

## I. UNDERSTANDING THE DESIGN AND IMPACT OF CONDITIONALITY: A BRIEF LOOK AT THE LITERATURE

1. This chapter summarizes the literature on how conditionality is expected to operate and the criticism that conditionality has elicited. The chapter begins with a brief description of the evolution of the institutional framework for structural conditionality (SC). It then offers alternative views about the channels through which conditionality works. Finally, it presents the most common criticisms to the use of conditionality. Rather than a full review of the literature, the intent is to provide a brief overview of the issues most relevant to the evaluation. The chapter also identifies key challenges posed by the various competing forces that are usually present at the time an IMF-supported program is designed.

### A. Structural Conditionality at the IMF

2. The IMF Articles of Agreement stipulate that one of the purposes of the IMF is “to give confidence to members by making the general resources of the Fund temporarily available to them under adequate safeguards...” (Article I.v).<sup>1</sup> In an authoritative review of IMF conditionality, Guitián (1981) noted that “Except for a brief period after the Fund came into existence, Fund members have agreed that the Fund’s financial assistance should be conditional on the adoption of adjustment policies,” and that throughout the years “the Fund has developed a pragmatic and flexible body of policies and procedures—known by the term conditionality—to govern the use of its resources in a manner that will fulfill the prescriptions of the Articles of Agreement.” Conditionality was, thus, seen as playing two roles in IMF-supported programs, namely (i) providing assurance to members that the committed resources will be available to them upon compliance with agreed policies; and (ii) giving the IMF confidence that the country will be able to repay—which requires that the policy program being supported be consistent with restoring the country’s external viability.<sup>2</sup>

3. Guitián (1981) also noted that the practice of conditionality had evolved in response to changing circumstances. These changes were accompanied by modifications in Fund practices, most notably the completion of the first (1968) and second (1979) reviews of conditionality. Thereafter, an increase in the use of structural conditions was observed, particularly since the mid-1980s (IMF, 2001b).

4. The emergence and proliferation of structural conditions took place in the context of new facilities. Early on, structural conditions were introduced in the Extended Fund Facility (EFF), aimed at addressing countries’ economic imbalances rooted in structural difficulties.

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<sup>1</sup> Article V.3.a, further indicates that when making its resources available to members to solve their balance of payments problems, the Fund “will establish adequate safeguards for the temporary use of the general resources ...” The IMF’s Articles of Agreement are available at [www.imf.org/external/pubs/ft/aa/index.htm](http://www.imf.org/external/pubs/ft/aa/index.htm).

<sup>2</sup> See, for example, IMF (2001a, 2005a).

Structural conditions were used with the goal of removing disincentives to saving and investment, when these were seen as the underlying cause of chronic balance of payments problems. Subsequently, the use of structural conditions on policies that were intended to correct distortions in relative prices or trade policy became common practice in the context of the IMF's concessional facilities for low-income countries (the Structural Adjustment Facility (SAF), Enhanced Structural Adjustment Facility (ESAF), and Poverty Reduction and Growth Facility (PRGF)).

5. Besides the creation of new facilities, the increase in the number and scope of structural conditions also reflects the IMF's adaptation to a changing international economic environment. In transition economies, for example, SC focused on policies that were intended to remove pervasive non-market mechanisms and promote the development of institutions that were needed to support the functioning of a market economy. The rapid development and integration of capital markets in the 1990s and, in particular, the capital account crises suffered by several emerging market countries, led to the use of SC with the purpose of reducing these countries' vulnerability to changes in market sentiment. As a result, IMF-supported programs in emerging markets have often incorporated SC in macroeconomic areas (for example, calling for the introduction of fiscal responsibility law, or the creation or upgrading of monetary and/or financial institutions).

6. But the expansion of SC went beyond traditional areas of IMF competency and into areas such as the restructuring and privatization of SOEs, and civil service and pension reforms. The expansion in scope and volume of SC led to criticism and prompted an institutional response, first through an initiative launched in 2000 and led by then Managing Director Horst Köhler. This initiative was aimed at streamlining the use of SC. Subsequently, in 2002, the Executive Board of the IMF approved new conditionality guidelines (CG), which called for parsimony and introduced a "criticality" test for all conditions. The 2005 review of the CG (IMF, 2005a, p. 7) pointed out that, as far as structural conditionality is concerned, the key changes introduced by the CG had been largely foreshadowed by the 2000 Interim Guidance Note on Streamlining Structural Conditionality.

7. The increase in SC over the last two decades reflects only part of the expansion of IMF activities into the structural reform area in low-income and transition economies, as well as in other countries facing crises rooted in structural imbalances. Beyond the observed conditionality the IMF involvement in structural issues typically entailed giving policy advice in the context of programs and bilateral surveillance activities, as well as technical assistance.

8. This evaluation found that there are differing views within the Fund as to the role and scope of conditionality (for example, see Chapter V in this volume and paragraph 50 in the main report). Some focus on its role in protecting Fund resources, others emphasize its function to interrupt the Fund's support when it becomes apparent that the agreed program goals are unlikely to be achieved, thus mitigating reputational risk in addition to financial

risk. The CG provides room for establishing conditions critical to monitor the implementation of the program in parallel to conditions over measures that are critical to achieve its goals. Currently, SC appears to aim at complementing traditional, quantitative conditionality by (i) correcting non-macroeconomic problems that critically affect growth and poverty reduction in low-income countries, and (ii) seeking a lasting solution to macroeconomic problems through more fundamental policy and institutional changes (including measures aimed at averting the emergence of macro/financial vulnerabilities) in the IMF membership more generally. This evaluation focused on the contribution of SC to the promotion of structural reform.

### **B. How is Conditionality Expected to Work? An Organizing Framework**

9. This section describes different channels through which conditionality is expected to operate. It looks at several ways in which conditionality can promote or facilitate policy changes, and then describes how conditionality can be used to signal commitment to these policies.

10. **Conditional financing as inducement.** The most commonly seen argument in the policy-related literature on SC is that conditional money is used to “buy reform.” According to this argument, large donors and/or multilateral agencies provide resources to induce country authorities to implement policy changes that they would not otherwise make. This is sometimes referred to as conditionality as “bribery,” and it differs from the use of conditionality to facilitate adjustment by reducing the political cost of adopting painful reform measures.

11. **Promoting reform through the strategic use of conditionality.** “Strengthening the hand of reformers” is another way in which conditionality may operate.<sup>3</sup> In some cases, the IMF and the negotiating authorities have the same objectives, but the authorities face domestic opposition (from parliament, regional governments, interest groups) to their reform attempts. In this setting, conditionality may help ensure that parties opposed to reform do not succeed in blocking it. For example, conditionality could effectively raise the political cost that a parliament faces if it rejects a submitted proposal, giving the executive greater bargaining power. In these cases, the authorities would request specific conditions that are determined by the political players they face. Similarly, the authorities may use the IMF as a scapegoat, to minimize the political cost of enacting the reforms that they want to pursue (Vreeland 1999, 2005). These cases require the acquiescence of the IMF, which may be forthcoming even if the conditions are not critical for the achievement of *stated* program objectives. The result may be a set of conditions that may not necessarily appear well focused or “parsimonious,” as required by the 2002 IMF guidelines. In some instances, strategically

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<sup>3</sup> Drazen (2002) provides a very useful framework for understanding the role of conditionality in a setting where domestic agents are heterogeneous. Mayer and Mourmouras (2002) show how conditionality can be used to neutralize the strength of powerful vested interests.

designed conditionality will not work as intended—as for example when a mere association with the IMF increases political resistance. Also, sometimes the opposition may be able to extract concessions from the authorities as a quid pro quo for approving actions needed to meet conditionality. In these cases, a country’s compliance with conditions may not lead to the desired outcomes.<sup>4</sup>

12. **IMF conditionality, donors, and policy change.** James (1998) discusses bilateral donors’ use of IMF conditionality to push reforms that they want countries to make while avoiding the political costs that they would face if they acted bilaterally. For example, in some low-income countries the IMF’s financial contribution is small relative to pledges by bilateral and other multilateral donors, and the leverage of IMF conditionality derives from its ability to affect the disbursement of all aid that is tied to the program. When donors tie their disbursements to an IMF-supported program that is “on-track” (i.e., meeting its conditions), the design of the program and its conditionality is likely to also reflect donors’ views and interests.

13. A related but different role is the one that IMF conditionality can play in helping donor countries to overcome problems related to accountability for the use of public funds (see Martin, 2006 for an extensive discussion of this issue). Delegating the administration of their aid to multilateral agencies can resolve a domestic problem in donor countries, by blurring the link between the volume of aid granted and the type of spending it finances. This may enable a donor government to pursue a foreign assistance policy that otherwise would be politically difficult, e.g., if it wants to use aid to pursue strategic political or economic goals, while the country’s taxpayers favor humanitarian objectives.

14. An instance where conditionality is used as a monitoring tool is the accession process of Central and Eastern European countries to the European Union (EU). Many of these countries have relied on low-access precautionary IMF arrangements in recent years (IMF, 2004). IMF conditionality appears to play two roles in this setting: (i) it helps induce reform through the leverage afforded to the IMF by the EU’s requirement that accession countries be in good standing with the IFIs;<sup>5</sup> and (ii) compliance with conditionality allows the accession candidate to provide the EU with a certificate of continued progress in reform at regular intervals. Naturally, for this mechanism to work, the SC in the program would have

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<sup>4</sup> Coate and Morris (1996) show in a non-bargaining setting that conditionality, even if formally met, can be completely neutralized if it does not extend to all variables under the control of policymakers.

<sup>5</sup> There is no formal accession requirement calling for IMF-supported programs. However, in many cases the EU has asked countries to have programs with IFIs. The 2004 Report of the European Commission on Romania stated, “A two-year successor arrangement with the IMF was agreed in July 2004, embedding the authorities’ reform strategy and balanced policy mix in a program framework under comprehensive monitoring of policies. Ownership and strict adherence to the arrangement’s objectives and instruments are imperative in order to keep up progress”—Commission of the European Communities (2004), p. 35.

to be closely aligned with EU accession requirements or policies deemed important by the EU.

15. **IMF-supported programs as policy frameworks: conditionality and the setting of priorities.** According to this view, IMF-supported programs sometimes provide a framework for deciding on priorities in countries with low institutional capacity. This assistance could also be provided through technical assistance and surveillance, but some argue that conditionality could also help to enforce financial discipline.

16. **Conditionality as signaling.**<sup>6</sup> In its simplest form, the signaling model argues that conditionality serves to provide potential investors with information on the authorities' commitment to certain policies. This can be necessary because borrowers and creditors have asymmetric information, or as a multi-period commitment mechanism—by raising the cost of changing policies (e.g., Sachs, 1989; Diwan and Rodrik, 1992). The literature shows that an agreement to follow an IMF-supported program sometimes serves as a signal of the country's willingness and ability to reform successfully and that conditionality may help creditors in screening borrowers (Marchesi and Thomas, 1999). The evidence of a significant catalytic role of IMF programs, however, is mixed (Bird and Rowlands, 2002; Mody and Saravia, 2003). The informational value of Fund arrangements and conditionality is weakened if waivers are commonly granted. Similarly, signaling may become ambiguous if Fund support is given to countries in distress for programs with low domestic ownership and a low likelihood of implementing reform (Collier, 1997).

17. This typology of the expected goals of conditionality, and the channels through which it is expected to operate, has implications for design and implementation. For example, conditionality needs to be rather inflexible if it is being used for signaling or as a commitment mechanism. By contrast, where conditionality is used as a framework for the design and conduct of policymaking it needs to adapt quickly to political and economic developments. And less friction between the IMF and the authorities is likely to occur in implementing conditionality designed as a signaling device than when conditionality is trying to play a catalytic role in reforms.

### C. Conditionality: The Critics

18. Criticism of IMF arrangements and their conditionality has evolved over time.<sup>7</sup> One of the first waves of strong criticism of IMF lending activities took place in the late 1970s and early 1980s, in the context of the second oil shock and fast growth in commercial banking flows to developing countries. The IMF-supported programs of the time were

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<sup>6</sup> See IMF (2004) for a thorough discussion of the many ways in which the IMF provides signals (defined in a broad sense) to private markets or official creditors.

<sup>7</sup> See Willett (2001) for an analysis of the main critiques of conditionality.

criticized for being excessively dogmatic and inflexible, and for imposing unduly harsh austerity measures. Killick and others (1984) pointed to the importance of macroeconomic management, but raised the concern that the IMF had a poor record in securing compliance with its conditionality and that IMF-supported programs were largely ineffective in achieving their stated goals. Killick (1996) and Mussa and Savastano (1999) also raised the issue of low compliance with conditionality. In addition to looking at the relatively poor records of compliance, several authors found that often borrowing countries comply with conditions during the lifetime of programs but do not follow up thereafter (Collier, 1997; Collier, Guillaumont, Guillaumont, and Gunning, 1997; Dollar and Svensson, 2000; and Killick, 1997).

19. The content of conditionality has also received much criticism. Some observers have argued that in areas such as trade reform and privatization the IMF has become too ideological or mechanical, and that its structural conditions in these areas in low-income countries are not based on sound analysis (Action Aid, 2004; Eurodad, 2006). Others have argued that the IMF uses crises as opportunities to force fundamental institutional reforms, hence leading to inappropriate conditionality (Feldstein, 1998). Some have questioned the legitimacy of the policies that the authorities agreed with the IMF, pointing out that key sectors of society are not properly consulted or are excluded from program negotiations (Oxfam International, 2004).

20. A view that grew very strong in the midst of the Asian financial crisis was that the number of structural conditions was excessive and unnecessarily detailed. In this context, conditionality was seen as intrusive and, as such, capable of overwhelming domestic implementation capacities and undermining national ownership of policies (Goldstein, 2000; Wood and Lockwood, 1999).

21. Killick (1997, 1998) argues that conditionality can only be useful where country authorities and officials from international financial institutions agree on the reform agenda, i.e., when conditionality is “consensual.” A common response to this argument is that conditionality is unnecessary (and sometimes unhelpful) since if reforms were strongly owned they would go ahead in any case; and without ownership, conditionality is unlikely to bring about reform and even less likely to sustain it.