



INTERNATIONAL MONETARY FUND
WASHINGTON, D. C. 20431

MANAGING DIRECTOR

CABLE ADDRESS
INTERFUND

September 18, 2000

To: Heads of Departments and Offices

Dear Colleagues:

Streamlining Structural Conditionality

The appropriate scope and depth of structural conditionality in Fund programs has been raised consistently in my discussions with member country officials, and it has also figured prominently in the deliberations of the Executive Board retreat last July and of the Reform Task Force. I am personally convinced that there is substantial scope to streamline and focus our conditionality, both to reinforce country ownership of the programs which the IMF supports and as part of our overall efforts to focus the work of the Fund on its core areas of competence.

The design and application of conditionality is a complex subject. In the coming months the Executive Board will consider a number of papers reviewing our experience with structural conditionality in different types of programs, and on how to manage better the link between conditionality and country ownership in the design and implementation of programs. I look forward to these discussions which should serve to provide a clearer framework for applying a more streamlined and focused approach to conditionality in Fund programs.

However, I also see a need to begin immediately to gain experience with streamlining. This experience will provide some concrete illustrations of the issues we will face in moving forward in this general direction. To this end, at my request, an inter-departmental working group has prepared the attached interim guidance note to help staff determine the appropriate scope and detail in applying structural conditionality in Fund supported programs now under preparation. These interim guidelines will be reviewed in the light of initial experience and the forthcoming Board discussions on the topic.

Let me be clear that the objective is to strengthen results on the ground, not weaken the content of Fund-supported programs. Thus, where a specific measure is critical for the success of the program, I expect that this will continue to be covered by program conditionality. It is in the monitoring of the remaining aspects of the program, aspects which may be relevant or important but are not demonstrably critical for program success, that the note suggests a shift in approach. In these areas, we generally need to better focus our

conditionality on the Fund's core areas of responsibility and to prioritize even within these core areas.

The principles set out in the attached note are necessarily general and their application in individual cases will depend on your own best judgment and discussions with management on the basis of arguments provided in briefing papers on the merits of each case. They should be seen, however, as establishing an expectation of a more streamlined and focused approach to structural conditionality in Fund-supported programs. I look forward to our joint efforts in making this approach work effectively in the coming months.

Sincerely yours,

A handwritten signature in black ink, appearing to read "J. Kuhl". The signature is written in a cursive style with a large initial "J" and a long, sweeping underline.

Attachment

cc: The Deputy Managing Directors
Members of the Inter-Departmental Working Group on Streamlining Structural
Conditionality

Streamlining Structural Conditionality in Fund-Supported Programs Interim Guidance Note

1. This note has been prepared by an Inter-Departmental Working Group¹ on streamlining structural conditionality in Fund-supported programs. The general principles set out below are preliminary and will be reviewed in early 2001 in light of the initial experience and the Board's discussion of the forthcoming papers on *The Experience with Structural Conditionality in Fund-Supported Programs* and *Ownership, Conditionality, and Policy Implementation*.

2. The Reform Task Force in its interim report on "The Future Role of the Fund" recommends that Fund programs should henceforth be formulated on the "... presumption that structural conditionality will be limited to a core set of essential measures that are macro-relevant and in the Fund's core area of responsibility, with a broader approach requiring justification based upon the specific country situation."² The report further notes that "...the Fund may continue to advise on a broader range of structural reforms in some cases, but they would not generally be part of conditionality." (§51)

3. This note outlines some principles to assist staff in determining the appropriate scope of structural conditionality in Fund arrangements in the general resources account, as well as in PRGF arrangements. These principles are inevitably fairly general and will need to be applied judiciously on a case by case basis. However, they should be seen as establishing a general presumption that structural conditionality in Fund-supported programs should be selective and justified by the program's overall macroeconomic objectives. This should not weaken the quality of Fund-supported programs; rather, it should help strengthen conditionality and ownership in those areas that are critical for the program's success.

4. The authorities' policy commitments in the structural area are laid down in the letter of intent (LOI) or the memorandum on economic and financial policies (MEFP). Implementation of these policy commitments is monitored through performance criteria, structural benchmarks, prior actions, or in the context of program reviews. The form of monitoring depends on the importance of certain structural reforms for the program's objectives as well as the nature of the measures involved. Applying performance criteria requires that specific measures can be clearly and unambiguously defined, and that these

¹ The Working Group comprised Messrs. Ahmed (PDR, Chair), Artus (EU1), Cardemil (WHD), Collyns/Moghadam (APD), Davis/Mahler (FAD), Fajgenbaum (AFR), Havrylyshyn/Saavalainen (EU2), Nashashibi (MED), Mr. Sundararajan/Ms. Gulde-Wolf (MAE), and Ms. Schulze-Ghattas (PDR, Secretary of the Group).

² Core areas of responsibility are defined in paragraph 2 of the report. They include "macroeconomic stabilization; monetary, fiscal and exchange rate policy, including the underlying institutional arrangements and closely related structural measures; and financial sector issues, including the functioning of both domestic and international financial markets."

measures in and of themselves are sufficiently important to warrant holding up the arrangement in cases of non-compliance. Structural benchmarks too are applied to individual, well-defined measures, but they do not assign the same weight to these measures as do performance criteria; rather they serve as markers in the assessment of progress with the implementation of reforms in a given area. Finally, reviews provide a framework for an assessment of structural reforms against established benchmarks or of reforms that are either less critical or characterized by a series of smaller steps, which may be of moderate significance individually and have to reach a critical mass to signify progress. Reviews provide considerable scope for judgment and, hence, flexibility to the Fund, but they imply less clearly defined assurances for the borrowing country regarding the conditions under which purchases can continue.

5. Sometimes, the authorities and/or staff find the LOI a useful vehicle to set out the authorities' broader policy agenda for either national or international audiences. In these instances, only part of the LOI may constitute firm policy commitments under the program in the form of performance criteria or benchmarks. In such cases, review clauses need to indicate clearly the areas that will be covered by program reviews. The principles outlined in the following paragraphs (¶¶ 6-11) focus on structural reforms that constitute policy commitments in the sense that they are subject to some form of monitoring under the program. Issues related to the broader coverage of structural measures in LOIs or MEFPs are briefly discussed in paragraph 12.

6. *Fund conditionality should cover only structural reforms that are relevant for a program's macroeconomic objectives.* There are, however, no clear rules for classifying structural reforms according to their macro-relevance. While all Fund-supported programs ultimately seek to achieve medium-term external viability together with strong and sustainable growth, the conditions that determine what needs to be done to achieve these objectives vary considerably across programs. For example, in recent financial crises, the overriding goal of Fund-supported programs was to restore market confidence, ensure orderly external adjustment, address the weaknesses that had made these countries vulnerable to a crisis, and create the conditions for growth to be resumed. In the 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. While macro-relevance needs to be established on a case by case basis, it will be important to make this assessment explicit in program documents.

7. *Not all structural reforms that meet the macro-relevance test will typically be subject to program conditionality.* In order to determine which reforms should be covered, it is useful to distinguish between structural reforms that are essential or critical for the program's macroeconomic objectives and reforms that are macro-relevant but do not have the same degree of importance. Distinguishing between the two is obviously a matter of judgment. One way to do so is to ask the question: If the reforms in question were not carried out, would achievement of the program's macroeconomic objectives, including the restoration of sustainable growth, be seriously jeopardized, regardless of progress in other areas? If the answer is no, the reforms in question may be macro-relevant but are probably not critical.

8. *Structural reforms that are critical for the achievement of the program's macroeconomic objectives will generally have to be covered by Fund conditionality.* If measures can be identified that are specific, well-defined and monitorable, and mark important steps in the whole reform process, they would likely be subject to performance criteria or prior actions. For structural reforms that are critical for a program's macroeconomic objectives but are defined by a series of individual small steps that have to reach a critical mass, monitoring would typically rely on benchmarks and/or program reviews, with review clauses highlighting the relevant area.

9. *If certain structural reforms are critical for the program's success but outside the Fund's core areas of responsibility, the Fund will have to seek assistance from the World Bank or another institution to provide input in designing and monitoring the reform measures and, if necessary, give technical advice on implementation to the country.* In these cases, the Fund would still bring these measures under its own conditionality and decide on the adequacy of implementation on the basis of assessments provided by the World Bank or other relevant institution.³

10. *Structural reforms that are relevant—but not critical—for the program's macroeconomic objectives and within the Fund's core areas of responsibility may be subject to conditionality.* Whether such reforms should be included and in what form they should be monitored is a matter of judgment and depends on their relative importance for the program's objectives and the nature of the measures involved. However, the presumption would be that structural performance criteria would not be used in these cases, and that prior actions or structural benchmarks would be used sparingly and would require justification. In most instances, structural policy commitments to the Fund that fall into this category would be monitored in the context of reviews as part of an overall assessment of progress under the program.

11. *If structural reforms meet the macro-relevance test but are neither critical nor in the Fund's core areas of responsibility, Fund conditionality would generally not apply.* If these measures are covered by the World Bank, the Fund may, and in many cases would, take note

³ In the case of PRGF-supported arrangements, it has been decided that the respective areas of responsibility of the Fund and the World Bank will be delineated in the PRSP. It is intended that the Fund would "...not apply conditionality in areas outside the Fund's mandate and expertise, with the possible exception of measures that are critical to the country's fiscal and/or external targets..." (see, *Key Features of PRGF-Supported Programs* (SM/00/193, 8/17/00, ¶18)). It is recognized, however, that changes at the World Bank--in particular, the development of the Poverty Reduction Support Credit--and the nature of the World Bank's current lending operations in specific countries will affect how quickly it will be possible to move in this direction. In the interim, PRGF conditionality may cover additional measures that are critical for the program's objectives.

of the Bank's assessment of progress with implementation in forming a judgment on the country's adjustment effort.⁴

12. The general principles outlined above focus on structural conditionality, i.e., policy commitments to the Fund in the structural area that are subject to some form of monitoring under the program. As noted in ¶4, however, LOIs or MEFPs may include the authorities' broader policy agenda. In these cases, review clauses need to delineate the areas that are covered by Fund conditionality beyond those covered explicitly by performance criteria. The breadth as well as the level of detail of the measures covered by LOIs or MEFPs should continue to be determined by what is most useful in each country context. Nevertheless, in some cases, MEFPs containing large and detailed policy matrices have raised concerns about excessive intrusiveness of Fund conditionality. Such detailed matrices should be avoided unless they are considered necessary by the authorities to express their policy commitment or by the staff to monitor policy implementation.

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⁴ In the case of PRGF arrangements, it is envisaged that the Fund will take into account the World Bank's assessment in all areas for which the Bank has responsibility under the PRSP (or I-PRSP).