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## Financial Sector Conditionality: Is Tougher Better?

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*Roger Kronenberg*



## IMF Working Paper

Monetary and Financial Systems Department

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#### Abstract

**This Working Paper should not be reported as representing the views of the IMF.**

The views expressed in this Working Paper are those of the author(s) and do not necessarily represent those of the IMF or IMF policy. Working Papers describe research in progress by the author(s) and are published to elicit comments and to further debate.

The aim of this paper is to take a closer look at IMF conditionality in the banking sector. Our analysis shows that while such conditionality became more stringent following the Asian crisis, compliance has remained broadly unchanged, comparing unfavorably with other structural reforms. The results of panel data regressions show that while compliance with IMF-supported banking sector reform strategies has contributed to an improvement in banking sector performance, increases in the hardness and intensity of IMF conditionality may not be, *ceteris paribus*, effective. The policy implication is that the IMF should, therefore, continue its efforts in enhancing countries' ownership and streamlining conditionality.

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*“... it is important that ownership of any banking sector program stays with the country itself.” (Stanley Fischer, 1997)*

*“What is food to one man is bitter poison to others.”  
(Lucretius, 96 BC–55 BC)*

## I. INTRODUCTION

The rationale for and successfulness of IMF conditionality has been hotly debated since the establishment of the IMF. There is, indeed, a substantial literature that has scrutinized various aspects of conditionality, ranging from the economic and political forces that helped shape conditionality (Gould, 2002), to the evolution in the breath and scope of conditionality (Goldstein, 2003), and to its contribution to macroeconomic stabilization and economic growth in borrowing countries (Gosh and others, 2005).

This paper takes a closer look at one particular aspect of conditionality, its application to the financial sector, in particular to the banking sector. Banking sector conditionality has been an important driving force behind the overall growth in IMF conditionality, but it has not received much individual attention. The aim of this paper, therefore, is to review how conditionality has been used in the banking sector and to make a preliminary assessment of the effectiveness of conditionality in helping strengthen the performance of the banking sector. Using a sample of 158 IMF-supported programs for 83 countries approved between 1995 and 2003, we construct indicators to capture three key dimensions of IMF conditionality: (i) the “intensity” or the quantity of banking sector measures in a IMF-supported program; (ii) the “hardness” or the share of conditions the nonobservance of which would trigger an interruption of disbursements under a IMF arrangement; and (iii) the “compliance” or the share of measures that were actually implemented.

The results of our analysis need to be interpreted cautiously, since significant measurement problems arise in the classification, quantification, and monitoring of banking sector conditionality.<sup>2</sup> Besides, difficulties in isolating the impact of IMF conditionality may be complicated further by the actions of other multilateral and bilateral agencies that also play an important role in banking sector reform.<sup>3</sup> Nevertheless, our study offers a number of interesting results. In the period immediately following the Asian crisis, the quantity and the scope of banking sector conditionality increased sharply, and they have since remained higher than in the pre-crisis period. Along with the increased incidence of conditionality, the form of conditionality has also changed, with greater reliance given to prior actions and performance criteria, which, contrary to structural benchmarks, require explicit approval of waivers by the Executive Board of the IMF. Despite this apparent “hardening” of conditionality, however, we find that actual compliance in implementing the reform measures has remained low, comparing unfavorably with other structural reforms.

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<sup>2</sup> In the MONA database, information on compliance was missing in nearly 20 percent of total banking sector measures.

<sup>3</sup> See World Bank (2004) for a thorough analysis of its assistance in financial sector reform.

Differences in the design of IMF conditionality seem to emerge comparing different types of IMF arrangements, as well as IMF-supported programs in different geographical regions. The results of panel data regressions confirm the view that IMF programs have contributed to improvements in banking sector performance, but increases in the hardness and intensity of IMF-conditionality may not be, *ceteris paribus*, effective. This corroborates the view that fostering country “ownership” and streamlining IMF conditionality are crucial elements for the success of the reform process.

The paper is structured as follows. Section II provides a brief overview of how IMF conditionality has evolved over time. Section III summarizes the main challenges in designing banking sector conditionality. Section IV discusses the principal trends in IMF banking sector conditionality and the results of the panel analysis. Section V concludes.

## II. A BRIEF HISTORY OF IMF CONDITIONALITY

Conditionality—the mechanism by which IMF credit is made dependent on the country’s implementation of agreed economic and financial policies—is one of the linchpins of IMF lending. In broad terms, conditionality serves two critical purposes. First, it provides assurance that the use of IMF resources will be accompanied by policies to resolve a country’s balance of payments difficulties and to lay the foundations for strong and sustainable economic growth. In so doing, conditionality is seen by the IMF as a means of ensuring that the borrowing country will be in a position to make timely repayments, consistent with the revolving nature of IMF resources. Second, conditionality gives confidence to the borrowing country that the financial resources will, in fact, be disbursed by the IMF according to a predictable timetable, provided that the country implements the agreed program of measures.

The nature of conditionality has evolved considerably over the decades. Conditionality was not even mentioned in the original Articles of Agreement.<sup>4</sup> Initially, borrowing members merely needed to attest that their request to use IMF resources was consistent with the purposes of the IMF. However, the desirability of exercising firmer control over the use of IMF resources became apparent early on, and conditionality was introduced under an Executive Board decision in 1952. Subsequently, in 1969, the principle of conditionality was enshrined in the Articles of Agreement under the First Amendment. A decade later, the Board conducted a comprehensive conditionality review. The 1979 Conditionality Guidelines, which came out of that review, specified that performance criteria should normally be limited to those measures necessary to evaluate program implementation and generally confined to macroeconomic variables. In exceptional circumstances—when the measures are essential for program effectiveness because of their macroeconomic impact—conditionality could be extended to other variables.

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<sup>4</sup> This apparently was the result of a compromise between the United States, which favored some form of conditionality and the European countries, which saw themselves as potential borrowers, and hence, were less inclined to support the idea.

Notwithstanding these guidelines, the scope of conditionality broadened significantly during the 1980s and 1990s, as the IMF increasingly came to see structural reform as an integral element in its mandate to promote strong, sustainable growth and financial stability. In the mid-1980s, less than one-fifth of all General Resources Account (GRA)-supported arrangements had structural conditionality. By the mid-1990s, structural conditionality was nearly universal. At the same time, however, there was a growing recognition at the Board that excessive conditionality could undermine national ownership of a policy program, strain administrative capacity, and weaken implementation of policies that are truly essential.

Some observers outside the IMF also called attention to the risks of excessive conditionality.

- “Detailed conditionality...has burdened IMF programs in recent years, and made such programs unwieldy, highly conflictive, time consuming to negotiate, and often ineffectual” (International Financial Institution Advisory Commission, *Meltzer Report*, 2000).
- “The IMF should eschew the temptation to...force fundamental structural and institutional reforms on countries...unless they are absolutely necessary to revive access to international funds” (Feldstein, 1998).
- “The [IMF] staff will almost invariably press...to specify detailed targets and policy commitments in a way that greatly reduces or eliminates the authorities’ flexibility, even in the implementation of their own ideas and policies.... These attitudes and practices make conditionality unnecessarily intrusive” (Buirra, 2003).
- “Efforts to include in IMF conditionality everything but the kitchen sink under the loosely defined agenda of pursuing “high-quality” growth have taken the IMF too far from its comparative advantage and have elicited legitimate charges of mission creep” (Goldstein, 2003).

Against this background, the Board embarked on a new conditionality review in 2001. While agreeing that conditionality remained an indispensable element of IMF-supported programs, Directors emphasized the importance of avoiding ill-focused or unduly intrusive conditionality that could detract from ownership. They also stressed the need to make a clearer distinction between the authorities’ overall policy program and those measures that are subject to conditionality.

New Conditionality Guidelines were issued in 2002 by the Board, which identified five basic principles for program design:

- **Conditionality should be used parsimoniously.** Specifically, conditionality should (i) be limited to the minimum necessary to achieve the goals of the IMF-supported program or monitor its implementation; (ii) normally be related to IMF’s core areas of responsibility; and (iii) be critically important to achieving the program’s goals.
- **Conditionality should be conducive to national ownership.** Primary responsibility for program design rests with the country authorities. Staff should seek proposals

from country authorities at an early stage and should be flexible in accommodating authorities' preferences.

- **Conditionality should be tailored to members' circumstances.** The IMF should take account of a country's track record in previous programs, while preserving the basic uniformity of treatment of its members.
- **Conditionality should be based on effective coordination with other international financial institutions (IFIs).** Program elements outside the IMF's core areas of responsibility should, to the fullest extent possible, be based on advice of the other IFIs (e.g., the World Bank). Flexibility is called for in areas of overlapping responsibility, including financial sector work.
- **Conditionality should be clearly specified.** Program-related conditions should be transparently distinguished from other elements of the authorities' program both in staff reports and in the member's program documents.

The Board reviewed the experience with these Guidelines in early 2005 (IMF, 2005b). While recognizing that significant progress had been made in better focusing conditionality on critical measures, the review concluded that there was still scope for further streamlining the coverage of structural conditionality and emphasized the need for improving the formulation of structural conditionality, including avoiding overambitious timetables for implementation.

### III. OVERVIEW OF BANKING SECTOR CONDITIONALITY

Macroeconomic stability and the soundness of financial intermediaries are closely intertwined. Financial market development and intermediation play a crucial role in shaping saving decisions, promoting the efficient allocation of such a scarce resource, and hence fostering economic growth.<sup>5</sup> The health of the banking sector can also affect the transmission of monetary policy as well as threaten the sustainability of public finances. Due to growing financial market integration, stable macroeconomic policies are a necessary but not sufficient condition to avoid financial and economic crisis. Unsound financial systems may be the origin of the crisis or the channel through which shocks are transmitted and amplified to a full-blown crisis. Consequently, the IMF's financial programming exercise has started taking explicit account of the state of the banking sector and the measures needed to improve it.<sup>6</sup>

Given the important bearing of banking sector health on macroeconomic stability and growth, it is not surprising that banking sector conditionality has been an important driving force behind the overall growth in IMF structural conditionality.

Banking sector reforms aim to strengthen the financial soundness of the banking industry, enhance the institutional and legal framework, and put in place the right incentives to operate

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<sup>5</sup> For a review of the literature on the importance of financial system for economic growth, see Levine (2004).

<sup>6</sup> Fischer (1997).



properly. It is, therefore, a complex multi-step and multi-dimensional process.<sup>7</sup> Depending on the starting situation, it may require significant modifications to the legal framework, strengthening bank supervision, including prudential norms, fundamental improvements in bank governance, and in particular changes in the banking culture. It may also involve the creation of new institutions, such as asset management corporations aimed at dealing with banks' troubled assets.<sup>8</sup> It often requires a parallel financial and operational restructuring of the corporate sector. Any such changes may be strongly resisted by vested interests since banks are "a source not only of funds, but also of substantial discretionary powers over the economy" (Calomiris and Masson, 2003). Mustering the necessary political consensus and willingness is therefore crucial to move reforms ahead.<sup>9</sup>

The inclusion of banking sector reform in IMF-supported programs raises, therefore, a number of thorny issues. Unlike many other types of structural reform that can typically be designed and implemented in the context of a medium-term frameworks (such as trade liberalization, the introduction of a value-added tax (VAT), or labor market reforms), banking sector reforms may take place against the backdrop of an unfolding crisis, requiring rapid action by the authorities and the IMF to restore financial stability. The timing and pace of reforms have to reconcile the medium-term nature of banking sector reform with the need for a rapid response to crises and on generally shorter-term character of IMF arrangements. The strategy must also be sufficiently flexible to respond to changes in the operating environment, particularly if a crisis is unfolding.<sup>10</sup>

Minimizing intrusiveness and streamlining IMF conditionality are indeed important factors to consolidate country's ownership of the reform process. For countries with large access to IMF resources or a mixed track record in policy and reform implementation, tensions might emerge between the goal of safeguarding program realization through the adoption of more stringent conditionality, such as prior actions and performance criteria, and the need to minimize intrusiveness. Similarly, an equilibrium has to be found between the goal of monitoring adequately such a multi-faceted reform process, usually involving several policy measures/actions, and the need for streamlining IMF conditionality.

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<sup>7</sup> Calomiris (1998) and Calomiris, Klingebiel, and Laeven (2003).

<sup>8</sup> For an analysis of the issues related to the establishment of asset management corporations, see Ingves, Seelig, and He (2004).

<sup>9</sup> "Countries that have achieved successful banking reform have done so over many years and as a result of a strong domestic commitment to improve banks incentives, and not in response to IMF conditions" (Calomiris, 1998, p.5).

<sup>10</sup> On these issues, see Lindgren and others (1999).

## IV. EMPIRICAL ANALYSIS

### A. Data Description

We used the MONA database to identify programs that had important financial sector components.<sup>11</sup> Our database contains information on financial sector conditionality for 83 countries under 158 IMF arrangements approved between 1995 and 2003. By type of IMF facility, there are 70 Stand-By Arrangements, 18 Extended IMF Facility (EFF), and 70 Enhanced Structural Adjustment Facility and Poverty Reduction and Growth Facility (ESAF/PRGF) programs. Geographically, the sample covers 29 countries in Africa, 12 in Central and Eastern Europe, 11 in the Commonwealth of Independent States (CIS), 11 in Asia, 3 in the Middle East, and 17 in the Western Hemisphere.<sup>12</sup>

As described in Appendix 1, we divided the financial sector measures into three broad categories (central banking, bank sector, and other) and into further subcategories.

- The central banking category includes all structural reforms pertaining to the functioning of a central bank as well as the working of money and foreign exchange markets.
- Banking sector measures are broken into seven sub-categories, following the phases of banking restructuring described in Hoelscher and Quintyn (2003): (i) containment and liquidity management (which includes measures aimed at containing a banking crisis with particular emphasis on those affecting bank liquidity); (ii) restructuring (which covers a wide array of measures; from the elaboration of a broad strategy, to the requirement of external audits, to bank privatization, merger and acquisition); (iii) asset management (which comprises measures aimed at reducing the burden of nonperforming assets, including the establishment of asset management corporations); (iv) laws and by-laws (which incorporate measures reforming bank legislation, including bank resolution process, deposit insurance, and anti-money laundering and combating the financing of terrorism (AML/CFT)); (v) norms (which encompasses measures enhancing prudential powers and regulations); (vi) data and other information; and (vii) other measures.
- The “other” category pertains to measures that directly support banking sector restructuring, such as bankruptcy reforms.

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<sup>11</sup> The MONA database, established in 1993, provides what amounts to a cumulative history of IMF-supported programs from Executive Board approval through its termination, covering the economic objectives, structural measures, type of conditionality, and outcomes of IMF-supported programs. The sector classification has been recently revised and extended. Now, it includes 14 categories, and the financial sector category has been subdivided into bank regulation and supervision, central bank reform, financial legal reforms, restructuring and privatization of financial institutions, and monetary statistics.

<sup>12</sup> See Appendix 1, Table 11.

In addition, our database includes some measures such as privatization of state-owned banks that were not classified as “financial sector” in the MONA database. When individual policy measures were listed as a single condition in the MONA database, we broke that condition into its component parts. As a result, our database contains a total of more than 1,200 policy actions.

The database also contains information on the form of conditionality (i.e., prior actions, performance criteria or structural benchmark), the outturn (i.e., met, met with delay, not met, no information, ongoing), the type of IMF-arrangement, the geographical area of a program country, and whether a country has experienced a systemic banking crisis at the time of the program.<sup>13</sup>

## B. Indicators of IMF Conditionality

Our analysis considers three dimensions of conditionality: (i) the “intensity” or the number of measures included in a program; (ii) the “hardness” or the share of policy actions that are vital for IMF disbursements; and (iii) the “compliance” or the share of measures that were implemented as intended. We constructed three indicators:

- **Intensity (I)** is measured by the number of “actions” that a country is expected to implement in a year. Therefore, for country (or program)  $i$ , we have:

$$I_i = \sum_j n_{ij} / m_i * 12 \quad (1)$$

where  $n_{ij}$  indicates policy action  $j$  of program  $i$  and  $m_i$  is the effective length of program  $i$  measured in months.<sup>14</sup>

- **Hardness (H)** is assessed by the ratio between the sum of prior actions (PA) and performance criteria (PC) over total actions envisaged in a program ( $\sum_j n_{ij}$ ):<sup>15</sup>

$$H_i = \sum_j (PA_{ij} + PC_{ij}) / \sum_j n_{ij} \quad (2)$$

We implicitly assumed that the higher the number of prior actions and performance criteria, the more binding is the conditionality in an IMF-supported program. The IMF’s Guidelines on Conditionality distinguish structural benchmarks from the other forms of conditionality for two main reasons, either because they “cannot be specified in terms that may be objectively monitored” or because their “nonimplementation would not, by itself, warrant an interruption of purchases or disbursements under an

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<sup>13</sup> Information on systemic banking crisis was drawn from Caprio and Klingebiel (2003).

<sup>14</sup> This is calculated as number of months between the Board meeting and the expiration date of a program less overlapping months in case of a subsequent program.

<sup>15</sup> It goes without saying that  $\sum_j n_{ij} = \sum_j (PA_{ij} + PC_{ij} + SB_{ij})$ , where SB stands for structural benchmark.

arrangement.”<sup>16</sup> Therefore, structural benchmarks implicitly introduce an element of flexibility in an IMF-supported program.<sup>17</sup>

- **Compliance (C)** is gauged by the ratio between policy actions met according to the original schedule ( $n_{ij}^M$ ) and the total number of actions excluding those still ongoing ( $\tilde{n}_{ij}$ ).<sup>18</sup>

$$C_i = \sum_j n_{ij}^M / \sum_j \tilde{n}_{ij} \quad (3)$$

Policy measures implemented with delays are not included in the numerator of the index because the occurrence of delays is indicative of difficulties in properly timing the condition either because the timeframe was ambitious or because the commitment involved a third-party’s action (e.g., congressional approval of a piece of legislation).

These indicators need to be interpreted cautiously for a number of reasons.

- The indicators are based on the conditionality specified in the original programs, and do not take into account possible changes in the type of conditionality (for example, from structural benchmark to performance criterion) during the life of a program.<sup>19</sup>
- Notwithstanding our adjustments to the data, the indicators still depend to a certain extent on the degree of detail with which the policy measures were originally specified (e.g., the number of actions needed to bring an intervened bank to the point of sale may be counted in a variety of ways).
- Similarly, once identified, all measures are given the same weight in the statistical analysis, even though they may have a different bearing on the success of a reform process.
- Implementation of conditionality is measured on a “met/met with delays/not met” scale, which does not provide information on the effectiveness of the implementation.

### C. Main Trends

The data reveal a number of interesting trends in financial sector conditionality since the mid-1990s.

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<sup>16</sup> Article 11 (d) (iii) of Guidelines on Conditionality, September 25, 2002.

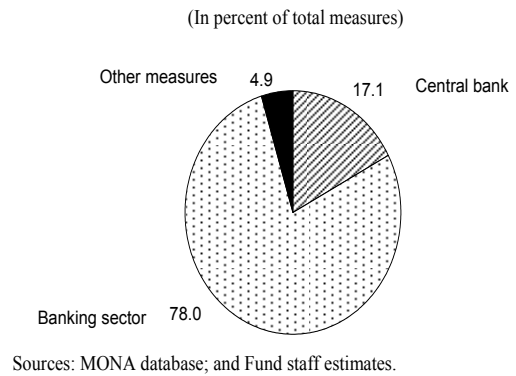
<sup>17</sup> Contrary to the case of prior actions or performance criteria, the nonobservance of a structural benchmark does not call for a request of a waiver that has to be approved by the Executive Board of the IMF.

<sup>18</sup> In the MONA database, information on compliance was missing in nearly 20 percent of total financial sector measures. In a draconian way, we assumed that those conditions were not met.

<sup>19</sup> Thus, for example, if a structural benchmark was not met as originally scheduled and subsequently was changed into a performance criterion for the next review when it was met as scheduled, the measure would appear as a structural benchmark “met with delay” in our database.

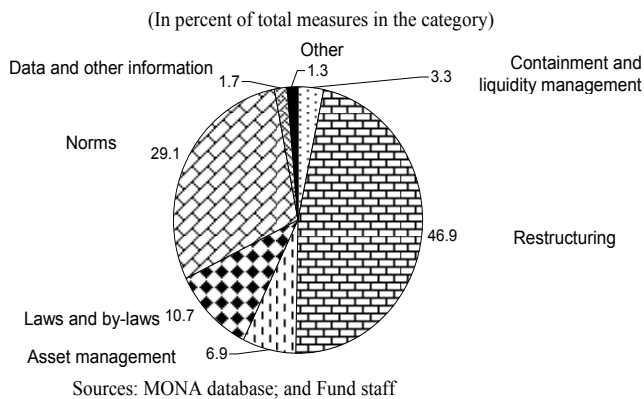
Financial sector conditionality has focused increasingly on the banking sector. For the 1995–2003 period as a whole, more than three-quarters of financial sector conditionality was focused on the banking sector area, while less than 20 percent was in the area of central banking and about 5 percent falls in the category “other financial sector issues” (Figure 1). Comparing the periods before (1995–96) and after (1997–2003) the Asian crisis, the share of banking sector conditionality has expanded from 65 percent to 80 percent of total financial sector measures, while the share of conditionality affecting central banking has almost halved, falling from 29 percent to 15 percent.<sup>20</sup>

Figure 1. Financial Sector Conditionality: 1995-2003



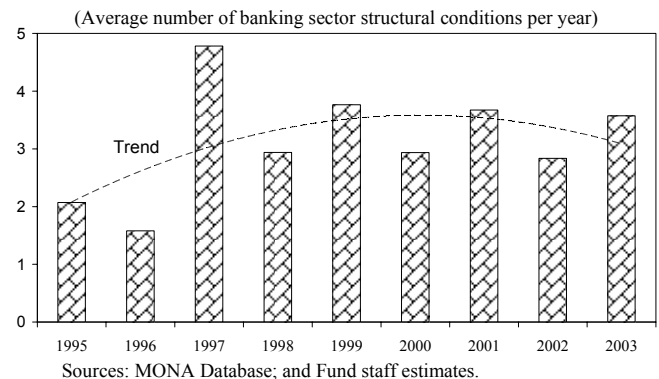
Within the banking sector, the scope of conditionality has broadened. Whereas the majority of IMF-supported programs prior to 1997 contained conditions pertaining to only one out of the seven banking sector categories (mainly “bank restructuring” and “norms”), half of the programs approved during 1997–2003 included conditionality in two or three banking sector areas (Figure 2). This is indicative of a growing and more comprehensive attention of IMF programs, and hence of IMF conditionality, to the functioning of the banking industry.

Figure 2. Banking Sector Conditionality: 1995-2003



The intensity of banking sector conditionality has increased after the Asian crisis (Figure 3). Whereas IMF-supported programs included, on average, less than two banking sector structural measures per year during 1995–96, that number increased to almost five conditions per year in 1997. Although the intensity of banking sector conditionality subsequently eased somewhat, it still remains, on average, about twice the amount in pre-Asian-crisis IMF arrangements. This rise in the intensity of conditionality has been common to all banking sector categories (Table 1).

Figure 3. Intensity Indicator; 1995-2003



<sup>20</sup> Only 12 out of the 158 IMF-supported programs in the sample did not include any conditionality on the banking sector.

Table 1. Indicators of Banking Sector Conditionality: Breakdown by Category

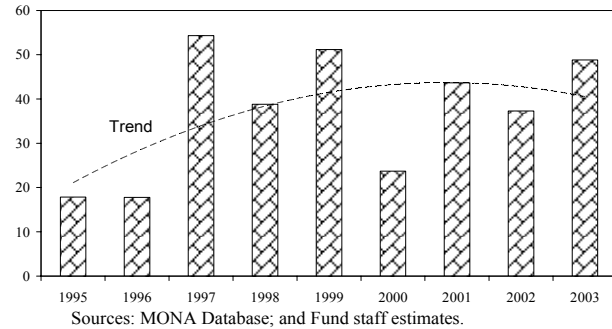
(Program averages)

|            | Total | Containment | Restructuring | Asset Management | Laws and By-Laws | Norms | Information | Other |
|------------|-------|-------------|---------------|------------------|------------------|-------|-------------|-------|
| Intensity  |       |             |               |                  |                  |       |             |       |
| 1995       | 2.1   | ...         | 1.1           | ...              | 1.0              | 1.6   | 0.3         | 0.3   |
| 1996       | 1.6   | 0.3         | 1.1           | 0.5              | 0.8              | 0.8   | 0.3         | 0.3   |
| 1997       | 4.8   | 0.6         | 2.5           | 1.1              | 1.0              | 1.3   | 0.3         | 0.3   |
| 1998       | 2.9   | 0.3         | 2.1           | 0.5              | 0.5              | 1.3   | 0.3         | 1.3   |
| 1999       | 3.8   | 0.7         | 2.0           | 1.0              | 1.0              | 1.7   | 0.6         | 0.3   |
| 2000       | 2.9   | 6.0         | 1.7           | 3.3              | 1.0              | 1.2   | 0.4         | ...   |
| 2001       | 3.7   | 0.5         | 2.3           | 0.4              | 0.7              | 1.6   | 0.8         | 0.3   |
| 2002       | 2.8   | 0.5         | 1.5           | 0.7              | 0.6              | 1.5   | 0.6         | ...   |
| 2003       | 3.6   | 0.6         | 1.9           | 2.5              | 1.9              | 1.6   | 0.3         | ...   |
| Average    | 3.1   | 0.9         | 1.8           | 1.1              | 0.9              | 1.4   | 0.5         | 0.4   |
| Median     | 2.0   | 0.6         | 1.3           | 0.7              | 0.7              | 1.0   | 0.3         | 0.3   |
| Hardness   |       |             |               |                  |                  |       |             |       |
| 1995       | 17.9  | ...         | 0.0           | ...              | 0.0              | 37.5  | 0.0         | 0.0   |
| 1996       | 17.8  | 50.0        | 16.8          | 0.0              | 62.5             | 14.4  | 0.0         | 0.0   |
| 1997       | 54.3  | 87.5        | 57.0          | 50.0             | 50.0             | 60.1  | 50.0        | 50.0  |
| 1998       | 38.8  | 100.0       | 40.9          | 50.0             | ...              | 34.3  | 0.0         | 50.0  |
| 1999       | 51.2  | 77.8        | 55.4          | 33.3             | 71.7             | 39.9  | 50.0        | 100.0 |
| 2000       | 23.7  | 60.0        | 36.0          | 7.1              | 35.0             | 24.1  | 0.0         | ...   |
| 2001       | 43.7  | 100.0       | 49.4          | 33.3             | 35.2             | 38.9  | 50.0        | 100.0 |
| 2002       | 37.3  | 25.0        | 50.2          | 60.0             | 14.3             | 17.8  | 66.7        | ...   |
| 2003       | 48.8  | 100.0       | 31.8          | 30.0             | 30.0             | 64.3  | 50.0        | ...   |
| Average    | 36.8  | 76.1        | 38.8          | 36.1             | 39.7             | 37.1  | 37.5        | 65.0  |
| Median     | 33.3  | 100.0       | 33.3          | 0.0              | 0.0              | 25.0  | 0.0         | 100.0 |
| Compliance |       |             |               |                  |                  |       |             |       |
| 1995       | 68.7  | ...         | 86.7          | ...              | 40.0             | 56.3  | 100.0       | 100.0 |
| 1996       | 48.6  | 50.0        | 41.5          | 25.0             | 37.5             | 66.7  | 100.0       | 0.0   |
| 1997       | 59.3  | 87.5        | 50.4          | 58.3             | 45.8             | 69.6  | 50.0        | 100.0 |
| 1998       | 47.3  | 100.0       | 45.8          | 0.0              | 39.4             | 65.5  | 100.0       | 50.0  |
| 1999       | 55.0  | 88.9        | 36.7          | 55.6             | 47.5             | 81.5  | 0.0         | 100.0 |
| 2000       | 34.0  | 80.0        | 49.4          | 48.8             | 45.0             | 16.7  | 0.0         | ...   |
| 2001       | 74.3  | 100.0       | 68.6          | 50.0             | 77.8             | 81.4  | 50.0        | 100.0 |
| 2002       | 44.8  | 0.0         | 43.8          | 10.0             | 57.1             | 56.1  | 33.3        | ...   |
| 2003       | 24.5  | 50.0        | 16.7          | 10.0             | 30.0             | 33.3  | 50.0        | ...   |
| Average    | 51.0  | 70.4        | 48.4          | 34.6             | 48.4             | 61.6  | 43.8        | 85.0  |
| Median     | 52.9  | 100.0       | 50.0          | 0.0              | 50.0             | 69.0  | 0.0         | 100.0 |

Sources: MONA database; and IMF staff estimates.

Similarly, IMF-supported programs have been increasingly used more stringent forms of IMF conditionality, as shown by the “hardness” indicator (Figure 4). Whereas in 1995–96 less than two conditions out of ten were prior actions or performance criteria, nearly two-thirds were in these categories in 1997, and the number has since hovered at around 50 percent.<sup>21</sup> The tendency to apply a more stringent conditionality has affected banking sector measures across the board, with the notable exception of those concerning legislative reforms.

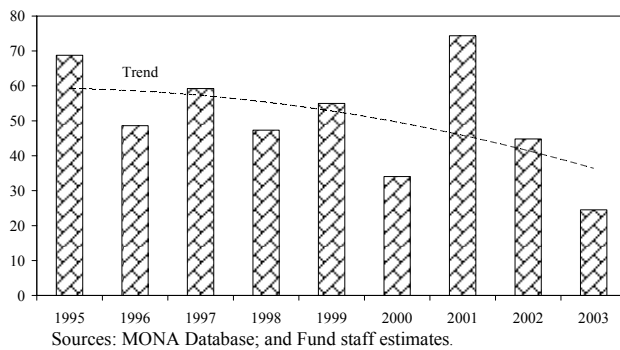
**Figure 4. Hardness Indicator; 1995-2003**  
(In percent of total banking sector structural conditions)



The increased use of performance criteria and prior actions, which must be observed for continuing disbursements of a IMF credit,

might be expected to result in improved compliance. This was not the case (Figure 5).<sup>22</sup> On the contrary, the use of more stringent conditionality has yielded a somewhat declining delivery rate.<sup>23</sup> This trend is broadly common to all the categories.<sup>24</sup>

**Figure 5. Compliance Indicator; 1995-2003**  
(In percent of total banking sector structural conditions)



The view that IMF conditionality stepped up following the Asian crisis but countries’ compliance remained broadly unchanged is corroborated by a simple test. We calculated the sample means of

the three conditionality indicators for the two sub-periods and then tested whether the difference between these sample means is significantly different from zero (Table 2). The sample averages are significantly different in the two sub-periods for the intensity and the hardness indicators, whereas this is not the case for the compliance indicator. These results remain valid even if the IMF-supported programs with Korea, Thailand, and Indonesia are excluded from the sample.

<sup>21</sup> This increase in the hardness indicator may also reflect a better recording of prior actions by the IMF following the change in policy in 2000, when prior actions became subject to the misreporting policy and a rule was introduced that all prior actions had to be accurately listed in the text of arrangements (see IMF, 2005b).

<sup>22</sup> For similar results, see also Goldstein (2003).

<sup>23</sup> This remains valid even if we exclude the very low rate recorded in 2003.

<sup>24</sup> As shown in Table 12 in Appendix 1, “bank restructuring” and “asset management,” as well as “corporate restructuring” and “reform of bankruptcy laws,” have been the areas in which high levels of noncompliance or compliance with delay have been recorded.

Table 2. Banking Sector Conditionality: Tests on Period Averages 1/

|                           | Intensity | Hardness | Compliance |
|---------------------------|-----------|----------|------------|
| Period 1995-1996          |           |          |            |
| Averages                  | 1.8       | 17.8     | 56.9       |
| Variances                 | 2.7       | 968.1    | 1,494.2    |
| Number of observations    | 34        | 34       | 34         |
| Period 1997-2003          |           |          |            |
| Averages                  | 3.5       | 42.5     | 49.2       |
| Variances                 | 12.2      | 1,369.8  | 1,228.8    |
| Number of observations    | 112       | 112      | 112        |
| Statistics (t-student) 2/ | -3.94     | -3.87    | 1.05       |
| Degrees of freedom 3/     | 119       | 64       | 51         |

Sources: MONA database; and IMF staff estimates.

1/ Excluding IMF-supported programs without banking sector conditionality.

2/ For intensity and hardness significant at 1 percent.

3/ The number of degrees of freedom depend upon the sample variances and the number of observations.

The trend toward a more numerous and stringent conditionality may have been the result of a number of factors (see also Section III). The need to send a strong signal to international capital markets that a clear and comprehensive reform strategy was in place, especially in countries experiencing an unfolding financial crisis, may have indeed contributed to a more wide-ranging and stringent IMF conditionality. Concerns about the proper monitoring of a multifaceted process, such as banking sector reform, may have also led the IMF staff to be very detailed in defining structural conditionality, in particular in the case of countries with a poor track record.

It is difficult to say whether the increased conditionality was excessive. Yet, a number of programs, instead of limiting conditionality to broad policy, included very detailed, micro-level, conditions, such as defining the minimum level of capital adequacy above which undercapitalized banks could be allowed to operate (Ecuador), the reduction in the number of branches of two banks (Turkey), and setting specific targets for asset sales (Indonesia and Turkey). Concerns about the proper monitoring of the reform process, especially in the case of countries with a poor track record, may have contributed to these developments. National authorities, on the other hand, may have accepted ambitious reform programs being aware that a waiver would likely be granted in case of nonobservance.<sup>25</sup>

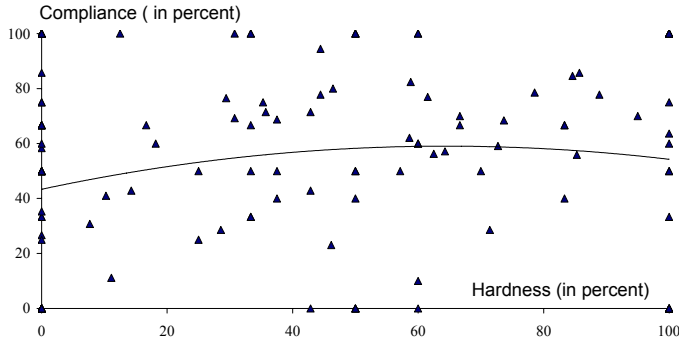
<sup>25</sup> The proliferation of waiver is analyzed in details in IMF (2005b).



A number of studies have emphasized that excessive conditionality can weaken national

ownership of a policy program and thus undermine its implementation.<sup>26</sup> This can be pictured by plotting the compliance indicator against both the hardness and the intensity indicators. As shown in Figure 6 and Figure 7, compliance seems to be positively correlated with hardness and intensity at relatively low values of these variables. However, this positive relationship tends to be reversed when the hardness and intensity of conditionality reach high levels.

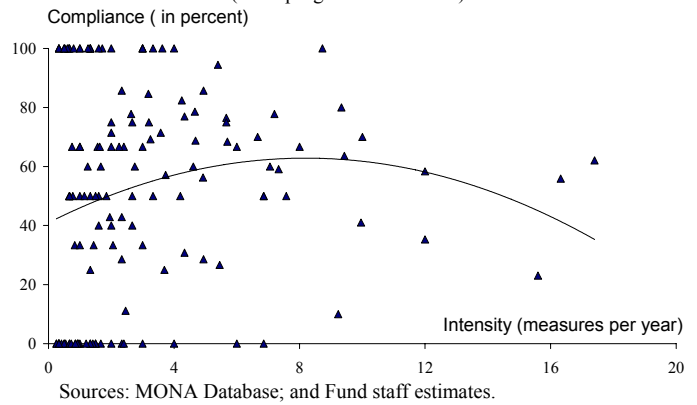
**Figure 6. Compliance vs. Hardness**  
(Fund programs 1995-2003)



Sources: MONA Database; and Fund staff estimates.

Looking at IMF-supported programs in general, Ivanova and others (2003) conclude that the extent and structure of conditionality are irrelevant to the probability of success of a IMF arrangement. Program implementation depends primarily upon the domestic political economy of borrowing countries. In particular, strong vested interests, political instability, bureaucracy inefficiency, and ethnic fragmentation are among the main impediments to program implementation.

**Figure 7. Compliance vs. Intensity**  
(Fund programs 1995-2003)



Sources: MONA Database; and Fund staff estimates.

Compliance with banking sector conditionality does not compare favorably with other structural reforms. For instance, a recent study on trade conditionality in IMF-supported programs found out that, over the 1990–2004 period, 71 percent of trade-related conditions were implemented on time and about 20 percent were implemented with delay or rescheduled (IMF, 2005a). Although the two samples and methodologies are not wholly comparable, we observe that only 58 percent of banking sector program-related conditions was met as originally scheduled and an additional 12 percent were implemented with delay (Table 3). Similarly, if we compare our findings with those of the recent review of IMF conditionality (IMF, 2005b), the implementation index for banking sector conditionality does not compare favorably with the ones calculated for the whole set of structural conditionality (Table 4).

<sup>26</sup> See, for instance, Kenen (2000), Boughton (2003), and Goldstein (2003).

Table 3. Implementation of Banking Sector Conditionality, 1995–2003

(In percent of total number of measures over the 1995–2003 period)

|                                       | Number of<br>Measures | Met         | Met With<br>Delay | Not Met     | No<br>Information |
|---------------------------------------|-----------------------|-------------|-------------------|-------------|-------------------|
| <b>Total banking sector measures</b>  | <b>937</b>            | <b>58.1</b> | <b>12.2</b>       | <b>11.0</b> | <b>18.8</b>       |
| Containment and liquidity management  | 29                    | 79.3        | 6.9               | 6.9         | 6.9               |
| Restructuring                         | 440                   | 55.9        | 12.5              | 14.1        | 17.5              |
| <i>Of which: privatization</i>        | 115                   | 35.7        | 22.6              | 23.5        | 18.3              |
| Asset management                      | 63                    | 44.4        | 12.7              | 12.7        | 30.2              |
| Laws and by-laws                      | 101                   | 53.5        | 19.8              | 4.0         | 22.8              |
| Prudential regulation and supervision | 276                   | 63.8        | 9.1               | 8.7         | 18.5              |
| Banking data or other information     | 15                    | 46.7        | 13.3              | 13.3        | 26.7              |
| Other banking                         | 13                    | 76.9        | 15.4              | 7.7         | 0.0               |

Sources: MONA database; and IMF staff estimates.

Table 4. Implementation Index of Structural Conditionality 1/

|           | Banking Sector<br>Conditionality | All Structural Reforms     |                             |                  |
|-----------|----------------------------------|----------------------------|-----------------------------|------------------|
|           |                                  | Performance<br>Criteria 2/ | Structural<br>Benchmarks 2/ | Prior Actions 2/ |
| 1995–1997 | 1.29                             | 1.39–1.37                  | 1.29–1.43                   | 1.59–1.82        |
| 1998–2000 | 1.02                             | 1.36–1.37                  | 1.36–1.35                   | 1.85–1.83        |
| 2001–2003 | 1.12                             | 1.35–1.44                  | 1.34–1.42                   | 1.92–1.97        |

Sources: MONA database; IMF (2005b); and IMF staff estimates.

1/ The index assigns a weight of 2 to measures implemented on time, 1 to measures implemented late or rescheduled, and 0 to measures not implemented.

2/ The first number refers to Stand-By Arrangement and EFF; the second one refers to ESAF and PRGF.

Looking at the individual components of banking sector conditionality, the areas in which program implementation was more problematic are those of “privatization” and “asset management.” A number of factors may have had a bearing on this result, including hurdles created by vested interests, deficiencies in the legal and judicial framework, not always fully recognized in designing IMF programs,<sup>27</sup> and the weak economic environment distinguishing program countries.

We also find that banking sector conditionality differs across types of IMF-arrangements. As shown in Table 5, GRA-supported arrangements (Stand-By Arrangements and EFFs) have included much higher number of structural conditions on the banking sector than programs for low-income countries (ESAFs and PRGFs), reflecting the fact that systemic banking crisis have affected more emerging market and middle-income countries, for which Stand-By Arrangements and EFFs are typical. These differences are statistically significant only in the case of the intensity indicator. However, this implies that even though the share of prior actions and performance criteria is not statistically different between the two groups of IMF arrangements, the conditionality has been more stringent in GRA-supported arrangements due to the higher number of more binding conditions (Table 6).<sup>28</sup>

Table 5. Banking Sector Conditionality by Type of IMF Arrangement, 1995–2003 1/  
(Sample averages)

| Type of IMF Arrangement  | Intensity | Hardness | Compliance |
|--|-----------|----------|------------|
| Stand-By Arrangements  | 4.2       | 39.2     | 49.1       |
| Extended IMF Facilities  | 3.2       | 30.5     | 54.2       |
| Enhanced Structural Adjustment Facility/ Poverty Reduction and Growth Facility | 2.0       | 36.0     | 52.0       |

Sources: MONA database; and IMF staff estimates.

1/ Excluding IMF-supported programs without banking sector conditionality.

Some differences in conditionality also emerge across geographic regions (Table 7). In particular, the intensity of conditionality has been higher in Asia, Central and Eastern Europe, and the Western Hemisphere than in Africa and the Middle East, where financial sector crises have been less prevalent.

<sup>27</sup> See, for example, the ex post assessment on Turkey.

<sup>28</sup> If we apply the same test to a new conditionality indicator, which is a linear combination of the hardness and the intensity indicators, we find that the sample averages of this new indicator are significantly different between the two groups of IMF programs, thus confirming that structural conditionality has been more stringent for GRA-supported arrangements.

Table 6. Banking Sector Conditionality:  
Tests on IMF Arrangement Averages, 1995–2003 1/

|                           | Intensity | Hardness | Compliance |
|---------------------------|-----------|----------|------------|
| Stand-By Arrangement, EFF |           |          |            |
| Averages                  | 4.0       | 37.4     | 50.2       |
| Variances                 | 14.4      | 1,590.9  | 1,208.8    |
| Number of observations    | 81        | 81       | 81         |
| ESAF, PRGF                |           |          |            |
| Averages                  | 2.0       | 36.0     | 52.0       |
| Variances                 | 3.5       | 1,134.2  | 1,413.3    |
| Number of observations    | 65        | 65       | 65         |
| T-student 2/              | 4.23      | 0.23     | -0.29      |
| Degree of freedom         | 122       | 144      | 132        |

Sources: MONA database; and IMF staff estimates.

1/ Excluding IMF-supported programs without banking sector conditionality.

2/ For intensity, significant at 1 percent.

Table 7. Banking Sector Conditionality by Region, 1995–2003 1/

(Sample averages)

|                                    | Intensity | Hardness | Compliance |
|------------------------------------|-----------|----------|------------|
| Africa                             | 1.3       | 34.4     | 50.9       |
| Central and Eastern Europe         | 4.5       | 38.4     | 59.6       |
| Commonwealth of Independent States | 2.8       | 35.9     | 59.7       |
| Asia                               | 5.2       | 50.3     | 42.7       |
| Middle East                        | 1.0       | 42.0     | 52.0       |
| Western Hemisphere                 | 3.8       | 32.1     | 41.0       |

Sources: MONA database; and IMF staff estimates.

1/ Excluding IMF-supported programs without banking sector conditionality.

A test based on single-factor analysis of variance (ANOVA) confirms that the intensity of banking sector conditionality has been significantly different among programs grouped by geographical criteria (Table 8). This difference, however, does not emerge in the case of the hardness of conditionality and its compliance.<sup>29</sup>

Table 8. Banking Sector Conditionality: Tests on Regional Averages 1/

| Source of Variation | Standard Deviation | Degrees of Freedom | Variances | F (5,152) |
|---------------------|--------------------|--------------------|-----------|-----------|
| <b>Intensity</b>    |                    |                    |           |           |
| Between regions 2/  | 297.4              | 5                  | 59.5      | 6.81 (*)  |
| Within regions      | 1,223.1            | 140                | 8.7       |           |
| <b>Hardness</b>     |                    |                    |           |           |
| Between regions     | 3,931.6            | 5                  | 786.3     | 0.56      |
| Within regions      | 196,001.0          | 140                | 1,400.0   |           |
| <b>Compliance</b>   |                    |                    |           |           |
| Between regions     | 8,223.6            | 5                  | 1,664.7   | 1.29      |
| Within regions      | 179,043.6          | 140                | 1,278.9   |           |

Sources: MONA database; and IMF staff estimates.

1/ Excluding IMF-supported programs without banking sector conditionality.

2/ For F (5,152) intensity between regions, significant at 1 percent.

#### D. Panel Analysis

Conditionality is only useful to the extent that it actually fosters a stronger banking sector. An interesting question, therefore, is whether differences in the degree of intensity, hardness, and compliance in banking sector conditionality contribute to explain dissimilarities in banking sector performance in program countries.

To shed some light on this issue, we consider three different aspects of banking sector performance: its profitability, its intermediation capacity, and the degree of depositors' confidence.<sup>30</sup> Specifically, we estimate regressions with three different dependent variables:

- The average return on assets (ROAA), as an indicator of bank profitability.

<sup>29</sup> If we apply the same test to the combined indicator of hardness an intensity of conditionality, the resulting statistic is close to the significant level, thus corroborating the view that banking sector conditionality has been different among regions.

<sup>30</sup> Similar variables were chosen by Dziobek and Pazarbaşıoğlu (1997).

- The change in bank credit to the private sector in percent of GDP ( $\Delta CR/Y$ ) as a proxy for the intermediation capacity of the banking sector.
- The change in bank deposits in percent of GDP ( $\Delta D/Y$ ), as a measure of depositors' confidence on the banking sector stability.

These variables are regressed against the three conditionality indexes (intensity, hardness, and compliance); two indicators of balance sheet strength, and real output growth:

- The coefficients for intensity, hardness, and compliance are expected to be positive.<sup>31</sup> The hypothesis is that a “strong” IMF-supported program (as indicated by high values of the three conditionality indicators) would lead to better results in terms of recovery in banking sector profitability, in its capacity to lend to the private sector, as well as in its ability to attract depositors.
- The capital asset ratio ( $K/A$ ) is expected to assume a positive coefficient whereas the ratio of nonearning assets to bank capital ( $NEA/K$ ) should have a negative coefficient.<sup>32</sup> The basic assumption is that, other things equal, a more resilient banking sector—that is a banking sector showing a higher degree of capitalization and a lower burden of nonearning assets—would be in a better position to invest in riskier assets, such as loans to the private sector, and hence earn a higher rate of return.<sup>33</sup> A sounder banking sector would also be able to attract or regain depositors.
- The real GDP growth variable is included as a proxy of banks operating environment which can improve as a consequence of the macroeconomic stabilization program supported by the IMF and/or exogenous factors such as a positive terms-of-trade shock.

To mitigate possible simultaneity problems, all the right-hand-side variables are lagged one period (one year). Accordingly, the panel regressions take the following forms:

$$P_{it} = \beta_0 + \beta_1 I_{it-1} + \beta_2 H_{it-1} + \beta_3 C_{it-1} + \beta_4 (K/A)_{it-1} + \beta_5 (NEA/K)_{it-1} + \beta_6 RG_{it-1} \quad (4)$$

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<sup>31</sup> We have to make the bold assumption that the three conditionality indicators are constant during the whole program. If a program starts in the second half of a year, it is assumed that the effects start being felt in the following year. Analogous hypothesis is made as far as the end year is concerned. If two subsequent programs happen to end and start in the same year, a weighted average of the indicators was calculated for the year at issue.

<sup>32</sup> Similar assumptions are made in Baqir (2004). The aggregate nonearning assets include fixed assets, other nonearning assets, and impaired loans.

<sup>33</sup> In extreme circumstances, undercapitalized banks striving for survival may be willing to bet on high-risk investment hoping to gain a higher rate of return. In this case, the capital-asset ratio variable should take a negative coefficient.

where  $P_{it}$  denotes one of the three bank performance indicators mentioned above. Because of the constraint imposed by data availability, our sample is based on 32 countries representing 103 IMF-supported programs over the 1996–2003 period. We also consider a more limited sample, selecting only those countries which experienced a systemic banking crisis in the considered period. The results are reported in Table 9.<sup>34</sup>

In broad terms, the results of the panel regressions tend to confirm that IMF-programs matter to banking sector performance. Indeed, the compliance indicator assumes a positive coefficient, significantly different from zero, in all regressions. Interestingly, the coefficients of both the intensity and hardness indicators are in most cases negative, although not always significantly different from zero. These results suggest that, although the IMF's banking sector reform strategy proves to be correct overall, increases in the intensity and hardness of IMF conditionality may not be, *ceteris paribus*, effective. This is consistent with the view that country "ownership" is important for successful program results and that selectivity in conditionality may be desirable.

The results for the other variables are mixed. The coefficients of the two balance sheet variables have the expected signs and both are significantly different from zero in the equation explaining average return on assets. This suggests that, in case of a shock to the banking sector, the process of financial restructuring has, on average, fairly rapid effects on banking sector performance. In fact, in many countries that suffered a banking sector crisis, the average return on assets of the banking system shows a V-shape over time: it initially falls quite sharply, reflecting the identification of current as well as hidden losses, and then recovers, taking between one and three years to return on positive territory or around values prevailing before the crisis. However, the bank balance sheet variables have statistically significant wrong signs in the regressions for credit to the private sector and deposit growth.<sup>35</sup> In the former case, the results may be capturing the boom and bust of a credit bubble, when an expansion in bank lending to the private sector is associated with a deterioration in bank balance sheet. Indeed, when the balance sheet variables are lagged by two years, they assume the expected coefficients, although the coefficient for the capital-to-asset variable is not significantly different from zero.<sup>36</sup>

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<sup>34</sup> A test on fixed effects indicates that data can be pooled in the case of the regression on the average rate of return on assets. Fixed (i.e., country-specific) effects have to be considered in the other regressions.

<sup>35</sup> In the case of the smaller sample of "crisis countries," the asset-to-capital ratio continues to assume the wrong negative coefficient whereas the ratio of nonearning assets to capital takes the correct negative coefficient.

<sup>36</sup> In the case of "crisis countries" sample, a similar regression does yield better results. The coefficient of the capital-to-asset variable maintains a negative coefficient, although not significant, while the nonearning asset variable assumes, as in the original specification of the regression, the expected negative coefficient, which is significantly different from zero.

Table 9. IMF Structural Conditionality and Bank Performance: Econometric Results

|                             | Whole Sample                           |                                |                                |                                | Crisis Countries               |                                |                                |                                |
|-----------------------------|--|--------------------------------|--------------------------------|--------------------------------|--------------------------------|--------------------------------|--------------------------------|--------------------------------|
|                             | ROAA                                   | ΔCR/Y                          | ΔD/Y                           | fixed effect                   | ROAA                           | ΔCR/Y                          | ΔD/Y                           | fixed effect                   |
| Constant                    | 0.22256<br><i>1.61787</i>              |                                |                                |                                | 0.35007<br><i>1.28105</i>      |                                |                                |                                |
| Intensity (-1)              | 0.03172<br><i>1.61962</i>              | -0.30865<br><i>-4.72434</i> 1/ | -0.16103<br><i>-1.42125</i>    |                                | -0.00399<br><i>-0.06761</i>    | -0.46776<br><i>-4.49995</i> 1/ | -0.02246<br><i>-0.34022</i>    | -0.19799<br><i>-2.28249</i> 2/ |
| Hardness (-1)               | -0.00440<br><i>-4.58001</i> 1/         | -0.01412<br><i>-1.53597</i>    | -0.00794<br><i>-1.47114</i>    |                                | -0.00608<br><i>-4.53945</i> 1/ | 0.00516<br><i>0.57786</i>      | -0.04691<br><i>-4.97922</i> 1/ | 0.00524<br><i>0.51735</i>      |
| Compliance (-1)             | 0.00282<br><i>5.32042</i> 1/           | 0.02029<br><i>4.31287</i> 1/   | 0.01417<br><i>3.13362</i> 1/   |                                | 0.12152<br><i>2.10412</i> 2/   | 0.03998<br><i>4.92308</i> 1/   | 0.03785<br><i>4.10325</i> 1/   | 0.01336<br><i>2.10025</i> 2/   |
| Capital asset ratio (-1)    | 0.07151<br><i>4.89961</i> 1/           | -0.01076<br><i>-0.51584</i>    | -0.04116<br><i>-0.26870</i> 1/ |                                | 0.10525<br><i>7.29689</i> 1/   | -0.24003<br><i>-3.53307</i> 1/ |                                | -0.26049<br><i>-4.41845</i> 1/ |
| Nonearning asset ratio (-1) | -0.00073<br><i>-2.48345</i> 1/         | 0.00276<br><i>11.64651</i> 1/  | 0.00531<br><i>5.70558</i> 1/   |                                | -0.00437<br><i>-3.52447</i> 1/ | -0.01600<br><i>-6.46378</i> 1/ |                                | -0.00983<br><i>-2.14314</i> 2/ |
| Capital asset ratio (-2)    |  |                                |                                |                                |                                |                                |                                |                                |
|                             |  |                                |                                | 0.03329<br><i>0.04598</i>      |                                |                                |                                |                                |
|                             |  |                                |                                | -0.00179<br><i>-2.21463</i> 2/ |                                |                                |                                |                                |
| Nonearning asset ratio (-2) |  |                                |                                |                                |                                |                                |                                |                                |
|                             |  |                                |                                |                                |                                |                                |                                |                                |
| Growth (-1)                 | 0.01076<br><i>1.45238</i>              | 0.03543<br><i>1.41832</i>      | 0.01496<br><i>1.89571</i>      |                                | 0.00228<br><i>0.01120</i>      | 0.11200<br><i>2.95684</i> 1/   | 0.14090<br><i>2.65111</i> 1/   | 0.04488<br><i>2.88314</i> 1/   |
| AR(1)                       | 0.51104<br><i>9.15082</i> 1/           | -0.55618<br><i>-1.31848</i>    | 0.11368<br><i>1.92479</i> 3/   |                                |                                | -0.24092<br><i>-2.54001</i> 1/ | -0.16626<br><i>-1.90013</i> 2/ | -0.09930<br><i>-2.63813</i> 1/ |
| Method                      | Pooled EGLS (Cross-section weights)    |                                |                                |                                |                                |                                |                                |                                |
| Sample                      | Robust coefficient covariances methods |                                |                                |                                |                                |                                |                                |                                |
|                             | 32 countries; 103 IMF programs;        |                                |                                |                                |                                |                                |                                |                                |
|                             | Annual data;                           | Annual data;                   | Annual data;                   | Annual data;                   | Annual data;                   | Annual data;                   | Annual data;                   | Annual data;                   |
|                             | 1998-2003                              | 1998-2003                      | 1998-2003                      | 1998-2003                      | 1997-2003                      | 1998-2003                      | 1998-2003                      | 1998-2003                      |
| Number of observations      | 192                                    | 192                            | 192                            | 192                            | 112                            | 96                             | 80                             | 96                             |
| Adjusted R-squared          | 0.88991                                | 0.86356                        | 0.86975                        | 0.86975                        | 0.71269                        | 0.84593                        | 0.95417                        | 0.88189                        |
| Durbin-Watson               | 2.12143                                | 1.91848                        | 1.91955                        | 2.05735                        | 1.73516                        | 2.16331                        | 2.17484                        | 2.12036                        |
| F-statistic                 | 221.56180                              | 32.81358                       | 35.47010                       | 95.63361                       | 46.88928                       | 24.70841                       | 75.75735                       | 33.24102                       |
| Prob(F-statistic)           | 0.00000                                | 0.00000                        | 0.00000                        | 0.00000                        | 0.00000                        | 0.00000                        | 0.00000                        | 0.00000                        |

Sources: Bankscope; WEO, and IFS.

1/ Significant at 1 percent.

2/ Significant at 5 percent.

3/ Significant at 10 percent.



This implies that, on average, bank restructuring, which results in an improvement in the balance sheet conditions of the banking sector, does not lead to an immediate recovery in bank lending to the private sector. The process requires some time. As for the real growth variable, while it assumes the correct positive coefficient in all regression, its explanatory power varies across the different regressions.

## V. CONCLUSIONS

IMF conditionality in the banking sector has been an important driving force behind the overall growth in IMF structural conditionality, but it has not received a great deal of attention in the literature. This paper tries to fill this gap.

To investigate IMF banking sector conditionality, we used the MONA database to construct three indexes to capture the key dimensions of conditionality: its intensity (number of policy actions per year); its “hardness” (share of prior actions and performance criteria); and its compliance (share of measures met as scheduled).

The results of our analysis can be summarized as follows:

- As expected, we found that IMF structural conditionality on the banking sector became more stringent following the Asian crisis. However, compliance remained broadly unchanged, comparing unfavorably with other structural reforms.
- Differences in the design of IMF conditionality seem to emerge comparing different types of IMF arrangements, as well as IMF-supported programs in different geographic areas.
- While compliance with IMF-supported banking sector reform strategies has contributed to an improvement in banking sector performance, increases in the hardness and intensity of IMF conditionality do not necessarily lead to higher compliance.

These statistical results suggest that too many conditions, and among them too many prior actions or performance criteria, might not be effective. Further flexibility in banking sector conditionality might, therefore, be useful in strengthening national ownership and performance. The results also support the view that the IMF should continue to strengthen its surveillance of financial sectors in order to help prevent crises. While significant steps in that direction have already been made with the FSAP exercise, consideration should also be given to ways to integrate surveillance and conditionality.

Table 10. FSC Database—Classification Key

**Central banking**

- CB1 = Central bank law
- CB2 = Money market
- CB3 = FOREX market
- CB4 = CB norms/reform
- CB5 = Other

**Banking sector measures**

- BS1 = Containment and liquidity management
  - BS11 = Set up coordination committee
  - BS12 = Apply blanket guarantee
  - BS13 = Remove blanket guarantee
  - BS14 = Measures improving system liquid.
  - BS15 = Measures liquidity contain.
  - BS16 = Apply deposit freeze
  - BS17 = Deposit de-freeze
  - BS18 = Other administrative (in)
  - BS19 = Other administrative (out)
- BS2 = Restructuring
  - BS20 = General
  - BS21 = Nationalization
  - BS22 = Bank intervention
  - BS23 = Conversion into commercial bank
  - BS24 = External audit/due diligence/specific inspections
  - BS25 = Privatization
    - BS251 = Administrative steps
    - BS252 = Effective privatization
  - BS26 = Merger
  - BS27 = Liquidation
  - BS28 = Capitalization
  - BS281 = Limitations on use public funds
  - BS29 = Restrictions on bank activities
- BS3 = Asset management
  - BS30 = General
  - BS31 = Loan restructuring
  - BS32 = Loan recovery/write offs
  - BS33 = Loan/asset liquidation
  - BS34 = AMC
    - BS341 = Creation
    - BS342 = Organization & finance
    - BS343 = Asset transfer
    - BS344 = Asset management
    - BS345 = Asset liquidation
    - BS346 = Others
- BS4 = Laws and by-laws
  - BS40 = General review of banking law
  - BS41 = Intervention powers
  - BS42 = Bank resolution (including insolvency)
  - BS43 = Deposit insurance
    - BS431 = Legal aspects
    - BS432 = Administrative aspects
  - BS44 = AML/CFT

Table 10. FSC Database—Classification Key

- BS45 = Other
- BS5 = Norms
  - BS50 = Strengthening supervision
    - BS501 = Powers/independence/capacity
    - BS502 = Implementation/compliance
    - BS503 = Consolidated supervision
    - BS504 = Other
  - BS51 = Loan classification and provisioning
    - BS511 = Change in norms
    - BS512 = Implementation
  - BS52 = Minimum capital
    - BS521 = Increase
    - BS522 = Implementation
  - BS53 = CAR
    - BS531 = Change in definition
    - BS532 = Increase
    - BS533 = Implementation
  - BS54 = Bank reserve requirement
    - BS541 = Change in norms
    - BS542 = Implementation
  - BS55 = Bank liquidity
    - BS551 = Change in norms
    - BS552 = Implementation
  - BS56 = Accounting norms
    - BS561 = Change in norms
    - BS562 = Implementation
  - BS7 = Foreign exchange exposure
    - BS571 = Change in norms
    - BS572 = Implementation
  - BS59 = Other
- BS6 = Banking data or other information
- BS7 = Other banking
- Other FSC measures**
  - OT1 = Bankruptcy law
  - OT2 = Corporate restructuring
  - OT21 = Debt work-out
  - OT3 = Other

Table 11. Countries in the FSC Database

| Country                  | Region                     | Type of Fund Arrangement | Board Date | Systemic Banking Crisis 1/ |
|--------------------------|----------------------------|--------------------------|------------|----------------------------|
| Albania                  | Central and Eastern Europe | PRGF                     | 5/12/1998  | No                         |
| Albania                  | Central and Eastern Europe | PRGF                     | 6/21/2002  | No                         |
| Algeria                  | Africa                     | EFF                      | 5/22/1995  | No                         |
| Argentina                | Western Hemisphere         | EFF                      | 2/4/1998   | Yes                        |
| Argentina                | Western Hemisphere         | SBA                      | 3/10/2000  | Yes                        |
| Argentina                | Western Hemisphere         | SBA                      | 1/24/2003  | Yes                        |
| Argentina                | Western Hemisphere         | SBA                      | 9/20/2003  | Yes                        |
| Armenia                  | CIS                        | SBA                      | 6/28/1995  | Yes                        |
| Armenia                  | CIS                        | ESAF                     | 2/14/1996  | Yes                        |
| Armenia                  | CIS                        | PRGF                     | 5/21/2001  | No                         |
| Azerbaijan               | CIS                        | SBA                      | 11/17/1995 | Yes                        |
| Azerbaijan               | CIS                        | EFF                      | 12/20/1996 | No                         |
| Azerbaijan               | CIS                        | PRGF                     | 7/2/2001   | No                         |
| Belarus                  | CIS                        | SBA                      | 9/12/1995  | No                         |
| Benin                    | Africa                     | ESAF                     | 8/28/1996  | No                         |
| Bolivia                  | Western Hemisphere         | PRGF                     | 9/18/1998  | No                         |
| Bolivia                  | Western Hemisphere         | SBA                      | 4/2/2003   | No                         |
| Bosnia & Herzegovina     | Central and Eastern Europe | SBA                      | 5/29/1998  | Yes                        |
| Bosnia & Herzegovina     | Central and Eastern Europe | SBA                      | 8/2/2002   | Yes                        |
| Brazil                   | Western Hemisphere         | SBA                      | 12/2/1998  | Yes                        |
| Brazil                   | Western Hemisphere         | SBA                      | 9/14/2001  | No                         |
| Brazil                   | Western Hemisphere         | SBA                      | 9/6/2002   | No                         |
| Bulgaria                 | Central and Eastern Europe | SBA                      | 4/11/1997  | Yes                        |
| Bulgaria                 | Central and Eastern Europe | EFF                      | 9/25/1998  | No                         |
| Bulgaria                 | Central and Eastern Europe | SBA                      | 2/27/2002  | No                         |
| Burkina Faso             | Africa                     | ESAF                     | 6/14/1996  | No                         |
| Cambodia                 | Asia                       | ESAF                     | 10/22/1999 | No                         |
| Cameroon                 | Africa                     | PRGF                     | 12/22/2000 | No                         |
| Cape Verde               | Africa                     | PRGF                     | 4/10/2002  | No                         |
| Central African Republic | Africa                     | ESAF                     | 7/20/1998  | Yes                        |
| Chad                     | Africa                     | PRGF                     | 1/7/2000   | No                         |
| Colombia                 | Western Hemisphere         | EFF                      | 12/20/1999 | No                         |
| Colombia                 | Western Hemisphere         | SBA                      | 1/15/2003  | No                         |
| Congo                    | Africa                     | PRGF                     | 6/13/2002  | No                         |
| Costa Rica               | Western Hemisphere         | SBA                      | 11/29/1995 | No                         |
| Cote d'Ivoire            | Africa                     | PRGF                     | 4/2/2002   | No                         |
| Croatia                  | Central and Eastern Europe | EFF                      | 3/12/1997  | No                         |
| Croatia                  | Central and Eastern Europe | SBA                      | 3/19/2001  | No                         |
| Croatia                  | Central and Eastern Europe | SBA                      | 2/3/2003   | No                         |
| Djibouti                 | Africa                     | SBA                      | 4/15/1996  | No                         |
| Djibouti                 | Africa                     | PRGF                     | 10/18/1999 | No                         |

Table 11. Countries in the FSC Database

| Country                | Region                     | Type of Fund Arrangement | Board Date | Systemic Banking Crisis 1/ |
|------------------------|----------------------------|--------------------------|------------|----------------------------|
| Ecuador                | Western Hemisphere         | SBA                      | 4/19/2000  | Yes                        |
| Ecuador                | Western Hemisphere         | SBA                      | 3/21/2003  | Yes                        |
| Egypt                  | Middle East                | SBA                      | 10/11/1996 | No                         |
| Egypt                  | Central and Eastern Europe | SBA                      | 7/29/1996  | No                         |
| Estonia                | Central and Eastern Europe | SBA                      | 12/17/1997 | No                         |
| Estonia                | Central and Eastern Europe | SBA                      | 3/1/2000   | No                         |
| Ethiopia               | Africa                     | ESAF                     | 10/11/1996 | No                         |
| Ethiopia               | Africa                     | PRGF                     | 3/20/2001  | No                         |
| Gabon                  | Africa                     | SBA                      | 10/23/2000 | No                         |
| Gambia, The            | Africa                     | PRGF                     | 6/29/1998  | No                         |
| Georgia                | CIS                        | SBA                      | 6/28/1995  | No                         |
| Georgia                | CIS                        | ESAF                     | 2/28/1996  | No                         |
| Georgia                | CIS                        | PRGF                     | 1/12/2001  | No                         |
| Ghana                  | Africa                     | ESAF                     | 6/30/1995  | No                         |
| Ghana                  | Africa                     | ESAF                     | 5/3/1999   | No                         |
| Ghana                  | Africa                     | PRGF                     | 5/12/2003  | No                         |
| Guatemala              | Western Hemisphere         | SBA                      | 4/1/2002   | No                         |
| Guatemala              | Western Hemisphere         | SBA                      | 6/19/2003  | No                         |
| Guinea                 | Africa                     | PRGF                     | 1/13/1997  | No                         |
| Guinea                 | Africa                     | PRGF                     | 5/2/2001   | No                         |
| Guinea-Bissau          | Africa                     | ESAF                     | 1/18/1995  | Yes                        |
| Guinea-Bissau          | Africa                     | PRGF                     | 12/15/2000 | No                         |
| Guyana                 | Western Hemisphere         | ESAF                     | 7/15/1998  | No                         |
| Guyana                 | Western Hemisphere         | PRGF                     | 9/13/2002  | No                         |
| Haiti                  | Western Hemisphere         | SBA                      | 3/8/1995   | No                         |
| Haiti                  | Western Hemisphere         | ESAF                     | 10/15/1996 | No                         |
| Honduras               | Western Hemisphere         | ESAF                     | 3/26/1999  | No                         |
| Indonesia              | Asia                       | SBA                      | 11/5/1997  | Yes                        |
| Indonesia              | Asia                       | EFF                      | 8/25/1998  | Yes                        |
| Indonesia              | Asia                       | EFF                      | 2/4/2000   | Yes                        |
| Jordan                 | Middle East                | EFF                      | 4/15/1999  | No                         |
| Jordan                 | Middle East                | SBA                      | 9/13/2002  | No                         |
| Kazakhstan             | CIS                        | SBA                      | 6/5/1995   | No                         |
| Kazakhstan             | CIS                        | EFF                      | 7/17/1996  | No                         |
| Kazakhstan             | CIS                        | EFF                      | 12/13/1999 | No                         |
| Kenya                  | Africa                     | ESAF                     | 4/26/1996  | No                         |
| Kenya                  | Africa                     | PRGF                     | 8/4/2000   | No                         |
| Kenya                  | Africa                     | PRGF                     | 11/21/2003 | No                         |
| Kenya                  | Asia                       | SBA                      | 12/4/1997  | Yes                        |
| Kyrgyz Republic        | CIS                        | PRGF                     | 6/26/1998  | Yes                        |
| Kyrgyz Republic        | CIS                        | PRGF                     | 12/6/2001  | Yes                        |
| Lao People's Dem. Rep. | Asia                       | PRGF                     | 4/25/2001  | No                         |

Table 11. Countries in the FSC Database

| Country            | Region                     | Type of Fund Arrangement | Board Date | Systemic Banking Crisis 1/ |
|--------------------|----------------------------|--------------------------|------------|----------------------------|
| Latvia             | Central and Eastern Europe | SBA                      | 12/10/1999 | Yes                        |
| Latvia             | Central and Eastern Europe | SBA                      | 4/20/2001  | Yes                        |
| Lesotho            | Africa                     | SBA                      | 7/31/1995  | No                         |
| Lesotho            | Africa                     | PRGF                     | 3/9/2001   | No                         |
| Lithuania          | Central and Eastern Europe | SBA                      | 3/8/2000   | No                         |
| Macedonia (FYR)    | Central and Eastern Europe | SBA                      | 5/5/1995   | No                         |
| Macedonia (FYR)    | Central and Eastern Europe | ESAF                     | 4/14/1997  | No                         |
| Macedonia (FYR)    | Central and Eastern Europe | EFF                      | 11/29/2000 | No                         |
| Macedonia (FYR)    | Central and Eastern Europe | SBA                      | 4/30/2003  | No                         |
| Madagascar         | Africa                     | ESAF                     | 11/27/1996 | No                         |
| Madagascar         | Africa                     | PRGF                     | 3/1/2001   | No                         |
| Malawi             | Africa                     | ESAF                     | 10/18/1995 | No                         |
| Malawi             | Africa                     | PRGF                     | 12/21/2000 | No                         |
| Mali               | Africa                     | ESAF                     | 4/10/1996  | No                         |
| Mali               | Africa                     | ESAF                     | 8/6/1999   | No                         |
| Mauritania         | Africa                     | ESAF                     | 1/25/1995  | No                         |
| Mauritania         | Africa                     | ESAF                     | 7/21/1999  | No                         |
| Mauritania         | Africa                     | PRGF                     | 7/18/2003  | No                         |
| Mexico             | Western Hemisphere         | SBA                      | 7/7/1999   | No                         |
| Moldova            | CIS                        | SBA                      | 3/22/1995  | No                         |
| Moldova            | CIS                        | EFF                      | 5/20/1996  | No                         |
| Moldova            | CIS                        | PRGF                     | 12/15/2000 | No                         |
| Mongolia           | CIS                        | ESAF                     | 7/30/1997  | No                         |
| Mongolia           | CIS                        | PRGF                     | 9/28/2001  | No                         |
| Mozambique         | Africa                     | ESAF                     | 6/21/1996  | No                         |
| Mozambique         | Africa                     | ESAF                     | 6/28/1999  | No                         |
| Nepal              | Africa                     | PRGF                     | 11/24/2003 | No                         |
| Nicaragua          | Western Hemisphere         | ESAF                     | 3/18/1998  | No                         |
| Nicaragua          | Western Hemisphere         | PRGF                     | 12/13/2002 | No                         |
| Pakistan           | Asia                       | SBA                      | 12/15/1995 | No                         |
| Pakistan           | Asia                       | ESAF                     | 10/20/1997 | No                         |
| Pakistan           | Asia                       | SBA                      | 11/29/2000 | No                         |
| Pakistan           | Asia                       | PRGF                     | 12/7/2001  | No                         |
| Panama             | Western Hemisphere         | EFF                      | 12/10/1997 | No                         |
| Panama             | Western Hemisphere         | SBA                      | 6/30/2000  | No                         |
| Papua New Guinea   | Africa                     | SBA                      | 3/29/2000  | No                         |
| Paraguay           | Western Hemisphere         | SBA                      | 12/15/2003 | No                         |
| Peru               | Western Hemisphere         | SBA                      | 2/1/2002   | No                         |
| Philippines        | Asia                       | SBA                      | 4/1/1998   | Yes                        |
| Romania            | Central and Eastern Europe | SBA                      | 4/22/1997  | Yes                        |
| Romania            | Central and Eastern Europe | SBA                      | 8/5/1999   | Yes                        |
| Romania            | Central and Eastern Europe | SBA                      | 10/31/2001 | Yes                        |
| Russian federation | CIS                        | SBA                      | 4/11/1995  | Yes                        |

Table 11. Countries in the FSC Database

| Country             | Region                     | Type of Fund Arrangement | Board Date | Systemic Banking Crisis 1/ |
|---------------------|----------------------------|--------------------------|------------|----------------------------|
| Russian federation  | CIS                        | EFF                      | 3/26/1996  | Yes                        |
| Russian federation  | CIS                        | SBA                      | 7/28/1999  | Yes                        |
| Rwanda              | Africa                     | PRGF                     | 6/24/1998  | No                         |
| Sao Tome & Principe | Africa                     | PRGF                     | 4/28/2000  | No                         |
| Serbia & Montenegro | Central and Eastern Europe | EFF                      | 5/13/2002  | No                         |
| Sri Lanka           | Asia                       | SBA                      | 4/30/2001  | No                         |
| Sri Lanka           | Asia                       | PRGF                     | 4/18/2003  | No                         |
| Tajikistan          | CIS                        | PRGF                     | 6/24/1998  | No                         |
| Tanzania            | Africa                     | ESAF                     | 11/8/1996  | Yes                        |
| Tanzania            | Africa                     | PRGF                     | 4/5/2000   | No                         |
| Thailand            | Asia                       | SBA                      | 8/20/1997  | Yes                        |
| Turkey              | Central and Eastern Europe | SBA                      | 12/22/1999 | Yes                        |
| Turkey              | Central and Eastern Europe | SBA                      | 2/4/2002   | Yes                        |
| Uganda              | Africa                     | ESAF                     | 11/10/1997 | Yes                        |
| Uganda              | Africa                     | PRGF                     | 9/13/2002  | Yes                        |
| Ukraine             | CIS                        | SBA                      | 4/7/1995   | No                         |
| Ukraine             | CIS                        | SBA                      | 5/10/1996  | Yes                        |
| Ukraine             | CIS                        | SBA                      | 8/25/1997  | Yes                        |
| Ukraine             | CIS                        | EFF                      | 9/4/1998   | Yes                        |
| Uruguay             | Western Hemisphere         | SBA                      | 6/20/1997  | No                         |
| Uruguay             | Western Hemisphere         | SBA                      | 3/29/1999  | No                         |
| Uruguay             | Western Hemisphere         | SBA                      | 5/31/2000  | Yes                        |
| Uruguay             | Western Hemisphere         | SBA                      | 3/25/2002  | Yes                        |
| Venezuela           | Western Hemisphere         | SBA                      | 7/12/1996  | No                         |
| Vietnam             | Asia                       | PRGF                     | 4/13/2001  | Yes                        |
| Yemen               | Middle East                | SBA                      | 3/20/1996  | Yes                        |
| Yemen               | Middle East                | EFF                      | 10/29/1997 | No                         |
| Yugoslavia          | Central and Eastern Europe | SBA                      | 6/11/2001  | No                         |
| Zambia              | Africa                     | ESAF                     | 12/6/1995  | Yes                        |
| Zambia              | Africa                     | PRGF                     | 3/26/1999  | No                         |
| Zimbabwe            | Africa                     | SBA                      | 6/1/1998   | Yes                        |
| Zimbabwe            | Africa                     | SBA                      | 8/2/1999   | Yes                        |
|                     |                            |                          |            | No                         |
|                     |                            |                          |            | No                         |

1/ According to Caprio and Klingebiel (2003).

Table 12. Financial Sector Conditionality Compliance, 1995–2003 1/

(In percent of total measures in each category)

|  | Met         | Met<br>With<br>Delay | Not<br>Met  | No<br>Information | Total        |
|--|-------------|----------------------|-------------|-------------------|--------------|
| <b>Total measures</b>                      | <b>58.8</b> | <b>12.6</b>          | <b>10.6</b> | <b>17.9</b>       | <b>100.0</b> |
| Central banking                            | 67.5        | 11.7                 | 7.8         | 13.1              | 100.0        |
| Central bank law                           | 57.6        | 15.2                 | 12.1        | 15.2              | 100.0        |
| Money market                               | 67.2        | 11.5                 | 9.8         | 11.5              | 100.0        |
| FOREX market                               | 74.1        | 11.1                 | 3.7         | 11.1              | 100.0        |
| Norms                                      | 46.2        | 23.1                 | 0.0         | 30.8              | 100.0        |
| Other                                      | 73.6        | 8.3                  | 6.9         | 11.1              | 100.0        |
| Banking sector                             | 58.1        | 12.2                 | 11.0        | 18.8              | 100.0        |
| Containment and liquidity management       | 79.3        | 6.9                  | 6.9         | 6.9               | 100.0        |
| Restructuring                              | 55.9        | 12.5                 | 14.1        | 17.5              | 100.0        |
| Asset management                           | 44.4        | 12.7                 | 12.7        | 30.2              | 100.0        |
| Laws and by-laws                           | 53.5        | 19.8                 | 4.0         | 22.8              | 100.0        |
| Norms                                      | 63.8        | 9.1                  | 8.7         | 18.5              | 100.0        |
| <i>Of which: strengthening supervision</i> | 54.5        | 10.1                 | 7.1         | 28.3              | 100.0        |
| Banking data or other information          | 46.7        | 13.3                 | 13.3        | 26.7              | 100.0        |
| Other                                      | 76.9        | 15.4                 | 7.7         | 0.0               | 100.0        |
| Other financial sector measures            | 41.0        | 23.0                 | 14.8        | 21.3              | 100.0        |
| Bankruptcy law                             | 13.3        | 40.0                 | 13.3        | 33.3              | 100.0        |
| Corporate restructuring                    | 0.0         | 50.0                 | 0.0         | 50.0              | 100.0        |
| Debt workout                               | 75.0        | 0.0                  | 25.0        | 0.0               | 100.0        |
| Other                                      | 50.0        | 17.5                 | 15.0        | 17.5              | 100.0        |

Sources: MONA Database; and IMF staff estimates.

1/ Excluding ongoing measures.



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