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Conditionality in Fund-Supported Programs

IMF Establishing International Capital Markets Department

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Priorities for the IMF

Remarks by Stanley Fischer[1]
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To the Bretton Woods Committee
Washington DC, April 27, 2001

Good morning. It is always a great pleasure to address the Bretton Woods Committee, which has done so much for our institutions over the years, and in the best way—offering constructive criticism at times, but always steadfast in arguing the case for international economic cooperation and the essential role of the Bretton Woods institutions.

This morning, at the start of the spring meetings of the Bank and the Fund, I'd like to talk briefly about some of the changes currently under way at the IMF. I will concentrate on two in particular: the evolution of Fund conditionality—which will take up the bulk of the presentation—and the Fund's role in capital market issues. Both these topics will be discussed by the International Monetary and Financial Committee, the IMFC, the successor to the Interim Committee, on Sunday.

Let me start by putting these two topics briefly in context.

1. Refocusing the Fund

At our annual meeting in Prague last year, Horst Köhler—who is about to complete his first year as the Fund's Managing Director—put forward a vision for the Fund in which it focuses its activities on promoting international financial stability as a public good. This in turn implies concentrating on our core areas of expertise: in macroeconomic—exchange rate, monetary, and fiscal—policies, and financial sector and capital market issues. The membership enthusiastically backed this approach.

Much has already been done to begin implementing this refocusing of the Fund. In particular, the Fund has strengthened its surveillance of national policies and international capital markets, devoting more time and resources to those policy and institutional areas where weaknesses can leave countries vulnerable to crises—for examples, poor macroeconomic policies, weak financial sectors, unstable exchange rate regimes, and poor management of debt and reserves. Promoting transparency and adherence to international standards and codes of good conduct is an important part of this agenda. The Fund has also

rationalized and updated its armory of lending facilities, as well as gradually, pragmatically, and case-by-case, developing a framework for the involvement of private sector creditors in the resolution of crises.

All this comes under the heading of reforming the architecture of the international financial system—a process that will go on forever, as the structures of domestic and international markets continue their never-ceasing process of change.

2. Conditionality, Ownership, and Governance

Another important facet of refocusing the Fund has been to look afresh at the policy conditions we attach to its loans. The first of our Articles of Agreement defines one of the primary purposes of the Fund as—and I quote: "To give confidence to members by making the general resources of the Fund temporarily available to them under adequate safeguards, thus providing them with opportunity to correct maladjustments in their balance of payments without resorting to measures destructive of national or international prosperity." The policy conditions we attach to our loans are the "adequate safeguards" this clause refers to, and they are analogous to the physical or financial collateral that a private lender might demand.

The objectives of conditionality are twofold: to ensure that IMF resources are used to promote economic reform and adjustment, rather than to postpone it; and to ensure that the borrower is able to repay the loan on the agreed terms, thereby making the resources available to other members who may need them.

Conditions have been attached to Fund lending since the mid-1950s, focusing initially on monetary, fiscal and exchange rate policies. But more recently—and especially since the early 1980s—the scope of conditionality has broadened significantly to encompass a wide range of sometimes detailed *structural* policy measures: measures that relate to policy or institutional changes in particular sectors of the economy, such as the financial sector, or the energy sector, or privatization.

To put some numbers on this, the average program involved two or three structural conditions per year in the mid-1980s, rising to an average of 12 or more in the second half of the 1990s. There were several reasons for this trend:

- First, the Fund has put greater emphasis on growth as an explicit policy objective, at the same time recognizing that raising growth on a sustainable basis requires action to strengthen the supply-side of the economy as well as macroeconomic stability. Indeed, the Fund was often criticized in the 1980s for concentrating too much on stabilization and not enough on improving living standards.

- Second, the Fund became increasingly involved in countries for which structural policies were essential to economic reform. In both low-income countries and those making the transition from central planning, it soon became clear that transferring large amounts of resources would be futile without tackling structural distortions. Structural reforms were also important in the Asian crisis countries, because the serious financial sector vulnerabilities that were at the root of these crises had to be tackled if confidence was to be restored.

- Third, there was greater awareness that structural factors help determine a country's ability to deliver on its macroeconomic policy objectives. This explains why much of the growth in structural conditionality has come in areas like fiscal policy, financial sector reform, and liberalization of the exchange and trade system. Other structural policy areas—like public enterprise reform, privatization and social security—also have an important bearing on macroeconomic policy through their fiscal impact.

Notwithstanding the importance of structural policies in the countries to which we lend, there is general agreement that our conditionality in this area has sometimes become unduly detailed and restrictive. Demanding too many and too detailed structural conditions can be counterproductive. One concern is that unnecessarily extensive conditionality undermines the sense of *ownership* of those policies by the government, for the policies are seen to be imposed from outside. For the same reason, extensive conditionality is more likely to galvanize domestic opposition to reform. Further, long lists of policy conditions make it much less transparent to the authorities what in fact is crucial in determining whether they will receive the next tranche of their loan or not.

Last September the Managing Director issued interim guidelines to the staff on how to streamline conditionality. Last month the IMF board agreed there was a need to streamline and focus Fund conditionality, and welcomed initial efforts by the management and staff to do so. They generally accepted the notion that structural conditions should be included in IMF programs only if they meet a macroeconomic relevancy test—that they are essential to achieving the macroeconomic goals of the program. But they also noted that doing so involves considerable judgment on a case by case basis. The objective is to confine conditionality to areas that are critical to a program's success, but drawing the lines between critical and merely useful is not easy.

Determining the boundaries of conditionality is particularly difficult when problems in the area of *governance* have a significant macroeconomic impact. It is—fortunately—an unavoidable fact that if the international community wants to help countries in trouble, it will be

hard to sustain public support for lending by the Fund and the Bank if people believe that the money we lend ends up in the hands of crooks. So inevitably governance issues have to be addressed.

I don't want to sound defensive about this. I firmly believe that tackling governance problems is good both for the country concerned and the international community as a whole. How far you go in a particular case requires judgment. There is a certain degree of corruption in every country and you have to decide how much is too much. Consider, for instance, Indonesia in 1997-98. We could either have attempted to deal with major problems of governance in the program, or decided not to lend at all. It would have been irresponsible for the international community not to help Indonesia at the time. Thus I have no doubt that some conditions relating to governance were needed in the Indonesian program—though whether the measures that were included, such as confronting the clove and plywood monopolies, were necessarily the best ones, is a question over which reasonable people can disagree.

Turning to ownership: the evidence is clear that programs have a greater chance of success when the authorities—and ideally society as a whole—feel a sense of ownership for them and are committed to their success. If streamlining structural conditionality helps achieve this, then that is all to the good. But cases where the international community is in effect deciding whether to support a particular reformist policy line within a country are more difficult. Indonesia, Nigeria and Russia are all good examples of this dilemma. If we took a purist approach and never supported any program in which ownership is less than complete, then we would could end up with very few programs—and we would not have started some programs that later succeeded. It is for our members, represented in the IMF board, to decide in each case whether the risk—for instance the risks inherent in our present program with Nigeria—are worth taking.

While other things equal, more ownership is better than less, other things are of course not always equal. There can be a trade-off between ownership and program quality, especially in low-income countries where policy-making and policy-implementing capacity may not be well developed. The challenge is to help countries reach a situation where their programs are both locally-owned *and* high-quality.

3. The Fund and Capital Markets

Let me now turn briefly to another aspect of our efforts to refocus the Fund, namely to strengthen our work on global capital markets. In recent months the Fund has deepened its analysis of capital markets as an integral part of the Fund's surveillance activities, with the objective of contributing to crisis prevention. The *International Capital Markets Report* remains the main instrument for this surveillance effort, but a number of additional studies have been undertaken in areas including:

over-the-counter derivatives markets, the consolidation of financial institutions, and the role of foreign financial institutions and private sector creditors in crisis resolution. We also now publish a quarterly report on the risks and opportunities facing emerging market countries in accessing international capital markets.

We have also undertaken some institutional innovations. The first, which will be familiar to you, was the creation of the Capital Markets Consultative Group last year. This brings together senior Fund staff and private sector market participants to discuss issues of mutual interest. It is proving a useful way for the Fund to get a clearer view of how the markets are thinking and for the Fund to give its views on developments.

We are also in the process of creating a new International Capital Markets Department in the Fund. By consolidating activities and operations previously spread throughout the Fund, and by extending their scope, the new department should enable us to conduct surveillance more effectively at both national and international levels, and to develop more effective early warning systems to identify areas of potential stress in financial markets.

In addition, we hope the new department will:

- Deepen our understanding of capital market operations and the forces driving the supply of capital to our member countries;
- Help us address systemic problems and opportunities created by developments in the international capital markets; and
- Strengthen our ability to help member countries to gain access to capital markets, maximizing the benefits of doing so while minimizing the costs and risks.

4. Conclusion

These are just a couple of the key issues that the world's finance ministers and central bank governors will be discussing at our meetings in the next few days. Several other important issues will be on the agenda too, including the progress of our joint debt relief and poverty reduction efforts in the poorest countries, carried out in close cooperation with the World Bank. No doubt a great deal of attention will focus on the very uncertain outlook for the world economy and financial markets.

All of this is continued evidence of the central roles of the IMF and the World Bank in the international economic system, roles which the Bretton Woods Committee has so successfully supported over many years.

Thank you.

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[1]Remarks prepared for delivery at the Annual Meeting of the Bretton Woods Committee, US State Department, April 27, 2001. Views expressed are those of the author and not necessarily of the International Monetary Fund. I am grateful to Robert Chote for assistance.

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