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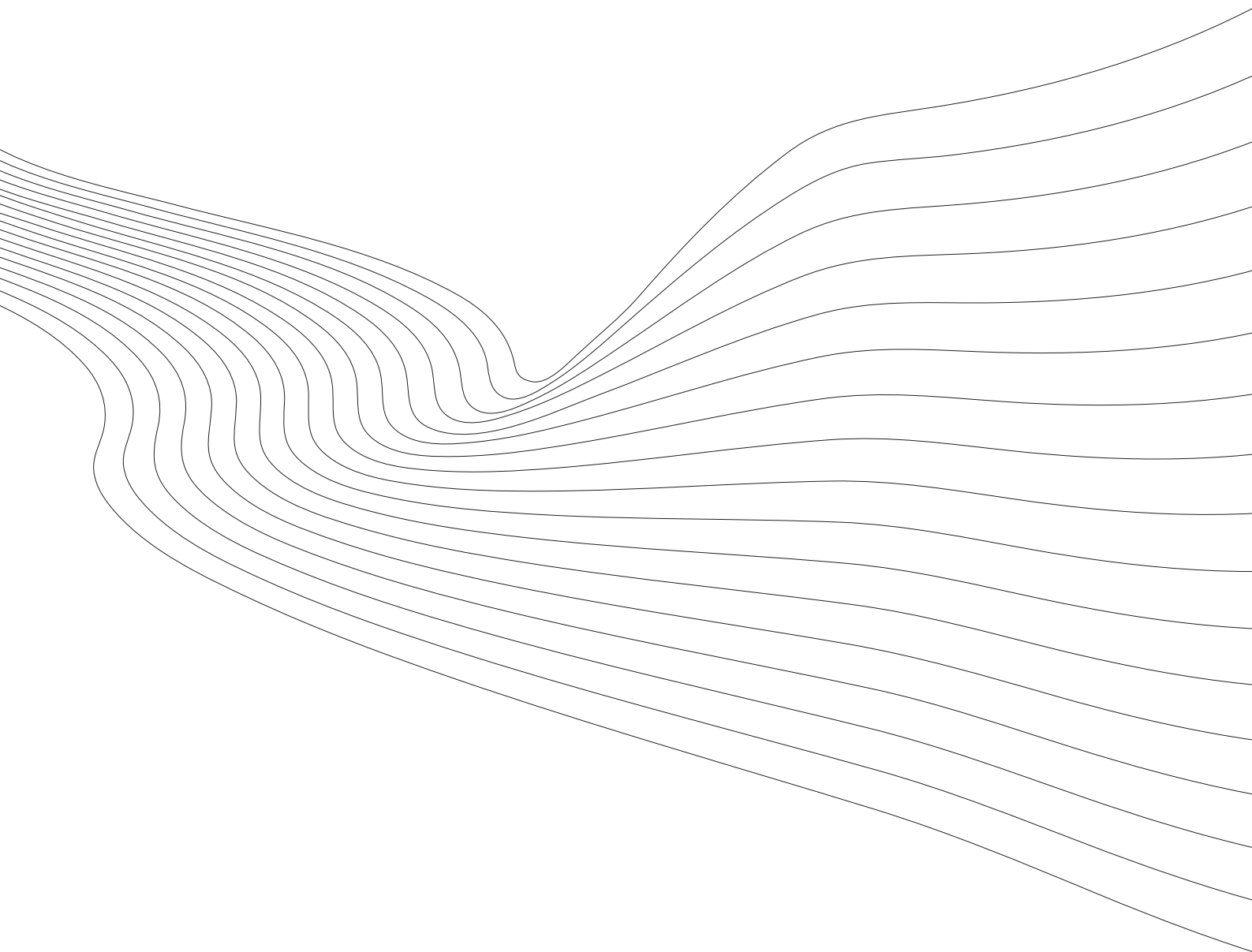
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# KOF Working Papers

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# IMF Conditionality: Theory and Evidence

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## Abstract

This article analyzes whether and to what extent reliance on conditionality is appropriate to guarantee the revolving character of Fund resources. The paper presents theoretical arguments in favour of conditionality, and those against the use of conditions. It summarizes the track record of program implementation and discusses the evidence of factors determining implementation. Whether proponents or critics of conditionality can be supported by existing data analysis is also investigated, as is the success of conditionality in terms of outcomes. The final section draws policy implications.

**Keywords:** IMF, conditionality, compliance, implementation

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## 1. Introduction

Conditionality is the practice of giving financial assistance contingent on the implementation of specific policies. As the IMF's Articles of Agreement put it, borrowing countries' policies have to be in line with the purposes of the Fund, avoiding "measures destructive of national or international prosperity". They have to guarantee that resources are made "temporarily available...under adequate safeguards". According to the IMF, loan repayment would be at risk without conditions; to secure the revolving character of the Fund's resources conditionality is thus inevitable (see, e.g., IMF 2001a).

The importance of conditionality in IMF programs continuously increased over time, with the number of conditions steadily rising (see Textbox 1). This increase in the number of conditions has been heavily criticized, as has the concept – and the specific content – of IMF conditionality. Criticism aims at the ineffectiveness of IMF conditions to overcome the dependence of a range of low-income countries on IMF money. In fact, the IMF became an almost continuous provider of aid to a few dozens of developing countries and emerging market economies (IFIAC 2000, IEO 2002). Regarding content, it has been argued that the Fund has put too much emphasis on internal adjustment and neglected development (Payer 1974). Some researchers have claimed that its programs focus too narrowly on reducing demand, so jeopardising growth (Allen 1984). Its intrusiveness has been criticised (Williamson 1983) as well as its devaluation policy (Dell 1982). The Fund has also been accused for neglecting the needs of the poor and for not taking the social consequences of its conditions into account.<sup>1</sup>

Particularly strong criticism aims thus at the Fund's structural conditionality, which, to a huge extent, replicates conditions demanded by the World Bank.<sup>2</sup> It has been argued by the IFIAC (2000) and Feldstein (1998), among others, that structural conditionality is simply not the IMF's business.<sup>3</sup> According to Feldstein, wide-ranging and micro-managed policy conditionality discourages crisis countries from turning to the Fund, thereby worsening crises. In the words of Radelet and Sachs (1998: 67-68), "most of the structural reforms, however, simply detract attention from the financial crisis. They have taken government expertise, negotiating time, and political capital away from the core issues of financial markets, exchange rate policy, and the like". Severe structural conditionality could make potential private lenders suspicious of a country's political and economic situation, inducing them to

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<sup>1</sup> This line of criticism might have contributed to the increase in conditions, as IMF programs covered more and more areas of the borrowing countries' economies.

<sup>2</sup> See IMF (2001c, 2001d) and Dreher (2002) for a detailed description of the content of IMF conditionality.

<sup>3</sup> Interestingly, the Fund has been criticized in the 80s for neglecting the structural origins of balance of payments crises (e.g. Spraos 1986), whereas today the criticism is on too much structural conditionality.

lend less instead of more (Radelet and Sachs 1998). It has even been claimed the Fund simply lacks the expertise to engage in wide-ranging structural policy conditionality (see Goldstein 2000). In fact, Radelet and Sachs (1998) claim that structural conditionality has often been prescribed in the wrong cases and in wrong dosages.

As another issue in the conditionality debate, there is the question of which countries should bear the costs of balance of payments adjustment – those in surplus or those in deficits (Loxley 1986). Related to this is the question whether, in imposing conditions, the Fund should distinguish among origins of the crisis. It has been suggested that conditionality should take the cause of a crisis into account. According to Dell (1981, 1982), it would be more appropriate to provide unconditional loans when crises are due to external shocks. Countries in balance of payments deficit simply mirror countries in surplus and, so the argument, there is no reason to make the former bear all costs of adjustment. However, the Fund has no mechanism for compelling surplus countries to adjust. Moreover, critics of this proposal point out that the relevant question is whether disturbances are self-reverting or not rather than the origin of the crisis. If disequilibria are permanent, a country has to adjust regardless of the origin of its crisis. This is also the position of the Fund (Nowzad 1981, Khan and Knight 1983).<sup>4</sup>

It has been criticized that politically weak countries have to accept stronger conditionality than more influential ones (see, e.g. Goldstein 2000, Dreher 2004a, Dreher and Jensen 2007). It has also been criticized conditionality would not take the specific political situation in the borrowing countries into account. For example, Dreher and Vaubel (2004b) argue that conditionality ought to take account of a borrowing governments' incentives to abuse Fund money to engage in political business cycles prior to national elections.

Though it is important to discuss the effectiveness of specific policy concepts, this is not the main focus of this article. What we will focus on instead is the question of whether conditionality should be applied at all. With respect to conditionality per se, criticism is also widespread. It has been argued conditionality – if it works – undermines democracy in the recipient countries (Santiso 2003). Others argue that conditions are not enforceable if country authorities do not want to implement them and that they are unnecessary if they reflect the country authorities' own agenda (Drazen 2002).

One of the most important insights regarding the concept (as well as the content) of conditionality is that conditions can not substitute for creditor ownership. Today, “ownership” has been identified as being among the most important conditions to successful

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<sup>4</sup> For a discussion see Jeker (1979) and Williamson (1983).

implementation of IMF-supported policies (e.g. IMF 2001a, Boughton 2005, Paloni and Zanardi 2004; for a recent discussion see Bird and Willett 2004). As a consequence, pressure on the IMF to seriously reform its lending in a way increasing ownership intensified. However, what exactly does the term “ownership” imply? In the bulk of literature, surprisingly, the term has only vaguely been defined – or not defined at all. Existing definitions differ widely. Koeberle (2004: 15), for example, defines ownership as “commitment to aid-supported reforms by country authorities and a majority of domestic stakeholders”. Morrissey and Verschoor (2004) distinguish ownership from commitment. In their definition, policies are “owned” if they originate from borrowing country policy makers. In the words of Khan and Sharma (2001: 13), ownership “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”. According to this definition, ownership is somehow exogenous. Clearly, the Fund has no influence on the policies that would have been implemented without its involvement.

The IMF (2001b: 6) itself defines ownership as

a willing assumption of responsibility for an agreed program of policies, by officials in a borrowing country who have the responsibility to formulate and carry out those policies, based on an understanding that the program is achievable and is in the country’s own interest.

Similarly, Drazen and Isard (2004) relate ownership not only to the willingness to carry out a program, but also to the technical capacity to implement the program and the political ability to do so. In their definition, the phrase “ownership is required for program implementation” is almost circular. “Building” or “creating” ownership would almost by definition imply an increase in the probability of program implementation. In any case, to aim at building ownership recognizes that ownership is endogenous instead of being exogenously determined. The key question, then, is how the IMF can enhance program ownership (Drazen and Isard 2004). Given the focus of this paper, the question is whether conditionality can increase ownership (or whether ownership would be greater without conditionality).<sup>5</sup>

Clearly, IMF conditions are not imposed exogenously on borrowing countries (e.g. Conway 2003). They depend, among others, on the severity of a crisis, the quality of domestic policies and the past relationship of borrower and Fund. They depend on the relative bargaining power of various stakeholders, including national politicians and interest groups,

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<sup>5</sup> Apart from conditionality, the IMF tries to increase ownership by fostering public discussion. This implies the potential drawback that special interest groups are strengthened so that IMF programs do not reflect the broader public interest (Drazen and Isard 2004). According to Buiter (2004), enhancing ownership would require greater selectivity.

G7 governments and foreign banks (Gould 2003, Dreher 2004a). Also, they depend on the relative power of groups within the Fund. The IMF is no unified actor, and the interests of the staff sometimes differ from those of management, the Executive Board and the Board of Governors. As one example, Killick (2004a) observed that there is only variable acceptance of streamlining conditionality among IMF staff, although management and Board seemed to endorse streamlining (while, of course, still supporting the principle of conditionality).<sup>6</sup> As a consequence, the reduction in the number of IMF conditions does not seem to be universal. While there is evidence that the average number of conditions has declined in recent arrangements (IMF 2001c: 294, Abdildina and Jaramillo-Vallejo 2004), there seems to be no reduction in the number of conditions in programs with low-income countries (Killick 2004a).<sup>7</sup> Especially in low-income countries reliance on conditionality remains high (Killick 2004a).

In this article, we analyze whether and to what extent reliance on conditionality is appropriate to guarantee the revolving character of Fund resources. We discuss the rationale for the use of conditionality, and the critique. The paper is organized as follows. Section 2 first presents theoretical arguments in favour of conditionality, and then those against the use of conditions. In section 3, the track record of program implementation is summarized, followed by a discussion of the evidence of factors determining implementation. Whether proponents or critics of conditionality can be supported by existing data analysis is discussed in section 4; section 5 analyzes the success of conditionality in terms of outcomes. Finally, section 6 concludes and draws policy conclusions.

#### Textbox 1: The Development of Conditionality

When the IMF concludes an arrangement it agrees with the program government to a set of conditions on the loan.<sup>8</sup> Such conditions typically include limits on credit expansion,

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<sup>6</sup> According to the Fund's new guidelines (as revised in September 2002), five principles are key to effective program implementation: national ownership of programs, parsimony in the application of conditionality, tailoring of programs to countries' circumstances, effective coordination with other multilateral institutions, and clarity in the specification of conditions (see also IMF 2004). Erbas (2003) provides theoretical justification for greater parsimony. In his model, too many program conditions produce worse results than fewer conditions, as they reduce ownership. Drazen and Isard (2004), to the contrary, argue that streamlining can reduce ownership. This is because those conditions will probably be eliminated first for which ownership is greatest.

<sup>7</sup> Regarding structural conditionality, the number of conditions did decline in programs under the PRGF, while under the General Resources Account there has been a shift from performance criteria to structural benchmarks, leaving the overall number unchanged (IMF 2004).

<sup>8</sup> For a detailed discussion of IMF conditions see Dell (1981). Dreher (2002) summarizes conditions included in a huge number of programs. Joyce (2004) is an excellent recent summary of reasons for adopting IMF programs and their impact.



reforms of the financial system, a target on foreign reserves and the budget deficit and a range of structural measures.

When the IMF was founded in Bretton Woods in 1944, there was no consideration of the intrusive conditionality now common under its programs. The Fund was created to provide short-term balance of payments credits and stabilize the post war financial architecture under a fixed exchange rate system. In the beginning of its operations, the only nation interested in IMF conditionality was the United States – the only country which was able to provide internationally accepted currency after the war. Even though the United States did not seem to have any interest in attaching detailed conditionality to the IMF's loans they wanted to be able to reject drawings if misbehaviour was flagrant (Cornelius 1988: 48). Not surprisingly, countries expecting high deficits, such as the United Kingdom refused this. Due to this conflict no ultimate decision on conditionality was made at Bretton Woods. Therefore, as the Fund started its operations, its Executive Board had to decide on whether to attach conditions to the loans. It was agreed that several goals should be negotiated to secure the revolving character of IMF resources. The borrowing countries were, however, free to decide with which instruments to achieve these goals.

In the beginning of Fund operations conditions mainly focused on policy targets. Those targets covered monetary and fiscal policy, relative price distortions, current account and budget deficits, and international reserves (Dreher 2002: Table 1). In the following years, however, especially after the introduction of the Extended Fund Facility in 1974, IMF conditions became increasingly detailed. Moreover, not only targets were negotiated but also detailed conditions concerning specific instruments (Dreher 2002, Gould 2003). This should give a borrowing country confidence that negotiated tranches would be available in the case of compliance with conditionality. Would only targets be negotiated, external shocks could be responsible for deviations from these targets. However, this new type of conditionality increasingly reduced the scope for independent policy.

Policies included in IMF programs often were not those preferred by borrowing countries' governments; they claimed that the increasing intrusiveness of conditionality would not be justified by the relatively small amount of money provided. Developing countries protested that IMF conditions were not tailored to individual countries' circumstances and that industrialized countries received its loans merely without conditionality. Their protests led to a review of Fund conditionality in 1979. It was agreed that individual country's priorities and characteristics should weigh more heavily in the programs. However, at the same time, a new kind of conditionality was introduced. In addition to performance criteria, which must be implemented to secure tranche releases, prior actions should be taken before a program is presented to the Executive Board. Officially, these prior actions should ensure that programs were in line with the targets of the IMF. However, governments frequently had to execute prior actions not critical for the success of programs in order to demonstrate willingness to comply.

In the years following the IMF conditionality review, supply side aspects gained weight in Fund programs. This led to greater IMF involvement into social and political issues of developing countries. Compared to the 70s, not only did the IMF prescribe more detailed conditions – it also paid out less money at the beginning of its programs. Moreover, waivers were more difficult to achieve (Dreher 2002).

In 1986, the IMF introduced the Structural Adjustment Facility (SAF). With the introduction of this facility, another kind of conditions – structural benchmarks – became prominent. If those conditions – which were not provided for under the IMF guidelines – are not met, access to credit tranches is not automatically terminated. Non-compliance with these benchmarks might lead Fund staff, however, to be more stringent if performance criteria were not achieved. Moreover, though the importance of structural benchmarks within the IMF is not clear, non-compliance can lead to program interruptions (IMF 2001a: 17). Compared to

traditional performance criteria, structural benchmarks are much more microeconomic, which reflects the shifted focus of the Fund.<sup>9</sup> Whereas its initial focus has been to provide short-term balance of payments support, it increasingly evolved into a development agency with a focus on economic growth in borrowing countries.

The tendency to include structural conditions has been enhanced by the breakdown of the Soviet Union and their successors' huge demand for Fund credit. The Asian crisis had a similar effect on conditionality (Dreher 2004a). With the evolution of the IMF, the average number of conditions gradually increased and became inseparably associated with the loans. As the IMF (2001) reports, the number of structural conditions rose on average from about 3 in 1987 to about 9 in 1999. This is mainly due to the increase of benchmark conditions that increased from 0 to an average of 5 in the same time period. However, performance criteria surged as well, as did prior actions.<sup>10</sup> Whereas earlier programs contained only some performance criteria, in the 90s, an average program included almost 12. The average number of total conditions in a sample of programs between 1999-2001 analyzed by Dreher (2002) was about 21.

Several studies try to explain the increase in the number of conditions. Among them, Gould (2003) stresses the influence of private actors attaching their money to the IMF's programs. It has been claimed that the Fund's policies are driven by its major members, especially the US government (Vaubel 1991: 210; Frey 1997: 121; Goldstein 2000: 67) and by borrowing countries' politicians (Vaubel 1991, Dhonte 1997, Vreeland 2001). Moreover, the interests of IMF staff in conditionality have been proposed to be among the reasons for the increased number of conditions (Vaubel 1991: 211). The development of IMF conditions can thus be explained by changes in relative power and interests of the different stakeholders over time (see Dreher 2004a for such explanation).<sup>11</sup>

## 2. Theory

### *Objectives of conditionality*

The literature distinguishes five major objectives of conditionality.<sup>12</sup>

First, IMF conditionality might serve as a *commitment* device to address time inconsistency problems. The objective of conditions is to provide credibility. Models along those lines can be summarized under two major headings. One group of models treats governments of borrowing countries as unified actors, and their preferred policies might be similar to those preferred by the Fund. The role of conditionality under those circumstances is to make it more difficult to change policies in the future. The IMF would thus help in solving the time-consistency problem in the design of economic policies. As markets cannot take for granted that governments pursue appropriate policies and, as a consequence, governments do not receive loans, those governments have incentives to bind themselves in order to minimize investors' risk perceptions (Dhonte 1997). This idea has been formalized in a couple of articles. A range of those articles emerged in the wake of the 1980 debt-crisis and is based on

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<sup>9</sup> A detailed description of structural conditionality since 1987 can be found in IMF (2001d).

<sup>10</sup> Dreher and Vaubel (2004a: Table 1) document the increase in the number of conditions. For the development of prior actions over the period 1992-1999 see Thomas (2002). See also Goldstein (2000).

<sup>11</sup> See also Vaubel (1986) and Frey (1997).

<sup>12</sup> See, among others, Bird (1984), Collier et al. (1997) and Dreher and Vaubel (2004a).

the observation that high levels of sovereign debt are usually associated with inefficient policy outcomes. With a high level of external debt, governments face incentives to reduce their reform efforts as a large proportion of the gains of reform would have to be transferred to creditors. This can lead to lower debt repayments. Sachs (1989), Diwan and Rodrik (1992) and Fafchamps (1996) model IMF conditionality along those lines.<sup>13</sup>

There are two links between a debt overhang and the effectiveness of conditionality (Sachs 1989). First, in the absence of debt relief country authorities might not have incentives to comply with conditionality as the benefits of reform fully accrue to creditors while the costs fall on the country. Second, if governments heavily discount future consumption, debt relief alone might not induce reforms. Then, a combination of debt relief and conditionality could raise welfare of borrowers and debtors, while neither debt relief nor conditionality alone could do so. This is because conditional IMF lending shifts the balance in favour of accepting the reforms. Arguably, the most crucial point with this model is the assumption that conditionality can be enforced. In fact, accepting IMF money and renegeing on its promises would be optimal from the government's perspective in the framework of this model.

Diwan and Rodrik (1992) consider a government with debt overhang that has to decide whether or not to undertake reforms in order to reduce this overhang. In the absence of external financing, (current) costs of reforms would exceed (future) benefits for the government. If external financing is provided by commercial creditors, governments' promises to reform would not be credible as those promises could not be enforced. Banks will therefore only be willing to lend when they are rather certain that the money will change governments' incentives to adjust. This requires loans that might be far too high relative to expected banks' returns. According to the authors, conditionality might change the bargain, in that loans will only be disbursed once conditions are accepted. Again, the model presupposes that conditionality can actually be enforced and be proportionally associated with disbursements of loans. As the choice, then, is between reforming with new loans and no reforms without new loans, the amount of loans necessary to induce reforms is lower, compared to what private creditors would have to provide.

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<sup>13</sup> See also Federico (2001) who combines various features of those previous models. He presents a principal-agent model of conditional IMF lending, showing that conditionality can be effective in safeguarding the Fund's resources. Following a crisis event, the IMF offers governments conditional liquidity contracts designed in a way to maximize reform effort and minimize liquidity provided. According to the model, if capital outflows are not too large, conditionality can protect the Fund's resources and provides a commitment technology to the recipient country that enhances efficiency both ex ante (before a crisis takes place) and ex post (after the occurrence of a crisis).

According to Fafchamps (1996), similarly, conditionality has a role in eliminating debt overhang in certain circumstances. As the basic idea of his model, sovereign borrowing is characterized by a failure to credibly commit repayment of debt. Conditionality provides a partial solution to this commitment problem, in that it improves trade policies – and the penalties creditors can impose on debtors are modelled to depend on the level of trade. However, if private lenders anticipate IMF involvement, the model shows that conditionality may lead to situations with persistent debt overhang and ever continuing conditionality.

To summarize this line of commitment models, conditionality may represent a mechanism which allows recipient governments to commit to reforms, and might therefore allow for an efficient exit from the debt-overhang situation – if, and only if conditionality can be enforced.

The second group of commitment models takes into account that governments are not unified actors. Those models allow for disagreements among different ministries. Conditionality might then ‘tip the balance’ in favour of reformers or may allow reformers using the Fund as a ‘scapegoat’ (Bird and Willet 2004). Governments are thus no longer modelled to be helpless victims of economic crisis when turning to the Fund.

The most influential model along those lines has been developed by Vreeland (1999). The recipient government’s utility is initially modelled to be increasing in the amount of loans received and decreasing in the extent of conditionality imposed, so that governments are only willing to accept more stringent conditionality if they can get more money. Then, however, countries would only accept conditionality, if they need foreign exchange – a condition which is frequently violated. Hence, Vreeland suggests altering the basic framework, supposing governments would favour some degree of conditionality in order to gain domestic bargaining power. In other words, the IMF serves as a ‘scapegoat’ for the borrowing country.

Drazen (2002) analyzes the relation between IMF conditionality and country ownership from a political economy perspective. Employing a model of lending and policy reform, he shows that conditionality can play a role even when Fund and domestic authorities agree on the goals of an assistance program. Drazen’s model highlights the heterogeneity of interests among governments and domestic interest groups that oppose reforms. Given this internal conflict, the IMF can provide leverage either when its assistance affects the welfare of domestic interest groups opposed to reforms or, when the government is not the agenda setter, by changing the incentives of the government in a way that it affects what interest groups offer in the bargaining process. When there are no domestic political constraints on the

government, however, there is no role for conditionality if government and Fund agree on the reform agenda.

In summary, “conditionality as commitment models” provide interesting insights in the incentives of borrowing countries. These insights might have some implications for the design of IMF programs and facilities. In particular, the models stress the difference between conditional money and conditionality per se. Not all of the models discussed imply a role for lending, as conditions have a value in itself. If this would be the main rationale for conditionality, IMF facilities that do not provide access to finance should be strengthened. The usefulness of “conditionality as commitment models” is limited by the fact that those models rely on the key assumption that conditionality does actually change borrowing country’s policies – an assumption that is not supported by available empirical evidence.<sup>14</sup> The second group of models stresses the importance of the Fund in changing the relative power of interest groups in the borrowing country. To what extent this is a legitimate goal will be discussed below.

As a second objective, conditional lending is employed to induce governments to pursue policies they would not have chosen without the offer of aid (*bribery*). Arguably, this objective becomes more relevant, the worse a country’s policy from the Fund’s perspective. Clearly, it will be a more relevant objective of conditionality in some cases, and less so in others. While bribing governments is probably more important in PRGF programs, where governments of the poorest countries often pursued policies very different from those preferred by the Fund over long periods of time, it is also a relevant objective in SBAs with middle income countries.<sup>15</sup>

One reason for bribing governments has already been introduced: According to the IMF, conditionality is necessary to safeguard its resources. In the words of Khan and Sharma (2001: 3 and 6), the IMF “is a lender that has to have assurances that it will be repaid, and this requires placing conditions on its loans”. IMF conditionality serves “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”. And finally, “finance considerations alone provide the justification for IMF conditionality being a necessary part of all IMF lending”. The provision of financing probably weakens incentives to reform. Conditions are

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<sup>14</sup> Note that this does not imply that specific conditions are generally not implemented. However, countervailing actions can make the achievement of certain targets ineffective or even counterproductive. This will be discussed in some detail below.

<sup>15</sup> In middle income countries program negotiations almost always begin upon request from the country, and the initial bargaining position of the Fund is subject to debate. Nevertheless, IMF loans are used to induce governments implementing specific policies they would not otherwise want to pursue.

accordingly applied because otherwise the borrower would not repay its loan, or would continuously depend on additional IMF money.

Bribing governments might be justified by the need to protect the interests of other Fund members from attempts by some borrowers to improve their welfare at the expense of others (beggar-thy-neighbour).<sup>16</sup> To some extent, adjustment might have public good characteristics. Smoother, less disruptive adjustment might avoid contractionary effects on other countries via multiplier effects (e.g. Spraos 1986).<sup>17</sup> The Fund could even lend with less stringent conditions attached in world wide recessions and more conditions if the world economy is booming, a proposal going back to Cooper (1983). This proposal rests on the assumption that in spite of the conditions demanded, credits can be expansionary (Cornelius 1988). The extent of the expansionary stimulus could be controlled by variations in the stringency of conditionality.

It has also been claimed the Fund's stakeholders would employ the Fund to impose conditions in their interest – to do their “dirty work” (Vaubel 1986). Major shareholders of the Fund enforce conditions which they would have difficulties to demand on a bilateral basis (James 1998, Mussa and Savastano 1999, Dreher and Jensen 2007). It has been asserted that the US government drives the IMF's policies (Frey 1997: 121, Goldstein 2000: 67). It has even been stated that “no managing director...can make a major decision without clearance from the U.S.” (Swedberg 1986: 379). In a similar vein, Gould (2003) argues commercial banks would use the IMF to impose conditions in their interest. As another reason for bribery, the Fund might have superior information and experience to generate better designed policies (Kenen 1986). In all those cases, IMF conditionality is employed to induce policies governments would not otherwise want to pursue.

Models along those lines usually assume that governments of borrowing countries are unified actors with no or little disagreement within the government about policy design. However, governments' policy preferences are modelled to be different from those of the IMF. Mayer and Mourmouras (2004), for example, employ a dynamic common agency model where the government is both an agency of interest groups and the IMF. In the absence of external assistance, the government pays attention to special interests to gain political support. Conditional assistance can then raise world welfare in that the power of interest groups is reduced. It is shown that under certain assumptions conditional loans imply Pareto-optimality. However, to derive this result Mayer and Mourmouras assume that conditional loans can be enforced from period to period.

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<sup>16</sup> See, e.g., Kenen (1986).

<sup>17</sup> For an in depth discussion of global public goods and the role of multilateral institutions see Sandler (2006).

Coate and Morris (1996) show that if conditionality extends to all channels by which governments can make transfers to their constituencies, conditionality may work quite well. However, if conditionality cannot cover all channels, this result does no longer hold. In the short run, improvement of ‘irrational’ policies that would have been pursued in the absence of conditionality to favour special interest groups may induce policy makers to make those transfers in a more costly way. In this case, conditionality would make the recipient country worse off. In the long run, of course, conditionality will only have an impact if reforms persist. As Coate and Morris argue, if policy conditionality is required, this is probably the case because governments do not want to reform. Then it is most likely that reforms will be abandoned once conditionality disappears. However, the introduction of reforms might create enough support for it to be maintained. Interest groups representing the net beneficiaries might defend those reforms even in the absence of conditionality. The assumption is thus an asymmetry in the lobbying capacity of interest groups in introducing reforms and defending them.<sup>18</sup> As one explanation, Coate and Morris argue, when reforms are introduced, agents will respond by changing their behaviour to benefit from those reforms. These behavioural changes can then increase future willingness to pay for the maintenance of those reforms and investments in lobbying activities increase.

Another explanation goes back to Fernandez and Rodrik (1991) showing that the uncertainty over the distribution of gains and losses from policy changes can prevent reforms. Once introduced, however, there might be a majority supporting the status quo as the elimination of uncertainty alters voters’ preferences over policies. As an even more subtle explanation, agents might perceive gains and losses differently. They might thus fight harder against the loss of an entitlement as they would fight for its original implementation. In all those cases, bribing governments to introduce welfare-improving policies might actually lead to persisting reforms. Again, conditionality is only beneficial if it can be enforced.

As a third rationale for conditionality, conditions may *signal* the type of the borrowing country’s government. Arguably, the IMF prefers lending to countries with competent governments and good policies as this might be more productive. Conditions may serve to solve the IMF’s selection problem in environments of asymmetrically imperfect information – they help in alleviating adverse selection.<sup>19</sup> Moreover, if the loans are tied to conditions in an

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<sup>18</sup> “For the initiator [of a new system] has the enmity of all who would profit by the preservation of the old institution and merely lukewarm defenders in those who would gain by the new ones”, Machiavelli, *The Prince*, 1513, cited in Feinberg (2006).

<sup>19</sup> This is the rationale for ex ante conditionality established by the Fund in 1999 with its Contingent Credit Line (CCL). This facility, however, had been designed in such a way that it could not function and has been allowed to expire in 2003. To be eligible, the potential borrowers had to sign up in advance, thereby signaling that they

appropriate way, they will be demanded only by the truly needy (Nichols and Zeckhauser 1982). In that sense, conditionality could signal the type of the government to the IMF.

It has also been argued that IMF conditionality might provide a ‘seal of approval’ to private and official creditors finding it preferable to free-ride on the decisions of the Fund, a suggestion going back to Bird (1978). For the IMF to provide a “seal of approval”, it would need information superior to those of private and bilateral lenders. The Fund could signal the governments’ type to other (potential) lenders. Again, if this would be the rationale of IMF conditionality, Fund arrangements without providing money should be strengthened: There would be a role for conditionality but not necessarily for conditional money. By separating conditions from money, the conflict of interest between disbursing the funds promised and monitoring implementation would be eliminated. The signal could become more valuable.<sup>20</sup>

Marchesi and Thomas (1999) develop a model where the adoption of an IMF program signals a country’s productivity. They assume two types of countries, one with a high return to investment, and one with a low return. In the presence of a debt-overhang countries might chose a level of investment that is too low, as part of the returns accrues to their creditors. Creditors might then want to offer debt reductions but face the problem of being unable to discriminate among high and low productivity types. If the country is credit-constrained and cannot signal its productivity by buying back part of its debt in order to gain debt relief, IMF conditionality can offer an alternative screening device.

The signal provided by the Fund might also be valuable for official creditors. However, when it comes to official creditors, the story might equally well be a different one. Official lenders tend to lend not only when an IMF program is in place, but also when the IMF provides them with an Assessment Letter or, until recently, when the IMF staff agreed to monitor a domestic arrangement through a Signalling Staff Monitored Program (SMP). As in either case the IMF’s Executive Board is not involved, there is no real “seal of approval” by the institution. Instead of profiting from a signal of the borrowing governments’ type, official creditors might be interested in some form of “delegated monitoring” by the Fund.<sup>21</sup> The

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anticipate a crisis and a need for credit. To be effective, ex ante conditionality has to be mandatory and universal (Dreher and Vaubel 2004b). Ex ante conditionality is discussed in more detail below.

<sup>20</sup> As potential counter argument, the IMF’s signal might be more valuable when its own resources are at stake. However, IMF money is almost always repaid – and in spite of non-implementation of conditions (see Aylward and Thorne 1998). There might thus be better mechanisms to signal good policies. As one example, the amount of money the IMF has at its disposal could be made dependent on the effectiveness of its programs (with effectiveness, of course, not judged by the Fund itself).

<sup>21</sup> See Bordo, Mody and Oomes (2004).



impact of IMF programs on official creditors' lending behaviour might then be different from those on private creditors.<sup>22</sup>

Fourth, the IMF might want to restrict the way aid is spent, because it has other preferences than the government in the use of aid in raising the recipients' welfare (*paternalism*),<sup>23</sup> and utility maximization must allow for the donors' preferences also (e.g. Buchanan 1968, Garfinkel 1973). There might even be a principal-agent problem within the country. The objective of loans might be to ensure redistribution from rich to poor people – not from rich to poor countries, and there might be no reason to believe this would be achieved by unconditional loans (Little and Clifford 1965).

Fifth, conditionality addresses the problem of *moral hazard*. In principle, moral hazard arises when the provision of insurance leads the insured to take actions that increase the probability of bad outcomes. IMF lending may be interpreted as (subsidized) income insurance against adverse shocks (Vaubel 1983). The insurance cover induces the potential recipients to lower their precautions against such damages (or even to intentionally generate a crisis). This form of moral hazard may be called “direct moral hazard” because it looks at the behavior of the direct recipients of insurance payments – the governments of the member states (Dreher and Vaubel 2004b). It ought to be distinguished from indirect moral hazard effects on the lending behavior of creditors, i.e. the “bailout” of foreign bondholders, banks etc.<sup>24</sup>

A model illustrating the moral hazard problem is presented by Svensson (2000). In the game between donor and recipient, borrower countries chose a certain set of reforms in the first period, interacting with exogenous shocks to an uncertain outcome in the second. Loans are then disbursed in the second period. According to Svensson's model, reform effort is higher compared to a situation without aid if the donor can credibly commit to a disbursement rule – in other words, when donors make credible that funds are only released when conditions have been implemented. Without a credible commitment to insist on those conditions, however, incentives to reform are reduced, implying a worse outcome for all parties involved.

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<sup>22</sup> As Gai and Vause (2003) stress, private creditors are more likely to be interested in short-term stabilization, whereas official lenders focus on medium to longer term development.

<sup>23</sup> See Dreher and Vaubel (2004a).

<sup>24</sup> IMF lending provides insurance to creditors as well. If markets refuse to roll over maturing debt, the Fund, knowing that restructuring is costly, provides resources that can be used to finance investors' exit. Since investors take this into account when deciding whether and where to invest, allocation of credit becomes distorted, increasing the risk of future crises. The empirical literature on this topic is summarized in Dreher (2004b).

To sum up, conditionality – if it works – might prevent the recipient from abusing the money so as to remain dependent on further transfers (Bruce and Waldman 1991, Vaubel 1991, Dreher and Vaubel 2004a).<sup>25</sup>

Arguably, the effectiveness of conditionality depends both on the recipient governments' willingness to implement the conditions and its ability to do so. Finally, even if conditionality is implemented as agreed, desired outcomes will only be achieved if the appropriate conditions have been chosen and no exogenous shocks have undermined their impact. As a next step, and before we turn to the results of empirical studies on this topic, we review the theoretical literature on the effectiveness of conditionality to achieve those objectives.

### *The critique*

Tied transfers have frequently been attacked because they prevent the recipients from maximizing their utility, are of uncertain value within any framework of redistribution and cause large administrative costs (Dreher and Vaubel 2004a). In the following, we will consider theoretical arguments against the rationales of conditionality discussed above.

If *commitment* is the reason for conditions, enforcement has to be credible. Clearly, there are cases in which IMF conditionality can have some commitment value. This might especially be true if there are no alternative sources of credit available and investors thus expect the country to have no choice but to comply with conditionality. However, as will be summarized below, implementation of IMF conditionality is on average far from perfect. If agents do not expect conditions to be implemented, especially if they are opposed by governments, why should IMF conditionality have any commitment value? After all it is well known that non-compliance is not rigorously punished by the Fund (e.g. Killick 2004b). Maybe it would increase the commitment value of conditionality if programs would make explicit whether certain conditions have been demanded by the Fund or have been desired by the government. Arguably, the process of formulating conditions has to be transparent and should relate to a set of well-established ultimate objectives (Dhonte 1997). Most importantly, and illustrated by the model of Svensson (2000) presented above, conditionality does only work if the Fund can commit to disburse its money only if agreed upon conditions are actually

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<sup>25</sup> Conditionality does not, however, as long as it is ex post, prevent negative incentive effects on the behavior of creditors and borrower governments that might eventually cause a crisis (Dreher and Vaubel 2004b). This behavior can only be prevented by ex ante conditionality – which we will address below.

implemented. In fact, however, waivers are quite frequent.<sup>26</sup> If Fund and government agree on the objectives of the program, the Fund is probably even less likely to interrupt the program after slippage on conditions. As programs are currently designed, there is on average little commitment value of Fund conditionality. If conditionality is used to ‘tip the balance’ in favour of reformers within the borrower country or government, again the question of democratic legitimacy arises. If democratically elected, should an external actor be allowed to interfere with economic policy? What is the democratic legitimacy of the Fund?<sup>27</sup>

There are some problems with *bribing* governments to implement policies they would not otherwise pursue also. If Khan and Sharma (2001) would be right in arguing the only justification for conditionality is safeguarding the revolving character of the Fund’s resources, every individual condition would only be justified if it would indeed be necessary to guarantee repayment of the loan. Would concerns for repayment be the rationale for conditionality, the number and scope of Fund conditionality would have to be substantially reduced. However, IMF loans are almost always repaid – and few would argue that this is due to the success of program conditions. In a strict sense, then, IMF conditions would not be necessary and should be abolished completely. In a wider sense, IMF conditionality might be necessary to improve policies and macroeconomic outcomes. In the longer run, countries might thus prosper and would no longer depend on the IMF’s (development) loans. The money would be available for its other clients. Does IMF conditionality improve policies and outcomes? This is an empirical question. We will return to it below.

Another problem regards the content of conditionality. Does the IMF really have better information as compared to national authorities? And, if so, why would it not be enough to provide this information – to consult governments instead of forcing them (Dreher 2002). Of course it could increase welfare if the more competent one enforces its views. However, though in the case of the Fund this might sometimes be the case, it does not excuse behaving as if it would always be true (Spraos 1986). The content of IMF conditionality has frequently been attacked. It has been criticized that the Fund’s conditionality does not directly refer to real targets, but to instruments (e.g. Spraos 1986). Policy would thus be committed to instruments, whether or not they work as anticipated. In the words of Spraos (1986: 13), “even when the genuine targets are agreed upon, the choice of instruments is not value-free ...

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<sup>26</sup> There has even been an increase in the overall number of waivers over the past several years, especially regarding Structural Benchmarks (IMF 2002). Martin and Bargawi (2004: Annex Table 6) report the number of waivers obtained in recent PRGF programs.

<sup>27</sup> Frey and Stutzer (2006) make an interesting proposal that would give international organizations democratic legitimacy. According to their suggestion, a representative sample of trustees is chosen among the citizenry of the member states. The trustees can launch initiatives and vote in referenda on issues related to the organizations. They would be allowed to recall the institutions’ executives.

so that an imposed targeting of instruments creates discord and division". If targeted at instruments, conditionality imposes rigidity when flexibility is warranted in order to respond to unanticipated exogenous events. Of course, while allowing more flexibility, focusing on targets comes at some cost. Outcomes based conditionality may be irrelevant if it leaves room for temporary external shocks to be interpreted as durable adjustment.<sup>28</sup> Specifying conditions on outcomes rather than instruments makes sense, however, when the outcome is measurable within reasonable limits of time and is under the authorities' control to a reasonable extent (Boughton 2003).<sup>29</sup>

There is no unanimous model among economists about which policies to pursue (e.g. Spraos 1986).<sup>30</sup> As Bird (2001) stresses, while we know that monetary expansion leads in the long-run to inflation, the impact of modest inflation on an economy is debatable. Adam and Bevan (2001) show that in low income countries growth-maximizing inflation lies in the range of 5-10 percent, while higher and lower rates of inflation tend to reduce economic growth. The Fund's PRGF targets, to the contrary, aim at an average inflation of below 5 percent (Eurodad 2003), which is probably too restrictive (Killick 2004b). The same is true for moderate fiscal deficits – and this list could easily be continued. If conditionality would focus on what the IMF definitively "knows" about economics, conditionality would be less embracing and less precisely defined (Bird 2001).<sup>31</sup> Clearly, this would be especially true in countries where inflation and fiscal deficits are comparably modest from the outset. In countries experiencing hyperinflation, of course, the basic remedies are rather uncontroversial. As Cooper (1983: 571) claimed at a conference on IMF conditionality, "we could choose any five people present and make a team to work up an economic adjustment program for a particular country other than our own ... the program we came up with not differ greatly from a typical IMF program". While this is probably true with respect to the broad outline of IMF programs, there is definitively no consensus about the specifics of Fund conditionality.<sup>32</sup> In any case, if the basic purpose of conditionality, as the Fund claims, is

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<sup>28</sup> It is interesting to note that performance criteria generally referred to targets at the beginning of the Fund's operation (see Textbox 1). This made borrowing countries insecure about whether the agreed money would actually be disbursed, even when they tried to implement reforms (but exogenous shocks prevent them from achieving targets).

<sup>29</sup> For a more in depth discussion see Khan and Sharma (2001) and Koeberle (2004).

<sup>30</sup> And, of course, the prevailing development doctrine changes over time. While until the 1970s inward looking import substitution was quite fashionable, from the 80s onwards more market oriented reforms have been endorsed by the majority of the economics profession (Kanbur 2003).

<sup>31</sup> Of course, governments also have to make decisions facing uncertainty and this is not to say that there are not also policies hugely deviating from IMF advice, and leading to extremely negative outcomes.

<sup>32</sup> To the contrary, Krueger (1998) states that "many of the lending changes supported by the Bank and the Fund ... are ones that would be endorsed in broad outline, if not in detail, by almost all economists".

really to safeguard its resources, this could almost certainly be achieved with more modest conditions (Bird 2001).

In order to contain the risk of internationally destructive national measures, IMF conditionality might be counterproductive. This is because crisis countries, anticipating tough conditionality, try avoiding IMF programs as long as possible. This might severely worsen the crisis and the risk of spillovers increases (Spraos 1986).<sup>33</sup> To some extent, this line of argumentation might contradict others, arguing that Fund conditionality can easily be circumvented and imposes thus no costs on governments. On the other hand, even if conditionality is not binding, turning to the Fund might be considered as a proof of failure and might thus be politically costly. Political costs of turning to the Fund might be particularly high when there has been no IMF program with this country for some time. They are also higher at national election times (Vreeland 1999, Dreher 2004c).

As a further problem with bribing governments, conditionality cannot cover all policy channels, and governments might countervail policies they dislike even if they formally comply with conditionality. This is particularly true as IMF loans are meant to be temporary, and policies are thus likely to be reversed after no more loans are expected. To which extent reforms themselves create enough support to be maintained, cannot be answered from a theoretical perspective and is in the end an empirical question. As private agents might expect policy reversals, even reform-minded governments may lack credibility (Collier et al. 1997).

Collier et al. (1997) identify a potential conflict between the IMF's role of bribing governments and its paternalism and signalling role. In order to induce governments to pursue specific policies, loans are most effective if the government can freely dispose of them. With respect to signalling, the negotiation of an IMF arrangement may be a signal of economic failure, with the degree of conditionality signalling the extent of the failure (Bird 2001). In any case, investors might become unable to distinguish reform-minded governments from bribed governments.

This point is illustrated more formally by Rodrik (1989) who presents a model where governments can obtain a foreign transfer in the first of two periods, subject to conditionality. If the government reforms in the first period to get the transfer, its promise to retain those reforms in the second period might not be credible. This is because the public is unable to distinguish a reform-oriented government from a redistributive one. In the absence of conditionality, the reformist government could more easily signal its type – the presence of conditionality makes a pooling equilibrium more likely and is thus counterproductive. In

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<sup>33</sup> Of course, you can hardly blame the dentist for patients' procrastinating (and letting their teeth rot) simply because dental procedures are not pleasant.

addition, by relaxing the budget constraint, foreign aid permits a larger redistribution by the non reformist government – even if conditionality is implemented in the first period. To convince private agents that reforms are permanent, reformist governments' policies must overshoot, so that conditionality might be counter-productive: Uncommitted governments will reform to get the transfer, but will return to the previous policies after the money has been disbursed. Governments committed to reforms will find it more difficult to signal their commitment, as the presence of a foreign aid agency makes it promising for the redistributive government to imitate the reform-oriented government.

In summary, bribing governments to pursue reforms they dislike can only safeguard the Fund's resources if conditions are actually implemented and if they are maintained after termination of the IMF arrangement (as it is then the loans have to be repaid). Arguably, this is an empirical question – a question which will be addressed below.

With respect to the *signalling* function for creditors, conditionality can only be of value if the Fund's "seal of approval" is reliable. As the Fund is currently lending to competent and incompetent governments alike, this rarely seems to be the case. This is particularly true when conditionality and lending are influenced by the Fund's stakeholders and when confidence in the Fund's influence on actual policy is low. Moreover, conditionality makes it more difficult to assess the government's own preferences about reform, thus obscuring commitment (Bird and Rowlands 2004). Bird and Rowlands (2004) thus conclude that the analytical justification for anticipating the IMF to catalyze private flows is at best thin.

If *moral hazard* is the problem, the current practice of IMF conditionality is clearly inadequate. As Ramcharan (2003) shows, the IMF has incentives to disburse loans regardless of compliance with conditionality once the borrowing country's debt stock is huge enough for the country being able to threaten defaulting on this debt. This is because the IMF can postpone the default by continuing to lend (and this might be less costly). As a consequence, malevolent governments pretend to reform while deliberately increasing their outstanding debt. Once the level of debt reaches a certain threshold, the government openly extracts rents from the economy, knowing that the IMF can increase its utility by lending nevertheless.

To limit moral hazard and facilitate public scrutiny, conditions ought to be few and simple and they ought to be published without exception (Vaubel 1991). As has been argued by Dreher and Vaubel (2004a), the Fund should also be obliged to inform the public whether the conditions have been implemented and, if not, why additional installments of the credit have been disbursed. To keep the recipients fully responsible, the conditions ought to be

confined to instruments which they control and exclude target variables which are largely beyond their control.<sup>34</sup> Moreover, moral hazard arises not only ex post, i.e., after the damage has occurred – it may also be a cause of the crisis. Governments have incentives to exaggerate the costs of reform, to get a better deal from the Fund (Collier et al. 1997). If it is the major aim of the IMF to improve policies, aid ought to be concentrated on countries where policies are worst, because room for improvements is highest in those countries. Again, this implies negative incentives for policy design. Ex-ante moral hazard requires ex ante conditionality (Vaubel 1991, IFIAC 2000). Only ex ante monitoring also solves the adverse selection problem.

According to Collier et al. (1997), *paternalism* might be both undesirable and infeasible. It is undesirable, because donors' priorities are often based on a weak empirical basis. Regarding feasibility, fungibility of money implies that the IMF's control over its loans is limited. Of course, truly benevolent donors would respect the recipients' preferences (Dreher and Vaubel 2004a). In the words of Finch (1983: 77-78), "The Fund has to accept that the authorities of a country are the sole judges of its social and political priorities". As Mark Allen (2004) puts it, it is simply not legitimate for the IMF using conditionality to persuade countries doing things they would not otherwise have done. And even if there is a potential principal-agent problem within the country, it would apply mainly in the case of non-democratic countries. Can it really be legitimate for an international institution to interfere with policies of democratically elected governments? Or should not those elected representatives have the final say in the choice of policies?<sup>35</sup> Arguably, if conditionality is significantly influenced by the Fund's stakeholders in pursuit of their own interests, the rationale for conditionality is greatly weakened. To the extent that conditionality is designed to satisfy important Fund stakeholders, the Fund's economic rationale – and finally its reputation – will be undermined (Bird 2001). If the wrong policies are chosen, it is the country bearing the consequences, and not the IMF. This does clearly not imply that democracy is a sufficient condition for sound policies as perceived by the majority of the economics profession. But it might imply that the decision about what is sound and what is

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<sup>34</sup> E.g. Vaubel (1991), IFIAC (2000) and the Board of Executive Directors in September 2002.

<sup>35</sup> As potential counter-argument, conditions might be considered being the outcome of negotiation, thus also representing the views of countries' citizens (represented by their government). However, during severe crisis negotiation is not among equals, and governments in desperate need of international reserves might be forced to accept whatever the Fund demands.

not should (at least at the margin) be decided by the borrowers – and not by the Fund. There would then be no role for detailed conditions.<sup>36</sup>

To summarize, most theoretical models that show conditionality to be effective assume that conditions can be enforced. However, there is now a huge empirical literature (discussed below) showing that conditionality as it is designed by the IMF simply does not work. White and Morrissey (1997) provide a theoretical basis. Allowing for non-compliance, they present a small model providing a general case of existing analyses of conditionality. Their model implies four special cases, where, first, donors and recipients share preferences for lending and reform, second, parties conflict on preferences for reform, third, parties conflict on preferences for lending, and, fourth, parties conflict over lending and reform. As has been argued above, even if there is agreement over reform and lending, there might be a role for conditionality. However, White and Morrissey show that the utility-maximizing equilibrium will only be obtained if the agreed upon conditionality is really feasible and can be enforced. If donors and recipients do not realize that certain conditions are infeasible, non-compliance is clearly unavoidable. The donor can then increase its own and the recipient's utility by disbursing the money anyway, raising, however, problems of credibility. This becomes even more severe, when donors' and recipients' preferences differ with respect to reforms. In this case, the recipient has incentives to breach conditions, knowing that the donor can increase its own utility by disbursing the money nevertheless. In the third case, when the parties' preferences differ with respect to lending, conditionality is also likely to fail. Finally, when donors and recipients' preferences differ both about lending and policy, conditionality has no useful role in supporting reforms – and punishing non-compliance tends to undermine recipients' ability to reform. In summary, the authors show conditionality not only to be ineffective in promoting reform, but to have negative consequences in nearly all circumstances. According to the model, the genuine reform effort of governments is inhibited and wrong signals to private creditors are sent.

As compliance with conditionality is central to the conditionality debate, the literature on program implementation is reviewed in the next section. We then present evidence on the empirical literature on IMF conditionality, starting with evidence on the various theories presented. Finally, we discuss the literature on the success of IMF conditionality in achieving better outcomes.

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<sup>36</sup> In practice, of course, it might sometimes be difficult to decide whether countries are democratic or not. Whether a country is a democracy or not must not be decided by the IMF because it has a vested interest in conditionality and lending. The decision ought to be delegated to an institution containing a majority of clear-cut democratic countries (Dreher and Vaubel 2004a).



### 3. Implementation of IMF Conditionality<sup>37</sup>

Measuring the implementation of IMF conditions is not straightforward. Many earlier studies employed proprietary data, mostly from the Fund's internal documents. Using such documents, first evidence on compliance with conditionality was presented by Beveridge and Kelly (1980). They showed that out of 105 countries with upper-credit-tranche programs implemented over the period 1969-78 only 60 percent achieved the target for the overall fiscal deficit and 54 percent complied with the credit ceiling. Another study on implementation of IMF conditions is Haggard (1985), reporting extremely low rates of compliance with conditions under the Extended Fund Facility (EFF) between 1974-84. Of the thirty cases studied, sixteen were cancelled and eight more were not implemented in their original form. Zulu and Nsouli (1985) found similar results in a study of African adjustment programs in the years 1980-81. Only half of the countries achieved the negotiated credit ceilings and compliance with fiscal targets has also been poor. According to Edwards (1989), conditions on the government's deficit have been achieved in only 30 percent of 34 programs approved in 1983. In 1984 compliance was even lower: the ceiling was observed in only 19 percent of the programs. One year later, 57 percent of the countries failed to comply. As for changes in domestic credit, compliance was highest in 1983 (55 percent). It reduced to 46 percent in 1984 and 41 percent in 1985. On average, compliance was higher for changes in net domestic credit to the government with 72 percent in 1983 and about 52 percent in 1984 and 1985. This study has been updated by Polak (1991), who added programs in place between 1988 and 1989. According to his results, compliance with fiscal and credit targets has been 40 percent for the 17 SAF programs and 60 percent for the five ESAF programs under study.

Mecagni (1999) evaluated 36 countries with an IMF program under the Structural Adjustment Facility (SAF) or the Enhanced Structural Adjustment Facility (ESAF) approved in 1986-94. His findings show that 28 of the evaluated countries interrupted their programs 51 times in total. 17 countries had more than one interruption. Only 10 programs were in effect for three or four years without any major interruption and policy slippage. 38 programs made it at least one year, in the second year, 22 programs remained in effect. 33 interruptions were caused by slippage on conditionality; only eight programs broke down due to disagreements about future actions. In some cases, governments needed more time to get political support in their countries in favor of an IMF program. In 1988-89, only 40 percent of 17 countries with

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<sup>37</sup> This section draws on Dreher (2006). See also Joyce (2004).

an SAF program complied with the postulated credit ceiling. The same is true for the overall fiscal deficit.

Edwards (2001a, 2001b) analyzed 347 programs between 1979 and 1997. He gathered information from different sources, including the Fund's archives, on whether a program was suspended. Over the whole period of study, 138 programs have been suspended prior to expiration. This corresponds to a completion rate of 60 percent. Interruptions have been particularly frequent over the period 1988-1991. Also using binary data on program completion, Thomas (2002) reports that 40 percent of the programs went permanently off track over the period 1992-99 – with programs that were replaced by a successor program for political reasons not included in this number.

Since the beginning of the Nineties the IMF itself provides data on compliance with conditionality. Its database on Monitoring Fund Arrangements (MONA) contains data on the implementation of performance criteria and structural benchmarks that have been implemented under its programs. In the MONA database, compliance is scored as a 0-1 indicator per criterion. At each review an average for a given program is generated. When a condition is not met and a waiver is granted, the record is still “non-compliance” or 0. These data are not free of problems (Bird and Willett 2004): Only those programs are included in the database, which have been reviewed by the Executive Board. Programs that are interrupted or permanently cancelled will therefore not be covered – which might overstate compliance. As another problem with this database, coverage does not go back in time far enough to allow longer-term empirical analysis. Moreover, this measure can easily be manipulated. Overall compliance would be shown to be higher, when many conditions are included which the borrowing country can readily implement. The more the IMF's success is judged by outsiders according to compliance with its conditions, the less likely it is therefore that this measure is meaningful.

Mercer-Blackman and Unigovskaya (2004) use MONA data to give evidence on compliance in countries in transition to market economies. Of the 33 countries analyzed, only 17 implemented more than 50 percent of the structural benchmarks included under their program between 1993-97. The IMF (2001d) itself reports compliance with structural benchmarks in 57 percent of all programs in 1987-99. Compliance with performance criteria was almost ten percentage points higher, while prior actions have been implemented in 80 percent of the programs analyzed. The worst implementation rates were found for conditions relating to privatization (45 percent), the social security system (56 percent) and public enterprise reforms (57 percent).

The most widely used measure of program implementation has been a proxy suggested by Killick (1995). He employed IMF loans agreed but left undrawn at program expiration as an indicator of performance under a program. When 20 percent of the agreed money remaining undrawn at program expiration is taken as cut-off, 47 percent of IMF programs are completed. Killick finds that over the period 1979-93 compliance was higher in earlier programs; and also in SBAs as compared to EFFs.

Bird and Willett (2004) summarize the disadvantages of this approach. Resources may not be withdrawn, because of improvements in the economy. Sometimes programs are approved on a precautionary basis only, without intension to draw at all. On the other hand, the Fund might disburse its money even though implementation of conditions has been low, for example because it feels that significant progress has been made, or even for political reasons. Also, not all programs cancelled and renegotiated soon after represent signs of failure. The exact amount of non-compliance is thus difficult to assess and, clearly, this variable allows different interpretations. In the interpretation of Mussa and Savastano (1999), programs with disbursement of up to 50 percent (which account for 1/3 of all programs) may include a few cases where the program was so successful (or conditions improved so rapidly) that the program country no longer needed the remaining financing. The third quartile (50 to 75 percent, accounting for 18 percent of arrangements) might contain some highly successful programs, some arrangements cancelled but followed rapidly by new ones, and some permanently off track. Programs in the fourth quartile (75 or more, which accounts for 46 percent of programs) are generally successful.

There is an additional shortcoming with this approach to measuring compliance (Dreher 2003). If countries fail to implement agreed conditions at the beginning of a multi-year arrangement, money will be withheld. In many cases this money will be paid out later, after agreement about future conditions is reached. Though non-compliance might be severe during major parts of the program period, finally the whole amount is disbursed, so this failure to comply would not be reflected by Killick's indicator.

In order to make up for this shortcoming, Dreher (2003) proposes a slightly revised proxy. After concluding an arrangement, part of the credit associated with it will be paid out immediately. The rest is payable in tranches which are usually equally phased. Since IMF credits are highly subsidized, countries almost always withdraw all the money available at once. However, the money is conditional on observance of several performance criteria. Unless a waiver is granted, non-compliance results in program interruptions. If there are large unused credit lines, non-compliance is likely to be the cause. Therefore, Dreher (2003)

proxied compliance using a dummy which takes the value of one if in a certain year at most 25 percent of the amount which would be available for that year under equal phasing remained undrawn and zero otherwise. According to this proxy average compliance is well below 50 percent.

Summarizing the evidence, compliance with IMF conditionality is rather low (while the exact number depends on how compliance is measured). The natural question arising, then, is why are conditions so frequently not implemented? Only very recently, some studies tried to answer this question systematically. As discussed above, there are various proxies for implementation of conditionality, all with their strengths and weaknesses. It would thus increase confidence in the reliability of the results, if there would be a robust pattern of determinants of compliance among the different proxies.

An attempt to explain three different proxies for implementation with the same explanatory variables is Dreher (2006). According to his results, program continuation as measured by Edward's data (introduced above) is more likely with more foreign direct investment in the program country, greater freedom of the press and better rule of law. The results are easy to explain: Inflows of investment lead to (or signal) economic recovery, which makes compliance with conditionality easier, thus reducing the probability of program suspension. An independent and free press is essential to provide access to information about development policy, creating support for reforms, therefore making program suspension less likely. A better rule of law also makes compliance more likely. Reducing monetary expansion is usually included as a performance criterion in Fund programs – high expansion thus induces the IMF to withhold its money. High inflation, low political stability and reductions in per capita GDP indicate the severity of the crisis and tend to increase compliance. The positive influence of school enrollment and civil liberties is also easy to explain: A better educated and free society better understands and participates in policy making processes, thus increasing the chance for reforms.

When proxied by the index measuring equally spaced disbursement, compliance is significantly higher with a lower rate of monetary expansion, higher inflation, lower GDP per capita, higher trade volume, higher school enrollment, greater political instability and more civil liberties. As discussed above, democratic governments might include conditions in IMF programs which serve their own interests. Compliance is then more likely. High inflation, to the contrary, makes compliance more difficult. Regarding trade openness, the Fund might fear that withholding loans from more open countries leads to contagion – it may thus be more willing to accept policy slippage.

The third indicator analyzed, the share of money disbursed relative to money agreed is significantly higher in more democratic countries and when inflation is low. There is thus no clear pattern as to what factors are important for compliance among the three different measures of compliance analyzed.

Other studies show that program interruptions are more likely with higher domestic credit and lower international reserves (Edwards 2001b), higher government consumption and short-term debt (Dreher 2003), as well as higher debt in general (Killick 1995). All those variables are frequently employed as performance criteria, so expansive fiscal and monetary policies, high (and especially short-term) debt and low reserves make non-implementation more likely.

International power, proxied by a country's quota with the Fund and more US foreign aid received, significantly reduces the likelihood of program suspension (Edwards 2001b). Similarly, Dreher (2003) finds that interruptions are less likely in countries with higher GDP. It thus seems that more powerful countries successfully use their power to lobby the Fund for program continuation in spite of noncompliance.

Regarding the internal political situation in the borrowing country, it has been shown that program implementation depends on governments' ideological cohesion, the duration of its political regime and its degree of political openness (Joyce 2006). Compliance is lower before national elections (Dreher 2003). Generally, the IMF (2001a), Ivanova et al. (2006) and Nsouli, Atoian and Mourmouras (2004) find political and social opposition to be the major reasons for observed non-implementation. According to Ivanova et al. (2006), compliance is lower with stronger special interests, less political stability, inefficient bureaucracies, lack of political cohesion and greater ethno-linguistic fractionalization. Edwards (2001a) reports that the IMF is more likely to suspend programs in democratic countries having fractionalized legislatures and proportional representation systems. Nsouli, Atoian and Mourmouras (2004) find that the share of IMF loans disbursed is higher, and interruptions are less frequent, in countries with stable governments, less corruption, less military involvement in politics and lower ethnic tensions. The same is true if internal conflicts are more intense and law enforcement was weak at program initiation. Thomas (2002) shows that implementation is more likely with a higher quality of the bureaucracy in the borrowing country and (when accounted for endogeneity) when governments are more stable. The results clearly speak for themselves.

There is also some evidence regarding variables the Fund can influence directly: Programs implying smaller amounts of credit are less likely to be completed (Killick 1995,

Nsouli, Atoian and Mourmouras 2004). The IMF's effort – as measured by the number of hours worked on a particular country – has no significant impact on compliance (Ivanova et al. 2003). Thomas (2002) finds no evidence of a significant impact of the number of prior actions included in an IMF arrangement on program implementation over the period 1992-99. Prior actions did thus not achieve their goal to address weak implementation of Fund programs. Countries that have spent more time in previous IMF programs are less likely to interrupt their programs (Nsouli, Atoian and Mourmouras 2004).

#### **4. Empirical Evidence on the Rationales for Conditionality**

This section tries to shed some light as to whether proponents or critics of conditionality can be supported by existing data analysis. However, not all aspects of conditionality lend themselves to measurement. The “paternalism”-argument is mainly a theoretical one. The same is true for the debate of whether IMF lending internalizes external effects or avoids contractionary effects on the world economy. We assess those objectives or critiques of conditionality introduced in section 2 that can be confronted with data: various reasons for bribing governments, the question of moral hazard, conditionality as commitment device and the signaling role of conditions.

Regarding the Fund's main argument for bribing governments – the necessity to safeguard the revolving nature of its resources, at least one of two conditions should hold to justify conditions. First, conditionality should increase the likelihood of repayment. And second, conditions should improve the borrowing country's policies and institutions, thereby reducing the probability of future crises and thus the probability of turning to the Fund again. Both conditions are not supported by the data. Although compliance with conditionality is generally low (see section 3), IMF loans are almost always repaid (Aylward and Thorne 1998). Given this evidence, it is very unlikely that conditionality increases the probability of loan repayment. Empirical evidence also shows that macroeconomic policies become worse from one inter-program period to the next (Evrensel 2002). The probability of future IMF programs is thus not decreasing, but increasing with current IMF programs.

Does the Fund have superior information justifying its attempts to bribe governments? Its forecasts are comparatively poor (See Brunner and Meltzer, 1990, Table 4.5) and biased in favor of optimism.<sup>38</sup>

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<sup>38</sup> For a summary see Vaubel (1991: pp. 235).

The "dirty work"-hypothesis has also been examined.<sup>39</sup> There is now huge evidence that the G7 countries are in full control of the Fund when it comes to topics of some importance (Fратиanni and Pattison 2005). Closer G7 allies receive fewer program conditions (Dreher and Jensen 2007) and larger loans (Oatley and Yackee 2000, Oatley 2003 and Barro and Lee 2002). According to Dreher and Sturm (2005), G7 countries employ the Fund to influence outcomes in the UN General Assembly. Commercial banks also influence program conditions (Gould 2003).

With respect to the moral hazard hypothesis, a huge empirical literature recently emerged, mostly analyzing, however, indirect moral hazard effects on investor behavior.<sup>40</sup> Whether IMF bailouts lead to moral hazard with debtor governments has so far been investigated in a small number of studies, all finding evidence of moral hazard (Evrensel 2002, Gai and Taylor 2004, Dreher and Vaubel 2004b). However, the studies on moral hazard encompass methodological problems, to some extent challenging their results. None of the studies completely manages to separate the effects of moral hazard from other sources of influence.

There is also some evidence on commitment models. In testing the "scapegoat hypothesis", Vreeland (1999) runs a simple OLS regression explaining the size of IMF loans. Under the scapegoat hypothesis, one would expect countries with stronger international reserves to get larger loans from the Fund. This is because governments which prefer no conditions will only get small IMF loans, while the Fund is willing to disburse larger loans to governments which prefer more stringent conditions. While the former will only turn to the Fund when reserves are depleted, the latter might accept conditionality whether or not they run out of reserves. As the results show, the scapegoat hypothesis is supported by the data – however, the regression is rather rudimentary and no robustness test is provided.

A more direct test is Smith and Vreeland (2003), evaluating whether participation in IMF programs is rewarded by longer tenure in office despite bad economic conditions. According to the results of survival analysis, there is limited evidence in favor of the scapegoat hypothesis under certain conditions. Democratic incumbents inheriting existing IMF programs can drastically increase their term in office. This is interpreted by the authors as result of successfully attributing to their predecessors the blame for signing the IMF arrangement. Vreeland (2005) provides further evidence. He shows that governments can only

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<sup>39</sup> For a recent overview of this literature see Dreher and Sturm (2005).

<sup>40</sup> This literature is summarized in Dreher (2004b). The evidence shows that the results depend crucially on the choice of events. However, taken together, there is considerable evidence in favor of the hypothesis that the safety net provided by the IMF creates significant moral hazard with investors.

use the IMF to push for the implementation of unpopular policies when the Fund is not being abused by the US to reward its allies. Only in countries not particularly favored by the US conditionality can effectively ‘tip the balance’.

Overall, the strength of commitment models in being a rationale for conditionality depends on the enforceability of IMF conditions. As has been shown in section 3, however, compliance with conditionality is weak, limiting the usefulness of those models.

Regarding signaling to creditors, a huge number of papers tests empirically whether investors perceive IMF conditionality as “seal of approval” and thus invest more funds in countries that (formally) accept IMF conditionality than otherwise. Of course, this function of conditionality depends on whether IMF arrangements act as reliable signals that certain policies will actually be implemented. However, in order to attract private capital, actual compliance with conditionality might not be crucial. Instead, what is important is that investors believe the conditions will be implemented. When accepting IMF conditionality indeed attracts private capital, governments might sign agreements with no *ex ante* intention of implementing its conditions (Bird and Rowlands 1997). It might even be that governments would have implemented IMF conditions in the absence of private capital, as new IMF disbursements would depend on implementation. With private capital flowing, however, authorities’ dependence on the IMF diminishes, actually weakening incentives to reform (Dreher 2004a).

A summary of this literature can be found in Bird and Rowlands (1997, 2002).<sup>41</sup> According to the reading of Bird and Rowlands, the majority of the empirical evidence fails to provide support for the IMF’s catalytic role on private capital flows. What is more important than IMF conditionality is the perceived commitment by a government to a specific policy agenda. This is, for example, illustrated in case studies by Bird, Mori and Rowlands (2000). In their own econometric study, Bird and Rowlands (2002) find more nuanced effects. As they conclude, to the extent that there is a catalytic effect, this effect is only weak and partial, and depends on the country and type of capital flows involved. As another recent example, Bordo, Mody and Oomes (2004) find that IMF programs catalyze flows into countries with bad, but not very bad fundamentals. Mody and Saravia (2003) report a stronger catalytic impact for precautionary arrangements and for countries where the economic situation has not deteriorated drastically before the onset of the program. The results of the empirical literature do strongly depend on sampling and econometric procedures, so any generalization has to be viewed with caution. As Edwards (2003) shows, this remains true when the degree of

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<sup>41</sup> For a discussion of different channels for a potential catalytic impact of the IMF see Cottarelli and Giannini (2002).



program implementation is controlled for. There seems to be no strong evidence that IMF conditionality serves as seal of approval to investors and lenders.

Marchesi (2003) tests whether countries having arrangements with the IMF are more likely to obtain a rescheduling of their external debt than others. She concludes that the adoption of an IMF programme works as signal of a country's "good intent" which is rewarded with debt relief. The results confirm the existence of a significant effect of the adoption of an IMF programme on the subsequent concession of a debt rescheduling by private creditors.

There is also evidence of an impact of IMF programs on other (bilateral) official lenders (Bird and Rowlands 1997, 2002). However, this might rather reflect a simultaneous relationship – it is a matter of concerted lending (Bird and Rowlands 2004). In any case, the signal provided by the Fund might be more valuable for middle income countries with (potential) access to private capital markets, whereas poorer countries borrowing under the PRGF probably aim for supporting official funds (Bird and Rowlands 2004).

In summary, there is little evidence that

- conditionality helps governments to commit to their own preferred policies,
- conditions provide a valuable signal, and
- conditions confine moral hazard, and

no evidence that conditions help the Fund safeguarding its resources. With respect to guaranteeing the revolving character of IMF money, the next section might provide further evidence. Are IMF programs generally successful?

## **5. Success of IMF conditionality**

Measuring the effectiveness of IMF conditionality is by no means an easy task. Compliance with conditions is rarely a binary event. Consider a ceiling on current expenditures which is not met due to a negative exogenous shock, and in spite of the governments' intentions to comply. We can also think of cases where the government had no intention whatsoever to comply with program conditions, and did not change its original policies but achieved an expenditure ceiling due to an exogenous positive shock. Whereas "compliance" should be judged to be higher in the first case as compared to the second, actual implementation is the other way round – and this is what (at best) can be observed. Implementation of a specific condition does thus not necessarily imply compliant behavior. Of course, however, it does imply disbursement of the loan. If performance criteria are not implemented, to the contrary, money is withheld until the Fund grants a waiver. This will usually be the case, when

exogenous negative shocks hit the country, and the IMF nevertheless sees attempts to improve on policies. This implies that the effectiveness of IMF conditionality is extremely difficult to gauge. Moreover, even when conditions have been met, this does not imply conditions make a difference. Maybe conditions have not been sufficiently ambitious, or the government would have implemented the underlying policies anyway. Even if implemented as agreed, specific policies might later be reversed.<sup>42</sup> So, if a program achieves its main target, e.g. a certain rate of GDP growth over a specific period of time, can this really be related to conditionality? Even if all aspects unrelated to the Fund could be held constant, the various channels by which the IMF can influence growth are rather difficult to disentangle. Apart from conditions, the IMF gives advice to country authorities, disburses money, and might imply direct or indirect moral hazard effects. Judging the average effect of conditionality is thus not straight forward, and cross country study regression analysis ought to be complemented by in depth case studies.

A huge number of studies has been undertaken to assess the impact of the IMF on economic policies and outcomes.<sup>43</sup> In principle, three methods of evaluation have been employed.<sup>44</sup> First, before-after analysis compares targets or outcomes before the IMF program has been approved with its value after the program period. Differences are then attributed to the program. Obviously, this method has its drawbacks. Participation in IMF programs is not exogenous but usually consequence of a crisis. In attributing all changes over the program period to the IMF, the Fund's effects are probably judged too negatively.

A second approach to evaluate the IMF's impact has been to compare policies or outcomes in program countries with their development in a control group (with-without approach). Exogenous shocks hitting not only program countries but countries in the control group as well would then not distort results. The problem, of course, is finding an adequate control group. Ideally, for each program country there should be a control country in exactly the same initial position. Programs are not randomly distributed over member countries, however, but are chosen from countries with specific characteristics. As Santaella (1996) has shown, the initial situation of program countries differs greatly from non-program countries. Even if the control-group would be chosen according to economic indicators, the most

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<sup>42</sup> Evrensel (2002) finds that improvements on the current account balance and the level of international reserves during the existence of an IMF program are reversed in the post-program years.

<sup>43</sup> For a detailed summary see Haque and Khan (1998) or Bird (2001). Dreher (2006) summarizes studies evaluating the IMF's impact on economic growth. More recent evaluations are, among others, Barro and Lee (2002), Hajro and Joyce (2004), Jensen (2004), Dreher (2005, 2006), Nsouli, Atoian and Mourmouras (2004) and Veiga (2005).

<sup>44</sup> See Goldstein and Montiel (1986) for an extensive treatment.

important difference could not be accounted for: The decision to negotiate an IMF program in the first place.<sup>45</sup>

The third method is regression analysis – it has been used by most recent studies. When endogeneity of the IMF-related variables is carefully taken into account, this method seems to be the most promising one.

The literature on the success of IMF programs failed until recently to distinguish among the various channels by which the Fund could influence policies and outcomes. If a program achieves, e.g., an increase in economic growth, does this imply that IMF conditionality works? Or has growth been achieved in spite of conditionality, because IMF money has helped alleviating the crisis? On the other hand, if IMF programs did not achieve an improvement in economic policies or outcomes, does this mean its conditionality is flawed? Or does it simply imply that its conditionality has not been implemented. As has been shown above, implementation of IMF conditions is weak. If not implemented, of course, we can not expect an influence of IMF conditionality on the economy. The success of conditionality thus depends on implementation of conditions, leading to meaningful changes in policy, to changes in intermediate targets (like, e.g. the current account balance or overall credit growth) to inflation and growth, or the income distribution. Unfortunately, only few studies tried to test the explicit links between IMF involvement and final outcomes. Those that do, in their vast majority analyze the impact of conditionality on economic growth.

Among the few studies trying to distinguish empirically the various channels by which the IMF might influence its borrowers are Boockmann and Dreher (2003) and Dreher and Vaubel (2004a). Boockmann and Dreher (2003) focus on three channels. First, money disbursed increases the governments' leeway and might thus weaken incentives to reform. Second, the Fund's technical assistance and consultation associated with its programs provides information that might change policies independent from conditionality. In fact, this might also spill over to non-program countries (in which case there would be no real counterfactual for empirical analyses). And third, conditionality might have a direct influence on policies, and thus, finally, on outcomes.<sup>46</sup>

Directly taking (the number of) IMF conditions into account, Dreher and Vaubel (2004a) analyze the Fund's influence on monetary growth, the budget deficit, the current account balance, international reserves and government spending – all variables frequently

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<sup>45</sup> Atoian and Conway (2005) provide a recent application of the method of matching to the impact of IMF programs.

<sup>46</sup> Focusing on precautionary arrangements could potentially avoid the disentanglement of conditions and borrowing. However, those results could probably not be generalized to other IMF programs. We are not aware of any study trying to test for the impact of precautionary arrangements on the borrower economy.

employed as performance criteria in IMF programs. As the results of the empirical analysis show, the number of conditions does not have a significant effect on any of those variables. However, the small number of countries and years in their sample does not allow to rigorously separating the impact of conditions from other potential influences of the Fund. Moreover, the number of conditions might be a bad proxy for the stringency of conditionality, and their implementation is not considered.

Only recently, some studies explicitly controlled for the implementation of conditionality. Several papers include the share of money disbursed under an IMF program as explanatory variables; others employ the Fund's own data on compliance. In interpreting the results of those studies, of course, it is vital to keep in mind the shortcomings of the various proxies for compliance with conditionality discussed above.

Hutchison and Noy (2003) report that program completion reduces economic growth, especially in Latin American countries; Hajro and Joyce (2004) find no significant effect. However both studies did not control for the amount of IMF loans and the existence of programs. Mercer-Blackman and Unigovskaya (2004) and Nsouli, Atoian and Mourmouras (2004) employ data from the Fund's MONA database. The former examined countries in transition to market economies between 1994 and 1997, the latter focus on a greater sample over the period 1992-2000. As the results of Mercer-Blackman and Unigovskaya show, there is no obvious relationship between structural benchmarks and compliance. There is, however, a significantly positive relationship between performance criteria and growth. Nsouli, Atoian and Mourmouras find some evidence that implementation of IMF conditions is associated with lower inflation and initially weaker, but ultimately improved fiscal outcomes. Economic growth is not significantly influenced by implementation of conditions. Dreher (2006) and Dreher (2005) achieve similar results for the period 1970-2000. The two studies distinguish four major channels for the impact of the IMF on economic policies and outcomes: Money disbursed, money available, implemented conditions, and policy advice. Controlling for the amount of credit and compliance with conditionality, dummies for existing IMF programs are meant to capture the effect of advice. With respect to economic growth, Dreher (2006) tests for the impact of three different measures of compliance with conditionality, money disbursed, and programs in effect. As the results for a panel with 98 countries over the period 1970-2000 show, IMF Stand-By and EFF programs reduce economic growth. There is weak evidence that compliance with conditionality mitigates this negative effect, while IMF loans disbursed have no statistically significant impact.

Regarding fiscal and monetary policy, there is evidence that participation in IMF Standby- and Extended Fund Facility arrangements improves economic policy (Dreher 2005). However, money disbursed and compliance with conditionality do not have any systematic influence. The same is true for future availability of resources as measured by exhaustion of a country's quota with the Fund ("moral hazard"). In a similar study, Bulíř and Moon (2004) do also not find evidence of a statistically significant impact of compliance with conditionality on fiscal adjustment. According to their results, fiscal structural conditions did not improve revenue performance after the end of an IMF program. However, there is evidence that programs with too many structural conditions had worse post-program results than those with fewer conditions.

In summary, the evidence implies that conditionality does not seem to substantially increase ownership (in the definition of Drazen and Isard (2004) introduced above).

## **6. Conclusions and Implications for Reform**

### *Summing up the Evidence*

The previous discussion has shown that IMF conditionality is ineffective. There is no empirical evidence showing conditions to enhance ownership or making program success more likely. To some extent, this might be due to the specifics of current programs. Feldstein (1998) has argued conditionality would be excessive and goes beyond what the Fund has the "moral right" to demand. But is conditionality really excessive? In order to answer the question, it is necessary to have some idea of the optimal degree of conditionality. As Bird (2001) argues, a high-conditionality program being only partially implemented may have less impact on the economy than a more modest program that is fully implemented. Also, implementation of conditionality might be more likely, the less stringent the conditions are. In other words, there might be a conditionality Laffer curve and from the viewpoint of maximizing reforms there would be an optimal degree of conditionality. The important question, then, is where on this Laffer curve current IMF programs are located. Clearly, there cannot be a definitive answer to this. However, given the weak record of compliance with conditionality and little impact IMF conditionality achieved on macroeconomic policies and outcomes, there might be reason to claim that conditionality is indeed excessive (Bird 2001). This claim is to some extent supported by the results of Bulíř and Moon (2004) reported above (showing too many structural conditions to imply worse outcomes).

Apart from the specific content – and number – of IMF conditions, the previous discussion has shown that there are no convincing reasons for trying to force borrowers

implementing detailed policies. Conditionality can only help committing governments to their preferred policies if compliance is sufficiently likely – and it is not. Even if compliance would be more pervasive, the moral foundation for conditionality would be weak. If there is commitment by the government, but there is domestic opposition, the Fund would tip the internal political balance. If Fund and governments disagree about appropriate policies, it is the government that should have the final say, and not the Fund. In summary, if there is commitment by country authorities, conditionality is unnecessary. If there is no commitment, it is unhelpful.

It has been claimed that aid can be effective in certain circumstances only. According to Burnside and Dollar (2000), the impact of aid on economic growth and infant mortality depends on the quality of economic policy (while aid has no significant impact on policy itself). In countries pursuing sound fiscal, monetary and trade policies aid has a positive impact, while it has no effect otherwise. Stronger property rights and the absence of corruption also improve outcomes.<sup>47</sup> Similarly, Svensson (1998) shows that aid is generally ineffective in improving policies – but less so in democracies. Dollar and Svensson (1998) find that the effort invested by the World Bank in a conditional loan program has no impact on the probability of program success, but that political factors are of overriding importance – an observation that perfectly fits to the evidence regarding the IMF reported above.<sup>48</sup> According to the results of their empirical study, the probability of success is higher in democracies. They also show that success is less likely, the longer a government already has been in power. Collier (1997) concludes that conditionality has failed, with borrowing governments' decisions to reform being independent of the structure of (World Bank) programs. The findings of large-country econometric analyses have been supported by case study evidence. As has been pointed out by Devarajan, Dollar and Holmgren (2001), large amounts of aid to countries with bad policies sustain those policies. However, these findings have also been challenged. Easterly, Levine and Roodman (2004), for example, re-estimate whether aid influences growth in the presence of good policy, employing the same variables and the same methodology as Burnside and Dollar (2000), but extending the period under study by four years to 1997. As their results show, the conclusion drawn by Burnside and Dollar does not hold for this longer period of time. Moreover, studies by Dalgaard and

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<sup>47</sup> The implication that large gains in terms of poverty reduction can be obtained by simply reallocating aid depends, however, on the assumption that the volume of aid is not determined endogenously by donors' preferences (Lancaster 1999).

<sup>48</sup> To the contrary, Malesa and Silarszky (2004), while confirming the overriding importance of political-economic conditions in the borrower countries, find that World Bank effort influences program success substantially.

Hansen (2001), Hansen and Tarp (2000, 2001) and Hudson and Mosley (2001) test the robustness of the interaction term between the Burnside-Dollar policy index and aid, reporting the interaction to be statistically insignificant in many cases. The recent meta analysis of Doucouliagos and Paldam (2005) also provides no support for the hypothesis that aid works in good policy environments.<sup>49</sup> What remains, then, is the evidence of a general ineffectiveness of conditional aid on policies and outcomes.<sup>50</sup>

As Drazen (1999) argues, foreign aid is frequently ineffective because it is misappropriated by the recipients – and this misappropriation depends on the political regime in the borrower country. Then, aid can only become effective after a regime change, and selectively denying aid is not only justified, but necessary, as more aid increases governments' leeway and makes reforms less likely. Thus, temporarily denying aid and the worsening of existing crises might lead to regime changes, improving policies in the long run. The argument is related to Drazen and Grilli (1993), showing that a crisis may be the trigger needed to achieve consensus over reform. This might imply to withhold money from countries in certain situations, not only to prevent a government from procrastinating, but also to allow a crisis to develop. By denying its loans the IMF could influence ownership. Clearly, this does not imply the Fund should generally stop trying to alleviate crises as soon as possible. However, it might imply that – as lending to non-reformist governments is likely to be counterproductive – no money should be disbursed when the implementation of productive policies cannot be expected – not even in severe economic crises.<sup>51</sup>

Temporarily denying aid to non-reformist regimes implies that the nature of the political regime is known. When there is doubt about the appropriative nature of governments, continued conditional lending might improve the situation. However, there should be no doubt about the nature of a regime when programs are continually interrupted over many years, without any significant improvement in policies. According to Drazen (1999), conditionality will not work if borrower governments have goals different from the IMF, because the former will always find a way of circumventing conditionality. The multiplicity of potential causes for success or failure of an IMF program implies that the causes for failure or success are not necessarily identifiable. As Drazen and Fischer (1997) point out,

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<sup>49</sup> Interestingly, however, the authors show that the answer to this question differs depending on the authors' institutional affiliation.

<sup>50</sup> Heckelman and Knack (2005) show that foreign aid even slowed reforms over the period 1980-2000. Boockmann and Dreher (2003) report the same for World Bank credits, while they do not find a significant impact of IMF loans and programs.

<sup>51</sup> The recent analysis of Hillman and Krausz (2005) lends support to this. They show that corrupt governments can use the International Financial Institutions' money for personal consumption and as insurance against the costs of being overthrown.

conditionality is an imperfect tool as the borrowing governments' actions are imperfectly observable.

All this has led the International Financial Institution Advisory Commission (2000: 43) to conclude that "The current practice of extending long-term loans in exchange for member countries' agreeing to conditions set by the IMF should end". In any case, the failure of conditionality and conditional lending in general calls for serious reforms.<sup>52</sup>

### *Proposals for a reform of conditionality*

The evidence discussed in this paper clearly shows that the current practice of conditionality has to be substantially reformed. As proposed by Vaubel (1991) and the International Financial Institution Advisory Commission (2000), existing ex-post conditionality ought to be replaced by a small range of ex ante conditions. The EU, for example, has established ex ante conditions allowing discriminating effectively among potential member countries. As discussed in Textbox 2, this ex ante conditionality has overall been rather successful.

Applied to the IMF, ex ante conditions could imply that all member states in which monetary expansion exceeds an n-year moving average of real GDP growth by more than x percent would be excluded from credits. Regarding fiscal policy, a limit for the budget deficit relative to GDP could be set as is now in force in the European Union (Dreher and Vaubel 2004b).<sup>53</sup> Clearly, it would be important that the IMF classifies countries' eligibility in the context of its regular surveillance missions – and not upon request by the member country. A negative signal associated with a country's application would thus be prevented.

As the EU's experience with ex ante conditionality shows (see Textbox 2), conditions work when there is commitment, with commitment depending on the expected pay-off. With respect to the IMF, there are two key differences. First, the pay-off associated with an IMF program is much lower. Second, IMF conditionality is mostly ex post, with compliance being more difficult to observe, and (well recognized) incentives to disburse loans anyway. The lessons for the IMF would be that introducing ex ante conditionality, making punishment credible, and increasing the pay-off are likely to substantially increase the effectiveness of its programs – and program ownership (as defined by Drazen and Isard 2004).

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<sup>52</sup> For recent discussion on how to reform IMF and World Bank see Meltzer (2006a, 2006b) and Krueger (2006).

<sup>53</sup> As is currently discussed with respect to the EU, this limit could depend on economic cycles instead of being a fixed number. Buiter (2004) suggests tying IMF loans to international benchmarks defined by, e.g., the Extractive Industries Transparency Initiative, the Publish What You Pay, Publish What You Receive initiative, Transparency International, the OSCE, and the Council of Europe.



## Textbox 2: EU Conditionality

Many of the criticisms discussed here, actually precede the IMF and apply to other international institutions as well. Particularly, comparison of the conditionality applied by the European Union to potential member countries with conditions set by the IMF might be instructive.<sup>54</sup>

The conditions imposed by the EU upon potential member countries go far beyond traditional IMF conditionality, covering areas like democratic principles, protection of minorities, judicial reform and prison conditions, social security systems and corporate governance (Grabbe 1999, Anastasakis and Bechev 2003). Conditionality for the ten Central and Eastern European countries being considered as future EU members prior to the 2004 enlargement evolved in three stages (Grabbe 1999). The first phase primarily involved trade relations, not necessarily implying progress to EU accession. The second phase aimed to establish freedom of goods, services, capital and labor. To this end, the EU signed “Europe Agreements” on a bilateral basis from 1991 onwards. Eligibility to those agreements depended on the rule of law, human rights, a multi-party system, free and fair elections, and a market economy (Grabbe 1999). In 1997, the EU first applied its conditions, when discriminating among the countries for starting accession negotiations, leading to the third phase (Grabbe 1999). The third phase, the “Accession Partnerships” have been introduced in 1998, tightening conditions for membership and making a wide range of policies conditional instead of negotiable. Specifically, the accession countries have not been allowed to negotiate opt-outs, as they apply to some previous member states on the monetary union or entry requirements for EU citizens (Schengen treaty).

EU conditions are not quantitative, as those of the Fund, but refer to a huge set of specific qualitative measures, and they are not *ex post*: The main reward for accepting EU conditionality – Union membership – comes at the end of a long process. In addition, compliance with conditionality might imply preferential trade agreements, technical assistance, policy advice, facilitated traveling to the EU territory and access to financial aid for particular projects (Anastasakis and Bechev 2003). The conditionality applied by the EU is *ex ante* in nature, reacting to fulfillment or non-fulfillment of its conditions by granting or withholding rewards. Specifically, conditionality is employed to differentiate among applicant countries.

Does EU conditionality work? In countries with initially favorable conditions, where costs of compliance are smaller, EU conditionality seemed to have established a virtuous circle, leading to earlier qualification for the Union (Ralchev 2004). In countries like Bulgaria and Rumania, to the contrary, where initial conditions have been more unfavorable, conditionality worked more slowly and less effectively (Ralchev 2004). In the Balkans, where EU conditionality relates to economic, political, security-related and social criteria, there are also problems (Anastasakis and Bechev 2003). As inputs from the region have only been limited, reforms are inhibited and there seems to be little local commitment with EU-driven policies. There is thus no consistent trend for more reforms as a route to membership. Conditionality in the Balkans is perceived as an instrument of pressure, legitimizing exclusion (Anastasakis and Bechev 2003).

Where does this difference in the effectiveness of EU conditionality come from? First, for most Central and Eastern European countries, EU membership was perceived as a huge reward and, more importantly, it was perceived to be within reach. The visible and realistic prospect of accession has been the key carrot in implementing conditions for the Central European and Baltic candidate countries (Anastasakis and Bechev 2003). In the Balkan, to the contrary, the EU did not make it clear that the key objective of its conditionality is accession to the Union, substantially reducing governments’ commitment to reform. As Anastasakis and

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<sup>54</sup> For a comparative analysis of EU, NATO, and Council of Europe conditionality see Checkel (2000).

Bechev (2003) put it, thus, the key variable for the success of EU conditionality is the level of commitment of the accession country (and the EU). Arguably, commitment depends on the size of the pay-off, and the likelihood of getting this pay-off in the near future.

Like IMF conditionality, the conditions of the EU have also been criticized, and on similar grounds. It has been asked for the “morality” imposing tough conditions on countries at a much lower level of development than current EU members. The neo-liberal content of EU conditionality was also subject to criticism, as was the EU’s favoring of non-majoritarian institutions and depoliticizing of the civil society (Anastasakis and Bechev 2003). The irony that a democratically deficient EU is prescribing accession countries how to become democracies is also recognized (Grabbe 1999). All this might imply that in spite of the EU conditionality’s overall success, commitment to the EU-driven reform programs has been low.

Objections to ex ante conditionality as summarized by Goldstein (2000) point to the insufficiency of those conditions to prevent a crisis. Once a crisis occurs, then, they would not guarantee that the crisis would be overcome. And if a crisis occurs without compliance with ex ante conditions, finally, the international community might be tempted to lend nevertheless if the government promises sound reforms or if there is risk of contagion.

Regarding the first objection, the crucial point is not whether crises could generally be prevented, but whether the likelihood of their occurrence could be reduced with ex ante conditions. Once crises occur nevertheless, those conditions do not help to overcome the crisis – but this seems to be true for existing ex post conditions also.

With respect to the second objection, the desire of the IMF to disburse its funds once committed greatly weakens the enforcement of conditionality (Mosely, Harrigan and Toyne 1991 and Dreher 2004a). This desire may be explained by altruism – the welfare of the domestic poor directly enters the utility function of the IMF, and withholding money is likely to hurt the poor (“Samaritan’s Dilemma”).<sup>55</sup> Conditionality is ineffective because it amounts to a non-credible threat; non-disbursements of funds might simply not be time-consistent (Coate and Morris 1999, Svensson 2000, Drazen 2000, Khan and Sharma 2001). As has already been discussed, the Fund may also continue lending to non-complying governments in order to not risk the repayment of its own outstanding loans (Ramcharan 2003).<sup>56</sup> Marchesi and Sabani (2005) show that the desire to disburse funds in spite of non-compliance becomes stronger with a longer relationship between a borrower and the IMF. This is because the IMF

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<sup>55</sup> See Coate and Morris (1995) for a general discussion of this argument (in a different context).

<sup>56</sup> Kanbur (2000) provides a nice illustration of pressure on the World Bank to disburse a tranche under its 1992 SAL to Ghana in spite of non-compliance with program conditions. Domestic and foreign private sector representatives lobbied the Bank to disburse, fearing for the business climate in general, and for certain contracts in particular which were unlikely to be paid would the government not get the loan. Bilateral donors also feared potentially disruptive consequences on the economy – others had concerns about the consequences for their agencies if bilateral money promised as co-financing with the Bank could not be released in the particular fiscal year. Still others did not want their bilateral aid projects to be slowed up by the absence of Bank money – and this concern was true for the Bank’s own projects also.

cares for its reputation as a monitor which is at stake when interrupting long-lasting relations. Once loans have been disbursed, the IMF's staff has a strong incentive to make the loan 'work' (Paloni and Zanardi 2004). The temptation to lend in spite of non-compliance with ex ante conditions has to be restricted by binding (and transparent) rules.

It has been proposed to maintain conditionality as within present arrangements, but to streamline conditions (see Goldstein 2000). Only those conditions ought to be included, that are directly relevant to achieve the program targets and that belong to the IMF's (macroeconomic) mandate. If those conditions are not imposed by the IMF but relate directly to the government's own program, they could complement ex ante conditionality as proposed above.<sup>57</sup> Clearly, to make conditionality effective, compliance with those few and important conditions would have to be strictly enforced. Waivers ought to be granted very selectively, and in a transparent manner. Particularly, the Fund would have to resist any pressure to include (or wave) conditions desired by certain stakeholders.

It has been discussed above that aid has to be selective, and should accrue only to "good" policy environments. Svensson (2003) provides theoretical support. He develops a model introducing ex post incentives for donors to reward good policies. Instead of committing aid ex ante, donors commit a fixed amount of money to a group of countries, and those countries compete for the money. The actual amount disbursed to each country would then depend on its performance relative to others. Donors would thus have stronger incentives to reward good policies as compared to the current system. Competition among recipients would also allow the IMF to make inferences about shocks common to all countries in the group, enabling giving aid more efficiently. This procedure would come close to the conditionality of the EU (discussed in Textbox 2). Clearly, this would not be a model for the IMF's short-term balance of payments loans. But it might improve the record of its longer term (PRGF-) development aid.

But why should the IMF give development aid at all? Is this not the task of its sister organization, the World Bank? Given the evidence summarized in this paper, it should be clear that there is no role for the IMF as development agency. Specifically, the IMF should not engage in any form of structural conditionality.

This implies that there is no rationale for the PRGF and the EFF. As has frequently been suggested in the literature, the IMF's mandate ought to be restrained to assisting countries in temporary liquidity crisis (e.g. IFIAC 2000). We suggest two facilities. The first could be designed along similar lines as the recently expired Contingent Credit Lines. The

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<sup>57</sup> If conditions would be few and simple, countries could be sure they get the financial support scheduled when complying. The greater certainty might make macroeconomic management easier.

main difference would have to be that all member countries had to participate in this facility – and the IMF would publish regular reports as to whether any country would be eligible for drawings. The amount of drawings and the interest rate on those loans could be contingent on policies and should also be pre-announced. This effectively implements *ex ante* conditionality and thus leads to greater selectivity. The proposal is similar to those of Sachs (1989), suggesting no conditionality at all but enhanced forms of surveillance to provide assurances to donors or other lenders.

While this facility would provide a solution to the moral-hazard problem, it is much more difficult to prevent the borrower from abusing the money once it has been disbursed. *Ex-ante* conditionality does not prevent governments that have behaved well in the past from obtaining loans, even at an interest penalty, and then spending the proceeds, e.g., to finance a pre-election boom (Dreher and Vaubel 2004b). The conditions have to relate to the subsequent use of the loan, but they have to be few and simple, as discussed above.

The second facility would correspond to the Standby facility; with the main difference that lending would be allowed only for crises disruptive to other countries. Lending under this facility would only be allowed to internalize external effects of a crisis. In this case *ex post* conditionality would be important and should be strictly enforced. The interest rate subsidy ought to be eliminated (Vaubel 1991). Indeed, as recommended by the IFIAC (2000), it could be replaced by a penalty so that the IMF becomes a lender of last resort.<sup>58</sup> In the past, it has rather been a lender of first resort.

The IMF recently streamlined its conditionality. Nevertheless, much more has to be done to take account of the insight that reformers cannot be created but have to be identified and that “IFIs should have no illusions that their conditionality will appreciably affect the probability of reform” (IMF 2001a: 59, based on results by Dollar and Svensson 2000). According to the head of the Fund’s Policy Development and Review Department there is now ‘overwhelming’ evidence, that conditionality is not effective in achieving policy changes (Allan 2004).

As has been pointed out by Killick (2004b), the World Bank shares the critique of conditionality and has recently reformed its structural adjustment lending. Instead of lending under the Structural Adjustment Facility, the Bank now supports countries’ own programs – without detailed conditions. The Fund, to the contrary, has for the most part tried to defend its (streamlined) conditionality. As the Fund puts it, “The Board agreed during the course of its review that properly designed conditionality can complement and reinforce national

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<sup>58</sup> The interest rate on the loan could be made contingent on compliance with conditionality. Low compliance would lead to an interest penalty (Dreher 2003).

ownership” (IMF 2003: 36). However, the IMF does not explain why and how conditionality could achieve this (Killick 2004b: 6). Given the evidence summarized in this paper, one can only be surprised about such optimism.

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