisions and policies. In these cases the Managing Director will keep Executive Directors informed in an appropriate manner of the progress of discussions with the member.

8. The Managing Director will ensure adequate coordination in the application of policies relating to the use of the Fund's general resources with a view to maintaining the nondiscriminatory treatment of members.

9. The number and content of performance criteria may vary because of the diversity of problems and institutional arrangements of members. Performance criteria will be limited to those that are necessary to evaluate implementation of the program with a view to ensuring the achievement of its objectives. Performance criteria will normally be confined to (i) macroeconomic variables, and (ii) those necessary to implement specific provisions of the Articles or policies adopted under them. Performance criteria may relate to other variables only in exceptional cases when they are essential for the effectiveness of the member's program because of their macroeconomic impact.

10. In programs extending beyond one year, or in circumstances where a member is unable to establish in advance one or more performance criteria for all or part of the program period, provision will be made for a review in order to reach the necessary understandings with the member for the remaining period. In addition, in those exceptional cases in which an essential feature of a program cannot be formulated as a performance criterion at the beginning of a program year because of substantial uncertainties concerning major economic trends, provision will be made for a review by the Fund to evaluate the current macroeconomic policies of the member, and to reach new understandings if necessary. In these exceptional cases the Managing Director will inform Executive Directors in an appropriate manner of the subject matter of a review.

11. The staff will prepare an analysis and assessment of the performance under programs supported by use of the Fund's general resources in the credit tranches in connection with Article IV consultations and as appropriate in connection with further requests for use of the Fund's resources.

12. The staff will from time to time prepare, for review by the Executive Board, studies of programs supported by stand-by arrangements in order to evaluate and compare the appropriateness of the programs, the effectiveness of the policy instruments, the observance of the programs, and the results achieved. Such reviews will enable the Executive Board to determine when it may be appropriate to have the next comprehensive review of conditionality.

specific tools used, and the relationship between conditionality and ownership. Chapter III reviews recent experience with conditionality. Chapter IV discusses approaches to streamlining conditionality, with regard to both its scope and degree of detail, also pointing to a need to clarify the tools and the boundaries of conditionality.

II. Conditionality and Ownership: General Principles and Issues

8. This chapter discusses the general principles underlying the existing framework of Fund conditionality, the issues that arise in its application, and the role of program ownership in this framework. It outlines the purpose of conditionality and the principles of program monitoring, and briefly describes the tools that are used to monitor policy implementation. The chapter concludes with a brief discussion of the role of ownership in program implementation and the relationship between conditionality and ownership.

A. Purposes of Conditionality

9. The Fund's financing is intended to enable a country to achieve a sustainable medium-term balance of payments at an acceptable and sustainable rate of growth, without adverse spillovers to neighboring countries. Balance-of-payments sustainability is required, inter alia, to safeguard the Fund's resources over the period during which the country is expected to repay the Fund. A durable strengthening of the balance of payments may require a combination of macroeconomic policies and structural reforms intended to underpin these policies and/or to strengthen the efficiency and resilience of the economy as well as reducing its vulnerability to shocks. The authorities and the Fund generally concur on the broad objectives but there are various ways in which they can be achieved—and there may be differences between the Fund and the authorities on the relative weight to be placed on different objectives of the program and the appropriate steps to achieving them. In particular, the Fund's fiduciary responsibility for safeguarding the revolving nature of its resources is a legitimate reason for the Fund to place more weight than the authorities on the objective of the country's achieving external sustainability over the relevant time horizon.[5]

10. Conditionality is an explicit link between the approval or continuation of the Fund's financing and the implementation of certain specified aspects of the government's policy program. In the first instance, conditionality requires the Fund to reassess the program of a member when there are deviations from certain agreed parameters, and gives the Fund the right to cease providing financing—or to refrain from providing such financing in the first place—unless certain key policies have been implemented. At the same time, it assures the country of its continued access to the Fund's resources provided that it observes certain agreed conditions. The need for such assurance, in particular, makes it preferable for these conditions to be highly specific and objectively verifiable. The legal framework underpinning conditionality is summarized in Box 2.

11. In this setting, making financing conditional on policy implementation provides a "stop-loss" option with a view to safeguarding the Fund's resources, enabling the Fund to avoid throwing good money after bad if policies are not implemented or if the overall program is going off track. Short of actually interrupting the program, conditionality provides a framework for signal extraction: in practice, the failure of the authorities to meet all agreed conditions does not typically imply that the program is beyond repair, but calls for a reassessment of the situation to determine whether and what further action is needed to achieve program objectives.[6] But to the extent that the authorities are aware that the Fund's

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[5] See for instance Guitián, 1995.

[6] Mussa and Savastano, 1999. For a specific application regarding Net Domestic Assets, see the appendix of *Inflation Targeting: Implications for Fund Conditionality* (1999) SM/99/296, December 1999.

financing hinges on their implementation of certain agreed policies, this also creates incentives for them to implement those policies; such incentives are often important, to the extent that these policies reflect a negotiated compromise between the authorities and the

Box 2. The Legal Basis of Fund Conditionality

The legal basis of Fund conditionality consists of the following three tiers, in descending order of importance. The first tier the provisions of the Articles of Agreement and the general decisions of the Fund; the second comprises Board decisions on individual members, usually taking the form of arrangements; the third arises from the role of staff and management in making recommendations to the Board on financing decisions for members.

The first tier

Conditionality in the General Resources Account stems first of all from Article V, Section 3, which requires the Fund to adopt general policies on the use of its general resources (e.g., the Guidelines on Conditionality for access to the credit tranches) and authorizes the Fund to adopt special policies (e.g., the Extended Fund Facility) that will assist members to solve their balance of payments problems in a manner consistent with the Fund's Articles (including but not limited to its purposes) under adequate safeguards. 1/ Although both general and special policies have the same objectives (resolution of the balance of payments problems of members in a manner consistent with the Articles while safeguarding the Fund's resources and safeguarding their revolving character), the distinction between general and special policies stems from the existence of different BOP problems and implies the need for different conditionalities to address these different BOP problems. This distinction is directly relevant to the use of structural conditionality in Fund financial assistance. The design of special policies to address different BOP problems drives different priorities in the use of conditionality (e.g., greater emphasis on structural adjustment under the EFF or PRGF than under the credit tranche policies) to support programs financed under these policies.

The second tier

The second tier of the framework comprises Board decisions for individual members, which take the form, for the most part, of arrangements. The legal nature of arrangements is specified in Article XXX(b): "a decision of the Fund by which a member is assured that it will be able to make purchases from the General Resources Account in accordance with the terms of the decision during a specified period and up to a specified amount." The concept of assurance to the member provides an important backdrop to the discussion of the tools of conditionality for it requires that all the conditions for access to the Fund's resources must be spelled out in the arrangement. Performance criteria are designed to identify the precise conditions necessary for releasing purchases under an arrangement without involving the

Board (unless a waiver is required). Consequently, PCs are monitored by staff and must be susceptible to precise drafting and objectively monitorable. Reviews are part of Fund conditionality as they condition continued access to Fund resources. Benchmarks and prior actions are not conditions under Article XXX if they are not mentioned in the Arrangement, although they are conditions for management to have the confidence to recommend approval or continuation of an arrangement to the Board.

The third tier

A third level of the Fund's legal framework concerning conditionality involves the role of staff and management. Obviously, staff is not the Fund and staff and management do not approve arrangements. However, staff plays an important role in advising management, which makes recommendations to the Board on financing decisions for individual members. In making such recommendations, staff and management make judgments on the weight to be given to prior actions, benchmarks and other measures of overall progress under the program. Thus, even though these recommendations are not binding on the Executive Board, they must be based on considerations that are consistent with the rules governing the Fund's conditionality.

1/ This Article states: "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, that will assist members to solve their 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. Article V, Section 12(f), which applies to the Special Disbursement Account resources and Article V, Section 2(b), which is applicable to the administered accounts (ESAF, PRGF) only require that the use of these resources be "consistent with the purposes of the Fund."

Fund.[7] Related to this incentive effect, conditionality can also lend credibility to the authorities' policy plans—for instance, their determination to rein in inflation—by making its financing depend on action taken to achieve these plans.[8]

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[7] This third purpose is still consistent with the cooperative approach to program design assumed in the Fund's traditional interpretation of conditionality: even if the program is, in the first instance, the authorities' own, it may reflect elements that are negotiated with the Fund; the link to financing influences their incentive to implement the program they have agreed.

[8] Models formalizing such a need for credibility are based on dynamic inconsistency of optimal policies, as defined by Kydland and Prescott, 1977. This rationale for Fund conditionality, specifically with regard to inflation, is discussed by Cottarelli and Giannini, 1999.

12. The Fund's financing and the agreed policy adjustments are intended as two sides of an integrated response to a country's balance-of-payments problem in the context of its overall economic situation. This can best be seen in the stereotypical situation in which a country faces acute external imbalances as a result of excessive monetary financing of a fiscal deficit. In such a situation, the Fund finances short-term external imbalances while the country pursues macroeconomic policies aimed at external adjustment over an agreed time frame, possibly accompanied by structural reforms to enhance the supply response. The objective is a sustainable medium-term balance-of-payments position that, inter alia, will ensure that the Fund's financing is indeed temporary. In such a situation, the need for adjustment would be clear, with or without the Fund; the Fund essentially provides financing that permits this adjustment to be made in a more gradual and orderly way. But the provision of financing by the Fund may itself weaken the authorities' motivation to implement the agreed policy adjustments—hence the need for successive tranches of Fund financing to be contingent on progress in achieving these policies.[9]

13. But there are many cases in which the link between program financing, balance-of-payments need, and economic policy adjustments, including structural reforms, is less obvious. In particular, during the 1990s, the Fund provided financing to many countries—notably transition economies and low-income countries—in which the main objective was not always to correct an acute pre-existing external imbalance, but to give members confidence to proceed with long-term, structural reforms associated with development or structural transformation that would likely require balance-of-payments financing. In the transition economies, for instance, there were prospective external imbalances associated with the shrinkage of the traditional tax base resulting from the dismantling of the state enterprise sector—even though it was believed that such reforms would ultimately generate sustainable external positions and the ability to repay the Fund. Similarly, in the low-income countries, it was understood that the macroeconomic and structural changes needed to lay a foundation for sustainable growth and improved living conditions for the population could have some transitional costs that would need to be financed. In both transition and low-income countries, the Fund provided financing while policies sought to address underlying weaknesses in the economy and put the external balance on a sustainable path.

14. In the 1990s, another set of issues arose in the programs designed to address capital account crises (in such countries as Mexico, Thailand, Indonesia, Korea, Russia, and Brazil). Here, the immediate external shock was a swing in the capital account associated with a sudden shift in market sentiment, which, in turn reflected, inter alia, concerns about some underlying weakness or vulnerability: in Mexico, fragilities in the public debt structure and the banking system; in Thailand, Indonesia, and Korea, various weaknesses in the financial system; in Brazil, the adverse public debt dynamics; and in Russia, a far-reaching mix of fiscal and structural weaknesses. In these countries, while the nature of the external

[9] See for instance Guitián, 1992.

imbalances were different than in the other cases discussed, the basic rationale was similar: to provide financing while economic policies sought to address the underlying weaknesses and to restore confidence on a sustainable basis.

15. Thus, the intended purpose of conditionality is as a mechanism to help bring together a combination of financing and policies as a solution to economic difficulties: it is needed to provide assurances to both the authorities and the Fund that both parts of the package are provided together. This concept of conditionality is fully consistent with a cooperative approach to designing and implementing programs. An implication of this formulation is that conditions should be limited to those that are necessary to evaluate whether the program is being implemented in a way that ensures that its objectives are achieved.

16. In contrast to this characterization of the intended purposes of conditionality, conditionality is often viewed as an attempt of international financial institutions (or aid donors) to use financing to "buy" policy reforms that are not desired by the authorities. The latter interpretation of conditionality is often reflected in the use of a principal-agent model, in which the Fund (the principal) establishes a mechanism intended to ensure that reforms will be undertaken by the authorities (the agent), in a setting in which the objectives of the Fund and the authorities do not fully coincide and there are informational asymmetries associated with the fact that the Fund cannot directly observe some aspects of the authorities' actions, objectives and/or circumstances. The presentation of the Fund as "the principal" in this framework is inconsistent with that of country ownership of the program. Not surprisingly, the literature applying principal-agent models to conditionality suggests that conditionality is unlikely to be effective in bringing about policy reforms unless the authorities share the broad objectives of these reforms.[10]

B. Principles of Program Monitoring

17. The application of conditionality relies on explicit links between the monitoring of progress with policy implementation and the phased disbursements of financing. Continued access to financing is conditioned on the assessment that policies are on track. In choosing the appropriate scope and modalities of program monitoring, several properties are desirable, and there are important tradeoffs between these properties. First, a basic requirement for conditions to fulfill their purposes is that these conditions need to be able to capture the aspects of policy that are critical to program objectives, so that they sound warning bells if

[10] See, for instance, Killick (1997), White and Morissey (1997). While the principal-agent framework has typically been applied to the case in which a lender or donor is trying to buy reforms not desired by the authorities, this framework is sufficiently general that it can also be adapted to the case in which conditionality is used by both sides as a mechanism to support implementation of an agreed combination of financing and policies to address a country's economic situation.

the program is not on track to achieve these objectives. In the macroeconomic area, where conditions typically relate to key intermediate targets, this requirement might fail to hold, for instance, if the underlying relationship changed or was incorrectly estimated, so that a condition might be met even though the relevant policies were off track. With macroeconomic as well as structural conditions, the scope for circumvention is another relevant consideration. The need to ensure that relevant aspects of policy are covered militates in favor of more extensive and detailed conditionality; this involves important tradeoffs with other properties of conditionality as discussed below.

18. A second important feature of program monitoring, related to the fundamental purposes of conditionality, is the extent to which it provides assurances of the country's access to the Fund's resources. Assurances to the member require, in particular, that conditions be specified as precisely as possible and should preferably be subject to the control, or at least the direct influence, of the authorities. But since in practice it is not always possible to ensure that warning bells ring whenever policies are off track and remain silent when they are on track, there is a tradeoff—analogous to the tradeoff between Type I and Type II error in statistics—between the need for assurances and the need to ensure that relevant aspects of policy are adequately covered.

19. A third desirable feature of conditionality is parsimony. The 1979 *Conditionality Guidelines* stress that performance criteria should be no more numerous than is necessary, and this principle is being given renewed emphasis in recent attempts to streamline conditionality. Streamlining is important both in reducing the cumbersomeness of a program and in ensuring the maximum room for the authorities to implement policies as they choose within the framework of the program. The effort for streamlining should take account of the need to capture aspects of policy that are critical to the program.

20. A fourth property is flexibility in the way in which information is taken into account in monitoring performance under a program. In many cases, the information relevant to monitoring policy implementation may change in ways that are unforeseen or otherwise difficult to specify beforehand. For example, in a country implementing monetary policy in pursuit of inflation targets, changes in financial market structure may make different indicators relevant. As another example, a privatization program may achieve its specified objectives with regard to private ownership, but a variety of other information may be needed to ascertain whether broader objectives, say, regarding efficiency and competition, are achieved. Different monitoring tools have different ways of taking information into account, as will be discussed below.

21. Another important requirement for conditionality is flexibility in accommodating country-specific circumstances. This is recognized in the 1979 Guidelines, which specifies that conditionality needs to be adapted to countries' own social and political settings. Providing such flexibility while also ensuring uniformity of treatment—another important property, related to the cooperative nature of the Fund—requires that cross-country differences in conditionality be well-motivated by differences in country circumstances.

22. Several of these properties of conditionality can also be viewed in terms of a broader choice of rules versus discretion. A rules-based approach to conditionality tends to provide greater assurances to the country as well as strengthening uniformity of treatment. An approach allowing for an element of discretion, on the other hand, tends to permit greater parsimony, flexibility in taking account of relevant information, and adaptability to country circumstances.

C. Monitoring Tools

23. Program monitoring relies on several different tools. The most basic monitoring tool is the *performance criterion* (PC), a condition formally specified in the country's arrangement with the Fund that must be observed if the country is to be allowed to make the next purchase, unless the Fund grants a waiver. A PC—whether it is a quantitative floor or ceiling or a specified structural measure—has the benefit of clearly establishing circumstances under which the authorities can use the Fund's resources. PCs are specified on actions or measures that are monitorable by staff (and at least in principle verifiable by independent observers) and preferably subject to the control—or at least the influence—of the authorities.

24. An essential counterpart of a PC is the process by which a decision is reached on whether a waiver should be granted. A breach of a PC does not necessarily indicate a failure of policy implementation, but may reflect a situation in which the economic conditions evolved differently than had been envisaged, due to external shocks or initial settings of performance criteria that turned out to be based on an incorrect assessment of economic relationships. This can be illustrated, for instance, in the case of a macroeconomic PC such as a ceiling on central bank net domestic assets (NDA) for a country implementing market-based monetary policy under a managed float: an increase in NDA above the ceiling could reflect easier-than-programmed monetary policy and/or sterilization of foreign exchange market intervention, but it could also reflect a shock to money demand, an error in estimating the underlying relationship, or deviations of other macroeconomic variables such as national income and inflation from their programmed paths. The process of discussing the conditions under which a waiver could be granted forces the Fund and the authorities to grapple with the reasons and work together to formulate an appropriate policy response; in some cases, the appropriate response would be to continue with existing policies—as, for instance, if it were determined that NDA had breached its ceiling because money demand had shifted or had been mis-estimated. In some cases, of course, it is not possible to reach agreement on appropriate remedial actions to deal with policy slippages and a program interruption results, but in a majority of cases a basis can still be found for continuing the program.[11]

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[11] Program interruptions in the context of ESAF programs were examined in the 1997 ESAF review; see Bredenkamp and Schadler (ed.) 1999, Chapter 9. A study covering standby and extended arrangements was presented in the 1994 Conditionality Review.

25. While a PC by itself may be viewed as a rules-based tool of conditionality, a decision on a waiver is a process in which there is a considerable element of discretion. A PC is asymmetrical in this regard, giving the country the benefit of the doubt: if the PC is observed, the country is assured of access (provided that other conditions of purchase are met), while if the PC is breached, that is only the beginning of a more flexible process through which various information, not specified in advance, is brought to bear in formulating an appropriate policy response.

26. A second major tool of conditionality is the *program review*. The 1979 Conditionality Guidelines envisage that reviews would be used for the purpose of setting PCs in cases in which it was impossible to set them sufficiently far ahead at the outset of the program as well as in some cases in which an essential feature of a program cannot be formulated as a PC at the beginning of a program year because of substantial uncertainty regarding major economic trends. Over the past 20 years, however, reviews have increasingly been used for broad-based assessments of progress with various aspects of the program—reflecting the possibility that, notwithstanding compliance with all quantitative PCs, a program could still fail to meet the broad macroeconomic targets—such as a narrowing of the external current account deficit—because of misspecification of PCs or unforeseen developments. They have also been used for more focused assessments of policy in certain areas.

27. The increasing use of reviews in conditionality reflects, in part, increased uncertainties surrounding the variables monitored as PCs, associated in part with the increased volatility of international capital flows, which has made it difficult to set a precise quantitative path for macroeconomic policies over anything other than relatively short periods of time. It also reflects the increased role of structural reforms, for which reviews are often a suitable monitoring tool, given their flexibility in taking account of information on the precise content of measures adopted which may be difficult to pre-specify. For the same reasons, more frequent reviews have been introduced, particularly in volatile situations such as early transition and capital crisis cases—with monthly or even more frequent reviews in a few cases (e.g., Russia, Korea, and Turkey).

28. The main advantage of a review is its greater flexibility with regard to the information that may be relevant to assessing policy. For this reason, reviews are often used for forward-looking assessments. For instance, they may be used for the purpose of assessing whether a new budget is adequate to put or keep fiscal policy on track to achieve program objectives. Similarly, reviews may now be used to assess monetary policy in countries using inflation targeting; such assessments would focus primarily, but not exclusively, on an agreed set of indicators.[12] Reviews are also often used to assess progress toward structural policy

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[12] This use of reviews was agreed by the Board in early 2000. See *Inflation Targeting—Implications for Conditionality* (SM/99/296, December 1999).

objectives that may take time to come to come to fruition; and for this reason, they have become more prevalent with the growing structural content of Fund-supported programs.

29. By their nature, reviews allow the Fund greater discretion than PCs, and reduce members' assurances of the conditions under which they will be able to access the Fund's resources. But the Fund's discretion on whether or not to complete a review is intended to be limited. In particular, a review is intended to provide an opportunity to adapt a program to changing circumstances: to convert indicative targets into performance criteria, based on the most recent economic data, or to devise appropriate corrective actions in cases in which past conditionality has not been observed. But it is not intended to be an opportunity to move the goalposts—that is, it should not result in a modification of broad program objectives. The discretionary aspect of reviews can, moreover, be limited further by specifying clearly the factors that will be taken into consideration (in some cases though structural benchmarks) as well as by prespecifying and maintaining program objectives. But in practice, in many instances the scope of reviews has not been clearly specified, creating ambiguity as well as leaving greater room for discretion. While the move toward making reviews more open-ended is, in part, a response to the difficulties of designing programs in an uncertain environment, the recognized aim is to limit this discretion.[13]

30. Other tools of conditionality affect the country's access to the Fund's resources to the extent that they enter into a decision to complete a review or the decision to approve a program to begin with. *Prior actions* (PAs) are an instrument of conditionality whose use has expanded considerably in recent years. PAs are steps that the authorities agree to take before management recommends a Board decision on the use of Fund resources—approving a program or completing a review and/or granting a waiver. The 1979 *Conditionality Guidelines* envisage that "a member may be expected to adopt some corrective measures before a stand-by arrangement is approved by the Fund, but only if necessary to enable the member to adopt and carry out a program consistent with the Fund's provisions and policies" (paragraph 7). The use of prior actions has extended beyond this characterization. In some cases, for instance, prior actions are viewed as a way of signaling the authorities' commitment to the program—although any such signal is usually difficult to disentangle from the authorities' desire for Fund financing.

31. In general, prior actions are negotiated between the authorities and the staff—albeit with the latter acting on instructions from management, and in many cases after consultation with the Board. But they are not specified in advance and, formally, only affect the Board's decision on the program after they have been implemented. In some cases, after initial

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[13] The need to focus reviews was recognized in the 1987 paper on "Monitoring of Structural Adjustment in Fund-Supported Programs," which recommended that the coverage of reviews be specified in some detail at the outset of the program (EBS/87/240, November 20, 1987, page 11.

agreement on a large number of prior actions, the staff and management would later accept the implementation of a critical mass as an adequate signal of the authorities' commitment to proceed to recommend Fund support of the program to the Executive Board.

32. Prior actions have not been used in a uniform way; on the contrary, there has been great diversity in the numbers of prior actions as well as practices for handling them. The Fund's recent adoption of a policy that prior actions should be explicitly referred to in decisions, intended to help ensure accurate reporting of the implementation of prior actions, may, however, also help establish more discipline in the use of prior actions, thereby helping to promote greater parsimony.[14]

33. *Structural benchmarks* (SBs), which are not mentioned in the 1979 Conditionality Guidelines, have also become increasingly prevalent in programs since their introduction in the context of SAF/ESAF programs in the 1980s. In many cases, benchmarks map out a series of steps toward a desired policy outcome, such as central bank independence or a broader tax base. The understanding of the precise nature of SBs, however, has been unclear, even within the Fund. While their record of implementation conveys information on progress being made in meeting structural objectives of a program, the implication of delays in implementation of some benchmarks for the program is more difficult to interpret. The delay of one or a few benchmarks would rarely if ever by itself interrupt a program or lead to a requirement for additional measures to complete a review. However, delays in a substantial number of benchmarks could interrupt a review or, at least, would likely require compensating actions. But it is not clear how the staff would determine what constitutes a critical mass.[15] There is no clear guidance on how the achievement of structural benchmarks should be taken into account in completing a review. The original ESAF Operational Guidelines stated that "a major departure from the benchmarks would create the presumption that substantial policy change would be required in order to complete a mid-year review or reach understandings on subsequent annual programs, or could indicate the need for a consultation between the authorities and the Managing Director of the Fund."[16] This language suggests that some kind of critical mass is envisaged, in the sense that while failure to meet a single structural benchmark cannot by itself stop access to the Fund's resources, failure to meet several by a wide margin could.

[14] The policy, adopted in July 2000, of stating prior actions formally in decisions was motivated by episodes of misreporting regarding prior actions. See SM/00/121.

[15] From a legal standpoint, SBs limit the scope of a review only if they are explicitly mentioned in a Board decision.

[16] *Enhanced Structural Adjustment Facility (ESAF)—Operational Guidelines for the Staff* (SM/88/148, July 1988), page 7.

34. Finally, it should be noted that policy measures sometimes shift from one monitoring category to another as a program evolves. For instance, measures that start out as structural benchmarks, or merely measures listed in a matrix, may become performance criteria or prior actions for subsequent reviews; other measures may be downgraded or dropped from the program. Such shifts often reflect the changing economic situation as well as the experience with program implementation, which may alter the priority attached to different measures.

35. Beyond the policy actions or measures that are specified as PCs, PAs, or SBs, Letters of Intent and/or the attached memoranda on economic policies and policy matrices frequently list many other policy actions. Are these part of conditionality? Here, the key question is whether they are taken into account in deciding whether to complete a program review. If so, they are part of conditionality, even though each individual measure will carry less weight than SBs and, in particular, PCs and PAs. Some of these measures, however, may reflect only the plans and intentions of the authorities, provided to the Fund as background information. In many cases, they may represent technical assistance recommendations, or the advice of other international financial institutions. The measures that matter for program reviews and those that do not count are generally not distinguished, creating ambiguity about the boundaries of conditionality. This ambiguity may serve a purpose—enabling the authorities to promote its entire program under the imprimatur of a commitment to the Fund, perhaps increasing the prospects of implementing useful measures. But this raises issues regarding program ownership. Moreover, the lack of clarity regarding the status of such measures is problematic in view of the Fund's desire to streamline conditionality.

D. Conditionality and Ownership

36. The Fund's traditional interpretation of conditionality as discussed earlier, assumes that the program is fundamentally the authorities' own, whereas conditionality is introduced to ensure that the Fund's resources are used for their intended purpose. According to this view, ownership is an essential foundation for conditionality: it is the authorities who decide what policies to adopt, including whether to seek the financial support of the Fund, and it is the authorities that are responsible for implementing the program. In formulating a program, there are many critical choices that are—and should be—dictated by the exigencies of political circumstances and the philosophy of the government in power. At the same time, the Fund's support will be provided only if staff, management, and ultimately the Board believe that the program is capable of achieving objectives consistent with the purposes of the Fund and that it is likely to be implemented.

37. In contrast, if (like many outside observers) one views conditionality as a mechanism by which the Fund uses financial leverage to induce the authorities to implement reforms they do not endorse, any expansion in conditionality implies a reduction in national ownership.[17]

[17] Literature on conditionality and ownership is reviewed in Annex II.

Thus, it is often argued that excessive use of conditionality may be counterproductive, by weakening program ownership and undermining the authorities' commitment to good policies. At the simplest level, the argument is that the authorities see conditionality as an imposition; the heavier this imposition, the greater the authorities' resentment and the less willing they are to implement whatever policies are in the program. Another possibility is that, if conditionality covers a long list of structural measures, the authorities may (correctly) feel that failing to observe many of these conditions is not likely to lead to a program interruption. As a related issue, establishing too many conditions in a program may distract attention from the key areas that are most in need of attention, overburdening implementation capacity as well as exhausting the political capital needed to secure agreement on the larger issues. The concern is not necessarily that the Fund may be prescribing the wrong policies, but that an overload of conditionality may reduce the overall effectiveness of the program. As an extreme form of this hypothesis, one could posit a "conditionality Laffer curve"[18] according to which more conditionality weakens ownership to such a degree that fewer reforms are actually accomplished—and conversely, that reducing the amount of conditionality would actually increase the number of desirable reforms implemented.

38. The relationship between conditionality and ownership is made more complex by the fact that interests and views invariably differ within a country, even if the Fund is not involved. Whose ownership is relevant? This question has always been present, to the extent that policies—including broad macroeconomic policies as well as structural reforms—can create winners and losers within a country. But it becomes increasingly important as programs have come to include measures outside the usual purview of the finance ministry and central bank, requiring help from other agencies of the state—including not only other government departments but often also the legislature and sometimes the judiciary. Moreover, various stakeholders in society can often either support or impede the implementation of various elements of a policy program by means that include the democratic process, lobbying, collective action, and street protests.

39. Given such differences in views within a country, the breadth of the program can also be seen in relation to the need to assemble a domestic coalition supporting a program. If the objectives included in a program were strictly limited to monetary and fiscal stringency, it would be unlikely to win support outside the finance ministry and central bank. Programs that include a wider range of reform measures intended to promote economic opportunity will likely have a wider appeal. Moreover, it may be argued that putting forward a critical mass of reforms may harness *synergy*: implementing some reforms may remove obstacles to others, and thus improve the implementation and effectiveness of the whole package. Similarly, at a dynamic level, if a program is implemented successfully, for whatever reason, this may itself broaden and deepen the ownership that is essential for sustained implementation. On the other hand, the opposite possibility is also quite real: a program covering a wider range of

[18] See Bird, 2000.

areas may also help galvanize an opposing coalition of entrenched interests, also enabling opponents to present themselves as championing national interests. Which of these possibilities emerges depends on the domestic political setting and the specific content of the program.

40. The country's capacity to implement policy reforms is clearly an important factor that needs to be taken into account in designing a policy program. If implementation capacity is lacking, the authorities' willingness to implement the necessary reforms may become secondary. But in some cases, the Fund may seek to use more detailed conditionality to assist the authorities in planning a sequence of reforms. This is the intended purpose of technical assistance, not conditionality: such use of conditionality may not only be ineffective but may also clutter the program with conditions that are neither necessary nor sufficient to safeguard the core objectives of the program. In such cases, where the authorities need advice with regard to the steps needed to implement reforms, but where these reforms are not essential to the program's macroeconomic objectives, such advice is best provided outside the structure of conditionality, often in the context of technical assistance. Technical assistance and other advice should, where possible, be aimed at strengthening the country's implementation capacity rather than substituting for a lack of capacity.[19]

41. Causality may run from ownership to conditionality as well as (or even rather than) vice versa: strong ownership may reduce the need for conditionality to provide safeguards for the Fund, while weaker ownership may give the issue of safeguards greater prominence and may well be reflected in more extensive conditionality. But it is not clear that attempting to compensate for weak ownership through micro-management is likely to be credible and hence effective.

42. There are also other cases in which ownership is high but the authorities wish to use Fund conditionality to crystallize their own reform program and possibly to send a signal to markets or various domestic constituencies—so that high ownership and very extensive and detailed conditionality may go hand in hand.[20] In such cases, the government may wish to use a Fund-supported program to lock in certain reforms and help resolve domestic policy disagreements. The Fund at times has agreed to play this role to help reform-minded elements in the government to accomplish change—perhaps supporting those taking the opportunity of acute financing needs to accomplish long-needed reforms. This approach has some

[19] The use of technical assistance to strengthen program implementation is one of the topics of the recent Review of Technical Assistance

[20] The background paper on Structural Conditionality presents case studies for Ukraine and Bulgaria illustrating these two alternative reasons for extensive conditionality, the cases of Zambia and Brazil illustrate that limited structural conditionality can likewise go along with either low or high ownership.

drawbacks,however: even when it essentially helps the authorities (or some elements among them) to accomplish reforms, it may be seen as short-circuiting legitimate domestic political processes. Moreover, allowing the Fund to be cast as an unyielding external partner may generate resistance to policy implementation and, in the longer run, undermine the overall effectiveness of the institution. Finally, as noted above, a longer list of conditions raises the likelihood of slippages, and may distract attention from what is really crucial.

43. The relationship between the amount of conditionality and the level of ownership can be considered in light of these issues. The foregoing discussion suggests that the relationship between conditionality, ownership, and policy implementation is likely both bi-directional and complex. It is therefore not surprising that the data presented in the background paper on *Structural Conditionality in Fund-Supported Programs* do not display a clear relationship between the number of measures included in a program and the rate of implementation.[21] To be sure, more conditions specified in a program tends to mean more measures implemented, but the average implementation rate is well below one and varies considerably across countries and types of condition (i.e. as between performance criteria, prior actions, and structural benchmarks). The data provide no indication that more conditionality impairs implementation—let alone the "conditionality Laffer curve". At the same time, they do not support the opposite view, that greater conditionality generates a synergy that improves the implementation of reforms. This result is consistent with the conclusion of the literature on aid effectiveness, that successful program implementation depends more on domestic factors than on the efforts of the international financial institutions.[22]

44. While there is no clear statistical evidence that more intensive conditionality either promotes, or hinders, the implementation of program policies, this does not preclude that in individual cases, extensive conditionality may weaken ownership and hence policy implementation.[23] Indeed, there are many reasons to expect that less intrusive conditionality is more conducive to ownership, paving the way for sustained implementation. Moreover, focusing conditionality on the measures that are crucial for the success of the program can

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[21] Implementation rates here refer to the share of conditions that were fully implemented. This comparison of course addresses only a very limited question and says nothing about whether conditions were appropriate and whether they achieved their overall objectives.

[22] See, for instance Dollar and Svensson (2000). Related literature is reviewed in Annex II of this paper.

[23] The experience in EU2 transition countries, reported in Annex II, is that extensive and overly-ambitious conditionality has been a factor in weak ownership and poor implementation, while several EU2 countries with strong ownership had successful programs without intensive conditionality.

increase the chances for sustained implementation by focusing the authorities' attention and energies.

III. Recent Experience with Conditionality

45. Throughout the history of Fund conditionality, concerns have been voiced about its content and extent.[24] In recent years, these concerns have focused primarily on structural conditionality—for reasons that are readily apparent. While there has been relatively little change in the number of macroeconomic performance criteria in Fund-supported programs in the past decade (Figure 1), the analysis in the background paper suggests that structural conditionality has expanded significantly. Whereas in the mid 1980s, conditionality related to structural reforms was relatively rare in Fund-supported programs, by the mid 1990s, virtually all stand-by, extended, and ESAF/PRGF-supported arrangements included some structural conditions. At the same time, the average number of structural conditions—PCs, PAs, and SBs—per program year increased substantially (Figure 2).

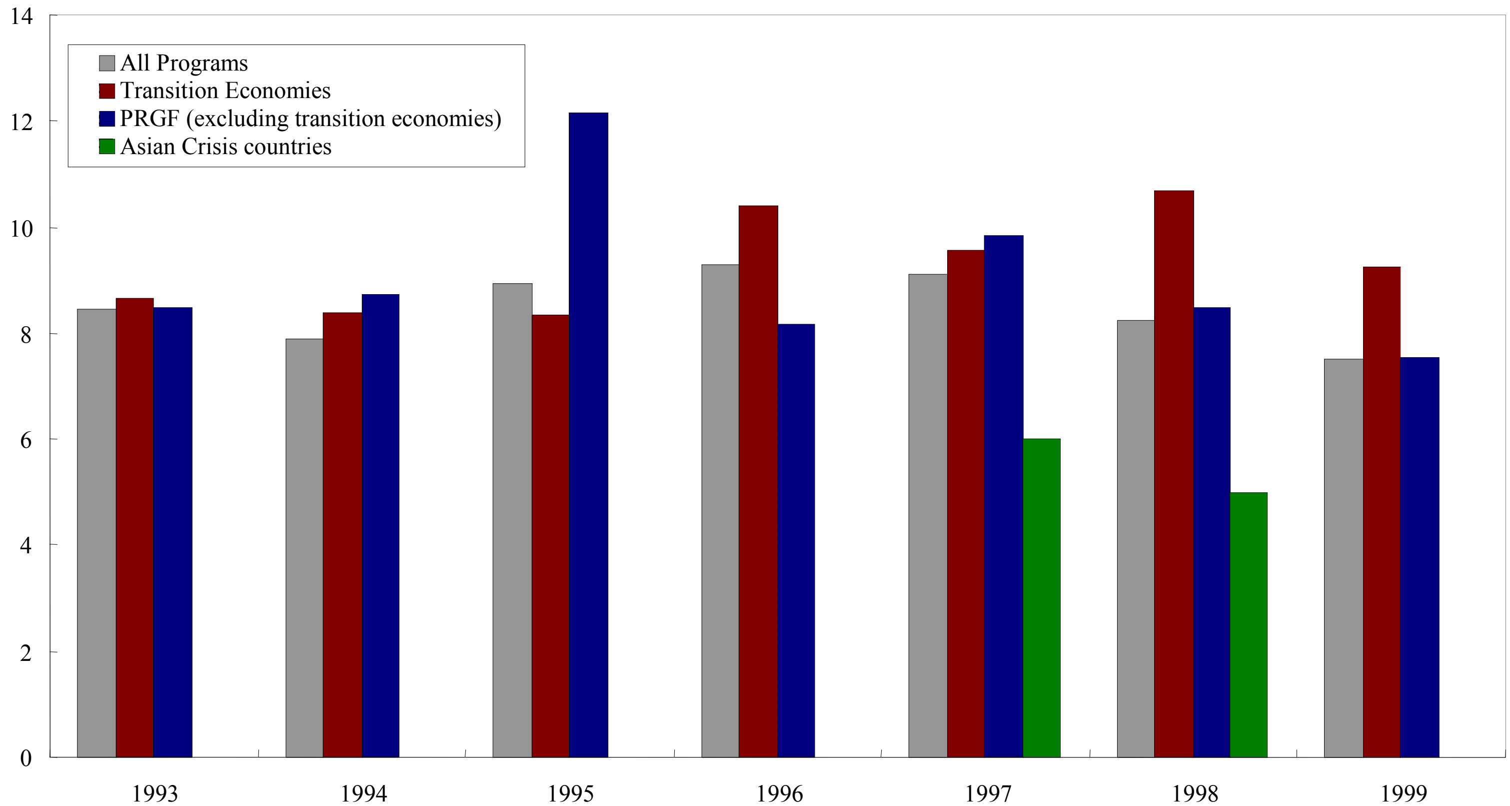
46. Any measure of the amount of structural conditionality based on the aggregate number of different types of structural conditions needs to be considered with certain caveats in mind. First of all, an increase in the number of conditions says nothing about the intensity of ambitiousness of reforms, or the importance of the measures subject to conditionality. Moreover, as noted in the previous chapter, these conditions play different roles—and carry different weights—in program monitoring. Looking at different types of structural conditions separately suggests that SBs, whose role in program monitoring is not as clearly defined as that of PCs and PAs, account for most of the increase in the number of structural conditions (Figure 3). PAs have also increased substantially, but the large discrepancies between averages and medians suggest that a significant part of the increase in the average number of PAs per program year may be due to a few programs with very large numbers of PAs. Finally, the average number of PCs is much smaller, and has increased less, than that of SBs and PAs.

47. Concerns about the expansion of structural conditionality however, go, beyond the increase in the number of PCs, PAs and SBs. They also focus on the growing breadth and detail of other measures listed in LOIs and the attached memoranda on economic policies or policy matrices. Some, perhaps many, of these measures matter for programs' macroeconomic objectives and may influence the decision to complete a review—not individually but as a critical mass. But some of these other measures in LOIs merely reflect the government's broader policy agenda and are not monitored in the context of reviews. LOIs generally do not make this distinction, conveying the impression that their whole content constitutes Fund conditionality.

[24] See, for example, Boughton (2001), chapter 13, for a summary of the discussion preceding the 1979 revision of the Conditionality Guidelines.

48. The increase in structural conditionality in Fund-supported programs in the past decade reflects several key factors. First, in the 1980s, against the background of slow growth in the heavily indebted countries and mounting criticism of Fund-supported programs as "austerity programs," the Fund began to embrace more explicitly the objective of raising growth on a sustainable basis. This broadening of program objectives, as well as the recognition that external adjustment may be hampered by serious structural impediments (which had motivated the establishment of the EFF a decade earlier), led to an increased emphasis on structural reforms in Fund-supported programs. Second, in the late 1980s the Fund established the Structural Adjustment Facility (SAF) and the Enhanced Structural Adjustment Facility (ESAF) to support external adjustment in its low income members. Given the protracted structural imbalances in these countries, structural reforms were

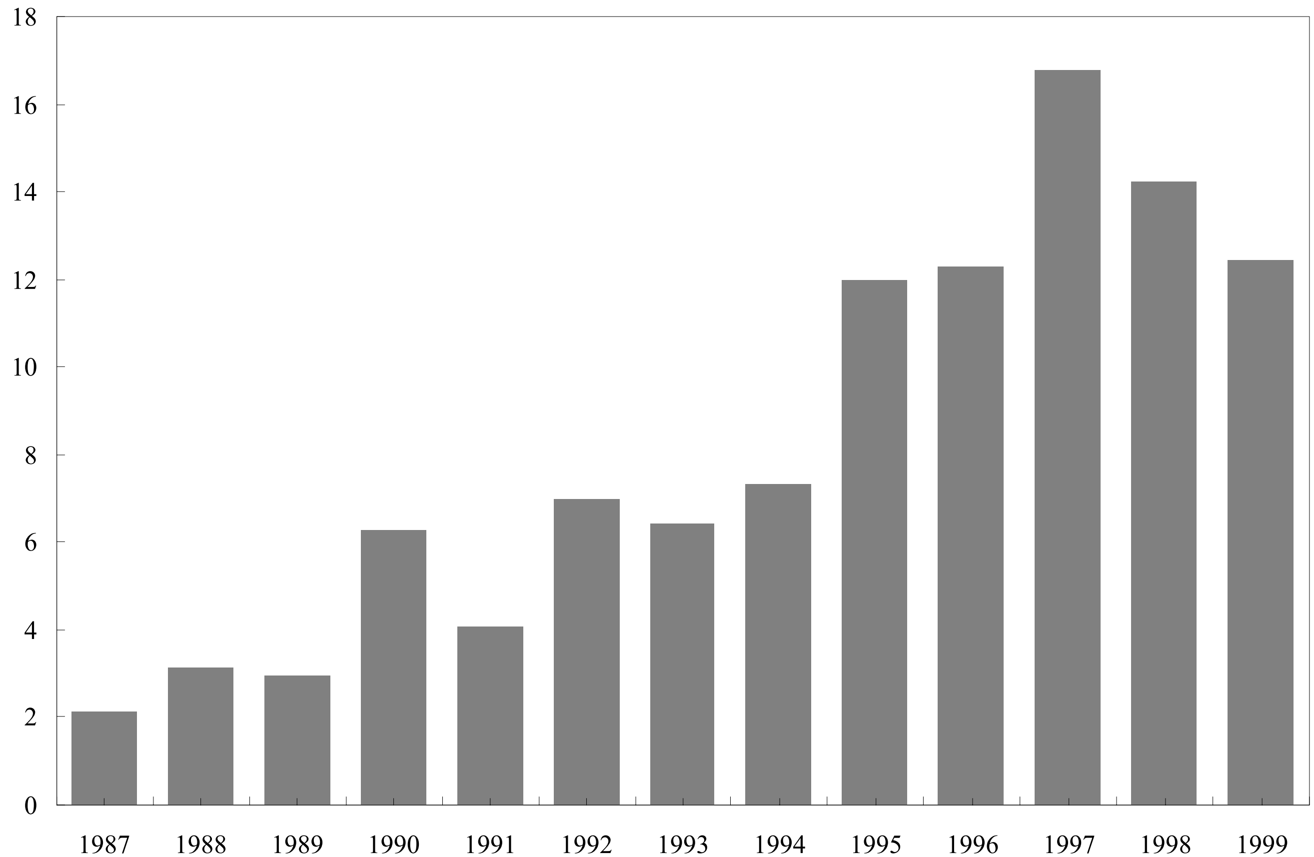
Figure 1. Average Number of Macroeconomic Performance Criteria per Program by Country Type



Source: International Monetary Fund, MONA database.

1/ Stand-by, EFF, andSAF/ ESAF/ PRGF-supported programs.

Figure 2. Average Number of Structural Conditions per Program Year 1/

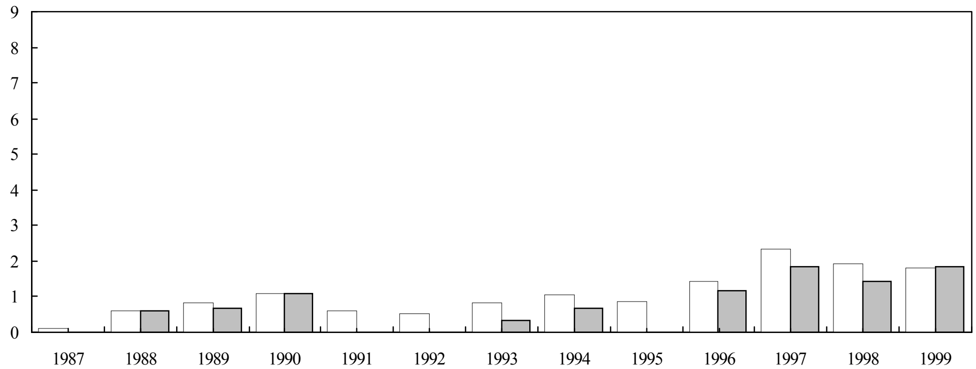


Source: International Monetary Fund, MONA database; and country papers.

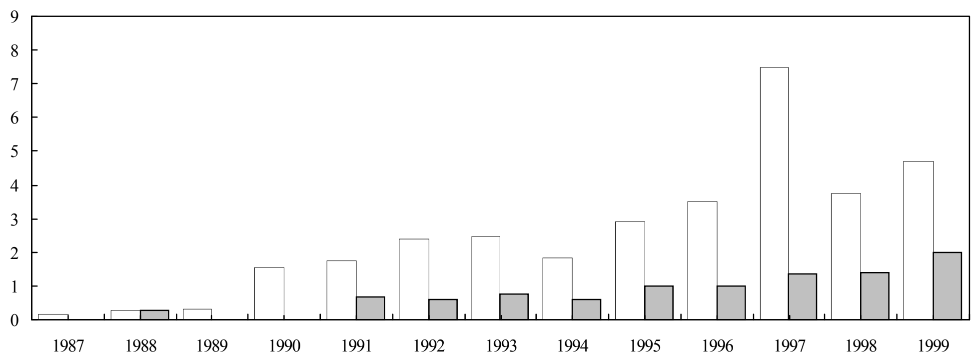
1/ Total number of structural performance criteria, benchmarks, prior actions, and conditions for completion of review in stand-by, EFF, and SAF/ ESAF/ PRGF-supported programs, adjusted for differences of program length.

Figure 3. Average Number of Structural Conditions per Program Year by Type of Condition 1/

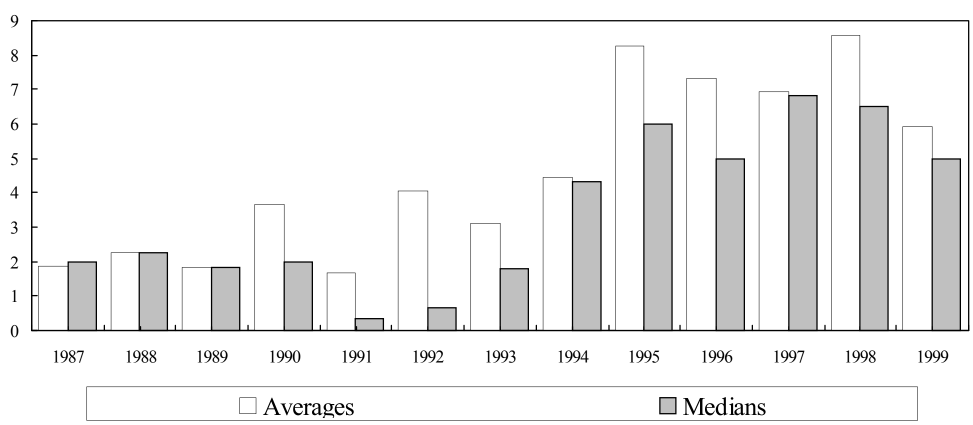
Performance criteria



Prior actions 2/



Structural benchmarks



Source: International Monetary Fund, MONA database; and country papers.
1/ Stand-by, EFF, and SAF/ ESAF/ PRGF- supported programs.
2/ Including conditions for completion of review.

expected to be at the very core of the programs supported by these facilities. Third, with the political changes in Central and Eastern Europe and the break-up of the Soviet Union, the Fund became involved in countries facing a wholesale transformation of their economic systems. Stabilization and external adjustment in these economies were closely linked to the structural transformation they were undergoing.

49. ESAF/PRGF arrangements and programs in transition economies accounted for one half to two thirds of Fund-supported programs in the 1990s and were a key factor in the expansion of structural conditionality. Nevertheless, structural conditionality also increased in more traditional stand-by and extended arrangements in other countries. In some of these, notably in the Asian crisis countries, structural reforms played a central role. In general, however, the number structural conditions in these programs was substantially lower than in the ESAF/PRGF and transition countries (Figure 4).

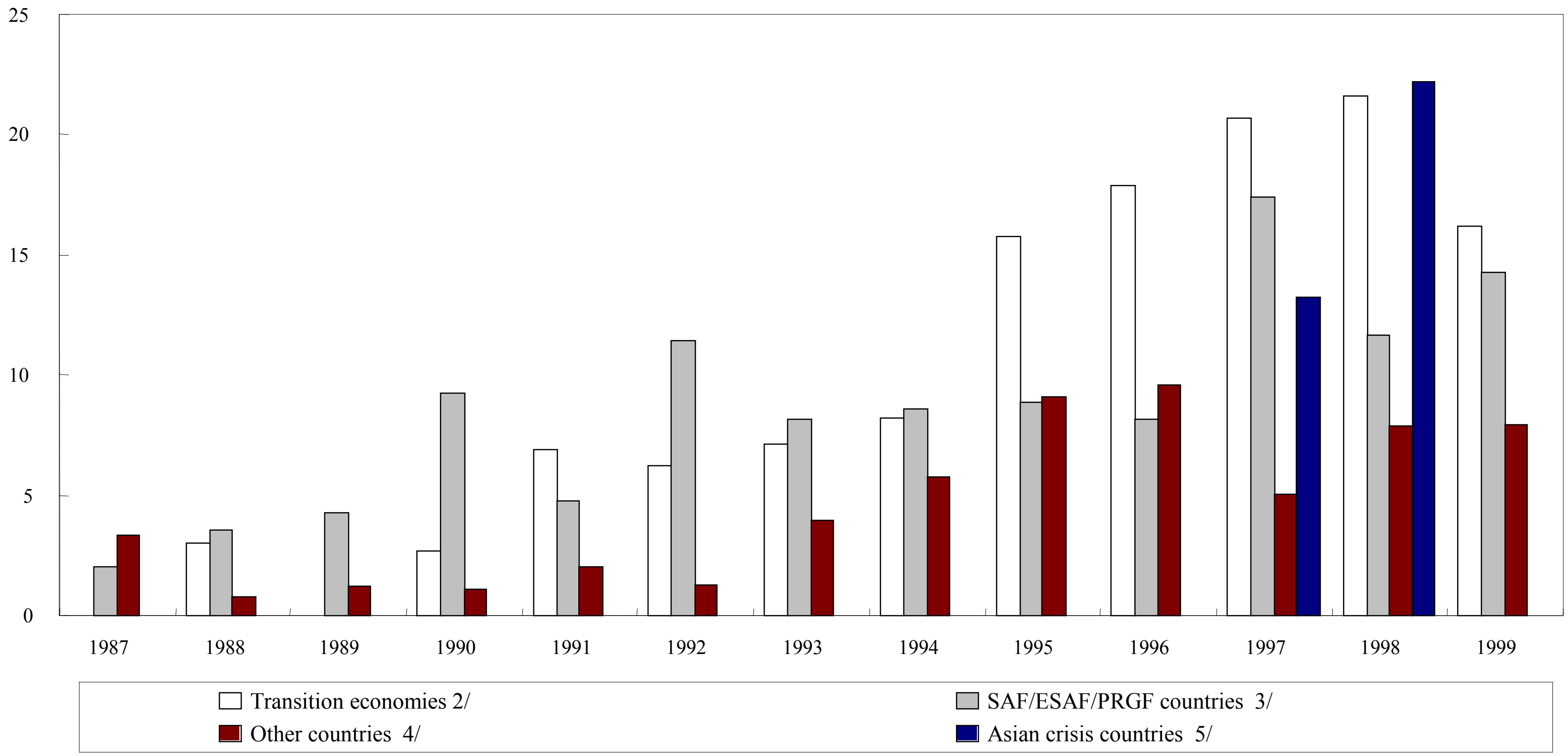
50. The expansion of structural conditionality reflects in part a broadening of the scope of structural issues addressed in the context of Fund-supported programs. However, coverage of an increasing variety of structural reforms is only part—and perhaps not the main part—of the story. The majority of structural conditions—between half and two thirds— have been, and continue to be, concentrated in a relatively small number of sectors that are at the very core of the Fund's involvement in member countries: exchange and trade systems, and fiscal and financial sectors (Figure 5). The relative importance of these sectors has changed, with reforms in the exchange and trade system now playing a smaller role and the financial sector a more important one than in the early 1990s. In addition, public enterprise restructuring and privatization—in part motivated by fiscal considerations—have accounted for about one fifth of the structural conditions in Fund-supported programs. Nevertheless, while a large part of structural conditionality has focused on a relatively small number of sectors that are closely linked to stabilization and external adjustment, this does not guarantee that structural reforms have always been adequately prioritized nor does it imply that too broad a reform agenda has never been an issue.

51. Greater detail in program monitoring has been as important as (and perhaps even more important than) the broadening of the scope of structural conditionality. Structural conditionality—unlike conditionality in the macroeconomic area—has typically focused on specific policy actions, frequently mapping out many small steps of a reform. In many instances, this may have provided helpful guidance, but it has also led to considerable intrusiveness and micro-management in program monitoring and has limited the government's flexibility.

IV. Streamlining Conditionality and Strengthening Ownership

52. Given the expansion of structural conditionality in the past decade, it is not surprising that recent reform proposals have focused primarily on this area. As noted above, there were good reasons for the Fund's growing involvement in structural issues, but there are also legitimate concerns that in many instances structural conditionality may have gone beyond

Figure 4. Average Number of Structural Conditions per Program Year by Type of Country1/



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

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

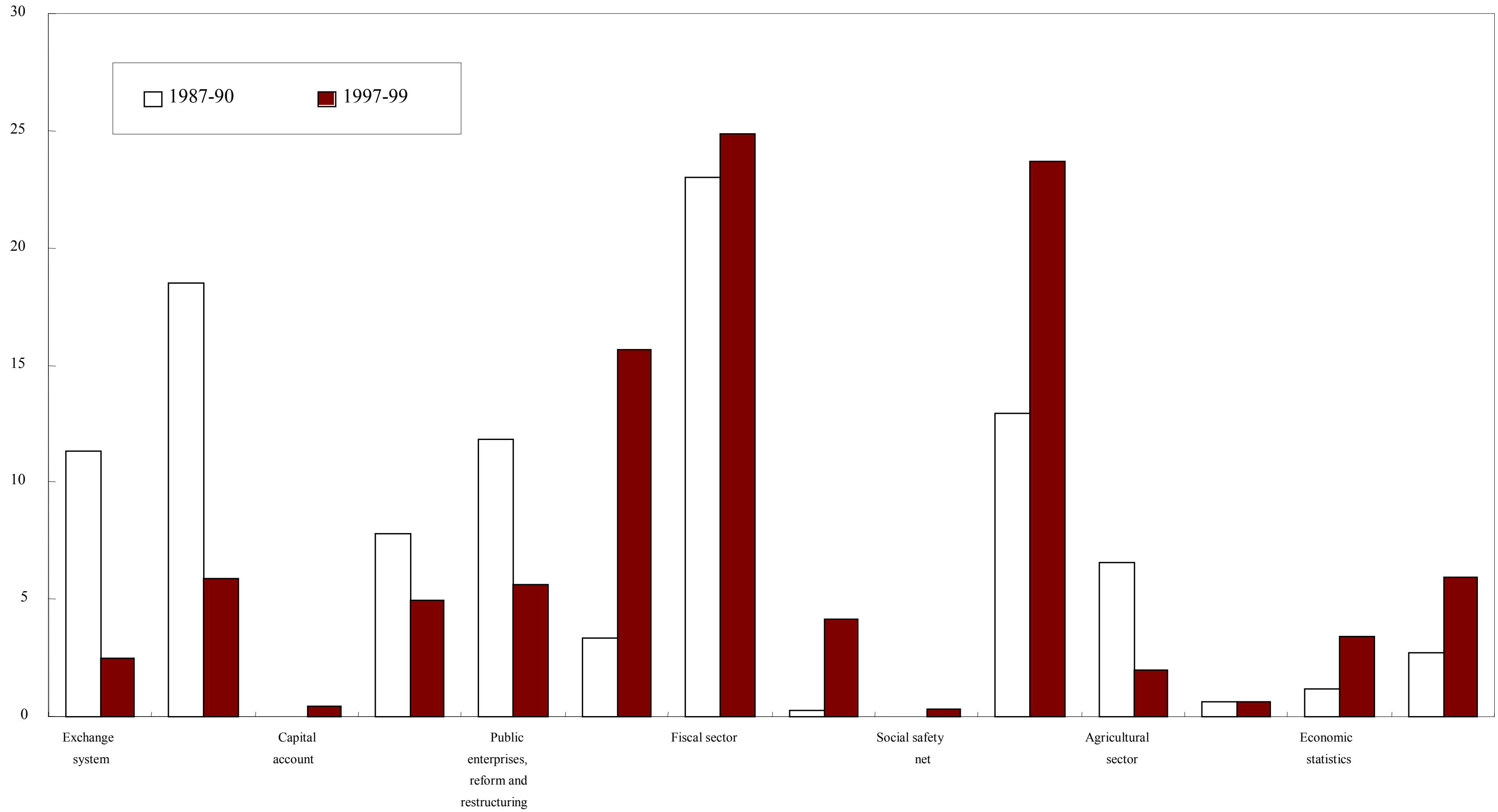
2/ As defined in the World Economic Outlook, covering former centrally planned economies in Eastern Europe, FSU countries, and Mongolia.

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

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

5/ Indonesia, Korea, and Thailand.

Figure 5. Distribution of Structural Conditions by Economic Sector
(In percent of total structural conditions 1/)



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

1/ Averages of the sectoral distributions of total structural conditions (performance criteria, structural benchmarks, prior actions, and conditions for completion of review) for each program.

what can be justified in relation to the intended purpose of conditionality in safeguarding Fund resources. These concerns relate to both the scope and detail of structural conditionality and have motivated the recent search for appropriate ways of streamlining. In addition, there are concerns that too little flexibility and inclusiveness in program negotiations may weaken ownership. Possible ways of dealing with these concerns are discussed in this chapter.

A. Narrowing the Scope of Structural Conditionality

53. In order to narrow the scope of structural conditionality, it is essential to establish a basis for determining what is the appropriate scope of such conditionality. The *Interim Guidance Note on Streamlining Structural Conditionality* (Box 3) proposes that the test for whether a particular structural reform should be monitored in a program is whether it is critical to the objectives of the program. This approach is consistent with the 1979 *Conditionality Guidelines*, which state that "performance criteria will be limited to those that are necessary to evaluate implementation of the program with a view to ensuring the achievement of its objectives." In the staff's view, this principle remains appropriate.

54. The application of this principle is made more difficult, however, by the fact that the measures deemed essential may differ in different cases. For instance, achieving fiscal sustainability may require changes in intergovernmental fiscal relations, privatization of key enterprises, or reform of ailing pension systems. As another example, countries that decide to establish a currency board would need to put the necessary structural conditions in place, such as changes in laws governing the central bank, steps to ensure financial system stability in the absence of a lender of last resort, and changes in the modalities of public sector financing. Likewise, in capital crises, reforms in banking systems may be necessary to address the structural problems that contributed to the crisis and provide the foundation for a return of confidence and sustainable growth. In other instances, supply-side reforms, such as abolition of government marketing boards, are intended to promote sustainable medium-term growth by increasing the efficiency and resilience of the economy. In yet other cases, reforms may be aimed at objectives that are not easily characterized in macroeconomic terms—for instance, social safety nets to protect the poor and vulnerable—but may be important for broad acceptance of the program. These examples illustrate that, even if programs are formulated with rather narrow macroeconomic objectives in view, structural reforms, some of which lie outside the Fund's traditional core areas, may nonetheless be seen as important to achieving these objectives. But caution is needed to ensure that the structural measures be adequately prioritized.

55. Given the diversity of structural measures that may be important for the achievement of a program's macroeconomic objectives, the Fund has used a case-by-case approach to determine the scope of conditionality, guided by the principle that conditions should be limited to those that are essential to program objectives. This approach relies largely on the judgment of the authorities and the staff, under the direction of management and the Board, to determine the appropriate scope of structural conditionality. However, within this case-by-case approach, there is considerable room for delineating the scope of structural

Box 3. Streamlining Structural Conditionality in Fund-Supported Programs Interim Guidance Note

1. This note has been prepared by an Inter-Departmental Working Group1/ on streamlining structural conditionality in Fund-supported programs. The general principles set out below are preliminary and will be reviewed in early 2001 in light of the initial experience and the Board's discussion of the forthcoming papers on *The Experience with Structural Conditionality in Fund-Supported Programs* and *Ownership, Conditionality, and Policy Implementation*.

2. The Reform Task Force in its interim report on "The Future Role of the Fund" recommends that Fund programs should henceforth be formulated on the "… presumption that structural conditionality will be limited to a core set of essential measures that are macro-relevant and in the Fund's core area of responsibility, with a broader approach requiring justification based upon the specific country situation." 2/ The report further notes that "…the Fund may continue to advise on a broader range of structural reforms in some cases, but they would not generally be part of conditionality."(¶51)

3. This note outlines some principles to assist staff in determining the appropriate scope of structural conditionality in Fund arrangements in the general resources account, as well as in PRGF arrangements. These principles are inevitably fairly general and will need to be applied judiciously on a case by case basis. However, they should be seen as establishing a general presumption that structural conditionality in Fund-supported programs should be selective and justified by the program's overall macroeconomic objectives. This should not weaken the quality of Fund-supported programs; rather, it should help strengthen conditionality and ownership in those areas that are critical for the program's success.

4. The authorities' policy commitments in the structural area are laid down in the letter of intent (LOI) or the memorandum on economic and financial policies (MEFP). Implementation of these policy commitments is monitored through performance criteria, structural benchmarks, prior actions, or in the context of program reviews. The form of monitoring depends on the importance of certain structural reforms for the program's objectives as well as the nature of the measures involved. Applying performance criteria requires that specific measures can be clearly and unambiguously defined, and that these measures in and of themselves are sufficiently important to warrant holding up the arrangement in cases of non-compliance. Structural benchmarks too are applied to individual, well-defined measures, but they do not assign the same weight to these measures as do performance criteria; rather they serve as markers in the assessment of progress with the implementation of reforms in a given area. Finally, reviews provide a framework for an assessment of structural reforms against established benchmarks or of reforms that are either less critical or characterized by a series of smaller steps, which may be of moderate significance individually and have to reach a critical mass to signify progress. Reviews provide considerable scope for judgment and, hence, flexibility to the Fund, but they imply less clearly defined assurances for the borrowing country regarding the conditions under which purchases can continue.

5. Sometimes, the authorities and/or staff find the LOI a useful vehicle to set out the authorities' broader policy agenda for either national or international audiences. In these instances, only part of the LOI may constitute firm policy commitments under the program in the form of performance criteria or benchmarks. In such cases, review clauses need to indicate clearly the areas that will be covered by program reviews. The principles outlined in the following paragraphs (¶¶ 6–11) focus on structural reforms that constitute policy commitments in the sense that they are subject to some form of monitoring under the program. Issues related to the broader coverage of structural measures in LOIs or MEFPs are briefly discussed in paragraph 12.

6. *Fund conditionality should cover only structural reforms that are relevant for a program's macroeconomic objectives.* There are, however, no clear rules for classifying structural reforms according to their macro-relevance. While all Fund-supported programs ultimately seek to achieve medium-term external viability together with strong and sustainable growth, the conditions that determine what needs to be done to achieve these objectives vary considerably across programs. For example, in recent financial crises, the overriding goal of Fund-supported programs was to restore market confidence, ensure orderly external adjustment, address the weaknesses that had made these countries vulnerable to a crisis, and create the conditions for growth to be resumed. In the transition economies, completing the transformation into a competitive market economy while restoring or maintaining stable macroeconomic conditions has been the key challenge. PRGF arrangements seek to promote poverty reduction by removing impediments to strong, sustainable growth and a viable external position. While macro-relevance needs to be established on a case by case basis, it will be important to make this assessment explicit in program documents.

7. *Not all structural reforms that meet the macro-relevance test will typically be subject to program conditionality.* In order to determine which reforms should be covered, it is useful to distinguish between structural reforms that are essential or critical for the program's macroeconomic objectives and reforms that are macro-relevant but do not have the same degree of importance. Distinguishing between the two is obviously a matter a judgment. One way to do so is to ask the question: If the reforms in question were not carried out, would achievement of the program's macroeconomic objectives, including the restoration of sustainable growth, be seriously jeopardized, regardless of progress in other areas? If the answer is no, the reforms in question may be macro-relevant but are probably not critical.

8. *Structural reforms that are critical for the achievement of the program's macroeconomic objectives will generally have to be covered by Fund conditionality.* If measures can be identified that are specific, well-defined and monitorable, and mark important steps in the whole reform process, they would likely be subject to performance criteria or prior actions. For structural reforms that are critical for a program's macroeconomic objectives but are defined by a series of individual small steps that have to reach a critical mass, monitoring would typically rely on benchmarks and/or program reviews, with review clauses highlighting the relevant area.

9. *If certain structural reforms are critical for the program's success but outside the Fund's core areas of responsibility, the Fund will have to seek assistance from the World Bank or another institution* to provide input in designing and monitoring the reform measures and, if necessary, give technical advice on implementation to the country. In these cases, the Fund would still bring these measures under its own conditionality and decide on the adequacy of implementation on the basis of assessments provided by the World Bank or other relevant institution. /3

10. *Structural reforms that are relevant—but not critical—for the program's macroeconomic objectives and within the Fund's core areas of responsibility may be subject to conditionality.* Whether such reforms should be included and in what form they should be monitored is a matter of judgment and depends on their relative importance for the program's objectives and the nature of the measures involved. However, the presumption would be that structural performance criteria would not be used in these cases, and that prior actions or structural benchmarks would be used sparingly and would require justification. In most instances, structural policy commitments to the Fund that fall into this category would be monitored in the context of reviews as part of an overall assessment of progress under the program.

11. *If structural reforms meet the macro-relevance test but are neither critical nor in the Fund's core areas of responsibility, Fund conditionality would generally not apply.* If these measures are covered by the World Bank, the Fund may, and in many cases would, take note of the Bank's assessment of progress with implementation in forming a judgment on the country's adjustment effort. 4/

12. The general principles outlined above focus on structural conditionality, i.e., policy commitments to the Fund in the structural area that are subject to some form of monitoring under the program. As noted in ¶4, however, LOIs or MEFPs may include the authorities' broader policy agenda. In these cases, review clauses need to delineate the areas that are covered by Fund conditionality beyond those covered explicitly by performance criteria. The breadth as well as the level of detail of the measures covered by LOIs or MEFPs should continue to be determined by what is most useful in each country context. Nevertheless, in some cases, MEFPs containing large and detailed policy matrices have raised concerns about excessive intrusiveness of Fund conditionality. Such detailed matrices should be avoided unless they are considered necessary by the authorities to express their policy commitment or by the staff to monitor policy implementation.

1/ The Working Group comprised Messrs. Ahmed (PDR, Chair), Artus (EU1), Cardemil (WHD), Collyns/Moghadam (APD), Davis/Mahler (FAD), Fajgenbaum (AFR), Havrylyshyn/Saavalainen (EU2), Nashashibi (MED), Mr. Sundararajan/Ms. Gulde-Wolf (MAE), and Ms. Schulze-Ghattas (PDR, Secretary of the Group).

2/ Core areas of responsibility are defined in paragraph 2 of the report. They include "macroeconomic stabilization; monetary, fiscal and exchange rate policy, including the underlying institutional arrangements and closely related structural measures; and financial sector issues, including the functioning of both domestic and international financial markets."

3/ In the case of PRGF-supported arrangements, it has been decided that the respective areas of responsibility of the Fund and the World Bank will be delineated in the PRSP. It is intended that the Fund would "…not apply conditionality in areas outside the Fund's mandate and expertise, with the possible exception of measures that are critical to the country's fiscal and/or external targets…" (see, *Key Features of PRGF-Supported Programs* (SM/00/193, 8/17/00, ¶18)). It is recognized, however, that changes at the World Bank--in particular, the development of the Poverty Reduction Support Credit--and the nature of the World Bank's current lending operations in specific countries will affect how quickly it will be possible to move in this direction. In the interim, PRGF conditionality may cover additional measures that are critical for the program's objectives.

4/ In the case of PRGF arrangements, it is envisaged that the Fund will take into account the World Bank's assessment in all areas for which the Bank has responsibility under the PRSP (or I-PRSP).

conditionality more or less narrowly, depending on the level of importance that is used to include structural reforms in a program. In order to streamline structural conditionality, the *Interim Guidance Note* seeks to raise this level and proposes a shift to a presumption of parsimony from a presumption of comprehensiveness.

56. Two main alternatives to this case-by-case approach may be considered. One would be to find some way of clarifying and limiting the *objectives* of Fund-supported programs. Up to a point, this would appear sensible. The program objectives guiding the scope of structural conditionality could explicitly be limited to achieving a viable external position at a healthy, sustainable rate of growth, and not to "fix" virtually every aspect of a country's economic policy. But external viability at a satisfactory and sustainable rate of growth has, implicitly, been the ultimate objective of most Fund-supported programs; if the intention were to narrow the range of structural reforms that may potentially be relevant for programs' macroeconomic objectives, these objectives might well need to be limited further. For instance, program

objectives could in principle be limited to immediate stabilization of the external position, eliminating any elements designed to pursue broader goals such as achieving medium-term external sustainability or preventing future crises.[25] But narrowing objectives in this way is likely to be seen as inconsistent with the Fund's Articles of Agreement: if the medium-term aspects of sustainability and crisis prevention were ignored, would the Fund be acting to safeguard the resources entrusted to it? Similarly, the Fund could drop its emphasis on promoting high-quality growth. But this objective is widely supported by the membership and arguably also has a basis in the Articles (Frenkel and Khan, 1990).

57. Another possibility would be to strictly limit the Fund's conditionality to measures in its *core areas of responsibility*—often taken to include exchange rate, monetary and fiscal policies and associated structural reforms, and the financial sector.[26] The motivation for such a rule would be that the Fund is less competent to advise on reforms outside its core areas. This issue of core competence is bound up with that of the division of labor between the Fund and other international financial institutions, notably the World Bank.

58. But a distinction should be drawn between the provision of advice regarding the implementation of a particular reform and making financing contingent on this reform. By way of analogy, a bank may need to ensure that a building is indeed being built before disbursing the next installment of a building loan, even though its staff would not be competent to advise the client on construction techniques. Similarly, before releasing the next tranche of its financing, the Fund may need to be assured of adequate progress with certain reforms, even though its staff could not by itself provide detailed advice on how to implement these reforms.

59. At the same time, it is clear that, for any measures the authorities are implementing, it is essential that they receive adequate advice to enable them to formulate what is to be done, to set a realistic timetable, and to implement the agreed reforms. Clearly, Fund staff should not be advising on areas beyond their competence: in policy areas outside the Fund's core areas, this advice generally should come from the World Bank, from other international financial institutions, from donor countries, or the private sector. In most cases this is how the division of labor has been arranged; but there have also been instances in which different institutions have given conflicting advice, or in which measures have been included under conditionality without ensuring that the authorities have been adequately advised on

[25] This approach, based on narrowing the mandate of the Fund, is discussed for instance in Goldstein, 2000.

[26] See, for example, the Interim Report of the Reform Task Force on "The Future Role of the Fund," which defines the Fund's core areas as: macroeconomic stabilization; monetary, fiscal, and exchange rate policy, including the underlying institutional arrangements and closely related structural measures; and financial sector issues.

implementation. Such instances underscore the importance of ongoing efforts to improve coordination, in particular between the Fund and the World Bank.

60. The alternative to coordination would be to confine conditionality strictly to the Fund's core areas. In cases where measures are critical to program objectives, this would need to be coupled with robust program design or, in extreme cases, a decision not to provide financing. The implementation of the measure in question would need to be treated as an uncertain event and, where possible, other aspects of the policy mix adjusted to allow for the possibility that the measure will not be implemented. But this may be very difficult to do in many cases, and is likely to lead to sub-optimal policies. For instance, if social security reform were viewed as critical to a country's fiscal sustainability, but could not be covered under conditionality because it lies outside the Fund's core area of competence, other less suitable policies, such as tax increases, would need to be included in the program to allow for the possibility that social security reform is not implemented. In cases in which certain structural reforms outside the Fund's core areas are truly critical to program objectives, and there is no way to reach agreement on a viable alternative program that does not depend on the implementation of these reforms, the Fund would not provide financing.

61. The alternative to sticking strictly to core areas is the combination of approaches taken at present. In some instances, the Fund sets specific conditions for implementation of measures outside its core areas under the program while relying on the Bank or others to advise the authorities on the details and to provide information to the Fund that is used in assessing implementation. This may in some cases lead to overlapping conditionality, although that is not necessarily inappropriate, given the need for both the Fund and the Bank to make their financing contingent on measures the implementation of which is essential to the objectives of their respective lending programs.

62. In the context of the PRGF, a sharper division of labor between the Fund and Bank has been arranged. Under current arrangements, it is intended that the Fund would "not apply conditionality in areas outside its mandate and expertise, with the possible exception of measures that are critical to the country's fiscal and/or external targets".[27] In those instances in which a Fund-supported program includes measures that fall into the World Bank's areas of primary responsibility, the Bank would advise the authorities on the design of such measures and would be responsible for monitoring and evaluating performance on these measures. In general, cross-conditionality is not allowed under the Fund's Articles, as it puts a decision on the use of Fund resources in the hands of another institution; if the Fund needs to make its financing contingent on the implementation of certain measures, it needs to specify these measures explicitly in the text of its arrangement with the member. But the PRGF arrangements do not formally involve such a loss of autonomy for decision-making

[27] See *Key Features of PRGF-Supported Programs*, SM/00/193, August 17, 2000, paragraph 18.

over the use of Fund resources, since the Fund's Board makes decisions taking the Bank's assessment into account. This approach would be most straightforward in cases in which the Bank provides financing through a parallel Poverty Reduction Support Credit (PRSC), but has also been used in conjunction with other World Bank lending instruments.[28]

B. Reducing the Detail of Program Monitoring

Greater Focus on Outcomes Rather Than Actions?

63. In addition to concerns about the scope of structural conditionality in Fund-supported programs, there have been equally important concerns about the increasing level of detail of conditionality and the resulting intrusiveness program monitoring. As a general remedy to this problem, some[29] have suggested that conditionality should focus primarily on outcomes rather than policy actions, leaving it up to the government to decide on the appropriate policy measures to achieve these outcomes. In its extreme form, outcomes-based conditionality would focus on the ultimate macroeconomic objectives of a Fund-supported program, for instance on indicators of the external balance and growth; in a somewhat less extreme form, it would rely on the outcomes of specific policies or reforms that viewed as critical for the achievement of these objectives.[30] For example, if financial system restructuring were deemed essential, the program could specify the desired result and leave the steps to achieve this result up to the authorities.

64. In assessing the usefulness of these proposals, it should be noted that program monitoring is not confined to a simple choice between policy actions and outcomes. In practice, there is a spectrum between actions and results, and the Fund's conditionality in the macroeconomic area has typically focused on intermediate variables, such as net domestic assets or credit to government, which reflect a combination of policy actions and macroeconomic developments. Moreover, the notion that program implementation needs to be viewed in relation to the overall results underlies the concept of program reviews, which are used to evaluate policies in relation to program objectives. It is, however, true that in the

[28] The World Bank recently established a Middle Income Task Force, which is working on these issues with regard to middle-income countries; this work may have ramifications for the way the two institutions coordinate their conditionality.

[29] See, for example, Goldstein (2000), p. 69, and Spaos (1986).

[30] Results-based conditionality is its extreme forms is akin to some of the pre-selection approaches discussed in Annex I, whereby the Fund would lend only to countries in which a critical mass of reforms had already been accomplished.

structural area, program monitoring has largely focused on specific policy actions and, as a result, has often involved considerable micro-management of the reform process. The main issue then is whether in the area of structural reforms a substantial move along the spectrum in the direction of outcomes-based conditionality would be feasible and desirable.

65. While greater reliance on outcomes rather than policy actions in monitoring program implementation would increase the government's flexibility and reduce the intrusiveness of conditionality, it would also raise a number of difficult issues regarding the timing of disbursements and the clarity of assurances. Given the need to synchronize the timing of program monitoring and the phasing of disbursements, an important question is how a move towards outcomes-based conditionality would affect the schedule of financing. In some cases, policy actions yield results relatively quickly, so there is nothing problematic about monitoring outcomes within a timeframe that is consistent with existing schedules of disbursements. In many other cases however, particularly in connection with structural reforms, the results may take much longer to materialize, requiring greater back-loading of financing. In many cases, such a back-loading would be problematic, as it would lead to a mismatch of financing with countries' financing needs.[31] The alternative to greater back-loading would be the current practice in which financing is based on some kind of assessment of countries' progress toward specified outcomes—generally in the context of a review, and possibly guided by structural benchmarks.[32]

66. Even if timing is not an issue because policies can be expected to yield results fairly quickly, the need to specify the outcome in all its relevant aspects may complicate the application of outcomes-based conditionality. In some cases, defining outcomes may be relatively straightforward; for instance, where the objectives pertain to foreign exchange market liberalization, the outcomes could be specified in terms of indicators such as bid-ask spreads. In other cases, such as the restructuring and recapitalization of an insolvent banking system, it may be difficult to define the desired outcome in a sufficiently comprehensive and specific way.

67. In this regard, one possibility would be to use standards and codes as a way of guiding program design as well as simplifying the specification of some of the policy outcomes in

[31] Further back-loading of financing would run counter to the conclusions from the experience with a number of recent Fund-supported program, particularly in countries experiencing capital account crises. These programs required substantial front-loading of financing, but involved extensive structural reforms that took time to show results. Floating conditionality based on the outcomes of certain reforms would entail some flexibility regarding the timing of financing, but it would, in essence, raise similar issues.

[32] The modalities of such an assessment are discussed in the next chapter.

programs and enhancing their legitimacy.[33] For instance, a program could include an agreement to bring the country into compliance with the Code of Fiscal Transparency or the Basel Core Principles by a specified date. Under the present approach, structural reforms included in Fund-supported programs are often ultimately intended to achieve fulfillment of certain standards and codes, but the program specifies the reform steps themselves rather than requiring that the country come into compliance with particular codes and standards or certain aspects of them. There may be considerable merit to the idea of using standards and codes as a way of monitoring policy plans in certain areas—to help pinpoint areas in which reforms may be needed as well as to indicate those areas in which policies are broadly adequate. At the same time, using standards and codes explicitly in conditionality would be a significant departure from the current policy under which the adoption of standards and codes is primarily voluntary.[34]

68. Finally, moving further along the spectrum towards outcomes-based conditionality would likely reduce the assurances to the authorities of the circumstances under which they could draw on the Fund's resources. This is partly related to the definability of outcomes, but even when outcomes can be specified in sufficiently precise terms, policy actions may, for a variety of reasons, not yield the expected results, implying that financing may be interrupted even though the relevant policy actions have been taken. (For instance, if the intended outcome is a workout of nonperforming corporate debt, setting up a framework for debt workouts may turn out not be sufficient to resolve the problem.) While this situation is common in the area macroeconomic conditionality (and typically prompts a reassessment of policy actions), it may raise more difficult issues in the area of structural policies where the links between policy actions and outcomes are often less well understood. However, it is the outcomes that matter for the achievement of program objectives and while action-based conditionality provides clearer assurances to the government, it provides no automatic recourse to reassess policies when the expected results do not materialize.

69. To be sure, there is a clear trade-off between the clarity of assurance on the one hand and the link between conditionality and program objectives on the other. Action-based conditionality provides clear assurances but may be far removed from the program's ultimate objectives, while outcomes-based conditionality ensures a close link between conditionality and program objectives but entails weaker assurances. Macroeconomic conditionality has typically focused on an intermediate point on the spectrum between actions and outcomes—

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[33] Of course, standards and codes could be brought to bear only on certain aspects of conditionality. In particular, many of these standards and codes focus primarily on formal institutional arrangements and not the policy content; for instance, a country could be in full compliance with the code of fiscal transparency and still pursue a fiscal policy that was completely inappropriate in the context of a balance-of-payments crisis.

[34] One exception is the use of subscription to the SDDS as a prerequisite for CCL eligibility.

variables that are largely but not exclusively influenced by policy actions and linked to the program's ultimate objectives. Such intermediate targets or outcomes are more difficult to define in the structural area but some steps in this direction may be worth considering. However, a radical move towards outcomes-based conditionality would likely create serious tensions between the timing of program monitoring, disbursements and financing needs, and may entail a serious weakening of assurances.

Clarifying Monitoring Tools and the Boundaries of Conditionality

70. The experience with structural conditionality suggests that streamlining conditionality also requires some clarification of how different monitoring tools should be used. Moreover, given the increasing breadth and detail of LOIs and the accompanying memoranda on economic and financial policies or policy matrices, there is a need to define more clearly the boundaries of conditionality.

71. The roles of performance criteria and prior actions in the context of program monitoring are relatively clear: both are directly linked to the approval or continuation of access to Fund resources. But the factors that should be taken into account in deciding whether to complete a program review are generally less clearly defined. As a result, the status of many of the policy measures mentioned in the LOI, including measures specified as structural benchmarks, is ambiguous. Therefore, clarifying the role of benchmarks and the coverage of program reviews is essential in delineating the boundaries of conditionality.

72. It has been noted earlier in the paper that the use of reviews has been extended beyond what was envisaged in the 1979 Conditionality Guidelines. In addition to providing a method of assessing progress on structural policies that is difficult to quantify, they have come to play an increasing role in assessing macroeconomic policies from a forward-looking as well as a backward-looking perspective. This broadening of the purposes of reviews has been accompanied by an increase in their frequency and scope; as noted above, this implies a shift toward greater discretion of the Fund, possibly at the expense of members' assurances regarding their ability to purchase.

73. The discretionary element of reviews can be countered, to some extent, by clarifying that the role of a review is to ensure that the program is on track to achieve its objectives, and not to reconsider those objectives—although, in many instances, achieving the same objectives may require different measures, either because the economic situation has changed or because the details of some key aspects of the authorities' strategy was not yet specified at the time of program approval. It should be made clear that reviews are not intended to move the goalposts, but only to ensure that the program as originally envisaged is being implemented. Moreover, it is important to specify, as clearly as possible, the scope of a review and the factors the staff will be taking into consideration in completing it. In most cases, this will not cover the authorities' entire economic program, but only those elements that have been clearly identified as of critical importance to the purposes of the Fund.

74. One key task in making reviews more focused is to clarify the appropriate role of structural benchmarks. Such benchmarks seem most suitable with regard to those structural reforms that are essential to the Fund-supported program, but that take a significant period of time to put in place. In many such cases, it is essential to assess progress toward these reform objectives in the context of program reviews; SBs serve as an explicit set of indicators to guide such an assessment. As discussed earlier, the use of SBs in this context serves to increase the member country's assurance of being able to use the Fund's resources.

75. A second use of SBs that may be appropriate is in the case in which a variable or action that is essential to the program cannot be specified or measured precisely enough to specify it as a PC. In this case, designating a SB can be a way of indicating that a policy is to be taken into account in the context of a review, without placing undue weight on imprecise data. At present, structural benchmarks are sometimes used in this fashion, as they are the only alternative readily available to the Fund. For instance, in a case in which improvements in tax administration are considered essential to fiscal sustainability, a structural benchmark on tax revenue may be a suitable way to monitor these improvements, if the revenue data are not adequate for the purpose of establishing a performance criterion. As another example, passing a bankruptcy law may be essential to re-establishing a country's access to international financial markets; a structural benchmark may be a suitable tool in such a case given the difficulty of specifying the needed features of the law in sufficient detail to set a performance criterion. SBs could be used in this fashion to focus the monitoring of structural reforms more on intermediate outcomes (raising tax revenue through improved tax administration, strengthening bankruptcy procedures through a new bankruptcy law) rather than detailed policy actions (establish a large taxpayer unit, complete draft of new bankruptcy law, submit law to parliament).

76. If this interpretation of the appropriate uses of SBs is agreed by the Board, this should be made explicit, both to guide practice and to give an accurate impression of their implications. Current practice appears to have been inconsistent. In some cases, SBs have been used to map out every detailed step of a reform, partly for the guidance of the authorities. In cases where the intention is to map out the implementation schedule for the authorities, such guidance should be provided to the authorities in the form of advice (possibly in the context of technical assistance) rather than being formalized as part of conditionality. Moreover, SBs should be used more sparingly than has often been the case in the past, to ensure that the actions specified in SBs are indeed important and representative steps toward an important outcome.

77. A related issue is the interpretation of the Letter of Intent (LOI). The LOI presents the authorities' understanding of the policies they have discussed with the Fund, and its publication is the main channel through which the public and the markets are informed of the contents of a Fund-supported program. Some elements of the policies outlined in the LOI are indeed monitored with a view to determining the country's ongoing access to the Fund's financing—but it is often unclear which elements. This is a matter of concern: in some cases such ambiguity may be viewed as helpful in "selling" the program to the public and the

markets, but it may give a false impression of the measures to which the Fund is applying conditionality. Letters of Intent should thus either be limited to aspects of policy covered by the Fund's conditionality, or they should clarify which aspects of policy are being monitored by the Fund as part of its formal conditionality. This could be done by including a separate section indicating the coverage of conditionality, including performance criteria, structural benchmarks, prior actions, and the areas of policy to be covered in program reviews. It may also be desirable to discontinue the practice of attaching to LOIs detailed matrices of implementation steps for policies not all of which are critical to program objectives. Publishing the text of countries' arrangements with the Fund would also be somewhat useful, in clarifying what the Fund will be monitoring, although this may not by itself provide sufficient clarity, since the legally precise language of arrangements may limit their accessibility to a lay readership.

78. Clarifying the boundaries of conditionality is essential to removing the impression that it is all-encompassing. It is important to draw the distinction between the authorities' program and their public pronouncements on it, and the conditionality that is related to Fund support. Conditionality is only that part of the authorities' program the implementation of which is monitored as the basis for decisions on the use of Fund resources: i.e., the defining question is, "If it is not done, can that stop a purchase?" By this definition, it is often the case that many policy undertakings mentioned in the authorities' LOI or accompanying matrices are not part of conditionality.

C. Flexibility and Inclusiveness in Program Negotiations

79. In addition to streamlining conditionality, the Fund could also make additional efforts to strengthen ownership by ensuring that program negotiations adequately incorporate the country's views and, to the extent possible, a wider dialogue among stakeholders within the country. This would mean applying current best practice to ensure that programs are formulated in the light of adequate discussion of the tradeoffs among various alternatives.

80. To begin with, a program is not likely to be nationally owned unless the authorities are fundamentally involved in every stage of its design. Sometimes this is interpreted as the requirement that the authorities, rather than the Fund staff, should draft the Letter of Intent (LOI).[35] This is probably desirable, where practicable, if only to help dispel the negative impression that may be created, in the country and elsewhere, by a situation in which Fund staff attempt to summarize the authorities' policies for them. But regardless of—and surely more important than—whether it is the staff or the authorities who actually take pen to paper, the LOI should fully reflect the position of the authorities, including their rationale for the policies adopted. The formulation of a program should flow from an adequate discussion of

[35] This was emphasized, for instance, in case studies for the External Evaluation of the ESAF.

the country's problems and the policies and financing needed to solve these problems, as seen by both sides, as well as adequate consideration of relevant alternatives.

81. Achieving a sufficiently constructive process for designing programs is likely to reflect an application of best practice, rather than the specification of formal requirements. For instance, in many cases mission teams do elaborate a variety of macroeconomic scenarios, with different implications for economic policies and discuss them with the authorities before reaching agreement on one for the program, and this practice needs to be followed more often. But at the same time, a formal requirement that missions present the authorities with, say, three fully articulated alternative scenarios for the authorities' consideration may not help this process: such a requirement would be unnecessarily formalistic if staff are already in close dialogue with the authorities and share their analysis of the macroeconomic implications of alternative policies; while, in the absence of such a cooperative relationship, the scenarios could easily be designed to tilt the authorities toward the alternative preferred by the staff.

82. Another important issue is the need for the Fund to assist the authorities where implementation capacity is weak. This is, in the first instance, an important role for the Fund's policy advice. The Fund staff may help by providing technical assistance or by advising the authorities on the implementation of key reforms, or at an earlier stage, in designing their own programs. As noted above, the emphasis of such efforts should be on building the country's own implementation capacity, rather than substituting for that capacity (although this may not be practicable in some crisis situations).

83. In addition to the process of negotiating with the authorities, consideration should be given to how to broaden ownership, to ensure that other institutions and interest groups in the country—including those whose support is needed to implement the program, but also those importantly affected—are both informed and heard. This is foremost the responsibility of the authorities, who are the legitimate representatives of their people and who are also more familiar than Fund staff with their own domestic political process.[36] But, subject to the guidance of the authorities, the Fund staff can also play a role—for instance, by holding substantive discussions with other groups, including other ministries, trade unions, industry representatives, and local non-governmental organizations, especially at a stage at which the design of the program is still under consideration.

84. More generally, greater transparency and improved communication by the Fund may help groups within the country to participate meaningfully in the process. In particular, the Fund's policies regarding publication of Letters of Intent, Staff Reports, Reports on Observance of Standards and Codes (ROSCs) and other documents pertaining to the country, as well as documents on the Fund's policies and procedures more generally, may contribute

[36] This was the view of the Board with regard to the 1997 External Evaluation of the ESAF.

to a more informed national discussion of policy alternatives in the context of a program. These publications should be supplemented by other forms of communication to clarify the nature of the authorities' agreement with the Fund as well as the Fund's own objectives and constraints.

85. Time constraints, however, also have important implications for the negotiation process, which differ across countries. During a capital market crisis, there is very little time for negotiation and formulation of alternative proposals, and there may well be heightened awareness by both sides of what needs to be done to stem the crisis. In this case, a more relaxed and flexible negotiating style, even though it would help contribute to building program ownership, may simply not be feasible. In contrast, in countries facing longer-term structural issues, such as in the context of PRGF programs, it is more likely to be worth taking more time to explore various alternatives more fully and bringing other groups on board. This is reflected, for instances, in the consultative process required for elaboration of a full Poverty Reduction Strategy Paper. There is a spectrum between these extremes, with greater degrees of time pressure reflected in diminished scope for building ownership.

D. Conclusions

This discussion suggests the following conclusions that, if the Board agrees, could be carried forward into a review of the Guidelines on Conditionality:

- Conditionality, a linkage between financing and policy implementation, is an essential feature of the Fund's financing, both in the context of standby and extended arrangements as well as the PRGF and other special facilities.

- Conditionality needs to be streamlined to the extent practicable, always focusing on what is needed to ensure that the key objectives of the program are being met. This principle needs to guide the application of performance criteria and prior actions, as well as the use of program reviews and of structural benchmarks in guiding such reviews.

- The use of program reviews both for forward and backward-looking assessments of policy implementation has appropriately expanded beyond what was envisaged in the 1979 Guidelines. But reviews should not be open-ended. They should not be used to change program objectives, but only to adapt policies to meet these objectives in the face of changes in the economic situation. They should also not become an occasion for the Fund to scrutinize every aspect of a country's policies as it sees fit: the aspects of policy to be covered and the basis on which implementation is to be assessed should be delineated as clearly as possible beforehand, and limited to what is necessary to provide assurances that the policies needed for essential program objectives are being implemented.

- Structural benchmarks may be used to guide the Fund's policy assessments in the context of reviews, in cases in which the implementation of policies that take several steps to accomplish is essential to program objectives. In some cases, a structural benchmark may also be used where data are inadequate for establishing a performance criterion. But in other cases, in which the policies in question are not essential to program objectives, structural benchmarks should not be used. And, in setting structural benchmarks, streamlining is again essential: even where benchmarks cover areas of policy that are essential to program objectives, care should be taken to ensure that the steps so specified are indeed important and representative of progress toward desired results.

- The Letter of Intent often summarizes the authorities' entire policy program, but, if reviews are appropriately focused, the country's access to the Fund's resources hinges on only part of this program. LOIs should make it clear which aspects of the country's policies are being monitored as part of conditionality; clarity is particularly important as LOIs and Staff Reports are now often being made public. Two approaches to clarity are possible: one is to narrow the scope of the LOI to cover only those aspects of policy monitored by the Fund as the basis for decisions on continued use of Fund resources. The other, in cases where the authorities wish to use the LOI to characterize their entire policy program, would be to include a separate section indicating the performance criteria and structural benchmarks as well as delineating the areas of policy to be covered in program reviews. Detailed matrices of implementation steps for policies that are not critical to program objectives should be dropped from LOIs. And the Fund should discourage the use of the LOI as a vehicle to advance technical assistance recommendations or to further the agendas of other international financial institutions, except where these are also essential to the purposes of the Fund.

- The scope of structural conditionality should be streamlined following two main approaches. One is by limiting Fund conditionality to what is essential (and not merely relevant) to program objectives. This is intended to change from a presumption of comprehensiveness to one of parsimony. A second, which is applicable to PRGF countries, is to make use of a coordination framework to achieve a better division of labor with the World Bank, permitting each institution to confine conditionality to its core areas while ensuring that the concerns of both institutions are satisfied.

THE RESULTS OF FUND-SUPPORTED PROGRAMS

I. INTRODUCTION

1. The results of Fund-supported programs have been examined in a growing body of cross-country and individual country studies. Section II discusses methodological issues, including the selection of the appropriate counterfactual. Section III reviews the evidence on the relatively narrow question with which the literature has mostly dealt, namely whether Fund-supported programs achieved their principal macroeconomic and balance of payments objectives of improving the current account balance, raising international reserves, lowering inflation and raising growth. Section IV reviews evidence on the structural and social impacts of Fund-supported programs. The issue of how national commitment to reforms affects the implementation of Fund-supported programs is taken up in Annex II.

II. METHODOLOGY

2. Four different approaches have been used to estimate a country's expected gain from participation in a Fund-supported program: before-after studies, simulations, control-group studies, and "generalized evaluation exercises". Each approach measures the impact of Fund-supported programs by comparing the actual result with a counterfactual using either country data or information from a sample of countries (Table 1).

- *Before-After calculations* compare the performance of the program country in the program period with its own performance in the period before participation. This method suffers from confounding-effect bias due to a change in the economic structure of the country or shocks.

- *Estimation and Simulation*. Confounding bias can be eliminated either (a) by estimating the economic model and policy reaction function of the participating country before and during the Fund program; or (b) pairing the program country with one or more non-program countries and attributing differences in performance to program participation.

- *Control Group Comparisons*. Each Fund program country is paired with a non-participant and the difference is attributed to the Fund program. This method requires only macroeconomic performance and policy data for two countries but is biased due to cross-country differences in exogenous shocks, in economic structures, and the participation decision. Control-group methodologies address the bias problem by assembling data for a large group of countries, dividing the countries into participants and non-participants, and testing for statistical significance of differences in average macroeconomic performance and policy.

- *Generalized Evaluation Estimator*. This approach removes external influences through explicit estimation of the various channels through which the Fund program and the various external shocks affect macroeconomic outcomes in the participating and non-participating country. This is the most informationally demanding method.

3. The fundamental issue in program evaluation is the specification of the appropriate counterfactual, which consists of the unobserved economic performance and policy outcomes against which observed performance and policy must be measured (Conway, 1998). The problem of defining a counterfactual can be illustrated by the following mathematical model, used by Conway (1998). Consider the performance of a country *i* during a time period in which it participates in a Fund program (the equilibrium is denoted by *P* for participating). External and macroeconomic performance during the program, Y_i^P, is a function of exogenous variables W_i, policy choices P_i^P, and shocks U_i^P.

$$Y_i^P = W_i \eta_i^P + P_i^P \varepsilon_i^P + U_i^P, \qquad U_i^P \sim iid. \tag{1}$$

The government sets policy under the program P_i^P according to a reaction function

$$P_i^P = W_i \rho_i^P + R_i^P, \qquad R_i^P \sim iid, \tag{2}$$

where ρ_i^P is a list of variables that the government consults in setting its responses (this list would include present and lagged values of Y_i and lagged values of W_i). Combining these two equations we get a reduced form

$$Y_i^P = W_i \beta_i^P + V_i^P, \tag{3}$$

where

$$\beta_i^P = \eta_i^P + \rho_i^P \varepsilon_i^P \text{ and } V_i^P = U_i^P + R_i^P \varepsilon_i^P. \tag{4}$$

A Fund-supported program has its effect through the values of the coefficients $\eta_i^P, \rho_i^P, \varepsilon_i^P$: which characterize the effects of exogenous variables on policies, and of both exogenous variables and policies on economic outturns.

4. The impact of participation in a Fund program can be established by setting up a counterfactual, namely an equilibrium (denoted *NP* for non-participation) for the same economy over the same time horizon facing the same exogenous factors, and differing only in its non-participation in the Fund program. The equilibrium for such an economy would, as described in a set of equations for the non-participating country (simply replace P with N in equations (1)-(4)). For any given country, either *P* or *NP* is observed, and the model of the economy and the government reaction function may not be known. The ideal measure of program impact will indicate the expected gain attributable to the switch from non-participation to participation, holding all other features of the economic environment equal. This unobservable expected gain from a switch from non-participation to participation can be written $\Delta_i(w_i) = E\left((Y_i^P - Y_i^{NP}) \mid w_i\right) = w_i\,(\beta_i^P - \beta_i^{NP})$, where *E* denotes all information available at the time of the switch. Note that the program impact measure is a function of the specific realization w_i of exogenous factors. In this framework, care must be taken to address the selection bias inherent in separating the observations into those associated with participation and non-participation.

III. MACROECONOMIC EFFECTS

5. The literature has focused on the impact of Fund-supported programs on inflation, growth, the current account and the change in international reserves. Many early studies using the before-after or control-group approaches found inconsistent or insignificant results (Table 2). However, four of these studies did find that participation in Fund-supported programs had improved the balance of payments or the current account, three studies found that Fund-supported programs had significant deflationary effects, while only one study found a positive and significant effect of program participation on growth. Khan and Knight (1981, 1985) reached broadly similar conclusions using before-after or control-group methodologies, although program participation was found to be associated with depressed growth.

6. More recent empirical evidence using the generalized evaluation estimators concluded that Fund-supported programs were successful in improving the current account and the overall balance of payments and in correcting distortions in relative prices and exchange rates (Ul Haque and Khan, 1998). The results for inflation are less clear-cut. Most of the recent studies find that the rate of inflation falls but this is not statistically significant. In the case of growth, the consensus is that things start out badly but end up well. In the first year of an IMF program the current account improves, and growth and the investment ratio deteriorate as demand is compressed. In following years, participation in Fund programs begins to pay off: the current account continues to do well and growth and the investment ratio improve as structural measures begin to have a positive effect on the supply side (Conway, 1994). But another paper (Conway, 2000) qualifies this result, finding that the macroeconomic performance of countries under Fund-supported programs declined with the length of time a country spent under such a program.

7. Various literature has found a positive association, over the medium term, between macroeconomic stability and growth, although this literature does not generally distinguish whether stability was achieved within a Fund-supported program. Using the generalized evaluation approach, Corbo and Rojas (1992) found that growth performance was significantly higher in 25 countries with World Bank SALs during 1981–88 than growth in 53 developing countries without SALs. Eighteen of the SAL countries were also in Fund programs over this time (Conway, 1998, pp. 37–38). Fischer (1994) concurred with the mixed verdict arguing that the Fund's lending to developing countries in support of stabilization was frequently productive while lending to countries with deep-seated structural problems, many of them in Africa, had not been successful.

8. A related issue concerns the evaluation of macroeconomic performance under Fund-supported programs dealing with capital account crises. A recent paper (Kaplan and Rodrik, 2000) compares macroeconomic performance in Indonesia, Korea, and Thailand—three countries with Fund-supported programs—with the experience of Malaysia which instead

opted to impose wide-ranging capital controls. Using an index of exchange market pressure developed by Eichengreen, Rose and Wyplosz (1995), these authors developed a counterfactual to the Fund-supported program which compared the economic situation in Malaysia starting at the time when capital controls were first introduced with the experience of other countries following their decision to participate in a Fund-supported program (i.e. a "phased difference in differences" comparison). After allowing for differences in the external environment, this counterfactual attributes differences in performance between the three countries and Malaysia following their respective decisions to the different policy choices. A shortening of this approach is that it disregards the effects of other factors—including Malaysia's initial situation as well as developments in the world economy—that could account for differences in economic performance.

9. Another recent study, dealing with transition economies, suggested that the effects of Fund-supported reforms on economic growth depend on the extent to which the policies envisaged in the program are implemented. Mercer-Blackman and Unigovskaya (2000) used the MONA database to construct two indices of implementation of Fund conditionality: the percentages of performance criteria and structural benchmarks implemented. Countries that implemented programs early on and completed them successfully as measured by the PC implementation index had the best growth performance. However, there was no evidence that compliance with structural benchmarks as measured by the SB index had any effect on growth. These results do not mean that successful implementation of Fund programs necessarily causes good performance, as both implementation and good performance could both be caused by an unobservable third variable such as ownership. The authors suggest that in some cases authorities willing to reform may find it convenient to have a Fund program to signal to the markets their reform intentions and to bind their hands vis-à-vis domestic anti-reform elements.

IV. Structural and Social Effects

10. While there has been considerable interest in the microeconomic, structural and social effects of Fund programs, especially on poverty and income distribution, systematic empirical evaluation of the effects has been constrained by data scarcity and methodological problems. Some studies have found that poverty declines, income distribution improves, and health, education and social indicators rise following the adoption of Fund programs. However, there are doubts whether these positive developments can in fact be attributed to Fund programs. A recent paper (Easterly, 2000) found that the elasticity of poverty reduction with respect to economic growth is lower in countries with many IMF and World Bank adjustment loans than in countries with fewer such loans. If this result is correct, it means that the poor benefit less from output expansion and suffer less from output contractions in countries with IMF- and World Bank-supported adjustment programs. This outcome could be due to the relative insulation of the poor from the formal sector, which is most affected by adjustment programs, or to the effects on poverty of formal safety nets called for in most Fund- or Bank-supported adjustment programs. These results are not definitive of course, particularly as they do not distinguish between two constituent components of growth on poverty: the elasticity of

poverty reduction with respect to trend growth of output (which should be high) and that with respect to cyclical fluctuations (which should be low).

Table 1. Evaluation Methodology Criteria

		Country Origin of Counterfactual	
		Same country	***Other country***
Explicit Control for Exogenous Shocks	***No***	Before-After	Control-Group
	Yes	Simulations	Generalized Evaluation Estimator

Table 2. Summary of Empirical Evaluations of the Effect of Fund Programs 1/ 2/ 3/

Study	Time Period	Number of Programs	Number of Countries	BOP	CA	Effects on Inflation	Growth
Before-after							
Reichman and Stillson (1978)	1963-72	79	…	0	..	0	+
Connors (1979)	1973-77	31	23	0	0	0	0
Killick (1984)	1974-79	38	24	0	0	–*	0
Zulu and Nsouli (1985)	1980-81	35	22	…	0	0	0
Goldstein and Montiel (1986)	1974-81	68	58	–	–	–	–
Pastor (1987)	1965-81	…	18	+*	0	0	0
Khan (1990)	1973-88	259	69	+	+*	–	–
Killick, Malik and Manuel (1995)	1979-85	…	16	+*	+*	–*	+*
Schadler, et. al. (1993)	1983-93	55	19	+	–	–	+
Simulation/estimation							
Khan and Knight (1981)	1968-75	…	29	+	+	–	–
Khan and Knight (1985)	1968-75	…	29	+	+	–	–
Control-group							
Donovan (1981)	1970-76	12	12	…	…	–	+
Donovan (1982)	1971-80	78	44	+	+	–	–
Goldstein and Montiel (1986)	1974-81	68	58	–	+	–	+
Gylfason (1987)	1977-79	32	14	+*	…	0	0
Loxley (1984)	1971-82	38	38	0	0	–*	0
Khan (1990)	1973-88	259	69	+*	+*	–	+
Generalized Evaluation							
Goldstein and Montiel (1986)	1974-81	68	58	–	–	+	–
Khan (1990)	1973-88	259	69	+*	+*	–	–*
Conway (1994)	1976-86	217	73	..	+*	–	–, +*
Bagci and Perraudin (1995)	1973-92	…	68	+*	+*	–	+*
Dicks-Mireaux, et. al. (1997)	1986-91	88	74	..	..	–	+*

Source: Conway (1998).
* indicates statistically significant results
1/ 0 indicates that the results of the various studies were inconclusive.
2/ + indicates a positive effect on the variable indicated.
3/ – indicates a negative effect on the variable indicated.

Ownership And Program Implementation

I. Introduction

1. The relationship between conditionality, ownership and the implementation of Fund-supported programs has been the subject of an extensive debate, both inside and outside the Fund. Systematic evaluation of the empirical link between conditionality, ownership and program implementation is, however, complicated by difficulties in observing and assessing the degree of commitment of the authorities and other stakeholders.

2. This Annex examines some indirect evidence on this question, drawing from several sources. Section II reviews case studies from the external evaluation of the ESAF; Section III presents evidence on the role of ownership in Fund-supported programs with transition economies, drawing on recent work by EU2 staff. Section IV asks whether a lack of ownership causes program interruptions—an issue addressed in the internal evaluation of ESAF; Section V reviews the implementation record of low-conditionality programs in the first credit tranche. Section VI turns to the role of ownership in World Bank programs; finally, Section VII discusses the issue of credibility and time inconsistency in conditionality and its implications for efficient allocation of aid. This diverse body of work surveyed strongly suggests that national commitment to reform programs—a factor largely outside the control of the Fund or the Bank—is critical in the success or failure of Bank or Fund-supported adjustment programs.

II. ESAF Case Studies

3. The External Evaluators of ESAF (IMF 1998) presented case studies based on their review of country experiences and interviews with officials from several countries with Fund-supported programs (Bangladesh, Bolivia, Cote d’Ivoire, Malawi, Uganda, Vietnam, Zambia, Zimbabwe). The country cases examined included some in which lack of ownership resulted in poor implementation—such as in Zambia 1976–91, Uganda in the late 1980s, and Malawi under the 1994 SBA and successor ESAF. The evaluators also examined some cases in which broad national ownership and political commitment from the top leadership contributed to success: the latter cases included Cote d’Ivoire’s 1994–97 ESAF, Uganda’s ESAF in the 1990s, and Vietnam’s go-it-alone post-1986 reforms.

4. The case studies underscored the importance of consensus within government and by broad-based economic management teams that transcend the Ministry of Finance; in contrast, ownership and implementation were weaker in programs in which the technical and policy agendas and/or their pace of implementation were set mainly by Fund staff. In contrast, in successful programs such as in Bolivia’s Cote d'Ivoire and Uganda, the authorities took a strong role in setting the policy agenda and in technical discussions and were closely involved in the preparation of PFPs and other policy documents.

5. The evaluators noted that, in the successful cases, ownership and effective program implementation were promoted by open, inclusive public debate sanctioned by the top leadership. In contrast, in some cases such as in Zimbabwe, program implementation was undermined from the start by opposition within government and the leadership, as well as by a lack of political backing for reforms by the President and opposition from business groups. The case studies also illustrated how opposition to reforms from civil servants, staff in state-owned enterprises and other entrenched interests and a failure to identify and protect vulnerable groups hurt by reforms can weaken national ownership and program implementation. Finally, the studies underscored the need for appropriate sequencing of reforms and coordination among donors and IFIs, noting that in some cases (such as in Malawi) problems in these areas had contributed to weakening ownership and implementation.

III. THE TRANSITION COUNTRIES

6. The staff recently assessed the importance of ownership in program implementation drawing on the experience with Fund-supported programs in EU2 countries during the 1990s. Insufficient ownership was found to be at the root of the disappointing record of structural and institutional reforms in several EU2 countries. Signs of weak ownership emerged in some programs in the mid-1900s, including misreporting by Russia and Ukraine, overstatement of reforms implemented by the authorities in several countries, lack of adequate support by local authorities for final consolidation efforts, and serious conflicts between the executive branch and parliament in Ukraine and other countries. In response, and partly to help reformers, conditionality under subsequent programs was intensified. This intensification did not, however, seem to help improve policy implementation in countries not committed to reforms. By contrast, EU2 countries with strong national ownership of reforms were able to successfully implement programs without extensive conditionality. For instance, in the Baltics the Fund's structural conditionality was relatively light and implementation was good.

7. Several reasons accounted for weak ownership and poor implementation. One was inappropriate modalities of Fund conditionality. Fund arrangements (including those with longer maturities) were not always the best instruments for promoting structural reforms in EU2 countries because they may be too "impatient" for effective implementation of such reforms. For example, the necessary due diligence for structural measures often takes longer than the time horizon for negotiating a Fund program. In addition, the long-term nature of many structural measures makes them unsuitable for use as prior actions. As a result there has been a perception that the Fund follows a "textbook" approach to structural conditionality which, together with staff arrogance, may undermine ownership.

8. A second factor was excessive and not properly prioritized structural conditionality. Many measures were implemented superficially to meet the letter of programs and were not followed up. Countries felt they could violate some of the conditions included in long lists of structural conditionality with little risk that this would interrupt the program. Poor

demarcation of boundaries between what was and was not structural conditionality, together with discretion in enforcement, meant that it was not always clear what actions would stop Fund support.

9. A third element was the Fund staff's lack of expertise in designing and monitoring structural conditionality together with decreasing returns to scale in monitoring. The staff needed to rely on the World Bank and others, but these other institutions did not always deliver. When structural conditionality expanded, the staff's ability to monitor implementation was challenged, especially in areas not normally belonging to its specific macroeconomic expertise.

10. Political economy provided a fourth reason. The powerful new elites formed in the early years of transition were able to capture the institutions of government and become a strong vested interest blocking reforms. While pro-market in general, these elites feared that greater transparency, good governance, and the rule of law would reduce their ability to extract economic rents. Moreover, the authorities sometimes agreed out of desperation to measures that they could not or did not intend to implement. The resulting policy reversals, program interruptions and loss of confidence undermined the credibility and the signaling function of conditionality. In addition, most structural reforms (be that in the areas of trade, taxation, enterprise restructuring, labor market, or others) by their very intention imply large structural changes in the economy. These changes will inevitably lead to significant transitional cost for some groups (unemployment, retraining, displacement, etc.); not even the best-designated social safety net is likely to compensate for the increased uncertainty such reforms may generate.

11. Fifth, the incentives of donors and weak administrative capacity played a role as well. On the one hand, donors had strong preferences regarding the detailed content of structural reforms, making it difficult to find a set of policies acceptable by donors and the authorities. On the other hand, poor administrative capacity and lack of effective TA from the Fund and other donors meant some reforms could not be implemented regardless of whether ownership was lacking or not. Structural benchmarks were often missed because the expertise to implement the reforms was not available.

IV. Causes of Program Interruptions

12. Further evidence on the impact of ownership on program implementation can be gleamed from a review of the completion rate of IMF-supported programs. The internal ESAF review (*The ESAF at Ten Years*, IMF (1997)) found that about ⅔ of program interruptions were related to serious policy slippages that weakened the government's credibility or produced protracted disagreements between the Fund and the government on remedial measures. The large deviations of actual from programmed policies and the difficulties in formulating or adhering to sound policies, which were the proximate causes of

program interruptions, could be traced to political upheavals or to flagging national commitment.[1] The ESAF review concluded that "… to lessen risks of this kind—for instance, around the time of elections, when pressures on policymakers are often severe—the IMF would need to seek greater assurances than in the past with respect to a government's willingness and ability to carry out its policy commitments."

13. To address the issue of policy credibility and its impact on market sentiment and economic performance, the 1997 ESAF Review examined interruptions in or between SAF/ESAF-supported programs. The study found that 51 significant interruptions of SAF- or ESAF-supported programs had occurred since the inception of the SAF in 1986, affecting 28 of the 36 countries reviewed. Only ¼ of all three- or four-year arrangements were completed without significant interruptions. The study looked into the factors giving rise to interruptions and asked whether changes in program design or monitoring could have reduced the frequency of interruptions without unduly compromising program objectives. More importantly, to the extent that changes in the design or monitoring could not have been expected to eliminate interruptions, the study asked whether greater selectivity in approving arrangements would have helped limit program interruptions. The review concluded that while greater selectivity could help build countries' resolve to implement programs as agreed, establishing criteria for greater selectivity would be far from straightforward. Without greater selectivity, however, interruptions were likely to remain a feature of the ESAF (and now PRGF) experience, as the Fund continued to assist members at the margins of commitment and in the midst of difficult political transitions.

14. In almost ⅓ of the 51 episodes examined, the primary cause of program interruptions was not related to the need to correct significant policy slippages. About ⅙ of interruptions stemmed from severe political upheavals that called into question the authority of the government to negotiate or provide a credible commitment to a program. In another ⅙ of the interruptions, past policies had been broadly satisfactory, but there were delays in agreeing on future policies. In most of these episodes, time was needed for the authorities to muster political support for certain measures or for the Fund and the authorities to agree on measures to address the effects of a recent unexpected external shock. Thus, about ⅔ of the interruptions were strongly affected by serious slippages in past policies that either weakened the government's credibility or produced protracted disagreements between the Fund and the government on remedial actions.

15. The review also concluded that changes in program design would not have significantly reduced the frequency or length of those program interruptions that were related to policy slippages. None of the aspects of program design examined—i.e., over ambitiousness of macroeconomic policies and financial targets, overly ambitious or

[1] "The ESAF at Ten Years" and "Economic Adjustment and Reform in Low-Income Countries".

insufficiently prioritized structural reforms, adequacy of technical assistance, more frequent monitoring, and contingency planning—provided a compelling explanation of program interruptions related to policy slippages.

16. The implication of the above results is that most program interruptions have been the result of factors outside the Fund's control—that is, major political upheavals and flagging commitment. Discontinuities or weaknesses in policy management appear to have been related in roughly a dozen cases to less severe forms of political disruption, including routine elections, transitions to multiparty political systems, and social unrest. These events typically resulted in government overspending and a general distraction of the decision-making authority. However, in more than one-third of the interruptions no unusual event of this kind occurred during the period leading up to interruption. In most of these cases, myriad influences were at play in the failure to implement policies as planned: disagreement within narrower political circles, reluctance of the authorities to confront special-interest groups, poor organization, and governance-related weaknesses.

17. The Review also addressed whether greater selectivity in approving arrangements would have helped to limit interruptions (by withholding Fund support until the authorities demonstrated that they could deliver policy changes). The review concluded that: (i) greater selectivity would probably require stronger assurances than have been provided in the past of the authorities' ability to implement policies during election cycles. (ii) Past interruptions were an imperfect guide to the likelihood of future interruptions (only about ½ of the countries that had interruptions had more than one). (iii) Staff-monitored programs were almost as likely to be followed by an interrupted arrangement, or no arrangement at all, as they were to precede a program completed without interruption.

V. First Credit Tranche Programs

18. Additional evidence on the role of ownership in Fund programs can be inferred from the record of policy implementation of programs in the first credit tranche ("Selected Operational Issues Related to the UFR", EBS/91/108). The objectives and policies of these programs are similar to those of programs under the upper credit tranches. But unlike performance criteria and phasing in the upper credit tranches, requests for Fund resources in the first credit tranche not require high conditionality: these requests are approved if a member is making "reasonable efforts" to solve its problems and there are adequate safeguards for the use of those resources.[2] The review of first credit tranche programs in the

[2] All requests for first credit tranche transactions, whether outright purchases or under SBA, are accompanied by letters of intent describing the member's adjustment programs. The LOIs together with the accompanying staff paper, forms the basis for the Fund's assessment whether the member is making reasonable efforts to solve its problems and hence whether there are safeguards to the temporary UFR.

1980s (EBS/91/108) strongly suggests that despite the absence of performance clauses and phasing, program monitoring through quarterly targets for the main financial variables considerably helped members in meeting their objectives.

VI. Ownership in World Bank Conditionality

19. In principle, more indirect evidence on the effect of ownership on Fund-supported programs could be obtained by extrapolating from research of World Bank staff on the factors determining success or failure in World Bank adjustment operations (Dollar and Svensson (2000), World Bank (1998), Dollar and Collier (1998), and Burnside and Dollar (1998)). This section provides a brief review of this work. However, it is an open question whether these results are applicable to Fund-supported programs, and whether the role of ownership beyond these broad political factors can be quantified.

20. The Bank staff shows that including such political economy variables as the democratic or dictatorial nature of the regime and the length of time the regime has been in power are helpful in explaining the success or failure of adjustment programs. Program success was unrelated to donor behavior, such as the resources the Bank put into preparing or monitoring the program or the level of aid it provided. The Bank's conditionality was most effective where it was parsimonious, focusing on a small number of truly important measures. These results are interpreted as showing that World Bank conditionality was effective only in environments in which governments were already committed to reform before large-scale aid arrived, and for reasons unrelated to the inducement effects of conditionality. Collier, Dollar and Stern (2000, p. 23) put this as follows: "Success of some World Bank-supported reform programs has depended more on underlying political economy factors than on the efforts of the Bank or other outside actors. Thus…aid can be a critical support to communities and countries in which there is a genuine movement for change, but that the country must be "in the driver seat" if reform programs are to succeed."

21. The influential study by Dollar and Svensson (2000) utilized a sample of about 200 World Bank structural adjustment programs, a third of which had been rated by the Bank as unsuccessful. These data provided a consistent measure of program success and of details of World Bank preparation and monitoring inputs. The dependent variable was a zero-one variable reflecting failure or success of each reform program as determined by the Bank's Operations Evaluation Department, an independent unit that reports directly to the Bank's Board. While subjective, this measure was unlikely to be systematically biased.[3] The right-hand side variables were political economy variables donor inputs.

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[3] The OED measure did not look narrowly at whether loan conditionalities were observed or not but rather represented OED's judgment of whether broader program objectives had been met. The OED measure was consistent with the case study literature and was also closely

(continued…)

22. A two-step procedure was used which treated reforms as an unobserved variable. A probit model was first used to estimate the probability of reform, $\pi_i = probit(r_i = \beta_x' x_i + \varepsilon_i)$, where π_i is the probability of reform, r_i is a binary variable proxying reforms, and x_i is a vector of political determinants of reforms. In the second stage, the estimated probability was used as a proxy to explain the difference between committed and disbursed funds: $sf_i = \gamma\hat{\pi}_i + \beta_z' z_i + \eta_i$, where sf_i is the share of committed funds disbursed, and z_i is a vector of controls influencing the disbursement decision. The authors found that a small number of political economy variables could successfully predict the outcome of an adjustment program 75 percent of the time (Table 1). They also concluded that (1) there was little relationship between the share of committed funds disbursed and success of reforms; (2) successful reforms were associated with democratic governments and political stability; (3) ethnic fractionalization inhibited reform; (4) long-term incumbents were not likely candidates for reform; (5) Countries with larger initial debt were more likely to receive committed funds and were less likely to experience cancellations of commitments.

23. Dollar and Svensson corrected for endogeneity of Bank-effort variables: the Bank could devote more resources preparing loans judged to have a lower probability of success ex ante. Alternatively, the Bank could try to rescue failing loans by increasing supervisory resources. The authors found that when endogeneity was not controlled for, program success was positively related to Bank preparation effort and negatively related with Bank monitoring effort. When endogeneity was corrected for, however, Bank-effort variables bore no relationship to program outcomes while the relationship between political-economy variables and outcomes was robust. These results indicated that the Bank devoted more resources to likely winners when preparing adjustment programs, while it naturally put more resources in monitoring programs that were at risk. Interestingly, income inequality, terms of trade shocks, and the level of inflation and budget surplus prior to the reform did not have marginal explanatory power in the regressions.

24. The broad thrust of these results is that the primary role of International Financial Institutions (IFIs) is to identify reformers, not to create them. Following this logic, the IFIs would search to find promising candidates to support by investing to better understand the political economy of different countries (Dollar and Svensson, 2000). This view was best expressed by Ranis (1995): “The lending cum conditionality process works well only when local polities have decided, largely on their own, possibly with outside technical help, to address their reform needs, effect certain policy changes sequentially, and approach the international community for financial help in getting there.”

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correlated with improvements in observed economic indicators, such as the rate of inflation and the budget deficit.

25. These results also indicate that while the IFIs may wish to take risks in helping unwilling reformers, they should base their plans on objective analyses of risks, costs, and benefits of reform efforts based on political economy. In particular, IFIs should have no illusions that their conditionality will appreciably affect the probability of reform (Dollar and Svensson, 2000). The Fund and the Bank could ascertain the probability of reform from political economy variables historically associated with successful programs. However, conditionality could still be useful as a commitment technology, offering a way for reformers to tie their hands and be insulated from special-interest group pressures.

26. Finally, data indicates a positive relationship between ownership and the success of World Bank projects. The World Bank's OED maintains a large data set on evaluated Bank projects. It also rates the government commitment in each project (measuring, in a sense, the degree of ownership). OED rates both the project outcome (PO) and government commitment (GC) using a variety of objective and subjective indicators. Running a simple regression for 250 World Bank projects over the period 1996-2000 yields the following results (t-values in parentheses):

$$PO = 1.43 + 0.45\ GC$$

$$(18.83)\ (17.14)$$

$$R^2 = 0.21$$

This regression shows a positive relationship between the project outcome and the degree of government commitment/ownership.

VII. Credibility, Conditionality and the Efficient Allocation of Aid

27. Related research at the Bank focused on the inefficient use of aid (Collier and Gunning, 2000). A priori, the amount of aid should depend on the degree of need, the quality of policies and the law of diminishing returns. For a given level of need, aid should be higher the better the *level* of policy. These authors ran regressions that explained aid in terms of poverty, population, colonial history, and the policy environment. They found that aid tended to flow into policy environments that were too weak for it to be effective and tended to taper out in precisely those environments in which policy was good enough for it to be highly effective (as stylized in Figure 1). Conditional aid was tied to promised *changes* in policy (rather than actual levels) and continued to flow to weak policy environments, often even when promised changes in policy were not forthcoming, donors did not cut off aid. Similarly, Boone (1995, 1996) concluded that aid primarily goes to consumption and there was no relationship between aid and growth. Moreover, aid did not help the poor as measured by improvements in human development indicators. More recent research has shown that aid has a positive impact on growth in countries with sound macroeconomic policies (Burnside and Dollar, 2000) and in countries with well-developed systems that check government power (Svensson, 1999b).

28. The tenuous connection between the implementation of agreed policies and the allocation of aid is due to the unobservable nature of many reforms and to time inconsistency problems which make donors' threats to cut off aid if reforms are not implemented less than credible. The time inconsistency problem is due to inappropriate incentives sometimes faced by donors. Bilateral aid agencies are under pressure to spend their budgets in full despite conditionality.[4] World Bank officers have latitude in explaining deviations from agreed policies and discretion to continue with programs through the granting of waivers (Mosley et. al, 1995). Alternatively, enforcing Bank conditionality may be compromised because of third party interventions (e.g., by the major shareholders) or may be in conflict with the Bank's other goals (Svensson, 1999a). For example, donors enforcing conditionality have an interest in being repaid. Under some conditions, withholding financing when conditionality is not met may lower the probability of repayment, resulting in defensive lending. While in principle a number of screening devices within the Bank could be used to counteract "irresponsible" lending, these devices are weaker for program than project lending (Mosley et. al, 1995). Moreover, many conditions attached to Bank lending permit subjective assessments of progress. The empirical evidence demonstrates that whether World Bank loans were disbursed depended more on indebtedness than on adherence to conditionality.

29. In a rational expectations world, countries promise too much since they know that donors' threats to cut off aid if conditions are not met are not credible. For governments not committed to reforms, policy changes are simply the price they must pay to receive aid, implying that the marginal reforms will not be in their own self-interest (as opposed to the interests of the poor). With partial or no observability of reform efforts and lack of commitment to cut off aid if reforms are not implemented, governments have fewer incentives to maintain reforms once aid has been delivered. This perverse incentive is reinforced by aid's income effect, which serves to dull aid's substitution effect: by relaxing the government budget constraint in poor policy environments, aid reduces the incentive to change policies. Moreover, the signaling value of conditionality is lower even if reforms are implemented: investors cannot tell if reforms are being carried out at the margin because the government was committed or because it was imposed by the IFIs.

30. In a world of declining official aid, the efficiency of aid in reducing poverty could be increased by strengthening ex post incentives, including greater country selectivity. This could be implemented via "aid tournaments" where, rather than committing fixed amounts of money to each recipient ex ante, conditional on specified reforms, donors would commit

[4] As put by a former chief of the Swedish aid agency: "Both donor and recipient have incentive systems which reward reaching a high volume of resource transfer…In many administrations, both bilateral and multilateral, the emphasis is on disbursements and country allocations…Besides, when the time has come to evaluate the project, most of those responsible will have been transferred" (Edgren, 1996, p. 11, cited by Svensson, 1999a).

larger sums to an entire group of countries and centralize disbursement decisions by linking the amounts disbursed to relative economic performances (Svensson, 1999a).

31 According to its proponents, the use of aid tournaments could correct both the problem of the unobservability of policy actions of recipients and the lack of credibility of ex ante conditionality. By explicitly linking aid to performance, aid tournaments would raise the opportunity cost to donors of disbursing aid, which strengthens donor incentives to reward good policies and ameliorates time-inconsistency problems. Competition among recipients would also benefit the donors by allowing inferences to be made about common shocks, which would otherwise conceal the recipient's actions. This approach would, of course, remove any direct link between the allocation of aid and countries' financing needs; moreover, it could penalize countries whose economic performance deteriorated due to factors not explicitly allowed for in the tournament.

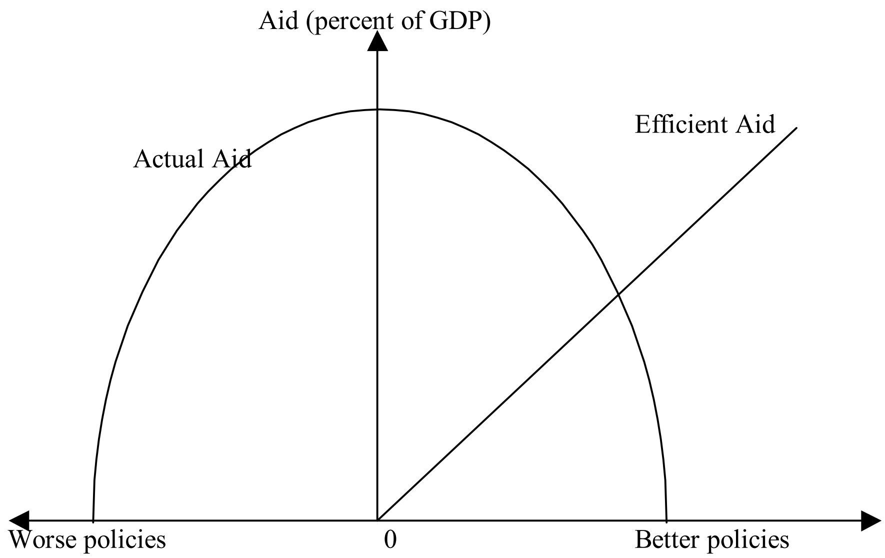
32. In a related context, Svensson (2000) has also argued for institutional change to reduce the distortions in recipients' incentives to undertake reforms which arise when donors cannot enforce conditionality to alleviate the time inconsistency problem in the aid relationship between donors and recipients. Without an effective commitment technology, aid disbursements are partly guided by the needs of the poor, resulting in low effort on the part of the recipient governments to alleviate poverty, diversion of aid to consumption of the non-poor. To deal with the resulting low efficiency of aid in reducing poverty, this author advocates delegating part of bilateral aid budgets to an international agency with less aversion to poverty than the bilateral donors and greater use of tied project aid. Delegating part of the aid budget to a more "conservative" donor is analogous to a well-known result in the monetary policy literature, namely, that delegation can relax binding incentive constraints in situations of strategic interaction. The use of tied project aid, which is a novel suggestion, improve incentives by introducing a third party, i.e., private firms, into the game between the donor and the recipients, thereby creating a conflict of interest between different aid recipients.

Table 1. Features of Successful and Failed Adjustment Programs

	Successful	Failed
Country characteristics		
Democratically elected	50.4	32.3
Political instability (average no. of government crises during reform period)	0.08	0.23
Ethnolinguistic fractionalization	0.48	0.51
Length of time the incumbent has been in power prior to the reform (years)	7.5	7.8
World Bank-related variables		
Preparation staff weeks	141	128
Supervision staff weeks	69	101
Number of conditions	45	44
Loan size (million $)	160	153
Sample information		
Number of loans	117	65
Features of successful and failed adjustment programs (small sample)		
Budget surplus prior to the reform (percent of GDP)	-0.043	-0.059
Inflation prior to the reform (percent per annum)	27	34
Income inequality (gini coefficient)	44	43.5
Terms of trade shock (percent)	1.92	1.54

Source: World Bank

Figure 1. Effectiveness of Conditional Aid



PROPOSALS FOR GREATER COUNTRY SELECTIVITY AND PRECONDITIONS

I. Introduction

1. The concerns about the effectiveness of Fund conditionality discussed in the main papers have generated several proposals to reform or even eliminate conditionality with a view to enhancing the role of national ownership in formulating and securing implementation of economic policies. This Annex reviews proposals that would (i) apply stricter or more differentiated conditions for eligibility for the Fund's financing through prequalification and the use of international standards; and (ii) monitor programs on the basis of outcomes rather than actions of the authorities.[1]

2. Section II reviews proposals to replace conditionality with greater reliance on preconditions and country selectivity. These proposals are partly motivated by the desire to prevent the Fund from being a source of low-cost financing for countries with access to private capital or for countries with weak policies (Meltzer Commission; CFR Report, ODC report). Some proposals made by Collier, Dollar, and Svensson are first discussed (related analysis was reviewed in Annex II), followed by proposals made by the Meltzer Commission and a critical evaluation of the general approach. Sections III-V present other related proposals that might result in greater country selectivity. Section III goes over proposals to differentiate the terms and access to Fund credit on the basis of adherence to international standards. Variants of this approach have been advocated in the CFR report and by Williamson and Kenen. Section IV discusses proposals to base Fund lending on collateral. Section V discusses outcomes-based and floating tranches combined with enhanced enforcement of conditionality.

II. ELIGIBILITY CRITERIA

3. One approach suggested by some critics of conditionality would be to lend unconditionally while exercising greater selectivity with regard to which countries have access to the Fund's resources. Under this approach, the IMF would lend only to countries that already have good policies, somehow defined. There are two main motivations for arriving at this proposal, with different implications for the aspects of good policy that are emphasized.

A. Proposals of Collier, Dollar, and Svensson

4. One set of proposals to allocate all multilateral lending (as well as bilateral aid) to countries with good policies has been elaborated in some recent work. The intellectual

[1] Proposals to increase flexibility and inclusiveness in program negotiations and outcomes-based monitoring are discussed in the main policy paper.

foundation of this approach is the literature on aid effectiveness, notably the finding that aid contributes to growth only in good policy environments.[2] Another premise of this work is that aid and financing do not by themselves improve the policy environment.[3] This points toward allocating aid and financing exclusively to countries with established records of macroeconomic stability and frameworks of good governance. This could, in effect, mean basing the allocation of lending on some indicators of the policy environment, of ownership for good policies, or of the underlying political determinants of both.[4]

5. These papers by Dollar and Svensson, 2000 have argued that the primary role of international financial institutions (IFIs) should be to identify reformers—not to create them. Greater reliance on ownership could mean greater selectivity: the IFIs would need to invest resources to understand the political economy of different countries and find promising candidates to support (Dollar and Svensson, 2000; Drazen, 1999). The Fund and the Bank could still provide financing to governments not committed to reforms, but would need to base their plans on objective analyses of the costs, benefits, and risks of reforms, with a clearheaded assessment of the probability that governments would implement the agreed reforms. To assess these risks, a small number of political economy variables that were historically associated with successful adjustment programs would need to be consulted, such as the length of tenure of governments, their democratic or authoritarian nature, and the extent of ethnic and linguistic divisions in the borrowing country.

6. The authors note that in countries with untested but reform-minded governments, Fund-supported programs could nonetheless provide a mechanism for reformers committed to good policies to tie their own hands and insulate themselves from pressures from special-interest groups (Dollar and Svensson, 2000; Vreeland, 2000).

B. Meltzer Commission

7. A second set of proposals, presented in the International Financial Institutions Advisory Commission ("Meltzer Commission") report, has a different emphasis. The report's central proposal regarding conditionality is that access to IMF financing be limited to countries with sound financial supervision, to ensure that "IMF…lending [is not] used to salvage insolvent financial institutions, directly or indirectly, or to protect foreign lenders

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[2] See Burnside and Dollar, 1997. The literature on aid effectiveness more generally is reviewed by Tsikata, 1999.

[3] See e.g., Collier and Dollar, 2000.

[4] For instance, Dollar and Svensson, 2000, found that four variables—a new government, a multi-ethnic society, democratic governments, and political instability—could explain 75 percent of the success or failure of a large sample of World Bank lending programs.

from losses". The report thus proposes to limit international moral hazard by lending only to countries that have taken adequate steps to prevent a crisis.[5] The intention is to create incentives for countries to adopt appropriate policies. To be eligible for IMF lending, countries would have to permit freedom of entry and operation for foreign financial institutions, ensure adequate capitalization of commercial banks, publish the maturity structure of outstanding sovereign and guaranteed debt and off-balance-sheet liabilities, and establish "a proper fiscal requirement". The Commission's proposal would also rely on shortened lending maturity and a stronger legal entrenchment of the Fund's preferred creditor status to safeguard the Fund's resources in the absence of conditionality.

8. The Meltzer Commission (p. 7) would altogether eliminate phased disbursements with conditionality attached. The Commission would turn the Fund into a smaller institution to serve as a quasi-lender of last resort to emerging economies that had met certain preconditions. The Fund would normally only provide short-term financing to solvent governments in crisis, charge penalty rates (above the borrower's recent market rate) and secure its loans by "a clear priority claim" on the borrower's assets. This system would be phased in over five years in order to give countries time to adjust to the Commission's incentives for financial reform. If a crisis occurred in the interim, countries would be allowed to borrow from the IMF at an interest rate above the penalty rate. In addition, the Fund would be allowed to lend to countries that had not prequalified if they faced a crisis that posed a systemic threat to the global economy.

9. The Commission suggested the following four pre-qualification criteria (p. 8). First, emerging markets would allow gradual entry of foreign financial institutions in their financial markets. Foreign participation would promote a competitive banking system, increase portfolio diversification and would be especially useful in limiting cronyism and corruption, such as use of local banks to finance "pet projects," or loans to favored groups or on favorable terms. Secondly, Fund borrowers would be required to publish regular and timely data on their sovereign and guaranteed debt and their off-balance sheet liabilities in order to provide lenders with accurate information on borrowing countries' short-term liabilities and allow proper assessment of credit risk. Thirdly, commercial banks would be required to be adequately capitalized either by a significant equity position, in accord with international standards, or by subordinated debt held by non-governmental and unaffiliated entities. In addition, the Fund in cooperation with the BIS would promulgate new standards to ensure adequate management of liquidity by commercial banks and other financial institutions so as to reduce the frequency of crises due to the sudden withdrawal of short-term credit. Finally,

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[5] It should be noted that there is, so far, little empirical evidence supporting the report's central premise that moral hazard created by the availability of IMF financing is an important phenomenon. See Lane and Phillips (2000), Zettelmeyer and Jeanne (2000), Zhang (1999), and Willett (1999).

the Fund would establish a proper fiscal requirement to assure that its resources would not be used to sustain irresponsible budget policies.[6]

10. Several potential advantages of this approach were cited. One was that the knowledge that a country had prequalified for large credits before a crisis could act as a deterrent against speculative attacks. A second advantage could be that penalty rates would reduce resort to Fund financing and might increase the incentives of emerging market economies to graduate from the Fund. This rationale was echoed in U.S. Treasury Secretary Summers' (12/14/99) suggestion that it would be appropriate to introduce significantly higher charges for standby loans to deter excessive recourse to the core IMF financing arrangements. A third potential benefit from limiting the Fund to short-term loans backed by pre-conditions would be that it would eliminate the need for detailed conditionality. In the Commission's view, such detailed conditionality had made Fund programs "unwieldy, highly conflictive, time consuming to negotiate, and often ineffectual."

C. Evaluation

11. Both the proposals by Collier, Dollar, and Svensson and those of the Meltzer Commission seek to address some valid and important issues. The proposals rightly emphasize that good policies need to be home-grown and that the scope to impose policies from outside is very limited—even if this were an appropriate role for international financial institutions. The idea of limiting financing to countries in which good policies already have strong domestic roots is thus quite appealing. At the same time, narrowing access to the Fund's financing in this way would raise the issue of what can be done for countries that lack a track record but the government is willing to change. A related consideration is that disengaging from financing a country with chronically weak policies could lead to a further deterioration of the situation, and the overall results could be worse than those of remaining engaged and trying to bring about some marginal improvements in policies.

12. The Meltzer Commission proposals, on the other hand, appropriately emphasize the need for prevention, especially with regard to a sound prudential regime and transparent data. Clearly, the more that can be done to ensure that these conditions are in place beforehand, the less needs to be done in the event of a crisis—and the smaller the probability of a crisis in the

[6] This was added at a late stage to avoid exposing the Fund to countries with unsound fiscal policies. While the Commission did not elaborate on the fiscal requirement, Williamson (2000a) mentions the following possibilities: (1) the Maastricht criterion of a budget deficit no greater than 3 percent of GDP and a ratio of public sector debt to GDP of under 60 percent or trending down; (2) a limit on the primary fiscal balance; (3) the cyclically-adjusted fiscal balance; (4) the operational deficit; (5) A flexible requirement that would allow the Fund to make judgments on a case-by-case basis Williamson (May 2000).

first place. The proposed approach rightly stresses the need for international financial institutions to work with, rather than contrary to, the forces of market discipline.

13. This said, establishing explicit criteria for pre-selection would raise some general issues. One feature of any explicit eligibility criterion is that it pre-specifies the aspects of policy that are relevant. For example, while the criteria mentioned in the Meltzer Commission report would cover the general causes of most previous crises, the experience with financial crises is that such crises drew attention to issues that had not previously received adequate attention.[7] It may be premature to assume that all potential causes of crises have now been identified. Similarly, the proposals that would base access to financing on specific political indicators that are predictors of good policies could miss the effects of other factors that could become relevant under other circumstances.

14. Moreover, any attempt to formalize criteria for selectivity on the basis of ownership or governance would be subject to the problems of any kind of signaling mechanism. Even if one could find a limited set of indicators, actions, or information that in the past had been found to be a useful source of information on an underlying characteristic—such as bank capital adequacy, or ownership for good policies—the knowledge that this was being taken into account by the Fund in determining access to its financing would immediately reduce its information value as a signal. On the other hand, examining a broader set of indicators and conducting a more thorough examination of countries' policies and institutions to verify the substance behind these indicators could involve as much intrusiveness into countries' policies as now goes into monitoring program implementation.

15. In considering any systematic criterion for selecting which countries could receive the Fund's resources, the Board would also need to consider the tradeoff between the benefits of channeling the Fund's limited resources to cases in which they indeed support good policies and the implied narrowing of the availability of Fund resources to fewer countries. This narrowing would of course be greater under some criteria than others; in particular, the degree of selectivity implied by the Meltzer Commission proposal would—by design—entail a drastic curtailment of access to IMF financing, with serious implications regarding the usefulness of the Fund to many of its members. In particular, as pointed out by several observers (see U.S. Treasury, 1999, pp. 17-18, Fischer, 2000, CFR report, p. 61), implementation of these proposals would seriously limit the Fund's flexibility to respond to crises in most of its membership, including all the countries affected by crises in the late 1990s, the lower income countries and many transition economies.

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[7] For example, in their assessment of Korea prior to November 1997, Fund staff focused on the strong macroeconomic performance and did not take adequate account of the severity of financial sector problems.

16. As a related point, a substantial general move toward pre-selection may not be credible, given the pressures on Fund staff and management to recommend approval of an arrangement in some cases—including countries of systemic or geopolitical importance as well as countries for which a Fund arrangement is needed for a Paris Club rescheduling or a successful donors' meeting. Even if formal eligibility conditions were established for the use of Fund resources, there would be strong pressure to override these conditions in some cases.[8] When acute financing needs arise in a country with poor policies and little will to change them, it may be felt that providing financing and using a combination of conditionality and persuasion to change them, while clearly second best, may still be less damaging than standing back while a country's crisis deepens.

17. In addition, as noted in the CFR report, prequalification would raise difficult issues regarding any step to disqualify a country if it behaved badly between the time the credit line was committed and the time it was needed. Moreover, prequalification could compete with private contingent credit lines and discourage countries from relying more on their own resources and on private sources of liquidity. Finally, up front and automatic provision of large scale financing without any conditionality could create moral hazard for prequalifying countries and for investors.

18. Thus basing all access to Fund resources on formal eligibility criteria as an alternative to conditionality would raise some difficult issues—and would prevent the Fund from fulfilling its current mandate to make its resources available to countries whose policies are inadequate but are willing and able to carry out necessary adjustments with the support of the Fund. But, some shift toward greater selectivity would be possible within existing rules, and may be desirable. To begin with, some selectivity is already implied by the Fund's existing *Guidelines on Conditionality,* which stipulates (paragraph 7) that "The Managing Director will recommend that the Executive Board approve a member's request for the use of the Fund's general resources in the credit tranches when it is his judgment that the program…will be carried out." Management and the Board could, if they chose, say "No" more frequently to countries that lack the political foundations of support for program implementation or that have demonstrated their lack of ownership by persistently failing to implement either agreed policies or any reasonable alternatives.

19. It is also feasible to tighten eligibility for access to particular Fund facilities, and/or for access under particular circumstances, as reflected by the Fund's Contingent Credit Line (CCL). Eligibility for the CCL is based on a track record of sound policies together with progress toward adherence to codes and standards and constructive relations with creditors.

[8] This is also potentially a problem with traditional conditionality, as emphasized by Killick (1997). But the credibility problem may be even more serious in the case of pre-selection, since such criteria would leave the authorities less room to maneuver, since supposedly they would not be able to gain access to the Fund's resources by changing existing policies.

But the CCL is intended only for a comparatively small group of countries with first-class policies, and for use only under circumstances in which a country's financing needs result from circumstances beyond its control.[9] Extending the same approach to all Fund financing would, in contrast raise the question of whether the Fund was fulfilling its mandate to make its resources available to all its members.

20. In conclusion, there is some scope for greater selectivity in the use of Fund's resources under existing rules if the Fund wished to use it. To the extent that greater selectivity channeled Fund resources to countries that had some key aspects of sound policies already in place, it would reduce the need for further policy adjustments during the course of a program. But, for the reasons discussed, it would not be desirable to push selectivity to such a degree as to make traditional conditionality unnecessary.

III. International Standards

21. While skeptical of the Meltzer Commission's specific approach to preconditions, (CFR report, pp. 62-67; Geneva Report, p.44), other recent reports were generally sympathetic to the need to changes in Fund procedures to encourage prevention of capital account crises and to foster "good housekeeping". As an alternative to detailed country-specific structural conditionality in each crisis, the CFR report (1999, p. 10), Goldstein (2000b, p. 70), Williamson (2000), and Kenen (2000) argue that the Fund should rely on international "good housekeeping" standards. To encourage countries to take action, the terms on which countries would receive emergency financial assistance would be linked to implementation of these standards.

A. The CFR Proposal

22. The CFR Report, for instance, would create a contagion facility which would be activated only in rare cases of systemic threats to the world economy, such as those prevailing in the fall of 1998. While the Fund would adhere to normal access limits and smaller emergency loans for "country crises" due to faulty domestic policies, loans from the contagion facility would be larger, disbursed quickly, be free of policy conditions, and would be priced more expensively than normal Fund loans. Adherence to a set of international standards would substitute for policy conditionality (Goldstein, 2000a, p. 13). Countries that failed to meet certain standards or requirements would be charged higher interest rates while countries that managed their economies appropriately could be rewarded by being able to access Fund resources at lower rates of charge and/or higher access levels.[10] The CFR report

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[9] Furthermore, after the first tranche has been drawn the CCL is subject to the same conditionality as the Supplementary Reserve Facility.

[10] Some members of the CFR task force favored (p. 68) making countries that did not implement international financial standards ineligible for Fund loans. They felt that stronger

(continued…)

also urged the Fund to reduce its financial support for countries maintaining overvalued exchange rates and would encourage its members to make greater use of private debt rescheduling.

23. More specifically, the CFR report proposed that the Fund grant more favorable interest rates to countries that followed (1) sound macroeconomic policies; (2) complied with a set of international financial standards and good practices (especially with regard to financial supervision and data dissemination); (3) maintained a "viable" currency regime; (4) had prudent debt management (particularly as regards the maturity and currency composition of external and domestic public debt); and (5) made efforts to put in place various (non-Fund) sources of liquidity support that could be activated in the event of a crisis (ranging from contingent credit lines from private financial institutions to holdings of international reserves).

24. The report suggested that each Fund member could be put into one of three categories: class A—currently complies with a core set of international financial standards; class B—is making good progress and has pledged to meet these standards within a three- to five-year period; or class C—is in early stages of reform and/or has made no commitment to these standards. Other things being equal, class A countries would face lower Fund borrowing costs than class B countries, which in turn would face lower costs than class C countries.

25. To increase countries' market payoffs from joining the good house-cleaning club, the Fund would make public "standards reports" providing periodic assessments of members' compliance with international financial standards and would publish its Article IV reports. (This is in fact now being done, on a voluntary basis, with the Reports on the Observance of Standards and Codes (ROSCs) assessments.) In revising the Basle Capital Accord for credit risk of banks and in setting bank provisioning guidelines, international and national financial regulators would take account of the Fund's standards report and country classifications.

26. The report argued that, after a transition period, private credit-rating agencies could incorporate compliance with international financial standards in their ratings. It also noted that some of its task force members argued that the incentive for greater crisis prevention efforts ought to be framed in terms of access levels to Fund resources rather than to the interest rate charged for Fund borrowing, since the latter could be deemed inconsistent with the IMF's present charter. A few task force members urged going further, by making countries that did not implement international financial standards ineligible for Fund loans. They felt that stronger penalties were necessary, in particular to bring public data disclosure

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penalties were necessary to bring public data disclosure practices to the standards mandated for public issuance of securities in the United States.

at the international level up to the standards mandated for public issuance of securities in the United States. Most task force members, however, favored the interest rate channel.

B. Williamson

27. Williamson's (2000) preconditions also include adoption by countries of various standards and codes and maintaining good macroeconomic policies: (1) adoption of the Basel Core Principles for the domestic banking system; (2) subscribing to the Special Data Dissemination Standard; (3) maintaining a good rating for macroeconomic policy in the most recent Article IV consultation with the Fund; and (4) including collective action and allied clauses in countries' foreign bonds. While the ODC report expresses skepticism about the CCL, it did call for maintenance of the Compensatory Financing Facility.

28. It is argued that differentiated access to Fund resources could result in greater flexibility in the implementation of Fund programs and thus enhance ownership. Charging higher prices to prolonged users and insisting on stronger prior actions in countries with a record of missing targets and not completing programs would provide safeguards for the Fund's resources while encouraging borrowers to graduate from Fund financing. But as with the suggestion of prequalification and selectivity, differentiated pricing and access would raise questions about uniformity of treatment.

C. Kenen

29. Kenen (2000) proposes separating long-term financial sector reforms from Fund conditionality. Kenen proposes long-term (five year) contracts between member countries and the Fund aimed at achieving compliance with key standards and codes. The contracts would spell out detailed steps and their sequencing on the basis of the findings of FSAPs for the countries concerned. To ensure ownership, the reforms would be designed and implemented by the government (with assistance from the Fund, the Bank and other outside experts), allowing sufficient time for them to be widely disseminated and discussed with the private sector at home to achieve a degree of national consensus. The advantage of these contracts would be that if the country found itself in the midst of a crisis it would have fewer reforms to implement, which may accelerate negotiation of Fund programs and may help restore confidence more quickly. Countries successfully implementing such contracts would be granted preferential access to assistance from the Fund, perhaps through more front-loading and higher levels of access. This would essentially formalize the existing voluntary process of reforming financial supervision and regulation in line with international standards, also creating an explicit link to future IMF financing.

30. Furthermore, a recent report prepared for the G-24[11] proposes the creation of a new Fund facility, the Cooperative Credit Agreement (CCA), the purposes of which would be (i)

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[11] See Bérand, et. al. (2001).

to provide additional incentives for emerging markets and other developing countries to undertake reform and (ii) to enable those same countries to exercise some limited degree of flexibility in the management of small-scale crises. The proposed CCA would be intended to decrease the scope and depth of conditionality, provide an incentive mechanism for voluntary participation in reform, contributing to crisis prevention by promoting reforms before a crisis hits and establish a more effective mechanism for monitoring such reforms; it would also be intended to provide flexible access to funds in the event of a crisis.

IV. Collateral

31. Fund to lend only against good collateral, such as U.S. Treasury securities, tax or oil receipts. Lending to solvent borrowers possessing good collateral, at penalty rates, is, of course, Bagehot's recommendation to national lenders of last resort and has been advocated by Feldstein (1999) and Meltzer (1999)[12] have argued that the IMF shall follow the same principle. Lending against collateral is permitted by the Articles of Agreement, but the Fund has only done so rarely. The Fund obtains safeguards for the resources it makes available to members in the context of Fund-supported programs indirectly through its preferred creditor status and the conditionality it establishes, which ensures that program implementation would improve the balance of payments and enable the country to repay.

32. The argument for requiring collateral would be that it would provide safeguards for Fund resources lent to members without any need for conditionality—thus making the ownership issue moot. Feldstein proposed a collateralized credit facility, i.e., a voluntary arrangement between a sovereign borrower and a group of creditors that could include private banks, the Fund and/or the Bank. The facility would determine in advance the amount of foreign exchange and the terms under which it would be made available, such as the period during which it would be available and the market-based interest rate or spread that the borrowing country would pay. The creditors could participate on equal terms or some creditors could choose to take on more risk in exchange for higher interest rates or fees. Use of this facility would require legislation to be introduced requiring immediate repatriation and transfer of all export receipts to a trustee who would use a part to service the newly created debt and transfer the remainder to the government to pay exporters.

33. A collateralized credit facility would be less expensive than accumulating reserves. But it is likely that most countries turning to the Fund do not have good collateral: if they did, they would probably not have been liquidity constrained in the first place. To the extent that such collateral consists of export receipts or a lien on tax revenues, liquidating this collateral may be highly politically sensitive. Moreover, activating such a facility would require the imposition of currency controls and it would also require laws to be passed in advance that would allow the diversion of export earnings quickly if the loan is drawn.

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[12] But not the Meltzer Commission, as discussed below.

34. The Meltzer Commission stated (p. 44) that the many practical and legal problems in providing collateral would make it difficult for the Fund to lend against collateral. First, "negative pledge clauses" prevent governments from effectively subordinating existing creditors by pledging collateral on new loans. Second, while commodity exports could serve as collateral in principle, this would be a cumbersome process. Third, a collateral requirement against Fund credit could have the unintended effect of encouraging countries not to privatize important export-producing sectors so that the government could retain control over exports. Fourth, requiring the Fund to lend against good collateral would provide countries in crisis with little additional financing: countries possessing good collateral could use the collateral to borrow from private markets (Goldstein, 2000a).

35. To ensure the Fund's seniority as a creditor, the Meltzer Commission recommended the following approach. The membership would agree to three debt management rules as part of the Commission's prequalification requirement: (1) Members would specifically exempt the Fund from negative pledge clauses in all new sovereign debt issues.[13] Most sovereign debt outstanding by developing economies is of relatively short maturity. These contracts could be amended to give priority to the Fund. Issuers could also repurchase outstanding debt or ask creditors to accept an exchange of new debt (containing the exemption) for old debt. (2) Borrowers would give the IMF explicit legal priority with respect to all other creditors, secured and unsecured. (3) Members that defaulted on their IMF debts would not be eligible for loans or grants from other multilateral agencies or other members.

V. Other Proposals

A. Results-Based Conditionality

36. Another proposal is to make Fund disbursements depend on positive changes in the actual performance in agreed economic outcomes rather than on specific structural or other policy actions (Goldstein, 2000, p. 69; Spraos, 1986). This proposal is partly motivated by concerns that compliance with Fund conditionality has been an increasingly serious problem (Goldstein 2000b, pp. 45-46) and that conditionality based on specific actions may be too intrusive into national decision-making processes. The policy objectives of Fund-supported

[13] Many existing sovereign debt contracts specifically exempt from negative pledge clauses short-term debt, debt to foreign monetary authorities and multilateral institutions, and debt which is not publicly offered. There are various possible approaches to resolving the legal and practical problems of ensuring IMF priority when negative pledge clauses apply. For example, IMF advances can be treated as "exchanges of assets," rather than as loans, to avoid the application of negative pledge clauses. Another approach, in a crisis, would take advantage of the grace period allowed before the enforcement of negative pledge clause violations (typically 90-120 days). This would permit collateralized IMF loans of sufficiently short maturity.

programs would be negotiated between the member and the Fund, so that it would still be required that the authorities and the staff agree on the objectives of the program. But the process (meaning the sequence of policy actions needed to achieve the joint objectives and the mechanisms linking objectives and policies) would be largely left up to the authorities.

37. According to its proponents, this approach would encourage ownership of the reform process by leaving countries considerable freedom to devise the details of their own policy actions and judging them only by outcomes. For example, instead of making changes in the judicial system or establishing a new framework for debt restructuring conditions of Fund-supported programs, the Fund could agree with the country that a certain percentage of nonperforming loans would need to be rescheduled by a certain date. The outcomes-based approach is consistent with the general theory of incentive mechanisms, which suggests using a mixture of incentives based on actions and outcomes, depending on the observability and accuracy with which different actions or outcomes can be monitored (Dixit, 2000, p. 5). Outcome variables have been defined as performance criteria in programs. For example, most programs include a floor on net international reserves as a performance criterion. More recently in Brazil, the adoption of an inflation targeting framework has made inflation a key monitored variable. One advantage of using outcomes would be greater ownership because the design of policies would be the responsibility of the authorities. As a consequence, the scope for discretion on the part of the domestic authorities, and thus for domestic ownership of the program, is increased.

B. Floating Conditions

38. Another proposal is for the Fund to adopt floating conditionality, as in some Bank lending: the authorities would choose the timing of implementation of reform and would receive tranche of money when reforms are complete. Its proponents argue that floating tranches could help to deal with the greater uncertainty attached to the timing of structural measures. Coupled with stronger enforcement, this could help reestablish the credibility of the Fund's structural conditionality and discourage the authorities from agreeing to measures that they have no intention of implementing. The Bank's evaluation of its Higher Impact Adjustment Lending (HIAL) program concluded that floating tranches can promote ownership by providing flexibility in timing of reforms and suggested greater reliance on (a) performance-based country selectivity; and (b) multiyear programs of single-tranche adjustment lending. Applying such an approach in the context of Fund-supported program would, however, sever the link between the disbursement of Fund resources and balance-of-payments need.

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