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IMF Conditionality and Country Ownership of Programs

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Only when a small country asks for concessional external credit, such as that provided by the IMF or by bilateral aid programs, is there a case for international discussion of that country's stabilization plans. This is the key justification for "conditionality"; if you ask for a gift, you must listen to your patron.

Carlos F. Diaz-Alejandro (1984).

I. Introduction

IMF lending in support of adjustment programs is conditional on the country undertaking certain agreed policy measures. The set of conditions that apply to loans is what is commonly referred to as "IMF conditionality".[2] As the literature on the subject shows, the discussion of the nature and merits of IMF conditionality has a long history. Recently, the issue has gained renewed attention, with questions raised about whether the conditions imposed by the IMF on borrowing countries have been too intrusive, and whether the design and implementation of IMF conditionality has undermined country ownership of adjustment programs aimed at correcting macroeconomic imbalances. The IMF itself is currently engaged in a comprehensive analysis of the conditionality and ownership issue, and is soliciting the views of the public on this matter.[3]

This paper uses concepts and results from the finance literature to establish two important propositions regarding IMF conditionality and country ownership of programs. First, some form of conditionality is present in all borrower-lender relationships—the key to the ability to borrow is the ability to pledge income back. The IMF is a lender that has to have assurances that it will be repaid, and this requires placing conditions on its loans. The analysis here is designed to dispel the fairly widespread notion, articulated for example by Carlos Diaz-Alejandro (1984) in the quotation above, that conditionality stems from a "patron-beneficiary" relationship between the IMF and the borrowing country. Finance considerations alone provide the justification for IMF conditionality being a necessary part of all IMF lending. Thus, the view expressed by Killick (1997) that IMF conditionality "should be the exception rather than the rule" is incorrect; indeed this paper argues that it should be exactly the reverse. Second, country ownership of programs, because it aligns the incentives of the borrower and the lender, is fundamental. For the country, program ownership is critical because without a firm commitment from the government and other relevant constituencies, the difficult policy measures designed to correct economic problems are less likely to be

[2] For discussions of IMF conditionality, see for example, Williamson (1983), Polak (1991), Guitián (1995), and James (1996). The most recent description of IMF conditionality is provided in Boughton (2001), Chapter 13.

[3] See IMF (2001a). This paper, along with other supporting papers, has been put on the IMF's website to seek outside views. Also, seminars in various locations (Berlin, Tokyo, London) have been organized by the IMF in 2001 to generate wider discussion of the issue.

implemented. For the IMF, program ownership raises the probability of the success of programs and thus increases the "value" of the safeguards on its resources provided by conditionality. Both IMF conditionality and country ownership have a clear rationale and the task is how to reconcile the two. The paper considers a number of proposals that have been made recently to achieve such a reconciliation.[4]

The paper proceeds as follows: The next section examines the main features of IMF lending, and the implementation and effectiveness of conditionality. Section III deals with issues related to program ownership in the context of IMF lending. Section IV discusses some recent initiatives for fostering greater ownership. Section V outlines possible new approaches to enhance ownership, and the last section concludes.

II. IMF Lending and Conditionality

A. Features of IMF lending

Between every lender and borrower there is always a fundamental asymmetry in information availability. The borrower always knows more about his own abilities, opportunities, and intentions than the lender. This information asymmetry gives rise to two incentive problems: adverse selection and moral hazard. Adverse selection arises before the transaction takes place, and stems from the fact that information deficiencies make it difficult to distinguish good from bad risks.[5] Moral hazard arises after the lender has given the funds to the 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.[6] In the financial world, collateralization, contract design, transparency, and reporting requirements attempt to mitigate such moral hazard. Monitoring by independent company directors, shareholders, debt holders, market analysts, and rating agencies serves the same purpose. These different types of monitoring are costly to the firm, but are done to assure investors that their claims will be respected.[7]

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[4] It should be noted that some of these proposals are already being implemented by the IMF. See IMF (2001a), (2001b), and (2001c).

[5] Compared to private lenders, the IMF faces a different selection problem, in that only members experiencing some distress approach the IMF for financing, and all have a right to IMF resources.

[6] More formally, moral hazard can be defined as the actions of economic agents maximizing their own 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).

[7] See, for example, Greenbaum and Thakor (1995), and Mishkin (1998).

Pledging collateral is expensive, but firms incur that cost to provide the lender assurance that the funds will be used for stated purposes and in a way that will not jeopardize their eventual repayment. In fact, the very existence of financial markets depends crucially on such assurance. To this end, corporate governance and the institutions and practices of finance have the common rationale of increasing the resources that can be pledged to outside debt and equity holders, while maintaining the appropriate incentives for management 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 cover its resources by taking control of the pledged assets and selling them. In new or emerging firms with very little physical or financial collateral, the relinquishing of control rights to the venture capitalists by the entrepreneurs provides the needed assurance that the funds will be well spent, since the venture capitalist has considerable say in the decision-making process. Clearly, the allocation of some control rights to investors should be designed in such a way as to provide maximum assurance to investors while not impairing the functioning of the firm and its ability to exploit its commercial opportunities. Still, in many circumstances, and for many firms, especially those in distress, or those that have little reputational or financial capital, the relinquishing of such control rights may be costly and almost certainly will limit management discretion in substantive ways.

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 transferring collateral rights to the lender be made contingent on default or on observable measures of financial and non-financial performance. In the case of control rights, another purpose is served. Clearly, after an adverse shock, the borrower is more likely to gamble for resurrection (i.e., undertake more risky behavior) the greater the deterioration of the financial health of the firm. Contingent transfer of control rights protects the 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 and ex post, it constrains the ability of firms to take gambles. Even if the firm does not engage in risky strategies when performance deteriorates, the contingent transfer of control rights provides the lender with the option to re-examine the new situation. For example, in new enterprises, 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.[8]

IMF lending and its associated conditionality follow broadly the same principles as private financial contracts, although as will be argued below, there are additional dimensions that make IMF lending qualitatively different. The IMF is mandated by its Articles of Agreement

[8] See Kaplan and Stromberg (2000).

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 would be used for the purposes defined by the Articles of Agreement, and in a manner that does not jeopardize their contractual servicing and repayment. Consequently, many of the finance propositions relevant to private financial institutions apply equally 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 resources from the IMF.[9] 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 the country's nontradables. In the absence of collateral, private loan contracts typically would include various forms of 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 contained in IMF-supported programs essentially serve to provide the 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.[10] The conditionality associated with IMF-supported programs can therefore be thought of as a substitute for collateral.[11]

Conditionality attached to sovereign lending has a long history. An interesting example of the use of collateral to back a sovereign loan is given by Ferguson (1998). In 1818, Prussia, effectively bankrupted by the Napoleonic wars, approached Nathan Rothschild of the House of Rothschild for a loan. As Ferguson says, "From the onset of negotiations, Nathan argued that any loan would have to be secured by a mortgage on Prussian royal domains guaranteed

[9] Of course in a crisis situation, even if the country had internationally-acceptable collateral, it might still not be able to use it to borrow from private capital markets.

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

[11] It is interesting to note that the Articles of Agreement of the IMF explicitly recognize this trade-off between collateral and conditionality (Article V, Section 4). A country can pledge collateral of "acceptable assets" in order to obtain waivers on certain conditions (i.e., borrowing in excess of IMF limits, or obtaining loans despite being ineligible to borrow).

by the Stande (parliament) of the domains concerned" (p. 504). Nathan Rothschild sent the Prussian State Chancellor a "remarkable memorandum", to quote Ferguson (1998), in which he stated that a loan to a foreign government needed some security as backing, and in its absence raising the money from the British public would be hopeless.

The modern model for conditional lending to sovereign governments in the absence of collateral is considered by many to be the Turkish agreement of 1881—known as the "Decree of Mouharrem"—that 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 part of Turkish government revenues was placed under the Council's direct control and was used by it for the service and repayment of the debt. It was argued even then that the daily surveillance of the Turkish economy had reduced the sovereign authority of the government to practically zero.[12]

The League of Nations also attached strict conditionality in its adjustment programs, or "reconstruction schemes" as they were known, with six European countries in the 1920s. These conditions included maintenance of fiscal equilibrium and monetary discipline, as well as currency reform. The League took care to arrange various means to guarantee the enforcement of its programs, and to safeguard the interests of foreign creditors and bond holders. This included the appointment of a League Commissioner to the country and an Advisor to the central bank to administer and monitor the program.[13]

Agreeing to conditionality is an imposition on a country, even though the objectives of both the IMF and the borrowing country may be the same—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 much 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 in all cases part of an implicit one, irrespective of the language used in the documentation. The challenge of designing IMF conditionality is to specify the "optimum covenant"—the optimal set of policy conditions given the circumstances of the country, the disbursement intervals for the loan, the type of monitoring involved, and so on—needed for achieving the program objectives, while providing sufficient safeguards to the IMF. Still, at a general level, IMF lending conforms to the principles governing private lending.

[12] See Anderson (1966). We are grateful to Harold James for bringing this information to our attention.

[13] For a discussion of the League of Nations programs, see Santaella (1993). The League of Nations programs with Austria and Hungary are also described in James (2001).

At the same time, there are significant ways in which IMF lending is different. First, as mentioned above, unlike private financial transactions where covenants may be quite straightforward, defining IMF conditionality is much more complicated. It basically involves assessing the macroeconomic imbalances or structural deficiencies that lead to macroeconomic problems, and then coming up with a negotiated agreement with country authorities that will address them.

Second, it is difficult if not impossible to establish the "value" of IMF conditionality. The value of negotiated conditionality depends to a considerable extent 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 effort of two (or more) agents. Typically, the detailed negotiations for a program are conducted with certain representatives of the government (central bank, finance ministry), while the success of the program depends on many other stakeholders in society—other ministries, trade unions, professional associations, civic groups, NGOs.

Fourth, the IMF by design is a cooperative that makes loans to its sovereign members. In the event of default, there is no court to which it can appeal, and there is no tangible collateral on offer that can be used to make up for its resources. The enforcement mechanism for ensuring that borrowing countries live up to their obligations essentially amounts to some 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, whose lending is generally subject to well-defined legal codes that can be enforced in courts of law, and where shareholders or investors could orchestrate a change in the management of a company or take it over, the IMF cannot obviously replace sovereign governments, and can only refuse to provide financing to a country in arrears.

Finally, compared to private lenders, the IMF, given its mandate and cooperative structure, faces what in other contexts has been called the "Samaritan's dilemma".[14] For example, to provide the right incentives ex ante a private lender may impose a set of harsh conditions on a borrower in the event of poor performance, but ex post, that is after underperformance by the firm, it may not want to go through with such an imposition for a number of reasons. It could be, for instance, that the option of selling certain assets (or liquidating the company itself) is worth less than keeping the assets with the company (or the company as a going concern). Of course, if the liquidation value was higher a private lender may not hesitate to sell the assets.

[14] See, for example, Buchanan (1975), and Lindbeck and Weibull (1988).

For the IMF there is a different incentive problem, since the borrowing country is "always more valuable as a going concern." Hence, country authorities know that in the event of nonperformance, at worst, the program will be renegotiated (Drazen and Fischer, 1997). This creates the wrong incentives, ex ante. Countries know that, faced with underperformance and a weak economy, the IMF, since it has to be concerned with the borrowing country's welfare, is unlikely to go ahead with the imposition of harsh conditionality. The IMF, being a cooperative institution, cannot walk away and "cut its losses". Simply put, ex ante penalties have limited credibility, since they are unlikely to be enforced ex post. And this is one of the reasons why there have been suggestions that the IMF should only lend to pre-qualified countries with good policy environments. In other words, the IMF should lend only to those countries that have a good economic track record; and hence access to funds should be provided only to those that can provide "good collateral".[15]

B. Implementation of IMF conditionality

Conditionality is implemented through program design and monitoring arrangements that track whether agreed policies are implemented in a timely and effective manner. Program design begins with an in-depth analysis of the sources of macroeconomic imbalances.[16] The next step is to agree with the authorities on policy objectives and on an appropriate mix of macroeconomic policies and structural reforms to achieve those objectives. Monitoring arrangements take various forms, depending on country circumstances and the facility being used, but generally include prior actions, performance criteria, structural benchmarks, and reviews. They also prohibit actions inconsistent with the provisions of the Articles of Agreement, such as the introduction of new exchange restrictions. Release of IMF financing credit is linked to compliance with the monitoring arrangements.

Prior actions are specified where up-front implementation is critical to program success or to allay doubts about the authorities' commitment. Examples are passage of an agreed budget, an exchange rate realignment, the adoption of structural reforms, or enactment of relevant laws. They are to be taken prior to approval of a program by the Executive Board of the IMF, which then triggers the first disbursement. Performance criteria normally include quantitative targets for specified financial aggregates (e.g., bank credit, net international reserves, fiscal balance), and may often include structural measures (e.g., tariff reductions, revision of tax systems, privatization of public enterprises). The observance of these criteria triggers the release of subsequent tranches of committed IMF resources. Macroeconomic and structural benchmarks provide indicative targets for macroeconomic variables and structural policies that are important for effective program implementation. They do not directly affect

[15] A proponent of this view has been the Meltzer Commission; see Meltzer (2000).

[16] See Mussa and Savastano (1999) for an exposition of the IMF's approach to economic stabilization.

scheduled disbursements. Reviews are designed 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 disbursements after a scheduled review date if the review is not concluded.

Typically, a program is a negotiated compromise between the IMF and the country authorities. To start, there may be disagreement about an assessment of the situation and hence over the objectives of the program. There may also be some differences on what prior actions are needed for setting the stage for an IMF program. Next, after agreement has been reached on objectives, intermediate targets and policy measures need to be identified that are sufficiently under the control of the authorities and that will achieve the program objectives.

Once the negotiated program is in place, there can be considerable uncertainty associated with evaluating and monitoring it. The authorities may have sufficient control over policies, but one still has to deal with the uncertain links between policy instruments and objectives. Quite often judgments have to be made on the need to change policy settings, because of program design problems, lack of effort on the part of authorities in implementation, or in response to exogenous shocks. If the program goes off track, the IMF needs to analyze the reasons for the underperformance and whether or not a waiver should be granted in order to disburse the funding. Also, an understanding needs to be arrived at with the authorities on the changes in performance criteria and the nature and extent of remedial action to be taken. It is particularly difficult to judge the progress made in attaining structural objectives and whether delays, or non-achievement of some structural benchmarks, should precipitate compensatory action. And, in the course of a program, one may need to deal with the difficult question of whether funds should be disbursed when the specified polices are taken but the desired results are not obtained.[17]

C. Effectiveness of IMF conditionality

A question that often arises is whether IMF conditionality works. On the one hand, there is the view of the Meltzer Commission Report (2000) 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" (p. 35).

[17] Strictly speaking, if all the policies are in line with the agreement, then disbursement would have to take place, irrespective of the results. The problem occurs when performance criteria are also placed on outcome variables—typically net international reserves—that are not under the authorities' control. This issue is taken up in Section V.

The IMF, not surprisingly, believes otherwise. The IMF's mandate is to provide short-term lending to support balance of payments adjustment, and in this regard it believes that its conditional lending has been generally successful in improving the borrowing country's external accounts.

What then is the evidence on the effectiveness of IMF conditionality? Specifically, have IMF-supported adjustment programs been effective in achieving their objectives of improving the current account balance, increasing international reserves, lowering inflation, and raising the growth rate? This is essentially an empirical question that requires evaluating the effects of past programs on the macroeconomic variables of interest. Such evaluations are conducted periodically by the IMF's Policy Development and Review Department and the results reported to the IMF Executive Board.[18] In addition, a number of studies have been undertaken over the past 20 years or so, both inside and outside the IMF, that examine the question using a variety of empirical methods.

The existing empirical literature on the subject highlights the fact that defining the effectiveness of IMF-supported programs is not a straightforward task for at least three reasons. First, although the success of a program is measured in terms of macroeconomic outcomes (e.g., an improvement in the balance of payments), the conditionality agreed to by the IMF and the country relate to policy variables (e.g., the expansion of domestic credit or an exchange rate change). While it is relatively easy to check whether the program country has implemented the agreed policy changes via the setting of performance criteria on key policy variables, it is more difficult to know whether these changes would always lead to the desired macroeconomic outcomes in a predictable manner.

Second, an IMF-supported program is only one of the many macroeconomic "shocks" to the country with a program. External shocks, such as changes in the terms of trade or in the cost of servicing external debt, will also affect the country's ability to achieve the macroeconomic objectives of the program. Measures of program effectiveness have to filter out these unanticipated exogenous influences.

Third, the proper measure of the effectiveness of the program has to compare the effects of the program to the alternative of what would have happened in the absence of the program. In other words, a comparison has to be made between the actual outcome due to the program with the "counterfactual"—that is, the macroeconomic outcome that would have resulted without the program. But, of course, the counterfactual is not observed and has to be constructed. How this is done will matter significantly for gauging the effectiveness of programs.

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[18] Evaluations of programs will henceforth presumably also be conducted by the IMF's newly-established Independent Evaluation Office.

The existing empirical literature yields two broad conclusions.[19] First, the empirical analysis has been conducted using different methodologies, the relative merits of which deserve careful consideration. Many of the earlier studies attempted to assess program effectiveness by comparing macroeconomic outcomes in program countries with performance prior to the start of the program or with the observed performance of countries without programs. If, as argued above, the proper standard for measuring program effects is to compare the macroeconomic outcomes with the counterfactual, then the earlier approaches—labeled by Haque and Khan (1998) as the "before–after" and "with–without" approaches—are not fully satisfactory.[20] More recent studies have controlled for exogenous factors and initial conditions, and have estimated policy reaction functions to get a handle on what the country would have done in the absence of a program. These later studies get much closer to the ideal counterfactual comparison.

Second, almost all the studies surveyed by Haque and Khan (1998) show that programs improve the current account balance as well as the overall balance of payments. The results for inflation, however, are less clear. Most of the studies indicate that while inflation does fall, the decline is generally found to be statistically insignificant. In the case of growth, the evidence indicates that output generally will be depressed in the short run, that is in the stabilization phase, but that as macroeconomic stability is established growth begins to pick up over time. The newer 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.

The empirical results obtained by different studies, however, provide only an average picture, and there are enough program failures to warrant serious concern. For example, Mussa and Savastano (1999) used the share of the total IMF loan disbursed as an indicator of the success or failure of a program, arguing that a low value indicates the program was not successful, while a high value indicates that it was. They regard cases where 75 percent or more of the loan was disbursed as having been successful, in that the country adhered closely to the set of policies agreed with the IMF over the course of the program. Using this criteria, they found that during the period 1977-97, only 45 percent of all programs could be deemed successful. Despite the problems inherent in using disbursements as an indicator of the success or failure of programs, these numbers are troubling.[21] Clearly, the aim has to be to raise the success

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[19] For a comprehensive survey of the available empirical studies, see Haque and Khan (1998).

[20] For the biases that arise in the case of these two approaches, see the appendix in Haque and Khan (1998).

[21] A low share of disbursements could also include cases where the program was so successful that the country only needed to use a small proportion of the available IMF funds. Also, the numbers include precautionary arrangements where there is a presumption that the country will not draw on the loan.

rates of programs, which will require work on better design of programs, better handling of exogenous developments, and better implementation.

III. Ownership of Programs

The case for ownership has a strong theoretical foundation. In the context of agency theory, principal-agent problems arise in situations where one party (the principal) relies on the another party (the agent) to accomplish certain objectives. Due to asymmetries in information and lack of a perfect monitoring technology, if the agent's actions and their consequences cannot be easily verified and monitored, the agent has greater scope for pursuing its own interests rather than those of the principal. Principal-agent theory says that an agent will do a better job for the principal if its objectives are well-aligned with those of the principal. Thus, for those conditions whose actual realization hinges strongly on cooperation and implementation by the agent, ownership of the project is essential. As Tirole (2001) puts it, in this case ownership is not a goal but a necessity.

IMF lending to countries can also be cast in a principal-agent framework. In this case, the borrowing governments are the "agents" and the IMF, the delegated monitor of a revolving fund, is the "principal." This particular principal-agent problem is complex because of the nature of the task and the underlying loan contract, the mandate and structure of the principal, and the characteristics of the agents. And this complexity, combined with the difficulty of specifying all contingencies in the contract, makes the ownership of programs all the more critical for their success.

The importance of country ownership of programs was recognized early in the IMF. When discussing the possibility of a program with Spain in 1959, Per Jacobsson, the then Managing Director, was quite explicit on how the IMF saw the ownership issue. In a television interview in June 1959, he emphasized "that such programs can only succeed if there is the will to succeed in the countries themselves". He went on to add that the IMF "does not impose conditions on countries; they themselves freely have to come to the conclusion that the measures they arrange to take—even when they are sometimes harsh—are in the best interests of their own countries".[22]

The problem is that ownership of IMF-supported programs is an elusive concept and is hard to define or pin down. Implicitly, it refers to a situation in which the policy content of the program is similar to what the country itself would have chosen in the absence of IMF involvement. This is because the country shares with the IMF both the objectives of the program as well as an understanding of the appropriate economic model linking those objectives to economic policies. In such a situation, the country "owns" the program in the

[22] These quotations are taken from James (1996), p. 109.

sense that it is committed to the spirit of the program, rather than just to complying with its letter.

But since only countries in some distress due to macroeconomic or structural imbalances borrow from the IMF, provision of sufficient safeguards for access to IMF resources and avoiding the moral hazard problem will require conditionality that has some "bite." Hence, there is unlikely to be "full" ownership, and the problem is really one of trying to maximize ownership within the context of conditionality. It should be clear from the earlier discussion that ex post conditionality is likely to place some substantive constraints on the authorities' actions and the use of funds. In addition, given that programs generally have implications for economic and social trade-offs, perceptions may be created that program conditionality does not take proper account of the country's individual circumstances, including its economic priorities, political conditions, culture, and traditions. And 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.[23] Program agreements cannot envisage all contingencies that could possibly affect a program and specify in advance actions that authorities should take in response. When the program is owned by the country, decisions on such actions are likely to be made quickly and in support of the program, which makes it more likely that the program will succeed. Furthermore, ownership will make it easier to generate domestic political support for the program, since it is likely to be seen, at least in part, as an indigenous product, rather than a foreign imposition.

Ownership also matters for the catalytic role that IMF lending can play and a country's access to foreign lenders. With the increasing importance of private capital flows in international finance, a critical issue for borrowing in international markets is the nature and ability of the lender to exercise control rights. Foreign investors also confront moral hazard in teams—the payoff to investments depend on the behavior and effort of private borrowers as well as the government of the country in which the private borrower resides (Tirole, 2001).

Firms investing across borders design appropriate covenants to alleviate moral hazard on the part of the private borrowers. The control rights not vested with investors, but that have an effect on borrower behavior, are actually shared between the borrower and the government. Returns to an investment are dependent on the environment created by government policies

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[23] There is no direct empirical evidence on the link between ownership and IMF-supported programs. However, some evidence on the importance of ownership for project lending is provided by the experience of the World Bank. The World Bank's Operations Evaluation Department (OED) assigns a rating to the government's commitment for each project (measuring in a sense the degree of ownership) using a variety of objective and subjective indicators. The positive relationship between the project outcome and the government commitment turns out to be quite strong (and statistically significant).

on the domestic creation and management of liquidity, tax and labor laws, and other institutional factors; and when differences arise between lender and borrower, or in times of distress, a just treatment of parties to a contract is crucially affected by public attitudes and policies towards law enforcement, bankruptcy rules, and corporate governance. Further, national policies that adversely affect the amount of tradables or other internationally valuable collateral generate a negative externality for foreign investors—lack of investment in infrastructure that adversely affects exports and tourism, taxation of exports, depreciating the domestic currency when foreigners hold domestic-currency assets, a depletion of foreign exchange reserves, and creating incentives for currency and maturity mismatches that increases credit or default risk for foreigners.

Whether such government moral hazard is important is an empirical issue and depends on the circumstances. It may be limited since governments do lose power and credibility after a crisis, and IMF conditionality associated with programs in such situations does place some constraints on the authorities' policy choices (De Gregorio et. al., 1999). Others argue that it may be a cause for concern: as in private firms, the threat of losing one's job after a crisis may prevent misbehavior, but could also increase moral hazard by creating an incentive to gamble for resurrection; and actions that affect the tradable-nontradable mix, and hence hurt foreign investors more than domestic investors, are less likely to generate an adverse reaction from the country's population (Tirole, 2001).

Hence, country ownership of policies that reduce moral hazard vis-à-vis foreign investors 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, ex post, in the event of nonperformance or adverse shocks to the borrower, it will not inhibit the transfer of control rights to creditors. Of course, sovereigns cannot relinquish control rights as easily as firms, but all that means is the set of transferable rights in their case will be more limited.

The feasibility of achieving a particular degree of ownership, and determining when it has been obtained, are both problematic issues that are likely to vary from country to country. A complicating factor in assessing the degree of ownership is that most countries, especially democratic ones, 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 that negotiate the program with the IMF, or to the views of the entire domestic bureaucracy that has to implement the program, or to the views of the parliament that has to approve the necessary legislation, or to the beliefs of civil society at large? And if the views of civil society ultimately carry the greatest weight, how are they to be assessed and brought to bear on program design and implementation in the face of competing interests? So ownership is intricately connected to questions of the trust in domestic institutions, the 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 there is insufficient ownership of programs by borrowing countries. In the more visible capital-account crisis cases, as speed has been of the essence,

this is perhaps understandable. There may simply not be enough time to get full country support for all the necessary policy actions.[24] But the problem goes beyond the capital-account crises programs and is evident in other programs as well. In recent years the objectives of programs have tended to increase, as the IMF has taken on tasks that go beyond its traditional mandate to establish macroeconomic and financial stability. The expansion of structural objectives in many programs was done to facilitate the transition to a market economy, the integration of the domestic economy into the world economy, the diversification of the production and export bases, the development of the financial sector, and the promotion of "high-quality" growth. In the 1990s, these goals were explicitly specified in the case of the transition economies, and given prominence in the context of Sub-Saharan African countries. Also, in the recent Mexican and Asian crises, the key role played by financial fragilities and issues of corporate governance expanded the list of goals. The problem is that ownership of programs by the countries is less likely when programs have too many objectives. This is because the larger the number of objectives, the less likely it is that the authorities and IMF staff will agree on the full range of objectives or on how these are to be attained.

The borrowing countries may themselves be partly responsible for the lack of ownership. Some countries may be so eager for the initial disbursements and 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 not likely to be implemented. In private markets, if a lender has serious doubts about the borrower's intentions or is not provided sufficient collateral, the optimal course of action is not to lend. Given the cooperative structure of the IMF, and the Samaritan's dilemma it faces, for it to refuse to lend to a member in need is much more problematic (see also Drazen and Fischer, 1997).

IV. Fostering Greater Ownership: Current Initiatives

Recently, a number of proposals to enhance country ownership of policies associated with IMF-supported programs have been put forward. This section discusses five current initiatives: pre-selecting countries eligible for IMF lending, encouraging countries to design their own programs, developing a menu of policy options for the authorities to choose from, investing time and effort in "selling" programs, and streamlining structural conditionality.

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[24] Even for the case of countries facing a capital account crisis, Feldstein (1998) argues that the IMF may have been too intrusive in its interventions and should ask two questions of each conditionality measure: (i) Is it necessary for restoring access to international capital markets? (ii) Would the IMF ask the same measure of a major industrial country if it had a program?

A. Pre-selection

It can be argued that, in order to provide adequate safeguards, weaker ex post conditionality needs to be balanced with stricter ex ante pre-qualification. Under this approach, the IMF would provide resources up to specific limits to countries with a track record of good policies at penalty interest rates. This would be consistent with safeguarding IMF resources, while encouraging the country to secure market financing before coming to the IMF, thereby reinforcing the role of the IMF as a lender of last resort.[25]

This is the main recommendation of the Meltzer Commission (2000) which saw the primary role of the IMF as providing short-term liquidity support to countries that satisfied four structural pre-conditions: (i) free entry of foreign financial institutions; (ii) regular and timely publication of the maturity structure of sovereign and government guaranteed debt; (iii) adequate capitalization of commercial banks, with a significant equity position or subordinated debt held by non-government and unaffiliated entities; and (iv) a fiscal requirement. Only countries satisfying the above criteria would be eligible to borrow from the IMF, while those that did not meet these conditions would be excluded.[26]

There are three objections to the pre-qualification approach proposed by the Meltzer Commission. First, while the above structural characteristics may lower the risk of getting into difficulties, they would not prevent crises. Second, its most serious shortcoming is that it provides no guarantees against undesirable changes in the domestic policy stance (perhaps through changes in government), and thus may weaken the safeguards on IMF resources. Third, this approach would exclude a large number of member countries not having access to international capital markets from IMF lending, and this would be fundamentally inconsistent with the rights of all members to IMF resources under the Articles of Agreement.

B. Home-grown programs

The IMF could require or put more pressure on the member country to produce its own home-grown program. In some cases, this may be seen as "forcing ownership," but the design of the program can be worked out cooperatively between the country and the IMF. To the extent that lack of expertise and capacity at home are the constraints that prevent countries from developing their own programs, the IMF could provide technical assistance and training, or encourage the authorities to hire independent technical advisors for advising them in developing their own programs.

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[25] Currently, the only IMF lending facility that requires pre-qualification is the Contingent Credit Lines (CCL) Facility. While it does not impose ex post conditionality, activation of the facility requires an approval of the country's policy environment by the IMF.

[26] See Meltzer (2000), and the U.S. Treasury's (2000) reply to the Meltzer report; pre-qualification is also discussed by Goldstein (2000a) and in the report of the Council on Foreign Relations (1999).

While there are some examples of home-grown programs, as a general rule this approach has not worked very well for several reasons. First, countries may use optimistic assumptions in valuing their program. For example, countries may have a systematic tendency to underestimate the extent of their difficulties and to overestimate the potency of their policy instruments in the formulation of their programs. Second, if the process of formulating a complete program, with its associated domestic political compromises, hardens the domestic authorities' negotiating position with the IMF, this is likely to imply significant delays in program negotiation. Third, countries may also have a preference for having the IMF prepare the program because they do not have, or choose not to have, the internal mechanisms for making decisions on difficult trade-offs. This may require the IMF to force the issues for decision. Fourth, from a negotiating standpoint, countries may wish to see the IMF's position before putting forward their own in the form of a program document.

C. Policy options

IMF staff could develop and discuss with the authorities alternative options (or scenarios) regarding the policy objectives and the policy measures to achieve them. The advantage of the options approach is that it opens up a debate and requires the government to become actively engaged in the design of the program, whereas in the past it may have been involved only passively. Ownership is achieved through the country being able to make specific choices, rather than accepting a single option prepared by the IMF. The provision of choice for the authorities would increase ownership within the range of choices available, while preserving IMF conditionality in terms of adequacy of program design and monitoring. Although this approach is followed already to some extent in negotiations with many countries, particularly in the larger and more high-profile cases, it could be made explicit and generalized to all programs.

The fact of the matter is that there are typically a number of alternative options that can achieve a given set of objectives. Indeed, there may well be too many options and the problem is to limit them to a manageable set. Even when the set of prescribed policy objectives is limited, a substantial range of choices is still available to the authorities on how to attain those objectives. Consider the case where a targeted path is chosen for the trade balance (since the projected path of the trade balance is central to determining the country's solvency, and hence its ability to repay the IMF). In this case, the country may wish to use capital account restrictions. If they are used, then the authorities have two independent monetary policy instruments available—open market operations and foreign exchange market intervention. If not, then there is a single monetary policy instrument, consisting of either foreign exchange market intervention or open market operations. Assuming the availability of two monetary policy instruments, the desired trade balance target could be sought with some combination of exchange rate policy and monetary policy. Even if only a single monetary instrument is available, there remains a choice of which instrument to employ (the country could choose to follow a fixed or floating exchange rate regime or, as is popular now, choose between a hard peg and a free float). If fiscal adjustment is brought into the picture, then the set of choices available expands to include the basic fiscal-monetary

(and possibly exchange rate) mix. With fiscal policy, a host of other choices opens up as well—whether to operate on the revenue or expenditure side of the government budget, the composition of expenditures and taxation, and so on.

All of these choices will be made by the authorities taking account of the effects on other worthy economic or social objectives. The central point is that when the number of objectives targeted in a program is small, the desired outcomes for the excluded objectives—and the policies required to achieve them—are determined by the country authorities, who thereby acquire greater ownership of the program.

It needs to be acknowledged that one drawback with the options strategy is that the discussion of alternative options is bound to stretch out the negotiation process. In crisis situations, there may simply not be time to examine in detail the merits of different policy packages; but then there may well be greater uniformity of views between the country and the IMF on what needs to be done. In non-crisis situations, however, the negotiation process may turn out to be a lengthy one, which in turn could be an undesirable consequence for a country seeking quick access to IMF resources.

D. Transparency and the "selling" of programs

The current cooperative approach to program design and policy-based conditionality leads to an impression in many cases that because the IMF imposes conditions for access to its funds, it is also responsible for the success of the program. Greater transparency in the negotiation process, as well as public statements about the program objectives and the concerns of the country and the IMF would clarify the responsibilities that a borrowing country agrees to undertake, and hence enhance ownership. However, there are constraints to information revelation. The IMF has a role to play in promoting transparency and data dissemination standards, but in policy negotiations it is privy to confidential information and there are limits to what it can make public while maintaining the trust of member countries.

That said, the authorities and the IMF staff could spend more time explaining the content of programs to various domestic constituencies. This could be particularly relevant in situations where the program has been negotiated with a very small group of people and other relevant parties (including in the government) are not well informed about it.

To this end, the authorities and IMF staff need to consider the political economy of the reform process. In increasingly democratized country environments, the existence of multiple stakeholders makes it difficult to determine who the target audience should be for explaining the program. For coming up with answers to such questions, it is necessary to identify the winners and losers, and then placate political, social and environmental concerns and to "sell" the program as being beneficial in net terms to the public over some time horizon.

A more difficult question is determining the role of the international financial institutions in selling the programs. While clearly the IMF staff needs to justify the design of programs and the conditions required for disbursement, any involvement in the country's politics could be

misconstrued and lead to reduced ownership. Generally speaking, it should be made clear that the IMF can play a facilitating role, but that ultimately the "sale" of a program is the government's responsibility.

E. Streamlining structural conditionality

Over the past two decades, there has been a major proliferation of structural conditions in IMF-supported programs.[27] The expansion of structural conditions would appear to leave more limited scope for domestic policy choices, thereby reducing country ownership. Many reasons have been advanced for the increase in structural conditionality.[28]

- In the late 1970s and early 1980s, the IMF was criticized for being interested only in narrow (balance of payments) outcomes and relatively unconcerned about growth. Thus the IMF, in response to calls by its membership, began to include in programs policies to remove structural impediments to growth and the efficient allocation of resources. These policies became an integral part of conditionality. It is, however, not entirely clear whether the membership's broad support of the growth objective in programs means that it wants adjustment programs that are not excessively recessionary in the short run, or programs that promote long-term growth of productive capacity. Presumably it is when long-term growth is the objective that large-scale structural reforms become necessary.

- The IMF has to aim for sustained medium-term improvement in economic performance, not the least because it has to ensure the loan is repaid on the date of maturity. Also, medium-term viability provides assurances that the country will not have to make repeated demands on IMF resources. Sustained balance of payments improvement usually requires structural transformations, and thus the need for structural reforms.

- The reformers in the government with whom the IMF is usually negotiating want to put in place policy measures that would force the less reform-minded parts of the government to accept reforms. Whether the IMF should be involved in the internal political-economy debate in a country, and be used by the reformers in this way, is certainly questionable, although it may be inevitable.

- Certain structural conditions may be necessary to signal the government's commitment to macroeconomic stability. Securing this depends not only on short-run macroeconomic management given an existing set of institutions, but also on the quality of institutions themselves. These could include budgetary institutions

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[27] This has been tabulated in Goldstein (2000b) and IMF (2001c).

[28] See IMF (2001a), (2001b), and (2000c).

(covering issues of fiscal federalism, social security, and pensions, systems of budgetary control on public enterprises, etc.), the central bank (covering independence, competence, etc.), the regulatory regime governing banks and financial markets, and so on. Because these macroeconomic institutions define the domestic macroeconomic framework within which adjustment policies are designed and implemented, their quality directly affects the country's medium-term macroeconomic performance. Institutional development and reform require a variety of structural policy changes, and this is a justification for including them in programs.

- Some structural measures may be included in programs for symbolic reasons to show that a new way of doing things is being established. This presumably buys the government credibility both at home and in the international financial markets. It has been argued that some of the structural reforms introduced in programs in Asian countries in the late 1990s were of this nature.

- Structural conditions may be necessary if there are concerns about governance issues in the borrowing country. Faced with the prospect that the country may not choose to, or be able to implement the policies necessary for a favorable outcome, a private lender could simply decide not to lend. The IMF, as a cooperative institution, cannot disengage itself this way from a member country. Thus it needs to put in place program conditionality that will compensate for governance problems and protect IMF resources.

- Structural conditions are also put in programs to ensure that key structural reforms are carried out by the government. Implicit in the rationale is the view that more structural conditions are needed because of insufficient country ownership. However, it is difficult to assess the direction of causation. It can equally well be argued that increased structural conditionality may be an important contributing factor in the reduced country ownership of programs.

While there is considerable validity in the reasons advanced for the expansion in IMF structural conditionality, it must be stressed that many structural reforms are microeconomic in nature, and thus are likely to be more intrusive than macroeconomic policies. Country ownership of programs is essential for the design and implementation of these microeconomic measures, since they have a differential impact on various segments and vested interests in society.

It is generally felt that the IMF has gone too far in structural conditionality and overloaded programs with structural measures. Many structural reforms are not critical for the achievement of macroeconomic stability. There is also no compelling evidence that programs with a greater number of structural conditions have been more successful. The two main dangers of increased structural conditions are, first, that they result in reduced country ownership of programs and therefore impair their effectiveness. And second, the failure to implement structural reforms that are not critical for macroeconomic stability may undermine confidence in the overall program, which could trigger reactions in domestic and

international capital markets that could make the overall program objectives more difficult to achieve.

It would be difficult, as well as undesirable, to have a major shifting back of the clock and eliminate all structural conditions from programs. However, at the same time, careful thought should be given to what structural reforms are critical to achieving the principal objectives of the program. These reforms will undoubtedly vary from country to country, but sharply pruning the list of structural conditions is possible without jeopardizing the success of the program or the ability of the IMF to be repaid. In other words, prioritizing or streamlining structural conditionality does not mean weakened overall conditionality.

The IMF has acknowledged that structural conditionality has expanded too much, and a major effort is underway to streamline structural conditionality in programs. An Interim Guidance Note on Streamlining Structural Conditionality issued by IMF Management to staff defined broadly the principles to determine the appropriate scope of structural conditionality in programs.[29] In summary, these principles are:

- Structural reforms that are critical for the achievement of the program's macroeconomic objectives will generally have to be covered by IMF conditionality.

- Structural reforms that are relevant—but not critical—for the program's macroeconomic objectives and within the IMF's core areas of responsibility may be subject to conditionality.

- If structural reforms meet the macro-relevance test but are neither critical nor in the IMF's core areas of responsibility, IMF conditionality would generally not apply.

The proposals contained in the Interim Guidance Note represent an important move by the IMF away from a concept of comprehensiveness of structural conditionality to one of parsimony. But they are still sufficiently general so that they may in the end not lead to a significant reduction in the number and scope of structural conditions. The intentions are in the right direction, and experience with programs negotiated after the issuance of the new Interim Guidance Note will show whether these intentions are being fulfilled.

V. New Approaches to Enhance Ownership

There are two further ways in which the form of IMF conditionality can be altered to enhance country ownership of programs: (1) introduce flexibility in the timing of structural policy measures, or "floating tranche" conditionality; and (2) have conditionality apply to outcomes rather than policies, or "outcomes-based" conditionality.

[29] See IMF (2001b), Box 3.

A. 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 as well as strain their implementation capacity.[30] Programs could be designed to allow for greater flexibility in the timing of structural reform measures, thereby increasing the scope for greater ownership. One way to achieve this is through the use of "floating tranche conditionality" for structural measures. Under this approach, the availability of a loan disbursement would not be tied directly to any specific date; instead, the disbursement would become available upon completion of certain agreed structural reforms. This floating tranche approach gives the country flexibility in the timing of implementation.[31] Furthermore, it allows the de-linking of disbursements associated with the implementation of one part of the program from another part of the program.

Specifically, the floating tranche approach could be used by the IMF to divide conditionality into two segments. One part of the financing could be made conditional on achieving the usual quantitative performance criteria under a pre-set schedule, while the other part could be dependent on the implementation of certain structural measures at any time prior to the expiration of the arrangement (and provided the macroeconomic program stayed on track). In the floating tranche segment the country would have control over when it undertook the reforms, and assurances that when it did it would receive the funding. The IMF would be protected since it would only disburse when the structural reforms were undertaken.

Obviously, the segmentation of conditionality would involve decisions on the proportion of the financing subject to standard fixed tranche conditionality, and that subject to floating tranche conditionality. The decisions would be based on judgments about the relative importance of different parts of the program in achieving the overall objectives. Clearly not all structural reforms would be made subject to floating tranche conditionality. Some reforms

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[30] There are many examples where rigid schedules have posed serious problems for countries. One concrete example involves the passage of laws. Legislatures in some cases have been surprised to find that the program has committed them not only to a specific legislative agenda, but also to a set of deadlines under which the relevant legislative actions have to be taken.

[31] 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 Executive Board. The timing of the Board meeting and the disbursement of funds, therefore, depends on the prior actions having been taken. Reviews themselves may also be considered a form of floating tranche conditionality, since their completion (and the accompanying disbursements) depends on the agreed policy measures being taken.

are critical to support the macroeconomic framework. For example, an independent central bank could be considered necessary to promote monetary stability, or a proper tax collection system may be necessary to achieve fiscal discipline. One could not leave the timing of such reforms 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. The final decision would be made on a case-by-case basis and would be the result of negotiations and agreement between the IMF and the country authorities.

There is experience with a form of floating tranche conditionality in the context of Higher Impact Adjustment Lending (HIAL), which was introduced by the World Bank in the Africa region in 1995. The tranching innovations under HIAL have two objectives. First, to give governments more freedom in the timing of agreed reforms, thereby increasing ownership; and second, to reduce pressure on the World Bank to disburse when conditions have not been met. These objectives are to be achieved through multiple, but smaller tranches, more disbursement after delivery of reforms, and introduction of independent floating tranche arrangements.

Prior to HIAL, adjustment loans typically were two tranche arrangements. The HIAL initiative introduced the floating tranche mechanism, 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, they are in addition to regular tranches. Under HIAL, floating tranches have been applied to reforms in the financial and banking sector, the parastatal and public sectors, privatization, and civil service reform. A tranche release is triggered only when the structural condition is met, irrespective of when this happens. Of the 21 HIAL operations in Africa in 1996–98, about two-thirds of the operations had adopted the new tranching mechanisms.

An evaluation of 21 HIAL operations in 17 African countries over the period 1996-98 was conducted by the Operations Evaluation Department (OED) of the World Bank in 1999.[32] This study found that the HIAL initiative is associated with positive policy outcomes in terms of fiscal adjustment and exchange and interest rate policy. Moreover, the HIAL group of countries had a clear edge over the non-HIAL comparators in achieving lower inflation, improved current account balance, stabilized foreign exchange reserves, faster growth, and a sustainable debt path. The study based its findings on a comparison of outcomes before and after the start of HIAL, and on a comparison with outcomes in all other developing countries eligible for Bank lending. Even though HIAL programs differ in other respects from other World Bank programs, and the evaluation method does not take the role of exogenous factors into account, nevertheless the results do provide some support for the use of floating tranches.

[32] See World Bank (1999).

B. Outcomes-based conditionality

Outcomes-based conditionality involves conditioning disbursements on the achievement of results, rather than putting conditions on policy measures that are expected to eventually lead to attaining the program objectives. Changing from policy-based conditionality—the current system—to outcomes-based conditionality, leaving the choice of policies to the country authorities has been advocated by, among others, Carlos Diaz-Alejandro (1984), who said:[33]

> "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" (p. 7).

Under the outcomes-based approach, IMF conditionality would focus on the objectives (rather than on policy instruments and actions). Performance criteria for the disbursement of funds would be set on the achievement of targets for the policy objectives at selected dates. The policy objectives would be negotiated with the IMF, but the policy content of the program would be largely left up to the authorities. This is not as radical an approach as it might seem, since outcome variables have been defined as performance criteria in programs. For example, IMF-supported programs include a floor on net international reserves as a performance criterion. Furthermore, the adoption of an inflation targeting framework has made inflation a key monitored variable in the program for Brazil. Presumably as more countries adopt the inflation targeting approach to monetary policy, programs will have to follow the Brazilian model.[34] The list of potential variables that would be subject to outcomes-based conditionality, aside from net international reserves and inflation, could include the trade balance, the current account, investment, growth, and so on.

In principle, there are two major benefits to this approach. First, the design of policies to achieve desired goals would rest with the country authorities; hence they would bear the risk of success or failure. Because the design of policies would be the responsibility of the authorities (subject to the proviso that the policies adopted do not include any proscribed by the IMF's Articles of Agreement), this approach would enhance ownership by requiring that the authorities and the staff agree only on the objectives of the program, and not necessarily on the mechanisms that link these objectives to specific policies.

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[33] Spraos (1986) also made a similar point but on the grounds that the links between outcomes and policy variables were too tenuous to allow policy-based conditionality to be particularly meaningful.

[34] More generally, the creation of independent central banks, which the IMF has consistently advocated, would also suggest that monetary policy be judged in terms of inflation performance, rather than by variations in policy instruments. After all, that is the criterion by which independent central banks are judged.

Second, funds would be disbursed only on the attainment of certain goals, and this would provide the right incentives for both the country and the IMF to fashion appropriate policies. IMF resources would be safeguarded since disbursement would depend on achieving the desired results. If policies did not have the envisaged outcomes, it would force a rethinking of the economic strategy by the country and the IMF.

Implementing this approach can of course have some difficulties. First, outcomes-based conditionality could lead to the back-loading of funds which may be needed 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, since the agreed policies need 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 the trade accounts, and the data may be subject to frequent revisions, thus making timely monitoring and disbursements problematic.

Third, program objectives are influenced not just by policies that are under the control of the authorities, but also by exogenous factors that they do not control. While certainly true in principle, it is not clear that unexpected exogenous shocks create serious problems for program projections. For example, a recent study of program projections by Musso and Phillips (2001) shows that projections for growth, inflation, and international reserves were accurate relative to simple random-walk projections. However, projections for the current and capital account did not outperform the projections from the random-walk model. The more difficult question in this regard is even if exogenous factors force a program to go off course, to what extent should the authorities bear the risk of failure and 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 involve a sifting of the evidence to determine whether outcome targets were missed because of exogenous factors or because the authorities genuinely came up short, and if the former, there would be a case for waivers as there is under policy-based conditionality.

In the context of outcomes-based conditionality one can ask the basic question of when it would be feasible for the IMF to disburse funds based on promises to achieve certain objectives without 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 and/or high net worth. Similarly, for IMF loans this is likely to happen only in the case of countries which have a track record of economic performance and management, a reputation for good governance, a history of paying their debts as contracted, and those facing a situation that is not too dire. Otherwise, giving the country complete freedom in choice of policy actions would not provide adequate safeguards for resources lent. Even for the best client, covenants are likely to give complete freedom of policy actions only as long as the capacity of the client to repay is not impaired by endogenous or exogenous factors. For what ever reason, if there is a deterioration in the health of the borrower, the lender will specify contingent measures in the contract to protect its resources.

Another difficulty with the implementation of outcomes-based conditionality is similar to that in the "pre-commitment approach" for setting capital adequacy standards of financial institutions, in which regulators levy penalties on banks ex post if they ex ante underestimate the (market) risk of their portfolios.[35] The key problem is how to make penalties credible. Should banks be penalized when they are vulnerable and it is revealed that they are under capitalized relative to the risks on their balance sheets? Would the imposition of penalties by regulators at such a juncture be impractical and counterproductive?

Two points can be made in response to the problems raised above regarding outcomes-based conditionality. First, even under outcomes-based conditionality the disbursement of funds will be done in tranches. For example, a program put in place to correct an imbalance in the balance of payments could achieve its objective of attaining a comfortable level of international reserves in multiple steps. The first tranche could be disbursed on a promise, but each subsequent tranche would be secured by the country only after achieving a particular level of international reserves. In fact, even the release of the first tranche could require some prior actions. Hence, by breaking up monitoring and disbursement into a set of smaller components, a sequence of outcomes-based criteria can simultaneously provide sufficient safeguards and prevent excessive back-loading of financing.

Second, just like any creditor, the IMF would combine outcomes-based conditionality with a system of monitoring so that if a borrower's position deteriorated sufficiently, it would intervene to contain the damage, take prompt corrective action, and attempt to change the strategy of the borrower. Hence, as mentioned before, we are likely to have ex ante ownership but ex post conditionality—that is, a program may have little bite initially, but would impose stricter constraints contingent on some events occurring. Also, since all possible contingencies cannot be specified ex ante, it is natural that the IMF will design outcomes-based programs with the option to intervene should it be necessary for protecting its resources.

VI. CONCLUSIONS

This paper draws heavily on the well-established literatures on agency and corporate finance to argue that conditionality has to apply to all IMF lending, and that country ownership of programs is essential. Since increased ownership matters for the success of programs, both the IMF and country authorities have a common incentive to create contracts that maximize ownership subject to the safeguards required by the IMF for its resources.

There is currently a widespread perception that too often countries do not have sufficient ownership of the programs they negotiate with the IMF. It is necessary perhaps to distinguish

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[35] See, for example, American Enterprise Institute (2000).

between countries already in crisis and those with emerging imbalances. In the former countries, there will be less room for maneuver, and speed will be of the essence. Here the issue of ownership may be less important and, given the exceptional and extreme circumstances, agreement possibly easier to obtain. However, in other countries, the additional time spent on negotiations may be a necessary price to pay for greater effectiveness in securing program outcomes. In fact, different IMF facilities could cater to countries in different circumstances and the scope and modalities of conditionality could differ depending on the facility accessed.

Ownership can be enhanced by limiting the objectives of IMF-supported programs, which in turn would allow for a more focused conditionality. If the objectives are to establish and maintain macroeconomic and financial stability, then the range of structural measures required by IMF conditionality would be narrower. The IMF, in its capacity as policy advisor, can advise on the merits of various structural reforms, but in the context of programs would only include as conditions the critical ones that directly support the macroeconomic policy framework. Encouraging the domestic formulation of programs, the selling of programs to multiple stakeholders in countries, discussing alternative policy options, and greater information revelation should all help to increase country ownership of programs.

To date, conditionality design has focused primarily on policy actions rather than outcomes. This paper has argued that there is merit in changing the emphasis towards outcomes-based conditionality and explore the use of floating tranches, especially for structural reforms. Such outcomes-based conditionality would increase ownership by giving authorities greater discretion and flexibility in choosing the policy mix and the timing of structural measures. For the borrowing countries, this increased leeway for program implementation would be tied to explicit acknowledgement of ownership, improvements in data and reporting standards to facilitate monitoring by external observers, and an acceptance of the responsibility for program outcomes. For the IMF, outcomes-based conditionality will have to be combined with an agreed monitoring system for programs and the establishment of certain pre-set rules of behavior for the borrower. Such rules would be applied uniformly and enforcement would be through peer pressure and international norms of behavior, since there is no recourse to legal action by the IMF.

While a good case can be made for incorporating outcomes-based conditionality in IMF lending, this is not an either-or matter. Programs would presumably combine both policy-based and outcomes-based conditionality. The balance would depend on the circumstances of the country, the nature of the economic problem it is facing, the accuracy with which different policy actions and outcomes can be monitored,[36] and of course, country preferences. Programs having this balance would bring IMF conditionality and country ownership into closer alignment—which is undoubtedly the shared goal of the IMF and its member countries.

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[36] See Dixit (2000) and Drazen and Fischer (1997).

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