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G-24 Discussion Paper Series

Governance-related Conditionalities of the International Financial Institutions

Devesh Kapur and Richard Webb

No. 6, August 2000

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**Research papers for the Intergovernmental Group of Twenty-Four
on International Monetary Affairs**



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PREFACE

The *G-24 Discussion Paper Series* is a collection of research papers prepared under the UNCTAD Project of Technical Support to the Intergovernmental Group of Twenty-Four on International Monetary Affairs (G-24). The G-24 was established in 1971 with a view to increasing the analytical capacity and the negotiating strength of the developing countries in discussions and negotiations in the international financial institutions. The G-24 is the only formal developing-country grouping within the IMF and the World Bank. Its meetings are open to all developing countries.

The G-24 Project, which is administered by UNCTAD's Macroeconomic and Development Policies Branch, aims at enhancing the understanding of policy makers in developing countries of the complex issues in the international monetary and financial system, and at raising the awareness outside developing countries of the need to introduce a development dimension into the discussion of international financial and institutional reform.

The research carried out under the project is coordinated by Professor Dani Rodrik, John F. Kennedy School of Government, Harvard University. The research papers are discussed among experts and policy makers at the meetings of the G-24 Technical Group, and provide inputs to the meetings of the G-24 Ministers and Deputies in their preparations for negotiations and discussions in the framework of the IMF's International Monetary and Financial Committee (formerly Interim Committee) and the Joint IMF/IBRD Development Committee, as well as in other forums. Previously, the research papers for the G-24 were published by UNCTAD in the collection *International Monetary and Financial Issues for the 1990s*. Between 1992 and 1999 more than 80 papers were published in 11 volumes of this collection, covering a wide range of monetary and financial issues of major interest to developing countries. Since the beginning of 2000 the studies are published jointly by UNCTAD and the Center for International Development at Harvard University in the *G-24 Discussion Paper Series*.

The Project of Technical Support to the G-24 receives generous financial support from the International Development Research Centre of Canada and the Governments of Denmark and the Netherlands, as well as contributions from the countries participating in the meetings of the G-24.

GOVERNANCE-RELATED CONDITIONALITIES OF THE INTERNATIONAL FINANCIAL INSTITUTIONS

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G-24 Discussion Paper No. 6

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Abstract

This paper examines the new found enthusiasm for governance-related conditionalities in the International Monetary Fund (IMF) and World Bank lending. This new agenda has focused in particular on legislative and institution-building efforts by borrowers to increase accountability, transparency, the rule of law, and participation. The paper attempts to document this trend by analysing a sample of 25 upper-tranche arrangements in 1999.

A review of past efforts to impose conditionality in related areas provides a discouraging background to this even more ambitious attempt by the international financial institutions (IFIs) at governmental and social re-engineering. Critical weaknesses in the new agenda are highlighted, particularly the complexity and potential conflicts that follow from a multiplication of goals, and also the distortions and ineffectiveness that result from a narrow focus on borrower governments, to the exclusion of private actors and civil society, who are also part of the problem. A brief account of some alternatives to conditionality, as currently practised, are also examined. Finally, the paper raises some troubling implications of this new agenda for the IFIs themselves, especially with regard to their operational effectiveness, their legitimacy and their fairness.

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GOVERNANCE-RELATED CONDITIONALITIES OF THE INTERNATIONAL FINANCIAL INSTITUTIONS

Devesh Kapur and Richard Webb

I. Introduction

This paper looks at the current trend towards governance-related conditionality in lending by international financial institutions (IFIs). Section II focuses, in particular, on legislative and institution-building efforts by borrowers to increase accountability, transparency, the rule of law, and participation. The trend is difficult to document because statistics drawn from loan contracts do not clearly distinguish between exhortative or best-effort requirements and *sine qua non* conditions. The data also miss crucial up-front and side-letter conditions which do not appear in loan contracts.

Section III reviews past efforts to impose conditionality – especially those related to institutional development and civil service reform (CSR) – which provides a discouraging background to this

review of the way in which the GRC agenda is likely to affect the IFIs themselves, especially with regard to their operational effectiveness, their legitimacy and their fairness.

II. Evolving conditionality

International agreements or collaborations, such as those between IFIs and their borrowers, must deal with the risk of non-compliance which could arise by accident or opportunism. Different mechanisms have evolved for managing that risk. One consists of *ex ante* demands on borrowers. By requiring prior concessions, a party to the agreement may improve the expected outcome by enough to compensate for the risk of a breach. A second approach is to structure the agreement itself in ways that reduce the level of risk, often through stipulations that restrict a par-

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