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Conditionality as an Instrument of Borrower Credibility

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Abstract

Fund member countries that adopt market-friendly policies often encounter a credibility problem—market-friendly policies are not effective in stimulating private investment as long as there remains a significant risk of policy reversal. The root of this risk lies in the discretionary policy-making authority of governments. Committing to a program with the Fund, and endorsing its conditionality, is one instrument available to governments to overcome this difficulty. The paper develops this interpretation of conditionality and indicates some of its operational implications for Fund programs.

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1. Introduction

A new assignment of Fund conditionality is emerging in response to members' changing needs. From an obtrusive means to enforce policy adjustments, conditionality is turning into an instrument willingly used by governments to establish the credibility of their policies. This has been a gradual development, an evolving emphasis rather than a revolution; still, the evolution has been far–reaching, both in its underpinnings and in its implications. This note details the shifting emphasis, explores the burden it puts on the Fund's own credibility, and considers some of the operational implications.

2. From Conditional Financing to Financed Conditionality

While Fund programs are driven by a continuing purpose, the manner in which they combine policy advice, financing, and conditionality is changing. The basic purpose of use of Fund resources, as defined by Article I (v), is to "give members confidence" that they can pursue policies consistent with international cooperation. To this end, Fund arrangements provide financing conditional on observance of agreed policy intentions. This blend of policy adjustment, financing, and conditionality is, constitutive of all Fund "programs;" the respective role of these three components varies, however, depending on circumstances.

The early design of conditionality assumed that a consensus existed between members, covering the importance of dealing with macro-imbalances (as evidenced by balance

of payments difficulties) and the definition of appropriate policies to remedy them. In this original atmosphere of cooperation (to this day, the Fund has "members," not "clients"), members' determination to adopt such policies was in little doubt, and conditionality was seen as the expression of this consensus. While members might have to deal with contrariness in public opinion, credibility in these "pre–markets" days was a limited issue. Transitory balance of payments needs were to be remedied by adjustment, with contingent financing provided as a backup to weather the storm. Appropriate corrective measures were key; in their support, financing and conditionality were assigned balanced and specific roles. Financing gave members assurances that cooperative policies would have a chance to see the country through the crises; conditionality, in the guise of protecting the Fund's financial integrity, ensured that its assets would be used in accordance with their purpose—it guaranteed the so–called monetary character of the Fund. Thus, financing gave confidence to the member and conditionality gave confidence to the Fund.

By the 1970s the consensus had grown tenuous, and in many a case conditionality had come to be resented as an imposition. Membership grew rapidly, members advocated diverse economic philosophies, and an abundance of international bank lending seemed to authorize a variety of experiments. Moreover, market credibility was not recognized as a prominent issue, and loss of market access was often interpreted as the result of political maneuvers—a fairly unattractive setting for Fund operations.

The bursting of the debt bubble in 1982 restored a more positive perception of Fund support. Financing became "catalytic," implying that besides the member and the Fund, official creditors and markets acting in a "concerted" way emerged as parties to the programs. Accordingly, conditionality was called upon to fulfill an expanded role of giving confidence, not only to the Fund, but to these creditors as well.

Two developments in the early 1990s have led to further changes in perception. First, a distinct shift in policies, and even more so in persuasion, has removed much of the sting of conditionality. Most Fund members have moved to a more market–friendly stance, as shown by the growing proportion of countries that have removed exchange controls on current or capital transactions (Table 1); Guitián (1995) thus points out to the "significant areas of common ground between this economic policy consensus and the policy framework underpinning IMF conditionality practices," and notes that this "coincidence of ideas and policy approaches augurs well for ... the acceptance of conditionality."[2]

Second, "markets"— domestic and foreign— have become key players in the development strategy. Table 2 shows in this respect the extraordinary expansion of spontaneous market-based international financing, mostly in the form of direct investment, in recent years. Markets do not take it for granted that countries, despite their new persuasion, pursue appropriate policies; their implicit view is that, in the name of sovereignty or of lesser

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[2]Guitián (1995) offers an elaborate analysis of the historical stages of Fund conditionality from the perspective of the rules versus discretion debate.

motives, countries resist rules-based, market-oriented approaches, and cannot be trusted to implement them predictably. This poor borrower predictability is a deterrent of investment, domestic and foreign, because the uncertainty increases the "option value" of waiting, and raises commensurately the profitability threshold required for investment (Serven, 1996).

When it comes to markets, therefore, countries need to establish a reputation for predictable behavior, and they have a strong interest in achieving that form of credibility.[3] No country will attract investment if unfettered government discretion maintains a risk of abrupt changes in tax laws, whimsical withdrawal of business licences, or arbitrary confiscation of the investor's assets. This "predictability gap" is rooted in the government's discretionary decision-making authority, and can only be controlled if "government in all its actions is bound by rules fixed and announced beforehand," which is Hayek's definition of the rule of law (Hayek, 1994, p. 80). It follows that governments have an incentive to bind themselves through the operation of "agencies of restraint," be they independent central banks, multilateral arrangements, trade treaties, or other impediments to whimsical action, so as to minimize investors' perception of a risk of policy reversal. Collier, who coined the expression,

[3]The relevance of this specific form of credibility is well captured in a recent study which, after reviewing a number of possible specifications of credibility, settles on identifying "the gut feelings of entrepreneurs with regard to their confidence in government predictability" (S. Borner and others, 1995, p. 51). The two survey questions used in the study to embody this concept are illustrative: "As an entrepreneur, do you regularly have to cope with *unexpected* changes in laws and/or policies which could seriously affect your business?" and "Do you expect the government to stick to announced major policies (e.g., a new tax law, an infrastructure project, a budget goal)?". What these questions seek to capture—with good results in the light of empirical evidence—is the risk of policy reversal: the predictability of government policies is the epitome of credibility.

distinguishes between domestic agencies of restraint (e.g., adoption of a cash budget or a currency board) and external agencies (e.g., international institutions such as WTO, MIGA, or OPIC) (Collier, 1996; and Bates, 1996). By making use of such "agencies," governments can separate themselves from some of their decision-making discretion and achieve a higher degree of predictability.

This is what conditionality can help achieve. As an externally enforced restriction that limits the members' policy options to those that have been agreed with the Fund, it not only serves to protect the Fund's financial integrity, but also, critically, helps establish the credibility of the chosen policy options vis-à-vis market participants. This does not mean that policies have to be set and immutable, but that the process of formulating them should be transparently related to a set of well-established ultimate objectives.

3. Implications for the Fund

The need to close the predictability gap provides a renewed perspective on the role and function of Fund programs and, in particular, of their conditionality component. In the presence of market forces, conditionality outgrows its traditional posture as a frequently obtrusive means of enforcing creditors' views and becomes an instrument of governments to establish the predictability of their policies. This shows quite clearly in the growing demand for "precautionary" arrangements. Indeed, the demand for Fund programs may be inversely related to the credibility of the country. Table 3 shows that the average credit rating of

program countries in selected years was significantly below the nonprogram country average; [4] for countries that have a lower than median rating, the probability of entering into an arrangement with the Fund is about one half (Table 4).

This new role of conditionality puts a new onus on the Fund. This can be explored by contrasting its commitment vis-à-vis official creditors and its relationship to market participants, while noting that support from both groups is usually needed—with varying emphasis—in real life situations. In its commitment to official creditors, the Fund—jointly with the World Bank—is expected to provide assurances that the member is making progress toward the critical mass of structural and other reforms that allows a transition to sustained economic growth. It is also committed to provide a credible assessment of the member's financing needs and to muster appropriate financing to cover them. The audience principally comprises the aid agencies, including the Paris Club, and other arrangements for concerted financing, such as the London Club. For the past ten years, its support has been cemented by the shared vision of the "Washington consensus," explaining perhaps why the assurances demanded by this group place equal value on the country's efforts as on its achievements. The readiness of the Paris Club to reconvene and reconsider the treatment of previously rescheduled debts, or of official lenders to refinance arrears, shows their ability to accommodate partial, incremental progress, to step in early to contain the risk of policy

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[4]The credit rating used for this calculation is that of the *Institutional Investor* which, being based on surveys of bank operators, comes closest in concept among generally available sources to S. Borner's preferred approach. The bivariate relationship cited here must of course be taken with caution: Knight and others have shown that the determinants of demand for Fund programs are complex (M. Knight and J. Santaella, 1994).

reversal (even though such risk remains), and to respond to delayed policy adjustments to external shocks. In this environment, the Fund is expected to fulfill an audit function, to verify the books, to assess the feasibility of policy adjustments, and to secure a reasonable measure of commitment by the authorities.

A different challenge is being faced when it comes to the Fund's relationship to market participants. Private investors, whether domestic or foreign, are a far more exacting public than official entities are, because the scale of their involvement is closely related to the secondary market price of new debt, i.e., the extent to which the market is assured that the risk of policy reversal is removed, and the capacity to respond to shocks is established. The experience of Latin America after the 1982 debt crisis has shown that it is not easy to provide such assurances, because they imply a judgment not only on the technical aspects of the policies, but also on the policy-makers' determination to sustain them. The Fund puts its own credibility at risk in vouching for this determination, most visibly by the commitment of its own resources. Markets do not, obviously, take Fund assurances at face value; but program conditionality can nevertheless help the member signal its determination to act in a restrained manner.

Even at this heightened level of expectations, there is reason to believe that the Fund can successfully help members build up a reputation for predictability. First and foremost, there is the track record of Latin America, which has secured renewed access to financial markets, although more in the form of equity than debt financing. This restored access is due

in part to a distinct change in policies and in global approach in the countries of the region, which Fund programs have been instrumental in stimulating, and which justifies markets' renewed appreciation of regional opportunities.

Second, there is evidence that markets' assessments are "rational," at least in the specific sense that economic fundamentals are good predictors of credit ratings; Haque and others (1996) have shown that a country's level of international reserves, its current account position, and its growth and inflation performance explain a large share of the variation in credit rating, as assessed by *Institutional Investor*. Their study also reviews a number of earlier surveys, which reach the same broad conclusions. The findings give confidence that progress on improving the fundamentals will pay off in terms of market recognition, an encouraging conclusion, even though many factors besides the country's credit rating may be at work at any given time in determining capital flows and domestic investment decisions.

Third, while ratings for African countries remain exceedingly low on average, there are suggestions that "good performers" do not rate as low as the rest, and that their ratings are trending upward (Collier, 1996). Since a hysteresis effect seems to be at work—once credit ratings sink this low, it would be difficult for them to recover, whatever the underlying policies, because of cognitive distortions— early indications of a positive response of credit ratings for good performers should be taken as an encouraging sign.

4. Operational Implications

If conditionality is to help establish a government's reputation for predictability, it is not enough to take the "right" decisions; they must also be predictable, and free of risk of policy reversal. Therefore, programs in developing and transition economies need not only to change policies but also to change the way policies are made.

It follows, first, that capacity building becomes a first–rank objective of programs, on an equal status with policy design. Capacity building has long been narrowly recognized as needed to support the sustained implementation of appropriate policies. There is much more to it: it is necessary to predictable policy making. De facto recognition of the importance of capacity building in the programming process has indeed been running ahead of its formal recognition; in particular, the buildup of national negotiating teams, the strengthening of budgetary controls, and the structuring of monetary data in the programming process have been the object of dedicated efforts, and have been instrumental in bringing about a gradual change in culture and in securing program "ownership." Appropriate "public relations" have also become an integral part of the adjustment effort: they aim at improved communications within the government, with the public, and with markets.

Second, the new role of conditionality introduces a far–reaching extension in the scope of needed reforms. For policies to be made in a market–friendly way, it is not only necessary to rely on a core team of national coordinators; in many cases, there must also be a

strengthening of the whole civil administration, in particular the judiciary. An efficient civil service, backed up by a competent judiciary, is necessary for the solution of the authorities' time consistency problems and for the establishment of the rule of law, and thus for the creation of an economically secure environment. In this specific sense, "good" governance is an integral component of Fund programs.

Third, there is a need to remain realistic and firm on conditionality, because it is of little use otherwise. The "rules fixed and announced beforehand" only constitute a rule of law if they are accepted as also binding, which means that the system of incentives and disincentives attached to their enforcement must be of sufficient scope. The ultimate incentive is of course the attention paid by markets to the enforcement of conditionality; but markets would not mind, unless significant proximate sanctions are also present.

Fourth, this analysis explains why program implementation is necessarily conflictual, and why programs often seem slow in yielding results. Programs are conflictual because they do not just change policies, but upset and redirect policy making authority. Restrictions on discretionary decision–making powers are resented and actively resisted; this is typically the case with efforts to establish transparency in fiscal accounts, especially where oil production, or even domestic distribution, are involved, or to implement effective budgetary control.[5]

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[5]Resistance to fiscal transparency is rooted in a long tradition. In 1781, reformist Finance Secretary Necker issued the first published budget in French history, his famous *compte-rendu*. While he had often "affronted the stalwarts of the old regime tradition," he experienced on that occasion that "no offense was more rank than the central principle of his *compte-rendu:* public scrutiny." (Shama, 1990, p. 94).

Resistance to reforms is also rife, and even more diversified when it comes to establishing a high quality civil service, or establishing a truly performing judiciary, making this an inherently slow process.

Fifth, the initial negotiation process is an essential part of programs. The opportunity to negotiate, at length when necessary, until some degree of genuine agreement (the so-called ownership) has been achieved, gives the Fund the element of asymmetric information that makes it possible to enter into a program with countries that, as discussed above, have limited credibility in the market. This is the sense in which conditionality Guideline No. 7 stipulates that the Managing Director, before presenting a program to the Executive Board, must be satisfied that policy makers are committed to the program.

Finally, it is important to ask the "right" questions in program evaluation. One reason why programs seem slow in getting results is that, all too often, program evaluations focus on whether measurable improvements in the ultimate objective of sustainable growth can be identified. It would be more topical to identify progress in capacity building and in formulating and implementing policy, and the conclusions could well be more sanguine.

Table 1. Exchange Controls, 1979-95

(Number of Fund member countries)

	1979	1989	1995
All countries			
Article VIII			
- accepted	51	70	131
- not accepted	89	83	49
Capital controls			
- removed	35	33	54
- maintained	105	120	126
Program countries			
Article VIII			
- accepted	7	8	34
- not accepted	16	37	12
Capital controls			
- removed	6	3	8
- maintained	17	42	38

Sources: IMF, *Annual Reports on Exchange Arrangements and Exchange Restrictions*, 1980, 1990, and 1996; and Treasurer's Department.

Table 2. Developing Countries: External Financing

(In billions of U.S. dollars)

	All LDCs	
	1988	1995
Total net external financing	37.0	235.8
Of which:		
Market financing	28.6	191.1
(direct investment)	(19.2)	(90.0)
(other)	(9.4)	(100.2)
Official financing	8.4	44.7

Source: Based on *WEO*, October 1996, Table A 33.

Table 3. Credit Rating of Program Countries

(Ratings in points) 1/

	1979	1989	1995
Program countries 2/			
Number	17	32	36
Average rating	36.0	20.7	23.9
Variance	28.2	91.1	75.6
Nonprogram countries			
Number	76	81	99
Average rating	59.8	45.9	43.9
Variance	507.0	735.5	693.4
(*F* statistic)	16.54	25.93	19.66

Source: *IFS*, and *Institutional Investor*, various issues.

1/ *Institutional Investor* ratings reflect bank managers' perceptions of country risk (see Haque, 1996). Ratings range from 1 to 100 (for 1979, published ratings on a scale of 1 to 10 have been normalized to 1 to 100).

2/ Countries for which a program was supported by an arrangement in place with the IMF in midyear and for which credit ratings are available.

Table 4. Frequency of Fund Programs

(Number of Countries)

	1979	1989	1995
Countries with above median ratings 1/			
Number	46	56	67
Of which: with program 2/	2	3	6
without program	44	53	61
Countries with below median ratings			
Number	47	56	68
Of which: with program	15	30	30
without program	32	26	38

Source: *IFS*, and *Institutional Investor*, various issues.

1/ *Institutional Investor* credit ratings.

2/ Countries for which a program was supported by an arrangement in place with the IMF in midyear.

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