Conditionality in the International Monetary Fund

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Introduction

1. Conditionality is a subject of enormous controversy. In popular and academic studies on the Fund, there is probably no term of art that is more frequently cited in support of as many different and, at times, contradictory positions. For demonstrators seeking to shut down the annual meetings of the Fund and the Bank, conditionality has become the lightning rod for what they regard to be the worst excesses of the Bretton Woods institutions. For countries seeking financial support from the Fund, conditionality represents the hurdle which they must clear in order to convince the international community of their commitment to economic reform. For the Fund itself, conditionality represents the most effective mechanism through which it can ensure that Fund financial assistance is used to serve the interests of its membership and the international monetary system as a whole.

2. One thing upon which all would agree is that conditionality has evolved considerably since its advent in the 1950s. In particular, the past two decades have witnessed a significant expansion in the range of measures which the Fund has attached to its financial assistance. Throughout this process of gradual change, however, the legal nature of conditionality has remained remarkably constant.

3. This morning, I would like to discuss the legal nature of conditionality, its essential features and principal modalities. I will begin by reviewing the purposes of Fund financing and the mechanisms through which it is provided. I will then turn to an examination of conditionality's legal nature and modalities. I will also discuss the manner in which conditionality has evolved, including the Fund's recent efforts to streamline it. Finally, I will conclude by raising a number of legal issues which have emerged from this initiative.

A. Background – Essential Features and Principal Modalities

4. Let me begin with an examination of the legal nature of conditionality. In this regard, what exactly is conditionality? While literature on the Fund often ascribes several different meanings to the term, conditionality may be best defined *as those features of a member's program of economic reform whose successful implementation is expressly established by the Fund as a condition for the availability of Fund financial assistance.*

5. To understand what this means, it is necessary to examine the purpose of Fund financial assistance and the manner in which it is normally provided. As set out in Article I(v) of the

Fund's Articles, the purpose of Fund financing is to "[t]o give confidence to members by making the general resources of the Fund temporarily available to them under adequate safeguards, thus providing them with opportunity to correct maladjustments in their balance of payments without resorting to measures destructive of national or international prosperity." Stated simply, Fund financing is extended to members experiencing balance of payments difficulties in order to meet a balance of payments need. It cannot be provided for other purposes, for example, to finance the budget deficit of a member government.

6. The Articles of Agreement require that Fund financing meet two conditions. First, it has to assist the member in addressing its balance of payments difficulties. Second, it has to be provided under conditions that ensure that the Fund is repaid. How does the Fund normally meet these two requirements? It is through conditionality.

7. More specifically, the Fund normally extends financial assistance to a member only if the member is prepared to implement a program of economic reform that is designed to address the member's balance of payments problem. If the program is successfully implemented, the member will be restored to a position of macroeconomic stability and will be placed in the position where it will be able to repay the Fund. Thus, the program is both the member's road to macroeconomic stability and the Fund's security for repayment.

8. The principal legal instrument through which the Fund provides financial assistance in support of a member's reform program is the Fund financial arrangement (the most well-known being the stand-by arrangement in the upper credit tranches which is what I will largely focus on this morning). A Fund arrangement is a decision of the Fund's Executive Board which allows the member to purchase from the Fund a specified amount over a designated period as long as the member meets the conditions specified in the terms of the arrangement. It is designed to provide the member with the assurance that it will be legally entitled to purchase from the Fund, without challenge, as long as the conditions specified in the arrangement are met.

9. In practice, a member will request an arrangement to support a program of economic reform of one to three years in length which the member intends to implement. In support of its request, the member will submit a policy memorandum describing in detail the measures that will be taken and the key macroeconomic targets that will be reached over the life of the program. As the purpose of the arrangement is to support these reform efforts, the arrangement will be structured in a manner that ensures that the member will only be able to draw from the Fund if the program is being successfully implemented. Thus, the arrangement will gradually make financial resources available and will set out conditions that will need to be met before each tranche may be drawn. The conditions which the Fund establishes are all drawn from the member's program. They consist of the program's most important macroeconomic targets and structural measures and will expressly be incorporated into the terms of the arrangement. To make a purchase, the member must show that the relevant targets have been met and the measures implemented.

10. In determining what constitutes Fund conditionality, it is important to remember that we are speaking only of those aspects of the member's program that are expressly incorporated as conditions in the arrangement for the availability of Fund resources. This actually forms a small part of member's program. Other aspects of the program do not constitute conditionality per se.

a. Types of Conditionality

11. What are the principal modalities of conditionality in a Fund arrangement? I will focus on three principal types: (i) performance criteria; (ii) program reviews by the Executive Board; and (iii) prior actions.

(i) Performance Criteria

12. The most common form of condition is the ***performance criterion***. Performance criteria may be divided into two broad categories. The first are **quantitative performance criteria,** consisting of quantitative targets respecting key macroeconomic variables that are expected to be reached over the life of the member's program. Common examples are the level of net international reserves, the size of the budget deficit, and the level of nonconcessional external borrowing.

13. The second category consists of **structural performance criteria**, that is, structural measures whose implementation is regarded as crucial to the success of the program. These conditions often involve legislative reforms such as the enactment of a new banking or bankruptcy law. With respect to both these various types of performance criteria, to be able to draw from the Fund, the member must demonstrate that the relevant performance criteria have been met and, on this basis, that the program is "on track."

14. While Fund arrangements are designed to ensure that resources will only be made available if the program is being successfully implemented, it does happen that a performance criterion will not be met and that disbursements will be interrupted. In these circumstances, it is open to the Executive Board to a grant a waiver for the nonobservance of the condition and to permit the disbursement to be made. Generally, the Board will only do so if it is satisfied that, notwithstanding the nonobservance, the program can still be successfully implemented. Thus, the waiver will normally be granted only if (i) the nonobservance is minor and essentially self-correcting, or (ii) in cases where the nonobservance is more serious, the member is prepared to take additional corrective measures to bring the program back on track.

(ii) Program Reviews by the Executive Board

15. Performance criteria serve as a valuable test in determining whether the program is being successfully implemented but they are not the only technique the Fund uses for this purpose. A second type of conditionality in an arrangement is a **program review by the Executive Board** in which the Board reviews the implementation of the member's program more generally. The member will not be able to make further purchases until the review is completed. The review will normally involve an examination of the observance of conditions specified in the arrangement and other aspects of the program as well.

16. The Board will only complete a review if it is satisfied that the member's program is on track. In reaching this assessment, the Board will review both past performance and potential implementation going forward. Board reviews give the Fund an important opportunity to establish conditions for future drawings under an arrangement if they have not been established at the time of the arrangement's approval. They also allow the Fund to modify the arrangement over time as the program is implemented.

(iii) Prior Actions

17. A third important feature of conditionality is the **prior action**. In deciding whether or not to approve an arrangement, complete a review, or grant a waiver for the nonobservance of a performance criterion, the Fund often requires that the member first take certain measures as a prior condition to the Board's decision. These prior actions are generally structural measures whose implementation is so important that the Fund will not be prepared to release any further purchases until they are taken. Prior actions are relied upon particularly where the member's track record of performance has not been good and the Fund doubts the member's commitment to its program.

18. It is only recently that prior actions have become part of the conditionality of a Fund arrangement. Historically, the Fund often called upon members to take certain measures as prior condition to the release of Fund financial assistance but the Fund did not expressly incorporate these measures into the terms of arrangement as conditions. Rather, the Fund simply sought to verify that the measures were taken before adopting its decision. The consequence of this approach was that the misreporting of information related to the implementation of these measures was not subject to the Fund's *Guidelines on Corrective Action for Misreporting under Fund Arrangements.* These *Misreporting Guidelines* allow the Fund to take remedial action in cases where a member has made a purchase from the Fund on the basis of incorrect information that has mistakenly led the Fund to believe that all conditions applicable to that disbursement were met. Remedial action may not be taken for the misreporting of information on aspects of the member's program that are not conditions.

19. In order to ensure that the reporting of information respecting the implementation of prior actions is subjected to this misreporting framework, the Fund has, since July, 2000, followed a policy of expressly incorporating prior actions as part of the conditionality of the

arrangement. More specifically, Executive Board decisions approving arrangements, completing reviews, or granting waivers for nonobservance are now adopted on the basis of an express condition that the information provided by the member on the implementation of specified prior actions is accurate.

b. Legal Nature of Conditionality

20. Let me now make a few comments on the legal nature of conditionality. As a starting point, it is important to distinguish between the member's program and the Fund arrangement. The program of economic reform is the program of the member rather than the Fund. In practice, these programs are effectively negotiated by the authorities of a member country and Fund staff but the program is put in place and implemented by the member and will only be successful if the authorities are genuinely committed to its implementation and, in the language of the Fund, have a strong sense of **ownership.**

21. In contrast, the arrangement supporting the program is a unilateral decision of the Executive Board. It is the Fund that sets these conditions and the Fund that determines whether these conditions are met. The Fund cannot delegate to another institution the power to establish conditions for the use of the Fund's resources or the power to assess whether particular conditions set by the Fund have been met. Such forms of **cross conditionality** are legally prohibited.

22. The Fund arrangement creates legal rights for the member and provides the member with a level of certainty as to what has to be done in order to receive financial assistance. At the same time, it does not subject the member to legal obligations to meet the conditions of the arrangement. To the extent that the member fails to meet a condition under an arrangement, the only legal consequence which ensues is that the member will not be able to purchase from the Fund. To understand what a Fund arrangement is, you have to understand what it is not. As a unilateral decision of the Fund, an arrangement is not a contract between the Fund and the member. The Fund sought to avoid subjecting a member to contractual obligations to implement their programs and putting the member the unenviable position of being in breach of a legal obligation if it failed to meet a condition. To provide incentives to members, the Fund sought to minimize the legal consequences attached to failure. A member is free to walk away from its program and the arrangement at any time.

23. The Fund's Articles and policies impose a number of limitations on the types of measures that may be made the subject of conditionality. First, the Fund's Articles require that conditionality be consistent with the Fund's purposes. Moreover, conditionality cannot be used by the Fund to interfere with legal rights of members that are created or recognized under the Articles. For example, the Fund cannot establish conditions that require members to remove restrictions on capital movements, given that capital account liberalization is not a purpose of the Fund and the Fund's Articles expressly recognize the right of members to restrict capital movements.

24. The Fund's **Guidelines on Conditionality** require that, in establishing conditions on the use of its resources, the Fund "pay due regard to the domestic social and political objectives" of members. Thus, the Fund cannot establish conditions that deal with issues that are essentially political in nature. Moreover, the Fund could not, for example, establish conditions that are related to the human rights record of a member. Fund policy prohibits the establishment of conditions that would require members to reduce the level of military spending. While the amount which the authorities of a member spend on the military may be very important for the country's macroeconomic position, the Fund has taken the position that the question of military spending is so inherently political in nature that it could not be appropriately made the subject of conditionality.

B. Recent Developments in Conditionality

25. Over the course of the past two decades, the Fund has become increasingly involved in the reform efforts of countries experiencing economic problems that were fundamentally different from those it had previously encountered. Fund involvement with the poorest countries of the developing world and with the countries of the former socialist bloc has presented the Fund with the challenge not only of bringing about macroeconomic stabilization but the implementation of a major structural transformation of the economy. Given the poor state of economic statistics in these countries, programs had to be designed on the basis of very unreliable information. Finally, financial assistance was sought by governments that, in some cases, were less than fully committed to the types of reforms the Fund felt necessary.

26. This environment prompted a significant change in the practical application of conditionality. To address the need for structural change, the Fund began to make much greater use of structural conditionality in the form of performance criteria and prior actions. In order to address deficiencies in economic information and forecasting, Board reviews became much more common in Fund arrangements. While, historically, a one-year stand-by arrangement would typically include one or, at most, two reviews, Fund arrangements in the former Soviet Union, in some cases, subjected every Fund disbursement to a Board review. Finally, in order to address concerns over a lack of ownership in some of these countries, the number of conditions attached to Fund arrangements, in particular prior actions, grew considerably.

27. While the reasons for these developments are, in many ways, understandable, a belief emerged that things had gotten out of hand. It was recognized that the proliferation of conditions attached to Fund financial assistance had undermined the authorities' sense of ownership of their programs. It was also believed that many of the structural conditions established in Fund arrangements dealt with issues that were not within the Fund's core mandate but rather should be addressed by the World Bank.

28. As a result, the Fund is in the process of reviewing conditionality with a view to streamlining it. While this work is ongoing, a great deal of progress has been made - this initiative has had two principal objectives. First, efforts have been made to strengthen member countries' sense of ownership of their programs, in particular, by reducing the number of conditions and giving the authorities greater choice in deciding how to reach particular objectives. Greater efforts have been made to promote a sense of program ownership not only amongst the governments but throughout the country's entire society. Members receiving financial assistance have been encouraged to publish their memoranda of economic policies to elicit the support of their populations in program implementation.

29. The second principal objective is to ensure that Fund conditionality focuses on areas in the Fund's core mandate leaves other areas to other international organizations. In particular, efforts have been made to more effectively coordinate the work of the Fund and the World Bank. In future, Fund conditionality will normally focus only on areas within the Fund's core mandate such as monetary, exchange rate, and fiscal policy. Areas within the competence of the World Bank, such as the design of the social safety net and privatization, will be left to the World Bank. Fund arrangements will no longer establish conditions in these areas unless they are judged to be particularly important for the success of the program.

C. Moving Forward – Issues for Discussion

30. While these initiatives are in their early stages, they do raise a number of interesting questions.

31. First, conditionality, although streamlined, will still need to serve as an effective mechanism for the monitoring of program implementation. The role of conditionality in judging program implementation is important not only for the Fund as lender but also for the rest of the international creditor community, both official and private creditors, who base their lending to member countries on the successful implementation of a Fund-supported program.

32. Second, while strengthening a member's sense of ownership is important, it cannot imply a weakening of conditionality or the safeguards that ensure the Fund will be repaid. If strengthened conditionality cannot be used to address an inadequate level of ownership, the Fund may only address such cases by refusing to provide financing – otherwise, the Fund will not have adequate safeguards to ensure that it is repaid.

33. Third, the Fund's withdrawal from structural conditionality on issues within the competence of the World Bank cannot give rise to the establishment of cross conditionality. Notwithstanding the formal boundaries of the Fund-supported program, the temptation may arise for the Fund to refuse financing for countries that are not on track with a Bank-supported program. The Fund will have to ensure that its decisions to approve access to Fund resources are based solely upon the member's observance of conditions that are set out in an arrangement approved by the Fund and in the program supported by the Fund. The

withdrawal of Fund conditionality from areas within the domain of the World Bank means that the member's performance in those areas can no longer be relevant for the Fund.

34. Finally, the fact that the Fund will focus its conditions on areas within its core mandate does not mean that the Fund will withdraw from the use of structural conditionality. The Fund will still establish structural conditionality in areas within its expertise. This will include conditionality directed towards the reform of the legal system in areas of importance to the Fund such as the banking system, and the regimes for secured lending and bankruptcy. This will mean that Fund lawyers will remain very busy for some time to come.