

OPERATIONAL GUIDANCE TO IMF STAFF ON THE 2002 CONDITIONALITY GUIDELINES

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1. The 2000-02 comprehensive review of the Fund's conditionality culminated in the adoption of a new set of conditionality guidelines by the Executive Board on September 25, 2002 (SM/02/276, Revision I). The 2002 Conditionality Guidelines replace the 1979 Conditionality Guidelines and the Interim Guidance Note on Streamlining Structural Conditionality of September 18, 2000. A review of experience with the guidelines, looking at how they have been implemented and at their impact, is conducted periodically.
2. As discussed in the staff statement attached to the new guidelines, the key principles that should guide the Fund in designing and setting conditionality are: (i) national ownership of reform programs, (ii) parsimony in program-related conditions; (iii) tailoring of programs to a member's circumstances; (iv) effective coordination with other multilateral institutions; and (v) clarity in the specification of conditions.
3. This note elaborates on the operational implications of these principles and the 2002 conditionality guidelines. It is not intended as a comprehensive stand-alone guidance note, but rather as an aid to the implementation of the new guidelines. The operational issues covered in the note are grouped into three areas: (i) the process of negotiation and program design; (ii) the design of conditionality; and (iii) the presentation of conditionality in Board papers for the use of Fund resources. In some cases, implementing the guidelines involves the development of new practices. In other cases, new practices had already been adopted in selected cases, which should become routine.

I. Negotiation and Program Design Process

4. The guidelines indicate that: (i) authorities have the lead role in designing their programs; (ii) the Fund should encourage members to build broad support for sound policies; and (iii) Fund-supported programs and conditionality should be coordinated with other international institutions in countries where those institutions are also involved.
5. ***The guidelines establish the principle that the primary responsibility for the design of the program lies with a member's authorities.*** The intent is to promote ownership by ensuring an active dialogue at all stages in the process of developing, implementing, and monitoring a Fund-supported program. This approach is intended to foster greater flexibility in program design, and hence greater ownership, without weakening conditionality or the quality of Fund-supported programs, for which the Fund retains responsibility. There is no requirement that country authorities actually draft the LOI and MEFP, but staff should be responsive to the authorities' desired role in the drafting of these documents. As with some other aspects of these guidelines, this may require allowing more time for program formulation. The guidelines implicitly recognize that experience in this regard will vary, and that the authorities might have limited capacity or inclination to draft program documents.

Drafting technical memoranda will continue to require a high degree of collaboration between staff and country authorities.

6. ***Staff should seek proposals from country authorities at an early stage in the policy dialogue, be flexible in program design when possible to meet the authorities' preferences, and actively develop policy options where possible.*** Briefs for negotiating missions should outline the authorities' initial proposals to the extent possible and the proposed staff response, including any options the staff will invite the authorities to consider. These proposals could reflect exchanges during previous Article IV consultations, staff visits, or bilateral meetings, such as those during the annual meetings. When the staff is not in a position to report any views, that should be made clear in the brief. The guidelines emphasize the importance of flexibility in order to allow considerations of ownership, implementation capacity, and member's circumstances to influence program design. When time pressures on negotiations are high, the ability to provide for such flexibility will necessarily be constrained.

7. ***Staff should encourage and assist members in broadening support for sound policies.*** Participatory processes are a requirement in PRGF-supported programs and have been adopted in many other program countries. Staff should encourage the authorities to engage in a transparent participatory process in developing a policy framework, and should continue to be prepared to assist the authorities in this process including by giving seminars, meeting with various interest or political groups (parliamentary committees, trade unions, business groups, etc.) and by being available to the media. In doing so, staff should be aware of the authorities' views on staff contact with domestic groups and, if necessary, seek their prior agreement. Resident representatives could be particularly useful in providing this assistance. Broadening political support for policies may require allowing greater time for program formulation.

8. ***Explicit assessments of potential implementation difficulties should be included in briefing papers.*** Assessments should reflect specific challenges to broader ownership in a country as well as other country-specific issues such as constitutional and political structures. Such assessments take on particular importance when implementation of key measures hinges on legislative approval or on actions by lower levels of government (e.g. fiscal adjustment by sub-national governments or reforms in state-owned enterprises with significant autonomy), rather than on executive actions alone. In some instances, where implementation requires cooperation by several ministries, the positions of these ministries are relevant to the assessments. To help ascertain prospects for successful implementation, the approval of specific measures by the entity responsible for the decision (e.g., the cabinet, the Parliament, sub-national governmental bodies) may be specified as prior actions. In some cases, where there are doubts as to whether a particular critical measure would be implemented after approval, it should be made a prior action (see also paragraph 14).

9. ***Briefs should include an assessment of technical capacity, including capacity building in the program.*** Briefing papers and staff reports should explicitly identify key

capacity weaknesses, explain how those weaknesses may affect the ultimate design of the program, and highlight the measures under the program to build capacity in those areas.

10. ***Collaboration with other multilateral institutions.*** The staff should consult with the staffs of other multilateral institutions involved in the country early on in the program design process. Briefing papers should clearly spell out the separate programs agreed with the relevant multilaterals, how these programs address the authorities' broad goals, and provide details of coordination in the areas of overlap, including a clear delineation of analytical responsibilities (in line with the lead agency principle). Continued close communication will be essential to adapt coordination as the Fund-supported program is being implemented (see also paragraph 24).

II. Designing Conditionality

11. ***Program-related conditions generally must be critical to the achievement of program goals, to monitoring implementation, or necessary to the implementation of specific provisions under the Articles of Agreement.*** The 2002 Guidelines replace the somewhat weaker standard of *macro-relevance* in the earlier Interim Guidance Note on Streamlining Structural Conditionality (September 2000). A judgment that a condition is of critical importance for achieving the program goals means that if it were not implemented, it is expected that the goals would not be achieved. Abstracting from conditions necessary for implementation of provisions under the Articles, all program-related conditions, whether inside or outside the Fund's core areas, must now be judged to be of critical importance (and, conversely, all critical program measures must have conditionality associated with them, because the Fund needs to be able to interrupt purchases or disbursements if the program is off track). The criticality criterion applies to all measures—whether they are in the Fund's core areas or outside, or whether they are or are not covered by another agency's (e.g., the World Bank's) conditionality. Recognizing that conditions that are critical to the success of Fund-supported programs are more likely to be in the Fund's core areas than outside, the guidelines state that conditions outside these areas may require more detailed explanation of their critical importance. Determining which measures are critical inherently involves an element of judgment in the context of the overall macroeconomic framework of the program.

12. ***Level of detail of conditions.*** Conditions should be formulated in ways that provide the authorities with clarity as to the measures on which continued access to Fund resources depends. Conditions formulated at a high level of detail may provide helpful guideposts to the authorities, but run the risk of being seen as unwelcome micromanagement. These considerations must be balanced on a case-by-case basis.

13. ***Use of structural performance criteria and benchmarks.*** There is no contradiction between the guidelines' requirement that all conditions be critical and their statement that structural benchmarks may be used where non-implementation would not, by itself, warrant an interruption of purchases or disbursements under an arrangement. Both structural performance criteria (SPCs) and structural benchmarks (SBs) are monitoring tools for critical reforms. SPCs are to be chosen when a measure is objectively monitorable and so critical, by

itself, for the achievement of program goals or for program monitoring that non-implementation warrants an interruption of purchases or disbursements under the arrangement. SBs are appropriate when the measure cannot be specified in terms that are objectively monitorable (i.e., judgment must be exercised in deciding whether the measure has been implemented), or where non-implementation would not, by itself, warrant an interruption of purchases or disbursements. In the latter case, SBs represent key components of a broader reform measure that is judged to be critical (e.g. steps in a tax reform or privatization program), but where non-implementation of a single component would not be judged sufficient to derail the entire reform. Like other conditions, SBs should be used as parsimoniously as possible.

14. ***Use of prior actions.*** A critical measure may be specified as a prior action to be completed before the scheduled date of a Board discussion to approve an arrangement, complete a review, or grant a waiver, when it needs to be implemented immediately in order to achieve program goals, or when there are significant doubts that the measure would be implemented at a later date. Conditions set for the completion of future reviews are not prior actions and should not be referred to as such; rather, they are either performance criteria or benchmarks. As with other forms of conditionality, prior actions are to be applied parsimoniously and must be justified in terms of their criticality to program objectives. In assessing the use of prior actions for approval of an arrangement, staff should be guided by the experience that programs with many prior actions often show worse-than-average implementation of other subsequent measures under the program. Prior actions are often used prominently in cases of countries with weak track records of implementation, and can still play a useful role by ensuring that conditions are met and that programs meet a minimum implementation standard. However, staff needs to be mindful of the possibility that prior actions may be implemented without genuine ownership of the program, and that implementation may be nominal or temporary as a result. Evidence exists that successful implementation of staff-monitored programs provides a useful screening device, because the implementation rate of subsequent Fund-supported programs has been found to be comparable to the average implementation rate.

15. ***Waivers of performance criteria.*** A waiver may be granted for nonobservance of a performance criterion if the Fund is satisfied that the program will nevertheless be successfully implemented—i.e., that it will achieve its goals—either because of the minor or temporary nature of the nonobservance or because of corrective actions taken by the authorities (which may include the delayed implementation of the measure at issue, e.g. as a prior action for the granting of the waiver). While the language on waivers in the guidelines does not explicitly allow for cases where the Fund considers that a measure is no longer critical (whether because circumstances have changed or because it judges that it previously erred), these could be cases where the Fund remains satisfied that the program will be successfully implemented, and the deviation in such cases would be considered “minor” in terms of its impact on program goals.

16. ***The scope of reviews should be clearly specified.*** Reviews will continue to have backward- and forward-looking components. The policy areas on which the backward-

looking component of the review is to focus should be specified, to the extent possible, in the form of performance criteria, indicative targets and structural benchmarks. Reviews are also forward-looking, providing the opportunity to assess prospects for achievement of program objectives in light of a range of available information. This may entail modifying program objectives as new information becomes available; for example, if additional adjustment is needed owing to changes in economic conditions. To limit the possibility that reviews will be used to add conditionality unless clearly justified by changes in circumstances, the original program documents should give at least a broad sense of the uncertainties that could require additional or modified conditionality during reviews. Adding new conditionality during a review in areas previously without any conditionality would require a clear justification as to why the related measures had become critical to program objectives.

17. ***Outcomes-based conditionality.*** The guidelines explicitly allow for performance criteria to be set on targets and objectives as well as on actions. While outcomes-based conditionality is not expected to be widely applicable, staff should be receptive to appropriate circumstances in which its use would provide greater flexibility in designing programs and in adapting them to subsequent developments. However, outcomes chosen as conditions must still be reasonably under the control of the authorities, so that exogenous shocks do not force undue use of waivers and thereby lessen assurances to the member of the availability of Fund resources under the arrangement. Moreover, outcomes-based conditionality should be designed to minimize the risk of situations in which targeted outcomes are achieved by means of policies that would undermine the achievement of program goals, such as reaching a higher revenue target by increasing tariffs. Even when conditions cannot be applied to outcomes, there may be scope for formulating conditions in such a manner that they may be met by implementing various measures.

18. ***Implementation timetables should be realistic but still appropriately ambitious.*** While the authorities should be free to set demanding timetables where they consider them helpful in driving their agenda forward, the staff should not press for overly ambitious timetables. Staff often face serious constraints in forming an accurate judgment on implementation capacity and political priorities. Overly demanding timetables have also been a major reason for frequent requests for waivers.

19. ***Floating tranches.*** The use of floating tranches is also explicitly allowed for in the Guidelines as another possible device available to staff in the design of conditionality. The availability of a floating tranche is contingent on implementation of a specific measure or measures, which has no fixed date attached, while the other purchases or disbursements are, as is normally the case, governed by conditions tied to test dates. Floating tranches may enhance ownership by giving authorities greater flexibility in choosing the timetable on which reforms, particularly structural reforms, are implemented, especially where there is some unavoidable uncertainty about the timing of the measure or where an upfront commitment on specific timing is for some reason not desirable. The internal logic of floating tranches suggests that the measures to which they are attached should satisfy two criteria: first, they must strengthen the external position over the medium term, so as to warrant the release of additional Fund resources; but they must also increase the balance of

payments need in the short term—otherwise, the program would be either underfinanced without the relevant measure, or overfinanced with it. Examples of measures that could satisfy these criteria include trade liberalization and debt restructuring needs. Structural reforms that might be appropriate for floating tranche conditionality are not expected to occur in very many cases, but it is therefore all the more important that the option of using them be considered when the above criteria are met.

III. Presentation in Board papers

20. ***Discussion of program design issues in UFR Board papers*** should provide a clear explanation of the choice of conditionality, in particular the judgments of criticality supporting the inclusion (or exclusion) of particular structural measures. Since the judgment of criticality depends upon program goals and the strategies adopted to achieve them, these should be set out as clearly as possible. The staff report should avoid conflating the objectives of the Fund-supported program with the authorities' broader goals, and should clearly identify and explain the strategies, or broad areas of policy action, embodied in the program. The linkage between structural conditions and program objectives should be drawn as clearly as possible. It is often helpful to set out rationales for specific conditions in a separate box, which can also usefully include the status of structural conditionality from earlier arrangements and the areas of reform covered by World Bank operations. Where possible, staff reports should also convey the discussion between staff and authorities on policy options.

21. ***More detailed explanations are needed for conditions outside Fund core areas.*** Conditions may be established on measures outside the Fund's core areas of expertise, but conditions outside core areas are likely to require more detailed explanations of their criticality. This reflects the general presumption that non-core conditions are less likely to pass the test of critical importance.

22. ***Staff assessment of potential implementation difficulties should be discussed.*** A more candid discussion on concerns about ownership will be expected in staff reports as well as briefs (paragraph 8). It will be important to acknowledge concerns about ownership which would increase risks to program implementation from the outset to enable the Board to make more informed judgments. In these cases, staff will need to convey the rationale for going ahead, including on the basis of the implementation of key measures necessary to improve prospects for the success of the program. Care will have to be taken to ensure that a discussion of ownership does not undermine confidence in the program.

23. ***Program conditions should be clearly identified and distinguished from other measures in program documents and staff reports.*** Tables for quantitative performance criteria and indicative targets are already required and are a standard part of Fund practice. All structural conditionality is also routinely identified in all UFR staff reports. An effective means of doing so is to include tables listing all quantitative and structural performance criteria, indicative targets, prior actions and structural benchmarks. If the authorities wish to list measures that are not conditionality, these should be listed separately and identified as

part of the authorities' reform agenda. The status of all past performance criteria, indicative targets, prior actions, and structural benchmarks should also be reported, and discussed in more detail for unmet or delayed conditions. This can also be done in tabular form. Staff reports should include clear justifications for waivers of performance criteria.

24. **Bank – Fund collaboration.** A discussion of collaboration with other multilaterals, in particular the World Bank, has also become a requirement of UFR staff reports where applicable. While much of this information should be contained in the World Bank Relations Annex, particularly relevant information should be brought into the main staff report. Staff reports should also discuss how the Bank- and Fund-supported programs have been coordinated – for example, where the Fund macro framework has been modified to accommodate Bank-supported reform programs, where reforms under a Bank-supported program have been chosen and sequenced to contribute to Fund-supported program goals, etc. Monitoring responsibilities of the multilateral institutions should be clearly delineated, while bearing in mind that the Fund bears the ultimate responsibility for establishing and monitoring its conditionality. (See memo by Mr. Geithner on Guidance to Staff on Implementing the Bank-Fund Collaboration Framework, May 13, 2002 for a more detailed discussion).