The Policy Support Instrument:
A Key Component of the Recent IMF Reform Movement

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The Policy Support Instrument is a new type of IMF program agreed to just last spring at the time of the IMF/World Bank meetings. The *sine qua non* of the Policy Support Instrument is that a country does not have to borrow from the IMF in order to receive many of the benefits that the IMF—the board, the management, the staff—gives to a country as part of a regular IMF program. These benefits include providing expert on-the-ground advice on monetary, fiscal, banking, and exchange rate issues, setting realistic benchmarks and timelines for achieving results, and validating the policy through IMF Board approval of the program and benchmark reviews. Simply put, the Policy Support Instrument is an IMF program without the borrowing, and for that reason it is sometimes called a "non-borrowing program."

In this note, I first review the case for the non-borrowing program and then put it in the context of the significant series of reforms that have been adopted by the IMF in recent years.

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The Advantages of a Non-Borrowing Program

There are many advantages of the new non-borrowing program:

- For a heavily indebted poor country seeking an IMF program, the main advantage of a Policy Support Instrument is that the poor country's *debt does not need to increase* in order to get the benefits of the program. Indeed, a series of requests for this type of program from the finance ministers of heavily indebted poor countries was what first put this idea on the reform agenda, and there appears to be a pent up demand for the program from such countries.
- A *greater degree of country* ownership of the macroeconomic policy program is another advantage of the Policy Support Instrument. Without IMF money on the table, it will be clearer that the country has developed its program on its own without the appearance of being under the pressure of the International Monetary Fund. In many countries and in many circumstances this demonstrated ownership of the policy can be politically very useful.
- For countries that are not heavily indebted and do not need IMF loans, the Policy Support Instrument can *provide a signal to the international financial markets* that their macro policy is strong.
- Because it is easier to develop a borrowing program if a country already has a non-borrowing program, the Policy Support Instrument will also be a way for a country to move gradually off IMF support after a crisis and a series of IMF loans, and to be better prepared for a crisis if that is a concern.
- Another advantage is that, with the Policy Support Instrument available, there is no reason for the IMF management and shareholders to get into a position where

they really have no choice but to make loans when in reality the loans are not needed for balance of payments purposes. In the past this situation has occurred, for example, where donors to a country need the IMF program to validate the fiscal and monetary policies of the country, but where the country does not have a balance of payment problems in the usual sense. Without the Policy Support Instrument, IMF loans were being made to countries and then being rolled over because they were the only way to provide the important seal of approval to donors and/or the multilateral development banks. In other words the existence of the Policy Support Instrument will make it *easier for IMF management and shareholders to follow in practice the key principle that IMF loan support be given when there is a clear balance of payments need*.

- A very important advantage is that the Policy Support Instrument will enable the IMF to *assist more poor countries in core IMF areas of expertise,* including those that do not have the need for IMF borrowing.
- The Policy Support Instrument will make it *easier to follow the principle of the division of labor* between the IMF and World Bank in which longer term development loans and grants come in from the World Bank, and shorter term balance of payments loan come from the IMF.

Concerns about Non-Borrowing Programs

As originally proposed and as it is now being implemented, the Policy Support Instrument is *voluntary*. That it is voluntary avoids disadvantages that some had worried about in such a program. If indeed there is an actual need for borrowing for a balance of payments crisis, then a conventional IMF program can be used.

If having outside pressure for reform from the IMF is viewed as useful to policy makers in a country, and if having a loan from the IMF helps convey the idea that such pressure exists, as critics of non-borrowing programs have argued, then a conventional IMF program can be sought.

Some criticism of the non-borrowing programs came from those who worried that it would not be voluntary in practice. Rather non-borrowing programs would be forced on countries which would rather have a conventional program. I have never heard of any intention to move in such a non-voluntary direction, but the agreement to support the non-borrowing program last spring was accompanied by explicit statements on the importance of continuing support for other facilities such as the Poverty Reduction and Growth Facility in order to alleviate such concerns.

Another objection to non-borrowing programs has come from those who wanted to achieve other changes in the way the IMF operates, a logrolling tactic that is common to all negotiations of reforms. The recent agreement meant that this objection was set aside in the spirit of international cooperation and in the interest of moving forward on an important reform.

The Policy Support Instrument as Part of a Broader IMF Reform Movement

The Policy Support Instrument is the latest component in a series of reforms that the IMF management and shareholders have recently adopted, and it is best considered as part of those reforms rather than in isolation. Here is a very brief summary of the other components of the recent reforms:

- *Collective action clauses.* After a long diplomatic effort by the United States and other IMF shareholders, these new clauses were first introduced by Mexico in a New York offering in 2003 and now have become the market standard. They provide greater predictability and orderliness to debt restructurings and, unlike a centralized sovereign bankruptcy mechanism, require a minimum of intervention from the official sector. Importantly, private creditors and borrowing countries have recently supported these clauses with a new code of conduct. If such clauses were in Argentine debt, the recent 76 percent participation rate would have been enough to deal with the holdouts. The clauses reduce the uncertainty and enable the official sector to clarify its own response, as the next reform in the list illustrates.
- *Clarified limits on IMF financing.* This reform was adopted by the IMF Board in 2003. The limits are stated in percentages of quota, so adjusting the quotas to give relatively larger amounts to countries that have grown more rapidly than others in recent years is therefore important. There are four criteria for exceptional access and an "exceptional access report" is required if the limits are exceeded. With the accompanying presumption that the IMF rather than official creditor governments is responsible for large scale loan financing, an overall budget constraint is also created. The purpose of the clarified limits is to reduce uncertainty and create the right incentives for both policy makers and private investors. As the limits become an established principle of IMF operations, market participants and

borrowing countries can make decisions with less uncertainty. In a similar way the new Policy Support Instrument will better enable the IMF to follow key principles stipulating when to lend and when not to lend. The new limits have held so far, except in the obvious cases of the need to draw down large exposure gradually from limits exceed previously.

- *Streamlined conditionality.* A widely held criticism of the IMF in the past was that there were too many conditions in its traditional programs. This raised serious questions of ownership and the division of responsibilities with the World Bank. This "streamlining" reform to deal with this criticism was adopted by the IMF Board in 2003. It has already greatly simplified and clarified the nature of IMF programs. It requires a clear division of responsibility between the IMF and the World Bank, because many structural conditions previously in IMF programs should be the responsibility of the World Bank. As I argued above, the Policy Support Instrument further clarifies the division of labor between the two institutions, and is supportive of the streamlined conditionality.
- *Focus on IMF core responsibilities.* The IMF core includes monetary, fiscal, banking, and exchange rate issues. The main purpose of this institutional reform has been to make surveillance and crisis prevention more effective. Greater clarification of the division of labor between the World Bank and the IMF has been an important by-product. Good progress is being made, and in order to further improve surveillance, the IMF is proposing changes in its organization and report writing.

Viewed as a whole, and in conjunction with supportive actions in practice, these reforms—including the Policy Support Instrument—represent a significant change in the operations of the IMF. Many of the reforms are based on ideas that were proposed and discussed in reports and academic conferences—much like the present one—starting around the time of the 50th anniversary of the founding of the IMF in 1944. The reforms have tried to deal with important changes in the world financial system, including the growing importance of securities compared to bank loans, the increased volume of private capital flows, and the greater connectivity of markets, which raised concerns about contagion and sudden-stops of capital flows. The reforms aimed at dealing with emerging market financial crises, which had grown in severity and number in the 1990s. The policy responses of the IMF to the crises of the 1990s were understandable, but they were difficult for market participants and policy makers in emerging markets to analyze and predict. The responses emphasized large official sector loans. In some cases, these responses had adverse effects on expectations or incentives. Many complained about an arbitrariness, or even a bias, in which some countries could expect large loan packages and others might not. The reforms listed here aim to provide greater clarity and accountability about IMF policy responses, as the limits on large scale borrowing and the new non-borrowing program illustrate most clearly.

International Cooperation in Implementing and Internalizing the Reforms

Although it is still early for a full evaluation, these reforms appear to be having beneficial effects. In my view they provide an institutional structure in which the IMF management and staff can now give better, and more likely accepted, advice, thereby dealing more effectively with many important policy issues, including exchange rate flexibility, currency mismatches, and current account imbalances. The Policy Support Instrument, when fully operational, will be an important component of this overall reform effort.

Agreement on these reforms—including the Policy Support Instrument—has entailed many tough debates, negotiations, and compromises in the international finance community. Reaching agreement would not have been possible without a remarkable spirit of international cooperation in the finance area in recent years. In my view, this spirit of international cooperation grew greatly in the weeks and months following the 9/11 terrorist attacks, but it has continued, and it was an underlying driving force behind the IMF reforms and other financial initiatives. In order to lock-in these reforms and to internalize them, as the IMF management is now proposing, those in the international finance community will need to continue with their support and cooperation, and given the recent progress, I have every reason to expect that they will.