ONCE AGAIN, ON THE QUESTION OF IMF'S CONDITIONALITIES

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1. Introduction

Less than a year before Nazi Germany's surrender, marking the end of World War II in Europe, the countries participating in the United Nations Alliance met in Bretton Woods to decide on the rules of a new international monetary system to be created after the war. The conference's debates were dominated by the concern with a possible return to the depression once military mobilization was over and aggregate demand returned to its *antebellum* levels. For the British delegation, led by Keynes, the priority was to avoid a return to the deflationary rules of the gold standard, which could become a fatal obstacle to the domestic pursuance of full employment policies. For the Americans, on the other hand, the goal was to prevent was the return to the widespread exchange manipulation and protectionist practices of the 1930s.

Keynes's proposal, rejected by the American delegation, involved the creation of a new international means of payment, the *bancor*, to be used only in transaction between central banks. The "supply" of bancors would increase with the expansion of international trade. It was to be managed by a new institution, the *International Clearing Union* (ICU), where debts would be liquidated through the transference of balances held in each country's account with the ICU. International liquidity would thus be *endogenous*, increasing in line with the growth of international trade.

The American proposal involved, in contrast, the continued use of existing national currencies in international transactions, with a prominent role naturally conferred to the US dollar. As the US dollar supply would continue to be created by domestic monetary policy, focused mainly on internal problems of the US economy, the provision of international liquidity could be inadequate for the needs of commerce. To deal with imbalances of this nature, an institution was created, the International Monetary Fund (IMF), which was

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endowed with a treasury to which all member countries contributed. Among other attributions, the IMF was thus to be a provider of short-term liquidity for countries undergoing temporary balance of payments disequilibria.

Surprisingly, perhaps, the conference left open, though, the crucial question of what exactly was to be the role of the Fund and the treasury it managed. In fact, during the conference, two views were confronted. On the one hand, the UK, and most of the countries participating in the conference, defended the idea that the Fund's resources should be considered a kind of secondary reserves, to be accessed, at a cost, by countries facing balance of payments deficits in a more or less automatic way. The opposite view was defended by the US. Although not clearly spelled out at first, the US, as the only country running a surplus on current transactions at the time and, by far, the greatest contributor the Fund's treasury, was worried by the possibility of giving a blank check to deficit countries.

The conference did not solve the dispute, which was resumed after the Fund began its operations in 1947. The US insistence on limits to loans to countries running balance of payments deficits finally paid off when the Fund began limiting the duration of loans and, to guarantee repayment at the agreed dates, imposing macroeconomic policy conditionalities on borrowers.

In its first years, conditionalities seemed to generally conform to the concern with credit risks manifested by the United States. Nevertheless, the set of conditonalities demanded by the Fund expanded monotonically through the years, not only in number but also in reach. The focus on repayment was replaced or complemented by goals like trade liberalization, financial liberalization, promoting growth, fighting poverty, etc.

There seems to be no consensus among analysts whether the expansion of conditionalities was part of a conscious strategy to amplify the reach of the Fund or if it was just a case of mission drift. Be it as it may, during the Asian crises of 1997/1998, the Fund seemed to recognize no limit on the legitimacy of its demands from borrowing countries. Becoming the object of widespread criticism, the Fund itself, in the early 2000s, initiated a review of its lending policies and its approach to conditionalities.

It is not yet clear how far the Fund has effectively changed its policy on conditionalities. As the number and reach of conditionalities were expanded, the initial clarity of purposes was lost and, it seems, never recovered. In this paper, we propose to reexamine the concept of conditionalities in the light of their changing alleged purposes and the Fund's repeated redefinitions of its own mission. To do it, we begin by outlining the emergence of policy conditionalities in the Fund loans, in section 2. Section 3 discusses the problems created by policy conditionalities. Section 4 concludes, offering some perspective for the ongoing process of reevaluation of this instrument.

2. The Emergence and Transformation of IMF's Conditionalities

The two leading proposals presented in the Bretton Woods conference, by the US and by the UK delegations, were different not only in form, but also in concept. The British proposal was oriented mostly to avoid the international economy posing difficulties for national governments willing to implement full employment policies. In this sense, what was mostly needed was a liquidity-creation mechanism that accommodated increased demands for means of payment resulting not only from the expansion of exports, but also to allow countries adopting expansive macroeconomic policies to face eventual deficits in balance of payments without losing reserves and contracting domestic liquidity, as it was the case under the gold standard.

The US' goals were different. The American government seemed to be more concerned with preventing other countries from "resorting to measures destructive of national or international prosperity", as phrased in article 1 of the IMF's Articles of Agreement.[1]

[1] According to the original version of article 1, "The purposes of the International Monetary Fund are: (i) To promote international monetary cooperation through a permanent institution which provides the machinery for consultation and collaboration on international monetary problems. (ii) To facilitate the expansion and balanced growth of international trade, and to contribute thereby to the promotion and maintenance of high levels of employment and real income and to the development of the productive resources of all members as primary objectives of economic policy. (iii) To promote exchange stability, to maintain orderly exchange

Exchange rate wars, beggar-thy-neighbor policies, protectionism, trade discrimination, even downright aggression were common in the 1930s. Having emerged from World War II as the only developed country able to preserve its productive capacity and ability to export, the US was afraid of becoming the target of everybody else's trade restrictions. Trade liberalization, exchange rate stability with the creation of cooperative mechanisms of exchange rate adjustments were among the most important demands of the United States in the conference.

The results of the Bretton Woods conference didn't really reflect any kind of compromise. Keynes's plan was simply defeated and the United States proposal was adopted with very minor changes. The US dollar was to effectively become the international currency, exchange rates were to be stabilized (as Keynes proposed too), and the countries signing the treaty should prepare to establish the convertibility of their balance of payments' current account after a given transition period. A new institution, the International Monetary Fund, was created with the dual function of managing and preserving the fixed but adjustable exchange rate regime agreed at the conference and of offering short term finance to help countries adjust their balance of payments position when deficits arose in their current accounts. To perform this latter function, the Fund was endowed with a certain amount of resources contributed by the member countries, in both strong currencies and gold and in their own currencies. The ability of the Fund to perform its liquidity-providing function, of course, would then be limited by the size of the treasury it was endowed with.

Having been defeated in the question of the nature and functions of the monetary institution created by the conference, Keynes still tried to attenuate the impact of operating with a fixed-endowment Fund by proposing a total value for this endowment much larger than the

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arrangements among members, and to avoid competitive exchange depreciation. (iv) To assist in the establishment of a multilateral system of payments in respect to current transactions between members and in the elimination of foreign exchange restrictions which hamper the growth of world trade. (v) To give confidence to members by making the Fund's resources available to them under adequate safeguards, thus providing them with opportunity to correct maladjustments in their balance of payments without resorting to measures destructive of national or international prosperity. (vi) In accordance with the above, to shorten the duration and lessen the degree of disequilibrium in the international balances of payments of members. The Fund shall be guided in all its decisions by the purposes set forth in this Article." Horsefield (1969b), pp. 185/6.

US had envisaged.[2] Again, as the most important contributor to the Fund's endowment, the US prevailed, so that the Fund opened for operations with a volume of financial resources that could rapidly become insufficient to allow member countries to deal with balance of payments constraints.

Soon after the Fund opened for business, the US began insisting on the need of limiting the maturity of loans, worried by the possibility of a quick depletion of the Fund's treasury if borrowers didn't repay their loans fast enough.[3]

In addition, at this time the IMF's staff and managers shared a view of the economic problems ahead of them that was diametrically opposed to the one that inspired the Bretton Woods Conference. The Conference's original participants were concerned with the possibility that the end of the war could bring back the depression of the 1930s, with its attending deficient aggregate demand, widespread unemployment, etc. By 1947, staff and managers of the IMF believed that inflation, that is *excess* aggregate demand, not deficient demand, was likely to be the most important macroeconomic problem to be faced by the world economy.[4] Under these conditions, balance of payments deficits were more likely to result from excess domestic absorption than by lack of world demand for exports. In other words, countries would exhibit current account deficits because they were spending too much, not because they were earning too little from their exports. If this diagnosis was true, financing balance of payments deficits of member countries should be strictly limited in time, only for the period necessary for the country to take the appropriate steps to reduce their domestic aggregate demand to sustainable levels. The US feared that, if time limits were not imposed on borrowing by member countries, they could use the Fund's resources

[2] For the participation of Keynes in the Bretton Woods Conference, see CWJMK, 26 and Skidelsky (2000). The characteristics of the Keynes Plan, its inception and development are extensively documented in CWJMK, 25. The proposals made by the US and the UK delegations, as well as those made by other participants to the conference are summarized in Horsefield (1969a), chapters 1 and 2.

[3] The protracted process by which conditionalities came to be introduced in IMF loans is described in detail in Horsefield (1969a).

[4] Cf. De Vries (1987): "Almost at the Fund's star, the Executive Directors, assisted by the staff of the Research Department under the direction of Edward Bernstein, realized and agreed that inflation and not deflation was the dominant characteristic of the economies of most of its members and was the most urgent problem to tackle if world trade was to expand and international payments equilibrium was to be restored." (p. 15)

to prolong the disequilibrium instead of adjusting to the relevant constraints on the economic activity.

As a result, demands, most notably from the US representative, became stronger and stronger that time limits on loans should be imposed. To ensure the efficacy of these time limits, on the other hand, it was necessary to remove any last trace of the notion that access to the Fund's resources was in anyway automatic.[5] The borrowing country had to give some guarantee that resources would be effectively used to promote an adjustment of its balance of payments in the shortest term possible. The notion of conditionalities emerged in this context.

i. The Emergence of Conditionalities

It should be clear that the original concern behind the definition of loan conditionalities was less the possibility that the borrower would actually default in the Fund's loans, but to guarantee that it would actually repay the loan *in a reasonable period of time*. However, conditionalities are explained most frequently and insistently by the Fund as a means to ensure repayment, that is, as a technique to limit exposure to credit risk.[6] In this latter capacity, however, conditionalities have been shown to be an awkward and inefficient instrument.

The introduction of limitations to the access to the Fund's loans, naturally, raised many objections from borrowing countries which saw it as an encroachment on their autonomy to set domestic policies. But limiting the scope of national policy autonomy was precisely the point. If balance of payments deficits were generated by unduly expansionist domestic policies, financial support from the Fund could only be *temporary* if the borrowing country

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[5] This view relied on the provision included in item v of article 1, above, that stated that members would have access to the Fund's resources "under adequate safeguards".

[6] "The IMF is a lender that has to have assurances that it will be repaid, and this requires placing conditions on its loans." (Khan and Sharma, 2001). The IMF fact sheet on conditionality states: "Conditionality is a way for the IMF to monitor that its loan is being used effectively in resolving the borrower's economic difficulties, so that the country will be able to repay promptly, and make the funds available to other members in need." IMF (2005). As an IMF official explained in a conference on conditionalities, IMF assistance is required in "cases in which an existing balance of payments deficit needs to be converted into a future surplus of a size adequate to allow repayment of the resources drawn." (Finch, 1983, p. 76).

agreed to change its policies. Opponents of these limitations argued that the potential borrower would find out that the Fund could refuse help precisely in those moments when it needed financial support. This would reduce, and could ultimately compromise, the efficiency of the Bretton Woods arrangements to sustain international monetary stability.

The conundrum was solved by the creation of what was called *Stand By Arrangement* (SBA). SBAs were designed to serve as a pre-commitment, by a potential borrower to adopt certain pre-specified policies or policy strategies favored by the Fund and by the Fund to supply financial help if needed by that same country.[7] The arrangements were supposed to last very short terms, since, with time, a country could reorient its policies any way its governing authorities wanted. Thus, in principle, a SBA would guarantee the right of a country to access the Fund's resources in a limited future time horizon to the extent that the country implemented a pre-specified (and pre-agreed with the Fund) list of macroeconomic policies.

SBAs would be signed, therefore, when a potential borrower signed a *Letter of Intent* (LOI), addressed to the Managing Director of the Fund stating the policies the government authorities were pledging to implement in the short term ahead. If accepted, the LOI would guarantee access to finance for an agreed short period, in case the country needed it.

SBAs, however, soon became something else. Most borrowers actually didn't approach the Fund preventively, they did it when facing an actual balance of payments deficit. In this context, signing a LOI acceptable to the Fund Managing Director and staff became a condition to obtain financial support. In fact, it became such an essential condition that the Fund staff itself took over the job of writing these letters.[8] Since policies could not be observed in advance, as originally planned, they had to be specified for the period where the loan would be conceded. As a result, *performance criteria*, to evaluate compliance with the determinations of the LOIs, were defined, giving increasing precision to the conditions

[7] Horsefield (1969a), pp. 328/332.
[8] Cf. Mussa and Savastano (2000). In an official document, the Fund recognizes that LOIs and MEFPs may actually be prepared by the Fund: " There is no requirement that country authorities actually draft the LOI and MEFP, but staff should be responsive to the authorities' desired role in the drafting of these documents." IMF (2006), § 5.

imposed by the Fund. The next step was to introduce *phasing*. To increase the enforceability of the commitments listed in the LOIs, financial support from the Fund would no longer be released all at once, but in installments, *conditional on the successful satisfaction of formally established performance criteria*.

LOIs became, thus, an increasingly crucial element of the financial contract established between the Fund and borrowing countries. Nevertheless, LOIs never lost their “informal” nature. It is not an official document, let alone a treaty or an actual contract, establishing obligations of a sovereign toward the Fund or any other foreign entity. It is a unilateral statement made by a government authority informing the Fund’s Managing Director of that government’s intended policies for a given period in the future.[9]

In consonance with the relatively disorganized way in which conditionalities emerged in the Fund’s deals, the content of these conditionalities, and therefore the list of policies government authorities were supposed to pledge in their LOIs, also came to be defined in a somewhat informal way. In contrast to the so called structural conditionalities that came to be imposed later, in this first period contionalities basically consisted of a set of macroeconomic policies that were supposed to reduce domestic absorption and restore equilibrium to the balance of payments. These policies were defined according to a macroeconomic model the Fund called *financial programming*[10], that in fact specified a few macroeconomic identities and an even smaller set of behavioral relations connecting

[9] The informality of SBAs arrangements and its conditionalities has been the legal position assumed by the Fund since the beginning: “ … The General Counsel [to the Fund] explained the nature of stand-by arrangements. He said that they were not international agreements, so that they did not require to be registered with the United Nations, nor were they subject to members’ domestic laws dealing with such agreements. Neither was the member’s letter of intent a contractual obligation; it was therefore not specifically approved by the Board.” (Horsefield, 1969a, p. 613) In 1979 an IMF decision on conditionalities reaffirmed that “Stand-by arrangements are not international agreements and therefore language having a contractual connotation will be avoided in stand-by arrangements and letters of intent.” (IMF, 2002) This position was confirmed in the 2002 document.

[10] Financial programming in fact just connects the result of the balance of payments, the variation of international reserves, with the balance sheet of the monetary authorities. Creation of money (the monetary liability of the central bank) finances the purchase of domestic assets (securities bought in the open market and the debt of the domestic banking system) and of foreign assets (international reserves). Thus, limits on the creation of money and on the growth of domestic assets (assumed related to aggregate demand) should achieve balance of payments objectives, as long as the latter’s disequilibria were due to aggregate demand/supply misalignment. If relative prices were “wrong”, a change of the par exchange rate could be required. On financial programming, cf. De Vries (1976), pp. 363/368.

monetary policy variables to the balance of payments components. As the staff of the IMF always insisted, the use of monetary variables did not betray any special bias toward monetarist world views, it was explained mostly by the reliability of these data and the speed with which they were made available.[11]

ii. The Expansion of Conditionalities

The 1970s represented a time for deep changes in the way the IMF worked. At the beginning of the decade, the exchange rate system created in 1944 collapsed and exchange rates between the main currencies of the world were allowed to fluctuate. The abandonment of the fixed but adjustable exchange rate regime forced a redefinition of the IMF's mission and an amendment to the Articles of Agreement. As a result, developed countries, the main clients of the institution, gradually stopped borrowing from the Fund, adjusting their balance of payments through changes in the exchange rates and financing the remaining disequilibria in the private financial markets. Even middle income countries seemed to be able to finance their balance of payments in private markets, circumventing the IMF. At this point, only less developed countries (LDCs) seemed to have no alternative but to appeal to the Bretton Woods institutions, the IMF and the World Bank. Balance of payments deficits of LDCs, however, were not considered to be attributable to just policy mistakes. On the contrary, it was believed that in these cases deficits reflected deep rooted inadequacies in the very structure of these economies.[12]

In addition, the large supply shocks that took place in the 1970s led to the widespread occurrence of balance of payments disequilibria that could hardly be considered as temporary and treated by the usual instruments at the disposal of the Fund. Later, in the early 1980s, the external debt crisis that hit Latin American countries created another instance of balance of payments disequilibria that could not be expected to disappear

[11] See, for instance, Polak (2001). J. J. Polak, a career economist of the IMF, was one of the original formulators of the monetary approach to the balance of payments adopted by the Fund. In this paper, Polak contrasts his (and the Fund's) model to the monetarist model developed by Harry Johnson. Polak states that the Fund's model was, in fact, an outgrowth of the Keynes/Harrod tradition, rather than the monetarist tradition.
[12] See Carvalho (2000).

quickly, just as a result of adopting contractionary aggregate demand policies. Finally, by the end of the 1980s, the block of formerly socialist economies began its transition to market economies and appealed to the Fund for support.

Some of these changes were relatively short-lived, some were persistent. In all cases, resulting balance of payments disequilibria were considered to be too large to be treatable by the usual demand management policies that characterized the first decades of the IMF's operation. In this context, in parallel to traditional macroeconomic conditionalities the Fund also defined *structural conditionalities*, that is, the commitment to changes in the structure of institutions and incentives of borrowing country.

Structural conditionalities, in fact, increased the degree of intrusiveness on the domestic processes of political decision. Some of them could be considered relatively harmless or even beneficial, such as those directed at increasing the efficiency of tax collection or enlarging the tax base, as well as those directed at clarifying responsibilities of government entities focused on economic policy-making. But structural conditionalities were also imposed based on shakier grounds. Liberalization measures, related to foreign trade and capital movements, were demanded less for their undisputable advantages than by their place in a given, strongly ideological, particular view of how capitalist economies are supposed to work best. In some cases, as in the Asian crises of 1997/1998, conditionalities were extended to cover industrial policies, bankruptcy procedures, etc.

In fact, in contrast to the traditional macropolicy conditionalities, there are no obvious parameters for the definition of structural conditionalities. The Fund staff and management frequently advanced a defensive argument in their defense, alleging that structural conditionalities on IMF loans were a response to the demands from various groups that the institution should consider promoting growth as one of its responsibilities.[13,14] The central

[13] Cf. Mussa and Savastano (2000). In an official document issued by the Policy Development and Research Department of the IMF, the demands for structural conditionalities were explained by the complaints of developing countries that the Fund didn't consider growth when fixing its conditionalities. Therefore, " …the Fund has over time placed increasing emphasis on economic growth as a policy objective, with the recognition that raising growth on a sustainable basis requires strengthening the supply side through structural reforms … Growth became increasingly prominent as an objective in the 1980s, against the background of the

point to stress is that macropolicy conditionalities had a clear aim: to restore an economy's balance of payments to equilibrium in a relatively short period of time by reducing domestic absorption. Structural conditionalities aim at much vaguer aims to be reached at indefinite dates in the future. The loose character of this type of conditionalities stimulates in fact an institution exhibiting a pro-intrusiveness bias, such as the IMF, to go as far as they can get away with, as shown in the case of the Asian crisis countries in the late 1990s.

The excesses of the 1990s, however, caused a backlash that forced the Fund to engage in a protracted process of revision of its conditionalities. The successors of Michel Camdessus as Managing Directors of the IMF seemed to have few doubts that in particular structural conditionalities had become too costly and intrusive for borrowers. In fact, potential borrowers were stimulated to search for other ways to control their exposure to balance of payments crises, thereby reducing the influence of the Fund.[15]

As a result of the process of revision, the Fund management decided that structural conditionalities had to be *streamlined*. When negotiating loans, the IMF staff should distinguish between those conditionalities considered *critical* to the success of the plan, and those which were merely *relevant*.[16,17] Only the first should be included in LOIs and become a condition for the release of loans by the Fund. As no major balance of payments

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poor growth record of the heavily indebted countries and mounting criticism that Fund programs had focused excessively on austerity." (IMF, 2001, § 5) More explicitly still is the following statement by two economists of the Fund's staff: "In the late 1970s and early 1980s, the IMF was criticized for being interested only in narrow (balance of payments) outcomes and relatively unconcerned about growth. Thus the IMF, in response to calls by its membership, began to include in programs policies to remove structural impediments to growth and the efficient allocation of resources. These policies became an integral part of conditionality." Khan and Sharma (2001).

[14] Later, the inclusion of provisions related to social safety nets for the poorest strata of the population and similar policies was to be justified in more or less the same way. See Carvalho (2001).

[15] It is possible to argue that the extensive reserve accumulation by emerging economies in the 2000s is an instrument of self-insurance not only against the possibility of balance of payments crises but also against the risk of having to appeal to the Fund for loans. Cf. Carvalho (2008a) and (2008b).

[16] The 2006 revision of the conditionality guidelines issued by the Fund in 2002 states that only critical, and not merely relevant, conditions should be demanded: "A judgment that a condition is of critical importance for achieving the program goals means that if it were not implemented, it is expected that the goals would not be achieved." (IMF 2006, § 11).

[17] The Fund, naturally, never formally accepted the common criticism raised during the Asian crises that some or most of the conditionalities it imposed actually had no connection whatsoever with balance of payments adjustments except in the vaguest of senses, that is, to promote reforms that could be well received by the "markets".

crisis has occurred in the 2000s, it still uncertain how far the distinction between critical and relevant conditions would actually go in reducing the intrusiveness of the Fund in domestic affairs of borrowing countries.

3. What is the Problem With Conditionalities?

The case against the imposition of conditionalities of any kind is certainly not very strong, once it is agreed that the IMF is expected to operate as a financial intermediary rather than a more or less passive supplier of secondary reserves to countries facing temporary deficits in their balance of payments. The relevant question then becomes not whether conditions should be imposed on a borrower desiring to access the Fund's resources, but what is the nature of these conditions and how are they negotiated. In other words, it is the *content* of conditionalities and the *process* by which they are defined that is, or should be, the target of critical scrutiny.

i. The Content of the Fund's Conditionalities

Standard debt contracts are often signed containing a certain number of clauses designed to reduce the ex-ante probability that the debtor may willingly default on its obligations. If, as it is reasonable to expect, the information about the willingness to default is private to the borrower, who is expected to try to conceal it from the lender, the latter will try to obtain guarantees that the obligation will be, in fact, honored by the former. Any very simple model of information asymmetry, thus, should be enough to explain why debt contracts include clauses like the definition of collaterals and other covenants.

As we have seen, the argument that the Fund had to be assured that the borrowing country would be able to repay its loans, so as to preserve the revolving nature of its resources, was the first, and it is still the more frequent, argument raised by Fund staff and management to justify the imposition of policy conditionalities.[18]

[18] Although the real problem leading the definition of loan conditionalities, as we saw, had been less the fear of default but, rather, the desire to guarantee *timely* repayment.

Conditionalities, in this sense should be seen as a form of covenant, limiting the use of Fund's resources in ways that could prolong balance of payments disequilibria and make it impossible or at least unlikely that borrowing countries could in fact pay back their debts in time. Conditionalities, therefore, are a technique to manage credit risks, since the other well-known instrument, posting collaterals, would raise possibly insurmountable difficulties.[19]

The set of conditionalities that was generally imposed in the first two decades of the IMF's operation seemed to be reasonably justifiable on the grounds just exposed. They consisted of specified macroeconomic policies that seemed to target the generation of balance of payments surpluses. In consonance with the basic diagnosis proposed by the Fund, which was that balance of payments deficits would arise when macropolicies overstimulated the economy, increasing its *absorption* beyond its potential output, the policy conditionalities that were imposed on borrowers would consist mostly of contractionary macroeconomic, that is fiscal and monetary, policies. Lower aggregate demand would reduce imports and raise exportable output surpluses, reducing the absorption of real resources and restoring balance of payments equilibrium. In fact, one can say that policy conditionalities were so consistent with this goal that nothing else seemed to matter. Everything else could be sacrificed, particularly economic growth.

This practice of conditionalities was the object of many criticisms.[20] As a technique to control credit risks, it was already pointed out that policy conditionalities were widely inefficient.[21] First, because borrowers had to observe conditionalities only while they were drawing their loans from the Fund. Repayment would only take place much later, years after conditionalities ceased to be in force. In the interval between the last draw of Fund's

[19] Many IMF documents and staff papers point out that countries appeal to the Fund when they have no other alternative, so that it would be unlikely they could offer valuable collaterals under these conditions. This does not seem to be the real story, though. On the one hand, there are well-known difficulties to recover collaterals owned by sovereigns: which court could order a sovereign power to surrender anything to a contract counterparty? In addition, the Fund actually seemed to have assumed that its mission really *was to intrude* in domestic economic policy making to favor liberal reformers unable to garner sufficient political support through the legitimate channels of political representation.
[20] See, for instance, Williamson (1983).
[21] Cf. Buíra (2003).

resources and the beginning of repayment, the borrower could easily switch policies and begin generating balance of payments deficits again, even if surpluses had actually been achieved while conditionalities were being enforced. Besides, by many metrics, most Fund loan programs were not actually completed.[22] Non-completion, most commonly, was due to the inability or unwillingness of a borrowing country to actually implement Fund's programs, as defined by performance criteria listed in Letters of Intention. However, even countries which didn't complete loan programs repayed their debts.

By all indications, the low rate of default in Fund's loans is mostly explainable by the success the IMF had in defining itself as a senior lender, which means having priority over other lenders when a borrowing country faces difficulties to honor its obligations. The priority is partly explainable by its cooperative nature to begin with, an institution created and controlled, in principle at least, in the interest of a community of nations. Most probably, the seniority results from the perception by borrowers that borrowing for balance of payments purposes may be recurrent so that remaining in good standing with the Fund would pay in the future in the form of easier access to needed resources. To the extent that this is true, conditionalities would in fact be superfluous as a means to guarantee repayment, since repayment would be in the interest of the borrowing country as well.[23]

Imposing conditionalities, thus, could be better understood as an instrument to influence domestic policy making rather than guaranteeing that loans would be repaid. The evidence seems to suggest that this was actually *not* their original purpose. The pressures coming principally from the US executive Directors pointed to the concern with the *time* a country could lead to repay its debts and the stimulus this represented to postpone any serious attempts at equilibrating its balance of payments, rather than a concern with *default* per se and even less with shaping domestic policies in borrowing countries. In sum, the Fund was not *reformist* in this period, it didn't assume as part of its mission to change the ways

[22] See, for instance Ivanova et alli (2003)
[23] In this sense, the fact that more and more countries are taking measures to control themselves their exposure to balance of payments disequilibria does not augur well for the Fund.

borrowing countries set their policies. Adjustment, not reform, seemed to be the Fund's motto.[24]

The relatively low importance of ideological factors in the definition of conditionalities was also illustrated by the pragmatism with which the Fund's models were constructed. As pointed out, most "models"were actually little else than glorified elaborations of macroeconomic identities and social accounting definitions. The few behavioral relations present in these models, mostly related to monetary variables, tended to be justified on empirical grounds or, most frequently, by the availability of data. Models were created as the Fund faced more and more complex adjustment problems with borrowing countries and the creators of models were sometimes at pains to make clear their distance from similar models created by doctrinarian economic theoreticians.

Perhaps the strongest "ideological" trait identifiable in the IMF's action in the period was the almost instinctive inclination to see any balance of payments problem as the result of excessively expansionary domestic policies as opposed to the possibility that it could result from deflationary shocks coming from the international economy. Even this feature, however, should be examined in the larger picture, that is, the decision made in Bretton Woods that countries should be penalized for their balance of payments deficits, but not for their surpluses, as proposed, for instance, in the Keynes's Plan.[25]

The introduction and expansion of structural conditionalities, especially from the 1970s on, radically changed this picture.

The collapse of the Bretton Woods exchange rate rules in the early 1970s freed member countries from the obligation to respect the Fund's determination on the setting of exchange

[24] Of course, one should remember that the main clients of the Fund in its first twenty years or so were developed countries, not willing to submit their economic structures to changes demanded by a multilateral institution.

[25] Keynes's bancor/ICU plan would impose a fine on countries that fomented deflation by accumulating unused reserves. Starting from an identity, that in a closed system, a country can only be in deficit if at least one other country is in surplus in their balance of payments, Keynes suggested that to the extent that the surplus country was forced to spend its hoardings of reserves, total aggregate demand would increase and adjustment would be expansionary, instead of the deflationary adjustment that ended up being practiced. Cf. CWJMK, 25.

rates. It also led developed countries to stop borrowing from the Fund, preferring instead to appeal to the international financial system for resources, in a context of floating exchange rates.[26] As a result, the Fund underwent an important change of character: from a cooperative institution, where countries could be lenders or borrowers in different moments, it became a financial intermediary, in which developed countries would only be lenders and developing countries only be borrowers.

Structural conditionalities were not a creation of the 1970s. Although the Fund was very secretive about its dealings until the late 1990s, there is evidence that a few structural conditionalities were included in SBAs with developing countries even in the 1950s. It is hard to imagine that developed countries would accept such a degree of intrusiveness when even macropolicy conditionalities faced strong resistance. With the withdrawal of developed countries from the roster of IMF's borrowers, however, the specification of structural conditionalites gradually increased, until they reached their apex in the 1990s.

Structural conditionalities cannot be justified as a credit risk management technique, as macropolicy conditionalities were. First, because all the limitations just presented in relation to macropolicy conditionalities are present, and more strongly, in the case of structural conditionalities. In fact, the time periods involved in promoting the changes that these conditionalities were supposed to achieve outlast by far the duration of any of the Fund's programs. In addition, structural conditionalities pursue objective such as obtaining *sustained growth*, which are actually much vaguer than it may sound.[27] There is no technical, objective way to set a growth objective, as it was the case with balance of payments equilibrium which means that any evaluation of efficacy of these conditionalities will involve a high degree of arbitrariness. The difficulty of defining *sustained* growth (and even more so in the case of *development*) in technical terms gives room for ideological

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[26]In fact, developed countries never again allowed the IMF to have any influence on their policy decisions. As stated by a former high-level IMF official: "Realism indicates that the Fund will never be given the power to impose on the large countries the policy corrections that some feel are needed as a consequence of the large imbalances in the current accounts that have appeared in recent years." Tanzi (2006).

[27] For instance, when growth should begin? How many periods after the reforms were made? How high should it be? How long should it last to be considered sustained? What characteristics should it exhibit? How could any growth rate change be attributed to a specific set of reforms, given the complexity of a process of economic growth? These are just a few of the questions to be answered if structural conditionalities are to be justified by their impact on growth.

views as to how ideal capitalist, or market, economies should look like to prevail. The defense of ideological views of capitalist economies, clearly based on stylizations of the so-called anglo-saxon model, became a trademark of IMF's documents.[28]

The fact that the goals to be pursued are vaguer and more ideological in the case of structural changes is also reflected in the specification of reforms to be demanded as conditionalities. In contrast to macropolicy conditionalities, the identification and specification of structural reforms does not result from the experience of the Fund in pursuing its objectives. In fact, the Fund has neither the expertise, nor the experience to actually deal with sustained growth and structural change.[29] The specification of reforms can either come from the study of history, in all of its complexity, or from the proposition of abstract virtuous principles derived from ideology rather than experience.[30]

Not only goals became vaguer in the case of structural conditionalities, but appropriate instruments are also harder to pin down. Thus, the increasing number of structural conditionalities appended to IMF's loans inevitably made the institution increasingly intrusive. The higher degree of micromanagement results from the need to specify in detail what the Fund demands in the case of structural reforms, since there is no accepted lexicon of reform concepts. Thus, if a reform of bankruptcy procedures is demanded by the IMF, it is necessary to spell out in some detail what a reform of this kind would entail. General propositions as those entailed by the financial programming models will not do in this case.

The trend just described was strengthened, but also largely concealed, by a parallel development in the IMF view of what constitutes a balance of payments equilibrium. The original concept, advanced in the Bretton Woods Conference, meant in fact a balanced current account. Capital movements were expected to be restricted to a minimum, by capital controls and other devices. The Fund was actually forbidden to give support to

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[28] Not only in the analyses produced by the Fund staff, but also in the kind of structural conditionalities that were imposed, for instance, during the Asian crisis of 1997/1998.

[29] A point raised by a World Bank official already in the 1980s. See Stern (1983).

[30] An example is the Fund's stated preference for the Anglo-Saxon model of financial institutions maintaining an arm's length relationship with borrowers as opposed to the Asian and continental European model of closer relationships between them.

countries facing balance of payments deficits resulting from capital flight episodes. Thus, if the capital account was kept under more or less strict control, balance of payments deficits could only be generated by current transactions being in deficit.

The Fund's position toward capital movements changed dramatically as years went by. By the late 1970s, the Fund's bias was obviously in favor of financial liberalization, even if it had later to be qualified as a *long-term* goal. *The growth of international financial transactions starting from the 1960s led the IMF to redefine balance of payments equilibrium from a position where net exports were zero, to one where current account deficits could be financed on a sustainable basis by capital flows*.

The concept of *sustainable* capital flows is as vague as that of *structural efficiency*, supposed to orient a structural reform strategy to be demanded under the guise of structural conditionalities. Nevertheless, it seemed to allow the Fund to propose a criterium to judge whether a given domestic policy strategy or institution was to be reformed or not. Policies and institutions should be designed to strengthen the confidence of international investors so as to determine a *market sentiment* that would stimulate the capital inflows necessary to finance eventual current accounts deficits.

It is important to remember that the Fund's clientele was constituted at this point entirely by developing economies, where capital is assumed to be the scarce resource. If this assumption is correct, the most efficient way to accelerate growth is to absorb foreign savings. A well know social accounting identity shows that foreign savings is defined as a deficit in the current account of the balance of payments. A developing country, therefore, should aim at keeping the current account in permanent deficits, as long as it could finance these deficits by a capital account surplus. The friendlier domestic policies and institutions were set to be, the more capital inflows these economies would receive and, thus, the larger the amount of foreign savings it could absorb, maximizing its rate of growth.

Thus, structural conditionalities tended to move, in the 1980s and 1990s, in the direction of opening developing countries' capital accounts and of shaping domestic policies and institutions toward increasing degrees of market friendliness to international financial investors and institutions.

There is an extensive literature criticizing these notions, which bore a large share of responsibility for the international financial crises of the 1990s, most particularly the Asian crises of 1997/1998.[31] Open capital accounts exposed developing economies to the volatility of largely unregulated international capital flows, which resulted in the long succession of balance of payments crises initiated by Mexico in 1994. The strong wave of criticisms against the pressures put by the IMF on developing countries to open their capital accounts led the Fund itself to retreat from its open defense of liberalization to the more ambiguous idea that financial liberalization remained a valid long-term objective but only *if* a sequence of preparatory reforms was implemented first.

The new millennium brought a new Managing Director to the IMF, Horst Kohler, who initiated a process of revision of structural conditionalities. Structural conditionalities should be *streamlined* in order to increase *ownership*, understood as the willing acceptance of IMF conditionalities by the borrower as a reasonable strategy of adjustment.[32]

The most important result of this attempt to review the Fund's structural conditionalities was the distinction between *critical* reforms and *relevant* reforms. The expression "critical reforms" is self-explanatory. "Relevant reforms" were those that were important and advisable but not essential to allow adjustment to be reached. Only the first should become structural conditionalities. Relevant reforms could be demanded by the IMF only under special circumstances. The Fund authorities acknowledged, however, that the distinction between critical and relevant may be hard to establish in actual situations of disequilibria, so even though there are no examples yet to allow a judgment of how far the IMF has changed its behavior, it is possible to maintain a pessimistic view of its ability to reform its ways.

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[31] For a summary of these criticisms, see Carvalho (2000/2001).
[32] Cf. Boughton and Mourmouras (2002).

Under these conditions, it should not be surprising the extent to which emerging economies are adopting self-insurance balance of payment strategies in the 2000s. As developed countries did in the 1970s, emerging economies are also trying to make sure that they will not have to appeal to the Fund and subject themselves to intrusive conditionalities. Developed economies did this by appealing to private financial markets. Emerging economies accumulate international reserves with much the same objective, that is, ensuring that they will be able to deal with balance of payments deficits without having to appeal to the IMF and to accept its conditionalities.

ii. The Negotiation Process

Negotiation procedures related to conditionalities are also a problem, quite independently of their content.

IMF documents have always tried to present loan conditionalities as the result of negotiations between the Fund and borrowing countries. In their original form, the idea that conditionalities would result from a bargaining process between a borrower and a lender in equal stand was reasonably close to the truth. Countries were expected to negotiate Stand-By Arrangements in "normal" times, to be activated if and when some balance of payments stress actually took place. Establishing a SBA was to be a *preventive* act, being the borrowing country under no special pressure to close the deal. In fact, the LOI was mostly a vehicle for the country to communicate the Fund its planned macroeconomic policies for a short-period ahead so that the IMF could make its eventual objections known in advance and a compromise be reached that would guarantee access to Fund's resources if and when needed.

LOIs, thus, were intended as informal descriptions of planned policies which allowed to Fund to issue an opinion about them in advance of any actual loan contract between the two parties. Their function was to define *access* conditions, not loan conditions as such.

In practice, however, SBAs were transformed from pre-commitment arrangements to actual credit lines. SBAs were established not in advance of difficulties but when countries actually faced balance of payments deficits that they could not finance in any other way than appealing to the Fund. That borrowing countries looked for support from the Fund when they already faced crises meant that the discussion of conditionalities were anything but a negotiation between “equals”. Borrowers were always under pressure, since they were usually already bleeding reserves when they contacted the Fund. The IMF, in contrast, would be under no pressure to quickly close a deal. The difference in bargaining powers between a lender and a stressed borrower became even more pronounced in the capital account crises of the 1990s, since capital account crises move on faster and involve much higher amounts than current account crises.

Under these conditions, maintaining the informality characteristic of the original SBAs in fact further weakens the hand of the borrowing country government. Most countries’ laws establish constraints on the ability of a government to enter into contracts or obligations with foreign entities. The requirement of authorizations by Parliaments is the most common of these constraints. Congressional authorizations, on the other hand, usually entail public audiences, testimonies, debates, etc.

The informal nature of the documents where conditionalities are set allows the Fund to circumvent these constraints. A LOI is not a contract, is not even a formal document written by a government. It is a letter signed by a Finance Minister directed at the Managing Director of the IMF stating “intentions”. The fact that these intentions become in fact commitments is just ignored in the process. A government cannot even allege, therefore, that its reluctance to accept certain conditionalities desired by the Fund would result from the impossibility of having them accepted by their Parliaments, since the latter are simply excluded from the process.

The Fund has always been fully aware of these advantages. In fact, the IMF is not only aware that these procedures can tip the domestic balance of power between a country’s various constituencies, it actually praises its own ability to strengthen the hand of so-called *reformist* financial authorities, who advance their liberal agendas under the guise of Fund's conditionalities. Local financial authorities may allege that they are just satisfying demands coming from the Fund in their conflicts with other interest groups represented in government or in society at large.

Finally, one last development to be stressed in the same direction is the change in the methods to evaluate compliance that resulted from the increasing importance of structural conditionalities in the Fund's loans. In contrast to the traditional macroeconomic policy conditionalities, establishing objective, quantitative performance criteria for structural reform is usually very difficult. In addition, structural reforms take much longer to implement than macroeconomic policies, so the maturity of some lines of credit from the Fund had to be extended making it more likely that overall conditions would change during implementation, requiring some periodical revaluation of targets.

To respond to these problems, the Fund began adopting, in parallel to the prior actions and the performance criteria that were common in LOIs, the practice of program reviews. These are periodical reexaminations of conditionalities and performance criteria that would, in principle, allow the Fund to be more flexible in its monitoring of the borrower's compliance with the loan conditionalities, but that, in practice, allow the IMF to change or increase their demands on the borrower *during a given contract*. It should be noticed that the Fund has frequently argued that listing conditionalities was in the interest of the borrower as much as of the Fund, because it would inform the borrower in advance the conditions in which it would have access to the IMF's resources. With the increasing importance of program reviews, the borrower in fact is kept permanently uncertain as to how exactly it has to behave in order to keep its access to Fund's finance.[33]

[33] The IMF Fact Sheet on Conditionality, for instance, stated that the specification of conditionalities "also gives confidence to the borrowing country by clarifying the terms on which the IMF will continue to make its financial resources available." (IMF, 2005). However, as admitted by Polak, among others, program reviews increases uncertainty as to what is going to be demanded by the Fund even to continue implementing ongoing programs. Cf. Polak (1991).

4. Conclusion

A case can be made in favor of appending conditionalities to IMF's loans as a guarantee, not against credit risk, but of compliance by a borrowing government to a policy program that does not aggravate the disequilibria that led it to the Fund to being with.

Of course, one has to recognize that this sort of influence is lopsided, since the Fund has no power or influence of any kind over the choices made by developed countries. The widespread practice of accumulating reserves as self-insurance by emerging economies threatens the influence of the Fund over another group of countries.

This points to a dilemma the Fund has to face while it tries to redefine, once more, its future role in the international financial and monetary system. The mess it faces in the attempts to redefine what may be legitimate conditionalities to demand from borrowers is just a reflection of the Fund's inability to find a relevant role to play in the 2000s. The IMF's efforts so far point to a renewed attempt to become a gatekeeper for the international financial markets, emphasizing its surveillance capabilities. In this case, the lending function would be downgraded and, with it, the question of conditionalities.

The function of liquidity-provider, however, that the Fund played for some decades remains important. It the Fund is to keep its role of liquidity provider, probably the only change acceptable to potential borrowers would be to return to balance-of-payments-related strictly macroeconomic policy conditionalities, with the abandonment of structural reforms. If the Fund is not capable of downsizing voluntarily, another institutions, able to focus on satisfying those needs will probably have to be created.

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