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IMF CONDITIONALITY: INEFFECTUAL, INEFFICIENT, MISTARGETED

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The International Monetary Fund is currently held in high esteem. Its role in the management of the international debt crisis has been much applauded in the creditor countries. But applause for short-run successes should not satisfy the IMF. At the next crisis or the one after, the Fund may receive plaudits yet again, but in the long run the worth of an institution and the value of its contribution must be judged on less transient considerations.

This essay will focus critically on a feature of IMF operations that has become permanent—conditionality. For more than three decades, members seeking access to the General Account of the Fund have had to commit themselves to explicit conditions regarding the conduct of their national policies. The principle of conditionality will not be questioned here, although it is worth recalling that there was a great debate inside the Fund in its early years on whether conditionality or automaticity was more in keeping with its Articles of Agreement. Conditionality became explicitly enshrined in the Articles only in 1969, twenty-four years after the Fund's inauguration, although it had been applied for many years before.

The questioning will be directed instead at the current *practice* of conditionality. It is the central theme of this essay that conditionality, as practiced, is conceptually flawed at its core: by targeting policy instruments, such as the volume of credit and the public-sector deficit, instead of genuine policy targets, conditionality reverses the natural priorities and leads to inefficiencies. It is proposed here that a switch be made to targeting the balance of payments, which is a genuine policy target and can therefore be logically cast in that role.

Section 3 is devoted to the central theme just described, and section 4 examines some practical problems and implications. Sections 1 and 2 build up to the central theme. Section 1 outlines the record of Fund programs. It is derived from secondary sources but plays an important part in the argument: by laying bare the fact that the record is unimpressive, it reinforces the logical argument for a change in the practice of conditionality. Section 2 considers the responsibilities of the IMF to the international economic system in the processes of balance-of-payments adjustment. It argues that they cannot be properly discharged because countries are massively inhibited from seeking early recourse to the Fund by the intrusiveness of conditionality as currently practiced. Thus the present regime fails to promote the efficiency of the system—yet another debit item.[1]

1 The Record of Conditionality

There is obviously a multiplicity of worthy targets of economic policy, including high employment, rapid growth, low inflation, more equitable income distribution, and balanced international payments. For three reasons, however, the balance of payments has a unique and preeminent position in the context of Fund programs. First, a member must demonstrate a balance-of-payments need in order to gain access to the resources of the Fund. Second, an improvement in the member's balance of payments is the only specific target prescribed in the IMF Articles. Third, a balance-of-payments improvement is needed if the Fund is to be paid back, and the Fund's own interest in repayment provides the major legitimization of conditionality in a world of sovereign states.[2]

The other target variables are not irrelevant, but their relevance is indirect, in that they are liable to affect or be affected by the pursuit of the balance-of-payments target. To put it another way, the other target variables define the tradeoffs that measure the cost of attaining the primary target. It is not meaningful, therefore, to put other target variables on an equal footing with the balance of payments and say, as some evaluations of Fund programs do in substance, that in x percent of programs the balance of payments improved, in y percent growth accelerated, and in z percent inflation slowed down. This is record keeping in the abstract. How would we judge Fund programs if the y percent of programs that were associated with accelerated growth comprised the same cases as the 100 percent minus x percent of programs in which the balance of payments had not improved?

It is, of course, hard in practice to apply the proper methodology, which would evaluate programs in terms of the cost incurred by each economy to achieve a given balance-of-payments improvement. But when the balance-of-payments record is weak, a negative assessment is appropriate on that basis alone. Failure in the primary dimension is dominant. Because the balance-of-payments record has in fact been weak, attention will be concentrated on this

[1] Sections 2 and 3 expand and develop ideas briefly adumbrated in Spraos (1984).

[2] Kenen (1986) neatly shows that the provisions for repayment of drawings on the IMF are neither necessary nor sufficient to ensure the revolving character of Fund credit. They are not necessary when there are no countries with persistent payments imbalances, and they are not sufficient when there are some persistent surplus countries. Pursuing Kenen's reasoning, it would seem that, to make credit revolve, the repayment provisions are necessary when there are persistent deficit countries and they are also sufficient if they succeed in securing repayment (thereby purging the system of persistent deficits).

one criterion, without regard to the tradeoffs. They would be relevant only to measuring the cost of success.

A number of studies have examined the balance-of-payments record of Fund-assisted countries before, during, and after the operation of IMF programs. One of the most recent, under the auspices of the Overseas Development Institute, is by Killick (1984) and his team, who also surveyed all the earlier studies. For the current account, the conclusion is that "there appears to be some tendency for the current account of programme countries to move in the desired direction but it is a tendency that has low established claims to statistical significance" (p. 233). For the "basic" and overall balances, "(a) there is a general tendency for Fund programmes to be associated with a reduced basic or overall BoP deficit," but "(b) the known statistical significance of the tendency towards improved balance is slight" (p. 235).

To add a quantitative flavor to these conclusions, Table 1 gives data extracted from an IMF staff study by Donovan (1982) for the decade 1971-80. The results of before-and-after comparisons are reported for the current ac-

TABLE 1

COMPARISONS SHOWING ABSOLUTE AND RELATIVE EXTERNAL-SECTOR IMPROVEMENT ASSOCIATED WITH UPPER-CREDIT-TRANCHE STANDBY ARRANGEMENTS, 1971-1980

	No.	Percent
Year before vs. year after program's inception (N = 64): [a]		
Absolute improvement:		
In ratio of current account to GNP	35	55
In ratio of overall balance to exports	39	61
In both ratios	28	44
Relative improvement: [b]		
In ratio of current account to GNP	44	69
In ratio of overall balance to exports	36	56
In both ratios	29	45
3 years before vs. 3 years after program's inception (N = 54): [a]		
Absolute improvement:		
In ratio of current account to GNP	32	59
In ratio of overall balance to exports	39	72
In both ratios	24	44
Relative improvement: [b]		
In ratio of current account to GNP	37	68
In ratio of overall balance to exports	36	67
In both ratios	25	46

[a] Because program and calendar years do not coincide, Donovan (1982) adopts a special convention for coping when data are available only annually.

[b] The benchmark is the performance of all nonoil developing countries combined.

SOURCE: Donovan (1982, Table 3).

count and the overall balance, in absolute terms and relative to all nonoil developing countries. Both annual and triennial comparisons are made.

Take absolute improvement first. With one exception, the proportion of cases showing an absolute improvement was no better than 3 out of 5. The respectable exception was with respect to triennial comparisons relating to the overall balance. (Though Donovan does not report statistical significance, this last case is the only one relating to absolute improvement that can boast of robust significance at the 5 percent level.)

A before-and-after comparison is of course imperfect (Williamson, 1983a). It does not require that all else remain the same (apart from IMF programs), but it does require that other factors do not bias the chosen measures of success either across countries or over time, and this condition is not easily satisfied. To eliminate bias, Donovan introduced a relative-improvement test. The underlying assumption is that all nonoil developing countries, including the program countries (which are, however, heavily outnumbered by the rest) were subject to the same systematic influences and can thus serve as a "control" group. A comparison between all nonoil developing countries and the program countries might then be expected to isolate more effectively the role of Fund programs.

It can be seen from Table 1 that the relative test favors the Fund more than the absolute test with respect to the current account, but it favors it less with respect to the overall balance, and the percentage of programs recording improvements in both current account and overall balance changes little between absolute and relative comparisons.

From the bare figures it might be argued that, on balance, the relative test makes the record of Fund programs a little more respectable. But, as Goldstein and Montiel (1986) point out, the relative test would be unbiased only if the nonprogram countries in the control group were drawn from the same population as the program countries. And this they are not in at least one particular that is crucial for the point at issue. As one would expect, the balances of payments of nonprogram, nonoil developing countries were in much better shape with respect to both the current account and the overall balance in preprogram years.[3] They were thus under less pressure (if any) to engineer an improvement or resist a deterioration, so that their use as a control flatters the Fund greatly.

With some allowance for this bias, the relative improvement shown in Table 1 becomes less than impressive. And it does not look as if this unimpressive record can be explained away by reference to countries that failed to comply with the provisions of Fund programs. When Connors (1979) sepa-

[3] Killick (1984) also alluded to this difficulty (p. 268, note 7) and Donovan (1982) was clearly aware of it.

rated "compliers" and "noncompliers," he did not find a statistically significant difference in current-account performance—in itself a result that is not helpful to the reputation of Fund programs.[4]

If the Fund could plausibly claim high marks for the effectiveness of its programs on the balance of payments, there would be reason to ask at what sacrifice this was achieved. Since such a claim is apparently not sustainable on the available evidence, we need not ask about tradeoffs. The ineffectiveness of Fund programs on the external front stands on its own.

2 Timing of Fund Assistance and System Efficiency

The IMF was created in the aftermath of World War II to help in the management of a stable exchange-rate system and to be a source of revolving international liquidity. (SDRs, which provide permanent liquidity, came much later.) The first function disappeared with the collapse of the Bretton Woods exchange-rate regime. The second, which concerns us here, has been distorted by the Fund's conditionality practices.

It has been frequently pointed out that countries with a balance-of-payments problem have a choice between a hurried and painful response and the use of international borrowing to finance the deficit while more measured and less disruptive adjustment is undertaken. The choice between the two will be influenced in a major way by the terms on which borrowing is available.

The international community's legitimate interest in this choice has two parts: one relates to redistribution, the other to efficiency. Redistributive considerations arise when the countries facing payments deficits are poor. But these considerations are not very germane to the work of the IMF unless it is viewed as an aid agency. Efficiency considerations are relevant whether the potential borrower is rich or poor. The efficiency issue arises because of the externalities associated with adjustment actions by countries facing deficits: smoother, less disruptive adjustment avoids unnecessary multiplier effects on other countries and wasteful counteradjustment by them.

Because these externalities do not figure in the profit calculation of the commercial banks, there is a need for an institution to make temporary liquidity available on terms more attractive than those offered by commercial banks in order to give countries an extra incentive to take the borrow-early-and-adjust-more-smoothly option.

The IMF was intended to be just that institution. Instead, it is now feared and resented by the developing countries. Its assistance is sought only as a

[4] The latest study that attempts to test for noncompliance relates to the effect of Fund programs on inflation (Kirkpatrick and Onis, 1985). Compliers and noncompliers are distinguished by a dummy variable in a regression equation, but the coefficient is not significant even at the 10 percent level.

last resort. It is not possible to devise an objective standard for measuring the appropriateness of resort to the IMF so that deviations from it could measure the reluctance of countries to turn to Fund assistance (but see Bird and Orme, 1981). However, the mood and perception of policymakers and their advisers in developing countries, as well as of articulate public opinion, is unmistakably anti-IMF. (A similar tendency is evident in developed countries, where it has become a common coin in the small change of party politics to accuse opponents of advocating economic policies that will lead the country to the IMF—the ogre that will devour naughty children.) In the late 1970s, Fund assistance was sought mainly by the poorest countries because their low commercial-credit ratings debarred them completely from alternative sources of funds. Middle-income developing countries like Mexico and Brazil did not return to the IMF until 1982, when the eruption of the international debt crisis put them in the same boat. The IMF itself expressed concern about these developments and sought to widen its appeal (Diaz-Alejandro, 1983), which may partially explain the short-lived easing of Fund terms from October 1979 to May 1981, documented by Williamson (1983b).

Arguably, some of these phenomena resulted in part from the increased availability of credit from private financial institutions, not just from Fund conditionality practices. But the question remains: why was the Fund, which had been designed to be at the front of the queue of lenders, pushed right to the back? The interest rate charged by the IMF does not exceed and is frequently well below that of commercial lenders. The terms of conditionality and their perceived high social costs must therefore be deemed responsible for developing-country hostility toward the Fund, carried so far that countries are reluctant to avail themselves of even the low-conditionality first credit tranche.

This relegation of the Fund to the end of the queue, to be approached only in desperation, marks a crucial failure by the IMF. It is a failure not by the standards of unreconstructed Keynesians, starry-eyed expansionists, or people who have failed to appreciate that, for a time, there was an increased supply of commercial lending for balance-of-payments purposes, but by the standards that the Fund itself enunciated as recently as 1979, when it adopted Guidelines to govern its conditionality practices. The very first paragraph stated:

> Members should be encouraged to adopt corrective measures, which could be supported by the use of the Fund's general resources in accordance with the Fund's policies, at an early stage of their balance-of-payments difficulties or as a precaution against the emergence of such difficulties.

Note that this guideline goes beyond early-stage assistance; it extends to the precautionary stage. Current practice could not be further removed from this precept.

If "encouraged" could be interpreted to mean "exhorted," the Fund could go on using its favorite argument that its clients themselves are to blame for onerous conditionality, because they delayed their approach to the Fund until painful surgery was necessary. But exhortation is cheap, and the Fund should not wash its hands in this manner. The guideline must be deemed to contemplate action by the Fund—action that would elicit the requisite response by members. Furthermore, encouragement, if it is not to be drained of meaning, must be strong enough to yield results and thus lessen the reluctance of member countries to resort to the Fund.

In terms of this criterion the Fund has failed. It has not performed the efficiency-enhancing role that it should be performing. And its failure has been getting perceptibly worse.

Damage limitation, though crowned with success in the international debt crisis, is neither the equivalent of nor a satisfactory substitute for the efficiency-enhancing role. Indeed, it is a distortion of the role for which the Fund was designed. Damage limitation is a last-ditch defense against collapse, whereas the Fund should be in the business of early-stage assistance. This is not to deny the usefulness of damage limitation, but to deny that the last ditch is the Fund's proper habitat. It is also to assert that praise for the Fund's contribution to damage limitation must be muted to the extent that the Fund's own practices regarding conditionality delayed earlier resort to the IMF by the debtor countries and thus exacerbated the debt problem itself.

Finally, the theme developed here must be linked with the ineffectiveness of Fund programs that was discussed in the previous section. The connection is a negative one. Considerations of efficiency emphasized here imply that the proper response to the Fund's ineffectiveness is not to make its programs tougher, as suggested in some quarters. More onerous programs will only drive the Fund further into the last ditch. The discussion of conditionality in the next section should help in the quest for a more appropriate response.

3 Confusion between Targets and Instruments

In order to establish an early-stage role for the Fund and thus promote its efficiency-enhancing function, the terms of conditionality must be made less unattractive. If this required a massive increase of transfers from developed to developing countries, one could not realistically expect the subject to be inscribed on the international agenda, given the current attitude of developed countries toward such transfers. Furthermore, it would be unfair to criticize the Fund for its practices and the associated retreat to the last ditch if that retreat could be halted only by mobilizing a large increase in transfers.

Fortunately, it is possible to separate, substantially if not entirely, the improvement in the terms of conditionality from the need for additional resources and more transfers. If, as will be contended, conditionality as now practiced is mistargeted, the mere change to more appropriate targeting will constitute a major amelioration.

The Present Practices of the IMF

When providing assistance from its General Account, the Fund is restricted by its Articles to instances in which members need it "to correct maladjustments in their balance of payments." Unsurprisingly, therefore, an improvement in the balance of payments is articulated explicitly as a program goal in virtually all Fund programs and is usually quantified as well.

But the conditions that bite, the terms that constitute the core of the conditionality package, are not attached directly to the balance of payments. Standby arrangements stipulate that access to successive installments of drawings depends on preconditions (so called because they must be satisfied before the formal beginning of a Fund program) and on performance criteria, and all of these relate to instruments of policy, not to the target of the balance of payments. It is these targets for instruments that are being enforced and policed by the IMF, not targets for genuine target variables.

The instruments favored overwhelmingly are ceilings on credit, restrictions on the public-sector deficit, and devaluation. The evidence is summarized in Table 2, which Killick (1984) has derived from a special survey conducted by the IMF in 1981. Because devaluation is often set as a precondition, it does not figure prominently in the table, but it is reported in Killick (1984, p. 194) that in 61 percent of standby and Extended Facility credits in the period 1973-80, a devaluation occurred within six months of either side of the credit arrangement. It is also reported in Killick (p. 191) that an unpublished Fund review of standby's in 1978-79 acknowledges that exchange-rate action (not necessarily devaluation) was set as a precondition in 9 cases out of 13.

TABLE 2

SELECTED PERFORMANCE CRITERIA IN UPPER-TRANCHE STANDBY ARRANGEMENTS

Criterion	Number of Observations [a]		
	1964-69	1970-73	1974-79
Credit ceilings:			
Total domestic credit	3	10	9
Credit to government/public sector	7	5	7
Credit to private sector	5		1
Devaluations	3		
Reduction in current payments arrears		1	2
Minimum levels for foreign-exchange reserves	1	1	4
Restrictions on new external debt	3	7	5

[a] The maximum number of observations for each entry is 10.

SOURCE: Killick (1984, p. 192).

Fund programs involve much more than preconditions and performance criteria. Policy understandings, incorporated in "Letters of Intent," may span a very wide range of measures, for example, measures affecting the functioning of public administration, the subsidization of consumer goods, and the control of wages. Increasingly, the Fund has stressed that measures relating to the supply side are being given prominence (Guitian, 1981; Crockett, 1982). Note that supply-oriented measures can mean very different things; radical development planners and conservative supply siders are both concerned with supply management, but in very disparate senses. But let us not be detained by this. For the main thrust of Fund programs is to restrict aggregate demand, and the policy instruments selected as performance criteria—the core of conditionality—confirm this thrust.

First Criticism: Neglect of Sources of Imbalance

Since policy instruments are numerous and are not ranked uniquely for efficacy and appropriateness, even among those who agree on the ultimate targets, the Fund's predilection for a particular set of instruments has generated much opposition. The criticism that has made the greatest mark was most clearly articulated by Dell and Lawrence (1980, p. 129):

> It is a fundamental conclusion of the present study that, in determining the appropriate volume of balance of payments support and the conditions required for the provision of that support . . . it is important to distinguish between those elements of the balance of payments deficit for which a developing country is itself responsible and those elements that are due to factors beyond its control.

Dell and Lawrence note that this principle was accepted by the Fund in the limited contexts of the Compensatory Financing Facility and the short-lived Oil Facility, but they argue that it should be applied more generally. Ceilings on credits and budget deficits are not necessarily the optimal remedies when a balance-of-payments problem is due to external events such as a rise in interest rates, a world recession, chronic surpluses in some countries, or a secular decline in the demand for a country's exports. Even if home-grown, the problem may be structural, requiring treatment different from that prescribed by the IMF.

The Fund's defense against this criticism is to deny the importance of the distinction concerning the source of the problem; what matters is whether the payments imbalance is long-term or transitory. If transitory, it should be financed, but if long-term, the economy must be made to adjust (Nowzad, 1981, p. 16; Khan and Knight, 1983).

Yet the need for adjustment, which is not disputed in the case of a long-term imbalance, does not itself indicate the appropriate form of adjustment and the best means of bringing it about. And this is what Dell and Lawrence were driving at. They may have narrowed the issue unduly by focusing on the