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REVISED OPERATIONAL GUIDANCE TO IMF STAFF ON THE 2002 CONDITIONALITY GUIDELINES

IMF staff regularly produces papers proposing new IMF policies, exploring options for reform, or reviewing existing IMF policies and operations. The Staff Report on Revised Operational Guidance to IMF Staff on the 2002 Conditionality Guidelines, prepared by IMF staff and completed on July 23, 2014, has been released.

The staff report was issued to the Executive Board for information.

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REVISED OPERATIONAL GUIDANCE TO IMF STAFF ON THE 2002 CONDITIONALITY GUIDELINES

July 23, 2014

EXECUTIVE SUMMARY

This note aims to provide broad guidance on the operational implications of the 2002 Conditionality Guidelines and the key principles underlying the design of conditionality in Fund-supported programs. These five inter-related principles are national ownership of programs, parsimony in program-related conditions, tailoring of programs to country circumstances, effective coordination with other multilateral institutions, and clarity in the specification of conditions. The operational issues covered are grouped into three areas: program discussions with the authorities and program design, the design of conditionality, and the presentation of conditionality in Board papers.

The note is not intended as a comprehensive guide, but rather as an aid to the implementation of the guidelines and the underlying principles. It should be used in conjunction with other relevant operational guidance notes, such as those on jobs and growth issues and debt sustainability analysis. It will continue to be revised on a periodic basis, especially following regular reviews of the conditionality guidelines.

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ACRONYMS

ECF	Extended Credit Facility
FCL	Flexible Credit Line
GRA	General Resource Account
ICCs	Inflation Consultation Clauses
LOI	Letter of Intent
MEFP	Memorandum of Economic and Financial Policy
MPCCs	Monetary Policy Consultation Clauses
NDA	Net Domestic Asset
NIR	Net International Reserve
PC	Performance Criteria
PNs	Policy Notes
PRGF	Poverty Reduction Growth Facility
PRGT	Poverty Reduction and Growth Trust
PRSPs	Poverty Reduction Strategy Papers
PSI	Policy Support Instrument
RFAs	Regional Financing Arrangements
TMU	Technical Memorandum of Understanding
VAT	Value Added Tax

INTRODUCTION

1. The 2000-02 comprehensive review of the Fund's conditionality culminated in the adoption of a set of conditionality guidelines by the Executive Board on September 25, 2002 (<http://www.imf.org/External/np/pdr/cond/2002/eng/guid/092302.htm>).¹ The 2002 Conditionality Guidelines (the "guidelines") replaced 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
2. As discussed in the staff statement attached to the 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. Within these principles, if feasible and appropriate, any adverse effects of program measures on the most vulnerable should be mitigated. Further, the guidelines require that program-related conditions will generally be established only on variables and measures that are critical to achieve the program goals, critical for monitoring program implementation, or necessary for implementing specific provisions under the Articles of Agreement.
3. This note elaborates the operational implications of these principles and the guidelines.³ It is not intended as a comprehensive stand-alone guidance note, but rather as an aid to the implementation of the guidelines. The operational issues covered are grouped into three areas: (i) the process of program discussions with the authorities and program design; (ii) the design of conditionality; and (iii) the presentation of conditionality in Board papers for the use of Fund resources.
4. Since the guidance note was first issued in 2003, it has been revised on four occasions. A revision undertaken following the 2005 review of the guidelines underlined the importance of ownership in the success of Fund-supported programs, and provided enhanced guidance on the

¹ The guidelines apply to arrangements under the GRA and the Poverty Reduction and Growth Trust (PRGT). They also apply to the Policy Support Instrument (PSI), except where the decision establishing the PSI sets forth a different framework.

² The last review was discussed by the Executive Board (<http://www.imf.org/external/np/sec/pn/2012/pn12109.htm>) in September 2012.

³ This note should be used in conjunction with other relevant operational guidance notes such as those on jobs and growth issues in *Guidance Note on Jobs and Growth Issues in Surveillance and Program Work* (<http://www.imf.org/external/np/pp/eng/2013/092713a.pdf>) and on debt sustainability in *Staff Guidance Note for Public Debt Sustainability Analysis in Market-Access Countries* (<http://www.imf.org/external/np/pp/eng/2013/050913.pdf>) and *Staff Guidance Note on the Application of the Joint Bank-Fund Debt Sustainability Framework for Low-Income Countries* (<http://www.imf.org/external/np/pp/eng/2013/050913.pdf>). Separate operational guidance on the FCL is provided in *Flexible Credit Line—Operational Guidance Note* (<http://www.imf.org/external/np/pp/eng/2012/053112.pdf>).

design of conditionality. The 2008 revision implemented the Board's recommendation to strengthen efforts to achieve parsimony by emphasizing criticality as well as requiring rigorous justification of conditionality. The 2010 revision reflected the reform of the Fund's conditionality framework in March 2009 to discontinue performance criteria for structural measures in all Fund arrangements effective on May 1, 2009, including those under facilities designed for low-income countries, and to place greater reliance on a review-based approach to monitor structural reforms in Fund-supported programs.⁴ Finally, in line with recommendations of the Review of Conditionality that was discussed by the Executive Board in September 2012, the 2014 revision primarily focuses on incorporating guidance on conditionality in relation to macro-social (also called jobs and growth) issues, better leveraging surveillance and technical assistance in program design, and improving partnerships with other institutions, particularly regional financing arrangements (RFAs). In addition, the revision adds guidance on the review-based approach to monetary policy conditionality in countries with inflation-targeting frameworks or evolving monetary policy regimes, consistent with Fund policy papers on those topics.⁵

PROGRAM DISCUSSION AND DESIGN PROCESS

5. 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.

6. ***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. In this context, it is the responsibility of the

⁴ Revised Staff Statement on Principles Underlying the Guidelines on Conditionality, and Operational Guidance Note on the 2002 Conditionality Guidelines (<http://www.imf.org/External/np/pdr/cond/2002/eng/guid/092302.htm>); An Independent Evaluation Office Evaluation of Structural Conditionality in IMF-Supported Programs (<http://www.ieo-imf.org/ieo/pages/CompletedEvaluation111.aspx>); The Chairman's Summing Up—IEO Evaluation of Structural Conditionality in IMF-Supported Programs (http://www.ieo-imf.org/ieo/files/completedevaluations/01032008SC_summing_up.pdf) and Implementation Plan in Response to Board-Endorsed Recommendations Arising from the IEO Evaluation of Structural Conditionality in IMF-Supported Programs (<http://www.imf.org/external/np/pp/eng/2008/040808.pdf>); Conditionality in Fund-Supported Programs – Purposes, Modalities, and Options for Reform (<http://www.imf.org/external/np/pp/eng/2009/012909.pdf>); GRA Lending Toolkit and Conditionality – Reform Proposals (<http://www.imf.org/external/np/pp/eng/2009/031309a.pdf> and <http://www.imf.org/external/np/pp/eng/2009/031909.pdf>).

⁵ See 2011 Review of Conditionality—Overview Paper (<http://www.imf.org/external/np/pp/eng/2012/061912a.pdf>); Jobs and Growth—Analytical and Operational Considerations for the Fund (<http://www.imf.org/external/np/pp/eng/2013/031413.pdf>); Stocktaking the Fund's Engagement with Regional Financing Arrangements (<http://www.imf.org/external/np/pp/eng/2013/041113b.pdf>); and Conditionality in Evolving Monetary Policy Regimes (<http://www.imf.org/external/np/pp/eng/2014/030514b.pdf>).

country authorities to draft the Letter of Intent (LOI), Memorandum of Economic and Financial Policy (MEFP), and Technical Memorandum of Understanding (TMU). Staff should assist and cooperate with the authorities on such drafting. As with other aspects of the 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.

7. *In helping the authorities to design a Fund-supported program, staff should (i) seek the views of country authorities early and make every effort to accommodate their preferences and policy choices—including on growth, labor market and distributional targets—where possible, subject to consistency with resolving balance-of-payments problems, macroeconomic stability, and all other program goals—and (ii) follow program preparation and review processes that can facilitate reflection on the links between program goals, strategies, and conditionality.* In particular:

- To develop the program goals of the Fund arrangement, staff could build on issues identified in previous discussions with the authorities, including Article IV consultations, technical assistance missions, staff visits, ex-post assessments, reports under the Financial Sector Assessment Program, and bilateral meetings. These goals are understood to represent a subset of the authorities' broader goals, or intermediate steps toward a longer-term goal, and should be identified as specifically as possible. It is expected that goals that extend beyond the program period would be addressed in the context of a potential successor arrangement or in some other dialogue with the authorities, such as in the context of surveillance.
- In this context, increased contingency planning by Fund staff for countries at risk can boost the value of surveillance for later program design. This planning can lay the analytical groundwork in advance when time is less constrained than during the design of a crisis program. Such planning would need to be conducted under strict confidentiality.
- Separately, outreach with regional or other institutions not used to working with the Fund can pave the way for later cooperation during Fund-supported programs. Standing dialogues with these bodies can help build mutual understanding prior to coordination in a program context where time and resources are typically constrained. Staff could identify the potential for such efforts during surveillance and build the knowledge and contacts necessary for their success should they become needed at a later stage.
- Reform strategies to be pursued should be identified early on, including any specific structural measures that are critical to the achievement of program goals. Staff should consider the appropriate timing and sequencing of reforms drawing on, e.g., analytical work on program design, reform effectiveness, and reform complementarities, calibrated to take account of the country's position in the business cycle. Modifications to the program design, including on reform strategies and related conditionality, may be required as new information becomes available during program discussions and the authorities' views are firmed up in the context of

program preparation and reviews. Indeed, the guidelines emphasize the importance of flexibility to allow considerations of ownership, implementation capacity, and members' circumstances. When time pressures on program discussions are high, the ability to provide for such flexibility will necessarily be constrained.

- The preparation process for program approval or review should be used to help ensure that the conditionality is parsimonious and well matched to tightly specified program goals, with due regard to the likely program effects on growth, employment and—at least where relevant for growth and stability—income distribution.⁶ In this process (including in Policy Consultation Meetings), staff should sketch out the reform strategy that is viewed as critical to achieve the goals supported by the Fund arrangement and, to the extent possible, anticipated structural conditionality should be indicated. This applies to all reform measures, whether within or outside the Fund's core areas of responsibility. Setting conditionality on non-core critical measures, however, requires a strong justification and a more detailed explanation of their criticality, and the Fund is expected to draw on the expertise of other institutions to the extent possible for those measures (see also paragraphs 13 and 14).
- In addition, risk analysis for programs can be enhanced, including through in-depth examination of debt sustainability assessments. This would be particularly important in market-access countries that have or are seeking exceptional access to Fund resources or other high scrutiny market-access countries.⁷
- In PRGT-supported programs, program requests should be explicit on how they advance the country's own poverty reduction and growth objectives, cross-referencing any existing poverty reduction strategy where relevant. Where feasible and appropriate, policy measures to mitigate adverse impacts on the most vulnerable should be included in program design.
- Policy Notes (PNs) for program discussion missions should, when possible, outline the authorities' views and initial proposals and the proposed staff response, including the options staff will invite the authorities to consider and the rationale for criticality of proposed conditionality. When the staff is not in a position to report the authorities' views, this should be made clear in the PN. The purpose of the above program preparation process is to define as early as possible the contours of the program, including in terms of the links between program goals, reform strategies, and supporting conditionality. As noted above, flexibility in modifying the program design during program preparation or review discussions will remain essential.

⁶ Program conditionality may also assist a member in pursuing its own objectives related to inclusive growth, as long as those objectives are consistent with macroeconomic stability and all other program goals.

⁷ See, in particular, *Staff Guidance Note for Public Debt Sustainability Analysis in Market-Access Countries* (<http://www.imf.org/external/np/pp/eng/2013/050913.pdf>).

8. Staff should assist members in broadening support for sound policies. Participatory processes involving a broad range of stakeholders are a requirement in the formulation of Poverty Reduction Strategy Papers (PRSPs), which are required to be submitted to the Executive Board in ECF (and PSI)-supported programs.⁸ Beyond this requirement, all low-income country instruments are designed to support economic policies rooted in country-owned strategies that aim to support poverty reduction and economic growth, and poverty reduction strategies are generally expected to underpin policies in all countries that seek concessional Fund support. Accordingly, staff should support the authorities' efforts 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, providing training to country authorities, meeting with various interest or political groups (parliamentary committees, business groups, and civil society organizations) 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 more time for program formulation.

9. Explicit assessments of potential implementation difficulties should be included in PNs. 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 23).

10. PNs should include an assessment of technical capacity, including capacity building in the program. PNs 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.⁹ The papers could also elaborate on the needed focus of technical assistance and training, and the possible modalities.

11. Collaboration with other multilateral institutions. The staff should consult, as needed, with the staffs of other multilateral institutions involved in the country early on in the program design process, especially on critical areas outside the Fund's core areas of expertise. PNs should

⁸ The role of PRSPs in the design of PRGT-supported programs is to be re-examined in the coming months, triggered in part by recent changes in the modalities of World Bank engagement with its borrower member countries.

⁹ A member needs to have the capacity to implement a Fund-supported program; particularly, program conditionality may not be established in areas in which the member still needs to build implementation capacity.

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 32 for a discussion on Bank-Fund and other collaboration).

12. Collaboration with RFAs.¹⁰ In general, when a Fund member is also a member of an RFA maintaining a dialogue with the RFA on economic developments in the member's economy and the region can help build mutual understanding on the challenges a member faces and appropriate policies to address them.¹¹ Where the member has a Fund-supported program and the RFA is also providing financing it would be useful for staff to understand the timing and phasing of RFA disbursements as these could be important parameters for the Fund-supported program. Where the RFA plans to set its own program with macroeconomic or structural conditionality, it would be important to reach mutual understandings on policy objectives and program design to remove or minimize any inconsistencies. The Fund should continue to make its own judgment on when and under what terms to provide its financing. Conditionality under the Fund-supported program should be guided by the conditionality principles (see paragraphs 15-16) and not aim to parallel RFA conditionality. Also the Fund cannot delegate the monitoring of conditionality to the RFAs. Finally, under the Fund's Articles of Agreement, the Fund can only provide its general resources to individual countries, and not to RFAs.

DESIGNING CONDITIONALITY

13. Program-related conditions generally must be either critical to the achievement of program goals, to monitoring implementation of the program, or necessary to the implementation of specific provisions under the Articles of Agreement or policies developed there under. The 2002 Guidelines replaced the somewhat weaker standard of macro-relevance in the earlier Interim Guidance Note on Streamlining Structural Conditionality (September 2000). Leaving aside conditions necessary for implementation of provisions under the Articles, a judgment that a condition is of critical importance means that if it was not implemented, it is expected that the goals would not be achieved or that program monitoring would not be possible. Conversely, all critical measures generally must have conditionality associated with them, because the Fund needs to be able to interrupt purchases or disbursements if the program is off track or if sufficient information is not being provided to adequately monitor program implementation. In judging that a condition is critical, staff affirms that, other things being equal, the expectation is that the condition

¹⁰ An RFA is broadly defined as a financing mechanism through which a group of countries in a region pledges financial support to members that are experiencing, or might experience, a liquidity shortage or balance-of-payments difficulties.

¹¹ Sharing of information or documents by Fund management or staff can only be done within the constraints of the applicable Fund policies and procedures. In particular, information or documents provided to Fund management or staff on a confidential basis may not be disclosed beyond management or staff without the consents of the provider of the information or documents. In addition, consistent with Article XII, Section 8, non-public views of the Fund (i.e., the Executive Board) regarding a member's economic policies may not be disclosed without the consent of that member.

should not be eliminated later. In particular, staff must avoid setting conditions on measures that may be desirable, but that are not critical for achieving the program goals or for monitoring implementation of those goals.

14. *The criticality criterion applies to all measures—whether they are in the Fund’s core areas of expertise 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 focus of conditionality should be primarily on core Fund competencies. For conditions outside these core areas, the guidelines require more detailed explanation of their criticality along with a strong justification. Moreover, for non-core but critical measures, the Fund will, to the extent possible, draw on the advice of other multilateral institutions, particularly the World Bank, or of bilateral donors that can provide the expertise. When the expertise in a critical area of reform is not available within the Fund, or other multilateral institutions and bilateral donors, the authorities would need to obtain the required expert input from others with the necessary expertise. In cases where the necessary expertise from these other sources is either unavailable or judged inadequate, approving a Fund-supported program would expose the Fund to reputational and financial risk. In such circumstances, the Fund would be faced with choosing between these risks or not supporting the authorities’ program.

15. *Staff should apply the principles of parsimony and criticality to all program-related conditions.* Staff should refrain from introducing conditionality that is requested by donors if it is not critical for program success or monitoring. To the extent that the addition of a donor-driven reform measure as a program-related condition is indispensable to ensuring program financing and thus program success, such measures should be clearly identified in the staff report and their criticality justified accordingly. As for conditions requested by the authorities, program ownership is clearly of utmost importance for program success. Nevertheless, reform measures that are not critical for achieving the program goals or for monitoring implementation but that the authorities wish to highlight could be addressed in the LOI/MEFP. In particular, a clear distinction should be drawn between conditionality upon which Fund financing is contingent and other elements of the authorities’ reform agenda noted in the LOI/MEFP. This is also important in the context of collaboration with RFAs and other institutions with differing mandates from the Fund’s. In addition, it is essential to keep in mind that countries often face additional conditions in the context of their relationships with these other institutions.

16. *Cross-conditionality, under which the use of the Fund’s resources would be directly subjected to the rules or decisions of other organizations, is prohibited under the Fund’s Guidelines on Conditionality.* The Fund cannot delegate its responsibility in assessing whether the conditions for the use of its resources have been met.¹² When Fund resources are committed to a

¹² For non-core areas, the Fund can, however, seek advice from other institutions, regarding the monitoring of conditions in the Fund-supported program.

Fund-supported program in collaboration with RFAs (or other institutions) and the Fund assesses that the conditions have not been met, it will not disburse, irrespective of the judgments reached by RFAs. Conversely, in cases where the Fund makes an assessment that the conditions have been met, but its judgment is not shared by other organizations, the Fund may not be in a position to allow use of its resources, however, if delays in disbursements by other institutions raise financing assurances issues; i.e., the program is not fully financed.

17. *Level of detail of conditions.* Conditions should be formulated in ways that provide the authorities with clarity as to the measures on which 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 micromanagement. These considerations must be balanced on a case-by-case basis.

18. *The scope of reviews.* Reviews 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 quantitative 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 and measures 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 (e.g., the existence of a new PRSP or economic developments that require a reassessment of priorities), the original program documents should give, to the extent possible, a broad sense of the uncertainties that could require additional or modified conditionality during reviews. Conditionality beyond the first year of a multi-year program will normally be set in the context of reviews. Conditions added during reviews should be anchored on the initiating program document and those added in new reform areas would require a clear justification as to why the related measures had become critical to achieving the program goals. Finally, while the last program review may not always be the most opportune time to assess the outcome of a Fund-supported program, staff could use such reviews for stocktaking and, where possible, provide a preliminary assessment of stated program goals and their achievement and of the experience with program implementation.

19. *Review-based approach to structural conditionality.*¹³ Since May 1, 2009, monitoring of performance on structural reforms under Fund-supported programs is conducted through reviews, with all structural conditions now to be always assessed in a program review and to take the form of

¹³ Under the review-based approach, the assessment of a program-related structural condition will be conducted through a review, which focuses on a range of factors relevant to program implementation. Unlike performance criteria, a failure to meet such a structural condition would not in itself result in the non-completion of a program review or trigger the need for a waiver. Instead, such failure would be an indicator that the program might not be on-track and completion of a program review would require a judgment by the Board that there are compensating factors. The review-based approach could also be applied to other forms of conditionality such as the inflation consultation clause or the monetary policy consultation clause (see below).

structural benchmarks or prior actions; structural performance criteria are no longer used. Reviews provide the primary tool for monitoring performance on the structural elements of all Fund arrangements. The discontinuation of structural performance criteria seeks to ensure that an excessively narrow or rigid focus on specific criteria is avoided. Under the review-based approach, all Fund-supported programs should include a specified agenda for critical structural reforms, if relevant.

20. Use of structural benchmarks under the review-based approach. Structural benchmarks should be critical for the achievement of program objectives, either by themselves or because they represent key components of a broader reform measure that is judged to be critical (e.g., steps in a tax reform or privatization program). A member's failure to meet a structural benchmark does not by itself automatically interrupt a purchase or a disbursement under an arrangement. Rather, deviations serve as indicators that the Fund-supported program may be off track. Completion of the review would then require a judgment by the Board that there are factors giving confidence that program objectives are being achieved. In case of substantial deviations from structural commitments and weak policy commitments to correct slippages, staff and management could decide not to propose completion of a review. Informal country matter sessions provide a forum to inform the Board about the status of discussions. Once new understandings are reached, the review could then be completed, allowing the member to make the associated purchase or disbursement.

21. Review-based approach to monetary policy conditionality.¹⁴ The "traditional" approach to monetary policy conditionality in Fund-supported programs has two standard quantitative performance criteria (PCs) derived from the monetary approach to the balance of payments. These PCs would typically be a floor on net international reserves (NIR) aimed at ensuring external sustainability, and a ceiling on net domestic assets (NDA) aimed at ensuring future sustainability by avoiding excessive credit expansion. These could be augmented through PCs or indicative targets, such as on reserve money. However, in some countries with evolving monetary policy regimes, as inflation falls to single digits and with financial innovation and deepening, non-observance of these monetary targets in Fund-supported programs has increased. But at the same time, no statistical correlation is observed in a low inflation context between reserve money target deviations and inflation deviations. This raises the question of whether reserve money targets are reliable indicators of the monetary policy stance, given financial innovation and shocks to money demand. Thus, a review-based approach to assess monetary policy is an option, especially as countries adopt more flexible and forward-looking monetary policy frameworks, which ascribe a greater role to policy interest rates and inflation targets or objectives.¹⁵

¹⁴ *Inflation Targeting: Implications for IMF Conditionality* (<http://www.imf.org/external/np/pp/eng/1999/121499.pdf>) and *Conditionality in Evolving Monetary Policy Regimes* (<http://www.imf.org/external/np/pp/eng/2014/030514b.pdf>).

¹⁵ NDA targets may still remain useful in addressing country-specific risks or circumstances in cases where a review-based approach might be appropriate.

22. **Implementation of the review-based approach to monetary policy conditionality.**¹⁶

- Inflation consultation clauses (ICCs).** Since 2000, a number of Fund-supported programs in inflation-targeting countries have applied a review-based approach to monetary policy conditionality through the use of ICCs. This approach has been applied and is appropriate only in cases where: (i) the central bank has a track record of commitment to low inflation; (ii) it has the technical capacity (and tested models) to forecast inflation over a 18-24 month horizon; (iii) clear empirical measures of inflation expectations, which are well anchored, are available; and (iv) the transmission mechanism from interest rates to prices is well understood. The approach includes: (i) a periodic (usually quarterly) review with emphasis on assessment of current inflation against forecast and implications for the inflation outlook; (ii) an *ex ante* understanding, when there are or are expected to be deviations from the targeted inflation path by a pre-specified margin, between Fund staff and the authorities on a timely remedial monetary policy response; (iii) a NIR floor to maintain external sustainability and safeguard the use of Fund resources, and (iv) a mechanism to deal with country-specific risks.¹⁷ Under the ICC, an inflation target (usually set by the authorities), as well as a tolerance band around a central inflation target, are set as a basis to guide monetary policy assessments during reviews. A consultation is triggered when inflation falls outside of the band. This would require (i) a consultation with the Fund's Executive Board if actual inflation (as defined in program documents) falls outside of an outer band; or (ii) an informal consultation with Fund staff if actual inflation falls outside an inner band.¹⁸ If the consultation with the Executive Board is triggered under the ICC, access to Fund resources would be interrupted until such consultation takes place.
- Monetary policy consultation clauses (MPCCs).** A review-based approach with an MPCC could be considered for countries with evolving monetary policy frameworks that have minimal fiscal dominance, relatively low and stable inflation, and a good track record of monetary policy implementation supported by central bank technical and institutional development (especially the capacity to analyze monetary conditions), or are committed to a substantial strengthening of the policy framework. Consideration of country-specific circumstances relative to this "standard" would be undertaken flexibly on a case-by-case basis, with learning from experience. Under the MPCC, monetary policy conditionality would include a quantified macroeconomic framework with a set of (quarterly or semiannual) monetary aggregate or inflation targets set normally within a single tolerance band, which would be assessed during the relevant program reviews. Deviations from the band would trigger a consultation with the Fund's Executive Board as part

¹⁶ The eventual adoption of a review-based monetary conditionality could also be supported by structural benchmarks in cases where the policy implementation track record has been lacking in some respects or where moderate gaps in the institutional set-up exist.

¹⁷ For example, this could be an allowance in setting the NIR floor for un-programmed intervention or the use of NDA ceilings where necessary. When NDA ceilings are maintained, the relationship between NDA and inflation targets need to be made clear in the staff report.

¹⁸ Some recent Fund-supported programs have only had a single band.

of the general review process, which would focus on (i) a broad-based assessment of the monetary policy stance and whether the Fund-supported program remains on track; (ii) the reasons for program deviations, taking into account compensating factors; and (iii) proposed remedial actions if deemed needed. When the consultation is triggered, access to Fund resources would be interrupted until it takes place and the relevant program review is completed. In addition, these programs would include a NIR floor, as a PC, to maintain external sustainability and safeguard the use of Fund resources. Indicative targets related to monetary policy (e.g., on NDA or net credit to government) could also be included to address country-specific risks, such as external stability or fiscal dominance concerns. If the MPCC regime selects inflation as the central target variable, a narrower inner band could be used as an early warning mechanism that would trigger an informal consultation with Fund staff.

23. 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 upfront implementation is critical to achieve program goals or monitor implementation, including when there are significant doubts that the measure would be implemented at a later date.¹⁹ Conditions set for the completion of future reviews are not prior actions and should not be referred to as such; rather, they are either quantitative performance criteria or structural 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. 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.

24. Waivers of quantitative performance criteria. A waiver may be granted for nonobservance of a quantitative 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. While the language on waivers in the guidelines does not explicitly refer to cases where the Fund considers that a performance criterion is no longer critical (whether because circumstances have changed or because it judges that it previously erred in the design of conditionality), 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.

¹⁹ With respect to the implementation of prior actions, the Executive Board has established a “normal practice that all prior actions must be carried out at least five working days before the Board discussion to which they relate.”

25. Outcomes-based conditionality. The guidelines explicitly note that program-related conditions may be set on targets and objectives as well as on actions. 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.²⁰ 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 an intermediate outcome-based target of higher revenue by increasing import 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.

26. 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 faces 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.

27. 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.

²⁰ Contingent adjusters to quantitative targets could also be used to address selective exogenous developments (such as a shortfall of projected external aid) to avoid undue use of waivers.

PRESENTATION IN BOARD PAPERS

28. *Discussion of program design issues in Board papers should provide a clear explanation of the choice of conditionality, in particular the judgments of criticality supporting the inclusion 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. At the time of approval of a new arrangement, the staff report should lay out the links between the program goals and reform strategies, and the corresponding structural conditionality. One option is for these links to be presented in a separate text table in the staff report.²¹ The program goals should be specified 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. Further, all future program modifications should be anchored in the originating program document and deviations from this document should be justified. Where possible, staff reports should convey the discussion between staff and authorities on policy options.
- All staff reports need to indicate as clearly as possible what is expected in the subsequent review(s) and specify critical future actions as structural benchmarks. This presentation is essential to ensure that the scope of the review is as predictable and transparent as possible, providing assurances to members regarding access to Fund resources.
- Staff reports for program reviews should provide an update related to the objectives of the structural reform agenda, as well as the strategies adopted to achieve them. The staff report should also assess if the structural elements of the program have been implemented successfully, i.e., that the program is on track for achieving the associated objectives.

29. *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 such conditions would require detailed explanations of their criticality along with strong justification. This reflects the general presumption that measures in non-core areas are less likely to pass the test. Further, staff reports should provide the necessary information as to which institution or donor provided expert advice. When the expertise in a critical reform area is not available within the Fund or other multilateral institutions and bilateral donors, and staff relies on the authorities to obtain the required expert input from other sources, the risks noted in paragraph 14 should be transparently reported in staff reports.

²¹ The Appendix provides an example of such a table, which is frequently used in staff reports; as is the case with other text tables, it would be excluded from word counts. Staff is encouraged to include new editions of the table when program reviews add conditionality.

30. Staff's assessment of potential implementation difficulties should be discussed.

A candid discussion on concerns about ownership will be expected in staff reports (as noted in paragraph 9 for PNs). 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 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 program success. Care will have to be taken to ensure that a discussion of ownership does not undermine confidence in the program.

31. 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 program staff reports. An effective means of doing so is to include tables in the LOI/MEFP listing all quantitative 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. These can be addressed in the text of the LOI/MEFP or in a text table attached to the LOI/MEFP, thus offering the authorities a venue for describing their broader goals, but should be clearly distinguished from conditionality on which Fund financing depends. 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.

32. Bank-Fund and other collaboration. A discussion of collaboration with other multilaterals, in particular the World Bank, has also become a requirement of program staff reports, where applicable. While much of this information related to the Bank should be contained in the annex on Bank-Fund collaboration, particularly relevant information on collaboration with other institutions, including RFAs, 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 or RFAs should be clearly delineated, while bearing in mind that the Fund bears the ultimate responsibility for establishing and monitoring its conditionality. (See the framework provided in the Joint Management Action Plan for strengthening Bank-Fund collaboration in areas of overlap.²²)

²² See <http://www.imf.org/external/np/sec/pr/2007/pr07235.htm>.

Appendix I: Criticality of Program Structural Conditionality—An Illustration^{1/ 2/}

Measures	Timing	Macroeconomic rationale (MEFP para)
I. PRIOR ACTIONS		
• Adoption of budget to limit fiscal deficit to 9.4 percent of GDP in 2009.	Implemented.	A first step toward fiscal and debt sustainability (¶118).
• Adoption of measures yield at least 1.0 percent of GDP to offset projected expenditure over-runs in the 2009 budget.	Implemented.	To preserve macroeconomic stability and avoid crowding out private sector credit (¶124).
• Selective public sector hiring freeze, with exemptions mainly limited to health and education trainees	Implemented.	To strengthen control of the high and growing public payroll (¶146).
• Reinstatement of automatic bi-weekly price adjustments for petroleum products.	Implemented	To eliminate energy subsidies (¶152).
II. STRUCTURAL BENCHMARKS		
<u>Tax policy and revenue administration</u>		
• Complete comprehensive reviews of zero-rated VAT items and the nature and scope of tax exemptions and discretionary waivers, as defined in paragraph 32.	End-Sep. 2009	Strengthen revenue mobilization as part of the fiscal consolidation strategy (¶132).
• Cabinet approval of a modernization strategy for revenue administration, as defined in paragraph 35.	End-Dec. 2009	Strengthen revenue mobilization as part of the fiscal consolidation strategy (¶135).
<u>Public expenditure management</u>		
• Review of the effectiveness of the existing budget information management system, and decision on whether it should be modernized or replaced.	End-Dec. 2009	Strengthen monitoring and control of budget execution (¶142).
<u>Public sector reform and payroll management</u>		
• Steps to strengthen oversight and control of public service recruitment and staffing, as defined in paragraphs 45-47.	End-Sep. 2009	To strengthen oversight and control of the high and growing public payroll (¶145-47).
• Establish institutional responsibility for the restructuring, commercialization, or liquidation of subvented agencies.	End-Dec. 2009	To promote fiscal savings by rationalizing subvented agency numbers (¶148).
<u>Monetary policy</u>		
• Adoption and launch of program to strengthen communication of framework for inflation targeting and disinflation over program period.	End-Dec. 2009	To support the disinflation program (¶158).

¹ This text table is an illustration based on the Ghana program under the PRGF arrangement approved on July 15, 2009 (Country Report No. 09/256) and its main purpose is to provide the rationale for criticality of each condition. Text tables using a similar format have been used in other programs; for example, Bosnia and Herzegovina (IMF Country Report No. 09/226).

² The text table covers backward-looking conditions for completion of the review as well as forward-looking elements of the review (i.e. conditions for future disbursements). If new conditions are introduced during program reviews, a new edition of this table with the new conditions would be added to the staff report to reflect the rationale for their criticality.