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To: Members of the Executive Board
From: The Associate Secretary
Subject: **Prior Actions - Fund Policy and Practice**

Attached for the information of Executive Directors is a paper on the Fund's policy and practice concerning the use of prior actions. Conclusions appear on pages 5 and 6

Mr. Bennett (ext. 38784) or Mr. Leckow (ext. 34799) is available to answer technical or factual questions relating to this paper.

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Department Heads

INTERNATIONAL MONETARY FUND

Prior Actions: Fund Policy and Practice

Prepared by the Policy Development and Review and Legal Departments

(In consultation with other Departments)

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1. During the Executive Board's discussion of the first monthly review under the extended arrangement for the Russian Federation (EBM/96/41), several Executive Directors enquired about the Fund's policy and practice concerning the use of prior actions. This note describes the Fund's practice relating to the formulation and monitoring of prior actions, the legal consequences which arise when a member fails to implement a prior action in the manner reported to the Board, and the approaches available to the Fund to ensure the more effective implementation of prior actions.

I. PURPOSE

2. Under an upper credit tranche stand-by, extended, or ESAF arrangement, the availability of Fund resources is made subject to compliance with performance criteria and completion of Board reviews. In addition, the staff may identify particular measures that the member must implement as a prior condition to the staff and management recommending approval of an arrangement for the member, completion of a review, or the granting of a waiver for the nonobservance of a performance criterion under an arrangement. 1/ These measures are known as prior actions. 2/

3. The viability of most programs depends on certain policy measures being in place early in the program period. In seeking the implementation of measures prior to recommending approval of an arrangement, the intention of staff and management is to ensure that the program has the necessary foundation, and—particularly where there is no established track record or only a weak one—to demonstrate the authorities' determination and political will to

1/ Such prior conditions have also played a critical role in programs supported by the Systemic Transformation Facility.

2/ The identification by the staff of particular measures as prior actions often follows explicit guidance received from the Board expressed in earlier discussions of the member's economic policies.

implement the program as formulated. For the same reasons, the implementation of prior actions can also be an important basis for a recommendation that the Board complete a review or grant a waiver.

4. The importance of prior actions was recognized in paragraph 7 of the Guidelines on Conditionality adopted in 1979 where it is stated: "The Managing Director will recommend that the Executive Board approve a member's request for the use of the Fund's general resources in the credit tranches when it is his judgment that the program is consistent with the Fund's provisions and policies and that it will be carried out. A member may be expected to adopt some corrective measures before a stand-by arrangement is approved by the Fund, but only if necessary to enable the member to adopt and carry out a program consistent with the Fund's provisions and policies." 3/

II. DEFINITION, TIMING, AND FORM OF REPORTING

5. The specific timing of implementation of a measure (and its role in the process of Board consideration) varies from case to case, depending on such factors as the importance of the measure, the feasibility of its early implementation, and the member's past record of policy implementation. Some such measures may well be taken before the program discussions are concluded (or even begun). Other measures may need to be implemented before the staff will be prepared to circulate the program documents or, alternatively, proceed with the Board discussion, and these measures will often be identified explicitly as prior actions in the documents circulated to the Board.

6. In order to serve their role effectively, prior actions must be discrete measures, defined without ambiguity, with their implementation readily verifiable, and with a realistic timetable set for their implementation. Such actions can include, for example: the submission to the legislature or passage of certain laws, such as privatization legislation or a budget consistent with a program's fiscal framework; specific changes which improve the prospects of attaining certain program objectives, such as an increase in utility tariffs or the elimination of specific subsidies; or changes in the management of key economic variables, such as the unification of an exchange rate or the elimination of price controls.

7. Different means are employed to follow up on the implementation of prior actions. Staff rely primarily on reporting by the authorities. In addition, where appropriate, legal documents pertaining to the measures are requested. Resident representatives and staff visits afford further opportunity to gather relevant information. Progress in implementation is

3/ "Guidelines on Conditionality" (Decision No. 6056-(79/38) approved March 2, 1979) reprinted in *Selected Decisions and Selected Document of the International Monetary Fund* (Twenty-first Issue, June 30, 1996), page 97.

usually reported to the Board either in the staff report (or in a supplement) or in a staff statement made at the Board meeting itself.

III. FAILURE TO IMPLEMENT A PRIOR ACTION AS ENVISAGED

8. On the whole, the procedures work well, and prior actions have contributed importantly to the implementation of many Fund-supported programs. Nonetheless, it is occasionally discovered, after the Board has taken a decision, that a measure identified by the staff as a prior action was either not implemented in the manner envisaged or not implemented at all, contrary to the information received by the staff and presented to the Board. There is, of course, a risk of possible misunderstandings between the staff and the authorities in the definition of prior actions. Therefore, it is important that prior actions be defined as clearly as possible. However, if there is a clear case of misreporting, what redress does the Fund have and, in particular, when will the misreporting lead to the application of the Guidelines on Corrective Action for Misreporting and Noncomplying Purchases? 4/

9. When the Executive Board adopts a decision approving a stand-by or extended arrangement for a member, completing a review, or granting a waiver for nonobservance of a performance criterion under such an arrangement, it is not the practice of the Board to expressly identify, in the text of the decision, the implementation of any of the prior actions as a condition for adopting the decision. Consequently, where it is subsequently found that the member has not implemented a prior action in the manner described to the Board, purchases made by the member as a result of the decision are not affected and, in particular, are not subject to the application of the Guidelines on Corrective Action. 5/ The failure of a member to implement a prior action in the manner described to the Board would lead to the application of the Guidelines on Corrective Action only if the Board, when it adopted the relevant decision, had expressly identified in the text of the decision the implementation of the prior action as a condition for adopting the decision. The attached Appendix I discusses in detail how the Guidelines would apply, and the consequences of their application, if the implementation of a prior action were made a condition for adopting a decision on a stand-by or extended arrangement.

4/ "Misreporting and Noncomplying Purchases under Fund Arrangements - Guidelines on Corrective Action" (Decision No. 7842-(84/165) approved on November 16, 1984) reprinted in *Selected Decisions and Selected Documents of the International Monetary Fund* (Twenty-first Issue, June 30, 1996), page 107.

5/ It should be noted that the Guidelines apply only to purchases made under stand-by and extended arrangements and not, for example, to disbursements under ESAF arrangements.

IV. SECURING IMPLEMENTATION

10. In order to secure more effectively the implementation of prior actions, three approaches can be envisaged.

11. First, and as has been done in cases of misreporting in the past, the staff or the Executive Board can stress to the authorities the importance of the relevant prior action, and the urgency of its implementation. If it is discovered that the member did not implement the prior action in the manner reported to the Board, the staff would inform the member that the implementation of the relevant prior action—if necessary by a certain date—would be considered an important element in the staff's recommendation or the Board's decision whether or not to complete the next review. 6/

12. Second, in adopting a decision on an arrangement (i.e., approval, completion of review, or waiver), the Board may wish to ensure that the member will not be able to make any further purchases (other than the one which may be made upon adoption of the decision) if it becomes known that the member has failed to implement the prior action as reported to the Board. In these circumstances, the Board could seek to ensure that the next purchase to be made available will be subject to completion of a review. 7/ Evidence that prior actions had not been implemented as reported could then, if the Board so wished, be taken into account in deciding whether this review should be completed. 8/ All subsequent purchases would then depend upon the Board's satisfaction in the context of this review.

6/ To the extent that the failure to implement was the result of a misunderstanding, the description of the prior action could be made subject to further refinement.

7/ Under the phasing provisions of an existing stand-by or extended arrangement, the member might be permitted to make several purchases before completion of the next review. In the circumstances of a review or waiver, the Fund may wish to modify the arrangement to provide that the next purchase will be subject to completion of a review. Of course, any modification to the terms of an existing arrangement would need to be requested by the member.

8/ With respect to Fund financing under an ESAF arrangement, it is normally the case that, of the two disbursements made available under an annual arrangement, the first disbursement is made available upon approval of the arrangement, and the second disbursement, *inter alia*, upon completion of a mid-term review. The linkage of a potentially delinquent prior action to a subsequent review would thereby be automatic for an ESAF arrangement, and would not require additional specification.

13. Third, and finally, the Board, when approving a stand-by or extended arrangement, completing a review, or granting a waiver for nonobservance of a performance criterion under such an arrangement, has the option, in its decision, of making the implementation of a measure an explicit prior condition for adoption of the decision, so that, if it becomes known that a member has not implemented the measure as reported to the Board, the Guidelines on Corrective Action would apply. ^{9/} However, this approach could erode the relationship of trust that typically exists between the Fund and its members. Such a practice should therefore be limited to only those circumstances where there is a demonstrated problem of misreporting. ^{10/}

V. CONCLUSIONS

14. Prior actions play an important role in the formulation of Fund arrangements in providing safeguards to Fund resources by improving the prospect that the program will achieve its objectives, and by demonstrating the commitment of the authorities to the program. Present practices have generally worked well, and instances of misreporting of prior actions have been rare. In the staff's view, approaches which seek to significantly strengthen the conditionality applied to prior actions should therefore be considered only where there is a demonstrated problem of misreporting.

15. To reduce the possibility of misreporting, staff should ensure that prior actions are unambiguously defined, and that their implementation is easily verifiable; to the extent possible, staff should also seek to ensure that prior actions are implemented well ahead of the scheduled Board date, to allow time for verification. Should misreporting occur, the staff and Executive Board can always utilize the occasion of a subsequent review to ensure that these actions are followed up in a timely manner.

16. In cases where it is deemed appropriate, however, the Board may seek to ensure, at the time of adoption of the relevant decision on an arrangement, that the next purchase will be conditional on completion of a review. Finally, in the case of stand-by and extended

^{9/} As noted above, the Guidelines on Corrective Action do not apply to disbursements under ESAF arrangements.

^{10/} Occasionally, there may be a concern that a member, after implementing a prior action, may reverse or weaken the particular measure. Policy reversals that concern prior actions are, in principle, no different from changes in any other policies specified in a Fund-supported program. The maintenance of measures implemented as prior actions, like the maintenance of all other policies, would always be a focus of subsequent reviews. In cases where a member has a demonstrated history of reversing policies, the maintenance of a particular measure can be made the subject of a performance criterion.

arrangements, where there is a demonstrated problem of misreporting by a member, the Board may wish to expressly identify the implementation of a prior action as a condition for adoption of a decision on an arrangement for that member, so that the failure to implement the prior action as reported would give rise to the application of the Guidelines on Corrective Action.

THE GUIDELINES ON CORRECTIVE ACTION AND PRIOR ACTIONS

17. The Guidelines on Corrective Action (the "Guidelines") ^{11/} were adopted by the Fund in order to deal with those cases in which it is found "that a member has made a purchase under a stand-by or extended arrangement which it was not entitled to make by the terms of the arrangement." The Guidelines concern those cases where "the purchase was permitted because, on the basis of the information available to it at the time, the Fund was satisfied that all performance criteria that were applicable to the purchase under the arrangement, or other conditions applicable to purchases under the terms of the decisions on the arrangement, had been observed, but this information later proved to be incorrect."

A. When do the Guidelines Apply?

18. The Guidelines apply to any purchase that a member has made within the previous two years under a stand-by or extended arrangement (an "arrangement") on the basis of information that has led the Fund to conclude incorrectly that the member has complied with (i) all performance criteria applicable to the purchase under the terms of the arrangement, and (ii) any "other conditions applicable to purchases" under the terms of the decisions on the arrangement.

19. While prior actions do not constitute performance criteria under an arrangement, the Executive Board may make the implementation of a prior action a "condition applicable to purchases" under the terms of a "decision on the arrangement." Although not defined in the Guidelines, the concept of a "decision on an arrangement" is broad enough to include not only decisions approving arrangements but also decisions completing reviews and granting waivers for the nonobservance of performance criteria under arrangements. Thus, where the Executive Board, in the text of a decision approving an arrangement, completing a review, or granting a waiver, expressly identifies the implementation of a particular measure as a condition for adopting the decision, and the member does not implement the measure in the manner reported to the Board, any purchase made as a result of the Board's decision will be subject to the application of the Guidelines.

B. What are the Consequences When the Guidelines Apply?

20. The following paragraphs describe how the guidelines would operate if the Board were to make the implementation of a prior action an explicit condition for the adoption of a decision on an arrangement. Where the Guidelines apply to a purchase because a member has not implemented a prior action in the manner reported to the Board, the Guidelines provide that the member will be expected to make an early repurchase, unless the Executive Board

^{11/} "Misreporting and Noncomplying Purchases under Fund Arrangements - Guidelines on Corrective Action" (Decision No. 7842-(84/165) adopted November 16, 1984) reprinted in *Selected Decisions and Selected Documents of the International Monetary Fund* (Twenty-first Issue, June 30, 1996), page 107.

decides to grant a waiver for the member's failure to implement the prior action. 12/ To which purchases would the Guidelines apply? Set out below are several different scenarios which identify the purchases that, in the staff's view, would be subject to the application of the Guidelines in different situations. 13/

Prior action for approval of an arrangement

21. If the Managing Director were to make a finding that a member had failed to implement a measure identified in an Executive Board decision as a prior action for approval of an arrangement, all prior purchases made by the member under the arrangement would be subject to the application of the Guidelines. 14/

Prior action for completion of a review

22. If the Managing Director were to make a finding that a member had failed to implement a measure identified in an Executive Board decision as a prior action for completion of a review, all purchases made by the member under the arrangement after completion of the review would be subject to the application of the Guidelines.

Prior action for granting of a waiver

23. If the Managing Director were to find that a member had failed to implement a measure identified in an Executive Board decision as a prior action for the granting of a waiver for the nonobservance of a performance criterion, all purchases made by the member as a result of the granting of the waiver would be subject to the application of the Guidelines.

24. In order to identify the purchases that would be subject to the application of the Guidelines in any particular case, it would be necessary to examine the nature of the

12/ Instead of repurchasing, the member may request the Fund to use an equivalent amount of its holdings of the member's currency in the Fund's transactions and operations, but only if such use can be made within 20 days from the date of the Executive Board decision establishing the repurchase expectation.

13/ There is no existing Board policy or practice on these questions.

14/ The Guidelines give the Managing Director the authority to make the finding that a particular purchase is subject to the application of the Guidelines. However, it is the Executive Board which decides whether or not to call upon the member to take corrective action. Where the Managing Director makes a finding that a particular purchase is subject to the application of the Guidelines, he must submit a report to the Executive Board which may include a recommendation that the member be called upon to take corrective action, or that a waiver be granted; the report will contain a draft decision, normally proposed for adoption on a lapse-of-time basis.

performance criterion with respect to which the waiver for nonobservance was granted. For example, where the relevant performance criterion was established for a test date at the end of a particular period (e.g., the end of a calendar quarter), any purchases made by the member during the following period would be subject to the application of the Guidelines. In contrast, where the relevant performance criterion is a “continuous” performance criterion whose nonobservance interrupts all subsequent purchases under an arrangement, ^{15/} all purchases made by the member after the granting of the waiver would be subject to the application of the Guidelines.

Specifying purchases applicable to a prior action

25. The failure of a member to implement a measure that was identified by the Board as a prior action for the adoption of a decision on an arrangement (e.g., approval of an arrangement, completion of a review, or granting of a waiver) can lead to the application of the Guidelines to several purchases under the arrangement. However, it would be open to the Board, in its decision specifying a prior condition, to make it explicit that the implementation of the prior action would be a condition only for the making of a particular purchase under an arrangement (e.g., upon approval) and, in these circumstances, the failure of the member to implement the prior action would lead to the application of the Guidelines to that purchase only.

Further purchases under an arrangement

26. The scenarios discussed above explain the circumstances in which the Guidelines would apply to purchases that the member had already made. In what circumstances would the member’s right to make future purchases under an arrangement be interrupted?

27. A member’s right to make purchases under an arrangement may be interrupted only in the circumstances that are specified under the terms of the arrangement. Under the standard texts of the Fund’s stand-by and extended arrangements presently in use, the failure of a member to implement a measure that had been explicitly identified by the Board as a prior action to adoption of a decision on an arrangement will lead to the interruption of the member’s right to make further purchases under the arrangement only if the Executive Board has called upon the member to make an early repurchase and the member has failed to meet the repurchase expectation within the period specified by the Board.

28. Except in these circumstances, a member that has failed to implement a measure identified in a Board decision as a prior action may continue to make purchases under an

^{15/} Such a performance criterion provides that the member’s right to make purchases under the arrangement will be interrupted “if, at any time during the period of the arrangement,” the performance criterion is not observed. Where such a performance criterion is not observed, purchases may only be resumed if the Board grants a waiver; in this regard, a waiver will be required even if the member brings itself back into compliance with the performance criterion.

arrangement even where the additional purchases will, as a result of the failure to implement the prior action, ultimately be subject to the application of the Guidelines. 16/ To the extent that the Fund wished to interrupt a member's right to purchase in circumstances other than those already specified under the terms of arrangements, it would be necessary to amend the texts of the arrangements accordingly.

16/ For example, under the present terms of arrangements, where the staff has learned that a member may not have implemented a measure that the Executive Board identified as a prior action in the decision to approve an arrangement and the staff is in the process of clarifying whether its information is correct, the member may continue to make purchases under the arrangement even if these additional purchases may subsequently be subject to the application of the Guidelines.