# IMF Conditionality and Country Ownership of Adjustment Programs

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*This article uses finance and agency theory to establish two key propositions about International Monetary Fund (IMF) conditionality and country ownership of IMF-supported adjustment programs. First, the authors propose that the conditionality attached to these programs is justified. Second, the article hypothesizes that country ownership of these programs is crucial for their success. Because IMF conditionality and country ownership are both necessary, the challenge is designing conditionality that maximizes ownership while providing adequate safeguards for IMF lending. The article analyzes several recent proposals aimed at enhancing country ownership of policies contained in IMF-supported programs. These proposals include encouraging countries to design their own adjustment and reform programs, streamlining structural conditionality, introducing flexibility in the timing of structural policy measures (floating tranche conditionality), and applying conditionality to outcomes rather than policies (outcomes-based conditionality).*



International Monetary Fund (IMF) lending in support of adjustment programs is conditional on the borrowing countries adopting certain agreed policies. The conditions attached to these loans are commonly referred to as *IMF conditionality*. As the literature on the subject shows, discussions of the nature and merits of IMF conditionality have a long history (see, for example, Williamson 1983; Polak 1991; Guitián 1995; James 1996; and Boughton 2001:ch. 13). The issue has recently gained renewed attention, with questions raised about whether the conditions the IMF imposes on borrowing countries have been too intrusive and whether the design and implementation of IMF conditionality have undermined country ownership of adjustment programs aimed at correcting macroeconomic imbalances.

This viewpoint has gained considerable currency as a result of the capital account crises in Mexico, East Asia, the Russian Federation, and Brazil in the 1990s. But during such crises, which require rapid responses, there may not be enough time to secure full

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country support for all the policy actions needed. Moreover, in the middle of a serious currency and financial crisis there may be greater agreement between the country authorities and the IMF on the immediate problems facing the country and the short-run measures needed to address them. Conditionality and ownership issues are probably less relevant for the recent capital account crisis cases and more relevant in standard IMF programs dealing with current account crises in low-income countries—and that is where most attention has been focused. The IMF itself has engaged in a comprehensive analysis of conditionality and ownership issues (see IMF 2001a.)

This article draws on finance and agency theory to establish two basic propositions about IMF conditionality and country ownership of adjustment programs. First, some form of conditionality exists in all borrower–lender relationships: Key to the ability to borrow is the ability to pledge income back. The IMF must have assurances that it will be repaid, and this requires that it place conditions on its loans. The analysis here is designed to dispel the fairly widespread notion—articulated, for example, by Diaz Alejandro (1984)—that conditionality stems from a "patron–beneficiary" relationship between the IMF and borrowing countries. As he puts it: "This is the key justification for 'conditionality'; if you ask for a gift, you must listen to your patron" (Diaz Alejandro 1984:7). Finance considerations alone provide the justification for conditionality being a necessary part of IMF lending. Thus the view expressed by Killick (1997) that IMF conditionality should be the exception rather than the rule is incorrect. Indeed, this article argues that it should be exactly the reverse.

Second, country ownership of programs is essential, because it aligns the incentives of the borrower and the lender. For the borrowing country, program ownership is critical because without a firm commitment from the government and other relevant constituencies, the difficult policy measures needed to correct economic problems are less likely to be implemented. For the IMF, country ownership increases the probability that programs will succeed and so augments the protection of its resources provided by conditionality. Thus the Poverty Reduction Strategy Papers (PRSPs) that have been developed jointly by the IMF and the World Bank put substantial emphasis on country ownership. So, both IMF conditionality and country ownership have a clear rationale; the challenge is reconciling the two. This article considers various recent proposals for achieving such a reconciliation.

## I. IMF Lending and Conditionality

This section examines the main features of IMF lending by comparing them to private loan contracts. It then assesses the implementation and effectiveness of IMF conditionality.

## *Conditionality in Private Financial Contracts*

Between every borrower and lender there is a fundamental asymmetry in information. Borrowers always know more about their abilities, opportunities, and intentions than do lenders. This information asymmetry gives rise to two incentive problems: adverse selection and moral hazard.

Adverse selection arises before a transaction occurs and stems from the fact that information deficiencies make it difficult for lenders to distinguish good risks from bad. The IMF faces a different selection problem than private lenders in that only members experiencing distress approach it for financing and all have a right to its resources. Moral hazard arises after a lender has given funds to a borrower. Having obtained the funds, it may be in the borrower's interest to take risks that may raise returns—but also increase the likelihood of default.[1] In the financial world, contract designs and collateral, transparency, and reporting requirements attempt to mitigate such moral hazard. Monitoring by shareholders, debt holders, market analysts, rating agencies, and independent company directors serves the same purpose. Such monitoring is costly to firms, but it is done to ensure investors that their claims will be respected (Greenbaum and Thakor 1995; Mishkin 1998).

Pledging collateral is expensive, but firms incur that cost to provide lenders with assurance that borrowed funds will be used for stated purposes and in ways that will not jeopardize their eventual repayment. Indeed, the very existence of financial markets depends on such assurance. To that end, corporate governance and institutions and practices of finance share the common rationale of increasing resources that can be pledged to outside debt and equity holders while maintaining appropriate incentives for managers and workers. Collateral is provided so that in the event of default or if the borrower does not live up to the terms of the contract, the lender can recover its resources by taking control of the pledged assets and selling them.

In new or emerging firms with little physical or financial collateral, relinquishing control rights to venture capitalists provides the needed assurance that funds will be well spent, because the venture capitalists have considerable say in decisionmaking. The allocation of control rights to investors should be designed to provide maximum assurance to investors without impairing the functioning of the firm and its ability to exploit commercial opportunities. Even so, in many circumstances and for many firms—especially those in distress or those that have little reputational or financial capital—relinquishing such control rights may be costly and will almost certainly impose substantial limits on management discretion.

Generally, the imposition of such conditionality—the allocation of return streams, liquidity, and control rights—is made contingent on the evolution of the borrowing firm's balance sheet and follows a simple carrot-and-stick logic. Posting collateral that can be sold by the lender in case of default provides the borrower with an incentive to prevent default. Agency considerations dictate that the transfer of

collateral rights to the lender be made contingent on default or on observable measures of financial and nonfinancial performance.

Such conditionality also serves another purpose when it comes to control rights. After an adverse shock, a borrowing firm is more likely to gamble for resurrection—that is, engage in riskier behavior—the greater is the deterioration of its financial health. Contingent transfer of control rights protects investors in that it prevents firms from undertaking excessively risky activities to repair balance sheets. Hence it serves two purposes. Ex ante, it provides incentives for preventing default. Ex post, it constrains firms' ability to take gambles.

Even if a firm does not engage in risky strategies when its performance deteriorates, the contingent transfer of control rights provides the lender with the option of reexamining the new situation. For example, in a new enterprise the venture capitalist obtains full control if the firm performs poorly—whereas if the firm is profitable, the venture capitalist may retain cash-flow rights but agree to cede control and liquidation rights to the entrepreneur (Kaplan and Stromberg 2000).

### IMF *Conditionality*

IMF lending and its associated conditionality follow broadly the same principles as private financial contracts, though several additional dimensions make IMF lending qualitatively different. 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). Like any lender, the IMF thus needs assurances from its borrowers that the funds lent to them will be used for the purposes defined by the Articles of Agreement and in a manner that does not jeopardize their contractual servicing and repayment. Many of the finance propositions relevant to private financial institutions also apply to the IMF.

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 require IMF resources. In a crisis situation, however, even if a country had internationally acceptable collateral, it still might not be able to use it to borrow from private capital markets. There is an important difference between national income and income that can be pledged to foreign lenders, including the IMF. Foreign loans can be used to produce both tradable and nontradable outputs, but foreigners typically have no demand for a country's nontradables. In the absence of collateral, private loan contracts typically would include various covenants coupled with monitoring. Formally, a covenant is designed to protect the lender and prohibit the borrower from taking actions that could reduce the probability of repayment. Covenants can impose clear obligations on the borrower, impose limitations on or prohibit certain actions, and specify when a borrower is considered to be in default.

IMF conditionality can be viewed as a complex covenant written into the loan agreement. The policy prescriptions in IMF-supported programs essentially provide safeguards that the country will be able to rectify its macroeconomic and structural imbalances and will be in a position to service and repay the loan.[2] Thus the conditionality associated with IMF programs can be viewed as a substitute for collateral.

Conditionality attached to sovereign lending has a long history. For example, in 1818 Prussia, effectively bankrupted by the Napoleonic wars, approached Nathan Rothschild (of the House of Rothschild) for a loan and was asked to pledge "Prussian royal domains" as collateral (Ferguson 1998).

For many analysts 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—which was implemented after the Turkish government defaulted on its foreign debt in 1875. The decree created the Council of Ottoman Debt, comprising seven members that represented different groups of bondholders. A large portion of the Turkish government's revenue was placed under the council's direct control and used by it to service and repay the debt (Anderson 1966).

The League of Nations also attached strict conditions to its adjustment programs (or "reconstruction schemes," as they were known) for six European countries in the 1920s. These conditions included maintenance of fiscal equilibrium and monetary discipline as well as currency reform. The League developed various means to enforce the programs and safeguard the interests of foreign creditors and bond holders, including appointing a commissioner to each country and an adviser to each central bank to administer and monitor the programs (Santaella 1993; James 2001).

Agreeing to IMF conditionality is an imposition on a country even though the two may share the same objectives—external viability, price stability, sustained high growth, reduced systemic risk, and so on. To be sure, the covenant in the loan agreement required by the IMF is far more complex and has different characteristics than covenants in simpler private financial transactions. It may also not always be part of the explicit contract, but it is always part of the implicit one, regardless of the language used in the documentation. The challenge in designing IMF conditionality is to specify the optimal covenant—the best policy conditions given the circumstances of the country, the disbursement intervals for the loan, the type of monitoring involved, and so on—to achieve program objectives while providing sufficient safeguards to the IMF. Even so, at a general level, IMF lending conforms to the principles governing private lending.

At the same time, IMF lending differs in significant ways. First, as noted, defining conditionality in IMF lending is much more complicated than in private financial transactions, where covenants may be quite straightforward. It basically involves assessing the macroeconomic imbalances or structural deficiencies that led to a country's macroeconomic problems, then negotiating an agreement with country authorities that will address those issues.

Second, it is difficult if not impossible to establish the value of IMF conditionality. The value of negotiated conditionality largely depends on the degree to which the authorities of the borrowing country adopt the program and are willing to expend effort and political credibility to implement it.

Third, unlike private lenders—for whom it may be sufficient to deal with a firm's management—the IMF faces what in agency theory is called "moral hazard in teams" (Holmström 1982). This refers to situations in which a principal's payoff depends on the joint efforts of two (or more) agents. Typically, the detailed negotiations for an IMF-supported program are conducted with certain government representatives (central bank, finance ministry), whereas the success of the program depends on many other stakeholders in society—other ministries, trade unions, professional associations, civic groups, and nongovernmental organizations.

Fourth, the IMF is by design a cooperative that makes loans to its sovereign members. In the event of default there is no court to which it can appeal and no tangible collateral that can be used to cover lost resources. The enforcement mechanism for ensuring that borrowing countries live up to their obligations essentially amounts to a combination of moral suasion, maintenance of the borrower's reputation, peer pressure, and the threat of being shut out of international capital markets. Unlike private firms—where lending is generally subject to well-defined legal codes that can be enforced in courts and where shareholders or investors can change the management of a company or take it over—the IMF obviously cannot replace sovereign governments and can only refuse to provide financing to a country in arrears.

Finally, relative to private lenders the IMF, given its mandate and cooperative structure, faces what in other contexts has been called the "Samaritan's dilemma" (Buchanan 1975; Lindbeck and Weibull 1988). For example, to provide the right incentives, ex ante a private lender may impose harsh conditions on a borrower in the event of poor performance, but ex post (that is, after poor performance) it may not want to impose those conditions for a number of reasons. For instance, selling certain assets (or liquidating the company) may be worth less than keeping the assets with the company (or maintaining the company as a going concern).

But the IMF faces a different incentive problem because a borrowing country is always more valuable as a going concern. Hence country authorities know that in the event of poor performance, at worst the program will be renegotiated (Drazen and Fischer 1997). This creates the wrong incentives, ex ante. Countries know that faced with poor performance and a weak economy, the IMF is unlikely to impose harsh conditionality ex post because it has to be concerned about the welfare of borrowing countries. Being a cooperative institution, the IMF cannot simply walk away and cut its losses. Thus ex ante penalties have limited credibility because they are unlikely to be enforced ex post. This is one reason it has been suggested that the IMF should lend only to prequalified countries with good policy environments. In other words, the IMF should lend only to countries that have

good economic track records and that can provide good collateral (see Meltzer and others 2000).

### *Implementation of IMF Conditionality*

Conditionality is implemented through program design and monitoring that tracks whether agreed policies are implemented in a timely and effective manner. Program design begins with in-depth analysis of the sources of a country's macroeconomic imbalances. (See Mussa and Savastano 1999 for a recent description of the IMF's approach to economic stabilization.) The next step is to agree with the authorities on policy objectives and on macroeconomic policies and structural reforms to achieve those objectives.

Monitoring takes various forms, depending on the borrowing country's circumstances and the IMF lending facility used. It generally includes prior actions, performance criteria, macroeconomic and structural benchmarks, and reviews. Monitoring also prohibits actions inconsistent with the IMF's Articles of Agreement, such as the introduction of new foreign exchange restrictions. Releases of IMF financing are linked to compliance with monitoring arrangements.

Prior actions are required when up-front implementation is critical to program success or to allay doubts about the authorities' commitment. Examples of required actions include passing an agreed budget, realigning the exchange rate, adopting structural reforms, or enacting relevant laws. Such actions must be taken prior to the approval of a program by the IMF's Executive Board, which then triggers the first disbursement.

Performance criteria normally include quantitative targets for specified financial aggregates (such as bank credit, net international reserves, or fiscal balance) and often include structural measures (such as tariff reductions, tax system revisions, or privatization of public enterprises). Meeting these criteria triggers the release of subsequent tranches of committed IMF resources.

Macroeconomic and structural benchmarks set targets for macroeconomic variables and structural policies important for effective program implementation. They do not directly affect scheduled disbursements.

Finally, reviews are used to assess overall progress toward program objectives, identify any sources of slippage (resulting from lack of policy implementation, external shocks, or program design issues), and take corrective actions. Reviews are usually specified as performance criteria—precluding further disbursements if the review is not concluded by the scheduled review date.

A common question is whether IMF conditionality works. On the one hand, Meltzer and others (2000:35) argue that "numerous studies on the effects of IMF lending have failed to find any significant link between IMF involvement and increases in growth or income." But the IMF, not surprisingly, disagrees. The IMF's mandate is to

provide short-term lending to support balance of payments adjustments, and it believes that conditional lending has generally improved the external accounts of borrowing countries.

What is the evidence on the effectiveness of IMF conditionality? Specifically, have IMF-supported adjustment programs achieved their objectives of improving current account balances, increasing international reserves, lowering inflation, and raising growth? This is essentially an empirical question that requires evaluating the effects that past programs have had on the macroeconomic variables of interest. Such evaluations are conducted periodically by the IMF's Policy Development and Review Department and by its recently created Independent Evaluation Office, with the results reported to the IMF's Executive Board. In addition, a number of studies over the past 20 years, both inside and outside the IMF, have examined the question using a variety of empirical methods.

Almost all the empirical studies surveyed by Haque and Khan (2002) show that IMF-supported programs have improved current account balances and the overall balance of payments in borrowing countries. The results for inflation are less clear. Most of the studies indicate that although inflation usually falls, the decline is generally statistically insignificant. For growth, output is generally depressed in the short run—that is, during the stabilization phase—but increases as macroeconomic stability is established. Overall, the most recent empirical results in particular indicate that on average, IMF-supported programs and the conditionality they incorporate have been reasonably effective in achieving their main macroeconomic objectives.

## II. Country Ownership of Programs

The case for country ownership of IMF-supported adjustment programs has a strong theoretical foundation. In the context of agency theory, principal-agent problems arise in situations in which one party (the principal) relies on the other (the agent) to achieve certain objectives. Due to information asymmetries and lack of perfect monitoring technology, if the agent's actions and their results cannot be easily verified and monitored, the agent has greater scope for pursuing its own interests rather than those of the principal.

But principal-agent theory also says that an agent will do a better job for the principal if the two parties' objectives are closely aligned. Thus if the realization of conditions hinges on cooperation and implementation by the agent, agent ownership of the project is essential. As Tirole (2002) puts it, in this case ownership is not a goal but a necessity.

IMF lending can also be cast in a principal-agent framework. In this case borrowing governments are the agents and the IMF—the delegated monitor of a revolving fund—is the principal. This principal–agent relationship is complex because of the

nature of the task, underlying loan contract, mandate and structure of the principal, and characteristics of the agents. This complexity, combined with the difficulty of specifying all contingencies in the contract, makes country ownership of programs all the more critical for their success.

The problem is that country ownership of IMF-supported programs is an elusive concept that is hard to pin down. Implicitly, it refers to a situation in which the policy content of the program is similar to what the country would have chosen in the absence of IMF involvement—because the country shares with the IMF both the objectives of the program and an understanding of the appropriate economic model linking those objectives to economic policies. In such a situation, the country owns the program in the sense that it is committed to its spirit rather than just complying with its letter. Thus the country will not deviate from its agreement with the IMF even if given the opportunity.

Because countries only borrow from the IMF when they face distress due to macroeconomic or structural imbalances, sufficient safeguards are needed when providing access to IMF resources and to avoid moral hazard—requiring conditionality with some bite. Hence full country ownership is unlikely, and the real challenge is maximizing ownership in the context of conditionality. As noted, program conditionality is likely to place substantive constraints on the authorities' actions and use of funds. In addition, given that programs generally involve economic and social tradeoffs, perceptions may be created that conditionality does not take proper account of a country's circumstances, including its economic priorities, political conditions, culture, and traditions. This can—and sometimes does—lead to differing views on objectives, program strategies, and the pace of reform.

Ownership matters because it directly affects program implementation.[3] Program agreements cannot envisage all the possible contingencies that could affect a program and specify in advance those actions that the authorities should take in response. When a country owns a program, decisions on such actions are likely to be made quickly and in support of the program, making it more likely that the program will succeed. In addition, ownership makes it easier to generate domestic political support for the program because it will likely be seen at least partly as an indigenous product, rather than a foreign imposition.

Ownership also matters for the catalytic role that IMF lending can play in increasing a country's access to foreign lenders. International flows of private capital have become increasingly important in recent decades, and a critical issue for borrowing in international markets is lenders' ability to exercise control rights. Foreign investors also confront moral hazard in teams: The payoffs to investments depend on the behavior and efforts of private borrowers as well as of the government of the country in which the private borrowers reside (Tirole 2002).

Firms investing across borders design appropriate covenants to mitigate moral hazard among private borrowers. Control rights not vested with the investor but

that affect borrower behavior are actually shared between the borrower and the government. Returns to a foreign investment depend on the environment created by government policies on domestic liquidity creation and management, tax and labor laws, and other institutional factors. When differences arise between a lender and a borrower or in times of distress, treatment of parties to a contract is crucially affected by public attitudes and policies toward law enforcement, bankruptcy, and corporate governance.

Government policies that reduce the amount of tradables or other internationally valuable collateral also hurt foreign investors. Such policies include taxing exports, failing to invest in infrastructure (which inhibits exports and tourism), depreciating the domestic currency when foreigners hold assets in that currency, depleting foreign exchange reserves, and creating incentives for currency and maturity mismatches that increase credit and default risks.

Whether such government moral hazard is important is an empirical issue and depends on the circumstances. It may be limited because governments lose power and credibility after a crisis, and in such cases IMF conditionality associated with adjustment programs places constraints on the authorities' policy choices (De Gregorio and others 1999). But it may be cause for concern: As in private firms, the threat of losing one's job after a crisis may prevent misbehavior—but it may also increase moral hazard by creating incentives to gamble for resurrection. Moreover, government actions that affect the mix of tradables and nontradables, and hence hurt foreign investors more than domestic ones, are less likely to generate adverse reactions from a country's population (Tirole 2002).

Hence country ownership of policies that reduce moral hazard related to foreign investment is likely to be important for a country's access to international capital markets. Such policies provide assurance to foreign investors that the government will not devalue their claims and, in the event of poor performance or adverse shocks to borrowers, will not inhibit the transfer of control rights to creditors. Of course, governments cannot relinquish control rights as easily as firms can, but that simply means that in their case the set of transferable rights will be more limited.

The feasibility of achieving a particular degree of ownership and determining when it has been achieved are problematic issues that vary by country. A complicating factor in assessing the degree of ownership is that most countries, especially democracies, have multiple stakeholders.

In pluralistic societies, does ownership refer to the views on program design and objectives held by the key ministers and central bank officials who negotiate the program with the IMF? Or does it refer to the views of the domestic bureaucracy that has to implement the program? Does it refer to the views of the parliament that has to approve the necessary legislation? Or to the views of civil society at large? If the views of civil society carry the most weight, how are they to be assessed and made to

influence program design and implementation in the face of competing interests? Thus ownership is intricately connected to trust in domestic institutions, effectiveness of political structures, and whether the government—negotiating on behalf of its citizens—has sufficient support to speak for a fair majority.

A widespread perception exists that program ownership by borrowing countries is insufficient. In recent years the number of program objectives has tended to increase because the IMF has taken on tasks that go beyond its traditional mandate of establishing macroeconomic and financial stability.[4] In many programs the number of structural objectives has been expanded to facilitate transitions to market economies, integrate domestic economies with the world economy, diversify production and exports, develop financial sectors, and promote high-quality growth. In the 1990s these program goals were explicitly specified for transition economies and made prominent for Sub-Saharan African countries. In addition, in the Mexican (1994–95) and East Asian (1997–98) crises the key roles played by financial sector fragilities and corporate governance shortcomings expanded the list of goals. The problem is that country ownership is less likely when programs have too many objectives—because as the number of objectives increases, it becomes less likely that the authorities and the IMF will agree on the full range of objectives or on how they are to be attained.

Borrowing countries may be partly responsible for the lack of ownership. Some countries may be so eager for initial disbursements and for the catalytic role of IMF financing that they are willing to agree to programs without being convinced that the associated conditionality is appropriate. Such agreements have a greater chance of unraveling at critical decision points when it becomes clear that difficult policy measures are unlikely to be implemented. In private markets, if a lender has serious doubts about a borrower's intentions or is not provided sufficient collateral, the optimal course of action is not to lend. Given the IMF's cooperative structure, and the Samaritan's dilemma it faces, it is much more problematic for it to refuse to lend to a member in need (see Drazen and Fischer 1997).

## IV. New Initiatives to Foster Greater Ownership

A number of proposals have recently been made to enhance country ownership of IMF-supported programs. Four such initiatives are considered here: encouraging countries to design their own programs (specifically in the context of PRSPs), streamlining structural conditionality, introducing flexibility in the timing of structural policy measures (floating tranche conditionality), and applying conditionality to outcomes rather than policies (outcomes-based conditionality).[5] The IMF is already implementing some of these proposals (see IMF 2001a, 2001b, 2001c).

### *Encouraging Countries to Design Their Own Programs*

The IMF could require or encourage borrowing countries to produce home-grown programs. In some cases this may be seen as forcing ownership, but program designs can be worked out cooperatively between the country and the IMF. If countries lack the expertise and capacity to develop their own programs, the IMF could provide technical assistance and training or encourage the authorities to hire independent technical advisers.

Although there are examples of home-grown programs, for several reasons this approach has generally not worked very well. First, countries often use overly optimistic assumptions when designing their programs. For example, countries may underestimate the extent of their difficulties and overestimate the potency of their policy instruments. Second, if the process of formulating a program—with its associated domestic political compromises—hardens the authorities' negotiating position with the IMF, it will likely cause significant delays in program negotiation. Third, countries may prefer to have the IMF prepare the program because they do not have (or choose not to have) domestic mechanisms for making decisions on difficult tradeoffs. This may require the IMF to force issues requiring decisions. Fourth, from a negotiating standpoint, countries may want to see the IMF's position before offering their own in a program document.

To increase program ownership by low-income countries, the IMF and World Bank recently began encouraging the production of PRSPs.[6] The papers are intended to specify and detail a country's policies for reducing poverty (see Ames, Bhatt, and Plant 2002). PRSPs have three key elements:

- They are prepared by country authorities in consultation with various levels of government, local communities, civil society groups, donors, and multilateral agencies.
- They diagnose the country's poverty situation with the aim of identifying the main obstacles to raising incomes and welfare.
- They set goals for poverty reduction, define the immediate and long-term policy actions needed to achieve those goals, and design a system for monitoring progress.

Recent experience with PRSPs suggests that they could foster program ownership in several ways. (For a comprehensive review of the PRSP approach and its early experiences, see IMF 2002a, 2002b.) By creating a forum for dialogue—both within the government and among other stakeholders in society—that papers can identify the concerns and views of affected groups as well as policymakers. Thus they should enable policymakers and donors to better understand the different facets of poverty and the main concerns of poor people. In this regard, the challenge for governments is to strengthen democratic institutions and provide a voice to all domestic constitu-

encies. In many developing countries it cannot be assumed that nongovernmental organizations and civil society groups have the capacity to adequately participate in such a dialogue and engage in policy design, monitoring, and implementation.

PRSPs should also lead to better, more systematic collection of data and more effective monitoring. As a result, they can be used to manage expectations and set realistic goals, evaluate the tradeoffs and constraints involved, and develop priorities for policy action. Again, increased ownership will require ensuring that countries have the technical capacity to formulate and analyze different policy paths. In addition, the effectiveness of PRSPs will depend on how much they contribute to better governance and how policy strategies deal with corruption.

By offering a coherent strategy for attacking poverty, PRSPs could enhance coordination of program and nonprogram aid from multiple donors and multilateral agencies. Bulir and Hamann (2001) show that for many countries aid is highly volatile (more so than fiscal revenues), mildly procyclical, and not very predictable. As Svensson (2000) argues, when donors are unable to monitor reform efforts, aid disbursements are likely to be tied to economic performance—and hence procyclical.

Aid volatility and unpredictability can complicate expenditure management, especially for governments with deficient fiscal infrastructure, resulting in adjustments borne mostly by poorer and weaker segments of society. To the extent that PRSPs help coordinate donor efforts and reduce the cost of mobilizing and using aid, they could contribute to the success of IMF and World Bank programs—and so enhance country ownership.

For the IMF and World Bank, an important aspect of facilitating country production of poverty strategies will be coordinating advice and technical assistance to member countries. Such coordination will involve ensuring that the macroeconomic and financial conditionality attached to IMF lending is consistent with the sectoral and project-based conditionality (for structural and social policies) attached to World Bank lending. Such consistency will be achieved only if the IMF and the World Bank agree on their respective conditionalities, then use them in programs that respect—to the extent possible—the overall strategies articulated by member countries. A collaborative approach will enable countries to access and use effectively the IMF's Poverty Reduction and Growth Facility and the World Bank's Poverty Reduction Support Credit facility.

### *Streamlining Structural Conditionality*

The past two decades have seen a major increase in structural conditions in IMF-supported programs (Goldstein 2000; IMF 2001c). The expansion of structural conditionality would appear to limit the scope for domestic policy choices, reducing country ownership. But there is considerable validity for the expansion (IMF 2001a, 2001b, 2001c). Even so, many structural reforms are of a microeconomic nature

and are likely to be more intrusive than macroeconomic policies. Country ownership of programs is essential for the design and implementation of these microeconomic measures because they have a different impact on various segments and vested interests in society.

It is widely felt that the IMF has gone too far with structural conditionality and overloaded programs with structural measures. Many structural reforms are not required to achieve macroeconomic stability. There is also no evidence that programs with more structural conditions have been more successful. In fact, programs with more structural conditions seem to have the same success rate as those with less (IMF 2001c).

Increased structural conditions pose two main dangers. First, they may reduce country ownership of programs and so impair their effectiveness. Second, a failure to implement structural reforms not critical for macroeconomic stability may undermine confidence in the overall program—possibly triggering reactions in domestic and international capital markets that could make overall program objectives harder to achieve.

It would be difficult and undesirable to turn back the clock and eliminate all structural conditions from programs. But careful thought should be given as to which structural reforms are essential to achieving a program's main objectives. These reforms will vary by country, but sharply pruning the list of structural conditions is possible without jeopardizing a program's success or the IMF's ability to be repaid. In other words, prioritizing or streamlining structural conditionality does not mean weakening overall conditionality.

The IMF has acknowledged that structural conditionality has expanded too much, and a major effort is under way to streamline it. IMF management recently defined broad principles for staff to use in determining the appropriate scope of structural conditionality in programs. In summary, the principles in the Interim Guidance Note on Streamlining Structural Conditionality (IMF 2001b:box 3) are:

- Structural reforms critical to achieving a program's macroeconomic objectives generally must be covered by IMF conditionality.
- Structural reforms relevant—but not critical—to a program's macroeconomic objectives and within the IMF's core areas of responsibility may be subject to conditionality.
- For structural reforms relevant to a program's macroeconomic objectives but neither critical nor in the IMF's core areas of responsibility, conditionality generally should not apply.

These principles represent an important shift by the IMF from comprehensive to parsimonious structural conditionality. Experiences with programs negotiated since the issuance of these principles will show whether this intention is being achieved.

### *Adopting Floating Tranche Conditionality*

Performance criteria and structural benchmarks in IMF-supported programs have specific dates attached to them. Countries often find that rigid timetables for major structural reforms constrain their choices and strain their implementation capacity.[7] Thus programs could be designed to allow for greater flexibility in the timing of structural reforms, increasing the scope for country ownership.

One way to achieve this goal is through floating tranche conditionality for structural reforms. Under this approach IMF loan disbursements would not be tied to specific dates. Instead, disbursements would be made available on completion of certain agreed-on reforms. This approach gives countries flexibility in the timing of program implementation.[8] It also allows for disbursements associated with implementation of one part of a program to be unlinked from those associated with another part of a program.

The floating tranche approach could be used to divide conditionality into two parts. One part of IMF financing could be conditional on achieving the usual quantitative performance criteria under a predetermined schedule, whereas the other part could be dependent on implementing certain structural reforms at any time prior to the expiration of the program (and provided the macroeconomic program stays on track). In the floating tranche part the country would have control over when it undertook reforms and assurances that when it did it would receive related funding. The IMF would be protected because it would disburse funds only when reforms were undertaken.

The segmentation of conditionality would require decisions on the proportion of IMF financing subject to standard fixed tranche conditionality and that subject to floating tranche conditionality. Such decisions would be based on judgments about the relative importance of a program's different parts in achieving its overall objectives.

Not all structural reforms would be subject to floating tranche conditionality, because some are essential to macroeconomic improvements. For example, an independent central bank could be considered necessary to promote monetary stability, and a proper tax collection system might be needed to achieve fiscal discipline. The timing of such reforms could not be left open. In other words, in deciding which reforms are subject to fixed or floating tranche conditionality, the interdependence between structural measures and macroeconomic management would have to be taken into account. Final decisions would be made on a case-by-case basis and would be the result of negotiations and agreements between the IMF and the country authorities.

There is experience with a form of floating tranche conditionality in the context of the Higher Impact Adjustment Lending (HIAL) initiative, which was introduced by the World Bank in Sub-Saharan Africa in 1995. The tranching innovations under the initiative have two objectives: first, to give governments more freedom in the

timing of agreed reforms, thereby increasing ownership; second, to reduce pressure on the World Bank to disburse funds when conditions have not been met. These objectives are to be achieved through multiple but smaller tranches, increased disbursements after implementation of reforms, and the introduction of independent floating tranche arrangements.

Prior to the HIAL initiative, adjustment loans typically were disbursed in two tranches. HIAL introduced floating tranches, with single tranche operations as an alternative in special circumstances. Floating tranches are usually targeted at policy reforms in certain sectors and, in some cases, are in addition to regular tranches. Under HIAL, floating tranches have been applied to reforms involving the financial and banking sectors, the parastatal and public sectors, privatization, and civil service reform. A tranche is released only when the structural condition is met, regardless of when that happens. Of the 21 HIAL operations in 17 African countries in 1996–98, about two-thirds used the new tranching mechanisms.

In 1999 the World Bank's Operations Evaluation Department conducted an evaluation of these 21 operations (World Bank 1999). The study found that the HIAL initiative was associated with positive policy outcomes in terms of fiscal adjustment and exchange and interest rate policies. Moreover, the countries involved did better than nonparticipating comparator countries in increasing growth, lowering inflation, improving current account balances, stabilizing foreign exchange reserves, and achieving more sustainable debt paths. Even though HIAL programs differ in other ways from other World Bank programs, and the evaluation did not take into account the role of exogenous factors, the results provide some support for the use of floating tranches.

### *Basing Conditionality on Outcomes, Not Policies*

Outcomes-based conditionality involves conditioning disbursements on the achievement of results rather than on the implementation of policies expected to eventually attain program objectives. Changing from policy-based conditionality to outcomes-based conditionality—leaving the choice of policies to the country authorities—has been advocated by, among others, Carlos Diaz Alejandro (1984:7):[9] "I propose that the international community should return to the key rationale for conditionality, and negotiate with countries borrowing on concessional terms only regarding the balance-of-payments targets, leaving to the countries the decision as to what policy instruments should be employed to achieve them."

Under the outcomes-based approach, IMF conditionality would focus on objectives rather than policy instruments and actions. Performance criteria for the disbursement of funds would be based on whether the targets for policy objectives were achieved by set dates. The policy objectives would be negotiated with the IMF, but the policy content of programs would largely be left up to country authorities.

This approach is not as radical as it might seem, because programs already define outcome variables as performance criteria. For example, IMF-supported programs include a floor on net international reserves as a performance criterion. Similarly, the adoption of an inflation targeting framework has made inflation one of the key variables monitored in the IMF's program for Brazil. Presumably, as more countries adopt the inflation targeting approach to monetary policy, more programs will follow the Brazilian model. Other variables that could be subject to outcomes-based conditionality include the trade balance, the current account, investment, growth, and so on.

In principle, there are two major benefits to this approach. First, the country authorities would be responsible for designing policies to achieve desired goals (as long as the policies are not prohibited by the IMF's Articles of Agreement). Hence the authorities would bear the risk of success or failure. This approach would enhance country ownership by requiring that the authorities and the IMF agree only on program objectives—and not necessarily on the mechanisms linking these objectives to specific policies.

Second, funds would be disbursed only on the attainment of certain goals, providing incentives for the country and the IMF to craft appropriate policies. IMF resources would be safeguarded because disbursements would depend on countries achieving the desired results. If policies did not have the envisioned outcomes, the country and the IMF would have to rethink the economic strategy.

Implementing this approach would undoubtedly present a few challenges. First, outcomes-based conditionality could lead to the backloading of funds that may be needed earlier to fill a temporary liquidity gap or to finance structural reforms. It would also lead to greater uncertainty for the country authorities about the availability of funds, because the agreed-on policies might not lead to the anticipated results.

Second, there may be significant lags in the reporting of data on outcomes, particularly for the real sector and for trade accounts. In addition, data on outcomes may be subject to frequent revisions, making timely monitoring and disbursements problematic.

Third, program outcomes are influenced not just by policies under the control of country authorities, but also by exogenous factors beyond their control. Though true in principle, it is not clear that exogenous shocks create serious problems for program projections. For example, a recent study of program projections by Musso and Phillips (2001) show that projections for growth, inflation, and international reserves were accurate relative to simple random-walk projections. But projections for current and capital accounts did not outperform projections from the random-walk model.

The more difficult question in this regard is, if exogenous factors force a program to go off course, to what extent should the authorities bear the risk of failure? Should

there be some assurance of IMF disbursement if it is judged that the authorities made a good effort to attain the goals? Thus even outcomes-based conditionality will require sifting the evidence to determine whether outcome targets were missed because of exogenous factors or because the authorities genuinely came up short—and if because of exogenous factors, whether there would be a case for waivers as there is under policy-based conditionality.

Outcomes-based conditionality also raises the question of whether and when it would be feasible for the IMF to disburse funds based on promises to achieve certain goals if it had not had any influence on the policy measures to attain them. In the private sector, such condition-free lending is made only to blue-chip clients or those with good collateral, high net worth, or both. Similarly, the IMF would likely provide such loans only to countries with strong records of economic performance and management, reputations for good governance, histories of paying debts as contracted, and those facing situations that are not too dire.

Otherwise, giving borrowing countries complete freedom in their choice of policy actions would not provide adequate safeguards for IMF resources. Even for the best clients, contract and loan covenants are likely to provide complete freedom for policy choices only as long as the client's capacity to repay is not impaired by endogenous or exogenous factors. To protect its resources, the IMF, like other lenders, will specify contingencies in the loan contract if the borrower's health deteriorates—for whatever reason.

Two points can be made in response to the problems raised regarding outcomes-based conditionality. First, even under outcomes-based conditionality funds will be disbursed in tranches. For example, a program to correct an imbalance in the balance of payments could take multiple steps to achieve its goal of attaining a comfortable level of international reserves. The first tranche could be disbursed based on a promise, but subsequent tranches would be released only after the country had achieved certain levels of international reserves. In fact, even the release of the first tranche could require some prior actions. Hence, by splitting monitoring and disbursement into smaller components, outcomes-based criteria can simultaneously provide sufficient safeguards and prevent excessive backloading of financing.

Second, like any creditor, the IMF would combine outcomes-based conditionality with a monitoring system so that if a borrower's position deteriorated sufficiently, it would intervene to contain the damage, take prompt corrective action, and try to change the borrower's strategy. So, as noted, there is likely to be ex ante ownership but ex post conditionality. That is, a program might have little bite initially, but stricter constraints would be imposed if certain events occurred. Because all possible contingencies cannot be specified ex ante, the IMF would design outcomes-based programs with the option of intervening should doing so be necessary to protect its resources.

## V. Conclusion

This article has drawn on the well-established literature on agency theory and finance to argue that conditionality must apply to all IMF lending and that country ownership of IMF-supported programs is essential. Because ownership matters for the success of these programs, the IMF and country authorities share an incentive to create contracts that maximize ownership—subject to the safeguards that the IMF requires for its resources.

There is a widespread perception that countries often lack sufficient ownership of the programs they negotiate with the IMF. Here it is important to distinguish between countries in crisis and those with emerging imbalances. Crisis countries have less room for maneuver, and their problems require rapid responses. In such cases ownership may be less important—and, given the exceptional and extreme circumstances, agreements may be easier to reach. In other countries the extra time spent on negotiations may be a necessary price to pay for better program outcomes. In fact, different IMF facilities could cater to countries in different circumstances, and the scope and types of conditionality could differ depending on the facility used.

Ownership can be enhanced by limiting the objectives of IMF-supported programs—which would also allow for more focused conditionality. If a program's objectives are to establish and maintain macroeconomic and financial stability, the range of structural measures required by IMF conditionality would be narrower. In its capacity as policy adviser, the IMF can advise on the merits of various structural reforms. But in the context of programs, it should include only conditions that directly support macroeconomic objectives. Encouraging the domestic formulation of programs, selling programs to multiple country stakeholders, discussing different policy options, and increasing information flows would all help increase country ownership of programs.

So far the design of conditionality has focused on policy actions rather than outcomes. This article has argued that there is merit in shifting the emphasis toward outcomes-based conditionality and exploring the use of floating tranches, especially for structural reforms. Outcomes-based conditionality would increase country ownership by giving the authorities greater discretion and flexibility in choosing the policy mix and the timing of structural measures. This increased leeway in program implementation would be tied to explicit acknowledgment of ownership, improvements in data and reporting (to facilitate monitoring by external observers), and acceptance of responsibility for program outcomes.

For the IMF, outcomes-based conditionality would have to be combined with an agreed monitoring system for programs and establishment of rules for borrower behavior. Such rules would be applied uniformly and enforced through peer pressure and international norms—because the IMF has no recourse to legal action.

Although a good case can be made for incorporating outcomes-based conditionality in IMF lending, it is not an either/or matter. Programs would presumably combine

policy-based and outcomes-based conditionality. The balance would depend on the country's circumstances, preferences, and economic problems and on the accuracy with which different policy actions and outcomes can be monitored (Dixit 2000; Drazen and Fischer 1997). Programs with such a balance would align IMF conditionality more closely with country ownership—undoubtedly the shared goal of the IMF and its member countries.

## Notes

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1. More formally, moral hazard can be defined as actions of economic agents maximizing their utility to the detriment of others in situations where they do not bear the full consequences of their actions due to uncertainty, asymmetric information, and incomplete or restricted contracts (see Kotowitz 1987; Stiglitz 2000).

2. Additional safeguards are provided by the fact that IMF claims are de facto senior to claims of other creditors and that funds are disbursed in tranches, conditional on the implementation of satisfactory policies (which are monitored) to correct the imbalances.

3. There is no direct empirical evidence on the link between ownership and IMF-supported programs. But some evidence on the importance of ownership for project lending is provided by the World Bank. The Bank's Operations Evaluation Department rates government commitment to each project (measuring in a sense the degree of ownership) using a variety of objective and subjective indicators. The relationship between project outcomes and government commitment turns out to be strongly positive (and statistically significant).

4. Feldstein (1998), for example, argues that the IMF has been too intrusive in its interventions and should ask two questions of each conditionality measure. First, is it needed to restore access to international capital markets? Second, would the IMF ask the same measure of a major industrial country if it had a program?

5. Other proposals not discussed here include preselecting countries eligible for IMF lending, developing policy options for country authorities to choose from, and investing time and effort in selling programs at home and abroad (see Khan and Sharma 2001).

6. Heavily indebted poor countries seeking debt relief and countries eligible to borrow from the IMF's Poverty Reduction and Growth Facility are required to produce a PRSP and have it approved by the Executive Boards of the IMF and the World Bank before seeking new program support.

7. In many cases rigid program schedules have posed serious problems for borrowing countries. One example involves the passage of laws: some legislatures have been surprised to learn that a program has committed them to not only a specific legislative agenda but also a set of deadlines under which the relevant legislative actions must be taken.

8. In principle, prior actions in IMF-supported programs can be thought of as a variant of floating tranche conditionality. A country agrees to undertake certain measures before the program (or program review) is discussed by the IMF's Executive Board. Thus the timing of the board meeting and the disbursement of funds depend on the prior actions having been taken. Reviews can also be considered a

form of floating tranche conditionality, because their completion (and accompanying disbursements) depends on agreed-on policy measures being taken.

9. Spraos (1986) makes a similar point but on the grounds that the links between outcomes and policy variables are too tenuous to make policy-based conditionality especially meaningful.

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