Improving Lending Policies and Practices

The IMF provides financial support to member countries under a variety of policies and lending instruments (see Table 8.1). Most forms of IMF financing are made conditional on the recipient country's adopting policy reforms to correct the underlying problems that gave rise to its need for support.

During FY2003, the Executive Board concluded a comprehensive, two-year review of conditionality (that is, the conditions related to IMF-supported programs) and approved new guidelines for the design and implementation of conditionality in IMF-supported programs. The new guidelines aim to streamline and focus IMF conditionality to promote the success of member countries' reform programs.

In the context of this major review of conditionality, the Board emphasized the need to establish a clear division of labor with other international institutions, especially the World Bank. In September 2002, Directors discussed the progress made on strengthening IMF–World Bank collaboration on country programs and conditionality under a new collaboration framework for the two institutions.

Also in September 2002, the IMF's Independent Evaluation Office (IEO) issued an evaluation report on the prolonged use of IMF resources by some member countries. Subsequently, the Board discussed the conclusions of a staff task force set up to make recommendations on how issues raised in the report might best be addressed.

New Conditionality Guidelines

To ensure continued effectiveness, the IMF regularly reviews developments in conditionality (see Box 4.1). In September 2002, the Board adopted new guidelines

Box 4.1

How IMF Conditionality Has Evolved

When the IMF commits its financial support to a member country, the country is expected to carry out policy adjustments and reforms to correct the underlying problems that gave rise to its balance of payments difficulties and its need for assistance. To this end, the IMF has attached conditions to its lending, focusing initially on monetary, fiscal, and exchange rate policies. Unsurprisingly, these conditions have evolved over the IMF's history as the circumstances and challenges facing its members have changed.

Structural Conditionality

Beginning in the late 1980s, the IMF increasingly emphasized the need to achieve adjustment through structural improvements in the economy. As a result of the greater focus on structural measures, the average number of structural conditions in a program, which was only 2 or 3 in the mid-1980s, climbed to 12 or more by the second half of the 1990s. Much of the increase was in the transition economies where, almost by definition, the programs had large structural content.

The increase in the number of conditions raised concerns that the IMF might be overstepping its mandate and expertise. Excessively detailed policy conditions can undermine a country's sense that it is in charge of its own reforms. Without such "ownership," reform is less likely to happen. Moreover, poorly focused conditionality can overburden countries attempting to implement nonessential reforms at the expense of reforms truly needed for achieving the program's objectives.

New Guidelines

In September 2000, the IMF's Managing Director issued interim guidelines on streamlining structural conditionality that set out general principles. From March 2001, papers prepared by IMF staff were posted on the IMF website to invite public comment on the principles and issues related to conditionality. Country officials, academic experts, and representatives of other organizations also added their views. Among their suggestions were the need to pay attention to the sequence and pace of policy implementation and the importance of a clear and coherent strategy for assistance from the international community.

In April 2002, the IMF's Executive Board agreed on the general principles to be embodied in new conditionality guidelines, and in September 2002 the Board approved the new conditionality guidelines, the first revision since 1979.

to encapsulate ongoing efforts to streamline and focus IMF conditionality. (The guidelines can be found on the IMF website.) An important objective of the new guidelines is to enhance country ownership and improve the prospects for sustained implementation of Fund-supported programs, most importantly by concentrating the IMF's policy conditions on areas that are critical to their success. The wholehearted implementation of these guidelines has also been identified in the IEO evaluation report on prolonged use of IMF resources as one of the key steps in avoiding the failure of Fund-supported programs.

The guidelines emphasize the need to focus conditionality on policies that are critical to achieving the macroeconomic objectives of Fund-supported programs. They also aim to establish a clearer division of labor with other international institutions, especially the World Bank. The guidelines are based on an increasing recognition of the importance of several interrelated principles:

- national ownership of policy reforms;
- parsimony in the application of program-related conditions;
- tailoring of programs to the member's circumstances; and
- clarity in the specification of program-related conditions.

The new guidelines introduce specific criteria for deciding whether conditions are appropriate in each case. Structural conditionality is regarded as an important element of Fund-supported programs, as long as it is critical to achieving the objectives of the program.

Box 4.2

A Framework for Bank-Fund Collaboration

In July 2001, Directors discussed the strengthening of IMF–World Bank collaboration on country programs and conditionality (see *Annual Report 2002*, page 41), and adopted a strengthened collaboration framework between the two institutions. The framework, which was also endorsed by the Executive Board of the World Bank, is based on three key principles:

- clarity about responsibilities,
- early and effective consultation, and
- the accountability of each institution for its own financing.

To implement the new framework, in the spring of 2002 the managements of both institutions issued a Guidance Note on *Operationalizing Bank-Fund Collaboration in Country Programs and Conditionality* to their staffs. Later in the year, the staffs of both institutions prepared a progress report examining their experience with collaboration under the Guidance Note.

The guidelines also spell out the roles of different types of program-related conditions, including performance criteria, structural benchmarks, and prior actions. A note by IMF staff providing additional explanation and context for the conditionality guidelines was released along with the guidelines.

An essential aspect of the IMF view of conditionality is that the member country will take primary responsibility for its own policies, and that documents setting out the country's reform agenda will be drafted by the authorities with the cooperation and assistance of Fund staff. The Board agreed during the course of its review that properly designed conditionality can complement and reinforce national ownership.

Strengthening IMF–World Bank Collaboration

In September 2002, the Progress Report on Strengthening IMF–World Bank Collaboration on Country Programs and Conditionality, prepared jointly by the staffs of the IMF and the World Bank, was discussed by the Board.

The progress report examined the experience with collaboration in relation to a Guidance Note issued in April 2002 (see Box 4.2). The report highlighted a survey of staff in the two institutions—World Bank country directors and IMF mission chiefs—examining their experience of collaboration. The survey found that, although collaboration was seen as satisfactory with no major problems indicated in most cases, a number of institutional factors were impeding fully effective collaboration—such as differences in working structures, time frames for achieving goals, and lending arrangements and instruments. These results con- firmed the need for continued efforts to strengthen collaboration.

In their discussion, Directors reaffirmed that close collaboration is indispensable for providing effective support to member countries, and forms an integral part of efforts to streamline and focus conditionality to enhance national ownership of reform programs. The move to strengthen collaboration in country programs is taking place against the background of progress achieved in a number of other areas, including the PRGF/HIPC framework and systematic joint analytic work such as that being done in the Financial Sector Assessment Program (FSAP) and Report on the Observance of Standards and Codes (ROSC) exercises.

The central principles of collaboration on country program design and conditionality, Directors noted, clearly designate one of the two institutions as a lead agency in particular policy areas and systematic information sharing between the two institutions. At the same time, they considered it essential that each institution retain ultimate responsibility for its own lending decisions.

The Guidance Note on *Operationalizing Bank-Fund Collaboration in Country Programs and Conditionality* was beginning to play a positive role in strengthening collaboration, Directors observed, while noting the limited basis for assessing progress at this stage.

Effective collaboration with the World Bank is critical for the success of efforts to streamline and appropriately focus IMF conditionality, Directors emphasized: it is needed to ensure that important measures are adequately covered as the IMF applies conditionality more sparingly outside its core areas. At the same time, Directors generally considered that structural measures that do not fall in the core areas of the IMF, but are critical for macroeconomic stability, should remain part of the IMF's conditionality.

For the low-income countries, Directors noted that the PRSP process provides a natural framework for ensuring collaboration between the staffs of the two institutions in support of a country-led strategy for addressing poverty and fostering sustainable growth. For middle-income countries, collaboration has been more varied and based on a less formal approach, depending in part on the circumstances of the country, and stronger efforts are needed to ensure an effective approach in these cases also.

Looking forward, Directors encouraged the staff of both institutions to move ahead on the basis of the Guidance Note and the approach set out in the progress report, subject to another review no later than the end of 2003. They stressed that the views of the country authorities need to be taken into account in evaluating the effectiveness of collaboration, and they also suggested seeking input from donors, as well as a wider sample of IMF and World Bank staff.

Prolonged Use of IMF Resources

In March 2003, the Board concluded its discussions on prolonged use of IMF resources, based on the report of the IMF's Independent Evaluation Office (IEO) and the conclusions of a staff task force (see Box 4.3).

Directors appreciated the work of the task force as a key step in following up on the IEO's candid and comprehensive analysis. Thorough implementation and review of the measures proposed by the task force—

Box 4.3
Evaluation of Prolonged Use of IMF Resources

The Independent Evaluation Office (IEO) was set up by the IMF's Executive Board in July 2001 to provide objective and independent evaluation on issues related to the IMF. It operates independently of IMF management and at arm's length from the Executive Board. In September 2002 the IEO issued its first evaluation report—on the prolonged use of IMF resources.[1] Shortly afterward, the Managing Director issued a statement to the Executive Board welcoming the IEO's report, agreeing with many of its findings, and indicating that the IMF's management would establish a staff task force to recommend how issues raised in the report could best be addressed, building on the recommendations made by the IEO. Directors welcomed both the IEO report and the Managing Director's proposal. After receiving the conclusions of the staff task force, the Board discussed them in detail, concluding its discussion in March 2003.

Financial support from the IMF is intended to assist members in overcoming temporary balance of payments difficulties. Particularly under Stand-By and Extended Arrangements, IMF-supported programs aim to attain external viability, after which the IMF's financial support should no longer be needed. At times, prolonged use of IMF resources may signal a failure to achieve this key objective—which can impose costs on the member country, damage the IMF's credibility, and make it more difficult for the member to meet its external obligations (including its obligations to the IMF). In past discussions of prolonged use, the Executive Board has stressed the importance of distinguishing between countries that are making adequate progress toward achieving their program objectives and those that are not.

The IEO report concluded that prolonged use of IMF resources was substantial and could be associated with a number of problems. These included:

- risks to the revolving character of IMF resources;
- the possibility that prolonged use may be the result of weak program design and implementation;
- unwarranted intrusion on the development of domestic policies and institutions; and
- a possible blurring of the IMF's role and mandate, especially in relation to the work of the World Bank and other development institutions.

Follow-Up

The follow-up to the IEO report focused more generally on improving the prospects for successful implementation of all IMF-supported programs, through the adoption of policies and procedures that promote better program design and strong country ownership, along with accountability for outcomes. It also included measures aimed specifically at cases of prolonged use of IMF resources. The follow-up was aimed as well at ensuring that the Board's decisions on whether to provide Fund financial support for a member's adjustment program are taken transparently and with a clear understanding of the risks and constraints.

In its work, the staff task force benefited not only from the IEO report but also from comments received by the IEO through a process of external outreach, including seminars in Berlin, Cambridge, London, Manila, and Tokyo.

[1] The IEO's report on Evaluation of Prolonged Use of IMF Resources is available on the IMF's website at *http://www.imf.org/external/np/ieo/2002/pu/index.htm.*

along with timely attention to the IEO's future reports—would be critical to ensure that the work of the IEO makes its maximum contribution to enhancing the listening and learning culture within the IMF.

In their March discussion, Directors generally reaffirmed their observations during the Board's discussion of the IEO report, in September 2002, regarding the extent and nature of problems posed by the prolonged use of IMF resources. Under proper circumstances, most Directors agreed, long-term IMF financial engagement could be an appropriate response to help member countries address deep-seated problems that, by their nature, required many years to resolve. These problems have been particularly prevalent in low-income countries and countries in transition. Directors also observed, however, that at times prolonged use can be associated with inadequate progress in dealing with a country's key economic problems, and that, in some cases, prolonged use and the associated policy conditionality can hinder the development of domestic institutions.

The financial implications of prolonged use for the IMF's regular resources and for PRGF resources also were a possible concern. Directors broadly endorsed a number of measures aimed specifically at cases of prolonged use while stressing that attention should also focus on improving the prospects for successful implementation of all IMF-supported programs. This would be achieved through the adoption of policies and procedures that promote better program design and strong local ownership, along with accountability for outcomes. In that context, Directors also supported the recommendation that Board decisions on the provision of IMF financial support be transparently based on candid assessments by the staff of the risks and constraints involved.

The strategy outlined by the task force received the Board's broad support. This would entail:

- the rigorous implementation of IEO recommendations to improve surveillance, conditionality, and program design (including the need for greater realism in program objectives and assumptions);
- additional measures to strengthen "due diligence" for prolonged users (including more systematic ex post assessments) and enhance information for decision making; and
- further substantive consideration of issues raised by the IEO in the context of future discussions on surveillance, program design, and the role of the IMF in low-income countries.

As for the priority accorded by the IEO and the task force to making surveillance more effective, Directors felt the diligent implementation of the conclusions of the recent surveillance review (see Chapter 2) would be key to identifying economic weaknesses and building domestic support for sound policies. Directors stressed the need for the staff to combine clarity and candor with a recognition of the social and political realities that shape economic policy; to complement sound advice on economic objectives with discussions of alternative ways of achieving those objectives; and to reach out more broadly, including to legislative bodies.

In addition, Directors noted that the linkage of some forms of donor assistance to the existence of an IMF-supported program, and the IMF's catalytic role with respect to private financing sources, can result in pressures for IMF lending decisions that contribute to prolonged use. In that context, Directors confirmed the conclusions of their recent discussion on mechanisms for signaling the IMF's assessment of members' policies (see Chapter 2).

Systematically monitoring the timely implementation of the various elements of this strategy, in the context of the IMF's reviews of conditionality, would be important, Directors stressed.