

## **UNDERSTANDING THE POLICY SUPPORT INSTRUMENT OF THE IMF:**

### **Abstract**

The plethora of acronyms in the IMF has a new addition- the 'PSI'. On October 17, 2005, the International Monetary Fund (IMF) approved Nigeria's request for a Policy Support Instrument (PSI), thereby documenting Nigeria as the first user of the new IMF program. Following the approval of the PSI, Nigeria signed an agreement with its Paris Club creditors on October 20 2005 under which approximately 60% of its \$30bn debt was written off on Naples terms, with the remainder to be paid back in two tranches over 6 months. Obtaining approval for its economic reform program through the Policy Support Instrument was one of the conditions for Nigeria's debt restructuring negotiations with the Paris Club.

The PSI is a voluntary instrument requested by a member of the IMF in order to get IMF approval for its economic policies. According to the 'PSI Factsheet' on the IMF website, the PSI which was introduced in October 2005 to "enable[] the IMF [] support low-income countries that do not want or need Fund financial assistance". "The PSI will help countries design effective economic programs, and, once approved by the IMF's Executive Board, will signal to donors, multilateral development banks, and markets the Fund's endorsement of a member's policies".

This paper intends to discuss the PSI using Nigeria as a reference point. What exactly is the PSI about and what is its purpose? How is it different from similar IMF instrument(s) which are currently operational? What is the modus operandi of the PSI? What are the

eligibility criteria for the PSI? What is the standard of assessment to be used in evaluating a PSI? These and more will be the focus of this research paper.

## **Introduction**

### **The IMF as an International Financial Institution**

The time of unprecedented cooperation and optimism towards the end of World War II and the determination to avoid mistakes of the past led to the signing of the Bretton Woods agreement by forty-four countries and the establishment of the IMF for the purpose of maintaining exchange rates for free international trade.<sup>1</sup> Generally the purpose of the IMF ('the Fund') among other things is to "promote international monetary cooperation through a permanent institution which provides the machinery for consultation and collaboration on international monetary problems; to facilitate the expansion and balanced growth of international trade; to promote exchange stability; and to assist in the establishment of a multilateral system of payments in respect of current transactions between members"<sup>2</sup>

Membership of the IMF necessarily implies certain expectations and obligations on its Members. First every member of the IMF must keep the other members informed of its economic policies. This method of reporting is through the institutional structure of the IMF. The contents of the report generally include information on its economy, its micro and macroeconomic policies, fiscal and monetary policies, administrative framework etc,

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<sup>1</sup> See generally Andres Velasco and Emre Deliveli, *The International Monetary Fund: Origin, Objectives, Controversies and Challenges* (2003), available at [http://www.clubmadrid.org/cmadrid/fileadmin/Velasco\\_Deliveli\\_Final\\_\\_Oct\\_18.pdf](http://www.clubmadrid.org/cmadrid/fileadmin/Velasco_Deliveli_Final__Oct_18.pdf) (last visited February 18 2006).

<sup>2</sup> See generally IMF Articles of Agreement art. I, which states the purposes of the IMF.

all of which the IMF documents and makes available to all its members. This information keeps members informed about the economic affairs of others and to make decisions according to the information circulated.

Next, every member is expected to watch out for the interests of the other members. By this, it means that members should not engage in trade and economic policies that are deliberately adverse to the interests of the others. In other words, the old system of ‘beggar-thy-neighbor’ policies<sup>3</sup> is to be avoided at all costs. This necessarily implies that every country must run its economy responsibly.

Thirdly and most importantly, as an international financial institution, lending to solve the balance of payment difficulties of its members is arguably the Fund’s most important activity. Consequently IMF members can expect the Fund to bail them out of balance of payment difficulties. Balance of payment problems arise where there is a shortage of foreign exchange to finance a country’s various obligations. This deficit occurs where a country’s imports far outstrip its exports such that it spends more foreign exchange than it earns. This leads to a situation where there is scarce hard currency for a country to meet its trading obligations and its debt servicing obligations. As a lender of last resort therefore, the IMF often has to put up the money to bail out countries that find themselves in such difficulty.

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<sup>3</sup> This is a system in the time before the Great Depression where countries increased trade barriers and engaged in competitive devaluations to make their goods cheaper and more attractive. The end-result was the total collapse of international trade where everyone ended up worse off.

### *The IMF's Main Activities*<sup>4</sup>

In order for the IMF to achieve its objectives, it performs certain activities. These activities are in three categories. I have already spoken about the lending activity of the fund in the preceding paragraph. The second activity of the Fund is the surveillance missions which it carries out regularly in its member countries. In today's globalized economy, where the economic and financial policies of one country may affect many other countries, international cooperation to monitor economic developments on a global scale is essential. The IMF provides the mechanism for this cooperation. Under Article IV of its Articles of Agreement, the IMF has a mandate to exercise surveillance over the exchange rate policies of its members in order to ensure the effective operation of the international monetary system.<sup>5</sup> In 1977, an Executive Board decision<sup>6</sup> recognized that the IMF's appraisal of exchange rate policy requires a comprehensive analysis of the general economic situation and policy strategy of each member country. The decision also emphasized that the ultimate objective of surveillance is to help member countries achieve financial stability and sustainable economic growth.

“Article IV consultations”, as IMF surveillance missions are known, usually take place once a year. IMF economists visit the member country to gather information and hold discussions with government and central bank officials, and often private investors, labor representatives, members of parliament, and civil society organizations. Upon its return,

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<sup>4</sup> For more information on the IMF'S activities, see “The IMF at Work” at <http://www.imf.org>.

<sup>5</sup> IMF Articles of Agreement art. IV, para. 3.

<sup>6</sup> Decision No 5392- (77/63), April 29 1977, *available at* <http://www.imf.org>.

the mission submits a report to the IMF's Executive Board for discussion. The Board's views are subsequently summarized and transmitted to the country's authorities.<sup>7</sup>

Third, the IMF provides countries with technical assistance and training in its areas of expertise i.e. macroeconomic policy, tax policy and revenue administration, expenditure management, monetary policy, the exchange rate system, financial sector sustainability, and macroeconomic and financial statistics. Technical assistance is one of the benefits of IMF membership. It is normally provided free of charge to any requesting member country, within IMF resource constraints. In order to strengthen the effectiveness of IMF technical assistance, measures are taken to integrate it more closely with surveillance and lending programs.<sup>8</sup>

Supporting all three of these activities is IMF work in economic research and statistics.

#### *The IMF's Evolving Role to its Borrowing Members*

Throughout its existence, the IMF has had to be creative in the facilities it adopts for the benefit of its Members. Policies of the IMF often evolve with demand and situations but always remain within the three core activities of the IMF i.e. lending, surveillance, and technical assistance.

#### *Stand-by Arrangements<sup>9</sup>*

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<sup>7</sup> See "Surveillance- A Factsheet" available at <http://www.imf.org/external/np/exr/facts/surv.htm>

<sup>8</sup> See "Technical Assistance- A Factsheet" available at <http://www.imf.org/external/np/exr/facts/tech.htm>

<sup>9</sup> "Financial Organization and Operations of the IMF" (Pamphlet Series No. 45 6<sup>th</sup> ed. 2001), available at <http://www.imf.org/external/pubs/ft/pam/pam45/pdf/pam45.pdf> (last visited May 1 2006)

The earliest facility of the IMF was the “Stand-by” arrangement created in the 1950s. The bulk of IMF lending is provided under short term “Stand-by” Arrangements that address balance of payments difficulties of a temporary or cyclical nature.

The “Stand-by” Arrangement is a decision of the IMF by which a member is assured that it will be able to make purchases (drawings) from the General Resources Account (GRA) up to a specified amount and during a specified period of time, usually one to two years, provided that the member observes the terms set out in the supporting arrangement. The arrangement is normally conditional on a country adopting and implementing a program of economic reforms affecting major macroeconomic variables such as the exchange rate, money and credit, and the fiscal deficit. Moreover, the financing provided by the IMF is temporary, to be repaid when macroeconomic imbalances have been rectified, and economic performance has improved. All credit outstanding incurs interest at the IMF’s basic rate of charge which is based on market interest rates and can be subject to surcharges depending on the type and duration of the loan and the amount of IMF credit outstanding.

#### *Concessional Lending*<sup>10</sup>

As time went on, a need arose to create a special facility for certain IMF members to make IMF fund available to those members on better terms than the stand-by arrangements. The IMF lends to poor countries at a concessional interest rate of ½ of 1 percent and over a longer repayment period than non-concessional IMF lending while these countries restructure their economies to promote growth and reduce poverty. The

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<sup>10</sup> *Id.*

IMF also provides assistance on a grant (no-cost) basis to heavily indebted poor countries to help them achieve sustainable external debt positions. These activities are undertaken separately from the IMF's regular lending operations, with resources provided voluntarily by members independently of their IMF capital subscriptions, and in part from the IMF's own resources.<sup>11</sup>

### *Providing Non-lending Support*

With time, many countries which qualified for concessional lending realised that they no longer needed financial assistance from the IMF. These countries had experienced some form of growth and stability and were even able to access funds directly from the capital markets. They therefore no longer needed the IMF's "stand-by" arrangements or its concessional lending facility. That was not to say however that they no longer needed IMF assistance; except that this time, they would need the assistance in a new form.

## **The Policy Support Instrument**

### *Background*

Countries often provide bilateral assistance to other countries by making funds available to them on a loan agreement. As with any lender-borrower relationship, there comes a time when it is time for debt repayment. It is a common occurrence that the debtor has difficulty in paying back its debt as and when due. In situations like this, especially when there is a chronic shortage of funds for the repayment, the only option could be a default

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<sup>11</sup> The IMF's concessional assistance is extended through the Poverty Reduction and Growth Facility (PRGF) Trust and in the context of the Heavily Indebted Poor Country (HIPC) Initiative through the PRGF-HIPC Trust, both of which the IMF operates as Trustee.

on the loan.<sup>12</sup> In order to prevent situations of debt default therefore, it becomes necessary for a country to re-negotiate its debts with its creditors.

Generally, in order for a country to be able to generate enough money to meet its debt obligations, it has to be able to increase its foreign exchange receipts through its earnings, or borrow more money i.e. re-financing. Although it is possible to re-finance loans through the IMF, there are several good reasons why a country would not want to borrow from the IMF in order to repay a loan. Chief among the reasons is the conditionalities which are a typical feature of IMF loans.<sup>13</sup> It could also be that the country believes it can increase its revenue in order pay off its loans by following appropriate policies without resorting to more borrowing. More borrowing is just a case of re-financing- it does not erase the debt. An increase in income could be achieved through a reduction in consumption; an increase in sales revenue i.e. reduced imports and increased exports; or by reduced government expenditure. Achieving these objectives will require the right policies being put in place. These policies if properly planned and managed will guarantee the generation of income to meet debt obligations.

In debt restructuring deals therefore, creditors often find themselves in a position where they want to ensure that the proper policies are being followed that will generate the income that will pay off the debts owed to them. This is where the IMF comes in. The

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<sup>12</sup> A default is when a country cannot raise the money needed to pay off its debts, and therefore decides unilaterally not to pay the debt. For e.g. During the last week of 2001 facing the impossibility to meet debt payments, Argentina defaulted on the larger part of the public debt, totaling no less than 93,000 million dollars.

<sup>13</sup> On conditionalities in the IMF generally, see “International Monetary Fund: Guidelines on Conditionality” (September 2002), *available at* <http://www.imf.org>

IMF as a credible international institution is often called upon to give its stamp of approval on the economic policies of a country. The IMF as an institution to which the creditor and the debtor both belong, acts as an intermediary to facilitate the debt restructuring discussions. The way it does this is financing part of the debtor country's debt by lending it a portion of the total debt obligation. The participation of the IMF in any package on a country's debt restructuring sends a positive signal to the creditor(s). In fact, it gives the creditor comfort that the IMF is involved and makes it more willing to restructure the debt. It is this role of the IMF that led to the Policy Support Instrument.

### *Creating the PSI*

As part of its ongoing reforms, the IMF is creating new policies, while retiring old and redundant policies.<sup>14</sup> The new policies are to respond to new demands as they arise. The Policy Support Instrument (PSI) is one of these new policies of the IMF. It was brought about as a result of the review of the IMF's medium term strategy, as an additional means of supporting its low-income members.<sup>15</sup>

The idea of a non-lending program was first mooted at the IMFC Meeting in April 2004 where the United States Secretary of the Treasury reopened IMF consideration of a mechanism through which the IMF could provide support for Members without lending.<sup>16</sup>

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<sup>14</sup> "Debt Relief, Globalisation, and IMF Reform: Some Questions and Answers By IMF Staff" (April 2000) available at <http://www.imf.org/external/np/exr/ib/2000/041200b.htm> (last visited April 28 2006)

<sup>15</sup> "Strengthening the IMF's Support for Low-Income Countries" (September 2005) available at <http://www.imf.org/external/np/exr/ib/2005/092105.htm> (last visited May 3 2006)

<sup>16</sup> Institute for International Economics (IIE), "A Strategy for IMF Reform" p.102, available at [http://www.iie.com/publications/chapters\\_preview/3985/05iie3985.pdf](http://www.iie.com/publications/chapters_preview/3985/05iie3985.pdf) (last visited May 1 2006)

[t]o strengthen its policy role, we favour the development of a new form of engagement for countries that do not have a financing need. Under this proposal, the IMF could assess an economic program prepared by the country itself and signal its view to donors, MDBs (Multilateral Development Banks) and markets. Such a non-borrowing vehicle for close engagement would benefit both poor countries and emerging market countries as it will show that a country has clear ownership of its policies and is strong enough to stand on its own feet”

By April 2005, the IMFC had signed up and expressed support for the US proposition on the basis that the proposed mechanism would be analogous to a grant of policy endorsement without financial resources.<sup>17</sup>

### *Features of the PSI*

The PSI is a non-lending program. It is often resorted to when a country no longer requires IMF funding, but it needs the IMF to endorse its economic policies in order to send a positive signal to the world that it is pursuing strong economic objectives which make it a veritable destination for investing.

The PSI is one alternative among the range of facilities from which low-income countries can choose their desired form of engagement with the IMF. As a policy, it was

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<sup>17</sup> Communiqué of the International Monetary and Financial Committee of the Board of Governors of the International Monetary Fund held on April 16 2005 in Washington DC, par.12 “[the committee] also looks forward to further work on a policy monitoring arrangement to enhance the IMF's signaling role for countries that do not need or want IMF financing.”

introduced in October 2005, and its purpose is to enable the IMF to support low-income countries that do not want or need its financial assistance. The way it does this is by helping countries design effective economic programs, and once these programs are approved by the IMF's executive board, it will signal to the donors and creditors alike that the IMF endorses those programs, which will in turn reassure those donors and creditors. The PSI aims to: (i) promote a close policy dialogue between the IMF and a member country; (ii) provide more frequent Fund assessments of a member's economic and financial policies than is available through the regular consultation process, known as surveillance; and (iii) deliver clear signals on the strength of these policies.<sup>18</sup>

The PSI is voluntary and is a complement to the Poverty Reduction and Growth Facility (PRGF).<sup>19</sup> Some of the key features of the PSI are as follows<sup>20</sup>:

- Program targets and structural reforms should be based upon a country's poverty reduction strategy to help ensure policy ownership;
- Programs should meet the same high standards as under a Fund financial arrangement;
- PSIs will have a fixed schedule of reviews to assess program implementation, with reviews normally scheduled semiannually. Only limited flexibility will be

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<sup>18</sup> "The Policy Support Instrument- A Fact sheet", available at [www.imf.org/external/np/ext/facts/psi.htm](http://www.imf.org/external/np/ext/facts/psi.htm)

<sup>19</sup> The PRGF was created to make the objectives of poverty reduction and growth more central to IMF lending to its poorest members. PRGF-supported programs are framed around comprehensive country-owned Poverty Reduction Strategy Papers (PRSP). PRSPs are prepared by governments with the active participation of civil society and other development partners. After these are considered by the IMF and the World Bank, it forms the basis for concessional lending and debt relief under the Heavily Indebted Poor Countries (HIPC) Initiative.

<sup>20</sup> See *supra* note 18.

- allowed in the timing of the reviews, and the Board will conduct reviews irrespective of the status or prospects of program implementation;
- The provision of timely and accurate information from the member with a PSI will be essential for the Fund’s assessments. A framework for dealing with possible cases of misreporting will be in place to safeguard the integrity of IMF assessments;
  - In the event of a shock, an on-track PSI could provide the basis for rapid access to PRGF resources through the Fund’s new Exogenous Shocks Facility<sup>21</sup>;
  - The publication of PSI documents is voluntary, but presumed. This is a similar policy to the one in effect for PRGF documents.
  - The PSI will be reviewed after a three- year period to determine its success.

The PSI is not available to all IMF member countries. It is only available to PRGF-eligible members with a Poverty Reduction Strategy (PRS) in place. The member country has to make a request for the PSI, and in making this request it has to submit a Letter of Intent which describes the policies the member intends to implement in the context of its request for a PSI from the IMF. Nigeria was the first country to request a PSI on October 6, 2005, and this was approved on October 17, 2005.

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<sup>21</sup> The Exogenous Shocks Facility (ESF) provides policy support and financial assistance to low-income countries facing exogenous shocks [An exogenous shock is an event that has a significant negative impact on the economy and that is beyond the control of the government e.g. commodity price changes, natural disasters, and conflicts and crises in neighboring countries that disrupt trade]. It is available to countries eligible for the Poverty Reduction and Growth Facility (PRGF) Financing terms are equivalent to a PRGF arrangement and more concessional than under other IMF emergency lending facilities. Through the ESF, the IMF can offer assistance in the form of quick-disbursing loans to meet immediate balance of payments needs, and by providing a signal on the adequacy of policies. IMF lending also can help to attract more concessional assistance from donors. For more information on the ESF, see “The Exogenous Shocks Facility- A Fact Sheet”, *available at* <http://www.imf.org/external/np/exr/facts/psi.htm>

## **Nigeria and the Policy Support Instrument**

### *Tracing Nigeria's Debt History*<sup>22</sup>

The origin of Nigeria's external debt dates back to 1958 when a sum of US\$28 million was contracted for railway construction.<sup>23</sup> By the late 1970s to the early 1980s, the oil glut in the international market had put Nigeria in a precarious position. The sharp fall in oil prices and dramatic reduction in domestic oil production led to a sharp deterioration in the balance of payments and government finances. Nigeria found it difficult to cope with this situation to the extent that its foreign reserves dropped from US\$10billion in 1980 to US\$3.9billion in 1981. The government's response to this crisis was to finance the deficits by borrowing, drawing down of external reserves and accumulation of arrears on external trade payments. Meanwhile spending remained high largely financed by external borrowing from bilateral and multilateral credit sources. Subsequent years saw widespread mismanagement of funds and corruption by successive governments. Refinancing was the principal means of dealing with the debt situation. The situation was not helped any by the global interest rates with LIBOR going up by about 10% between the early 1980s and 1989. By 2005, Nigeria's total external debt had risen to US\$36.2billion.<sup>24</sup> Of this total sum, US\$30.8 was owed to Nigeria's Paris Club creditors.<sup>25</sup>

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<sup>22</sup> See generally N.E. Ogbe, *Evaluation of Nigeria's Debt Relief Experience 1985-1990* Research Program on Financial Policies for the Global Dissemination of Economic Growth (Working Paper No.55 March 1992); Lex Rieffel *Resolving Nigeria's Paris Club Debt Problem: A Case of Non-Performing Creditors* (August 2005)

<sup>23</sup> Central Bank of Nigeria, "Structure of External Debt" available at [http://www.cenbank.org/paymentsystems/externa\\_debt.htm](http://www.cenbank.org/paymentsystems/externa_debt.htm) (last visited May 8 2006)

<sup>24</sup> [http://www.clubdeparis.org/en/news/page\\_detail\\_news.php?FICHIER=com11297988840](http://www.clubdeparis.org/en/news/page_detail_news.php?FICHIER=com11297988840) (last visited April 15 2006)

<sup>25</sup> The Paris Club is an informal group of official creditors. Its origin dates back to 1956 when Argentina met with its sovereign creditors in Paris to arrange a debt rescheduling in order to stave off an economic catastrophe. Till date, the Paris club meets in Paris regularly to consider appeals from debtor nations on

### *Debt Restructuring with the Paris Club*

As part of the conditions for the Paris Club restructuring Nigeria's debt, the country's authorities were to have obtained approval for a PSI from the IMF.<sup>26</sup> This approval was received from the IMF on October 17, after which the representatives of the Paris Club creditor countries met on 18, 19 and 20 October 2005 and agreed with the representatives of the Federal Republic of Nigeria on a comprehensive treatment of its debt. This agreement was to be implemented in two phases in consonance with the implementation of the PSI. In the first phase, Nigeria would pay arrears due on all categories of debts and Paris Club creditors would grant a 33% cancellation of eligible debts. In the second phase, after the approval of the first review of the PSI by the Executive Board of the IMF in March 2006, the Nigerian Government will pay amounts due under post-cut off date debt, Paris Club creditors will grant a further tranche of cancellation of 34% on eligible debts, and Nigeria will buy back the remaining eligible debts. In total, this agreement allows Nigeria to obtain a debt cancellation estimated at US\$18 billion (including moratorium interest) representing an overall cancellation of about 60% of its debt to the Paris Club of around US\$30 billion. Paris Club creditors will be paid an amount of US\$12.4 billion, representing regularization of arrears of US\$6.3 billion, plus a balance of US\$6.1 billion to complete the exit strategy.<sup>27</sup>

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debt restructuring. Its members include the U.K, the U.S, France, Japan, Australia, Canada, Austria, Germany, Italy, Switzerland, Spain, Sweden, Norway, Netherlands, Ireland, Belgium, Denmark, Finland, and Russia.

<sup>26</sup> Paris Club Press Release June 29 2005, "Paris Club creditors are ready to invite Nigeria to negotiate in Paris as soon as it has concluded a policy support instrument with the IMF", *available at* [http://www.clubdeparis.org/en/news/page\\_detail\\_news.php?FICHIER=com11201201230](http://www.clubdeparis.org/en/news/page_detail_news.php?FICHIER=com11201201230) (last visited April 15 2006)

<sup>27</sup> [http://www.clubdeparis.org/en/news/page\\_detail\\_news.php?FICHIER=com11297988840](http://www.clubdeparis.org/en/news/page_detail_news.php?FICHIER=com11297988840) (last visited April 15 2006).

### *Nigeria's Policy Support Instrument*

As part of the conditions to be met before getting a PSI approval, the requisite documentation is: a letter of intent, a policy statement, and a technical memorandum of understanding to be prepared by the country requesting the PSI. The letter of intent, addressed to the Managing Director of the IMF, requests the “assessment and endorsement of the policies by the [IMF] under a two-year [PSI] arrangement”.<sup>28</sup> The policy statement on the other hand outlined the “broad macroeconomic objectives and policies for 2005 and for the medium term... based on the National Economic Empowerment and Development Strategy (NEEDS)...”<sup>29</sup> The NEEDS program is Nigeria’s economic development map. It was wholly prepared by Nigeria’s Ministry of Finance, and had been presented and discussed under previous IMF Article IV missions.<sup>30</sup> The technical memorandum of understanding between the Nigerian authorities and the IMF sets out the definitions of performance targets as well as reporting requirements for the Nigerian reform program supported under the PSI.

The first review of Nigeria’s PSI has been carried out, fulfilling the criterion that a review is to be carried out every 6 months.<sup>31</sup> As a result of the approval of the PSI, Nigeria finally exited the Paris Club.

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<sup>28</sup> “Nigeria: Authorities’ Letter, Policy Statement, and Technical Memorandum of Understanding”.

<sup>29</sup> *Id.*

<sup>30</sup> See *infra* note 35

<sup>31</sup> According to IMF Press Release No 06/73 dated April 17, 2006, the first review of Nigeria’s PSI has been carried out and approved by the Executive Board of the IMF.

## **The Advantages of the PSI as a Non-Borrowing Program**

If the PSI stays true to its blueprint, there are quite a number of benefits that could be derived from such a program. The potentially most important benefit of the PSI is its signaling function. Many countries which have achieved a level of stability in their economies no longer require IMF funding for balance of payments difficulties (it should be remembered that IMF lending is basically for this purpose). This does not mean that they no longer require funds; but the kinds of funds needed this time around are for development purposes. These funds are better sourced from the capital market because of the huge amounts involved. However, because the operators of the market would need an analysis of the macro framework before they release the funds, the approval of a PSI would confirm to these countries that the right policies are in place in order to ensure a good chance of the repayment of the debt. The same logic goes for donors. There is an additional benefit to this: Once the IMF approves a PSI, there is no need for the creditor or donor to conduct an independent analysis of its own and it can be rest assured that a proper examination has been carried out, especially as they do not have the wide-reaching efficiency and experience that the IMF has. This result can be seen in Nigeria's debt restructuring with the Paris Club. The conclusion of a PSI was a condition for renegotiating Nigeria's debt with the Paris Club.<sup>32</sup> Without a PSI, the Paris Club creditors would still have wanted some guarantee as to the viability of Nigeria's economy to show that it was serious about its economic reforms that would guarantee that it could repay its debt and refrain from accumulating further debt, and it would have had to carry out an independent analysis of its own

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<sup>32</sup> See *supra* note 26

Again, the PSI does not increase the country's indebtedness to the IMF in any way. A continuation of an IMF program supported by borrowing from the Fund raises debt levels higher than they need to be in many countries. In the past, the IMF had to make loans even where the loans were not needed for balance of payments purposes. This situation occurred, for example, where donors to a country needed the IMF program to validate the fiscal and monetary policies of the country, but where the country does not have a balance of payments problem in the usual sense, without the PSI, 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.<sup>33</sup> With the PSI, now the IMF can support a country's economic recovery without the necessity of extending the IMF's funds which would increase the country's indebtedness.

One of the more endearing features of the PSI is that the country requesting the PSI prepares the policy statement for which it requires IMF support, by itself. The role of the IMF then is to review the policies and by employing its expertise, making the policies more effective. The user of the PSI thus has the advantage of developing its policies as well as employing the IMF's core competencies in macroeconomic, fiscal, and monetary issues i.e. the policies are a "home-grown" initiative with the backing of the IMF to show that it is a policy that has the potential to deliver good economic returns. This in turn signals to the international financial markets, donors, and creditors that the country has strong economic policies that qualify it for debt relief, future lending, or donations. Like

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<sup>33</sup> John B. Taylor, *The Policy Support Instrument: A Key Component of the Recent IMF Reform Movement*-Remarks prepared for the conference on IMF Reform Institute for International Economics Washington DC September 23, 2005.

the US Secretary of the Treasury said while making a case for a policy surveillance framework, “it will show that a country has clear ownership of its policies and is strong enough to stand on its own feet.”<sup>34</sup> Because the policies themselves are developed by the country and not fostered on them by the IMF, countries are free to develop policies that are tailored to their peculiar situation. In Nigeria’s case, its PSI is based on NEEDS, the economic recovery program championed by the Ministry of Finance. The broad goals of NEEDS could be summarized as poverty reduction, wealth creation, and employment generation through the empowerment of the private sector and a reorientation of national values.<sup>35</sup>

As an ancillary to the above point, the PSI compels the users of the program to stick to the policies which they themselves have designed. In this way it serves as an accountability mechanism. Because these countries are aware that a periodic review is going to be carried out, there is more of an impetus to make the program succeed. This is unlike in a situation where there is no outside supervision in which case there is always the tendency of failure to see the policies through.

### **Concerns about the Policy Support Instrument**

To the casual onlooker learning about the PSI, the first reaction usually is this: of what use is such a policy that sounds incredibly similar to surveillance missions? Even though the PSI has its merits, one wonders why there was the necessity of creating a separate

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<sup>34</sup> See *supra* note 16

<sup>35</sup> *Meeting Everyone’s Needs*- National Economic Empowerment and Development Strategy; Nigerian National Planning Commission Abuja 2004, available at [http://siteresources.worldbank.org/INTPRS1/Resources/Nigeria\\_PRSP\(Dec2005\).pdf](http://siteresources.worldbank.org/INTPRS1/Resources/Nigeria_PRSP(Dec2005).pdf) (last visited April 28 2006)

instrument when there already is in existence the yearly Article IV Consultations. It can be argued that really the difference between the PSI and the Article IV consultations is the same for the simple reason that at a base level, the PSI is about the IMF monitoring the economic policies of a particular Member for a period of time in order to give its stamp of approval and signal to the international community about the soundness of such a country's policies. Article IV Consultations could also fulfill the same purpose. Usually, at the end of a surveillance mission, the IMF prepares a report that is available to all its Member countries. This is a way of the IMF giving a feedback as to a country's policies. Anyone who needs to make a decision could as well look to the report of the surveillance. The IMF could endorse a country's policies or otherwise through the surveillance report. Thus, it can be argued that the PSI is redundant.

However, saying that the PSI and Article IV consultations serve the same purpose is to ignore the core differences between the two instruments. Though similar to Article IV Consultations, the PSI plays a different role. Article IV consultations are merely reviews of members' economic standing. They are conducted annually basically to have a status report of how each economy is doing and to make this information available globally. According to the current IMF Managing Director, Rodrigo de Rato, "[surveillance is] the international community's chosen instrument to promote global financial and economic stability." In the consultation report that follows a surveillance mission, the country authorities and the IMF both present their separate views on the state of the country's economy. The PSI is a bit more proactive than that however. The PSI is based on policies designed specifically for a purpose, and not a review of existing policies. Here, the requesting member makes a commitment to follow the laid down policies while the

IMF's part in the whole program is to approve and review the policies periodically. What is required is the IMF's 'seal of approval' for its economic policies. This would have the effect of increasing its credibility in the international economy. In other words, the PSI is a "signaling"<sup>36</sup> instrument. If approved, it signals that a country is on the right track to economic stability. The consultation report is not so much a signaling document as a situation report; it alerts every other country as to the existing economic situation in every other IMF member.

The PSI has to be approved before it can be implemented, and the member is bound by the contents of the Policy Statement it submitted as a pre-condition of the PSI. Moreover, the PSI has performance criteria attached to it, which have to be fulfilled in order to determine the success of the program. These criteria are defined the technical memorandum of understanding between the country and the IMF.

The targets of the consultation and the PSI also differ. The PSI is meant for low-income countries that have made significant progress toward economic stability and no longer require IMF financial assistance, while surveillance is applicable to every IMF member country regardless of its economic strength.

Apart from the differences between the surveillance and PSI, another objection is the voluntariness of the PSI. The letter of the PSI states that it is voluntary and purely demand-driven.<sup>37</sup> But is this really the case? In Nigeria's case, getting approval for a PSI was one of the conditions laid down by the Paris Club of creditors before its debt could

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<sup>36</sup> "Signaling refers to the information that [IMF] activities can indirectly provide about countries' performances and prospects", see *supra* note 18

<sup>37</sup> See *supra* note 18

be renegotiated.<sup>38</sup> What this implies is that Nigeria did not request the PSI of its own accord. While it may not be the IMF that applied the pressure, there was pressure from some other quarter and this puts paid to the notion that the PSI is voluntary. The truth of the matter is that the reason PSIs are requested is to satisfy conditions relating to the grant of funds in one form or the other i.e. through donations, debt relief etc. If countries are made to believe that without IMF support, they cannot receive outside funding, then they would feel compelled to request the PSI. I must state however that this does not conclude that the PSI is always coerced. In fact, Uganda has had its own PSI approved by the IMF and there is nothing to show that it was coerced to request a PSI.<sup>39</sup>

The IMF, as well as other international financial institutions, is currently facing a challenge to redefine itself and remain relevant in the global financial system. According to Jerome Levinson,<sup>40</sup> the new global financial environment has less and less use of these international financial institutions in their current forms: China is emerging as a big player in the global economy and making investments in many countries; Latin American countries like Argentina, Venezuela and Brazil are no longer indebted to these institutions; and African countries can now access funds from the capital markets. Thus the IFIs are facing a crisis and need to reinvent themselves. It has been suggested that,

[I]t [the PSI] would be the IMF's answer to the threat of losing control over the economies of countries receiving debt cancellation. If the

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<sup>38</sup> See *supra* note 26.

<sup>39</sup> It should be noted however that Uganda was the first country to qualify for debt relief under the HIPC Initiative, and it also recently got 100% debt relief under the Multilateral Debt Relief Initiative. See *World Bank and IMF Support Debt Relief for Uganda*, available at <http://web.worldbank.org/WBSITE/EXTERNAL/COUNTRIES/AFRICAEXT/UGANDAEXTN/0,,contentMDK:20019622~menuPK:374959~pagePK:141137~piPK:141127~theSitePK:374864,00.html>

<sup>40</sup> Former General Counsel to the Inter-American Development Bank, in his International Financial Institutions class at the American University, Washington College of Law, Spring Semester 2006

governments could be pressured to take out a PSI- with the assertion that they will need to demonstrate IMF approval in order to remain credit (and grant) worthy, their subservience will be guaranteed without the IMF having to put up any money.”<sup>41</sup>

It is therefore not farfetched to say that by creating the PSI, the IMF is creating an extended role for itself. Since fewer countries need the IMF to provide bail-out funds, it could be that the PSI is one way for the IMF to maintain some sort of relevance in the economic policies of its weaker members. One commentator while criticizing Nigeria’s ‘debt relief’ package with the Paris Club complained about “the degrading conditionality of obtaining a [PSI] from the [IMF] which Nigeria does not owe a single cent.”<sup>42</sup>

Finally, even though proponents tout one of the benefits of the PSI as the fact that the IMF does not force its own policies on the recipients, the fact that the idea of the PSI came from the Secretary of the U.S Treasury and approved by the other members of the IMFC suggests that this really isn’t the case. It removes the feeling that it is a program wholly developed by the recipient low-income countries.

## **Conclusion**

Whatever concerns there are regarding the PSI, the IMF is to be commended for the spirit behind the Policy Support Instrument. With this instrument, it is possible for countries on their way to economic stability to showcase this fact to the rest of the world in order to build some credibility. On April 17 2006, on completing the first review of Nigeria’s PSI,

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<sup>41</sup> Soren Ambrose, *Analysis: Debt Cancellation Undermined to Expand IMF Power* (2005), available at <http://www.50years.org/cms/updates/story/315> (last visited May 2 2006).

<sup>42</sup> Femi Falana, *The Dangerous Strings to Debt Relief*, Thisday (Nigeria) Newspapers, August 8 2005.

the IMF issued a press release. In the release, the first deputy managing director of the IMF, Anne Krueger made the following statement:

“Monetary policy [in Nigeria] is anchoring macroeconomic stability ...[s]ubstantial progress has been made in implementing the authorities structural agenda, including an ambitious bank consolidation, the liberalization of Nigeria's import tariff regime, the introduction of a wholesale auction for foreign exchange, continued efforts to reduce corruption, and progress in restructuring and privatizing state-owned enterprises. The authorities will continue their strong structural agenda including by further efforts to remove impediments to growth, and by strengthening institutions through the passage of a Fiscal Responsibility Bill, a public sector and civil service reform, improved governance and transparency in the oil and gas sector, and the continued privatization or strengthening of state-owned enterprises.”

Whether or not it is as a result of the PSI that the policies had some effect or they would have had an effect whether or not there was a PSI in place is not the issue. What matters is that as a result of this positive assessment, Nigeria was able to finally exit the Paris Club. This is not likely to be the only dividend of this assessment. It remains to be seen how other international institutions will respond to this. If all goes well, Nigeria should see an increase in foreign direct investments, and international aid. All is not over yet however. Nigeria's PSI is for a period of two years. This is only the first review and there

are three more reviews to come up by the time the program concludes in 2007. Therefore the program must be sustained to ensure that the full potential of the program is reached.

On a final note however, to ensure that the PSI generates the goodwill and confidence of the target recipients, it should not be subjected to the numerous conditionalities which are a typical feature of IMF assistance to low-income countries. And it should operate “as a transmission program for more successful countries to a less formal program of surveillance and monitoring, rather than as an instrument for prolonged engagement by the Fund.”<sup>43</sup> Maybe then the PSI would fulfill its mission as described below,

[w]e consider the PSI as a potentially valuable means to strengthen surveillance and signaling in low-income countries. By formalizing and codifying a judicious combination of existing surveillance and lending facilities including high standards of conditionality and review so as to preserve the credibility of the Fund’s ‘seal of approval’, PSI could support countries in safeguarding sound policies and in ensuring debt sustainability when a formal financial arrangement is not called for. PSI could be particularly useful for countries benefiting from debt cancellation...<sup>44</sup>

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<sup>43</sup> Steven Radelet, *The Role of the IMF in Well-Performing Low-Income Countries* (Centre for Global Development Working Paper No. 83, 2006) available at [http://www.cgdev.org/files/6350\\_file\\_WP\\_83.pdf](http://www.cgdev.org/files/6350_file_WP_83.pdf) (last visited May 4 2006).

<sup>44</sup> Statement of Mr. Per-Kristian Foss, Minister of finance of Finance of Norway at the 12<sup>th</sup> Meeting of the International Monetary and Financial Committee (IMFC) held on September 24 2005 in Washington DC, available at <http://www.imf.org/External/AM/2005/imfc/stmt/eng/nor.pdf> (last visited May 5 2006)