

## IMF Conditionality – A Better Way

Keynes who was one of the Fund's progenitors hoped that, despite the watering down of his own proposals, the Fund would play during depressions an expansionist, anticyclical role. It is clear now that this has not been so. Most critics and nearly all admirers perceive the Fund as exerting a restrictive influence. Recently, a few critics have emerged who not only view the Fund as too liberal but also as inherently inefficient because it transgresses on the territory of private bankers who left to themselves would channel funds efficiently under market-determined criteria. But these can be overlooked at a time when private banks depend heavily on governments, central banks and the IMF for bailing out of what, by market criteria, are gross errors in their lending to Third World countries.

The highly contentious subject of conditionality, which is the focus of this article, is closely related to the issue of IMF restrictiveness. The toughness of conditions attached to upper credit tranche stand-by arrangements will obviously depend on whether the Fund takes a restrictive or expansionist view of its role in any particular world macroeconomic conjuncture. But there are certain important aspects of conditionality which can be largely, though perhaps not wholly, detached from overall restrictiveness; it is one of these which will be discussed here and so, unless otherwise stated, the degree of restrictiveness will not be at issue. The focus will be on *what* conditions, not on how tough.

### Targets and Instruments

The legitimacy of some conditionality is not seriously open to challenge. It stems directly from the fact that drawings on the Fund by member countries (other than SDRs) have to be repaid. Though the Fund itself no longer chooses to emphasise this rationale for conditionality,

it remains the ultimate justification for the practice, a justification which is reinforced by the fact that, unlike other lenders, the Fund is not free to operate along other dimensions, such as the rate of interest charged or the security demanded, in order to adjust the terms of the loan to the circumstances of the borrower.

But while conditionality is legitimate in principle, its detailed application, over which the Fund has wide discretion, is very controversial and the source of bitterness in the relations of the IMF with its principal clients of recent years – the poor countries of the Third World.

The critique of the Fund's conditionality practices which will be advanced here hinges on the elementary but also elemental distinction between policy targets and policy instruments. By making performance depend not on the attainment of policy targets but on the behaviour of policy instruments, the Fund turns instruments into targets, which is inefficient and divisive.

The target of a Fund loan is the restoration of viability in a country's balance of payments. This is, or should be, common ground for both the Fund and the borrowing country. For the former, attainment of the target safeguards its interest in the repayment of the loan, while for the latter it is an unavoidable necessity.

Other policy targets, such as growth, employment, inflation and income distribution certainly impinge, but they impinge via the trade-offs between viability of the balance of payments and these other targets.

The policy instruments which can be used to attain the balance of payments target are numerous and their ranking for efficacy and appropriateness is not unique; it depends on the circumstances of the country, the social values of the policy makers and, not least, the model used to evaluate the instruments.

Yet the Fund programmes, while incorporating many instruments, have been overwhelmingly dominated by three: credit ceilings, ceilings to the fiscal deficit and devaluation (the latter usually to be satisfied before commencement of a programme, hence known as "precondition"). The ceilings are set as targets which the country must attain in timed steps. These steps serve as performance criteria which, if not satisfied, can and often do lead to the blocking of further loan instalments.

The usual criticism of the Fund practice is that though credit and fiscal deficit ceilings are appropriate instruments if the source of the

balance of payments problem is lax monetary policy or irresponsible budgeting, they are not well suited to the problem if the source is structural or external. By insisting on its preferred instruments even in unsuitable circumstances, the Fund is failing in its duty to minimise the cost of adjustment needed to attain a given improvement in the balance of payments.

The Fund resists this criticism on the ground that what matters is not the source of the payments imbalance but whether it is long-term or transitory: if transitory, it should be financed; but if long-term, it must be eliminated by adjustment of the economy.

This is a good argument against anybody who denies the need for adjustment. But about appropriate adjustment it says nothing and does not therefore detract from the validity of the criticism which rests on the proposition that the appropriateness of instruments depends on the source of the imbalance.

But, though valid, this criticism does not go far enough. For the Fund's practice is flawed at its core: by setting targets for instruments of policy it elevates instruments into targets and leaves genuine targets of policy untargeted.

Ironically, the genuine target of the balance of payments (in one or other definition) is not only included as an objective in virtually all the Fund programmes but, in most, it is also quantified. Yet its practical significance is negligible; it does not bite because it does not feature in the list of performance criteria on which the disbursement of successive instalments of a country's drawing depends. (The performance criteria increasingly include the level of foreign exchange reserves, but as made clear in the writings of IMF staff — for example Kincaid (1983) — this is not essentially for its balance of payments implications but for the sake of rendering more effective the credit ceilings which invariably take pride of place among performance criteria.)

The elevation of instruments into targets is inefficient on many counts.

First, it is inefficient because targets require (and, if genuine targets, deserve) firm commitments, whereas instruments should be flexible, adaptable to changing circumstances and discardable if they turn out to be ineffective or to involve too great a cost.

Second, it is inefficient because it can happen and has happened that the balance of payments improves while one or more of the performance criteria fail to be satisfied, not just quantitatively but also in direction — say, the fiscal deficit rises instead of falling. This is not just

inefficient, it is perverse. And it is no answer to say that in such circumstances waivers could be granted *ex post*. For it is the *ex ante* conditions which shape policy actions and determine the burden which such actions impose.

Third, it is inefficient because it is divisive. Divisive as between the Fund and its clients because, unlike the genuine target of a viable balance of payments, which in principle is common ground, the instruments which the Fund favours are often contentious in the political and economic context of individual countries, with the result that recourse to the Fund is delayed and in the case of countries which have the option to borrow commercially (a category which excludes, of course, many of the poorest Third World countries), the Fund is treated as a lender of very last resort, if not as wholly untouchable. Any undue delay is almost by definition inefficient because it allows the payments imbalance to fester and makes the remedies more painful.

Of course the Fund is not alone in blurring the distinction between targets and instruments. Under the name of "intermediate targets" we have lived for some years with the practice of targets being set for instruments such as the money supply or the public sector deficit by governments and central banks which were under no obligation to heed IMF persuasion. But a commitment which is not subject to enforcement by an outsider (such as the IMF) wielding the sanction of the purse is less rigid and can be adjusted in the light of circumstances. In any case, the high point of self-willed targeting of instruments is now well in the past, experience having confounded the more simplistic notions about relations between instruments — monetary instruments in particular — and genuine targets, which underpinned this targeting.

### Experience of the Fund

Which brings us to the experience of the Fund programmes themselves. In recent years the Fund has been more forthcoming about itself and its staff publications throw a useful light on the record.

For the present purpose one simple statistic is the most relevant: of 64 cases reviewed by Donovan (1982) involving upper credit tranche stand-by arrangements in the decade 1971-80, 35 recorded an improvement in the current account balance of payments (expressed as a

percentage of GNP) in the year following the programme as compared with the year before; the balance of 29 cases recorded a deterioration. So 45% failed to move in the desired direction. The outcome is better when the comparison is made relative to the performance of all non-oil developing countries or when the three years after the programme are compared with three years before, but in no case does the percentage recording an improvement exceed 70.

Killick (1984) of the London-based Overseas Development Institute, who together with three colleagues conducted a three-year study of the IMF with the cooperation of the Fund staff, concluded that "the known statistical significance towards an improved balance is slight" after reviewing all the evidence concerning the overall balance and the "basic" balance as well as the current account balance.

At face value this evidence must be disappointing to the IMF and doubly disappointing to its clients who incur the cost of the programmes.

But explanations are not lacking which are designed to place the evidence in a better light. Three of the most important ones are the following: first, many of the failures to achieve an improved payments balance may be accounted for by countries not observing the Fund programmes; second, most countries having recourse to the Fund are in the throes of a rapid deterioration in their balance of payments position, in consequence of which some deterioration may carry over into the record during and immediately after the programme period despite the beneficial effects of the programme itself; third, some programmes incorporate substantial liberalisation of international payments, a feature which can explain recorded deteriorations.

It is true that the balance of payments record reported by Donovan does not distinguish between programmes the provisions of which were or were not observed. Moreover, Killick (1984) reports unpublished in-house studies by the Fund which purport to show a superior record in the cases where the provisions were observed. But an independent study which was made by Connors (1979) and is reported by Killick (1984) denies this emphatically, finding no significant difference between the group of programmes the terms of which were observed and the group of programmes which were marked by non-observance.

Regarding the second explanation, it is not clear why it has greater force than its opposite, namely that a balance of payments crisis compels a cut in deficit willy-nilly; in any case what force it has when the balance of payments performance rests on a comparison of single years on each side of the programme is surely lost when three year spans are compared.

And as for the third explanation, its practical significance must be small: an unpublished Fund review of 23 programmes in 1978-79 disclosed by Killick (1984) reports that liberalisation of trade and payments was a precondition in one programme only. Moreover, its mitigating force must be negligible to a Third World country which may not view liberalisation as a leap in the direction of Pareto efficiency.

More revealing than any of these explanations for the indifferent achievement of IMF programmes is another statistic emanating from a Fund source: of 77 cases involving high conditionality in the period 1971-80 examined by Kelly (1982), 28 were marked by an improvement in both the current account balance and the fiscal balance, 20 by a deterioration in both balances and 29 by a movement of the two balances in opposite directions. The last group of 29, nearly two fifths of the total, represents cases where the movements of instrument (fiscal balance) and genuine target (current account balance) did not relate in a well behaved fashion.

This evidence is yet another blow to the belief that targeting instruments of policy is a good substitute for targeting genuine policy targets because there is a highly stable relation between instruments and targets.

Economic policy is not pure science, where a given input of policy is associated with a unique outcome of the target variable plus or minus a random error which cancels out in the long run. In the use of policy instruments flexibility is needed (not rigid targeting enforced by financial sanctions) to respond to unanticipated exogenous events and to allow for the trial-and-error component in policy management.

There are of course explanations and mitigating circumstances for the discrepant movements of the fiscal balance and the current account balance noted above. But the more explanations there are for discrepancies between instruments and genuine targets, the stronger the case for not turning the instruments into targets.

Even if the record was better, it would still be true that different policy mixes which may be expected to have the same effect on the balance of payments would have different side effects. For this reason governments would rank them differently, depending on their ideology and social values. For the Fund to claim that only one mix can succeed is both arrogant and unfounded or, if the Fund grants that more than one mix can succeed, it is infringing sovereignty by insisting on its own preferred mix. (Sometimes the claim is made that the Fund will accept any effective package of policy measures and that it is unbending over

the effectiveness of the total, not over the components of the package. But if, as it is counterclaimed, the Fund takes a very narrow view of what is effective, there is in the end no difference.)

### The Proposed Reform

What is then to be done? Modifying conditionality here and patching it there may no longer be enough. Despite the high standing of the Fund in the developed world, there is no room for complacency. For in terms of a very important test the Fund has been going backwards most of the time — it is viewed more and more as a last resort, recourse being had to it only when a country has its back to the wall. In consequence, adjustment is delayed and the Fund cannot play a smooth anticyclical role even if it had wanted to, all of which is utterly inefficient.

It follows naturally from the preceding arguments that conditionality should shift to the balance of payments and, in the author's view, more specifically to the current account. An improvement in the balance of payments is the one genuine target in which both the Fund and its clients have a common interest. It should not feature just as an objective in Fund programmes; it should become the chief performance criterion, with stage-by-stage targets for the current account being set, the attainment of which will be a condition for the disbursement of successive instalments of a loan. The final target will not be, typically, a zero current account deficit since sustainable long-term borrowing is in the interests of poor countries. All the targets must be contingent on certain exogenous circumstances, for example, the level of world economic activity, domestic harvests, prices of major exports and imports. If these deviate substantially from assumed levels, they should trigger off renegotiation of targets. Technically, this is none too difficult.

This is not a recipe for a general softening of the Fund's stance. Whether or not it should be softened is a different question which is not confronted here in a major way. A system of balance of payments targets can be administered either more or less restrictively — it is not biased towards less. Indeed some inexperienced developing countries might argue that the intractability of their payments balance is so severe that the proposed shift in targeting is liable to be *de facto* more restrictive; but this would be a misperception, since external solvency is not an optional extra.

There is, however, a partial softening implied in making the targets contingent on cyclical factors such as world economic activity. If the world economy is sliding towards a recession, failure by a borrowing country to meet pre-assigned targets would be excused and its drawings would not be jeopardised. While this has implications for the resources of the Fund, it is the least that the Fund should do to live up to its responsibilities for a high level of employment in the world, as enunciated in its own Charter. It is also the least it should do in order to be consistent with its own emphasis on the distinction between long-term balance of payments deficits which must be eliminated and transitory ones which should be financed.

On principle, the case for a switch to some sort of balance of payments targeting — though not necessarily to the current account targeting which is favoured here — is almost self-evident. To resist it, it is necessary to appeal to practical considerations and in particular to the difficulty of monitoring compliance in a system of balance of payments targeting, given the longish interval which tends to elapse between the adoption of remedial measures and the response of the target variable.

The difficulty is real and it would be unwise to belittle it. But hardened professionals are apt to exaggerate the practical difficulties while glossing over the difficulties associated with their existing practices.

The most direct and decisive way of overcoming the difficulty is to extend the time-span of Fund programmes — now commonly of 12 month's duration — so that some balance of payments response occurs within the programme period. This is obviously a point at which the conditionality argument touches on the question of Fund restrictiveness. Extension of the programme period implies some relaxation by the Fund and it would be unreasonable to advocate it as a solution to the monitoring problem if it was not desirable for its own sake. But from mid-1979 to mid-1981 the Fund did engage in some lengthening of programmes as part of what most observers deemed to be a move towards a concerted liberalisation of policies and there is now widespread regret for the abrupt ending of this phase. Since then, under the pressure of big debtors, some extended programmes have been granted. But a more general resumption of liberalisation by the Fund will have much support as an end in itself, while overcoming, at the same time, the perceived difficulty associated with balance of payments targeting.

With or without resumption of liberalisation, the difficulty of monitoring has to be seen in perspective by comparing it with the

existing state of affairs. What has the monitoring under existing conditionality practices accomplished in terms of compliance with performance criteria? The answer is very little. Bird (1983) reports that "Over recent years perhaps in as few as 20% of cases are performance criteria actually fulfilled". Monitoring under a balance of payments performance criterion does not have room to do much worse.

Nevertheless, if the Fund fears that a moral hazard will be created — countries failing to take remedial measures but helping themselves to successive instalments of a drawing while the response of the current account is being awaited — it should be possible to agree on interim criteria to serve as a token of good faith, for example by focusing on some quickly responding components of the current account.

Another objection that is liable to be raised against the balance of payments as a performance criterion is that payments balances are the outcome of a number of factors at work, of which policy is only one. As some of the other factors cannot be anticipated or are subject to chance, performance criteria should not relate to outcomes (with the risk of rewarding good luck and punishing bad luck) but should control compliance with agreed policy measures (Williamson, 1983).

The first thing to be said about this is that it represents a curious inversion of priorities: because there is no one-to-one relation between policy input and the outcomes of target variables, you freeze the policy input and let the target be a residual. Second, if, as proposed here, balance of payments targeting is made contingent on exogenous events, the element of luck in the outcome is reduced and the sting removed from this objection.

## Conclusion

The case has been argued for a switch of IMF conditionality to balance of payments targets. The case has logical merit in that it ties performance to a genuine policy target; the practical difficulties, though real, should not be daunting.

Such a switch will retain what is legitimate in conditionality while satisfying those who have rightly complained about the meddlesome guardianship imposed by the Fund — its "grandmotherly" role as Dell (1981) dubbed it — those who want to "remove conditionality from the

more political aspects of macroeconomic policy" (Diaz-Alejandro, 1983) and those who want the client countries to take the initiative in developing "alternative conditionality" (Stewart, 1984).

More importantly, it will encourage earlier recourse to the IMF by potential clients and thus improve the efficiency of adjustment which is sadly impaired by their extreme reluctance at present to fall into the Fund's embrace. This is a prize which the Fund should value most of all.

A switch to balance of payments targeting will not end all conflict between the Fund and the countries which seek its assistance. Borrowers and lenders have different perspectives and some differences will always be difficult to reconcile. But since an improvement in the balance of payments is an agreed ultimate target, the conflict will centre on issues which are central to the target itself, such as the time span over which the improvement is to take place, the factors on which it is to be made contingent, and the size of the current account deficit which can be deemed sustainable through long-term capital inflows.

The Fund will rightly say that it has accumulated much experience in running the present system and that it should not therefore be lightly discarded, particularly since the Fund is not completely obdurate about improvements at the margin. There are also said to be some borrowing countries which positively desire to have conventional performance criteria set for them. For these reasons and also for the sake of prudence, the proposed alternative could, for a time, run parallel to the existing Fund practice, the choice being left to the borrowing country.

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