

INTERNATIONAL MONETARY FUND

**Conditionality in Fund-Supported Programs—Purposes, Modalities, and Options for Reform**

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## EXECUTIVE SUMMARY

The paper, which is part of the broader review of Fund lending facilities, reviews the purpose and modalities of conditionality for the use of Fund resources. It explores options for more flexible approaches that can achieve the objectives of conditionality while being responsive to the changing needs and circumstances of members.

***The Purpose of Conditionality.*** The Fund's conditionality has its underpinnings in the Articles of Agreement and is aimed at (i) assisting members to solve balance of payments problems without resorting to measures destructive of national or international prosperity; and (ii) establishing adequate safeguards for the temporary use of the Fund's general resources. To this end, the conditionality framework involves setting clear and monitorable measures and targets as part of a broader strategy to achieve program objectives. Currently, this is done on the basis of prior actions, quantitative and structural performance criteria, indicative targets and structural benchmarks, and program and financing assurances reviews. However, there is flexibility regarding the specific modalities of conditionality under the current framework, and different structures have been used in the past.

***Motive for Reform.*** Reform of conditionality is an integral part of the ongoing reform of Fund lending facilities. The existing conditionality framework has been subject to considerable criticism. Many of the Fund's standard modalities for program monitoring (e.g., performance criteria and waivers) are perceived to be unnecessarily burdensome, creating a monitoring framework that members may try to avoid, which often delay the time at which they come to the Fund for assistance.

***Options for Reform.*** The paper considers three complementary options for reform:

- ***Review-Based Conditionality.*** This approach would involve the elimination of performance criteria and focus on "real-time" assessments of program implementation, rather than on rigid and backward looking performance criteria. Similar to the current set-up, a Fund supported program would include a small set of quantitative and, where relevant, structural targets that would be expected to be met at specific points during a Fund arrangement. However, unlike performance criteria, a failure to meet these targets would not in itself interrupt purchases under the program or trigger the need for a waiver. Instead, such deviations would be an indicator that the program might not be on-track and completion of a review would require a judgment by the Board that there are compensating factors. One key advantage of this approach is that it allows a review to focus on overall program objectives rather than small deviations from specific performance criteria.
- ***Ex Ante Conditionality.*** Use of ex ante conditionality (i.e., providing full access up-front based on strong fundamentals and policies and established track record of policy implementation) could reduce the perception of intrusiveness associated with program implementation. The Short Term Liquidity Facility is a recent and significant example of the use of an ex ante approach. While considerations could be given to applying ex ante conditionality in the context of an arrangement, the key challenge relates to the need for the Fund to re-evaluate the member's position with the passage of time.

- **Hybrid.** Finally, it might be possible to combine elements of the review-based and the ex ante approaches for members qualifying for ex ante conditionality who wish to receive an arrangement of a relatively longer duration (e.g., in excess of 6 months).

**Applicability.** The proposed options for reform of conditionality could be considered for all member countries including low income members.

## I. INTRODUCTION\* <sup>1</sup>

1. **This paper takes a fresh look at the purpose and modalities of conditionality for the use of the Fund’s resources.** It is part of a broader review of Fund lending facilities that includes access levels, charges and maturities, the analytical basis for Fund lending, and facilities for low income countries. It aims to explore options for more flexible approaches that would be responsive to the changing needs and circumstances of the Fund’s members while providing adequate safeguards for Fund resources. While these options have been developed with General Resources Account (GRA) facilities in mind as a complement to the companion paper on the analytical framework, they could apply, as appropriate, to facilities and instruments used by low income members.

2. **The broader review of Fund lending facilities is, in part, motivated by criticisms of the existing practices of applying conditionality in Fund arrangements.** As noted in *Review of the Fund’s Financing Role in Member Countries*, 8/29/08 (PIN/08/13, 10/9/08) (the “chapeau paper”), many observers see conditionality as heavy-handed, undermining ownership, and in the extreme, interfering with sovereignty. Moreover, many of the Fund’s standard modalities for program monitoring, such as performance criteria, benchmarks, prior actions, reviews and waivers, are perceived to be unnecessarily burdensome, creating an overall monitoring framework that members go to great lengths to avoid, often delaying the time at which they come to the Fund for assistance. The prevalence of waivers and missed structural benchmarks raises questions about the effectiveness of the current conditionality structure as a monitoring tool. Finally, policy frameworks in many members have strengthened in recent years, which may call for different forms of conditionality. At the time of the discussion of the chapeau paper, many Directors were of the view that new approaches to conditionality—including with respect to macroeconomic targets, up-front qualification, or review-based conditionality—should be explored by staff.

3. **This paper seeks to address some of the concerns raised through a number of options to reform certain aspects of program monitoring.** It does not delve into the other aspects of conditionality—such as, the design of the member’s program itself. Some of the latter aspects were covered by the 2005 Review of the Guidelines on Conditionality and the 2007 IEO Evaluation of Structural Conditionality, which focused on the scope for streamlining structural conditionality, including restricting conditionality to Fund core areas of expertise and raising standards of criticality and parsimony.

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\* This paper sets out initial options for reform. The subsequent paper [GRA Lending Toolkit and Conditionality: Reform Proposals](#) (03/24/09) identifies specific proposed reforms. Substantial differences between this paper and the subsequent paper are highlighted in the text. In particular, note that the Executive Board decided to maintain quantitative performance criteria.

<sup>1</sup> Paper prepared by a staff team consisting of Thanos Arvanitis, Wes McGrew, Alison Stuart, Guillermo Tolosa (all SPR); and Rhoda Weeks-Brown, Ceda Ogada, Yan Liu, Kyung Kwak, and Wouter Bossu (all LEG).

4. **The remainder of this paper is structured as follows.** Section II reviews the nature and purposes of Fund conditionality, provides an overview of the existing modalities that monitor program implementation and discusses concerns raised with this framework. Section III discusses three possible reform options for program monitoring that merit reconsideration in light of the changing needs and circumstances of members. Section IV presents issues for discussion.

## II. THE EXISTING APPROACH TOWARDS CONDITIONALITY

### A. Overview of the Nature and Purpose of Conditionality

5. **Conditionality refers to the various policies adopted by the Fund that require, as a condition for the use of the Fund’s resources, a member to implement measures that enable it both to resolve its balance of payments difficulties and repay the Fund.** Conditionality in its broad sense embraces both the design of Fund-supported programs—i.e., the underlying macroeconomic and structural policies—and the specific methods used in Fund arrangements to ensure the achievement of program goals.<sup>2</sup> This paper proposes certain options for reform of the methods of program monitoring, not of the underlying program design.

6. **The underpinnings of conditionality are found in the Articles of Agreement and the policies adopted by the Fund under them.** Specifically, Article V, Section 3(a) provides that the Fund shall adopt policies on the use of its general resources 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.” (Box 1). This requires the adoption of general policies applicable to all types of balance of payments problems (i.e., credit tranche resources) and authorizes the adoption of special policies for special balance of payments problems (e.g., the Short Term Liquidity Facility (SLF) and Supplemental Reserve Facility (SRF)).

7. **In individual arrangements, conditionality is found both in the understandings reached before a member’s request for an arrangement is proposed for approval and in the specific arrangement approved for the member.**

- First, a member’s request to use Fund resources will be approved only if the Fund is satisfied that the member’s program is consistent with the Fund’s policies and that the member is sufficiently committed to implement it. The Managing Director recommends Fund support only when these conditions are satisfied, and in many

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<sup>2</sup> For a more extensive discussion of these issues, see *Conditionality In Fund-Supported Programs*, Supp. 1, 2/20/2001 (PIN/01/125, 12/14/01).

cases this is based on the member implementing prior actions in advance of the recommendation.

- Second, as each arrangement is a self-contained document, all the country-specific conditions for access to the Fund's resources must be specified in the arrangement. In this regard, as long as the terms of the arrangement are met, the member will have the assurance of the availability of Fund financing.

8. **The conceptual framework of conditionality has not changed significantly since the Fund was created.**<sup>3</sup> However, the scope and modalities of conditionality have evolved considerably over time: on scope, with the gradual expansion of coverage of conditionality from macroeconomic to structural reforms and more recent streamlining of conditionality; and on modalities, from virtually no ex post monitoring to the presence of reviews and performance criteria in almost every Fund arrangement.<sup>4</sup>

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<sup>3</sup> While the original Articles of Agreement did not provide an entirely explicit basis for policy conditionality, this basis was clarified through the Board's interpretation in March 1948 (see Decision No. 287-3, 3/17/1948).

<sup>4</sup> For a detailed discussion of the evolution of policies on performance criteria and reviews, see Annex.

### **Box 1: The Legal Basis and Purposes of Conditionality**

The legal basis for Fund conditionality is Article V, Section 3(a), which requires the Fund to adopt policies that will (i) assist members to resolve their balance of payments problems in a manner consistent with the provisions of the Articles of Agreement, and (ii) establish adequate safeguards for the temporary use of the Fund's general resources. Consistent with this requirement, the policies adopted by the Fund are designed to ensure that the member takes the necessary steps to resolve its balance of payments problem within a time frame that will enable it to repay the Fund.

The objective of helping members solve their balance of payments problems in a manner consistent with the Articles of Agreement must be read in conjunction with the purposes of Fund financing as set forth in Article I(v):<sup>5</sup> Fund assistance—and the conditions pursuant to which that assistance is provided—must assist members in solving their problems without resorting to measures destructive of national or international prosperity. Thus, for example, standard performance criteria are included in arrangements regarding the imposition of exchange restrictions or the incurring of external arrears.

Given the requirement of safeguards, the general repurchase period specified in the Articles of Agreement (between three and five years) provides important guidance with respect to the speed of adjustment that will be needed under a Fund-supported program. Recognizing that certain balance of payments problems may, however, require longer or shorter adjustment periods, the Articles of Agreement specifically authorize the Fund to establish special repurchase periods for resources provided to address special balance of payments problems (e.g., the SLF, SRF, and Extended Fund Facility).

## **B. Overview of Existing Framework**

9. **The existing conditionality framework aims to provide a coherent approach to structuring the Fund's financial support to member countries.** It sets clear and monitorable measures and targets as part of a broader strategy to achieve program objectives. It is flexible to allow for mid-course corrections through reviews and waivers in cases where developments deviate from expectations and new understandings with the authorities are necessary to tackle new or already identified economic problems. Finally, by phasing

<sup>5</sup> See Decision No. 287-3, 3/17/1948, which clarifies that “consistent with the provisions of this Agreement” as used in Article V, Section 3 means consistent both with the provisions of the Articles other than Article I and with the purposes of the Fund contained in Article I.

purchases and linking additional financing to demonstrable actions, it aims to ensure progress in program implementation and to reduce risks to the Fund. Under the Guidelines on Conditionality, key aspects of the current framework include the following:

- **Program Design:** The vast majority of Fund financing is provided under an arrangement in support of a member’s economic program. Under the Guidelines on Conditionality, these programs should be directed primarily towards the following macroeconomic goals: (a) solving the member’s balance of payments problems without recourse to measures destructive of national or international prosperity; and (b) achieving medium-term external viability while fostering sustainable economic growth.
- **Program Monitoring:** The implementation of a member’s program is usually monitored on the basis of prior actions, quantitative and structural performance criteria, indicative targets, and structural benchmarks that are drawn from policy measures outlined in the member’s economic program, as well as on the basis of program and financing assurances reviews. The Guidelines on Conditionality provide that program implementation “may be monitored” on the basis of prior actions, performance criteria, benchmarks and program and other reviews.<sup>6 7</sup> While the Guidelines do not require use of these particular tools, they do provide that, in general, all variables or measures that meet the specified criteria will be established as conditions. In practice, each of these tools is routinely employed in upper credit tranche arrangements. As an integral part of program monitoring, financing under Fund arrangements is typically “phased,” with the member receiving additional tranches of financing as its balance of payments needs unfold over time and as it meets additional or incremental conditions. This phasing helps to reduce risks to the Fund by linking financial exposure to the member’s actions to solve its balance of payments problem and strengthen its position to repay the Fund.
- **Assurances Under Arrangements:** Article XXX(b) of the Fund’s Articles of Agreement requires that arrangements assure members of the availability of Fund financing in accordance with the terms of the arrangement. This means that the conditions for financing under an arrangement cannot be open-ended. Thus, with respect to reviews, the Guidelines on Conditionality require that arrangements and

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<sup>6</sup> Under the Guidelines on Conditionality, all conditionality under a Fund-supported program must be either critical to the achievement of program goals or for monitoring implementation, or necessary for the implementation of specific provisions under the Articles and policies thereunder.

<sup>7</sup> There is a long-standing policy requiring the use of performance criteria in connection with purchases beyond the first credit tranche in all stand-by arrangements. The latest Board reiteration of this policy is in Decision No. 12865-(02/102), 9/25/2002.

program documents specify as fully and transparently as possible those elements of the member's program that will be taken into account for such reviews.

**10. The existing conditionality framework, however, has been subject to considerable criticism, including the following:**

- Perception that Fund-supported programs focus on individual conditions rather than overall performance. The existence of performance criteria and structural benchmarks may have contributed to this perception, having become signposts of Fund-supported programs. When performance criteria are not observed, and waivers are requested and granted, this can have significant political costs for members while also sending a signal to markets that the member's performance has slipped—even though the Board assesses overall performance as satisfactory and completes a review.
- Perception that Fund-supported programs impose a one-size-fits-all model and that Fund conditionality may not be focused on macro-critical measures; the policy places equal weight on each performance criterion, even though in practice not all may be equally critical for the achievement of program objectives. This perception is also fueled by the little understood fact that, under the Guidelines on Conditionality, performance criteria may also be established for two other purposes, i.e., for monitoring program implementation and for the implementation of specific provisions under the Articles of Agreement.<sup>8</sup> Moreover, the frequent completion of program reviews without all performance criteria being met (i.e., where nonobservance of performance criteria is waived) increases the perception that not all performance criteria are critical.
- Perception that Fund-supported programs may impose a tight conditionality framework even where this is not needed due to the confidence provided by the member's strong policy framework, track record, and fundamentals.

In light of the foregoing, the existing conditionality framework may contribute to the stigma and sense of intrusiveness associated with Fund lending and a general lack of prestige implied by the need for Fund "tutelage".

**11. While not all of this criticism can be addressed by reforming the existing modalities of conditionality, alternative structures have been used in the past and could be considered for future application:<sup>9</sup>**

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<sup>8</sup> Guidelines on Conditionality, Decision No. 12864-(02/102), 9/25/2002, as amended by Decision No. 13814-(06/98), 11/15/2006, paragraph 7(a).

<sup>9</sup> See, e.g., *A New Facility for Market Access Countries—The Short-Term Liquidity Facility*, 10/24/2008, (PR/08/262, 10/29/08) for additional discussion of the background and evolution of conditionality.

- **Outright Purchases:** A key feature of outright purchases is that they rely on *ex ante conditionality*; i.e., where upon the Fund's determination that the member has in place the necessary policies and would adopt corrective policies as required, the member is permitted to make a purchase outside the context of an arrangement (e.g., without phasing and performance criteria). During the early years of the Fund, outright purchases were the primary modality through which members borrowed from the Fund. Outright purchases continued to be used frequently into the late 1960s but were used thereafter mainly for assistance in the first credit tranche (although no such purchases have been made in recent times) and for emergency assistance. The SLF is a more recent example of the Fund's use of outright purchases to deliver large amounts of resources to members.<sup>10</sup>
- **More Flexible Arrangement Modalities:** Arrangements - where resources are committed for a specific period – were originally designed to provide members with additional flexibility as to whether and when the member chooses to draw Fund financing. Such stand-by arrangements were normally to be approved for periods not exceeding six months, and contained no performance criteria or review clauses.<sup>11</sup> While the Fund over time became more willing to provide stand-by arrangements for longer periods, the Fund determined that it would only do so with the inclusion of a program monitoring framework to ensure that, as time passed, the members' policies and overall position remained appropriate. A robust program monitoring framework consisting of performance criteria and multiple review clauses has now become standard under Fund arrangements.

12. **Other key international financial institutions (IFIs) and official lenders adopt a variety of approaches to conditionality.** Although their mandates are different from that of the Fund, other IFIs have adopted monitoring frameworks for their lending operations that seek to provide a degree of flexibility and a link to countries' own programs (see Box 2).

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<sup>10</sup> Although for smaller amounts, Fund financial support under the Compensatory Financing Facility, Emergency Natural Disaster Assistance and Emergency Post-Conflict Assistance is also provided in the form of outright purchases.

<sup>11</sup> Even in somewhat more recent times, for example, a stand-by arrangement approved for the United Kingdom in 1969 provided for prior consultations concerning monetary and fiscal programs, but included no performance criteria or other standard monitoring variables.

## BOX 2. OTHER IFIS APPROACH TO CONDITIONALITY

Other International Financial Institutions adopt a variety of approaches to the implementation and monitoring of conditionality, and over time, some (e.g., the World Bank) have become more tailored to countries' needs.

**World Bank:** In 2005 the World Bank, in response to criticisms from the development community, completed an exhaustive review of conditionality policy and practice and efforts to streamline conditionality. This resulted in the adoption of five Good Practice Principles for Conditionality: ownership, harmonization, customization, criticality, transparency and predictability. In 2006 and 2007 there were further reviews of the Bank's conditionality in development policy lending which concluded that the World Bank's support was broadly in line with its good practice principles for conditionality. These reviews endorsed the World Bank's use of *programmatically* lending for development policy lending. The key features are:

Programmatic lending is a sequence of single tranche loans that are framed within a medium-term policy program where there is a clear expectation of how a series of subsequent lending operations will proceed in terms of timing, policy steps, and amounts.

In each programmatic operation the country and the Bank agree on a *limited set* of critical prior actions and on triggers for the next operation in the series. The triggers are not formal conditions but are expected to be prior actions for subsequent operations, and they are sketched in outline rather than specific detail. The triggers are not included in the lending operations legal agreement as "conditions" and can be adapted or modified before becoming prior actions for the next operation. Bank documents then report on how the triggers were adapted and modified to support the program's objectives.

Decisions to move from one programmatic operation to the next are made on the basis of an assessment of progress against the triggers.

The programmatic approach allows a great degree of flexibility to adjust to new information and changing country circumstances during implementation and to change the scope of the operation over time. However, the World Bank's review also noted that the approach entailed implementation challenges for the Bank. First, the flexibility in the Bank's approach entails discretion that needs to be exercised consistently and transparently. Second, the focus of triggers in the programmatic policy loans needs to be targeted to ensure that the program is consistent with the broader medium-term strategy set out in the Country Assistance Strategy.

**Inter-American Development Bank:** The IADB's main facility for programmatic lending, the Policy-Based Loan (PBL), usually also consists of a sequence of single tranche loans framed within a medium-term policy program. The loan release depends on compliance with specified conditions, as well as the maintenance of an appropriate macroeconomic policy framework. The IADB's Management decides, based on judgment, if there is substantial compliance with these loan conditions. The degree of compliance also affects the Board's decision for approving a subsequent single tranche loan, in case there is one. Programmatic lending is also done through Emergency Loans, designed to address financial emergencies, and more recently, through the Liquidity Program for Growth Sustainability. These loans are typically undertaken with close coordination with Fund or World Bank loans, and do not typically contain conditionality beyond that set by the loans of those institutions.

**European Union:** Medium term balance of payments support (MTFA) is available for EU countries that are not in the Eurozone but has seldom been used (Greece, Italy, Hungary, and Latvia to date). Economic policy conditions are attached to the medium-term financial assistance with a view to re-establishing a sustainable balance of payments situation and these conditions are guided by the country's Convergence Program/ National Reform Program; and loan disbursements are by successive installments. The release of the funds is based on a positive evaluation of progress made with respect to specific economic policy criteria set in a Memorandum of Understanding.

EU Macro-financial assistance (MFA) provides policy-based balance-of-payments support to non-member states. MFA includes economic policy conditionality, the observance of which is verified before the release of the successive tranches of the assistance. Unlike the MTFA to non-Euro member states, MFA is contingent upon the orderly implementation of a respective Fund (World Bank) program with the country in question. MFA conditionality is generally consistent with the reform programs of the country agreed with other IFIs and is designed to minimize cross-conditionality with other IFIs and to streamline the number of structural conditions and focus on those related to the core objective. However, the MFA may put forward specific conditionality to support, for example, action plans identified in the European Neighborhood Policy or Pre-Accession agreements, technical co-operation or project-related assistance programs, or improvements in the financial management of assistance.

### III. OPTIONS FOR REFORM

13. **Complementary reform measures could be introduced that would be designed to achieve the objectives of conditionality while responding to the changing needs of members.** One reform measure would involve a new and more flexible **review-based conditionality approach** to program monitoring, where reviews would be the primary tool for monitoring performance under arrangements in the GRA, and the use of performance criteria would be discontinued. An additional reform measure would involve greater reliance on **ex ante conditionality**, either through the use of outright purchases or arrangements with no program monitoring framework. Finally, a **hybrid approach** could be envisaged that involves elements of both ex ante and review-based conditionality. As discussed in Section D below, these approaches could apply, as appropriate, to facilities and instruments used by low income members.

#### A. Review-Based Conditionality\*

\*In the subsequent paper the conditionality proposals were revised and in the [Decisions](#) adopted by the Executive Board on 3/24/09 quantitative performance criteria were maintained.

14. **Review-based conditionality would involve the elimination of performance criteria.** Under this approach, the Fund-supported program would include a quantified macroeconomic framework, and specified structural reforms if relevant, along with a set of quantitative targets and structural benchmarks (hereinafter, “targets”) that the member would be expected to have achieved by various points during the period of the arrangement (e.g., quarterly or semi-annually). These targets would be similar in content to performance criteria typically used under current practices, including the standard continuous performance criteria on trade and exchange measures, and the criticality test and other specified criteria under the Guidelines on Conditionality would continue to apply. Prior actions could still be required under the new framework in the same circumstances as under the current Conditionality Guidelines.<sup>12</sup> In addition, purchases would still be phased as under current Fund arrangements, with each successive purchase becoming available as the scheduled reviews are completed.

15. **Importantly—and unlike in the case of performance criteria—a member’s failure to meet the targets would not in itself interrupt purchases under the arrangement.** Rather, deviations from the targets would serve as indicators that the Fund-supported program might no longer be on track for successful implementation. Completion of the review would then require a judgment by the Board that there are compensating factors (e.g., as applicable for waivers of nonobservance under the current Guidelines on

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<sup>12</sup> The new framework would also not entail any changes to the current requirements concerning financing assurances reviews under the Lending Into Arrears policy and Guidelines on Conditionality.

Conditionality, if the failure to meet the target was minor or temporary, or if corrective actions had been taken by the authorities). In case of substantial deviations from program targets and weak policy commitments to correct slippages, staff and management could decide not to propose completion of a review. As is currently the practice, the Board would be informed in informal country matter sessions about the status of discussions. Once new understandings are reached with the member, the review could be completed and the member would be able to make the associated purchases.

16. **The elimination of performance criteria would thus remove the need for waivers of nonobservance (and of applicability) of performance criteria—a source of significant tension between members and the Fund.** Members would no longer need to request waivers following even minor deviations from program conditionality.<sup>13</sup> Instead, members would be able to concentrate on achieving their program objectives, without being distracted by the need to request waivers or, in some cases, by engaging in window dressing operations in order to meet the technical requirements of performance criteria.

17. **Reviews would not be open-ended and, as required by the Fund’s Articles of Agreement, providing assurances to members regarding access to Fund resources would continue to be a key feature of Fund financing.**<sup>14</sup> In this regard, there would be a focus on ensuring that the scope of reviews would be as predictable and transparent as possible. Moreover, there would be a presumption that reviews would be completed in circumstances where all of the applicable targets have been met, and a forward-looking assessment confirms that policies remain supportive of the underlying objectives to be accomplished under the program.

18. **While the proposed approach would not significantly dilute conditionality, if approved, from the standpoint of the member, it could go a long way in alleviating the stigma associated with performance criteria and requests for waivers.** In addition to addressing members’ concerns, the approach has the following three advantages over the current system.

19. **First, the elimination of performance criteria would make transparent the role currently played by program reviews, which over time have become the central mechanism for program monitoring.** Performance criteria were originally envisaged as a tool to set the parameters for access to the next tranche of resources under a framework with

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<sup>13</sup> However, inaccurate reporting on the implementation of programs would continue to be subject to the misreporting framework. While reporting of information on the implementation of prior actions is already subject to the misreporting framework, in the absence of performance criteria, staff proposes that the misreporting framework be amended in order to cover the reporting of information on targets.

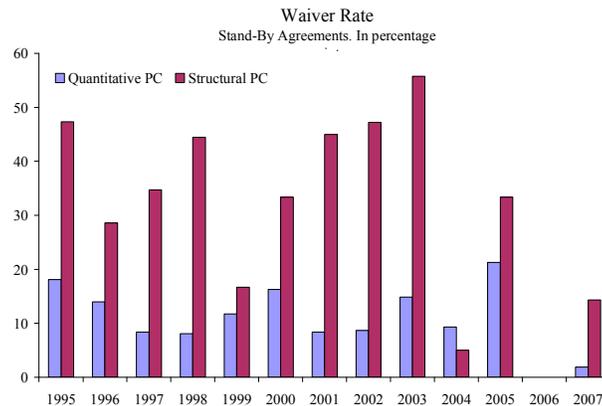
<sup>14</sup> As noted above, Article XXX(b) of the Fund’s Articles of Agreement defines a stand-by arrangement as a decision “by which a member is assured that it will be able to make purchases from the General Resources Account in accordance with the terms of the decision during a specified period and up to a specified amount.”

no further Board involvement prior to release of that tranche. This paradigm has changed, however, and the reality is that the large majority of purchases under current arrangements are tied not only to performance criteria, but also to reviews (Box 3). The “automaticity” associated with performance criteria for members or the Fund has thus effectively been reduced.

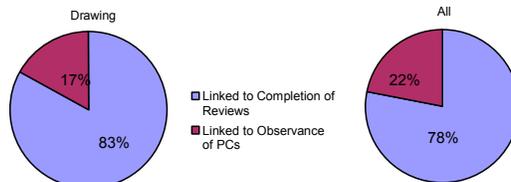
### Box 3. Waiver Rates and Review Frequency

A review of experience with Stand-By Arrangements (SBAs) since 1995 shows a relatively high incidence of waivers of nonobservance of performance criteria, in particular for structural performance criteria.

1. The average waiver rate (performance criteria not met over total number of performance criteria) over this period was 13 percent for quantitative and 37 percent for structural performance criteria.
2. In particular, 81 percent of programs over 2002–07 needed a waiver at some stage during the period of their respective arrangement.
3. About 78 percent of all purchases made available in the period since 1995 were linked to reviews. This ratio increases to 83 percent in drawing SBAs, reflecting the greater prevalence of quarterly reviews and purchases in these cases.



Purchases Subject to Review in SBAs (average 1995–2007)



Source: IMF staff estimates.

20. **Second, given the already central role played by reviews, the review-based approach would effectively codify existing practice and explicitly recognize that program reviews provide a context for a more robust and “real-time” assessment of program implementation.** In contrast to reviews, performance criteria are rigid and backward looking, and particularly in the case of structural measures, the needed precision is often hard to apply without stripping the objective of substance. Reviews provide a key opportunity to take stock of progress in program implementation based on a wide range of available information and discussions with the authorities, and to agree on corrective policies where necessary over the period of an arrangement.

21. **Third, the use of a review-based approach would largely eliminate the “blackout” periods (and related need for waivers of applicability) that are inherent in the structure of standard Fund arrangements.** Currently, after each test date, there is a blackout period that typically ranges from four to eight weeks during which members cannot access Fund financing until the data showing the observance of the applicable performance criteria become available and, where applicable, a review is completed. In order to make a purchase during this period, the member would need to be granted a waiver of applicability of the performance criteria for which data are not available. This is a disadvantage for precautionary arrangements, as it interrupts access even if the program is on track, barring a waiver of applicability. Under a review-based approach, since program targets, unlike performance criteria, are not conditions for the making of a purchase under an arrangement, the unavailability of data would not automatically block purchases or necessitate a request for a waiver. However, if data on the targets are not available by the scheduled review date, the review would likely be postponed. In such cases, the member would be unable to make any purchases from the original scheduled review date until the data become available and the review is completed.

22. **The foregoing advantages of the proposed review-based conditionality should be weighed against possible limitations and risks.** First, this approach is not likely to entirely remove perceptions of intrusiveness of Fund-supported programs. Such perceptions arise both from the underlying program design that is required for Fund support as well as the specific modalities used to monitor compliance with the program; review-based conditionality would not address the former. Second, while there will be a presumption for completion of a review if all targets are met and the program is on track, this could be seen as somewhat weaker form of assurance than the certainty of purchase where a purchase is primarily linked to the observance of performance criteria and there is no review. Third, the lack of performance criteria could possibly be seen as making it harder for staff to take a clear position that a program is off-track, enhancing concerns of political interference in decisions to complete reviews. Fourth, in the case of precautionary arrangements, the possibility that a member could make purchases during a period when data is not yet available, presents a limited risk to the Fund.

23. **A final issue that would need to be considered is the frequency of reviews.** Under this proposed approach, reviews would be required for every purchase (currently, these can be delinked from purchases under arrangements in the credit tranches, which may have quarterly purchases but semi-annual reviews) and the current policy is in principle to have no less than four purchases in a year for arrangements in the credit tranches.<sup>15</sup> To reduce the burden on members and the Board, reviews could be expected to be completed on a lapse of time basis under the existing guidelines for use of lapse of time procedures in circumstances where all of the specified targets have been met. In addition, to streamline the process, where programs are on track and no new policy commitments are needed, a short letter of intent from the authorities could suffice. If this is deemed to add an unwarranted burden to the authorities and the Fund, consideration could be given to allowing semiannual purchases in the credit tranches. When members' circumstances are considered to warrant semiannual reviews, semiannual purchases should not diminish the availability of financing or the signaling function of a Fund arrangement.

### **B. Ex-Ante Conditionality**

24. **A bolder option to reform the current conditionality framework and reduce perceptions of its intrusiveness would be to make greater use of ex ante conditionality, which is similar to the approach taken in the early years of the Fund.** The SLF is a recent and significant example of the use of an ex ante approach. This new facility provides substantial access upfront to a member facing exceptional balance of payments difficulties arising from external market developments, in cases where it is assessed that, due to the member's economic position, fundamentals and track record of policy implementation, these difficulties would be quickly self-correcting. The rationale for the ex ante approach under the SLF is that, as the member's fundamentals and policy framework are appropriate for the temporary capital account pressures that it faces, no new measures are required to resolve its balance of payments difficulties; and the member's very strong track record would give the Fund confidence that in cases of unexpected developments, the member would take additional measures appropriate for these developments. Thus, there is no need to have phased purchases and ex post program monitoring tools—whether in the form of performance criteria or reviews—to confirm implementation of critical reforms.<sup>16</sup>

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<sup>15</sup> Decision No. 7925-(85/38), March 8, 1985, as amended by Decision No. 8887-(88/89), 6/6/1988.

<sup>16</sup> While in most cases, prior actions would not be needed under the ex ante approach, there might be cases where notwithstanding the sound fundamentals and policies, the member is undertaking measures to reduce remaining vulnerabilities. In these cases, it would be open for management to consider establishing prior actions.

25. **In considering the use of this approach beyond the SLF, a key question relates to the circumstances under which ex ante conditionality could be appropriate.** Relevant considerations for this assessment include the following:

- Strong economic policies and fundamentals and an established track record of implementing appropriate policies would be a minimum prerequisite for ex ante conditionality. These factors are needed to provide a credible foundation for the Fund assessment that the member will implement appropriate policies and adapt them as necessary to changing circumstances, even after full financing has been made available to it, thereby satisfying the underlying requirements that Fund financing helps members resolve their balance of payments difficulties and establish adequate safeguards for Fund resources.
- An important consideration in this context would be the degree to which the member's reform agenda for reducing vulnerabilities is substantially completed, in the sense that the measures that need to be implemented to resolve the member's difficulties are relatively few.

26. **An ex ante approach would seem particularly appropriate for capital account-related financing to a member that is already in a very strong economic position with a strong record of policy implementation.** The resource needs in these cases are normally quite high and front-loaded, making relevant the large upfront financing that this approach facilitates. The strong qualification framework under this approach would constitute the key safeguard for the Fund.

27. **Consideration could also be given to applying ex ante conditionality in the context of a precautionary arrangement.** This would be particularly beneficial since the availability of significant upfront Fund financing in the face of potential balance of payments pressures could play a particularly effective crisis prevention role, thereby forestalling actual emergence of these pressures.

28. **The appealing feature of this approach is that for qualified members purchases would not be subject to any ex post conditionality.** It therefore addresses directly the issue of stigma associated with Fund lending. Further, for those members that would qualify for ex ante conditionality, risks to the Fund are likely to be low due to their strong policies and fundamentals. One challenge in applying ex ante conditionality is the difficulty in defining the threshold for qualification, and the potential for political pressures to be brought to bear on qualification decisions. Another key challenge of applying ex ante conditionality in the context of an arrangement relates to the need for the Fund to re-evaluate the members' position with the passage of time. As noted above, while ex ante conditionality was used in the context of arrangements during the early years of the Fund, these arrangements were short, no longer than six months. There is a risk that, as the arrangement – and the Fund's commitment – becomes longer, the Fund's resources are at greater risk since the member's

situation may change over time. To address this risk, consideration could be given to a hybrid approach discussed below.

### C. Hybrid Approach

**29. For members qualifying for ex ante conditionality who wish to receive an arrangement of a relatively longer duration (i.e., in excess of 6 months), the elements of both ex ante conditionality and a review-based approach could be used.** As under the ex ante conditionality approach, the full amount under an arrangement would be available upfront to the member in a single purchase, i.e., no phasing of purchases. Unlike the case with a pure ex ante approach, however, the member's continuing right to purchase would periodically become subject to the completion of reviews—once a review date is triggered, the purchase could be made only if that review were completed. Moreover, the underlying program would involve quantified targets against which the member's performance would be assessed at the time of the periodic reviews. This is largely the approach that was embodied in the Rapid Access Line proposal considered earlier by the Board.

### D. Applicability to Low Income Countries

30. The proposed review-based conditionality could be applied to low income as well as middle income members. The case for elimination of performance criteria is present in both middle income and low income countries, suggesting that review-based conditionality could be a desirable reform in both contexts.<sup>17</sup> Moreover, given the semi-annual frequency of reviews and disbursements under the PRGF, review-based conditionality for PRGF-supported programs would not entail any increase in the number of reviews. The use of ex ante conditionality (and the hybrid option discussed above) could also be considered for low income programs. Considerations that might be relevant in this context include the longer-term growth and poverty orientation of the PRGF (compared to the shorter-term and stability-oriented focus of the SBA); and the lesser degree of integration into global capital markets of PRGF countries. These issues could be taken up further in the context of the review of low income facilities.

### E. Consequential Changes to Existing Fund Policies

**31. Based on guidance from Directors, staff would prepare a further paper containing proposed decisions, including consequential changes that would be required under existing policies such as the Guidelines on Conditionality and the misreporting framework.**

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<sup>17</sup> This would apply to the PRGF as well as the Exogenous Shock Facility and Policy Support Instrument.

#### **IV. ISSUES FOR DISCUSSION**

- What do Directors see as the main problem of the Fund's modalities for monitoring program implementation from the members' perspective? Do Directors agree that there is a case to reform these modalities?
- Do Directors agree that the three complementary approaches described above—(i) review-based conditionality, (ii) ex ante conditionality, and (iii) hybrid approach—all have a role in the Fund's toolkit, depending on the specific circumstances?
- Do Directors agree that these complementary approaches will help over time to reduce the stigma associated with Fund lending?
- Do Directors see merits in extending these proposed approaches to facilities and instruments for low income members?

## **Annex. Evolution of Policies on Performance Criteria and Program Reviews in Fund Arrangements**

1. The Fund's present set of tools for conditionality has gradually evolved from its earliest days of operation to meet the changing needs of its members. Performance criteria and program reviews are two types of conditionality that have become principal features of Fund arrangements over time. As the Fund has continuously adapted these tools to improve their effectiveness, the dynamics of the relationship between performance criteria and reviews have changed over time. While the widespread use of waivers and frequent modification of performance criteria have diminished their intended effectiveness, the increasing importance of structural policies and the complexity of uncertain macroeconomic developments have significantly enhanced the role of reviews. This Annex briefly reviews the development of policies on performance criteria and reviews under Fund arrangements in the context of their historical evolution.

### **Era of Outright Purchases**

2. During the early years of the Fund, outright purchases were the primary modality through which members made use of the Fund's resources. Requests for outright purchases were approved based on an assessment that the member's current and future policies would be sufficient to deal with its balance of payments problems. Adequate safeguards were thus ensured through an ex ante assessment of the member's policies and there was no framework for performance monitoring or consultation.<sup>1</sup>

### **Emergence of the Stand-By Arrangement**

3. Thereafter, stand-by arrangements were developed to provide a member that did not have an immediate need for resources with the assurance that, for a specific period, Fund financing would be available if needed. The first stand-by arrangement was approved in June 1952. Originally, the member's right to purchase during the period of the stand-by arrangement was limited to six months under the initial decision on stand-by arrangements, and the early arrangements contained no performance clauses.<sup>2</sup> In a 1953 decision under which stand-by arrangements for periods longer than six months were first provided for, it was noted that the Fund and the member might find it appropriate to reach understandings in addition to those that would be expected for a shorter period.<sup>3</sup> The Fund continued to

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<sup>1</sup> While the original Articles of Agreement did not provide an entirely explicit basis for policy conditionality, this basis was provided through a March 1948 interpretation. See Decision No. 287-3, 3/17/1948.

<sup>2</sup> Decision No. 155-(52/57), 10/1/1952.

<sup>3</sup> Decision No. 270-(53/95), 12/23/1953.

experiment with a variety of “additional understandings”, and it soon became standard practice for a member requesting use of Fund resources to accompany such a request by a policy program.

4. Among the early “additional understandings” the Fund experimented with was the modality of phasing, a technique by which total approved access under an arrangement becomes incrementally available for purchase at quarterly or other periodic intervals. Phasing was introduced in 1956 to address the concern that as the duration of arrangements became longer, the Fund was faced with increasing risks, since a member’s circumstances could change over time. By 1960, phasing had become standard in arrangements.

#### **Early Development of Policies on Performance Criteria and Reviews (1950s–1970s)**

5. The introduction of phasing created some uncertainty as to when members would be able to make purchases. Performance criteria were introduced to provide an objective means of providing assurances to the member of the circumstances under which it would be able to make purchases. Performance criteria also provided safeguards to the Fund by ensuring that purchases could be automatically interrupted when a member’s program was off-track. Conversely, observance of performance criteria provided confidence that the objectives of the program were being achieved, and that the program was being implemented in a manner consistent with the purposes of the Fund. The first performance criterion was used in the stand-by arrangement for Paraguay in 1957. By 1960, performance criteria had become a standard feature of virtually all stand-by arrangements in the upper credit tranche. In codifying practices with respect to performance criteria, a 1968 Board decision established that performance criteria were to be included in all upper credit tranche stand-by arrangements. The decision also provided that no general rule as to the number and content of performance criteria could be adopted in view of the diversity of problems and institutional arrangements of members.

6. The function of program reviews evolved over time into a form of conditionality. The first review clause was included in a stand-by arrangement for Brazil in 1958. Initially, review clauses were used mainly in cases where the member’s outlook had been unusually uncertain, making it difficult to judge the efficacy of measures foreseen at the inception of the stand-by arrangement. However, the completion of such reviews was rarely made a condition for further purchases under arrangements until the establishment of the Extended Fund Facility in 1974. In providing for three-year arrangements, the facility required the member at the end of the first and second years, respectively, to present to the Fund the policies and measures that it would follow during the second and third years of the arrangement. Reviews were used as the modality for presentation to the Fund of the second- and third-year policies and measures. A similar approach was extended to stand-by arrangements through the adoption of the Guidelines on Conditionality in 1979, which required that, for arrangements of more than one year, or where performance criteria could

not be established for part of the program, provision would be made for a review in order to reach understandings for the remaining period.<sup>4</sup>

### **The Guidelines on Conditionality (1979)**

7. In 1978-1979, the Board reviewed conditionality in Fund-supported programs, which culminated in the adoption of the 1979 Guidelines on Conditionality. These Guidelines envisaged that program monitoring would be mainly through performance criteria. Program reviews were seen primarily as an occasion to set performance criteria beyond the first year of a program and, in rare cases, to monitor policies where uncertainties precluded the setting of performance criteria.<sup>5</sup>

### **Continued Evolution of Performance Criteria and Reviews (1980s–2000s)**

8. Following the 1979 Guidelines, the Fund made increasingly greater use of reviews. This reflected the close monitoring of policy implementation necessitated by the progressive complexity of members' problems. In particular, the increased incidence of reviews was attributed to the growing need for structural adjustment policies, which are often difficult to quantify. While it was recognized that reviews could be useful where performance could not be easily quantified or adequately specified, the general view of the Board was that performance criteria remained a critical tool, since they provide both the member and the Fund with a clear understanding of the nature and direction envisaged for adjustment policies. The Board was also of the view that the scope of program reviews should be defined with precision. The staff, in a 1987 Board paper, observed that there should be an appropriate balance between the need for precise specification of review clauses in order to restrict the extent of discretionary judgment and the need for flexibility given the uncertainties involved. At the same time, the paper recognized that reviews increasingly provided an opportunity for broad evaluation of performance necessary for assessing whether modifications to the program were required.

9. By the 2000s, reviews had come to play an important role in assessing policies from a forward-looking as well as a backward-looking perspective. They had become both more frequent and broader in scope, implying a shift toward greater discretion by the Fund and the possibility of less assurances to the member.<sup>6</sup> Reviews were increasingly used for broad-based assessments of progress with various aspects of the program—reflecting the possibility that, notwithstanding observance of all performance criteria, a program could still fail to meet the broad macroeconomic targets and there could be unforeseen developments, and thus the review would not be completed. At the same time, in certain areas, reviews were also being used for more focused policy assessments.

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<sup>4</sup> Decision No. 6056-(79/38), 3/2/1979.

<sup>5</sup> Decision No. 6056-(79/38).

<sup>6</sup> *Conditionality in Fund-Supported Programs – Policy Issues*, 2/16/2001.

### **Review of Conditionality (2000–2002)**

10. During 2000-2002, the Board conducted a comprehensive review of conditionality that aimed to enhance the effectiveness of Fund-supported programs. In the 2001 discussion on conditionality, the Board noted that the role of program reviews had changed importantly for the past two decades, with reviews being used for forward- and backward-looking assessment of economic policies. This change was considered to be appropriate: first, it reflected the increased uncertainty of macroeconomic relationships in a world of volatile global capital markets which had made it more difficult to specify macroeconomic performance criteria for more than a brief period ahead; and second, structural policies, which had become more prevalent, were less amenable to assessment in terms of quantified performance criteria. At the same time, the Board emphasized that the increasing prevalence of reviews should not weaken assurances to member countries regarding the conditions under which they would continue to have access to the Fund's resources. In the subsequent discussion on conditionality in 2002, the Board envisaged that reviews could become even more important as the use of other forms of conditionality—performance criteria and prior actions—was streamlined, while stressing that this evolution should go hand in hand with a clear delineation of the scope of program reviews. In light of the increasing frequency of reviews, while recognizing that more frequent reviews may be necessary in certain cases (particularly crisis cases), Directors reaffirmed that reviews should normally be on a semi-annual basis.

### **Guidelines on Conditionality (2002)**

11. The adoption of the revised Guidelines on Conditionality in 2002 was the culmination of the 2000-2002 review of conditionality. The main focus of the 2002 Guidelines on Conditionality was structural conditionality, with the aim of focusing and streamlining it and enhancing national ownership of policy programs.<sup>7</sup> The 2002 Guidelines underlined the role of reviews in assessing macroeconomic policies from a forward-looking as well as a backward-looking perspective; a program review would be completed only if the Board is satisfied, based on the member's past performance and policy understandings for the future, that the program remains on track to achieve its objectives. In making this assessment, the Board must take into consideration, in particular, the member's observance of performance criteria, indicative targets, and structural benchmarks, and the need to safeguard Fund resources. To provide assurances, the elements of a member's program that will be taken into account for the completion of a review should be specified as fully and transparently as possible in the arrangement.

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<sup>7</sup> *Guidelines on Conditionality*, Decision No. 12864-(02/102), 9/25/2002, as amended by Decision No. 13814-(06/98), 11/15/2006.

**Review of the 2002 Conditionality Guidelines (2005)**

12. In 2005, the Fund reviewed the 2002 Conditionality Guidelines, which covered, inter alia, an assessment of recent experience with implementation of conditionality since the adoption of the 2002 Guidelines. The 2005 review focused on the application of the Guidelines, and did not suggest substantive modifications to the role of performance criteria or reviews as set out in the Guidelines.<sup>8</sup>

**Evaluation of Structural Conditionality by the Independent Evaluation Office (2007)**

13. In 2007, the Independent Evaluation Office (IEO) conducted an evaluation of structural conditionality. The IEO recommendations mainly focused on parsimony and criticality in the setting of structural conditionality, and did not suggest reforms or new directions in relation to the existing rules on performance criteria and reviews in Fund arrangements.<sup>9</sup>

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<sup>8</sup> *IMF Executive Board Discusses Review of the Conditionality Guidelines*, PIN/05/52, 4/15/2005.

<sup>9</sup> *Independent Evaluation Office – Evaluation of Structural Conditionality in IMF-Supported Programs*, 2007.