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IMF Conditionality and Country Ownership of Programs

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I. Introduction

I am very pleased to be here in Delhi for this SANEI conference, and honored to be invited to give this lecture. This is the first time I have been to India, which has surprised many people, being that I am from Pakistan. So I am grateful to SANEI, and particularly Dr. Isher Ahluwalia, for inviting me to visit Delhi to speak to you about a subject that is receiving a great deal of attention in policymaking circles around the world—IMF conditionality and the country ownership of adjustment and reform programs supported by the IMF.

The paper on which this lecture is based is part of the current work going on in the IMF on the issue of conditionality and ownership (Khan and Sharma, 2001). Several other papers on various aspects of the subject have been produced over the past few months in the IMF. Some of these were put on the IMF website recently to solicit outside views. Seminars have also been held in Berlin, Tokyo, and London this year to generate wider discussion of the subject. Other papers are under preparation in the IMF and will appear over the next few months.

My paper with Sunil Sharma is by no means the last word. Nobody has that yet in the IMF or anywhere else. Specifically, the paper aims to do two things. First, to highlight the main issues relating to IMF conditionality and country ownership of programs. And second, to discuss a variety of proposals designed to bring IMF conditionality and country ownership of programs into closer alignment.

Let me start by defining IMF conditionality. Basically it is the set of policy conditions that is attached to IMF loans made to support adjustment programs. There is a large literature on various aspects of IMF conditionality, including for example, the book by John Williamson (1983) and the papers by Jacques Polak (1991) and Manuel Guitian (1995). The most recent description of IMF conditionality is contained in the history of the IMF done by James Boughton (2001). The literature clearly demonstrates that IMF conditionality has generated considerable controversy. Over the years some very basic questions have been raised about IMF conditionality, for example: (a) is conditionality necessary? (b) does conditionality work? (c) is conditionality too intrusive? and (d) has conditionality undermined country ownership of programs?

Using finance theory and concepts, I would like here to establish two propositions. First, IMF conditionality is justified and necessary, as in all borrower-lender relationships. Second, country ownership of programs is crucial to the success of these programs. The principal task, therefore, is to design conditionality so as to maximize program ownership subject to providing sufficient safeguards to the IMF for its loans. I will outline a number of proposals that have been made towards the end.

II. The Logic of Private Financial Contracts

Between every lender and borrower, there is always a fundamental asymmetry in information availability. This information asymmetry gives rise to two incentive problems: adverse selection and moral hazard. Adverse selection arises before the transaction takes place, and stems from the fact that information deficiencies make it difficult to distinguish good from bad risks. Compared to private lenders, the IMF faces a different selection problem, in that only member countries experiencing some distress approach the IMF for financing, and all have a right to IMF resources. Moral hazard arises after the lender has given the funds to the borrower, who may take risks to raise returns (but also increases the probability of default). The measures to mitigate moral hazards in the financial world include provision of collateral, covenants, monitoring, and reporting requirements.

Collateral provides the lender with the most assurances, but pledging collateral is expensive. If there is no collateral, then covenants can be introduced into the contract. Covenants can impose clear obligations on the borrower, impose limitations or prohibit certain actions, and specify when a borrower is considered to be in default. In new or emerging firms with very little physical or financial collateral, the relinquishing of control rights to the venture capitalist by the entrepreneur provides the needed assurance that the funds will be well spent. Basically the design of covenants and the allocation of control rights should be done in a way so as to not impair the efficient functioning of the firm, while providing adequate safeguards to the investor. In summary, the imposition of conditionality (whether in the form of collateral, covenants, informational requirements, or surrender of control rights) in private financial transactions serves two purposes. First, ex ante it provides incentives for preventing default. And second, ex post it constrains the ability of the borrower to undertake excessively risky activities.

III. IMF Lending and Conditionality

IMF lending and its associated conditionality follow broadly the same principles as private financial contracts. The IMF is mandated by its Articles of Agreement to extend temporary financial assistance to member countries facing balance of payments difficulties "under adequate safeguards" (Article I). Thus, like any lender, the IMF needs to have assurances that the funds it lends will be used for the agreed purposes and will be repaid.

A key aspect of IMF lending is that countries in need of IMF loans generally do not possess internationally valuable collateral. If they did, they could use it to borrow from private lenders and would not need the IMF money. Therefore, covenants are necessary and IMF conditionality can be viewed as a complex covenant in a loan agreement. The policies contained in IMF-supported programs essentially provide the safeguards that the country will be able to correct its macroeconomic and structural imbalances, and will be in a position to service and repay the loan. In a sense, IMF conditionality serves as a substitute for collateral and the surrender of control rights.

Conditionality attached to sovereign lending has a long history. For example, the Rothschild loans to Prussia in 1818 required explicit collateral. The bankers wanted the loans secured by a mortgage on Prussian royal domains. The modern model for conditional lending to sovereign governments in the absence of collateral is the Turkish Agreement of 1881, known as the "Decree of Mouharrem", that was implemented after the Turkish government defaulted on its foreign debt in 1875. The Decree created the Council of Ottoman Debt (comprising seven members representing the bond holders), which controlled all government revenues. These revenues were used for the service and repayment of the debt. The League of Nations also attached strict conditionality in its adjustment programs, or "reconstruction schemes" as they were known with six European countries in the 1920s. In all these cases, there was very harsh conditionality in the form of collateral requirements or surrender of sovereign control rights imposed by the lenders.

IMF lending is different from private lending for several reasons. First, IMF conditionality is much more complicated, because it involves assessing the macroeconomic imbalances or structural deficiencies that lead to macroeconomic problems, and then coming up with a negotiated agreement with country authorities to address them. Second, it is very difficult to establish the "value" of IMF conditionality, as this depends to a large extent on the degree of commitment of the authorities to implement the necessary policy measures. Third, the IMF faces what has been called in agency theory as "moral hazard in teams"—that is, the situation when a principal's payoff depends on the joint efforts of two (or more) agents. Fourth, the IMF is a cooperative institution, and in the event of default, there is no court to which it can appeal. Fifth, the IMF, given its mandate and cooperative structure, faces what has been called in other contexts as the "Samaritan's dilemma", because the borrowing country is always more valuable as a going concern, and the country authorities know that in the event of non-performance, the program will be renegotiated.

IMF conditionality is implemented through program design and monitoring arrangements that track whether the agreed policies are implemented in a timely and effective manner. Program design begins with an analysis of the sources of macroeconomic imbalances. The next step is to agree on the objectives and the policies to achieve them. Monitoring arrangements typically include prior actions (e.g., exchange rate changes, passage of the budget, enactment of laws), performance criteria involving quantified targets for specified financial aggregates (e.g., bank credit, international reserves, fiscal balance), and structural conditions (e.g., tariff reductions, privatization). Reviews that assess overall progress of the program are also part of the monitoring arrangements and are usually specified as performance criteria.

As mentioned earlier, a question that often arises is whether IMF conditionality works. The Meltzer Commission, for example, argued that it does not. The IMF naturally believes otherwise. The problem is that it is very difficult to evaluate the effects of programs on macroeconomic variables for several reasons. First, the links between policies and outcomes is uncertain. Second, it is necessary to filter out the effects of unanticipated exogenous influences. Third, one has to define the relevant "counterfactual"—that is, the macroeconomic outcome that would have resulted without the program. This counterfactual is not observed and has to be constructed. How this is done matters significantly for judging the effects of programs.

What then is the evidence? The existing empirical literature indicates that programs do improve the current account and the overall balance of payments. However, they do not appear to lead to a significant decline in inflation. Furthermore, they indicate that growth falls in the short run, that is, in the stabilization phase, but over time as macroeconomic stability is established, growth begins to pick up. On average, therefore, IMF-supported programs and the conditionality they incorporate have been reasonably effective in improving the macroeconomic picture. Of course, there are enough program failures to warrant serious concern. For example, during the period 1977-97, 75 percent of the loan amount was disbursed in only 45 percent of IMF programs. Despite the problems inherent in using disbursements as an indicator of the success or failure of programs, the fact that only 45 percent are successful is certainly troubling.

IV. Ownership of Programs

The case for ownership of programs by countries can be justified on theoretical grounds. Principal-agent theory tells us that the agent (in this case the country) will do a better job if its objectives are well aligned with those of the principal (in this case the IMF). For conditions whose realization hinges strongly on cooperation and implementation by the agent, ownership is a necessity.

The problem is that ownership of IMF-supported programs is a hard concept to define or pin down. Basically it refers to a situation in which the policy content of the program is similar to what the country itself would have chosen in the absence of IMF involvement. This is because the country shares with the IMF the objectives of the program as well as an understanding of the appropriate economic model linking those objectives to economic policies. In such a situation, the country "owns" the program. But since only countries with problems come to the IMF, there is unlikely to be full ownership. To provide sufficient safeguards for the IMF and to avoid the moral hazard problem will require conditionality that has some "bite", which goes against full ownership.

Ownership matters because it directly affects program implementation. Program agreements cannot incorporate all contingencies that could affect the program and specify all the necessary policy actions in advance. When the program is owned by the country, decisions on policy actions are likely to be made quickly to support the program, making it more likely that the program will succeed. Furthermore, ownership will make it easier to generate domestic political support for the program. Ownership also matters for the catalytic role that IMF lending can play in giving the country access to foreign lenders.

But, ascertaining the degree of ownership is a difficult issue because in most countries, especially democratic ones, there are multiple stakeholders. Therefore, one has to ask whose ownership matters? Is it the central bank and the ministry of finance, other key ministries, the domestic bureaucracy, parliament, or civil society at large?

There is a widespread perception that there is insufficient ownership of programs. For crisis cases, this is not surprising. There may not be enough time to get full country support for all the necessary policy actions. But the problem goes beyond crisis cases and is evident in other programs as well. Certainly the expansion of structural objectives that has taken place over the last decade has been a factor in reduced ownership. The larger the number of objectives, the less likely it is that the government and the IMF staff will agree on a full range of objectives or on how these are to be attained. Furthermore, borrowing countries may themselves be partly responsible for the lack of ownership. The fact is that they may be so eager for the initial disbursements of funds that they are willing to agree to programs without being convinced that the associated conditionality is appropriate. Such agreements have a greater chance of breaking down at critical decision points.

V. Fostering Greater Ownership: Current Initiatives

Recently, a number of proposals have been put forward designed to enhance country ownership of programs. Let me briefly discuss five current initiatives: pre-selection, home-grown programs, policy options, "selling" the programs, and streamlining structural conditionality.

1. Pre-selection

In order to provide adequate safeguards, weaker ex post conditionality could be balanced with stricter ex ante pre-qualification. Under this approach, which has been favored by the Meltzer Commission, the IMF would provide financing to countries with a good track record of policies at penalty interest rates. This would be consistent with safeguarding IMF resources, while encouraging the country to secure market financing before coming to the IMF.

Three objections can be raised to this approach. First, it would not prevent crises. Second, there is no guarantee against undesirable changes in domestic policies (perhaps through changes in government). Third, this approach would exclude a large number of countries that do not have access to international capital markets from IMF lending, and this would be inconsistent with the Articles of Agreement.

2. Home-grown programs

Developing programs on their own (or with the assistance of the IMF) would obviously increase the ownership of programs by countries. While there are some examples of home-grown programs, they have not generally worked very well. Countries have a systematic tendency to underestimate the extent of their difficulties and overestimate the power of their policies to correct these difficulties.

3. Policy options

The IMF could discuss with the authorities alternative options regarding the objectives and the policy measures. The advantage of this approach is that it opens up a debate and gets the government actively engaged in the design of the program. Ownership is achieved when the country is able to make specific choices, rather than accepting a single option prepared by the

IMF. Of course, one drawback with this approach is that the discussion of alternative options is bound to take time and extend the negotiation process. This could be an undesirable consequence for a country seeking quick access to IMF resources.

4. "Selling" of programs

Greater transparency in the negotiation process, as well as public statements about the program objectives, would clarify the responsibilities of the borrowing country, and hence enhance ownership. There are however constraints to information revelation. The IMF has a role to play in promoting transparency, but in policy negotiations it is privy to confidential information and there are limits to what it can make public.

5. Streamlining structural conditionality

Over the past two decades, there has been a major expansion of structural conditions in IMF-supported programs. While there are many good reasons for this expansion, it is still felt that the IMF has gone too far in structural conditionality and overloaded programs with structural measures. Many structural forms are not critical for the achievement of macroeconomic stability. And there is also no strong evidence that programs with a greater number of structural conditions have been more successful. There are two main dangers of increased structural conditions. First, they result in reduced country ownership of programs and therefore reduce their effectiveness. Second, the failure to implement structural reforms that are not critical for macroeconomic stability may undermine confidence in the whole program. The IMF has recognized this problem, and a major effort is underway to prioritize or streamline structural conditionality in programs. Whether or not a structural reform should be included in a program will depend on whether it is critical (or at least relevant) to the macroeconomic objectives and within the IMF's core areas of responsibility.

IV. New Approaches to Enhanced Ownership

There are two further ways in which the form of IMF conditionality can be changed to increase country ownership of programs: (1) floating tranche conditionality; and (2) outcomes-based conditionality.

1. Floating tranche conditionality

Performance criteria and structural benchmarks in programs have specific dates attached to them. Countries often find that rigid timetables for major structural reforms constrain their choices as well as strain their implementation capacity. Programs could be designed to allow for greater flexibility in the timing of structural reforms, thereby increasing the scope for greater ownership. One way to do this is through applying floating tranche conditionality for structural measures. Under this approach, which has been used by the World Bank in the context of its Higher Impact Adjustment Lending (HIAL) operations, the availability of a loan disbursement would not be tied to any specific date; instead, the disbursement would become available only on completion of certain structural reforms. This floating tranche approach gives the country flexibility in the timing of implementation, and further de-links disbursements associated with the implementation of one part of the program from another part of the program.

Thus, IMF conditionality could be divided into two segments. One part of the financing would be conditional on achieving the usual quantitative performance criteria under a pre-set schedule, while the other part would depend on the implementation of structural measures at any time prior to the expiration of the arrangement. In the floating tranche segment, the country would control when it undertook the reforms, and the IMF would be protected since it would only disburse when the reforms were undertaken.

2. *Outcomes-based conditionality*

Outcomes-based conditionality involves making disbursements on the achievement of results rather than on the policy measures undertaken. Changing from policy-based conditionality, which is the current system, to outcomes-based conditionality leaves the choice of policies to the country. From the IMF perspective, performance criteria for the disbursement of funds would be set on the achievement of targets for the objectives at selected dates. The objectives would be negotiated with the IMF, but the policy content would be largely left up to the country. This would enhance ownership since the responsibility for the policies would rest with the country. IMF resources would be safeguarded since disbursement would depend on achieving the desired results.

Implementing this approach does have some difficulties. First, outcomes-based conditionality could lead to a back-loading of funds. Second, there may be significant lags in the reporting of data on outcomes. Third, program objectives can be influenced by exogenous factors that are not under the authorities' control.

Two points can be made in response to these problems. First, even under outcomes-based conditionality the disbursement of funds will be done in tranches. Second, like any other creditor, the IMF would combine outcomes-based conditionality with a system of monitoring. If a borrower's position deteriorated, the IMF would need to intervene to contain the damage, take prompt corrective action, and change the strategy of the borrower.

VII. Conclusion

I have drawn heavily on the well-established literatures on agency theory and corporate finance to argue that conditionality has to apply to IMF lending, and that country ownership of programs is essential. Several initiatives are underway to enhance ownership while maintaining the essential nature of IMF conditionality. These include pre-selection, encouraging the domestic formulation of programs, selling programs to multiple state holders in the countries, discussing alternative policy options, and providing greater information on the programs. It has been argued here that there is considerable merit in changing the emphasis of conditionality towards outcomes-based conditionality and the use of floating tranches, especially for structural reforms. While a good case can be made for incorporating outcomes-based conditionality in IMF lending, this is not an either-or matter. Programs would combine both policy-based and outcomes-based conditionality, as well as fixed-tranche and floating-tranche conditionality. Programs with these combinations would bring IMF conditionality and country ownership into closer alignment. Many countries support these new approaches, and the IMF is moving in that direction.

References

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