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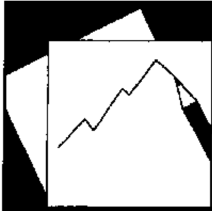

IMF Working Paper

Who's in Charge? Ownership and Conditionality in IMF-Supported Programs

James M. Boughton

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Policy Development and Review Department

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Abstract

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IMF lending is conditional on a country's commitment to carry out an agreed program of economic policies. Unless that commitment is genuine and broadly held, the likelihood of implementation will be poor. Is there a conflict between national commitment and conditional finance? Are national authorities or other agents in the country less likely to "own" a reform program simply because it is conditionally financed? This paper argues that potential conflicts are reduced when program design takes the country's interests and circumstances into account and when conditionality results from a genuine process of interaction between the IMF and the borrower.

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The IMF extends credit to countries with an external imbalance, conditional on the country's commitment to implement economic policies that will restore equilibrium. That conditionality serves two purposes. First, it ensures that the IMF's financial resources are used for the intended purpose, to the benefit of the country. Second, it ensures that the IMF will operate as a revolving fund for the benefit of all member countries. This simple description, however, gives rise to a conundrum. If the intended purpose is to benefit the borrower, then why is conditionality necessary? Why is it not sufficient to rely on the government to look after its own interests?

Several possible answers are available. The IMF might have superior knowledge or information, it might be relatively free of the distorting influence of short-term political constraints that limit rational policymaking, or—more sinisterly—it might have a hidden agenda of serving the interests of creditor countries rather than borrowers. The country's authorities might *prefer* conditional assistance, as a commitment device, as a means of overcoming domestic opposition, or as a means of enhancing the credibility of their program. The willingness of creditor countries to finance the institution might be enhanced by the perceived discipline conveyed by policy conditionality. But whether any or all of these answers is an adequate explanation is not obvious.

Whatever the story, a second fundamental question must also be considered. Since the country, not the IMF, must implement the agreed economic policies, it is essential that the country's commitment be authentic and sufficiently deep and broad. Is there an inherent conflict, or contradiction, between conditional finance and national commitment? Are national authorities or other agents in the country less likely to "own" an adjustment or reform program simply because it is conditionally financed? Only one of the justifications for conditionality suggested above—the hidden agenda—would clearly imply a conflict, but most of the others could be so construed.

I. What Is Ownership?

When the IMF embarked on a reexamination of its policies on conditionality in the millennium year 2000, a key objective was to promote national ownership of policy adjustments and structural reforms. It was clear from experience and from formal studies (see Schadler and others, 1995) that the main reason for failure of Fund-supported programs to achieve their objectives was that governments too often did not implement policies to which they had committed. Whatever could be done to deepen and strengthen commitment was likely to improve implementation and raise the success rate. Depth and breadth of genuine commitment were encapsulated in the phrase "national ownership," but it was not easy to define that phrase with sufficient precision to make it operational. After much internal debate, the staff settled on the following definition (IMF, 2001b, p. 6):

> Ownership is a willing assumption of responsibility for an agreed program of policies, by officials in a borrowing country who have the responsibility to formulate and carry out those policies, based on an understanding that the program is achievable and is in the country's own interest.

This definition incorporates several key elements:

- "Willing assumption of responsibility" is a judgment call. A government seeking financial support has an incentive to express commitment to strengthen its policies, even without genuine ownership. For an external agency such as the IMF to make such judgments requires a thorough understanding of political economy in the country.
- Ownership does not require that an IMF-supported program be a government's first choice, nor that it be the program that officials would have preferred in the absence of IMF involvement. In general, programs result from negotiations, the outcome of which—in a successful case—can be supported by all sides. In other words, ownership is dynamic and often fragile.
- Ownership does not require that everyone in the country support the program, but ownership usually must be broader than just the officials who negotiate with the Fund. Broad support throughout the country will raise the likelihood that a program will be successfully implemented, and cases will arise when the absence of majority support will undermine official ownership and scuttle implementation. In other cases, the government may abandon a program that has broad popular support if it does not think the program is in its own (possibly narrow) interest. In some cases, the country's top political leadership might allow or even encourage its finance officials to agree to a Fund-supported program and then undercut its implementation once it is approved. As a general proposition, what is essential is that the responsible and controlling officials be committed and that opposition can be overcome.
- Achievability can be a major obstacle to ownership when there are gaps between what the Fund judges to be necessary and what country officials think is feasible. If the gap arises because of weak administrative capacity (e.g., all concerned agree that tax reform is needed to shore up the country's fiscal position, but the government lacks the ability to collect revenues from a wide tax base), accommodation might be reachable through technical assistance, external support, or stretching out the length of the program. If the gap arises from political considerations (e.g., parliamentary or provincial opposition), it may be far more difficult to breach. Prolonged discussions between the Fund and country authorities might be needed to find alternative approaches that will still achieve the goals of the program.

II. Is Ownership Compatible with Conditionality?

Much of the criticism of IMF policy conditionality takes the form of saying that the Fund insists on telling the country to take policy actions that the country views as opposed to its own interests. If the country owned the policy changes, then it would implement them without the Fund's requirements, and conditionality would be unnecessary. Hence conditionality and ownership are said to be incompatible. If the Fund insists on national ownership as well, then that amounts to insisting that the country must not only do what the Fund wants, it must also at least pretend to want to do so. The basis for this criticism may be illustrated by a simple macroeconomic model of the type developed by Jacques Polak in the 1950s as a building block for Fund conditionality (see Polak, 1998, and Boughton, 2001).

The comparative statics of this model are shown in Figure 1, which shows a short-run (one-period) equilibrium between output (Y) and foreign exchange reserves (R). (For the mathematics, see Annex I). For this exercise, assume that the country has a fixed exchange rate and that its balance of payments is constrained by the availability of exogenously determined capital inflows. Output is determined by the horizontal Y line, which will shift positively with capital inflows (K) or expansionary domestic macro policies, represented here by government consumption spending (G). The balance of payments is determined by the vertical F line, which will shift to the right with K and to the left with G. The initial equilibrium is at Y_0, R_0 (point 0).

The classic situation forcing the country to seek the assistance of the IMF is an initial position of excess domestic demand, represented by point A in Figure 1.[2] The Fund approves a stand-by arrangement with credit available in quarterly installments, conditional on the authorities' agreement to adopt restrictive macro policies. In this stylized world, the authorities face a stark choice. They can either pursue their preferred policies until they run out of reserves or are forced to devalue the currency, or they can adjust policies in the direction of point 0 and receive an influx of cash and commitments sufficient to carry the economy the rest of the way. Ownership in this world is simply the recognition that the latter course is in their own interest. Because the initial position and the position required for Fund support are obviously different, the tension between ownership and conditionality is clear.

This basic tension, or what we might call "macro denial," implicitly underpins much of the political science literature on the role of policy conditionality in IMF lending.[3] It is also what Per Jacobsson would have had in mind when he first articulated the importance of ownership for Fund-supported programs in 1959. As Managing Director of the Fund, he was involved in negotiations with General Franco's Spain for a stand-by arrangement. In response to a question from a reporter for Spanish television, he stressed that the Fund could not just impose conditions and expect policy making to improve. "I must emphasize that such programs can only succeed if there is the will to succeed in the countries themselves. The Fund has always found people in these countries who know very well what needs to be done. The Fund does not impose conditions on countries; *they themselves freely have come to the conclusion* that the measures they arrange to take—even when they are sometimes harsh—are in the best interests of their own countries."[4] In that case as in many others, it is unlikely that Franco would have "freely" come to that conclusion without the carrot of the Fund's financial support or the benefit of Jacobsson's persuasive advice.

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[2] This assumption does not necessarily imply that the country has reached point A by pursuing an excessively expansionary macroeconomic policy. It might be that an adverse shock such as a drop in the terms of trade has shifted the internal and/or external balance curves inward and made the initial policy stance unsustainable.

[3] The catch phrase is "austerity" being imposed by the IMF and resisted by the government or by veto players in the country. The more sophisticated studies (e.g., Vreeland, 2003) use austerity as a metaphor for the whole range of policy reforms covered by Fund-supported programs, but they typically assume that the analysis extends to structural reform without fundamental modifications.

[4] Quoted in James (1996), p. 109, from a transcript of the interview in IMF Central Files (C/Spain/810). Emphasis added here.

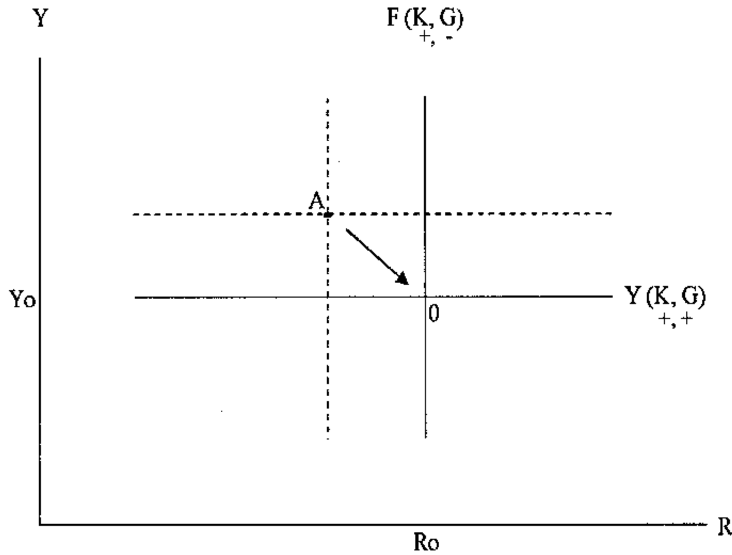

Figure 1. Overcoming Macro Denial

As a second example, consider the effects of a sudden withdrawal of capital, of the sort that triggered several financial crises in the late 1990s. To maintain simplicity of presentation, assume that the trigger for the crisis is purely exogenous; the economy is initially in equilibrium and then is thrown off balance by a capricious external shock. In Figure 2, this moves the economy from 0 to B, with a loss in both income and foreign exchange reserves. In this case, the status quo ante is no longer an option, at least in the short run. The authorities' initially preferred response may be to try to restore internal balance through expansionary macro policies, but this will take them to point C (with a further loss of reserves), not back to 0. The Fund, however, is likely to insist upon a move in the direction of C′ in order to restore *external* balance.

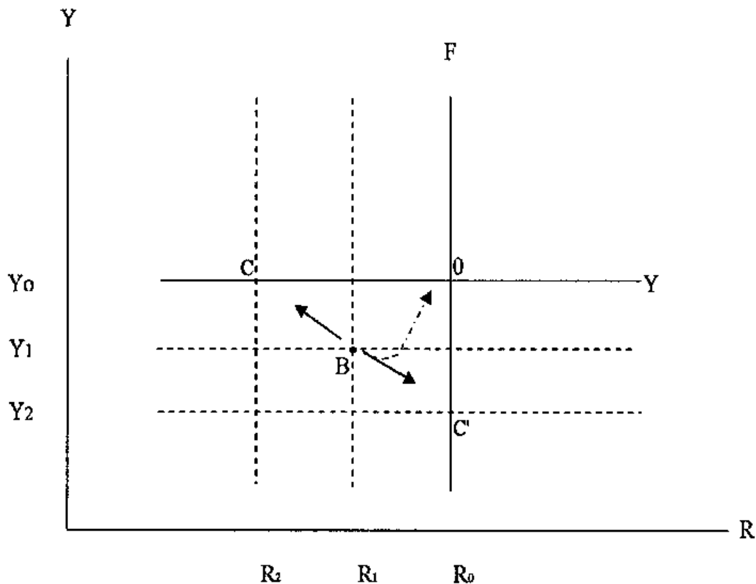

Figure 2. Overcoming Keynesian Optimism

This second case—let us call it "Keynesian optimism" [5]—is more nuanced than the first, in that there is more room for debate about the correct policy response. It is no longer a question of whether the government is prepared to bite the bullet, but rather of whether agreement can be reached on a viable path for approaching an undisputed goal. In general, both policy adjustment and new or replacement financing may be warranted, but the mix is not uniquely or clearly determined. The goal of the program is not to restore equilibrium for a given (reduced) level of capital flows, which would force a choice between C and C′. The goal is to instill confidence on the part of both domestic and international investors in order to reverse the initial outflow and ultimately to return the economy to point 0. If the initial position was strong enough, the country might be able to absorb a big loss of reserves or a large depreciation of the exchange rate and instill confidence by demonstrating the economy's ability to keep growing despite the crisis (point C). But if the initial position was that strong, what triggered the crisis? Almost without exception, the appropriate response will be in the direction of C′, because confidence cannot be restored without first shoring up the country's external finances. In such cases, negotiations over conditionality will focus on the balance between financing and adjustment, with the mutually agreed goal of trying to move as effectively as possible toward equilibrium along the path indicated by the dotted arrow in Figure 2.

More possibilities arise when allowance is made for a flexible exchange rate. Figure 3 shows a simple version of a Fleming-Mundell model with autonomous capital flows. Here the exchange rate (E – the domestic price of foreign exchange) replaces reserves (now assumed to be constant) on the horizontal axis. As in the second example, the country is shocked off its initial equilibrium by an outflow of capital. Output falls, and the exchange rate depreciates (point D). The authorities' preferred path might be to raise spending to offset the effect on output and employment, a course that will also bring a further depreciation (to point H). If this strategy works, then that is the end of the story. The depreciation, however, may destabilize the economy for a number of reasons. It may bring a wave of bankruptcies among firms with substantial currency mismatches on their balance sheets. It may aggravate the initial capital outflow by creating fears of a continuing deterioration. It may weaken consumer or investment outlays by depressing real incomes.

For these and other (including political) reasons, the authorities may wish to put a brake on depreciation and stabilize the exchange rate. To do so without further weakening output in the short run will require additional financing, for which they may turn to the IMF for assistance. Their goal will then be to get direct financial support and a seal of approval that will draw in additional capital from other creditors. In these circumstances, legitimate differences of view will arise regarding feasible paths from point D back toward point 0. An aggressive path would involve using a large injection of official financing to raise expenditure and induce spontaneous inflows of capital that will gradually bring the economy back to equilibrium through point O in Figure 3. A more conservative path would involve a strong stabilization program with moderate official financing, aimed at restoring equilibrium through point P. If the authorities are convinced that they can take an expansionary path through point O—"structural optimism"—while IMF officials are convinced that confidence can be restored only by taking a more cautious path

[5] This line of policy advice, which amounts to applying Keynesian principles to developing-country financial crises, is exemplified by Stiglitz (2002) and has been expressed with considerably more nuance by Corden (1998).

through P, then negotiations will be required that might or might not result in a program that the Fund will support and that the authorities will really own.

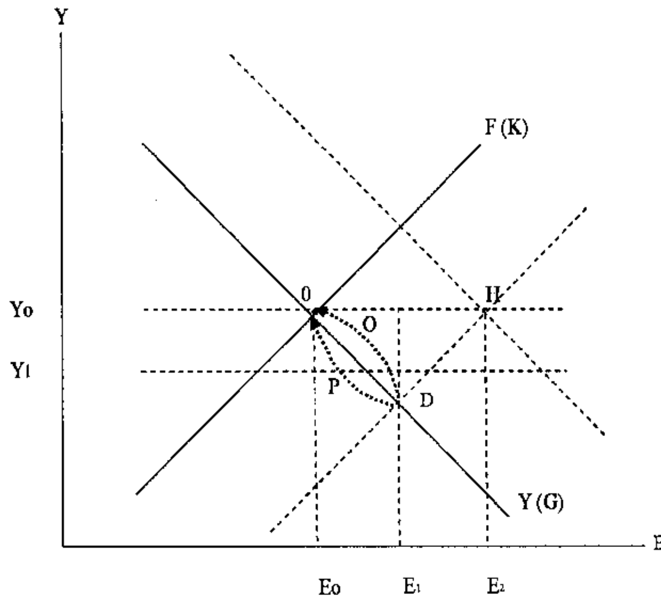

Figure 3. Structural Optimism / Pessimism

These simple models abstract from the complications that dominate both theoretical analysis and real-world discussions about economic policy. In most cases where a country applies to the IMF for financial assistance, the economy suffers from a combination of macroeconomic and structural imbalances that are more complex than the situations represented here. In many cases, basic disagreements over economic structure—the development role of the state, control over price and wage decisions, distributional issues—pose greater threats to ownership than the dynamic disputes described here. In all cases, detailed analysis of economic structure, domestic constraints, and dynamic adjustment is needed to determine the best course of action. That course of action must be evaluated in terms of economics (what is the best way to achieve program goals, assuming that the program can and will be carried out?), political economy (what is the best that can realistically be achieved?), and politics (how can the conflicting interests of various parties best be reconciled or balanced?). But even these abstract examples demonstrate that ownership is a much more complicated concept than it appears to be at first blush and that the challenges are linked to the nature of the problem. If ownership is initially lacking, is it primarily because of macro denial, Keynesian optimism, or structural optimism? To what extent is optimism warranted? Or, to turn the point around, is part of the reason for weak ownership that the proposed conditional arrangement is based on overly pessimistic assumptions by the IMF?

Specifically, four points emerge from this analysis that are worth stressing:

- First, establishing ownership is a two-way process. It is not just a matter of the authorities or other agents in the borrowing country coming to accept what is necessary. It also requires the Fund and other involved external agents to be flexible and responsive to the

institutional, administrative, and political factors that limit or alter the scope for action in response to adverse shocks.

- Second, as the goals of Fund-supported programs have been broadened beyond the resolution of temporary external financing problems, the need for both ownership and flexibility and the difficulty of achieving them have increased. Particularly when the country or a large portion of its population is impoverished, the goals of the program must include restoration or achievement of strong economic growth, creation of employment opportunities, and a reduction of poverty. Aiming to achieve such goals increases the scope for alternative approaches to economic policy making and may leave substantial room for debate about what policy adjustments or reforms are necessary. Implementing such structural and institutional reforms often requires a broader and deeper national commitment than simply adjusting macroeconomic and financial policies.
- Third, a substantial impediment to ownership is the likelihood of a painful dynamic path toward a favorable but distant and uncertain equilibrium. If output is expected to fall, and unemployment rise, for a lengthy interim period during which the ground is prepared for a healthy rebound, the combination of an adverse reality and an uncertain future will inevitably weaken any government's resolve to own and implement proposed reforms. In these circumstances, it is natural for the government to be overly optimistic about its ability to carry on without major adjustment and for the IMF to be overly optimistic about the magnitude and speed of the growth-enhancing benefits of reform.
- Fourth, a key to coping with these complications is to establish processes of interaction between the international agency and the country that are based on partnership and flexibility. It is no longer enough, if it ever was, to aver that the country must "freely come to the conclusion" that it must undertake harsh measures that are in its own interest. Fostering ownership also requires finding ways to accommodate legitimate concerns within the circle of feasible policy options.

III. How Can Ownership Be Strengthened in the Presence of Conditionality?

If—as the previous section suggests—processes and the specification of conditions matter, then what processes and what conditions will promote ownership and strengthen implementation and success of policy reforms? The IMF's millennium review of conditionality emphasized a number of aspects of interaction between the institution and borrowing countries relating either to the way programs and conditions are negotiated or to the specification of conditions. Many of these were adopted in the guidelines that were approved in September 2002 (see Annex II) and are now being implemented, but nearly all of them raise difficult issues of balance. How effective these changes will be is an open question that will have to be reviewed regularly.

A. Initial Discussion and Negotiation

Control of the Pen

The new guidelines affirm the principle that the country authorities are responsible for the design of their own policies, subject to the understanding that those policies must be acceptable to the Fund if the country is to qualify for financial support. The link between the policy program and Fund support is a Letter of Intent (LOI) addressed to the Managing Director of the IMF from the country's responsible officials, normally the finance minister and central bank governor. The LOI spells out the economic policies that they intend to carry out during the

program period (usually one to three years), and it is the basis for the specification of the Fund's conditionality. What the new guidelines mean is twofold. First, before the LOI is drafted, the Fund staff should ascertain the authorities' own preferences and intentions on how to strengthen their policies. The opening gambit should come from the country, not from the Fund. Second, *if the authorities wish*, they should be given the opportunity to write at least the first draft of the LOI themselves. In most situations, this guideline will make little difference, either because it reflects existing practices or because the country's authorities prefer not to take the initiative. In other cases, it has the potential to make a big contribution toward enhancing ownership.

Political Economy Analysis

Judging the breadth and depth of ownership is a delicate proposition that requires knowledge and understanding of the country's political economy as well as sensitivity to the limits of the Fund's own role. Are the economic officials fully committed? Do they have the support of the country's top political leadership? Is there broad support throughout the country? Are there groups in parliament or elsewhere with the power and the incentive to block implementation? Analyzing such questions does not mean interfering with the country's politics, but it does require an understanding of it. Whether the Fund's staff of highly qualified economists is also well qualified to do this type of political economy analysis is an open question, but the need for a broader perspective than has typically been applied in the past is well understood. Internal training on political economy is being expanded, and the role of the Fund's resident representatives in borrowing countries is being examined.

Participatory Processes

When the Fund established the Structural Adjustment Facility (SAF) in 1986, as a vehicle for making loans on concessional terms to low-income countries, it agreed with the World Bank to require borrowers to prepare a Policy Framework Paper (PFP) that would set out the country's overall policy objectives and strategy as a basis for financial support from the two institutions. Although the PFP was supposed to be the country's own document, prepared by the authorities with help from the staffs of the Bank and the Fund, in practice it was usually prepared largely in Washington with help from the authorities. That process continued to be applied through the 1990s under the Enhanced SAF (ESAF). In 1999, however, it was scrapped and replaced by a process that required the preparation of a Poverty Reduction Strategy Paper (PRSP) *in the country itself* and with broad participation by parliamentarians, nongovernmental organizations, and others. The objective was not only to generate more effective policy strategies aimed at reducing poverty and strengthening economic growth. It was also to use the PRSP *process* as a means of enhancing country ownership of policy reforms. Much effort has gone into making it succeed, and much more remains to be done.[6]

Generalizing the use of participatory domestic processes beyond the preparation of PRSPs is an even bigger challenge. Countries requesting to borrow from the Fund's general accounts rather than the concessional facility (now christened the Poverty Reduction and Growth Facility, or PRGF) are required to prepare only an LOI and a more detailed technical

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[6] As of March 2003, 51 out of 78 eligible countries had prepared either a preliminary paper ("interim" or I-PRSP) or a full PRSP, and most of those had been approved by the Executive Boards of the Bank and the Fund as a basis for lending. Only 24 of those, however, were full PRSPs.

memorandum specifying how policy implementation is to be measured and assessed. Especially in crisis cases where program discussions have to be completed very quickly, broad participation may be impractical. For the moment, therefore, the Fund is experimenting with a general injunction to the staff to *encourage* countries to engage in public discussions before deciding on policy reforms or agreeing to conditionality. Whether this recommendation resonates widely or has much impact on ownership remains to be seen.

Selectivity

If ownership is a necessary condition for successful policy implementation, then it follows that the Fund should refuse to lend when ownership is lacking. Applying such a rule, however, is far from straightforward. Ownership is not directly observable, it is not static, and it is assessed in degrees rather than absolutes. Where does one draw a line on an invisible and ever changing path? The Managing Director of the IMF has the responsibility to assess whether a country is sufficiently committed to and capable of carrying out the proposed program and to recommend approval only when he concludes that it will be implemented. This obviously must be a subjective judgment, but it is one that can be evaluated objectively after the fact. Did the country carry out its intended program or not? If not, was there a valid reason, and did the implementation failure cause harm to the economy? If the program was implemented, did it meet its objectives? If post mortems are conducted thoroughly and systematically, the effectiveness of the initial judgments is bound to improve over time.

B. Program Design

The second set of issues, after the processes discussed above, concerns the specification of conditions on Fund lending and the relationship between conditionality and the overall design of countries' policy reform programs. How can the Fund implement conditionality so as to enhance national ownership?

Parsimony in Conditionality

As far as ownership is concerned, limiting conditionality to a few key policy actions is almost axiomatically helpful. Within limits, the fewer conditions the better. The evidence on the implications of this point, however, is a little ambiguous. Empirical studies suggest that programs with large numbers of conditions are implemented at about the same rate as simpler ones.[7] In other words, even if governments prefer simple programs, they are not necessarily less willing or able to meet more complex requirements. The real question is whether a large number of conditions is necessary for a program to succeed in achieving its objectives. If the goal were just to balance a country's external payments position, the answer would surely be no, but when the goal is to solve the payments problem without unduly harming economic growth or the natural environment or neighboring economies while raising the country's potential growth rate and reducing the incidence of poverty, the optimum number of conditions might be considerably larger.

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[7] The implementation rate for conditions on Fund lending has been estimated (see IMF, 2001c, Figure 17) to be positively correlated with the number of conditions, but aside from prior actions the correlation is statistically insignificant. On average, countries implement around 60 percent of Fund conditions regardless of how detailed or extensive the program is.

In an ideal world, each country would pursue those broader objectives in its own enlightened interest, but in the real world conditionality can serve as a valuable commitment device that complements and enhances ownership of structural reforms (see Boughton and Mourmouras, 2002). The challenge is to determine what policy reforms are of critical importance for the success of the program—meaning that without them the program is expected to fail—and to be disciplined in limiting conditionality to that set of actions. That challenge must be met case by case. Even if every effort is made to restrict conditionality to what is critical, it is likely that the number of conditions in practice will range from a few to a great many. What matters is the burden of proof: if it is not critically important, then it should not be a condition on Fund lending.

Focus

In addition to limiting conditions to the critical set, it would be helpful if IMF conditionality could be limited to cover only those policies that are within its mandate and comparative advantage. In general, that would cover macroeconomic and exchange rate policies, closely related institutional arrangements, and financial system issues. But what should be done if some other policy—say, finding a way to stop a financial hemorrhage from a failing state-run enterprise—is critical for achieving program goals? The compromise embodied in the guidelines is for the Fund to ask the World Bank to design and monitor that part of the program but to continue to include it as a condition on Fund lending and to retain control over whether to disburse in the face of a slippage. Given the Bank's comparative advantage on such structural policies, this approach should lead over time to better program design and stronger national ownership. To be fully effective, it will also require drawing on country-led development strategies as much as possible. In any event, the overriding principle for coverage of conditionality must be criticality, while comparative advantage governs the focus of each institution's contribution to the process.

Flexibility

As an integral part of the millennium review of conditionality, the Fund held or participated in several seminars around the world to solicit views from country officials, NGOs, and scholars on how to promote ownership and make conditionality more effective.[8] One of the strongest and most consistent criticisms expressed in those consultations was that countries had too little flexibility in deciding how or when to implement reforms. From the Fund's vantage point, the problem is that financing constraints limit a country's flexibility and require rapid solutions to financial imbalances. Structural reforms often cannot wait, because delay is expensive and unaffordable. That objection, however, does not apply universally, and the Fund recognized the value of being responsive when it could do so without endangering the success of the program. Three aspects of that response are noteworthy.

- First, the use of "prior actions"—requiring the authorities to take certain actions before the Fund approves the program—is being limited to situations where it is critically important that the measure be implemented in this way. If the nature of the policy (e.g., a currency depreciation) requires prior action or if the authorities' ability or incentive to enact it would be weakened by waiting until after approval, then requiring a prior action

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[8] This outreach program also included use of the Fund's website (www.imf.org) to request views from the general public. Comments were posted on the website, and an overview was circulated to Executive Directors as an input to the review. See IMF (2001a).

makes sense. It does not make sense, however, to ask a country to complete reforms in advance as a demonstration of commitment, because such signals are unreliable and the requirement puts an undue burden on the country.

- Second, to the extent possible, it makes sense to specify conditions on outcomes rather than on policy instruments, as long as the outcomes are measurable within reasonable time limits and are reasonably within the authorities' indirect control. Again, the key is balance. Setting a condition on the inflation rate seldom makes sense, because the government cannot control it with any precision. Setting a condition on an instrument such as bank reserves may not make sense either, because the instrument may be only weakly related to inflation. Setting several conditions on various policy instruments or on frequent steps toward inflation control may be overly burdensome to administer and monitor. The goal is to allow as much implementation flexibility as possible without sacrificing the assurance that prices will be stabilized.
- Third, there may be some scope for linking the timing of disbursements to the completion of reforms, or of steps toward reform, rather than specifying in advance when actions must be completed in order to qualify for financing. These "floating tranches" have been used by the Fund in a few situations, notably for debt relief operations under the Brady Plan and the HIPC initiative.[9] The goal now is to find more general applications as a way of increasing countries' control over the timing of reforms.

Clarity and Transparency

One of the original objectives of the Fund's stand-by arrangements when they were inaugurated in 1952 was to provide clear assurances to countries that they would receive financing at specified times as long they met conditions that were spelled out in advance. As arrangements grew longer and more complex, it became necessary in some cases to include mid-term reviews when conditionality would be respecified in light of economic developments. Quantitative performance criteria were supplemented by benchmarks and indicative targets that would be taken into account in those reviews but that would not necessarily be required for financing to continue. While these innovations were necessary under the circumstances, they undermined the clarity of assurances that the Fund was able to give. In some cases, programs contained substantially more conditions than could reasonably be met, in the expectation that enough targets would be hit to warrant keeping the program going. The cumulative effect was often dispiriting, and it tended to undermine ownership. The new guidelines aim to alleviate this problem, not only by streamlining conditionality but also by requiring that the basis for reviews be specified as clearly as possible at the outset of the arrangement and be based as much as possible on the benchmarks and indicative targets that have been agreed in advance.

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[9] Under the 1989 Brady Plan, the Fund agreed to augment access to its financing to support countries' debt reduction operations such as buybacks of debt owed to external commercial creditors. Under the 1996 initiative for Heavily Indebted Poor Countries, the timing of decision and completion points as triggers for Fund financing is flexible and not determined in advance. Floating tranches are more widely used by the World Bank.

IV. CONCLUSIONS

The thesis of this paper can be briefly summarized: ownership is operationally important, it need not be undermined by conditionality, and the consistency of the two can be enhanced through sensitivity to processes and products. Doing so is not so easy. As Gustave Flaubert is supposed to have said, "le bon Dieu est dans le detail." The preceding review of changes that are being put into practice at the IMF has tried to convey some of the difficulties that might impede or limit their implementation. Even after taking account of those limitations, however, the cumulative effect on ownership and on program effectiveness should be positive and could eventually be dramatic.

This paper's focus on processes is not intended to imply that these changes will suffice to solve all ownership and implementation problems or to make all programs succeed. The larger debate must address more fundamental questions of program design: questions of how to extend or modify the so-called Washington Consensus and embed it into the Monterrey Consensus on development finance.[10] Stan Fischer recently summed up that issue neatly by noting that while the Washington Consensus is a "useful shorthand description of a major part of a desirable basic policy orientation" (Fischer, 2003, p. 8), real-world policy recommendations must be more nuanced and comprehensive. How can we assess when macro policies are appropriate to a country's circumstances? What policy changes are needed to restore investor confidence? How much should capital flows be liberalized, and how quickly? Will privatization improve economic efficiency in specific cases? Would a large increase in aid flows improve economic performance or run into administrative bottlenecks and inflationary pressures? As we get better answers to such questions, the effectiveness of conditionality and the depth of national ownership of reforms are bound to improve.

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[10] John Williamson (1990) coined the term Washington Consensus to characterize the set of policy reforms typically included in an IMF-supported program. The Monterrey Consensus (United Nations, 2002) is an international agreement on the mutual accountability of developed and developing countries for their respective responsibilities in fostering economic development.

MATHEMATICS OF THE DIAGRAMMATIC MODELS

Figures 1 and 2 (Polak model)

One-period model:

Demand for money (L)	$\Delta L = k\Delta Y$
Demand for imports (M)	$M = mY$
Payments identity	$\Delta R = X\text{-}M\text{+}K$
Supply of money	$\Delta L = q\Delta H$
Sources of monetary base (H)	$\Delta H = \Delta R + \Delta D$

where Y is GNP, X is exports, R is international reserves, K is the net capital inflow, and D is domestic credit of the banking system.

Semi-reduced form (shown in the figures):

$$Y = b_1[kY_{-1} + q(X+K+\Delta D)]$$

$$R = -b_2\Delta D - b_3Y_{-1} + b_4(X+K) + R_{-1}$$

where b_i are positive combinations of the structural coefficients m, k, and q. Since D is a positive function of government expenditure (G), it is straightforward to substitute G for D in the solution. Since R is absent from the first equation and the current value of Y is absent from the second, the two lines are horizontal and vertical, respectively.

Figure 3 (variant of Fleming-Mundell model)

Keynesian aggregate demand equation

$$Y = C(Y, E) + I(r, K) + G - K$$

Balance of payments

$$F(Y, E) = -K$$

where C, I, G, and F are, respectively, consumption, investment, government expenditure, and net exports; E is the exchange rate; and r is the domestic interest rate.

The line labeled Y(G) in Figure 3 is derived by differentiating the demand equation and assuming (1) that the interest rate is fixed by an unchanging monetary policy ($dr=0$) and (2) that the coefficient $I_K=1$. The first assumption allows one to focus on the effects of fiscal policy, while the second simplifies the exposition. If $I_K<1$, then $Y=Y(G, K)$ with $Y_K<0$. The slope of this line is $dY/dE = C_E/(1-C_Y) < 0$. The line labeled F(K) is derived by differentiating the payments equation. Its slope is $-(F_E/F_Y) > 0$.

IMF CONDITIONALITY GUIDELINES

Adopted September 25, 2002

A. Principles

Basis and purpose of conditionality. Conditions on the use of Fund resources are governed by the Fund's Articles of Agreement and implementing decisions of the Executive Board. Conditionality—that is, program-related conditions—is intended to ensure that Fund resources are provided to members to assist them in resolving their balance of payments problems in a manner that is consistent with the Fund's Articles and that establishes adequate safeguards for the temporary use of the Fund's resources.

Early warning and prevention. Conditionality is one element in a broad strategy for helping members strengthen their economic and financial policies. Through formal and informal consultations, multilateral su*rveillance including the World Economic Outlook and discussions of capital market developments, advice to members on the voluntary adoption of appropriate standards and codes, and the provision of technical assistance, the Fund encourages members to adopt sound economic and financial policies as a precaution against the emergence of balance of payments difficulties, or to take corrective measures at an early stage of the development of difficulties.*

Ownership and capacity to implement programs. National ownership of sound economic and financial policies and an adequate administrative capacity are crucial for successful implementation of Fund-supported programs. In responding to members' requests to use Fund resources and in setting program-related conditions, the Fund will be guided by the principle that the member has primary responsibility for the selection, design, and implementation of its economic and financial policies. The Fund will encourage members to seek to broaden and deepen the base of support for sound policies in order to enhance the likelihood of successful implementation.

*Circumstances of members. In helping members to devise economic and financial 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 and their administrative capacity to implement reforms. Conditionality and program design will also reflect the member's circumstances and the provisions of the facility under which the Fund's fina*ncing is being provided. The causes of balance of payments difficulties and the emphasis to be given to various program goals may differ among members, and the appropriate financing, the specification and sequencing of policy adjustments, and the time required to correct the problem will reflect those and other differences in circumstances. The member's past performance in implementing economic and financial policies will be taken into account as one factor affecting conditionality, with due consideration to changes in circumstances that would indicate a break with past performance.

Approval of access to Fund resources. The Fund will ensure consistency in the application of policies relating to the use of its resources with a view to maintaining the uniform treatment of members. A me*mber'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 provisions and policies and that it will be carried out, and in particular that the member is sufficiently committed to*

implement the program. The Managing Director will be guided by these principles in making recommendations to the Executive Board with respect to the approval of the use of Fund resources by members.

Focus on program goals. Fund-supported programs should be directed primarily toward the following macroeconomic goals:

(a) solving the member's balance of payments problem without recourse to measures destructive of national or international prosperity; and

(b) achieving medium-term external viability while fostering sustainable economic growth.

Scope of conditions. Program-related conditions governing the provision of Fund resources will be applied parsimoniously and will be consistent with the following principles:

(a) Conditions will be established only on the basis of those variables or measures that are reasonably within the member's direct or indirect control and that are, generally, either (i) of critical importance for achieving the goals of the member's program or for monitoring the implementation of the program, or (ii) necessary for the implementation of specific provisions of the Articles or policies adopted under them. In general, all variables or measures that meet these criteria will be established as conditions.

(b) Conditions will normally consist of macroeconomic variables and structural measures that are within the Fund's core areas of responsibility. Variables and measures that are outside the Fund's core areas of responsibility may also be established as conditions but may require more detailed explanation of their critical importance. The Fund's core areas of responsibility in this context comprise: macroeconomic stabilization; monetary, fiscal, and exchange rate policies, including the underlying institutional arrangements and closely related structural measures; and financial system issues related to the functioning of both domestic and international financial markets.

(c) Program-related conditions may contemplate the member meeting particular targets or objectives (outcomes-based conditionality), or taking (or refraining from taking) particular actions (actions-based conditionality). The formulation of individual conditions will be based, in particular, upon the circumstances of the member.

Responsibility of the Fund for conditionality. The Fund is fully responsible for the establishment and monitoring of all conditions attached to the use of its resources. There will be no cross-conditionality, under which the use of the Fund's resources would be directly subjected to the rules or decisions of other organizations. When establishing and monitoring conditions based on variables and measures that are not within its core areas of responsibility, the Fund will, to the fullest extent possible, draw on the advice of other multilateral institutions, particularly the World Bank. The application of a "lead agency" framework, such as between the Fund and the Bank, will be implemented flexibly to take account of the circumstances of members and the overlapping interests of the two institutions with respect to some aspects of members' policies. The Fund's policy advice, program design, and conditionality will, insofar as possible, be consistent and integrated with those of other international institutions within a coherent country-

led framework. The roles of each institution, including any relevant conditionality, will be stated clearly in Fund-related program documents.

B. Modalities

Nature of Fund arrangements. A Fund arrangement is a decision of the Executive Board by which a member is assured that it will be able to make purchases or receive disbursements from the Fund in accordance with the terms of the decision during a specified period and up to a specified amount. Fund arrangements are not international agreements and therefore language having a contractual connotation will be avoided in arrangements and in program documents. Appropriate consultation clauses will be incorporated in all arrangements.

Members' program documents. The authorities' policy intentions will be described in documents such as a Letter of Intent (LOI), or a Memorandum on Economic and Financial Policies (MEFP) that may be accompanied by a Technical Memorandum of Understanding (TMU). These documents will be prepared by the authorities, with the cooperation and assistance of the Fund staff, and will be submitted to the Managing Director for circulation to the Executive Board. The documents should reflect the authorities' policy goals and strategies. In addition to conditions specified in these documents, members requesting the use of Fund resources may in exceptional cases communicate confidential policy understandings to the Fund in a side letter addressed to the Managing Director and disclosed to the Executive Board. In all their program documents, the authorities should clearly distinguish between the conditions on which the Fund's financial support depends and other elements of the program. Detailed policy matrices covering the broader agenda should be avoided in program documents such as LOIs and MEFPs unless they are considered necessary by the authorities to express their policy intentions.

Monitoring of performance. The implementation of the member's understandings with the Fund may be monitored, in particular, on the basis of prior actions, performance criteria, program and other reviews, and other variables and measures established as structural benchmarks or indicative targets.

(a) *Prior actions.* A member may be expected to adopt measures prior to the Fund's approval of an arrangement, completion of a review, or the granting of a waiver with respect to a performance criterion when it is critical for the successful implementation of the program that such actions be taken to underpin the upfront implementation of important measures. In reaching understandings on prior actions, the Fund will also take into account the strain that excessive reliance upon such actions can place on members' implementation capacity. The Managing Director will keep Executive Directors informed in an appropriate manner of the progress of discussions with the member.

(b) *Performance criteria.* A performance criterion is a variable or measure whose observance or implementation is established as a formal condition for the making of purchases or disbursements under a Fund arrangement. Performance criteria will apply to clearly-specified variables or measures that can be objectively monitored by the staff and are so critical for the achievement of the program goals or monitoring implementation that purchases or disbursements under the arrangement should be interrupted in cases of nonobservance. The number and

content of performance criteria may vary because of the diversity of circumstances and institutional arrangements of members.

(c) *Reviews.* Reviews are conducted by the Executive Board.

(i) *Program reviews.* Program reviews provide a framework for an assessment of whether the program is broadly on track and whether modifications are necessary. A program review will be completed only if the Executive 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 Executive Board will take into consideration, in particular, the member's observance of performance criteria, indicative targets, and structural benchmarks, and the need to safeguard Fund resources. The elements of a member's program that will be taken into account for the completion of a review will be specified as fully and transparently as possible in the arrangement. Arrangements will provide for reviews to take place at a frequency appropriate to the member's circumstances. Reviews are expected to be held every six months, but substantial uncertainties concerning major economic trends or policy implementation may warrant more frequent monitoring. In cases of major delays in the completion of a review, the Managing Director will inform Executive Directors in an appropriate manner.

(ii) *Financing assurances reviews.* Where the Fund is providing financial assistance to a member that has outstanding sovereign external payments arrears to private creditors or that, by virtue of the imposition of exchange controls, has outstanding non-sovereign external payments arrears, the Executive Board will conduct a financing assurances review to determine whether adequate safeguards remain in place for the further use of the Fund's resources in the member's circumstances and whether the member's adjustment efforts are undermined by developments in creditor-debtor relations. More specifically, every purchase or disbursement made available after the approval of the arrangement will, while such arrears remain outstanding, be made subject to the completion of a financing assurances review. Financing assurances reviews may also be established where the member has outstanding arrears to official creditors.

(d) *Other variables and measures.* In monitoring the implementation of a member's program, the Fund may also examine variables and measures established as indicative targets and structural benchmarks. The same principles governing the scope of conditions set out in paragraph 7 apply to these variables and measures as well as to other program-related conditions.

(i) *Indicative targets.* Variables may be established as indicative targets for the part of an arrangement for which they cannot be established as performance criteria because of substantial uncertainty about economic trends. As uncertainty is reduced, these targets will normally be established as performance criteria, with appropriate modifications as necessary. Indicative targets may also be established in addition to performance criteria as quantitative indicators to assess the member's progress in meeting the objectives of a program in the context of a program review.

(ii) *Structural benchmarks.* A measure may be established as a structural benchmark where it cannot be specified in terms that may be objectively

monitored or where its non-implementation would not, by itself, warrant an interruption of purchases or disbursements under an arrangement. Structural benchmarks are intended to serve as clear markers in the assessment of progress in the implementation of critical structural reforms in the context of a program review.

Waivers. The Fund will grant a waiver for nonobservance of a performance criterion only if satisfied that, notwithstanding the nonobservance, the program will be successfully implemented, either because of the minor or temporary nature of the nonobservance or because of corrective actions taken by the authorities. The Fund will grant a waiver of the applicability of a performance criterion only if satisfied that, notwithstanding the unavailability of the information necessary to assess observance, the program will be successfully implemented and there is no clear evidence that the performance criterion will not be met.

Floating tranches. Conditions will normally apply to specified dates or continuously. However, when the Fund judges that the member will need to implement a particular structural measure or meet a particular performance target during the program period but not necessarily by a specific date, and when flexibility in timing would promote national ownership, the arrangement may provide for the purchase or disbursement of Fund resources to be made available whenever the measure is implemented or the target observed. These "floating tranches" are expected to apply primarily to structural performance criteria that are included because of their importance for medium-term external sustainability and growth.

C. Evaluation and Review

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

Periodic review. The Fund will review the application of this Decision at intervals of two years and at such other times as consideration of it is placed on the agenda of the Executive Board. These reviews will evaluate the consistency of conditionality with these guidelines, the appropriateness and implementation of programs, and the effectiveness of policy instruments.

Decision No. 270-(53/95), adopted December 23, 1953, *Stand-by Arrangements* as amended, Decision No. 6056-(79/38), adopted March 2, 1979, *Guidelines on Conditionality*, and Decision No. C-3220-(01/24), adopted March 9, 2001, *Concluding Remarks by the Chairman—Conditionality in Fund-Supported Programs*, are repealed.

Staff Statement
Principles Underlying the Guidelines on Conditionality

The IMF provides financing to assist a member country to resolve balance of payments problems. IMF conditionality specifies how the Fund's financing will be linked to the member's implementation of an adequate program of policy adjustments in response to its external imbalances. Conditionality is one element in a broad strategy for helping countries design and carry out programs of strong economic and financial policies.

Adoption of new guidelines for conditionality has been motivated by an increasing recognition of the importance of several interrelated principles for successful design and implementation of Fund-supported programs. Chief among these are national ownership of reform programs, parsimony in the application of program-related conditions, tailoring of programs to the member's circumstances, effective coordination with other multilateral institutions, and clarity in the specification of conditions.

National ownership refers to a willing assumption of responsibility for a program of policies, by country officials who have the responsibility to formulate and carry out those policies, based on an understanding that the program is achievable and is in the country's best interest. Conditionality, if well designed and established through a mutually acceptable collaborative process, can promote and strengthen ownership, in particular by demonstrating the authorities' commitment to a course of action. Judgments on the depth and breadth of national ownership of a proposed Fund-supported program are inherently subjective and difficult, and ownership itself is likely to change and develop over time. Nonetheless, ownership—along with the member's administrative capacity to implement reforms—is a key determinant of success, and the guidelines aim to promote ownership by ensuring that conditionality is well designed and is formulated through a mutually acceptable process led by the member. The guidelines also note that the need for ownership implies selectivity: approval of the use of Fund resources depends in particular on the Fund's assessment that the member is sufficiently committed to successful implementation.

Promotion of ownership depends in part on effective and inclusive processes of program development in which the authorities and the staff are both fully engaged. Therefore, in responding to a member's request for access to Fund resources, it is expected that the initial response by the staff will be to ascertain, through dialogue, how the authorities intend to adjust policies. Based on those intentions, the staff will endeavor to reach understandings with the authorities on a mutually acceptable means of achieving the program goals, while paying due regard to the domestic social and political objectives, the economic priorities, and the circumstances of the member, including the causes of the balance of payments problem and the member's capacity to implement reforms in the necessary time frame. Particularly in cases where the member's administrative capacity is weak, the staff will stand ready to advise the authorities on a range of available policy options and implementation plans, and to provide technical assistance as appropriate, so as to enable them to make informed choices.

It is also expected that program documents, including Letters of Intent, will be prepared by the authorities, with the cooperation and assistance of the fund staff, and will reflect the authorities' policy goals and strategies. Programs supported by the Poverty Reduction and Growth Facility (PRGF) will normally be based on a Poverty Reduction Strategy Paper (PRSP) resulting from a broad consultative process within the country.

Parsimony means that program-related conditions should be limited to the minimum necessary to achieve the goals of the Fund-supported program or to monitor its implementation and that the choice of conditions should be clearly focused on those goals. As stated in the conditionality guidelines, the macroeconomic goals of Fund-supported programs are to solve the member's balance of payments problem without recourse to measures destructive of national or international prosperity; and to achieve medium-term external viability while fostering sustainable economic growth. In this context, sustainable growth means growth that is strong, durable, and equitable, with reasonable price stability. Particularly for PRGF-supported

programs, the growth objective is linked to the pursuit of higher living standards and a reduction of poverty.

Conditions that are not of critical importance for achieving the macroeconomic goals of the program or for monitoring its implementation, or that are not necessary for safeguarding the Fund's resources or for the implementation of other specific provisions of the Articles of Agreement or policies adopted under them, are to be avoided. A judgment that a condition is of critical importance for achieving the macroeconomic goals means that if it were not implemented, it is expected that the goals will not be achieved. Conditions may also be applied in particular to the provision of accurate information, the adequacy of internal controls and procedures in a member's central bank, and other requirements for the safeguarding of Fund resources. Conditions to implement specific provisions of the Articles will include the avoidance of exchange measures subject to Fund jurisdiction and of import restrictions for balance of payments reasons.

The principle of parsimony in application pertains to all program-related conditions including the establishment of variables and measures as indicative targets or structural benchmarks. Decisions on whether to recommend waivers will be based on the criteria specified in the guidelines with the aim of avoiding excessive reliance on their use.

Tailoring of programs implies a recognition that the causes of balance of payments difficulties and the emphasis to be given to various program goals may differ among members. In addition, economic policy understandings should be consistent with the member's capacity to implement policies. Because conditionality must be aimed appropriately at the achievement of the program goals set out in the guidelines, most Fund-supported programs will include certain common elements. Moreover, Fund policies must be applied consistently so as to maintain the uniform treatment of members. Nonetheless, the specification and timing of policy adjustments and the appropriate mix of financing and adjustment will reflect the member's circumstances and the provisions of the facility under which the Fund's financing is being provided. For example, in some cases the overriding goal of Fund-supported programs has been to restore market confidence, ensure orderly external adjustment, address the weaknesses that had made these countries vulnerable to capital account shocks, and create the conditions for a resumption of growth. In 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. More generally, it is expected that arrangements supporting longer-term programs will have more extensive structural conditionality than shorter-term arrangements, because structural reforms are more likely to be critical for the achievement of longer-term goals.

The guidelines note that program-related conditions may contemplate the member meeting particular targets or objectives (outcomes-based conditionality), or taking or refraining from taking particular actions (actions-based conditionality). Outcomes-based conditionality may be beneficial where additional flexibility in policy implementation is desired and may be achieved without unduly weakening the member's assurances of Fund financing. In such cases, conditions will apply to performance objectives that are reasonably within the authorities' direct or indirect control and can be evaluated and verified within the required time frame.

Coordination with other multilateral institutions is often necessary in order for the Fund to provide consistent and effective assistance to members. Accordingly, the Fund's policy advice, work on program design, and conditionality should strive to be consistent with that of other institutions and, whenever possible, should be integrated within a coherent country-led framework. Responsibility and accountability for all conditions attached to the use of Fund resources reside with the Fund.

The primary relationship in this context is between the IMF and the World Bank and is based on a coordination framework that has been agreed between the two institutions.[11] A central element of that framework is the concept of "lead agency." When conditions in Fund-supported programs apply to measures that are not clearly within the Fund's core areas of responsibility as set out in the guidelines, the design and monitoring of those conditions will, to the fullest extent possible, be based on the advice of the World Bank. Each institution should communicate its work and its views systematically to the other institution, in Board documents and meetings, on the substantive areas and conditionality with respect to which it is in the lead. When appropriate, the staff may also draw upon the work and advice of other multilateral institutions. The application of lead agency should be flexible enough to accommodate the substantial areas of overlapping responsibility between the Fund and the Bank as well as differences in country circumstances. These overlapping areas include elements of financial sector work, some elements of public sector reforms, and issues of transparency, governance, corruption and legislative reform, trade policy, and debt management.

Clarity means that program-related conditions should be transparently distinguished from other elements of the authorities' program both in staff reports and in the member's program documents. In particular, although program documents, if the authorities so wish, may set out the authorities' broad policy agenda for national or international audiences, such documents as well as staff reports should clearly specify the parts of the agenda that constitute understandings on which continued access to Fund resources depends.

The guidelines on conditionality are supplemented by separate Board decisions and related documents, such as the guidelines on performance criteria with respect to external debt in Fund arrangements, guidance on the role of the Fund in governance issues, the decision on side letters and the use of Fund resources, and operational guidelines on the relationship between performance criteria and the phasing of purchases under Fund arrangements. In case of conflicts between this explanatory staff statement and the guidelines or other related Board decisions, the language in the relevant decision takes precedence.

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[11] See "Strengthening IMF World Bank Collaboration on Country Programs and Conditionality" (SM/01/219, Suppl. 1, Rev. 1, August 23, 2001), at http://www.imf.org/external/np/pdr/cond/2001/eng/collab/coll.htm; and "Guidance Note on Fund-Bank Collaboration" (FO/Dis/02/176).

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