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**The International Monetary Fund, Conditionality, and the  
World Economic Crisis: New Beginning or False Dawn?**

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In recent weeks, the International Monetary Fund (hereafter IMF) has been a focus of activity as states attempt to craft a multilateral response to the global economic crisis.<sup>1</sup> At the heart of this response is not only a new infusion of capital from the developed world, but also proposed reforms to conditionality. Conditionality refers to the policies that countries are required to adopt in order to remain eligible to receive loan installments from the IMF.

In light of the very recent nature of the conditionality reforms, a preliminary appraisal of them is essential. In the pages that follow I will briefly summarize these reforms and consider their broader implications both for what we already know about IMF conditionality and also for international agreements more generally. The Managing Director suggested at the Spring Meetings that the global crisis is far from over. In a similar sense, issues relating to the balance between domestic ownership and external conditions, potential political influence over the Fund by great powers, and the IMF's legitimacy in low income countries remain unresolved.

These reforms, which were outlined for the public on March 24<sup>th</sup> following their approval by the Executive Board, have the following three elements. First, the manner in which conditionality and lending is delivered will be more tailored to country circumstances. Second, the manner in which conditionality is employed in loan documents is going to change, as structural performance criteria will no longer be used in IMF adjustment programs. Third, the IMF created a new lending instrument known as the Flexible Credit Line (hereafter FCL) which is intended to aid developing countries with strong macroeconomic fundamentals. The FCL is a replacement for the Fund's Short Term Lending Facility (SLF), which was created in response to

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<sup>1</sup> Thanks to Chandra DeNap for superb research assistance in the writing of this paper.

the economic crisis, and is intended to reduce country stigma associated with borrowing from the IMF.

The idea that conditions should be tailored to country circumstances is not new. The timing of how Fund resources are delivered, though, has changed. For countries using the Fund's conventional balance of payments support tool, the Stand-by Arrangement (SBA), the standard procedure is for tranches of the loan to be disbursed quarterly following a review of Fund performance criteria. The problem that this produces is that it does not make the SBA a good crisis prevention tool. Governments might want the reassurance of an IMF program to forestall a run on the currency or capital flight, and a program that is dependent on roughly equal loan installments coupled with quarterly reviews of performance does not send a strong signal of IMF support. In fact, investors can be left waiting on the IMF to conclude a program or a review. The East Asian crisis brought home the importance of aggressively supporting investor confidence through front-loading programs so that more money was available up front. Thus, the number of purchases under the program, the degree of front-loading of support, and the number of program reviews is now negotiable by countries and IMF staff. Offering more support upfront that is detached from a review of progress in implementing conditions helps investors more efficiently allocate assets. Making conditionality more flexible in practice now means that these options are available to more countries.

As noted above, the Fund is eliminating the use of structural performance criteria in all its agreements and moving issues relating to structural reforms to ongoing reviews of country programs. Structural performance criteria refer to institutional changes that are needed in support of an adjustment program, such as making the central bank more independent,

reforming the tax system, or changing the exchange rate from fixed to flexible. This procedural change means that countries that either do not implement or cannot implement these performance criteria do not have to ask for a waiver from the IMF executive board in order to move the program forward. This not only ensures that conditionality focuses on core economic variables rather than structural reforms, but it also means that countries cannot have their programs suspended in response to a failure to implement a structural performance criterion. So long as the country's *economic* performance criteria are in good shape, the program will move forward. This move is in response to criticism about the expansive growth of structural conditionality (Goldstein 2003) and concerns about the effects and effectiveness of structural conditionality more generally (Molina and Pereira 2008, IEO 2007).

In what it is perhaps the most important initiative, the Fund has created a new lending instrument known as the Flexible Credit Line. The FCL has two key differences that separate it from conventional Fund lending programs. First, it is based on *ex ante* conditionality. Instead of demonstrating commitment to adjustment by agreeing to conditions that will jeopardize the loan, countries have to qualify for the FCL by demonstrating strong macroeconomic policies.<sup>2</sup> Second, it is largely condition-free. Once a country has qualified, conditionality only is applied if the country wants 12 months of access to this credit line. In those circumstances, a review of the program is required. Otherwise, the entire amount of the credit line is available to the

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<sup>2</sup> The nine policies at the heart of qualifying for an FCL arrangement are as follows: a sustainable external position, a capital account position dominated by private flows, a track record of steady sovereign access to international capital markets at favorable terms, a reserve position that is relatively comfortable when the FCL is requested on a precautionary basis, sound public finances, including a sustainable public debt position, low and stable inflation, in the context of a sound monetary and exchange rate policy framework, the absence of bank solvency problems that pose an immediate threat of a systemic banking crisis, effective financial sector supervision; and data transparency and integrity. Countries with good records on these nine criteria and a strong previous Article IV consultation will be eligible. (<http://www.imf.org/external/np/pp/eng/2009/031909.pdf> at page 7)

country upon approval of the arrangement. As with the reform of the Stand By, this makes the FCL more of a tool for crisis prevention.

The final element in the conditionality reforms addresses reducing the stigma associated with entering an IMF program. These reforms largely consist of overhauling the Fund's repayment schedules so that the Fund's liquidity for future lending is ensured and that countries have flexibility in borrowing without having to repay the loan immediately.<sup>3</sup> In addition, the access limits to IMF resources have been raised, so that those countries looking to use the Fund on a precautionary basis will be able to take on larger loans as a means to signal their commitment to weathering the economic crisis.

Taken as a whole, these reforms are intended to make conditionality more flexible. In addition, they are intended to transform the Fund's role, not merely by providing the resources for countries to ride out the present economic crisis, but also by strengthening the Fund's influence over financial markets. I now turn to discuss each of these points.

One rationale for IMF conditionality is informational (Rodrik 1996). Developing countries have a difficult time signaling to outside actors that they are committed to economic adjustment. Negotiating a loan agreement with the IMF according to this argument helps attract external investment for two reasons. First, it signals to the outside world that the country has moved from adopting market inappropriate policies to market appropriate ones. Second, and more important, Fund programs are a "costly signal" because a state that breaches its commitment forfeits the remainder of the loan.

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<sup>3</sup> The three month repayment window for SLF was thought to be a barrier to countries using it (<http://www.imf.org/external/np/pp/eng/2009/031309A.pdf> at page 7)

Empirical studies of catalytic effects, however, do not find that IMF programs consistently produce them (Edwards 2005, 2006, Jensen 2004, Bird and Rowlands 1997, 2000, 2002, Mody and Saravia 2003). It is in this light that the rationale behind the creation of the FCL and its design becomes clear. The development of a new instrument based on country prequalification with minimum conditionality is intended to raise credibility with financial markets. Countries can only draw from the FCL if they've been pre-approved, and their pre-approval is based on country economic fundamentals. This ensures that countries that delay taking corrective actions cannot draw from it. Moreover, in the extant literature evaluating the catalytic effect, conditionality has an independent negative effect on capital flows.<sup>4</sup> The FCL, by contrast, does not require the imposition of traditional performance criteria that might be harmful to foreign investment inflows. For some countries, it might not require any Fund conditions at all.

Rather than require countries to choose from a conventional array of programs, the development of the FCL is intended for select borrowers.<sup>5</sup> Coupling this with the higher access limits makes plain that the Fund is positioning itself with middle income countries to become a lender of first resort for countries seeking to insulate themselves from the effects of the economic crisis. The amount of the loans in question, which are well in excess of country quotas, is intended to send a strong signal. The Mexico FCL, for example, is two and a half times bigger than the loan in response to the 1995 peso crisis (\$47 billion USD, 31.5 billion SDR).

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<sup>4</sup> This is not hard to understand. Mandating that a country adopt a "hard" monetary policy will require raising interest rates, which will harm potential domestic borrowers by increasing their cost of capital.

<sup>5</sup> It is no accident that while countries did not use the SLF, three countries agreed to an FCL with the Fund almost immediately (Mexico, Poland, and Colombia).

These changes in conditionality also bring with them important implications for the ability of states to implement Fund programs. The move toward eliminating structural performance criteria serves to reduce the “price” associated with Fund assistance. The significant commitment to the Fund in recent months by Japan, the EU, and the G-20 make clear that rumors of the IMF’s death are at best premature. At the same time, though, these changes bring with them three unanswered questions.

First, while these reforms are intended to restore global liquidity and give a greater role to the IMF in the area of crisis prevention, there has been a corresponding diminution of the importance of borrower ownership of adjustment programs. Ownership was a key buzzword in the reform of conditionality in 2005, and it is well worth noting that this term appears nowhere in these new guidelines. Turning the IMF into a body that does lends more to prevent crises rather than in response to crises raises questions about the future importance of program ownership. Over its history, the Fund has always had to manage tensions between purely being a lender and being an organization that helps countries strengthen domestic commitment. Making sure that programs are owned is not easy, since it implies that the Fund will need to say no to developing countries. In the present, this puts it at odds with a need to lend to help countries address the economic crisis. Moving to a menu of loan programs is going to force the IMF to make hard choices. Not all countries that want a FCL should be allowed to have them, but the IMF’s track record at tough talk is thin at best (Rogoff 2003; Mussa 2002). For the countries that won’t prequalify for FCL, the Fund will still need to ensure that the program has a strong likelihood of success for it to move forward.

In this manner, relaxing conditionality too much can pose more problems than it solves. A consistent rationale for conditionality is that it is used to aid reform minded governments that face domestic opposition. The key for this is that the Fund is committed to reform and willing to hold back funding so that domestic groups mute their opposition. In the present context, making conditionality “cheaper” (and by this I mean in a policy as well as in a financial sense) may increase the willingness of countries to use it, but it might mean less actual reform. This is especially a danger for the non-FCL countries since there is no ex ante conditionality.

Second, the move away from conditions and toward more flexibility might not be a good thing for those seeking to make sure that countries are treated equally by the IMF. That political influence over the Fund exists and that it matters is not disputed (Copelovitch 2007, Stone 2002, Thacker 1999). However, the move away from “hard” performance criteria toward “soft” reviews opens the door to more great power influence over the Fund. Because the threshold for program interruption is now going to be more opaque, this can heighten concerns over equality of treatment for all borrowers. In addition, a less transparent process can give rise to more manipulation of the process of assessing program compliance.

Finally, given that the reforms for conditionality for lower income countries are still in the pipeline for release this summer, what implications follow? It’s clear from this that the IMF is moving toward a vision of two tiers of conditionality – with some programs intended for middle income developing countries and the extant tools such as PRGF dedicated to lower income developing countries. While the changes noted above are profound, they are not likely to extend to the low income countries. There the development issues are more severe, the ability to obtain external financing is nonexistent, and the political barriers to reform are more

profound. Reforms that are based on relaxed conditionality or prequalification make little sense in these contexts, and the move from structural performance criteria to reviews will matter little in a day to day sense. In these countries, IMF conditionality will be changed only on the surface. This in turn raises broader questions about the role of the Fund in the north-south dialogue. Is a two-tiered conditionality ultimately “fair” to the interests of the least developed countries, or is it discriminatory? In this light, then, the Fund may seem reinvigorated to meet the challenges of the economic crisis, but whether it will continue to alter conditions to meet the needs of less developed clients is an open question. From the above, these reforms are promising, but they certainly pose new questions and new challenges for the Fund.

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