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The Institutional Failures of Bretton Woods Institutions Conditionality

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Abstract

The conditionality used by the Bretton Woods Institutions (BWIs) in their policy lending is one of the main theme of controversies in the debate on the new international financial architecture. Indeed, numerous empirical studies have highlighted the inefficacy of conditionality. From an economic policy perspective, BWIs conditionality seems to suffer from "mission creep", moral hazard and lack of credibility. In this paper, we propose an interpretation of the failures of conditionality based on a double perspective. On the one hand, we used a traditional public choice approach in order to stress the inefficacy of conditionality explained by intrinsic institutional failures, that is bureaucratic bias and inadequate incentive mechanisms. On the other hand, using an Austrian theory of institutions, we explain that a second cause of inefficacy comes from the fact that the current structural conditionality is unable to maintain the coherence of the institutional order in the recipient countries. We consequently propose a new approach of conditionality which suggest to dissociate the role of BWIs –more particularly of IMF- as financial backer and the one as adviser for countries confronted to the globalization process.

JEL codes: F3; N2

1. Introduction

Conditionality is a central feature of the BWIs' activities. Broadly defined, it is "a mechanism that links financing and policies" (IMF, 2001a: 4). Conditionality specifies policies, performance criteria and standards which borrowing countries must meet to receive resources from the Fund. Conditionality can be interpreted as a delegated monitoring tool in which the IMF acts to "substitute for the missing contracts between the Sovereign and individual foreign investors and to thereby help the host country to fully benefit from its capital account liberalization" (Tirole, 2002: 114-115).

Following Collier and others (1997), conditionality is based on five rationales. First, conditionality is an incentive mechanism to promote policies changes in the recipient country, changes not envisaged without the foreign aid. It is the "inducement" objective. Second, international financial institutions (IFIs) can lend only to countries with a good policy environment. It is the "selectivity" objective. Third, IFIs can follow a "paternalism" objective. The aid must be spent on particular goods or services. Fourth, conditionality can be used as a commitment device for government policies. It is the "restraint" objective whose the efficacy rests on the credibility of the threat. Finally, in a context of asymmetric information, governments can use conditionality as a "signalling" mechanism in the direction of foreign investors. Conditional aid is synonymous of good policies. These five rationales for conditional aid are not necessarily mutually compatible. Thus, IFIs has to find a trade-off between them. As we will see below, one of the main factor explaining the failures of conditionality is the over-reliance of the IMF on the first objective, that is conditionality as a means of inducing policies changes.

If initially conditionality was a vague notion in the Bretton Woods Agreements, it developed during the 50's with the expansion of IMF lending activities, and more particularly after 1979[1]. During the 80's and 90's, the IMF has been confronted to problems more and more complex such as debt crisis of developing countries, transition to market economy of socialist countries and the increased influence of international capital markets. As a consequence, binding conditions attached to IMF agreements become more and more sophisticated and numerous. "The mean value of the average number of binding conditions for arrangements initiated between 1952 and 1973 was 4.23; between 1974 and 1982 was 7.13; between 1983 and 1990 was 12.07 and between 1991 and 1995/2000 was 12.42" (Gould, 2001: 6)[2]. This trend, similar for the World Bank, has been accompanied by two movements.

On the one hand, the IMF has exerted an increasing influence in domestic affairs. The increasing use of procedures conditionality –instead of target conditionality- is a clear illustration of this process. Targets refer to measure –like a fiscal deficit limit- that can be meet by borrowing countries whatever the ways they choose. Procedures specify both ends and means by requiring countries to implement a single one-time action –for example a change in exchange rate regime and the adoption of new corporate governance principles. One consequence is that "procedures more directly dictate borrowing country policies, constrain domestic politicians and violate sovereignty" (Gould, 2001: 8)[3]. On the other hand,

[1]. The World Bank lends funds to developing countries borrowed in international capital markets. Conditional lending is thus more natural and based on traditional financial considerations.
[2]. See also, Goldstein (2000) and IMF (2001a) for statistical data.
[3]. After 1982, we observe a steadily increase of procedures conditionality.

as noticed by Kapur and Webb (2000), both IMF and World Bank introduce more and more governance-related conditionalities in their programs. The point is that this new form of conditionality implies institutional changes in countries under IMF programs or World Bank loans. It is a clear departure from the original purpose of conditionality, that is to protect the financial integrity of the IFIs. With the increasing number of conditions, the IMF is more and more involved in micro-managing while initially it focused on its core areas, that is monetary-fiscal macroeconomic issues.

If conditionality is nowadays at the heart of BWIs' activities, it is at the same time one of the main area of controversies of the debate on the new international financial architecture. Indeed more and more observers consider that conditionality is inefficient. Inefficiency appears mainly through the weak completion of IMF and World Bank programs. Mussa and Savastano (1999) studied for example 615 IMF arrangements over the 1973-1997 period and a sample composed of 5 industrial countries and 121 developing countries. Their main result is that more than a third of IMF programs ended with disbursements of less than half of the initially agreed support. More recent studies confirm these weak completion of IMF programs[4].

There is an extensive literature dedicated to the failure of the BWIs conditionality, and more particularly of the IMF conditionality[5]. The main arguments are the following. Firstly, the growing number of monitoring tools used by the IMF makes conditionality too complex. The IMF itself admits an "ambiguity about the boundaries of conditionality" (IMF, 2001a: 18). Secondly, the growing number of structural conditions means that conditionality is too intrusive, largely illegitimate and ineffective to induce policy changes. Feldstein (1998) stresses that IMF conditionality should be less ambitious, leaving to the legitimate political institutions the initiative to "determine the nation's economic structures and the nature of its institutions"[6]. Finally, the IMF underestimates the influence of initial conditions. Burnside and Dollar (2000) show that the efficacy of foreign aid depends on the initial policy environment: the impact of aid is greater the lower is the distortion on the environment. Moreover studies on IMF programs implementations suggest that domestic political factors exert a decisive influence. As a result, the current conditionality founded on "inducement"

[4]. See, Joyce (2003) and Ivanova and others (2003).
[5]. See Goldstein (2000) for an overview.
[6]. The increasing number of IMF's objectives would lead the institution to suffer from a "mission creep". From this perspective, a refocusing strategy would be a condition to improve the efficacy of the IMF. See also Tirole (2002).

lacks credibility and efficiency: the IMF tries to buy reforms but without investing in the knowledge of initial conditions.

The purpose of this paper is to propose an analytical framework integrating these diverse explanations of the failure of BWIs conditionality. More precisely we explain that most of the criticisms addressed to conditionality should be analyzed through what we agree to call the institutional failures of BWIs conditionality. These institutional failures must be appreciated at two complementary levels: (i) the first level refers to the intrinsic bureaucratic bias of BWIs as the (ii) second deals with the inability of BWIs to manage the institutional change and hence to maintain the institutional order in recipient countries. But if the first level is particularly well studied by the so called international public choice approach, the second one is, in the best case, often reduced to a simple statement. However, analyzing together the two levels of the institutional failures of BWIs conditionality is not without consequences on the way to conceive the reforms of conditionality. Indeed taking into account the relationships between conditionality and domestic institutional change -the second level-invalidates the recommendation of the ex-ante conditionality made by the public choice approach –the first level- to the benefit of a new approach which suggest to dissociate the role of BWIs –more particularly of IMF- as financial backer and the one as adviser for countries confronted to the globalization process.

The remainder of the paper is structured as follows. Section 2 analyses the failure of BWIs conditionality from a public choice perspective. The purpose here is to come back to BWIs intrinsic institutional failures to understand the week completion of BWIs programs. Section 3 makes use of the Austrian theory of institutions in order to appreciate the institutional change challenge faced by recipient countries. We particularly focus our attention on the role of IMF in the debate dedicated to the new international financial architecture. Section 4 concludes and makes propositions for the improvement of conditionality.

2. The Intrinsic Failure of the Conditionality: a Public Choice Approach

Recent studies dedicated to the efficacy of IFIs programs put in the light the role of domestic political factors as a decisive condition of their success (Dollar, Svensson, 2000). The difficulty to take into account these factors constitutes one of the main reasons of the weak completion of IMF programs (2.1). Another reason makes reference to the institutional failures of the IMF and the World Bank, the cornerstone of the public choice approach. Two institutional failures are more particularly analyzed: the bureaucratic bias on the one hand; the weak incentives effects on the other hand (2.2.). This public choice approach leads to a specific reform of conditionality based on pre-conditions (2.3). However we explain that by not considering explicitly the relationship between the institutions and the markets, the public choice approach fails to appreciate the whole institutional feature of conditionality and hence proposes a very partial solution to conditionality failures.

2.1. The Political Factors of Conditionality

Political factors and IMF programs efficacy are in strong interactions: not only domestic political factors exert an influence on the IMF arrangements completion, but the IMF is not exempt from political considerations when it decides to stop or continue an incomplete program at the end of the initial period of arrangement.

The political economy literature based on the so-called "common agency models" shows that conditionality is useful when domestic political systems are imperfect. In such a framework, the authorities facing the IMF are not a unitary actor; each economy is characterized by special interest groups (SIGs) -both private and public. Policy choices thus reflect the concerns of diverse constituencies in the domestic economy following a noncooperative game where the authorities, the IMF, the veto players and the private SIGs strategically interact (Boughton, Mourmouras, 2002; Drazen, 2002). The function of conditional assistance is to alter the distortions on social welfare due to these divergence of interests. More precisely, the common agency problem literature shows that if unconditional assistance incites the authorities to reduce domestic distortions due to SIGs in order to increase the effectiveness of aid, the effect of conditional assistance is to strengthen the preceding effect. By maximizing the joint welfare of the IMF and the recipient government, conditional assistance improves policy outcomes. But, as noticed by Boughton and Mourmouras (2002), this improvement is achieved at a price: the IMF "is injected more deeply in the affairs of the recipient country" and "becomes a second principal" (p.9). Indeed, like SIGs, the IMF attempts to influence the authorities' policies choices.

The question is to determine if such influence is obviously welfare improving. Do political factors explain IMF's decisions to interrupt or continue a program with a member state? The answer specified in the IMF's Charter is clear: political factors do not exert any influence. Empirical studies are more blended. In order to explain why countries get financial assistance from the IMF, Barro and Lee (2002) suggest that political connections to the IMF appear to be significant explanatory variables of the probability and size of IMF loans[7]. Thacker (1999) studies the underlying causes of the IMF's behaviour concerning lending decisions and sanctions if borrower compliance with IMF conditionality is weak[8]. His main result is that politics matter in the IMF and consequently there is no guaranty that the deeper integration of IMF in the domestic political game leads to better outcomes. The decisions of the IMF do not necessarily follow the general interest, but can be the outcome of the strategy following by powerful states in the world economy.

When considering now the interaction between international and domestic institutions to explain programs completion Vreeland (2002) gives details that governments may use the IMF's leverage to favor unpopular policies[9]. In a close perspective, Edwards (2001) demonstrates that the ability of governments to meet IMF conditionality depends on the political system; fractionalized legislative political organization exhibits poorer performances to meet IMF programs. Dreher and Vaubel (2001) suggest that IMF assistance facilitates political business cycles in the recipient countries[10]. According to the authors, IMF lending facilitate pre-election boom while IMF conditionality is used by domestic authorities to justify post-election recession[11].

Overall, the influence of political factors on conditionality raises two main challenges for the Bretton Woods institution. On the one hand, it appears to be more and more necessary to devote enough resource "to identify reformers no t to create them" (Dollar, Svensson, 2000: 896). As a consequence, in the trade-off among the competing rationales of conditionality, more weight should be given to the selective objective and less to the inducement objective. On the other hand, the efficacy of such a strategy depends on the degree of depoliticization of IMF decisions. At this level, we must consider the IMF institutional failures.

2.2. BWIs Institutional Failures

Two institutional failures are distinguished: those coming from the existence of a bureaucratic bias -in which the activities of the institution do not respond to collective needs

[7] The determinants of the political connections are the following: country quota, national participation in the IMF staff, and member country's political and economic proximity to the IMF's major shareholding countries. Each of these determinants exert a positive influence of IMF loans.
[8] Decisions to lend are analyzed over 1985-1994 period for 87 developing countries.
[9]. See also Ivanova and others (2003) for a recent empirical study showing the strong influence of recipient countries' domestic political factors.
[10] Considering a sample of 106 countries having obtained IMF credit over the 1971-1997 period.
[11]. Joyce (2003) confirms that program interruptions are less frequent in election years.

but to the maximization of its budget- and those based on the weakness of incentives mechanisms within the IMF and between the IMF and the recipient countries.

A potential bureaucratic bias can emerge from the ability of international institutions to become autonomous and powerful actors in global politics. Autonomy is based on the knowledge about the functioning of the global economy, and leads to an expertise –both technical and informational- not shared by international institutions with other actors, mainly states. An illustration of this process is the evolution of conditionality within the IMF. "The development of the principle of conditionality went hand-in-hand with a shift in responsibility from the executive board to the staff" (Martin, 2002: 20).

The mission of the staff is to prepare agreements between the Fund and the borrowing countries. Thus the staff directly negotiates with them the binding conditions. In a principal-agent relationship, when we take into account the increasing complexity of these conditions, it appears more and more difficult for the Executive Directors (the principal) to exert a strong control on the staff (the agent). This technical advantage allows the staff to influence the content of programs. The staff has also a significant agenda-setting power based on the extension of IMF lending activities[12]. At the same time, because of the political nature of the Executive Directors, domestic authorities are reluctant to communicate strategic information to the IMF when they negotiate a loan. Indeed, they afraid that these information are used for political motivations. In order to incite domestic authorities from borrowing countries to give such information to the staff, the Executive Directors have guaranteed their confidentiality. One can find here a well-known situation of asymmetric information between the principal and the agent. The staff knows information about the countries economic situation not transmitted to the Executive Directors. This information constitutes a powerful source of autonomy for the staff.

And the point is that the staff can use this autonomy by changing conditionality over time to attain its own preferences, that is the maximization of its budget and its size. The evolution of conditionality is consequently not necessarily linked to changing conditions in the world economy. This hypothesis is confirmed by Dreher and Vaubel (2003) when explaining that the evolution of conditionality seems not founded on economic motives but on the level on demand for IMF credit relative to IMF quota[13]. Overall, the staff balances the marginal utility

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[12]. Recall that the Executive Board can approve or reject IMF programs only after a proposal from the staff.

[13]. Their study uses two main statistical sources : a chronological study from 1958 to 1999; an econometric analysis over the period October 1997-March 2003 for 206 IMF letters of intent with

of imposing conditions, that is the safeguard of its financial integrity, and the marginal disutility of losing demand for its credit as a consequence of stronger conditions, that is a decrease of its influence.

Considering now the second institutional failure, let recall that one can found BWIs incentive mechanisms at two levels: within each IFI on the one hand; between the IFI and the recipient countries on the other hand[14]. However these two incentive mechanisms are strongly interrelated: a weak incentive within the IFI always leads to weak incentive in the second situation.

Within an IFI, two main incentive failures can be distinguished. A first failure refers to the decision-making process. At this level, Willett (2002) stresses the career dependency of the staff relative to the IMF management[15] and Executive Board. The main point refers to the different appointment procedure when considering the staff and the management. If the former is appointed by the management according to expertise competencies, the latter is politically appointed by the Executive Board. As a result, in order to safeguard its career, each staff member of the review department tries to minimize the critics from the management. Thus, even if such a behavior does not correspond to economic considerations, the staff has tendency to validate management decisions. But this latter is submitted to strong pressures and lobbying from political constituencies. A obvious contradiction appears between incentives based on economic motives and incentives based on political considerations. Broadly speaking, if the latter follows a "benefits now, costs latter" logic, the former gives more weight to long term horizon. Overall, political pressures prevents the staff to advice decisions exclusively founded on an economic analysis: IMF lending to Russia is a good example where political pressures from the major industrial countries has led the staff to take inefficient decisions from an economic point of view. But taking into account the control of career by the management, it was rational to promote a lend to Russia.

A second incentive failure within an IFI makes reference to what Svensson (2003) has called the "budget -pressure problem". In most donor organizations, there is a separation between the allocation and the disbursement decisions. Generally, allocation decisions are centralized –depending on guidelines and procedures- while disbursement are decentralized –based on specific projects or countries. Consequently organizations exhibit "a strong bias towards

38 countries. "Conditionality increases when the demand for IMF credit grows relative to quota; (…) conditionality decreases or stagnates when the demand for IMF credit is weak or IMF quota have been raised" (Dreher, Vaubel, 2003: 10).

14. For an overview of incentive mechanisms of IMF programs, see Dixit (2000).

'always' disbursing committed to the ex ante designated recipient, irrespective of the recipient government's performance and the conditions in other potential aid recipient countries" (Svensson, 2003: 383). There is no link between the recipient country's efforts to fulfill conditionality and the disbursement of funds[16]. This bias arises from the soft budget constraint inside the IFI explained by a low opportunity cost for the disbursing bureau. The separation between the allocation of funds to a department and their disbursement by this department favors a bias towards "spending the budget" whatever its economic motives. Indeed, over time, decisions of new allocations depend on the disbursement history. In this perspective, a decrease in the disbursement rate during a year can be interpreted as a negative signal on the efficacy of the country department. In addition, the size of the budget allocated to each department exercises an influence on the status and the prestige of the jobs within them. If recipient countries know such a behavior, the *ex ante* threat consisting to interrupt the disbursement if conditions are not fulfilled is not credible. One can find here one evidence of the strong relationship between incentives within the organization and incentives between each IFI and recipient countries. The latter comes mainly from the differences in objectives between BWIs and recipient governments.

Taking into account such differences implies to build the incentives mechanisms which may induce a convergence of interests between the two actors. From a conditionality perspective, BWIs implemented three main mechanisms to encourage policies changes in recipient countries: (i) the size of the credits, (ii) the catalytic effects of BWIs' lending, (iii) the punishment used if the recipient authorities do not respect initial conditions linked to the lending. If appropriately applied, the first two mechanisms should diminish the opportunity cost to accept reforms in order to get lending from IFIs. However empirical studies indicates that size is not enough and that catalytic effect is weak (Killick, 1996 and 1997; Bird, Rowlands, 2001). Moreover the credibility of the punishment system is undermined by several factors: a pro-lending bias within BWIs (see above); political favoritism and pressures; and the co-operative nature of IFIs which undermines their willingness to interrupt lending to their members.

2.3. The Reforms of Conditionality in a Public Choice Perspective: To Tie the Hands of the BWIs

If current conditionality is essentially founded on the idea that it is possible for IFIs to induce policies changes, that is to "buy" reforms, political pressures and institutional failures

[15]. The Managing Director and Deputy Managing Directors.

undermine the efficacy of this strategy. Following a public choice perspective it appears more and more blatant that conditionality exhibits rather poor economic performances and that its legitimacy and perhaps efficacy is to be found in political factors.

The public choice solution to these economic inefficiencies is to tie *ex ante* the hands of the BWIs. Thus, in the spirit of the Advisory Commission (Meltzer, 2000), Dreher and Vaubel (2001 and 2003) propose to substitute the traditional *ex post* conditionality by an *ex ante* conditionality. The main purpose of this latter is to establish the pre-conditions that country members must fulfill in order to be eligible to IMF lending. Pre-conditions refer to financial soundness of countries, that is (Meltzer, 2000: 25): (i) country 's commitment to fiscal standard, (ii) a transparency policy based on the public communication of timely and accurate financial information, (iii) an adequate capitalization of domestic banks, (iv) the authorization for foreign banks to participate in the domestic banking system.

The IMF contingent credit lines (CCL) facility created in 1999 is close to this *ex ante* conditionality. The CCL offers member countries with strong economic policies a precautionary line of defense against balance of payments problems linked to financial contagion. However since its creation, no country has used the CCL, and the Executive Board has decided to expire the CCL in November 2003[17]. If the IMF justifies such a decision by stressing the strengthening of the international financial system, it seems that the CCL has been the object of a major breakdown. Indeed let recall that the CCL requires that each member country ought to sign up in advance its potential need of IMF lending. The difficulty lies in the fact that the risk exists that such an official declaration may be interpreted as a negative signal by international markets. The reasoning is the following: by subscribing to the CCL, a government implicitly announces that it anticipates a crisis and a need for IMF credit. That's why Dreher and Vaubel (2003) defend the idea that all countries should be eligible to such a facility, without a pre-declaration if they respect pre-conditions. These effective *ex ante* conditionality requires both an official mandate and an universal principle.

The main advantage of *ex ante* condition could be to reduce the political pressures during currency crisis and then to enhance the IMF credibility. But for the promoters of these so called *ex ante* approach conditionality should be limited only to short term credits made by the IMF during liquidity crisis.

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[16]. Svensson (2003) confirms this result using data from around 200 structural adjustment programs from the World Bank over the period 1980-1995.
[17]. IMF Press Release, n°03/207, November 26, 2003.

Our opinion is quite different. Without rejecting the whole analysis developed by the public choice approach we consider that these approach proposes a quite partial studying of the institutional dimension of IMF -and hence BWIs- conditionality. Indeed *ex post* as well as *ex ante* conditionality has to deal with the domestic institutional changes accompanying the lending to recipient countries. And the paradox is that as conditionality institutional failures are limited to the running of IMF itself and to the evaluation of the incentives schemes, the public choice view shares with IMF the same inconsistency when considering the institutional component of conditionality.

Now considering these institutional changes is for us a necessary condition in order to understand the circumstances for a better intervention of IMF. Such analysis will particularly lead us, contrary to the Advisory Commission, not to reject any long term structural lending from the IMF[18]. Indeed we consider that such a lending is useful to promote structural reforms in developing countries in order to adapt their economy to the globalization process. The problem for IMF then becomes not only to modify the incentive mechanisms, but also to think about the suitable reforms in the light of the subsequent domestic institutional changes process. The following section is dedicated to this issue.

3. Towards an Austrian Theory of IMF Conditionality Failures

This section comes back to the traditional conditionality, that is to structural conditions attached to BWIs programs. Following an Austrian perspective about the critical role of institutions in the market process, we explain how conditionality may jeopardize the institutional order of the recipient countries (3.1). Such analysis leads us to criticize the traditional propositions for the reforms of conditionality and to propose an original strategy for BWIs -more particularly for IMF- illustrated by the breakdown of the financial liberalization process (3.2). The cornerstone of this strategy consist in redesigning the relationships between the recipient countries confronted to major institutional changes and BWIs. Such evolution implies a transformation of the roles of IMF.

3.1. Institutions, Institutional Changes and Condtionality

Let recall that institution is usually defined as "a regularity in social behavior that is agreed to by all members of society, specifies behavior in specific recurrent situations and is either self-policed or policed by some external authority" (Schotter, 1981: 11). This definition

[18]. In a similar perspective, Willett (2003) proposes to separate IMF programs into two major categories: a short term facility with *ex ante* conditionality and a structural conditionality. The latter constitutes the traditional IMF conditionality.

requires consideration not only of the legal framework, but also of behavioral regularities associated with a set of rules, norms and routines. These two elements may determine both the emergence and evolution of institutions.

Institutions then represent a means by which agents, who are ignorant of each other' s actions and expectations, obtain the information that enables them to co-ordinate. In other words, they allow economies to be made with respect to knowledge and information. They represent "orientation points", which have the authority to render both actions and individual expectations compatible (Lachmann, 1970). They are implemented so as to offer a solution to the fundamental issue of coordination. Put in others words they represent nothing more and nothing less than the key link which settles all analytical reasoning in terms of market processes. The reasoning is the following. Time and uncertainty, which characterize all market processes, encourage agents to follow common rules. The latter leads to the emergence and development of institutions, which then reduce the uncertainty prevailing in the markets, by supplying stable models of interaction (O' Driscoll, Rizzo, 1996)[19].

Modifying the institutional structure of any economy is consequently not only complex but is susceptible to induce some deep and not necessarily forecasted nor appropriate economic changes. And this is the case for conditionality. Structural conditionality imposes domestic institutional changes, that is changes on the domestic institutional structure. An even if IMF try to reduce the number of structural conditions in its new programs -that is since 2000- (IMF, 2001c) the average number of structural conditions have steadily increased from 1987 to 1999 (IMF, 2001a). The structural benchmarks which exhibit a rather qualitative facet going beyond the traditional IMF quantitative approach follow the same evolution (IMF, 2001a)[20]. More fundamentally it appears more and more blatant that every IMF action whose main intention is to obtain macroeconomic equilibrium is never without consequences on the

[19]. This argumentation naturally rests on the idea that the knowledge disseminated by institutions is of a stabilising nature – in that it reaffirms the stability of the social structure at regular intervals – unlike that disseminated by the price system, which is of a dynamic nature – in that it leads individuals to revise their plans continuously (Hayek, 1945).

[20] "(SBMs) are indicators which aim to delineate the expected path of reform for individual structural policy measures and that can facilitate the evaluation of progress for these actions. Because many structural policies cannot be expressed in quantitative form, structural benchmarks are usually expressed qualitatively; for example, if the program calls for privatization of the state-owned telephone company, submitting the privatisation bill to the legislature by date x could be one structural benchmark. Failure to meet structural benchmarks conveys a negative signal but does not automatically render a country ineligible to draw; instead, a decision about eligibility would be judgmental and would likely be taken in a broader mid-year

institutional structure of the recipient country even if IMF try to concentrate the majority of structural conditions in a relatively small number of sectors[21].

The analysis of structural conditionality consequently requires that we specify the conditions for the coherence of the recipient country institutional order. More precisely such analysis must allow three interrelated types of problems to be solved.

Firstly the issue of the institutional order and its unity is formulated: if the complementarity of institutions builds the institutional order of a society the purpose is then to identify integrating forces as well as circumstances under which these forces cease to work. The distinction between 'designed institutions' and 'undesigned institutions' (Lachman, 1970) is here crucial. The former are legal norms or designed institutions which are "the products of legislation and other manifestations of the 'social will'" (Lachman, 1970: 69) while the latter are spontaneous or "non-designed institutions", understood as "recurrent patterns of conduct" (*ibid*.: p.75). By following Lachmann's logic, although, on the one hand, not all institutions assume the same status and function, they do, on the other hand, share the flexibility linked to the permanency of the whole. The matter that now arises is how to make institutional change and structural permanence compatible, since it is not so much the change *per se* which brings up problems here, but rather unexpected change[22]. Conditionality should not be implemented without taking into account its effects on the institutional complementarity that is on the institutional order of the affected country.

Secondly the distinction between induced and imposed institutional change (Lin, 1989) has to be considered. An induced institutional change refers to the modification or replacement of an existing institution or the emergence of a new one that is voluntarily initiated and executed by an individual or a group of individuals in response to profitable opportunities. An imposed change, in contrast, is introduced and executed by an authority following its

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program review --itself an instrument of conditionality -- with an eye toward the country's overall progress on the structural front" (IMF, 2000c).

[21] "The majority of structural conditions -between half and two thirds- have been, and continue to be, concentrated in a relatively small number of sectors that are at the very core of the Fund's involvement in member countries: exchange and trade systems, and fiscal and financial sectors (Figure 5). The relative importance of these sectors has changed, with reforms in the exchange and trade system now playing a smaller role and the financial sector a more important one than in the early 1990s. In addition, public enterprise restructuring and privatisation -in part motivated by fiscal considerations- have accounted for about one fifth of the structural conditions in Fund-supported programs. Nevertheless, while a large part of structural conditionality has focused on a relatively small number of sectors that are closely linked to stabilization and external adjustment, this does not guarantee that structural reforms have always been adequately prioritized nor does it imply that too broad a reform agenda has never been an issue" (IMF, 2001a).

own rationality. The main point here is that institutional changes accompanying BWIs' programs is often imposed and rarely induced. The consequence is that conditionality may conduct to a deterioration of agents economic performances compared to the initial situation.

Thirdly we don't have to forget that institutional change takes time. Indeed the adoption -the transfer-, just like the creation of new institutions, is subject to delays: delays of implementation in the first case, and delays of construction in the second. Yet, the amount of economic change possible per unit of time is always limited, because agents have limited training capacities. Indeed, if it is always possible, both in theory and in practice, to imagine a situation in which an economic or political authority –the IMF- decides to implement new institutions –through conditional Fund-supported programs- the benefits expected from this type of measure are a controversial issue. The reason is that, insofar as such a policy is, by definition, limited to designed institutions, its success depends on the capacity of these new elements to meet the demand for change in institutions not yet designed. The difficulty lies in the fact that, although the transformation of designed institutions is, in general, both radical and fast, that of non-designed institutions is of an incremental nature, and is necessarily subject to path dependence constraints. "Various institutions and social expectations change at different speeds, particularly when there is a mix of exogenous and endogenous forces, as when global markets interact with domestic policies [...].The central problem to be addressed […] is variable institutional adaptation" (Jacobs, 1999: 8). But in all the cases the time of any structural program that is the time of conditionality is radically different to the one necessary for implementing the required institutional change.

Solving these two kinds of problems comes down to providing a solution to what we agree to call the permanency-flexibility dilemma[23]: 'If institutions are to remove uncertainty, they must be permanent. But if they are to be shaped by market forces they must be flexible. The solution consists in setting up designed institutions which allow change to be integrated without altering the institutional structure as a whole. Such a solution implies however a transformation of the roles of IMF which cannot be simply reduced to the so-called *ex ante* conditionality.

3.2. Reforms of Conditionality : From Traditional Answers to a New Form of Conditionality

Propositions related to reforms of conditionality focus on the necessity to strengthen the ownership of programs. This is a result of the strong correlation between successful

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[22]. Only the last type of change is likely to upset some plans in the course of actions.
[23] Following Lachmann (1970).

arrangements completion and the degree of ownership[24]. Ownership is a multidimensional concept (World Bank, 1992). First, it refers to the extent to which the initiative for reforms planned in programs is local or external. Second it is based on the idea that intellectual conviction in the appropriateness of measures matters. Finally, the degree of support from the top political leadership appears to be a determinant of ownership[25]. Two complementary approaches of conditionality reforms aim to strengthen ownership.

The first approach establishes that the efficacy of conditionality could be improved with a more flexible approach[26]. It is here necessary to consider the inadequacy of penalties attached to the current conditionality. On paper, an incomplete program is penalized when taking into account the initial arrangement as a whole. Thus, implicitly the relationship between the BWIs and the recipient countries obeys to a "take it, leave it" logic. But not only such a penalty scheme lacks credibility (see above), but it also lacks flexibility when considering the obligation to implement both macroeconomic adjustments and structural reforms. A higher flexibility procedure could be based on a disaggregated reform package and a floating tranche. Leandro and other (1999), and in a similar approach Collier and other (1997), propose in these perspective to divide reform package into several reform areas, each of them being the object of specific conditionality and monitoring. The aim is to determine a more proportional penalty relative to the initial fault. The floating tranche approach, supported by Khan and Sharma (2001), would allow each country to implement structural reforms at their own rhythm without to question the assurance to receive the funding if a tranche of reforms has been –or not- completed. The proposition is that BWIs would disburse credits (called the floating tranche) in proportion with the adoption of structural reforms specified in the initial arrangement. But only usual quantitative performance criteria would be the object of traditional conditionality.

By another way the development of the flexible approach implies to engage the BWIs in intensive and informal policy dialogue with the recipient country. It is here necessary to take into account not only the government, but also the political leader, the trade unions and the members of the civil society. As explained by Collier and other (1998), the BWIs have to

24. Numerous empirical studies established this relationship. See Collier and other (1998).

25. IMF defines ownership as follows: "ownership is a willing assumption of responsibility for an agreed program of policies, by officials in a borrowing country who have the responsibility to formulate and carry out those policies, based on an understanding that the program is achievable and is the country's own interest" (IMF, 2001b: 6).

26. A detailed presentation of this approach is beyond the scope of this paper. See, among other: Leandro, Schafer and Frontini (1999); Collier and other (1997); Collier, Gunning and Hamada (1998); Khan and Sharma (2001).

develop "a more systematic mechanisms for providing ex post support for country-initiated, or home-grown, program" (p.22). Three implications are deduced from this new strategy. First, resident missions in recipient countries could have more authority. Second, the IFIs should allocate more resources and time in order to improve their understanding of countries' political constraints. Finally, more initiative could be given to domestic authorities during the negotiation of the program, the credibility of this process implying a more flexible behavior by the BWIs' staffs[27].

A second approach, promoted mainly by the IMF, is to streamline structural conditionality. Taking into account the poor performances of its recent programs, the IMF tries to reduce the number of its structural conditions in order to concentrate its attention on structural reforms that are "critical" for the achievement of the macroeconomic targets. The new conditionality guidelines follows three principles. First, IMF conditionality has to cover structural conditions which are "critical" for the success of the program's macroeconomic objectives. Second, structural reforms which are not critical but "relevant" for the program's macroeconomic objectives, and at the same time within the IMF's core areas, can eventually be subject to conditionality. Finally, conditionality would not apply to structural reforms which are not critical and outside the core areas of IMF's responsibilities; even if they are macro-relevant. Here, the main difficulty is to define the critical threshold. According to the IMF, "critical importance means that excluding the condition would seriously threaten the achievement of programs goals or the Fund's ability to monitor implementation […]. Determining which measures are critical is inherently an element of judgement" (IMF, 2003a). Ambiguity and imprecision are in part the product of the division inside the Executive Board on how far the reduction in structural conditionality should go. As a consequence, until now, the staff has used this division to resist to the streamlining of conditionality process. Killick (2002) estimated that on average the number of structural conditions decreased by about a quarter. These results exhibit "substantial differences between the aspirations of the Fund's management and actual changes so far achieved" (Killick, 2002: 2).

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[27]. In 1999, the IMF and the World Bank initiated the Poverty Reduction Strategy Papers which give more initiative to governments in low-income countries. Indeed, PRSP are prepared by the governments according to a participatory process involving domestic stakeholders. A PRSP describes the macroeconomic, structural and social policies and programs adopting by a country for several years. IMF (2003a). In September 2003, 32 countries had adopted this strategy. If it is to earlier to evaluation them, first evaluations have stressed the participatory gap after the adoption of the programs and the conflicts between their multiple objectives, revealing the

If all the previous approaches represent a progress in improving BWIs performances, it does not give an appropriate response to the problem of institutional changes implied by structural conditions. The main challenge consists in responding to new concerns encountered by the globalization of markets, mainly the compatibility between domestic and global goals. The BWIs suffer from a problem of adaptive efficiency in that the dramatic increase in its missions undermines its capacity to improve the market process.

For example, structural conditions imposed by the IMF, particularly after the Asian crisis, aim to modify the domestic institutions of economies profoundly. More and more conditions refer to public and corporate governance. The main pillars of this approach are well-known: transparency, dismantling of monopolies, elimination of directed lending, growing role of financial markets. This approach contradicts recent lessons suggested by the literature on growth strategies[28]. More precisely, the main lesson from Rodrik's survey on growth strategies is that "principles such as appropriate incentives, property rights, sound money, and fiscal solvency all come institutions free […]. There may be multiple ways of packing these principles into institutional arrangements" (Rodrik, 2003: 11). For example, China has experimented with a heterodox way of achieving the principles above while Latin American countries have adopted the Washington Consensus principles based on an orthodox concept. In term of growth performances, the two groups of countries have experienced contrasting outcomes: strong performance for China; poor for Latin American countries. Such differences suggest that successful reforms have to be country specific and not based on a global and uniform concept of the working of the market economy.

Our analytical framework leads us to suggest a different strategy for the BWIs. Let us, for example, try to analyze the institutional implications of financial liberalization. The answer raises the question of the resilience of financial systems in emerging economies, *i.e.* of their capacity to change structurally while preserving their basic properties. The latter differ according to the financial system. In market-based systems, like in the United States and the United Kingdom, basic properties refer to the prominent role of tradable financial assets (bonds and equities) and the decisive role of financial markets in disciplining company managers. In bank-based systems, basic properties concern the double role of banks which are at the same time creditors and shareholders of non-financial firms. In Japan and

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difficulty to adopt a clear priority order. For an external evaluation of PRSP, see Killick (2002); for an internal evaluation, IMF (2003b).

Germany, banks are at the interface between the credit market and the financial market. They play, particularly in Japan, the role of insurer in periods of financial distress in order to facilitate company restructuring. When basic properties are damaged by financial liberalization, the financial system loses its stabilizing properties. Thus, the main challenge of financial reforms in emerging economies is to implement a liberalization process and at the same time to protect the basic properties of their financial system.

In emerging economies, where asymmetric information is abundant, the problem faced by authorities is consequently to maintain an intermediated system compatible with growth in the market process. Indeed a largely intermediated structure is not, in itself, an obstacle to financial liberalization. The long relationship between administrated banking systems and public authorities in the model of financial repression must not eclipse the theory, which shows the compatibility of the market economy with financial intermediation in the presence of information costs. The critical stake for financial liberalization is the marketization of banks, that is their conversion from a restricted to a full-service institution in the market economy. Marketization is a process which increases the importance of market mechanisms in resources allocation (Allegret, Dulbecco, Courbis, 2003).

In this perspective, the adoption of an appropriate prudential regulation -based on a sound accounting structure and efficient control institutions-, the reduction of public authorities' involvement in financing, and the improvement of incentives for banks' stakeholders to develop competitive profit-seeking behavior, are measures which are likely to modify the banking behavior. But it is necessary to take into account that such prudential measures cannot alone lead to a new financial system in which market mechanisms should be more important. Let us recall that the implementation of new legal regulations by authorities does not necessary lead to the acquiescence of institutions. Indeed, not only such new laws have to be coherent with the basic properties of the financial system, they must also be adopted by private agents.

These two problems are linked by the following remark: the main challenge of such a liberalization process is to preserve advantages of the strong bank-firms relationship. In such system, banks are incited to search for information about firms because they can hold the informational rent. As a result, the reduction of information asymmetries decreases the borrowing costs for firms and promotes a cooperative behavior in case of financial

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[28]. Following Rodrik (2003), we define growth strategies as "economic policies and institutional arrangements aimed at achieving economic convergence with the living standards prevailing in

difficulties. Indeed, thanks to long-term relationships, banks can insure firms against non-contractual events such as financial distress. Such an insurance mechanism is absent in the market-based system. In emerging economies, especially in Asian countries, long-term relationships between banks and firms have promoted a high-investment-high-growth regime. One of the main reasons is that a strong bank-firms relationship reduces the liquidity constraint to invest.

Thus, lessons drawn from the Asian crisis, but also from the behavior of numerous banks in Latin American countries, lead us to draw attention to this following point: any reform concerning the banking behavior faces the important challenge to find the appropriate trade-off between a strong financial constraint -which could slow down investment- and a soft financial constraint -leading to inefficient resources allocation. In other words, promoting banking reforms, whose the main objective is to bring banking practices in emerging economies to converge towards practices adopted in numerous mature markets, is not necessarily the most efficient way to favor economic growth. Interpersonal relationships are less prominent in developed countries because of the presence of liquid financial markets with strong legal rules and contract-enforcement mechanisms.

Despite this positive value of relationship banking, numerous authorities in emerging markets implemented reforms after the crisis in which the role of banks was reduced in order to promote the financial markets. South Korea is a striking example from this viewpoint. If the role of the state limited the capacity of banks to monitor and exercise a credible threat over non-financial firms, it does not imply that the relationship banking system is inefficient per se. The main response of the Korean government has not been to implement a reform in which banks could stay at the heart of the system but effectively monitor non-financial firms. On the contrary, the government followed advises of International Financial Institutions and introduced principles of corporate governance originating from the Western experience. It seems to us that such a strategy could be dangerous because it could destabilize basic properties of the financial system. Let us recall that in numerous emerging economies, and particularly in South Korea, banks are the main institutions which allow the development of the contractual sphere. A better strategy would be to promote a strong banking system as in Japan where the main bank disciplines non-financial firms because control rights shifts from the internal management of firms to the main bank when the financial state of a firm falls below a threshold level.

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advanced countries" (p.2).

4 Conclusion

In this paper, we have stressed the failures of the traditional BWIs conditionality. At present BWIs have to face a double challenge. On the one hand, they must minimize the sources of inefficacy located inside each institution, mainly bureaucratic bias and inadequate incentive mechanisms. Such institutional failures are critical because they contradict the logic of current conditionality based on the inducement objective. As showed in this paper, the public choice approach of international institutions gives some elements of responses to these problems. On the other hand, and from our perspective it is the main challenge, BWIs have to build a new conditionality approach in order to safeguard the coherence of the institutional order in recipient countries. Conditionality implies institutional change and institutional change is a very complex process which can not be managed trough the so-called *ex ante* conditionality. The alternative is for us not to renounce this change but on the contrary to deal with such complexity and diversity. The analytical framework proposed should help to evaluate both the institutional component of conditionality and the necessary evolution of the roles of BWI's.

Indeed we suggest to dissociate the role of BWIs –more particularly of IMF- as financial backer and the one as adviser for countries confronted to the globalization process. From our perspective, the role of the Fund and the World Bank staff could be that of an external advisor or consultant in order to take into account the specificities of each country in a global context. By global context, we refer to the new constraints implied by globalization process which tend to impose a standardization of behaviors.

The evolution of conditionality proposed in this paper would imply for each country, benefiting from the advice of the IMF, to find the best trade-off between the specificity of the domestic institutional order and the global market. This is for us the main challenge of globalization that is to build a coherence between global governance and domestic objectives.

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