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THE CHANGING NATURE OF IMF CONDITIONALITY

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I. INTRODUCTION

In the terminology of the International Monetary Fund, "conditionality" refers to the policies the Fund expects a member to follow in order to be able to avail itself of credit from the Fund (Gold, 1979). Over the years, major changes in the landscape surrounding the Fund and in the situation of its members have brought about important changes in the content of conditionality. These changes have been most pronounced in the 1980s, and they have led to a gradual, but cumulatively fundamental, change in the Fund's relations with its borrowing members over the past decade — with further changes likely in the 1990s.

1.1 The impact of changing economic conditions

One major change affecting the Fund's conditionality has been the narrowing down of the Fund's *clientele* to its developing members. The Fund had been conceived as an institution to which any of its members could be expected to turn for temporary financing when faced with balance-of-payments difficulties. The main industrial countries accounted for over half of the use of Fund resources in the first two decades. As recently as 1977, the United Kingdom and Italy concluded major stand-by arrangements with the Fund. Since the early 1960s, even the United States was seen as a potential user of the Fund's resources. The General Arrangements to Borrow concluded in 1962 were to a large extent inspired by the realization that the resources available from quotas would not suffice to give large-scale assistance to the United States. And in November 1978 the United States announced a drawing on the Fund (admittedly in its reserve tranche, to which it had automatic access) as part of a stabilization exercise (Polak, 1989 (a), p. 49). But more recently, with the ample availability of credit from the world's capital markets, as well as credits from Brussels to the members of the European Community, the industrial countries have no longer felt the need to seek Fund credit even when their payments were in difficulties and their policies far from exemplary.

By contrast, and especially since the onset of the debt crisis in 1982, many developing countries have found the Fund as their main source of balance-of-payments credit. The resulting division of the Fund's membership into borrowers and non-borrowers has exacerbated the problem of conditionality by making one group of members overwhelmingly interested in making access easier, and the other group in making it more limited (Kafka, 1991).

A number of other developments over the last 15 years have played a role in bringing about a shift in content and emphasis in the Fund's conditionality. The introduction of the Extended Fund Facility in 1974 gave formal recognition to a

medium-term outlook in Fund programs, as well as greater attention to structural and supply aspects of adjustment. The adoption of structural adjustment lending by the World Bank at the end of the 1970s brought the Bank very close to (and perhaps sometimes across) the demarcation line between the respective fields of operation of the two organizations; the resulting increased competition made it imperative for the Fund to make sure that it did not overlook any aspects of adjustment that received close attention on the other side of 19th Street. The debt crisis brought about a major expansion in the list of the Fund's clients in the first half of the 1980s, and the problems of most of these countries soon proved to be unresponsive to simple traditional adjustment prescriptions. It also became clear that unless the highly indebted countries could resume a growth trend there would be no solution to the debt crisis. During that same decade of the 1980s, the retrogression in many African economies became increasingly evident and the conviction spread in the international agencies and the donor community, as well as in many of the countries themselves, that only radical changes of policy could reverse the depressing negative trends. Finally, in 1989/90, the search for policies of transition from state planning to market economies in Eastern Europe presented the Fund (and the Bank) with a new array of economic problems which forced the institutions to reconsider many of their previous operating assumptions.

The cumulative effect of these changes in the problems of member countries has brought about a fundamental shift in the institution itself. In its first quarter century the Fund's financial relations with its members were essentially episodic in character. Through misfortune or mismanagement, a member country might have to turn to the Fund for temporary help. But typically the underlying problems were quickly overcome, thanks in part to the rapid expansion of the world economy. Even then some countries in perpetual difficulties needed and received Fund credit under successive arrangements. But these were the exceptions, and the notion of the Fund as a "credit union" (Kenen, 1986) where members (industrial and developing) took turns as borrowers and lenders continued as a broadly valid characterization of the institution.

By now, however, that notion has been wholly overtaken by the events of the 1980s. Not only has the number of countries with Fund arrangements increased — to about one-third of the membership in recent years — but the problems that countries face are also far more complex and persistent than in the past; the adjective "intractable" has even slipped into the Fund's vocabulary, and the Fund has become reconciled to the proposition that many members will require its assistance over an extended period. This assistance is not limited to finance; the Fund is being called upon to mobilize and provide a wide range of services: policy advice, technical assistance, training and sometimes staffing to help countries improve the management of their economies.

Considerable emphasis is put on "working with" countries, to use a currently popular expression. We shall encounter a number of examples of this concept in the course of this study. It includes agreement by the Fund to a less than fully satisfactory program in hopes that the authorities will in this way be coaxed along to a better program next time around; or an initial arrangement comprising an elaborate fiscal

technical assistance program to lead the country into a fiscally sound successor arrangement.

Inevitably, approaches of this nature tend to string out over time the financial association between the country and the Fund — which may thus enhance the likelihood of prolonged use of Fund resources.

The changes described in the relationship between the Fund and members using its resources have made the Fund's conditionality more complex than it was in earlier years. Also, the massive increase in the Fund's case load in the 1980s and its more intensive involvement with structural policies in close association with the World Bank has yielded new findings on policies that work and policies that don't work in present conditions and this experience too has had an impact on the contents of the Fund's conditionality.

1.2 Changing conditionality: an overview

The Fund's conditionality was never a simple concept, but it has become a great deal more ambitious and complex as the Fund responded to the changes that have taken place in the world economy in the last decade and learned from its own experience. The changes that occurred in the Fund relate to many of its institutional features, policy objectives, policy instruments and to Fund/member relationships. It would be nice if these aspects could be presented in a logical order of description, analysis, discussion. Unfortunately, the aspects are too interwoven to make this a feasible approach. Thus, while the main aim of Chapter II is to provide to the reader the minimum necessary institutional knowledge, this attempt to describe certain current aspects of the Fund inevitably presents policy issues that need to be addressed. For example, the historic distinction between conditional and unconditional (or low conditional) Fund credit can hardly be described without pointing out that that distinction has for all practical purposes ceased to exist. What might appear as minor differences between the Structural Adjustment Facility (SAF) and the Enhanced Structural Adjustment Facility (ESAF) prove to harbor policy implications of more than casual interest. For reasons of efficiency of exposition, some of these policy issues are dealt with when they arise rather than being saved for discussion in a later chapter.

To help the reader to find his way through what is thus, inevitably, the somewhat confusing terrain of Fund conditionality, the following road map is offered.

Chapter II serves to familiarize the reader with various institutional and technical aspects of conditionality and to explain them in historical context. The first section (2.2) describes and interprets the types of arrangements under which members now receive credit from the Fund (four, as against only one prior to 1974). In addition to lending under arrangements, the Fund has made resources available under a number of special facilities in which it was assumed that the issue of conditionality did not arise in a major way because the policies of the member were broadly in harmony with Fund purposes. The Fund's 1963 decision on the compensatory financing of export fluctuations and, to some extent, its 1974 decision on an oil facility were based on the assumption that there could be a broad range of situations meeting this test. But by 1981 the Fund's most authoritative publication on conditionality noted without qualifications that "Fund members have agreed that the Fund's financial assistance should be conditional on the adoption of adjustment policies" (Guitian, 1981, p. 2). In fact, with minor exceptions, the Fund now operates on the assumption that the balance-of-payments difficulties of any country that seeks its resources require changes in its policies to ensure the temporary character of the use of those resources. Certain major features of the Fund's special facilities and the gradual

abandonment of the concept of low conditionality are discussed in section 2.2. The last section (2.3) discusses certain technical aspects of conditionality — some familiar and needing only brief mention, such as letters of intent and performance criteria, and others novel, in particular "financial assurances", which have not so far been discussed in the literature as an element in conditionality.

Chapter III starts out with a description of the content of the Fund's conditionality as it was mainly understood until about 10 or 15 years ago. At that time, balance-of-payments adjustment was central to the Fund's conditionality, but recent developments have for all practical purposes added growth as an equally (and in some respects perhaps even more) important Fund objective. The implications of this expansion of the Fund's concern are elaborated in sections 3.2 to 3.4. This is followed by a discussion of the ups and downs in the Fund's concern about price stability in the application of conditionality.

Chapter IV discusses the Fund's emerging concern with a number of other, secondary, objectives. Some of these the Fund acknowledges explicitly as matters that concern it, although not as targets on which to aim its conditionality: the relief of poverty, protection of the environment. Others, such as the containment of military expenditures, are kept out of the limelight but play nevertheless some (albeit for the time being a minor) role in countries' ability to benefit from Fund credit. The touchy question of political influence overriding the Fund's technical judgements — either in the refusal of credit where a country might technically qualify or in the granting of credit to countries with inadequate policies — is dealt with in the final section.

Chapter V deals with the policy instruments on which the Fund focuses its conditionality. The chapter begins with a brief description of "the monetary approach to the balance of payments" and an explanation why the Fund has selected a monetary balance sheet as the starting point for the development of a general model — or so much of such a model as is practicable from case to case — of the countries with which it deals.

The next two sections then enter into a more detailed discussion of two policy issues that have played a major role in Fund conditionality in recent years: exchange rate policy and fiscal policy. In both fields, current Fund views differ significantly from those of only a few years ago; this has led to important changes in conditionality, especially in the fiscal field.

Chapter VI ventures onto the treacherous grounds of measuring the degree of success of Fund-supported adjustment programs. Most of the evidence, such as it is, is found to be inconclusive. This then raises what is perhaps the most important issue about Fund programs: does stabilization under a Fund program lead in the end to sustained growth? The available evidence of the 1980s on this subject is not as conclusive as one would like. A major reason for this is that few of the problem countries with which the Fund has been dealing took early adjustment action and then stuck to it consistently. In many countries it took the better part of the decade for policy makers to come to a full realization of the range of financial and structural policies that needed to be implemented. In yet other countries, the process of adjustment has barely begun even now. Nevertheless, there is now enough

evidence — in Latin America, Africa and Asia — to justify some optimism with respect to the ultimate pay-off of adjustment policies.

Chapter VII looks ahead toward further changes in conditionality that are likely to occur or might be desirable. Fund arrangements, policy objectives and policy instruments all appear to be subject to change in the light of recent and prospective changes in economic conditions and Fund-member relationships. A number of proposals for changes in policy monitoring are discussed in section 7.2; some of these are endorsed as improvements while others raise major difficulties.

Chapter VIII, finally, draws on the considerable range of impressions garnered in the course of this study to take a somewhat broader view of the relationship between the Fund and the members that seek to use its credit. It concludes that in some of the best of cases — though by no means in all — this relationship has grown from adversarial to collaborative, from "conditionality" to joint "program design".

II. CONDITIONALITY — INSTITUTIONAL FEATURES

The Fund extends credit[1] to a member either to meet a general balance-of-payments need under one of a number of "arrangements", or to meet a specific balance-of-payments need under one of a number of "special facilities". The arrangements that are at present available are described in section 2.1; the main special facilities, in section 2.2.

2.1 Range of Fund credit arrangements

The Fund now extends credit to eligible member countries under four types of arrangements, two of which date from the last five years:

Stand-By Arrangements (since 1952)
Extended Fund Facility (EFF) (since 1974)
Structural Adjustment Facility (SAF) (since 1986)
Enhanced Structural Adjustment Facility (ESAF) (since 1988)

Only low-income developing countries (the approximately 60 countries with per capita incomes below the level that determines eligibility for IDA credits) can receive SAF and ESAF loans. These loans carry a nominal interest rate of l/2 per cent per annum, while credit under the first two arrangements is extended at what are essentially market interest rates. EFF, SAF and ESAF arrangements have repayment terms of 5-1/2 to 10 years; stand-by arrangements of 3-5 years.

The four types of arrangements have much in common, but also differ significantly as far as conditionality is concerned. All arrangements involve policy understandings for a period ahead, laid down in a letter of intent which may, at the Fund's discretion, be reinforced by prior action on the part of the member. Stand-by arrangements are now typically for a period of 12-18 months (in the early 1980s, there were a few 3-year stand-by arrangements which were hardly distinguishable from EFF arrangements). The three other types of arrangements always cover a three-year planning period, which for EFF as well as ESAF may be extended to a fourth year; all, however, require annual letters of intent in which specific policies for the next twelve months are agreed.

The conditions pertaining to EFF, SAF and ESAF arrangements give considerable emphasis to structural elements. While structural elements are certainly not absent in stand-by arrangements — in particular with respect to exchange rate and pricing policies — they are typically less elaborate. Often, the main reason why a country should receive a stand-by, rather than an EFF, arrangement is not that its problems are seen as solvable in a short period, but that there has not yet been enough time to assemble all the necessary elements of a comprehensive structural package. The long lead time required to work out a thorough fiscal program (discussed in 5.3 below) is frequently a main factor in this choice of arrangement.

Apart from the interest rate provisions mentioned, there remain only minor differences in conditionality between EFF and ESAF arrangements. In both types of arrangements, performance criteria are laid down which, if not observed, lead to the

interruption of drawings. One such difference is that under EFF (as under stand-by) arrangements drawings are normally made quarterly, provided the performance criteria of that quarter have been met; under ESAF, drawings are made semi-annually, based on semi-annual performance criteria and reviews, although the relevant data are collected on a quarterly basis as "benchmarks" and can thus serve as warning signals for needed action before the question of the next drawing arises.

One major difference in conditionality exists between SAF and ESAF loans. SAF loans are disbursed in one installment per year, and they are monitored by benchmarks only. The Fund has no leverage until the next year's letter of intent is agreed, when it may insist on prior action if the previous year's performance was unsatisfactory. In those circumstances there is frequently a gap of many months between the annual segments of a three-year SAF arrangement, indicative of difficulties of negotiation between the Fund and the member.

Apart from this difference in enforcement power, the Fund applies a weaker conditionality under SAF than under ESAF; the structural content of the SAF tends to be less well specified and less action-oriented, with greater acceptance of "studies". By and large, only countries that the Fund expects to deliver a solid performance are given access to ESAF, while weaker countries are allowed to use the smaller amounts of credit available under the more lenient provisions of SAF. These countries can graduate to ESAF once they demonstrate their ability to perform. Not surprisingly, the results under SAF arrangements are worse than those under ESAF arrangements. (Examples are cited in section 6.1 below.)

Why would the Fund apply two different standards of conditionality to the same group of members? When ESAF was conceived, there was no indication that its aims would be in any way different from those of SAF. What seemed needed in early 1987 was more money for the same purpose. But when ESAF was established in December 1987, the conclusion had already been reached that ESAF programs should be "more ambitious" than those under SAF, in terms of both the magnitude of adjustment measures and the timing of their adoption.

Part of the explanation lies in the fact that the Fund traditionally feels comfortable with a two-track access to its resources. The soft track permits the Fund to give at least some assistance to countries that demonstrate some, even though inadequate, efforts toward adjustment. It gives the Fund an opportunity "to work with" these countries in the hope of preparing them for access to the hard track, with more substantial access, at a later date. The soft conditionality of the first credit tranche, introduced as early as 1955, was the first example of this approach. Although the compensatory financing facility was not designed with this idea in mind, some of its earliest applications (Brazil, Egypt) were considered very much as serving this warm-up purpose. The disappearance of the CFF in this role, as it were as a "bridging facility", is still to some a cause for regret (Kafka, 1991). Again, when the Fund created Trust Fund loans in 1976 the mild conditionality of these loans, equal to that of the first credit tranche, was widely welcomed by the staff as providing the Fund with a first opportunity to get operational acquaintance with a number of low-income countries, especially in Francophone Africa[2].

Similarly, the creation of ESAF once again put the Fund in a position where two-track conditionality, even though it may not have been envisaged initially, became the answer to a practical problem. This problem arose from the differences in entitlements to SAF and ESAF funds. SAF funds were seen as available in perpetuity to the low-income developing countries[3]. ESAF funds, on the other hand, were derived from repayable loans made by development agencies and central banks mainly in the industrial countries. The Fund's decision of December 18, 1987 on the establishment of the ESAF Trust and the Chairman's summing up which accompanied it demonstrated that the lenders to the Trust wanted every possible assurance that they would receive "full and expeditious repayment". This attitude of the lenders was not compatible with the soft conditionality that had become the practice for SAF loans, and the two-track approach became the natural answer.

2.2 Special facilities: compensatory and contingency financing

This section will concentrate on the two most important of the Fund's special facilities, designed respectively to compensate members for export shortfalls and for external contingencies. Two other special facilities deserve brief mention. In response to the first oil shock the Fund established an oil facility in 1974 which was broadly patterned after the compensatory financing decision of 1963. The facility was allowed to expire in 1976, and was not brought back when the second oil shock hit in 1979; a similar facility was, however, introduced in late 1990 (see below). The Fund has had a "buffer stock facility" since 1969; it never became important and has wholly atrophied in the last few years.

(a) Compensatory financing

Since 1963, the Fund has allowed countries to draw under a special facility, outside the limits set under the credit tranches, to compensate shortfalls from trend in export proceeds (later expanded to include shortfalls in major invisibles and excesses over trend in the cost of cereal imports). The Compensatory Financing Facility had no phasing and its conditionality was limited to an obligatory statement by the member that it would "co-operate with the Fund in an effort to find, where required, appropriate solutions for its balance-of-payments difficulties". The Fund would not in advance of a requested CFF transaction explore with the member whether its payments difficulties required "appropriate solutions"; nor would it attempt at that stage to reach agreement with the member on what the nature of these solutions would be (Horsefield, 1969, p. 482). The assumption underlying the facility was that the occurrence of an export shortfall did not by itself create a presumption that adjustment was necessary. On the contrary, the measurement of the shortfall as a deviation from a five-year trend, centered on the shortfall year, was seen as providing the evidence that the export difficulties were temporary. The Fund had also to be satisfied that the shortfall was "largely attributable to circumstances beyond the control of the member". The broad aim of this provision — which has sometimes raised difficult problems of attribution — was to deny access under the facility in cases where the export problems were, to a major extent, due to such factors as currency overvaluation, domestic stockpiling, or unrealistic price setting for export crops.

Over the years, however, the Fund has increasingly come to the realization that even though a country's export shortfall was both "temporary" according to the formula and largely beyond its control, that country might still have balance-of-payments difficulties that were attributable to inappropriate policies, and that to provide large amounts of unconditional credit to such countries might delay their adopting needed policy adjustments (Goreux 1980, p. 41). This shift in emphasis was to some extent related to the increasingly difficult world economic conditions encountered by developing countries.

Over time, the Fund has been tightening the access to the compensatory financing facility by defining the required degree of "co-operation" of a country in terms either of a conditional arrangement with the Fund or of a set of policies that would qualify for such an arrangement. The net result has been that, in recent years, far fewer countries have received CFF drawings and that the overwhelming majority of them qualified on the ground of having a conditional arrangement (stand-by arrangement, EFF, SAF, or ESAF) (Table 1).

While in 1979-82 still over a third of the countries making CFF drawings were not subject to the regular Fund conditionality, in the last four years exactly one country (Indonesia in 1988) has had CFF access on this basis.

Table 1

NUMBER OF DRAWINGS UNDER THE COMPENSATORY FINANCING FACILITY, BY 4-YEAR PERIODS

Fiscal years	Total	Without conditional arrangement
1979-82	79	28
1982-86	59	13
1987-90	23	1

Source: IMF, *Annual Reports*.

It is only a slight exaggeration, therefore, to say that the CFF has ceased to exist as a special facility in the Fund. All that is left of it is a special rule on the amount of access to the Fund's resources under conditional arrangements for countries that are judged to have a qualifying export shortfall.

The same principle was observed when, on November 15, 1990, the Fund added on a temporary basis, up to the end of 1991, an "oil import element" under compensatory financing[4]. On that occasion, the Fund noted that experience suggested that the provision of added financing by the IMF should be primarily in the context of comprehensive adjustment programs. For drawings under the oil element,

there is an additional requirement that the member follow appropriate energy policies. In general, the additional compensation for high oil import costs has gone to countries that had, or were in the final stages of getting, upper credit tranche or comparable arrangements with the Fund. Only one country that did not qualify on this basis (India) obtained access under the facility on the strength of a simultaneous first-credit tranche arrangement.

Even though the Fund has ceased to put confidence in the built-in findings of "temporariness" for which such calculations were originally designed, it continues to measure export shortfalls by the elaborate five-year average technique which involves major commodity market forecasting exercises. (A comparable procedure is used on the import side for the "cereal cost element" of the facility; the same averaging technique has also been applied to the "oil element".) Nevertheless, the extra helping of Fund credit that the member may receive in export (or, for cereals and oil, import) compensation is by now only remotely related to the size of the shortfall or excess. From the start of the facility in 1963, CFF drawings were subject to a quota limit, which since 1983 had been 83 per cent of quota. That upper limit is theoretically preserved for a member whose "balance-of-payments position is satisfactory apart from the effects of the export shortfall; but the limit may be set by the Fund at 65 per cent, 40 per cent or 20 per cent of quota — or of course at zero — depending on how high or low an opinion the Fund has on the member's policies and its recent policy record". Nor can it be assumed that any compensatory amount for which the country qualifies is wholly additional to its access under a stand-by arrangement or an EFF concluded at about the same time. That access as applied by the Fund depends on many factors and in determining its size the Fund would no doubt take the size of the CFF drawing into account.

A comparable offset would be less likely if the country's conditional program was under SAF or ESAF; but countries that are eligible for the low-cost, five-to-ten year SAF or ESAF credits are understandably hesitant to apply for CFF credit, which is repayable in three to five years and carries a market-plus interest rate. Part of the decline in the number of CFF cases in recent years reflects the emerging view, in the Fund as well as in the SAF-eligible countries themselves, that these countries should in general no longer be considered for Fund credit at the standard interest rate. In fact, only three of the 22 conditional CFF drawings in the last four years (Table 2.1) went to countries with a SAF or ESAF arrangement.

(b) Contingency financing

In a 1988 decision the Fund merged its compensatory facility into a joint Compensatory and Contingency Financing Facility (CCFF). Except for a limited leeway for members to draw part of their total potential CCFF access under one or the other facility, the old CFF (with adjusted access limits as just described) and the new contingency facility operate as separate, and in part overlapping, facilities.

The contingency facility is, in principle, a valuable complement to the Fund's conditionality. It assures a member that concludes a stand-by or extended arrangement with the Fund additional access in the event certain exogenous key variables, such as its export prices or world interest rates, on balance affect the

country's balance of payments less favorably than had been assumed at the time the arrangement was concluded. The rationale for such a contingency facility is clear: the contingent access should enable the member to stick to its program in the face of unexpected difficulties. Unfortunately, the design of the facility as adopted in 1988 (and still as revised in 1989) is such as to limit severely its attractiveness to members entering into a credit arrangement with the Fund. Two features in particular limit the appeal of the facility: contingency disbursements are not available automatically when there is a net balance of payments shortfall attributable to the agreed key variables, but they require new understandings with the Fund on strengthened adjustment; and the facility is symmetrical, in the sense that favorable exogenous developments require the country to observe a higher reserve target than originally agreed, or to reduce its drawings under the arrangement. Since a country knows that it can always renegotiate its arrangement in case of unfavorable developments, some of which may moreover provide the basis for a compensatory drawing or may strengthen a country's claim for additional foreign aid, there is little interest in a promise of contingent access under new and unspecified policy conditions, matched by a contingent promise of smaller use, or less freedom in the use of reserves, in the event of favorable deviations. It is not surprising, therefore, that only two countries signed up for the contingency facility in the two years since it became available in August 1988. Since the outbreak of the Gulf War, the evidence of volatile oil prices has, however, led to a more active interest in the contingency provisions.

2.3 Technical features of conditionality

The purpose of the Fund's conditionality is to make as sure as possible that the drawing country pursues a set of policies that are, in the Fund's view, appropriate to its economic situation in general and to its payments situation in particular. The contents of some of the major policies that serve these purposes are discussed in Chapter V. Here the focus is on the technical provisions by which the Fund tries to pin down the desired policies, whatever their content.

(a) Letters of intent

The Fund's main instrument for this purpose is the Letter of Intent. This Letter (or its attached memorandum of economic policies) reflects the outcome of policy discussions between the Fund and the member. It spells out the policy actions that the member has taken and intends to take during the period of the arrangement. Ideally, it does so with sufficient precision that the member's subsequent performance can be monitored against its stated policy intentions.

(b) Policy framework papers

In connection with SAF and ESAF arrangements, the Letter of Intent is accompanied by another document submitted by the government, the Policy Framework Paper (PFP). This is a paper in which the authorities announce to the Fund and the Bank the broad outlines of their demand management and structural programs for the coming three-year period, with additional specification for the program year ahead. The PFP is the outcome of a tripartite drafting process, in which the borrowing country collaborates with the staff of the Fund and the Bank. One

purpose of this process is to have the borrowing country focus on the whole range of policy actions envisaged under the arrangement. Another valuable aspect of the introduction of this extra (and sometimes time-consuming) step in a country's application for SAF and ESAF credit is that it forces the staffs of the two institutions to pay attention to each other's concerns and to move in the direction of reconciling their views on major issues of policy, such as the exchange rate or the room for government investment provided by the budget.

The PFP approach has been applied since 1986 to countries receiving subsidized credit from the Fund and the Bank (SAF/ESAF and IDA). Similar documents have been developed in connection with recent EFFs for Hungary and Poland. It has also been suggested that the roles of the Fund and the Bank in countries seriously affected by the war in the Middle East could be co-ordinated by means of PFPs. It would indeed be a rational extension of this approach to apply it to all countries that receive credit from both institutions. So far, however, movement in that direction has been successfully resisted by certain major borrowers that do not want to narrow their room for playing off one institution against another or to widen the scope of conditionality.

(c) Prior actions

The strongest indications of a member's intentions are, or course, the actions it takes before receiving credit from the Fund. As late as 1979, however, the Fund was hesitant to ask for prior actions; according to the guidelines on conditionality, it could only insist on them if they were "necessary to enable the member to adopt and carry out a program consistent with the Fund's provisions and policies". These fluffy words only get meaning if read against the immediately preceding sentence which tells the Managing Director to recommend requests for drawings only if "it is his judgment that the program....will be carried out". Prior actions can be very helpful to enhance the probability that a program will be carried out, in particular where the member's past record in the Fund might be less than outstanding (Gold, 1979, p. 29). In recent years, reliance on prior action has become more common as the Fund has shed its defensive stand toward such action.

But prior action can also be used by the member to its advantage, as a way to minimize the policy commitments it has to make in its letter of intent and thus to present the authorities as deciding on adjustment policies on their own, rather than under pressure from the Fund. India's 1982 stand-by arrangement was an example of such "preemptive reform" (Stiles, 1990, p. 968), where the country devised and implemented an adjustment program in advance of seeking Fund credit[5]. The Fund has come to welcome such prior action; the last thing the Fund wants — as Managing Director Camdessus has made clear on a number of occasions — is for a borrowing government to cast it in the role of bogey man whose unreasonable demands the country cannot withstand because it needs the Fund's money.

(d) Performance criteria and benchmarks

The primary purpose of performance criteria is to monitor whether a member's adjustment program is on track and to encourage the member to take corrective action

when there are indications that the program may be moving off track. In addition, performance criteria have the positive function of ensuring a member access to the Fund's resources when the conditions are met, and the negative function to interrupt access when the country has failed to meet the conditions. "Benchmarks" used in SAF and ESAF arrangements, serve only the primary purpose mentioned, but in ESAF arrangements, in addition to quarterly benchmarks, performance criteria are also established for mid-year points of the program.

The tendency in the 1980s has been to increase the number of performance criteria as adjustment programs had to be executed in an increasingly difficult policy environment. From an average per arrangement of below 6 in the decade 1968-77, the number rose to about 7 in 1974-84, and to over 9-1/2 in 1984-87.

Performance criteria serve their purposes well only insofar as they are correct indicators of the target variables of the program. This raises no problem where the performance criteria themselves represent such target variables. Examples would be the standard provision that the member will not intensify trade or payments restrictions, or the special provision that **x** per cent of imports will be liberalized by a given date. But the case is less clearcut where ceilings are attached to intermediate variables. Thus, for example, the growth in domestic credit may be constrained by a ceiling of **x**, based on a string of assumptions and calculations that suggest that anything above **x** would lead to an unacceptable payments deficit in excess of **y**. If all goes according to plan, credit creation will be $\leq$**x** and the deficit $\leq$**y**. If policies are unsatisfactory but the linkage between **x** and **y** holds, the country will be barred from further disbursement for the good reason that it has jeopardized its adjustment program. But in addition to these two correct outcomes, there can also be two wrong ones. (a) The country sticks to its credit target but for various reasons (external or internal) the deficit ends up **>y**. The country is allowed to continue drawing even though its payments position has become unmanageable. (b) The country exceeds the credit limit, but the deficit remains **<y**. Disbursements are stopped even though, at least apparently, the balance of payments is within an acceptable range.

These problems of false positive and false negative outcomes are inherent in the use of performance criteria and there is no evidence that such problems have become more, or less, severe in recent years. Up to a point, they are the price that has to be paid if drawings are phased to prolong the Fund's policy leverage and members are to have at least some assurance that compliance with agreed policies will promptly release quarterly disbursements. The risk to the Fund or to the member can be reduced by improved specification of the underlying relationships, but there are limits to this process and, in any event, external factors affect the outcome. In part, the problem can be addressed by automatic adjusters to performance criteria and reviews. A number of further suggestions to mitigate the difficulties attached to performance criteria are discussed in Chapter VII.

(e) Reviews

In the 1970s reviews were considered exceptional except for programs extending beyond one year. Since then, mid-year reviews have become standard for all programs except those under SAF. Their purpose is not to renegotiate the

conditionality agreed at the beginning of a program (Gold, 1979) but to fill in performance criteria that cannot be specified at the start of the program and to mitigate the risks of false-positive or false-negative readings of the performance criteria by resetting targets in the light of new evidence. Reviews also play a role in the reexamination of financing assurances when these are not settled from the outset.

(f) Waivers

Where a performance criterion is not met but the Fund finds the noncompliance inconsequential, it can grant a waiver, but until such action is taken the member is not in a position to draw.

(g) Financing assurances

Traditionally, a key component in any Fund arrangement was that the resources provided by the Fund, together with those contributed from other sources (World Bank, aid donors, commercial banks, and others) would cover the country's projected balance-of-payments gap. In the absence of an integral financing package, the Fund could not be confident that the degree of adjustment negotiated with the country would be sufficient. It therefore sought "financing assurances" from the other suppliers of financial assistance.

In the second half of the 1980s, this approach by the Fund began to be exploited by the commercial banks. No longer afraid — as they had been in 1982/83 — of becoming the victims of a generalized debt crisis, the banks began to realize that they could insist on favorable terms for themselves by blocking a country's access to Fund credit (as well as to other credit that was linked to a Fund arrangement). In the process, the Fund was increasingly pushed into the position of being used by the commercial banks in the collection of their debts.

In response to this new situation the Fund began to reconsider its attitude toward "financing assurances". The same issue was also raised pointedly in the context of the 1989 Brady Plan, one of the main features of which was to deprive the commercial banks of the leverage that Fund and Bank lending would proceed only after countries had come to terms with them.

There is, unfortunately, no satisfactory answer to the question of financing assurances, and, as is evident from the discussion on this subject in its *1990 Annual Report* (pp. 30/31), the Fund has found it difficult to strike the right balance. Its original position clearly tilted too far in favor of the banks. But concern for financing assurances could not simply be dismissed either. That would raise issues of moral hazard, could jeopardize orderly relations of a member with its banks and would also put repayment of Fund credit at risk. The uneasy compromise that the Fund reached on this subject in May 1989 is evident from the guidelines on financing assurances which it issued at that time:

- "The Fund may, on a case-by-case basis, approve an arrangement outright before agreement on a financing package is concluded between a member and commercial bank creditors, (1) if it is thought that prompt Fund support

is essential for the implementation of the adjustment program and (2) provided that negotiations between a country and its creditors have begun and that it can be expected that a financing package consistent with external viability will be agreed within a reasonable period. Progress in the negotiations with bank creditors will be closely monitored. . .

- In promoting orderly financial relations, every effort will be made to avoid arrears, which could not be condoned or anticipated by the Fund in the design of programs. Nevertheless, an accumulation of arrears to banks may have to be tolerated where negotiations continue and the country's financing situation does not allow them to be avoided. The Fund's policy of nontoleration of arrears to official creditors remains unchanged." (*1989 Annual Report*, p. 26).

One year later, the Fund reaffirmed the guidelines, but in the process seemed to back some distance away from them (*1990 Annual Report* pp. 30-31). In any event, it reverted to something close to its original position in the case of Brazil. That country had adopted a program which, accordingly to the Managing Director, deserved the support of the Fund. Nevertheless, calling the accumulation of arrears "the willful destruction of a country's creditworthiness", the Managing Director indicated that he would not submit this program to the Executive Board until "negotiations with the banking community are firmly launched with a good prospect of a satisfactory solution" (Press Conference, September 20, 1990).

III. PRIMARY OBJECTIVES OF FUND CONDITIONALITY

The Fund's lending activities, like its other activities, are guided by its purposes. It will not lend money to a member country merely because the country wants to borrow, even when the Fund feels confident that it will receive interest and repayment when these are due. The Fund must also be convinced that extending credit promotes its purposes.

In broad terms, the objective of the Fund's conditionality has been described as helping members "to attain, over the medium term, a viable payments position in a context of reasonable price and exchange rate stability, a sustainable level and growth rate of economic activity, and a liberal system of multilateral payments" (Guitian 1980, p. 3). But this combination of desirable outcomes is not always achievable and the Fund has laid primary emphasis on one or another at various times in its history.

3.1 Balance-of-payments adjustment

Historically, the Fund's primary concern in extending credit related to the balance of payments of the borrowing country. With particular reference to developing countries, a viable payments position was seen as a current account deficit not in excess of what could be financed, on a sustainable basis, by net capital inflows on terms compatible with the development and growth prospects of the country. In accordance with its purposes, the Fund would want the member to attain this viable position with a minimum of reliance on trade or payments restrictions, although it was more willing to tolerate such measures, on a temporary basis, in the 1960s and 1970s than in the 1980s. The Fund's concern with growth, to the extent that it existed at all, was less pronounced.

The primary emphasis given by the Fund to external objectives and its restraint in terms of domestic policies has been justified under a principle of "political neutrality" which seeks an acceptable balance between the protection of the interests of an individual member and those of the membership as a whole (Guitian, 1987). It did not mean that the Fund's conditionality was limited to demand management. The Fund also recognized the importance of the exchange rate and producer prices of major export commodities as major instruments of adjustment, but for the purpose of switching resources into the balance of payments rather than, explicitly, to promote growth (Mohammed, 1991).

3.2 Economic Growth

It may come as a surprise to many that the Fund's Articles of Agreement do not include growth among the Fund's purposes[6]. That omission was not a historic accident: at the Bretton Woods Conference, India and Australia fought hard for its inclusion (Gold 1971). But most delegations did not want to leave any ambiguity as to the respective functions of the Fund and the World Bank. Thus growth appears in Article I(ii) not as a purpose, but as the expected result of the pursuit of the purpose of trade expansion[7]. Gold's paper cited above shows, however, that there was never any question that the Fund was fully aware of the strong interest that many members

showed in promoting growth as one of *their* major objectives, and was willing to support it.

The distinction between growth as a purpose of the Fund and growth as a purpose of the member might be little more than a thin legalism if it could be assumed that all members that applied for stand-by arrangements with the Fund did indeed consider growth as a primary objective of economic policy. But this was certainly not the case during the par value regime, and it still is not universally the case at present.

During the 1960s, countries in Central America and elsewhere would pursue policies of balance-of-payments adjustment by relying exclusively on severe demand restraint rather than combining a more moderate degree of such restraint with exchange rate adjustment — even in cases where the Fund would not have objected to devaluation on the ground that there was insufficient evidence of a "fundamental disequilibrium". On the contrary, the Fund might well favor devaluation. But at the time it felt constrained how far to push such a policy, and if the member insisted on attempting adjustment from the demand side only, and the Fund considered that the attempt had a reasonable likelihood of success, the Fund would not insist on devaluation as part of its conditionality[8].

In its relations to low-income countries in particular, the Fund has in recent years moved in the direction of promoting growth to one of its explicit purposes. This was not yet the case in 1976, when it established a *Trust Fund* for the benefit of these countries financed from the profits made on the sale of some of the Fund's gold. The purpose of that Trust Fund was, simply, "to support...members that... carry out programs of balance-of-payments adjustment". But ten years later, when the repayments from Trust Fund loans became available for a new round of loans under the *Structural Adjustment Facility*, qualifying members were asked to submit "a three-year adjustment program....to correct macroeconomic and structural problems that have impeded balance of payments adjustment *and economic growth*" (emphasis added). And the new larger Trust established in 1987 (ESAF) had the dual purpose of supporting "programs to strengthen substantially and in a sustainable manner [eligible members'] balance-of-payments position and to foster growth".

In practice, the staff now appears to see the adjustment and growth priorities in reverse order. As one recent report puts it: "The objectives of all programs supported by both the SAF and ESAF were to foster growth and to make *substantial progress* (emphasis added) toward a viable balance-of-payments position during the three-year arrangement period." Median targeted growth rates were 3.6 per cent per annum for SAF and 4.5 per cent for ESAF. On the other hand, even at the end of the three-year period, half the countries under SAF programs and one-third of those under ESAF programs were expected to be still in need of exceptional financing.

Thus, there would seem to be every evidence that growth has become a Fund purpose[9]. Indeed, in a recent speech to ECOSOC the Managing Director painted growth as the Fund's quintessential objective: "Our prime objective is growth. In my view, there is no longer any ambiguity about this. It is toward growth that our programs and their conditionality are aimed. It is with a view toward growth that we carry out our special responsibility of helping to correct balance-of-payments

disequilibria ....". He then went on to explain that what he had in mind was "high quality growth", which does not include "flash-in-the-pan growth" fueled by inflation and excessive borrowing, growth at the expense of the poor or the environment, or growth run by the state. In other words, the growth objective is redefined to incorporate adjustment, income distribution, the environment and the transition to a market economy in Eastern Europe (Camdessus, 1990(b)).

3.3 A conflict between growth and adjustment?

The new emphasis on growth brought to the fore the issue of a possible conflict between growth and adjustment. Much of the criticism directed at the Fund's conditionality is that it sacrifices growth to adjustment by compressing activity below its full employment or capacity level. While not denying the possibility of conflict, economists in the Fund, and many others, would point to three important qualifications.

First, they would observe that balance-of-payments difficulties frequently find their origin in fiscal or monetary policies that attempt to run the economy at above-capacity levels, leading to large spillovers of domestic demand into the balance of payments. In these circumstances, the application of policies of moderation of aggregate demand can bring about a major improvement in the balance of payments without much effect on employment or growth. A policy of disinflation can thus be beneficial all around; only a further dose of contraction in aggregate demand, adding deflation to disinflation, would pose a clear choice between growth and adjustment. In situations of severe and prolonged distortions of the economy and growing balance-of-payments disequilibrium, an element of deflation may be necessary as part of the adjustment process, though perhaps not for long even in those cases (Khan and Knight, 1980). Indeed, any prolonged balance-of-payments "need" for deflation would be prima facie evidence of an overvalued currency, which should be corrected by depreciation.

Second, the apparent conflict between growth and adjustment tends to vanish as this question is considered from a longer time horizon (Guitian, 1980). Over a short period, growth can be stoked by burning up all of a country's reserves and its access to voluntary and involuntary credit (arrears). Peru did this in 1986 and 1987 when it produced annual growth rates of about 9 per cent. After that, the game was up: 1988 and 1989 saw negative growth rates of 9 and 12 per cent respectively; an estimate for 1990 is negative 5 per cent at least. To an important extent, then, the choice before a country is not growth versus adjustment, but growth today versus growth tomorrow (Guitian, 1987).

Third, to the extent that adjustment is brought about by improvements on the supply side rather than by compressing demand, it obviously contributes to growth.

The three considerations mentioned — disinflation, intertemporal substitution and supply-side adjustment — indicate that the choices facing countries in payments difficulties are more complex and, in the last analysis, potentially more promising than the simplistic criticism of the Fund's conditionality implies.

3.4 Adjustment and growth in conditionality

Even though the Fund now supports growth and adjustment with equal fervor — or indeed sometimes seems to proclaim the primacy of the former over the latter — this does not mean that it also insists with equal firmness on policies needed for growth as on policies needed for balance-of-payments adjustment. When adjustment requires disinflation, the Fund will make every effort to ensure that enough disinflation occurs. The monetary approach, about which more will be said in section 5.1, is designed to ensure that the country's program cures the excess demand aspects of its balance-of-payments difficulties. If a reasonable agreement on this issue cannot be reached with the country, there will be no Fund program.

The situation is different with respect to structural policies. There is no longer any question that the Fund for its part is fully aware of the fact that countries suffering from major structural weaknesses will not achieve sustainable growth, even though they may achieve adjustment, unless they implement at an early stage carefully targeted structural measures as a complement to demand-management policies. It is not a safe assumption, however, that member countries will see the problem in the same way. While the pain inflicted by policies of financial restraint is typically widely distributed, structural measures hurt particular groups. Import liberalization eats into the profits of privileged importers. Financial liberalization, accompanied by higher interest rates, hurts privileged borrowers. The abolition of general food subsidies may be felt in particular by urban consumers. Against the pressure from groups that are hurt by such measures, not all governments are able to marshall a sufficiently strong coalition of the broad segments of the population that can be expected to benefit from structural adjustment measures and from the avoidance of excessive reliance on demand-management policies. It is, therefore, far too common for the Fund to find that would-be borrowers prefer to use traditional macroeconomic policies to more intrusive measures of structural adjustment. Thus the borrowing member may not be prepared to accept enough structural components in its stand-by arrangement or, even if it signs on for them, may find ways to delay their implementation. In such cases, the Fund will reluctantly go along with what it calls "second-best adjustment paths",[10] provided it feels reasonably confident that the member will stick to the macroeconomic measures and that the targeted payments effect will be attained. Thus, if the member is adamant, the Fund will settle for what it regards as insufficiently strong structural policies and broad promises, rather than precise performance criteria, for their implementation.

An arrangement that insufficiently addresses a country's structural problems may produce disappointing results in terms of both growth and adjustment if adjustment fatigue weakens the country's resolve to implement the macroeconomic part of its program. But this need not necessarily be the outcome, at least in the short run. In a study of a sample of SAF arrangements where the implementation of structural measures was weak, the Fund found that growth was, nevertheless, better than projected. There were a number of reasons for this, beyond the fact that raised producer prices had had the expected beneficial effects. The Fund's seal of approval (even if it was only the modest SAF seal) has in some cases unlocked financing from national and international donors that, at least temporarily, loosened the foreign exchange constraint on the growth of output. In other instances, poor implementation

of a fiscal program (say, the delay of a new VAT) had kept up demand and while it hurt the payments performance, it may have provided some initial stimulus to output. And in a number of countries improved weather conditions had produced an upturn in agricultural output.

3.5 Price stability

Is the control over inflation one of the elements of Fund conditionality? The answer to that question has moved back and forth between "yes" and "no" in the course of the Fund's history.

Price stability, as distinguished from exchange rate stability, did not find an explicit place in the Fund's original Articles of Agreement, although it could well be argued that member countries on joining the Fund expected to be helped in their struggle for domestic price stability by their commitment to maintain a stable exchange rate with respect to the U.S. dollar, whose domestic stability seemed assured by U.S. policy (Cooper, 1984). It was not until the first amendment (1969) that the avoidance of deflation and inflation entered as Fund objectives, in the context of the considerations that should guide the allocation of SDRs (and tucked away among the SDR provisions — Article XVIII, Section (1) — rather than inserted in the "Purposes" listed in Article I). In the second amendment (1978), moreover, "reasonable price stability" made its entry in the context of members' obligations with respect to their exchange arrangements.

Whatever the Articles said about price stability, the Fund has never left any doubt that it "stood for" stable prices and against inflation. But the extent to which it made this conviction part of its conditionality has changed over the years. Five phases can be distinguished.

1. In its early years, the Fund carried its commitment against inflation to the point of refusing to enter into arrangements that did not have the clear aim of bringing about price stability. In those days — roughly the 1950s and 1960s — the Fund rejected "gradualism" in the fight against inflation; if a country was not prepared to take the radical steps against inflation that would give a devalued exchange rate a good chance at being sustainable, it could not count on Fund support.

2. The Fund's experience with a number of countries in Latin America soon made it retreat from this dogmatic position. In the course of the 1960s the Fund became aware of the difficulties many countries had in controlling inflation and, giving clear priority to balance-of-payments adjustment, began to accept (and soon to insist on) downward floating exchange rates to match persistent inflation. With that, price stability in these countries receded as a Fund objective. The country could aim for it gradually, as long as it saw to it that its currency did not become overvalued; and in many cases, "gradually" came to mean "at some unknown time in the future". While most letters of intent contained target figures for inflation, these were never made performance criteria.

3. In spite of this relatively relaxed Fund attitude toward inflation, a number of arrangements in the first half of the 1980s became inoperative as inflation rates exceeded anticipations and led countries to miss their performance criteria for the budget deficit. In situations of inflation, the interest paid on domestic currency debt can be seen as representing the sum of the real interest rate and a "monetary correction", which is the percentage of the principal necessary to maintain its real value. If inflation exceeds expectations, the deficit as a percentage of GNP will grow in line with the increase in the monetary correction (Polak, 1989(b), p. 105). Thus, where the budget deficit (or, for that matter, any other nominal variable) was made a performance criterion, the inflation rate became a performance criterion in effect if not in name.

4. This problem could be overcome — and some steps have belatedly been taken to overcome it — by redefining the budget deficit used as a performance criterion, specifically by taking for this purpose the "operational deficit" (which includes only the real interest rate) rather than the "overall deficit" (which includes the monetary correction as well). In recent years, this practice has generally been adopted by the Fund in high inflation countries[11]. Inflation may even then, indirectly, affect a country's ability to stay within the parameters of its arrangement. For example, if higher-than-expected inflation led to lower-than-expected real tax returns (the Olivera-Tanzi effect) this could still cause a country to miss a performance criterion defined in terms of the operational deficit.

5. Finally, in the last few years the Fund has tended to lay greater stress on price stability, but not by making it part of the Fund's conditionality, but rather by being prepared to soften conditionality in other directions. In its support (in late 1989) for heterodox stabilization programs in Yugoslavia and Poland anchored on a fixed exchange rate the Fund hoped to bring inflation down sharply while accepting some risks that the currency might become overvalued and the current account position undermined. (We return to this question in the discussion of the exchange rate instrument in section 5.2.)

IV. SECONDARY OBJECTIVES OF FUND CONDITIONALITY

The Fund is an international organization that wields considerable influence — primarily vis-à-vis members seeking its credit but also through its surveillance activities with its membership in general. It has, over the years, tended to use this influence to broaden the areas in which it showed an interest well beyond any narrow definition of its purposes. Thus Article IV Consultations have, for many years, covered the size and nature of countries' contributions to foreign aid; for a period after the introduction of the Buffer Stock Facility in 1969, countries' policies with respect to primary commodities were also brought into the consultations.

In the framework of its credit operations, the Fund has likewise widened its agenda — not necessarily as part of conditionality but in any event to indicate an interest on the part of the organization. We have already noticed how economic growth has gained influence among the objectives that the Fund wants to promote, whether the member shares that view or not.

The last few years — or the last decade — have seen clear evidence of a widening range of subjects that may be brought up as policy objectives in discussions with members seeking Fund credit. (There has also, of course, been a widening of the policy instruments entering into Fund-member discussions as structural elements have received much more attention.) This chapter discusses a number of these new, and so far secondary, objectives. It also, in its last section, enters into a question that is not new, but has rarely received systematic discussion: the role of politics in Fund decisions to grant or to refuse credit to members.

4.1 Poverty alleviation

There are many strands to be recognized in the Fund's concern with poverty, and they cannot readily be woven together into a fully coherent picture.

- The Fund's historic reticence on spending and taxing decisions (to be discussed in Section 5.3) brought with it the position that, on poverty as well as on other social matters, the Fund respected "the domestic social and political policies of members" (Article IV, Section (3)(b)).

- If pressed on the issue of poverty, the Fund would stress the fact that its central mandate was to help member countries pursue sound macroeconomic and structural policies to maintain or restore sustainable economic growth, which in turn would have important beneficial implications for many of the poor (see for example, International Monetary Fund, 1991 (b), p. 29). Detailed concern with the broad problems of poverty is regarded as the domain of the World Bank and lying outside the range of expertise of the Fund.

- Nevertheless, Fund missions have frequently had to operate in situations where they had to help governments in the difficult task of reconciling two critical objectives: fiscal adjustment and protection of the poor. Thus, in the 1970s, in a number of countries Fund staff was engaged in the design of policies with an important income-distributional dimension.

But it was not until the late 1970s that the Fund began to pay systematic attention to the income distributional aspects of stabilization programs. A first paper, which included four case studies, was published in 1980 (Johnson and Salop, 1980). And it was not until 1986 that the then Managing Director offered a specific Fund contribution to poverty issues. "When requested to do so by a member country", Fund missions would be authorized to consider with the authorities the income distributional implications of alternative adjustment policies. He hastened to add to this modest offer an emphatic warning that decisions on adjustment strategies and spending priorities must rest with the countries themselves (de Larosiere, 1986).

The invitation did not produce requests by member countries. Yet the Fund's officially "neutral" position on poverty issues came increasingly under attack in the light of evidence that in some countries adjustment programs financed with Fund resources had critically worsened the situation of the poorest groups of the population. One critic pointed out that programs that immiserize the poorest parts of the population fail to achieve the Fund's purpose of promoting national prosperity (Sachs, 1989 (b)) and that extreme income inequalities may well have contributed to the failure of some Fund programs and thus indirectly to the destructive populist "solutions" adopted in a number of Latin American countries (Sachs, 1989 (a)).

Against such criticism, the "trickle-down" argument based on the Fund's central mandate referred to above obviously did not suffice, and in recent years the Fund has moved toward an active interest in poverty issues. In general, the Fund has defined this interest in somewhat restrictive terms, namely "the impact on poverty and income distribution of policy changes supported by Fund financial assistance" (IMF, *1990 Annual Report*, p. 42). In practice, however, the staff appears not to be restricted to these particular aspects of poverty and it has, for example, pursued pro-poor objectives in its fiscal technical assistance activities. The Fund's active interest in the establishment of social safety nets in Eastern European countries also transcends specific concern with the way that Fund programs affect the poor.

Even though some adjustment measures, such as higher prices for crops produced by poor farmers, may benefit the poor, other measures such as the abolition of food subsidies or personnel cuts in the government are likely to harm lower-income groups, including the poorest. To alleviate situations such as these, the Fund has taken the initiative to explore two approaches in its discussions with member governments aimed at providing better protection for the poor during the adjustment process (Mohammed 1991). First, it has suggested gradualism in the application of measures (such as the pass-through of exchange rate changes) that have a negative impact on the real income of the poor, with the temporary cost covered by increases in taxation (a solution, incidentally, that does not jibe with the Fund's general approach to efficient pricing nor helps the poor in the long run). Second, it has suggested improvements in the targeting of government expenditures to aim them more directly

to the poor. These expenditures include subsidies for vulnerable consumer groups, income-maintenance and retraining schemes for dismissed government workers.

To the extent that the Fund concentrates its attention on the "new poverty" resulting from adjustment programs, it may sidestep the pre-existing problems of the ultra-poor. But it may also provide indirect political strength to the adjustment program if "the losers" represent an important constituency.

The Fund recognizes that poverty concerns have to be balanced against other claims on fiscal resources, possible production disincentives and administrative feasibility. Hence the importance of what might be considered a third approach: strong support by the Fund for measures by donor governments, NGOs, and other international organizations for additional aid channeled toward the poorest groups of the population that have been hurt by adjustment measures. The most notable example of such action was Ghana's 1988 PAMSCAD (Program of Actions to Mitigate the Social Costs of Adjustment) financed by $85 million from bilateral and multilateral donors. In this program, the lead was taken by UNICEF and the World Bank; the Fund's main function in connection with PAMSCAD was that it certified the government's adjustment effort. Bolivia's programs in 1986/87 also incorporated social safety net features that were funded by the World Bank, and comparable arrangements were made in a number of other countries.

In the same general vein, the Managing Director of the Fund, after recognizing that by no means all developing countries shared the IMF's concern about income distribution, suggested that the countries that take their social responsibilities seriously are more likely to attract international help than those "that waste money on unproductive prestige projects or excessive military display" (Camdessus, 1990(a)).

This is not the place to enter into the political dimensions of pro-poor measures — both the difficulties of marshalling broadly enough support for such measures and the need for a government to bring some of the poor (and the not-so-poor) into coalitions that are broad enough to provide sustained support for adjustment policies (Nelson, 1989). But it is necessary to clarify the somewhat related issue of the link between the Fund's recent anti-poverty concern and its conditionality.

In its efforts to have the staff explore, and if possible find ways to mitigate, the effects of adjustment programs on the poor, the Fund has had to recognize the possible presence of two major roadblocks. First, member governments are often reluctant to accept external pressure on the politically sensitive subject of income distribution. Second, some staff members may understandably be hesitant to move too far away from the Fund's traditionally neutral position on government finance by recommending specific expenditures for specific groups. Sometimes, these roadblocks vanish when the government is badly in need of technical assistance to find, within its budget constraints, ways to align important categories of the poor in support of the adjustment coalition. Sometimes, on the other hand, the government's priorities may lie elsewhere.

Faced with a wide variety of member responses, the Fund has approached its activities with respect to poverty as an area of concern, discussion and — if the

member is interested — technical assistance, but has taken the formal position that "questions of income distribution should not be part of Fund conditionality" (IMF, *1990 Annual Report*, p. 41). But this declaration needs to be read in the light of other pronouncements on the poverty issue, such as the statement in the same section of the *Annual Report* that "the need to identify more closely the poor, assess the impact on them of policy reforms, *and improve the policy mix in programs* remains urgent. The Fund... is improving *its* design of policies to minimize the adverse effects on the poor" (p. 43, emphasis added). Members negotiating with the Fund over a wide range of issues will no doubt find it in their interest to make an effort to accommodate the Fund on an issue to which it is so strongly committed. Some recent letters of intent have in fact dealt specifically with poverty issues.

4.2 The environment

In recent years, interest in the quality of the environment has led to an awareness of its linkages with economic activities and to calls for greater recognition of environmental issues in the design of public policies. As a consequence, the Fund is being called upon by governments and non-governmental organizations (NGOs) to recognize any possible environmental implications of its policy advice and to encourage member countries to pursue environmentally sound policies. Specifically, the U.S. Congress has passed legislation calling on the U.S. Executive Director (i) to persuade the Fund to carry out a systematic review of the impact of its policies on the long-term sustainable management of natural resources and the environment, and (ii) to encourage the Fund to eliminate or reduce the potentially adverse impacts of Fund programs on the environment.

Pressures of this nature have induced the Fund to explore possible effects (positive or negative) of adjustment programs — or of members' economic policies in general — on the environment. These can, of course, be found, just as one could trace various links between economic policies and public health. Devaluation promotes exports, including in some countries exports of logs whose cutting may cause environmental degradation; and it can make imports more expensive and in this way curtail the environmentally harmful effects of excessive use of petroleum products or fertilizers. The Fund's general stance against subsidies on energy, irrigation water, fertilizers and pesticides will have generally beneficial effects on preserving the country's (and the world's) natural resources; but the Fund's concern about budgetary balance may lead to recommendations toward cutting expenditures, which may hit expenditures on the environment as well as on other deserving objectives of policy. The introduction of pollution taxes may improve the fiscal situation; but environmental subsidies would have the opposite effect.

These examples suggest that environmental questions can be more effectively addressed directly, by experts from the World Bank or the United Nations Environmental Program, than as the side effects of Fund programs. Increased awareness of the subject by the Fund staff will enable it to pay attention to environmental issues in Article IV consultations and in policy dialogues leading to use of the Fund's resources and perhaps in some instances to suggest complementary policies that would lead to environmentally more desirable outcomes. But does this mean more than that the Fund should so design its hiring practices and its in-house

education that it can send on its missions the most generally competent individuals possible? How does some more knowledge of environmental questions compare with knowledge of the country's history, culture, and politics, or of development economics, education or of the latest trends in world agriculture?

In any event, the objectives of the U.S. legislation referred to above and those of a number of NGOs would go beyond this benevolent but modest concern of the institution with environmental affairs. Indeed, to meet these objectives the Fund would have to incorporate environmental aims in its conditionality. Again, as on the question of poverty, the Fund's official line is to deny that the development of some modest modalities for dealing with environmental issues (the hiring of a few economists specialized in these issues) would amount to the adoption of environmental conditionality. In a formal sense, this is no doubt the case. In practice, the answer may not be so clear cut. Take one of the examples noted above. A country seeks an increase in exports of timber to correct a large trade deficit and proposes a sharp devaluation to achieve it, in the context of a Fund arrangement. The Fund staff is alerted to possible environmental effects of greatly increased logging activities. The Fund could not, on environmental grounds, object to the devaluation unless it saw reason to question it under the Articles — perhaps because the new rate gave the country an "unfair competitive advantage". But if it felt strongly on the environmental aspect involved, it might show itself less than forthcoming on a credit arrangement unless the member undertook to provide adequate environmental safeguards.

4.3 Containment of military expenditure

The Fund and the Bank are not on record as stipulating moderation in military expenditures as a condition for countries' access to their resources; but speeches in the last few years by the top officials of the two institutions indicate increasing concern about this issue (one such speech by the Managing Director was cited in section 4.1). These speeches have begun to address the diversion of resources from development to military purposes *by developing countries* in contrast to the earlier rhetoric castigating *world* arms spending, which pointed the finger mainly at the superpowers.

The concern of both institutions with the issue of military expenditure is evident also from the increasing attention that issue is receiving from their staffs. The December 1990 issue of the joint Fund-Bank journal *Finance & Development* carried an (unsigned) article "Are LDCs spending too much on defense?" showing a range of alarming statistics. In contrast to the situation in 1960, military expenditures as a percentage of GDP in recent years are almost as high in developing as in developed countries, as a result of a rise in the former and a fall in the latter countries; and arms imports (in volume) exhibit a clear lagged correlation to economic aid received.

The Fund staff has paid attention to data on military expenditures at least since the summer of 1987. A first result of these studies appeared in 1989 (De Masi and Lorie, 1989). It focuses on a rather minor aspect of military expenditure, namely their elasticity (somewhat confusingly called "resilience" in the paper) to a country's fiscal stance. The paper finds that, on account of the long lead time of such expenditures,

their ratio to total government expenditure tends to rise in situations of fiscal tightening associated with Fund programs, and to fall when fiscal policy is more expansionary.

In the light of this increasing attention it seems likely that both institutions will overcome their historic hesitancy to broach the subject of military expenditures in the context of their negotiations on the use of their resources. In at least one recent negotiation on the use of its resources the Fund has sought and received assurances about the applicant country's intention with respect to military expenditures. In a few other cases, it has exercised pressure toward reduced military expenditure as part of a program of fiscal adjustment. Action of this nature by Fund missions does not show up in letters of intent, and in that sense it does not form part of the Fund's formal conditionality. Further instances of the use of the institutions' financial clout to steer government finance in client countries away from military, and toward development, outlays can be expected.

4.4 Political considerations

The Fund is to a high degree a technocratic organization. In the great majority of cases the question whether a country can or cannot obtain a credit arrangement depends on a judgment by staff and management that the adjustment program the country is willing to undertake measures up to the requirements dictated by its current difficulties and its prospects in the world economy.

This appraisal of the Fund's decision-making process does not imply that this process is wholly objective or rational. Judgements by the staff reflect interactions among many — not necessarily infallible — economists, in different departments and with different backgrounds. Their views about the current position, the intentions and the outlook for a country result to a considerable extent from discussions with that country's representatives. Staff members are subject to persuasion and engage in give and take, also called "negotiation", on aspects of a program. With respect to the amount of an arrangement, there are established limits related to members' quotas ("which may be exceeded in exceptional cases"), as well as a variety of indicators (magnitude of the need, quality of the program, past performance, capacity to repay the Fund) that provide guidance on how closely these limits are to be approached in individual cases. Among other things, the vagueness of the guidelines on access leave room for rewarding "good behavior" in terms of policy on the part of countries with which the staff is seeking to reach agreement[12].

Clear cases of political decision making occur where decisions on access, or potential access, are not supported by a staff judgment on the adequacy of a country's program. The deviation may be in either direction. Some countries may for political reasons be barred from access even if they had a technically adequate program. Some other countries may, for political reasons, achieve access despite a staff judgment that their programs do not meet minimum standards. The two categories are briefly discussed below.

(a) Access barred on political grounds

The list of countries in the first group is a very brief one and each case would be difficult to document. It seems to me beyond question, however, that South Africa has been unable to use the Fund since the middle of the 1980s, as long as it maintained apartheid; and that China would have been unable to draw during the first year after Tienanmen Square. An arrangement with Vietnam that would have been technically possible has likewise been blocked by political considerations (even though it would have provided a link in the process of removing Vietnam from the list of countries with arrears to the Fund). But disregard for human rights has not in general constituted a bar to access to the Fund, as is evident from the Fund's active financial relations with repressive regimes in countries such as Chile, Zaïre, Uganda, Liberia, or Romania.

The question of human rights has been raised most explicitly in connection with the Fund's relations with South Africa. Ever since 1965 the United Nations General Assembly has each year adopted a resolution requesting the specialized agencies "to withhold from the apartheid regime of South Africa any form of collaboration or assistance in the financial, economic and technical fields...", and when the Fund was known to consider a transaction with South Africa in 1982, the Secretary General of the United Nations called on the Managing Director in an attempt to prevent it. On that and other occasions, the Fund has rebuffed these pressures from the United Nations on the ground that as long as South Africa was a Fund member, it was entitled to draw from the Fund if it met the Fund's criteria, and both it and the Fund were obliged to hold Article IV Consultations. In line with this posture, the Fund concluded the disputed stand-by arrangement with South Africa in 1982. The situation changed, however, with the widespread adoption of sanctions against South Africa, as a result of which the country became in fact barred from access to the Fund's resources. A major element in this development was the adoption of legislation in the United States under which the U.S. Executive Director in the Fund is instructed "to actively oppose any facility involving use of Fund credit by any country which practices apartheid....". The ostensible reason is economic: "That the practice of apartheid results in severe constraints on labor and capital mobility and other highly inefficient labor and capital supply rigidities which contribute to balance-of-payments deficits in direct contradiction of the goals of the International Monetary Fund" (the 1983 "Gramm Amendment" to the Bretton Woods Agreement Act, Section 43(b)). But if apartheid policies caused persistent balance-of-payments deficits, the Fund's standard conditionality would suffice to bar South Africa from access. Thus the purpose of the U.S. legislation must be seen as adding a political component to conditionality[13].

The proprieties of the Fund contain an unwritten rule that if at all possible political arguments be dressed up in economic garb. The wording of the U.S. legislation conforms to this rule, which avoids at least the appearance of violation of the Fund's Articles. The practice is sometimes carried to extremes. On one occasion in 1983, a Director from one of the Arab constituencies not previously known for its keen interest in Central American economies, surprised the Executive Board by questioning the routine approval of a minor waiver requested by Costa Rica. The waiver, which involved a short delay in removing an insignificant exchange restriction, was necessary to permit Costa Rica to make the final drawing under its stand-by

arrangement. After much sleuthing the origin of the director's sudden interest was discovered: Costa Rica had had the temerity to move its embassy in Israel from Tel Aviv to Jerusalem.

(b) Access given on political grounds

The Fund's method of handling a country's request for credit tends to discourage political pressure. The request is considered in detail by a mission in the country. If the mission is not satisfied that the program meets the Fund's standards, it leaves without an agreement. The country may try to reopen the negotiations at Headquarters and put its case directly to the Fund management. But this approach will rarely succeed unless the country has brought its position to within the range of what the Fund can accept on technical grounds.

Once the Managing Director accepts a program, he puts it before the Executive Board. The Board will then approve it in all but the most unusual case. It will do so even if it considers the program inadequate, but then with advice to management not to propose a comparable program again. Thus management can negotiate with a member in the confidence that what is agreed will also pass the Board. An equally integral part of this procedure is that the member cannot bypass staff and management and, through its Executive Director or directly, put its program to the Executive Board. Argentina tried this in 1984 and was promptly rebuffed.

These procedures have had a restraining effect on political pressure to grant Fund credit. They are not, of course, foolproof. Important members can urge staff and management to bend their judgments toward considering a program as "just good enough", perhaps after a long process of negotiation in which the country has moved a considerable distance in the right direction.

There have been several cases in the last decade where, at one stage or another, the Fund gave in to political pressure by major members against the staff's better judgment; Sudan, Zaïre, Egypt, Argentina (Stiles, 1990; Finch, 1988). Yet, political decision making is the exception, not the rule. After studying a sample of seven countries, all politically sensitive, Stiles is surprised to find "the degree to which military/strategic concerns are of secondary importance to many industrialized nations when dealing with strategic allies that are economically unstable" (p. 972).

Of the cases mentioned, that of the stand-by arrangement for Egypt in 1987 has perhaps received the greatest attention (Finch, 1988). It deserves closer inspection because it brings out, surprisingly, the strength of Fund procedures to withstand political pressure. Egypt had received an EFF arrangement of SDR 600 million in 1978. It drew SDR 75 million at once; the balance remained unused because of policy failures until the arrangement expired in 1981. Many discussions about a new arrangement followed while Egypt gradually repaid the Fund. It took until 1987, by which time Egypt's debt to the Fund had been reduced to SDR 19 million, before the Fund agreed to a one-year arrangement, this time for SDR 250 million. (To underline his doubt about the propriety of the arrangement and about Egypt's ability to regain creditworthiness unless it adopted more adequate policies, the Managing Director held out for, and received, an unprecedented guarantee of Egypt's new debt to the Fund

from the members of the Paris Club.) Egypt drew SDR 116 million of the arrangement at once, after which the country again failed to meet the agreed policy conditions. The balance was never drawn and new rounds of discussion with Egypt started. These were concluded in May 1991 with an 18-month stand-by arrangement for an amount of SDR 278 million based on a wide range of satisfactory policy understandings. Thus in the thirteen years since 1978 until this third agreement was reached, and despite strong political support from all the major powers, all that Egypt had been able to draw from the Fund amounted to less than SDR 200 million gross, and less than SDR 75 million net — a little over 10 per cent of Egypt's quota.

V. POLICY INSTRUMENTS

5.1 Monetary approach to the balance of payments

The general approach which the Fund staff has traditionally used to design economic stabilization programs is known as "financial programming". Because it is comprehensive in scope and eclectic in nature, it has not been subject to abrupt fundamental changes. Instead it has shown continuous incremental growth and adjustment, starting from the simplest monetary models in the 1950s, by the absorption of new data on the national accounts, new developments in economics, new country problems, new policy instruments and new concerns about countries' economic objectives. A recent detailed description of this approach is available in IMF (1987); only a few highlights need to be recorded here[14].

The approach takes as its starting point the consolidated balance sheet of the banking system. On the asset side, that balance sheet shows the net monetary balances of the three other sectors, viz., credit to the private sector, net credit to the government, and the net increase in foreign assets. The counterpart of these assets is the stock of broad money. Fanning out from this definitional equation, net domestic credit creation (one element in the supply of money) is construed as a policy variable and the model uses behavior equations relating to the demand for money and the balance of payments. Depending on the degree of refinement wanted and permitted by the available data, the variables entering into these equations can be explained in turn by further equations on output, price formation, the exchange rate (if this is an endogenous variable), and so on.

In most cases, there tend to be severe practical limits how far this process can be carried in a formal way. When a country undertakes a major program of structural adjustment, including sharp changes in the variables that are intended to affect the supply side (such as the real exchange rate and producer prices), the analyst in the mission will not be able to call up on his PC a ready-made country model with all the relevant supply equations. He will have to fall back on a careful ad hoc analysis of the factors determining supply and growth, and employ an iterative process in which both these factors and the financial variables are taken into account (Robichek, 1985).

An operationally usable model of an economy can of course be derived starting from any of the main macroeconomic equations. The Fund has had two important reasons to develop its model from the monetary angle. First, it found it essential to stress the monetary character of balance-of-payments problems, a point frequently ignored — at least in the past — in many member countries. Unless that cause of payments problems is addressed, these problems will persist. Second, monetary data are still the most accurate and the most promptly available and they thus play a crucial role as performance criteria to test whether countries adhere to the conditions of Fund arrangements.

In regard to one specifically monetary aspect of the Fund's financial programming approach, the staff has found it necessary to reconsider one of its basic assumptions. As Fund programs are designed for countries with balance-of-payments

problems, the Fund's primary concern in setting monetary ceilings has traditionally been to protect the balance-of-payments from excessive money creation. This objective is served by a ceiling on domestic credit creation, not on money or the monetary base (Guitian, 1973)[15].

The experience of some countries in recent years suggests, however, that this is not the optimal monetary policy in all circumstances. In Yugoslavia in 1985 and Mexico in 1987, the balance of payments developed far more favorably than had been expected. When this happens, adherence to the credit target leads to an excessive increase in the money supply and a higher inflation rate than had been expected. To prevent these results and yet safeguard the economy against the risk of a persistent balance-of-payments deficit, it would have been necessary to qualify the initial credit ceiling by a provision that would lower it when there was evidence of excessive money creation. In practice, this further refinement of monetary policy could not be promptly introduced and both countries in the end (Mexico in 1988, Yugoslavia in 1989) adopted heterodox policies to bring inflation under control. A credit ceiling with a contingent downward adjustment was incorporated in 1989 in Venezuela's EFF program.

In the Philippines, a traditional low inflation country, the primary objective of the authorities in adopting the 1984 adjustment program was to contain or reduce inflation, even at some cost to the reserves. Accordingly, the Fund, after much soul-searching, agreed to a program containing a ceiling on the monetary base, together with a floating rate. In this case too, a strong performance of the balance of payments led to a change in policy, including an upward revision of the monetary targets, as the appreciation of the real exchange rate raised concern about the future viability of the balance of payments.

In the next two sections we discuss two major policy instruments, the exchange rate and fiscal policy. But before dealing with these two instruments separately, attention should be directed to a change for the worse in their interaction in the stabilization process. As long as the Fund was dealing with countries that were not heavily indebted abroad, it could probably assume that in the generality of cases currency depreciation would by itself improve the fiscal imbalance (Polak, 1948); typically in a developing country, the proportion of taxes levied on trade (put at one-third or more in Tanzi, 1990) which, if *ad valorem*, would increase with the domestic currency value of trade, would be well in excess of the proportion of government expenditures directed toward imported commodities. But when, by the 1980s, interest payments on foreign debt had in many countries grown to a substantial percentage of GDP, it seems likely that the relationship was reversed, so that the real depreciation necessary to improve the current account of the balance of payments would in itself enlarge the budget deficit (Reisen, 1989).

5.2 The exchange rate instrument

In the last two decades, the Fund has been putting increased emphasis on exchange rate action as an instrument of adjustment. In part, this reflected a difference in philosophy: the attachment to a fixed exchange rate dating from the par value regime was gradually making way to belief in the perceived benefits of exchange

rate flexibility. But it also reflected a change in circumstances. In the 1950s and 1960s, most stand-by arrangements were granted in support of programs that dealt with moderate balance-of-payments problems without serious structural distortions (Johnson, 1985). The greater distortions of the 1970s and the even more serious disequilibria of the 1980s made exchange rate action increasingly unavoidable.

The change in emphasis is borne out by the proportion of programs (with countries that did not belong to currency unions) that included exchange rate action.

32 per cent in 1963-72
59 per cent in 1973-80
82 per cent in 1981-83,

with the percentage rising to close to 100 per cent in recent years.

In addition to the initial exchange rate action, most programs in the 1980s called for further adjustments during the program period, typically to maintain the real depreciation achieved or "to prevent a loss of competitiveness". Indeed, 18 of the 25 arrangements concluded in 1983 that started out with exchange rate action contained follow-up provisions of this general nature (Johnson, 1985).

A further Fund shift toward exchange rate flexibility occurred in the middle of the 1980s. Until then, it had been taken as axiomatic that a developing country could not allow the value of its currency to be determined freely in the market[16] (Polak 1988, p. 139) and that view was still to some extent reflected in the work of the staff team headed by G.G. Johnson (1985, p. 4). But in recent years, a substantial number of developing countries have adopted a truly floating rate in the context of Fund arrangements. Quirk *et. al.* (1987) report 13 such cases between September 1983 and the end of 1986; by end-1990 about 20 developing countries had floating exchange rates. Typically, these countries (including a number of very small ones) adopted floating from a position of extreme weakness, with severe payments difficulties, external payments arrears, and black markets in foreign exchange. The adoption of a free float gave the authorities an opportunity to liberalize the restrictive system and "to shed political responsibility for the adjustment of the exchange rate" (Quirk p. 4). The experience of these countries would seem to show free floating as a viable option in cases where exchange rate policy had become virtually unmanageable by other means, though it seems excessive to characterize that experience as "a significant step forward in the evolution toward exchange rate flexibility" in developing countries (Quirk, 1987, p. 1).

The last few years have seen a reversal of the staff's unqualified fealty to "flexibility" and a return to the themes of the exchange rate debate of twenty years ago, pitting discipline against flexibility. Criticism of a widespread attitude in the staff to favor depreciation as the stock answer to any payments problem has come both from the outside and from inside the organization.

Jeffrey Sachs (1989 (b), p. 113) has criticized attempts to lower the real exchange rate excessively in order to maximize the outward transfer of resources. He notes that these attempts are often unsuccessful and are likely to undermine the

credibility of a government's anti-inflation policy. Within the Fund staff, the merits of a real exchange rate rule were questioned even earlier by Adams and Gros (1986). Put in its simplest form, their argument runs as follows. Suppose that a government uses depreciation to raise the domestic price of tradables for the purpose of improving the current account from an existing level compatible with domestic equilibrium. The prices of nontradables will soon catch up as improvement in the balance of payments provides the necessary addition to the money supply, and the strategy will institutionalize inflation even in the absence of any domestic inflationary gap. (The particular case underlying the Adams-Gros model was that of Yugoslavia, where the authorities attempted for a number of years since 1983 to create a target spread between the prices of tradables and nontradables. The inflationary response in that country was particularly rapid because the exchange rate was linked to a price index of "nontradables" which, for want of anything better, consisted to a large extent of tradables.)

Another cause of the rising antagonism in the Fund to a real exchange rule was the success of the exchange rate mechanism in the European Community during the second half of the 1980s. In the early years of the ERM, realignments had occurred frequently, almost as soon as differential rates of inflation had brought about any substantial change in real exchange rates. During that period, academic observers were sometimes tempted to view the ERM as a crawling-peg mechanism. Recent experience, however, has demonstrated the error in that view. The essence of the ERM is that an inflation rate higher than the German rate is *not* automatically compensated by realignment. Realignments are delayed to make inflation painful, and are conditioned on policy adjustments in the inflating countries to produce better performance in the future. In this way, ERM has functioned as a disciplinary device in much the same way as the Bretton Woods system functioned in the 1950s and 1960s.

As the anti-inflationary success of the EMS mechanism became firmly established — with no general realignment since 1983 — some members of the Executive Board, especially from European countries, became increasingly wary of a "flexible exchange rate policy" as the standard remedy for all situations of external imbalance. Still, few of the countries that need the support of the Fund have achieved the degree of price stability that permits, say, France or Belgium, to accept the discipline of a fixed rate in the ERM.

Thus, to determine its general attitude toward exchange rate provisions in the context of stand-by arrangements, the Fund is, in some sense, resuming its debate of twenty years ago, at the very end of the par value regime, on the relative weights to be attributed to "discipline" and "adjustment" in setting exchange rate policy (IMF, 1970). In the meantime, there is evidence of greater variety in the arrangements that the Fund concludes with countries in Eastern Europe. The arrangements with Yugoslavia and Poland in early 1990 were both based on a fixed exchange rate, intended to serve as an anchor for price stability (which neither country managed to achieve during that year). The January 1991 arrangement with Czechoslovakia was also based on a fixed exchange rate as an anchor for price stability. In Hungary, Bulgaria and Romania, on the other hand, where larger price adjustments are part of the adjustment process and the actual or potential reserve cushion is less adequate,

more flexible exchange rate policies have been adopted in understandings with the Fund. The Hungarian arrangement could perhaps best be described as a fixed but quite likely adjustable rate; the Bulgarian, as close to a pure float; and the Romanian, as a dual exchange market.

5.3 The fiscal instrument

In no area of economic policy has the Fund's *de facto* conditionality changed as radically as with respect to fiscal policy.

Traditionally, the Fund had prided itself on taking a neutral position on the specifics of fiscal policy. Its interest was said to be limited to correction of the fiscal deficit, or more narrowly to the domestic credit extended to the government. How the government brought down the deficit — by raising taxes or cutting expenditure, and *which* taxes and *which* categories of expenditure — was, and should remain, the government's responsibility. This approach "kept the Fund from entering into areas that require[d] judgement of social and political priorities... to keep its distance from specific decisions required for policy implementation" (Guitian 1987, p. 88). If the country wanted advice on fiscal matters, it could ask for technical assistance, but there was no link between such advice and the conditions for use of the Fund's resources. By 1987, however, the Fund had already moved a considerable distance away from political neutrality. The traditional practice had for a number of reasons proved to be ineffective and indeed counter-productive (Tanzi, 1987):

1. Cutting credit to the government by the banking system does not automatically reduce the government deficit. Any government keen on avoiding effective constraints can find ways around macroeconomic ceilings, e.g. by borrowing abroad or running up domestic arrears. Additional performance clauses may be needed to plug up loopholes. Alternatively, the deficit can be financed by borrowing on the domestic capital market (perhaps forcibly, by changing the rules for institutional investors), thus crowding out private investment.

2. Reliance on macroeconomic ceilings may induce countries to adopt fiscal remedies that are easy but not durable. For example, taxes may be advanced, expenditures postponed, temporary taxes introduced, or public employees' real wages slashed to unsustainable levels for the duration of the program.

3. Most important, different fiscal measures that may be equivalent in their direct financial impact on the deficit have widely different effects on the growth of the economy, and hence also on the country's fiscal situation in the medium term. Given the Fund's interest in growth both as an objective in itself and as a determinant of countries' willingness to persevere in adjustment, the institution has gradually moved toward a greater interest in the specifics of fiscal adjustment[17].

The instrument through which it has done this is fiscal technical assistance. From experience, the Fund has learned that countries' commitments to cut the deficit by a given amount are not credible unless the country specifies *how* it will do this. Durable and effective new fiscal measures may well involve major structural changes, such as the introduction of a value added tax or of a new system of computerized

expenditure control. Therefore, the Fund is anxious to provide needed expertise through technical assistance, and such help can have a major impact on fiscal conditionality.

First, fiscal restructuring takes time and the timing and character of Fund programs may thus become a function of the progress of the fiscal technical assistance work. The Fund may agree on a modest one-year stand-by arrangement complemented by a tightly programmed technical assistance effort in anticipation of a far more ambitious, structurally-oriented EFF. The long gestation period of fiscal reforms will thus tend to produce a more lasting Fund involvement with the country.

Second, the close integration of fiscal assistance with the elaboration of Fund arrangements serves to introduce micro-conditionality in an unobtrusive way. As part of the letter of intent (or as prior action) the government may engage itself to introduce some broadly specified major structural changes in the fiscal field, it being understood that these changes are exactly those worked out over the past months between a fiscal technical assistance mission and the country's officials. A confidential document supporting the letter of intent will spell out the agreed details with respect to changes in taxes, public expenditure, tax administration and so on. In a formal sense conditionality guideline No. 9 (discussed in Chapter VII below), which, with only few exceptions, confines conditionality to macroeconomic variables, may still be considered to be observed; in fact, however, the member and the Fund have bypassed it. While Tanzi suggests that this guideline may have to be amended (1987, p. 137), the more likely outcome is that it will increasingly be ignored.

The increasing depth with which the Fund has been involved in countries' fiscal positions has, at the same time, expanded the scope of the Fund's fiscal activities well beyond the impact of fiscal measures on aggregate demand. Other dimensions of fiscal concern have included the quality of the country's administrative infrastructure, efficiency and equity. Concern with poverty is directly related to equity considerations in the tax and government expenditure fields. The Fund's nascent concern about high military budgets discussed in section 4.3 can appropriately emerge as a concern about fiscal inefficiency: military spending beyond a certain level can plausibly be castigated as 100 per cent waste.

VI. DO FUND-SUPPORTED PROGRAMS WORK?

6.1 How to measure the effects of Fund programs

Most of the earlier studies on the effect of conditionality, or the effectiveness of Fund programs, use either of two techniques, neither of which is satisfactory (Goldstein 1988, Edwards 1989). One group of studies seeks to measure results by comparing relevant variables (the current account, growth, inflation) in a country before and after the adoption of a Fund program; the findings are biased because this approach attributes the (positive or negative) impact of extraneous factors to the program. The other group of studies compares the average change in the target variables for a group of program countries with corresponding averages for a control group of countries without a Fund program. This too yields biased results, because control countries differ systematically from program countries: their problems tend to be less severe (otherwise they would have become program countries) and they show less improvement because they are not as urgently in need of it (Goldstein and Montiel, 1986). Comparisons with control groups also miss any extra effect that a given policy instrument may have as part of a Fund program, in particular the dimension of confidence.

More refined statistical methods can in principle be used to overcome these biases, but their success so far in finding statistically significant results remains less than impressive. The reason for this may be that there are no significant differences to be found between program countries and non-program countries, if only for the reason that some programs have not been effectively implemented. The one piece of solid evidence is that the balance of payments and the current account of countries with Fund programs improved. The effect of programs on inflation is uncertain. This is hardly surprising, given the wide range of inflation outcomes, especially in the 1980s. With respect to the growth rate, very similar and near-contemporaneous Fund and Bank studies come to clear, reportedly significant, but opposite results.

Khan (1990, p.215) finds, for the period 1973 to 1988 that "the growth rate is significantly reduced in program countries relative to the change in non-program countries". Using the lower of the two coefficients found by Khan, the predicted reduction in the growth rate would on average be 0.7 per cent of GDP for any year in which the country had a program with the Fund. Thus, a country that had say, six annual programs since 1980 would by 1988 have a level of GDP that was some 4 per cent lower (six times 0.7 per cent per program year) than if the country had done without the Fund programs. Doubts are raised about Khan's finding, however, by the fact that it is not confirmed if the subperiods 1973-1979 and 1980-1988 are considered separately: for each of these, the impact on growth of the program variable is found to be much smaller and not significant (Table 6 of the paper). If (with an abundance of statistical degrees of freedom) there is no clear evidence of a relationship for the 1970s or for the so different 1980s, can one put much credence in a relationship, even a "significant" relationship, found for the two decades combined?

Corbo (1990, p. 18) compares growth rates in 1985-88 with 1981-84 for countries with World Bank structural adjustment programs. After controlling for the external shocks, initial conditions, levels of external financing, and policies followed in the pre-

program period, he finds that "adjustment programs are estimated to have boosted the rate of GDP growth by close to 2 percentage points". The numerical implication of this study is that the 1988 GNP level of the countries with World Bank structural adjustment programs was on average about 8 per cent *higher* (4 years @ 2 per cent higher growth per program year) than if these countries had adjusted without a Bank program.

The bewildering impression created by these two findings (neither of which strikes this observer as particularly convincing) is not diminished by two further observations:

— the macroeconomic content of World Bank structural adjustment programs does not differ significantly from that of Fund programs; and

— eighteen of the 25 countries in the World Bank sample also had Fund programs, 10 of them in six or more years.

Future research may be more successful in isolating the effects on program countries of Fund programs or Bank programs, as distinguished from the policies that constitute these programs[18]. Or perhaps that question may just as well be allowed to remain unanswered, provided we can have a good analysis of the effects of Fund-type *policies*, perhaps combined with an in-depth analysis of the effects on groups of countries. An example of the latter type of analysis, on the growth of countries with SAF programs, was mentioned in section 3.4.

There is only a limited amount of information available that can be used to compare the execution of recent Fund programs with those in the past. Table 2 seems to suggest that countries with upper credit tranche programs in the mid-1980s and SAF/ESAF countries toward the end of the decade performed less well in adhering to Fund programs than was the case in the preceding decade. This finding would not be a reason for surprise in the light of the much more difficult external circumstances of the recent period and, in particular, the greater frequency of unexpected negative shocks.

Table 2

IMPLEMENTATION OF FINANCIAL CONDITIONS OF FUND ARRANGEMENTS, 1969-1989 (percentage of countries in sample observing ceilings)

Period	(i) 1969-78	(ii) 1983	(iii) 1988-89
Sample	105 Stand-by Arrangements	34 Stand-by and EFF Arrangements	22 Arrangements 17 SAF 5 ESAF
Credit Ceiling	55	44	40 (60)
Fiscal Performance	62	36	

Sources: (1): Beveridge and Kelly 1980, Table 2, last column (54 out of 99) and Table 3, line c; (2) and (3): IMF.

Note: This table expands on a comparison suggested in Edwards (1989). For the arrangements under (i), data on the observance of credit ceilings have been added and the figure of fiscal performance has been corrected. (Edwards indicates 48 per cent, which in the source is the performance on expenditure limits instead of the performance on the overall deficit.) The figures in column (ii) have been recalculated from the material apparently used by Edwards in his Table 4; they refer to the total number of annual below-ceiling performances for the three years 1983-1985 combined. Entries in column (iii) refer to "monetary and fiscal benchmarks/performance criteria"; entry for ESAF arrangements presented in () because of the small number of observations.

Beyond seeing how well countries implemented their undertakings with respect to instrument variables one can also observe the extent to which they achieved their objectives as defined in terms of various target variables. The two measurements of performance are not closely correlated; in a sample of 149 programs over the period 1983-87, only 63 countries observed the performance criteria, but of these only 60 per cent met their external targets; on the other hand, 40 per cent of the countries that missed the performance criteria still met their external targets.

Table 3 presents data on pre-program performance, program targets and program results for 44 annual stand-by and EFF programs in 1985-88, the most recent period for which such data are available (similar data for the years 1983 to 1985 were reproduced in Edwards, 1989).

The average annual growth rate under the programs works out at 2.5 per cent, about equal to the average program target, but considerably lower than the growth rate for the 22 low-income countries that had SAF and/or ESAF programs in the latter part of the 1980s. Those countries averaged about 4 per cent growth, compared with about 2 per cent in the three-year period preceding these programs.

All these data need to be interpreted with caution. For the reasons indicated earlier in this chapter, better performance during the program than before cannot simply be attributed to the program: too many other factors may have played a role. Alert to the pitfalls of before-after comparison, the staff focuses much of its attention on a comparison of results with targets. Some of these are shown in Table 3. The main finding is that slightly over half the countries met or exceeded their targets, and that the average excess performance on growth and the current account was also small — presumably well within the margin of error of these averages. For inflation, the average performance was 12 percentage points worse than the target; not surprisingly, the 21 deviations on the upside were larger on average than the 23 deviations on the downside.

What is the significance of these comparisons between targets and outcomes? It is important to understand that "targets" represent not so much an expression of countries' desires as informed staff guesses on what is likely to happen. In fact, the staff uses the three terms, "targets", "forecasts", and "projections" mostly without distinction. Accordingly, any comparison between targets and outcomes cannot be interpreted as an indicator of the quality of the program; it is essentially an indicator of the quality of the forecasting exercise done at the time the program was agreed. Read in this way, outcomes of approximately 50 per cent above and below target deserve commendation.... for unbiased forecasting.

Table 3

PROGRAM OBJECTIVES AND RESULTS
44 Annual Program Years, 1985-88

	Economic Growth	Infla-tion	Current Account
	%	%	(% of GDP)
Pre-program year	1.2	43	-5.8
Program target	2.3	27	-4.6
Outturn	2.5	39	-4.4
Outturn vs. target:	(Number of Programs)		
Equal or better	24	23	25
Worse	20	21	19

Source: IMF.

Compared to a similar exercise done a few years ago for the period 1983-85 (reported by Edwards 1989, pp 30-32), recent staff forecasting appears to have turned out more accurate with respect to growth and inflation. This may mean that it has

improved; or that exogenous factors have behaved less erratically; or, finally, that the staff is less prone to an earlier tendency, signalled by Guitian (1980, p.38), to announce optimistic targets in the hope of thereby influencing the results.

In this connection it is important to note that overly optimistic assumptions about inflation may have a contractionary impact on the outcome of a program, if these assumptions lead to credit targets being set too low. The fact that in the 1983-85 sample inflation "targets" underestimated outcomes in about 60 per cent of all cases caused Bacha (1987) to conclude that Fund programs engaged in "overkill of domestic demand". Yet, the same programs overestimated the growth component in the demand for money with about equal frequency. Even when both the inflation rate and the growth rate are forecast without bias, as in the 1985-88 programs, there may be individual cases where higher-than-projected inflation would lead to undue tightness in the money supply if the credit ceilings were observed. But that may have been a rare occurence; 11 out of the 21 countries in Table 3 that overshot their inflation targets also missed their credit targets, and of the 17 countries that met both the fiscal and credit targets, 13 also met the growth targets.

In any event, a judgement on the success of Fund programs can hardly be based on a comparison of outcomes with projections that may be faulty. The actual outcomes by themselves may be more relevant. In this context, the greatest interest attaches to the growth rate; balance-of-payments adjustment *had* to occur as resources ran out, and inflation performance differed enormously among countries, being generally much better in Africa and Asia than in Latin America.

Given the difficulty — perhaps the impossibility — of finding a statistical answer to the connection between programs and growth, some more qualitative thoughts on the subject would seem to be in order.

6.2 From stabilization to growth?

Adjustment measures are agreed between a country's government and the Fund. They are — or sometimes are not — implemented by the government. But the ultimate effects of these measures — price movements, exports, economic growth — are brought about by the responses of the private sector. What is the link between government action and private sector response?

With or without the help of a stabilization program supported by the Fund, a country may take all the right measures: cut the budget deficit, constrain credit, adopt a realistic exchange rate, liberalize imports, deregulate domestic financial markets. Sustained adherence to a comprehensive set of such measures is likely to ensure success in terms of stabilization. Inflation will come down to a low level and the exchange rate, even if it is not pegged, will be reasonably stable. Interest rates will decline, though not necessarily quickly or all the way to levels prevailing in international capital markets.

But will there also be a pay-off in the real sphere? Will stabilization be accompanied by, or at least soon followed by, a healthy resumption of growth? From a broad policy point of view, this is the most important test of the effects of the Fund's

conditionality. (Of less importance is some episodic evidence of instances where countries did all — or almost all — the wrong things and the private economy nevertheless remained on a healthy growth path. Brazil in the 1980s could perhaps be cited as a case in point, although one should note one helpful factor, namely that most of the time the Brazilian government avoided overvaluation of the country's currency.)

The Fund has — if not always, at least for decades — been aware of the fact that stabilization was not a sufficient condition for the resumption of growth (Jacobsson, 1961, pp. 30-31). But even when stabilization is "growth-oriented" (the Fund's and the Bank's currently favored adjective), can it be assumed that it will indeed be growth producing? Growth orientation includes such ingredients as an exchange rate, producer prices and trade liberalization aimed at stimulating the production of tradables; tax rates that encourage risk-taking; pruning expenditure not only to give confidence to entrepreneurs that the government's finances are being brought under control, but also to safeguard urgently needed outlays for the maintenance and expansion of the country's infrastructure, for worker training and basic education and for salaries high enough to maintain a motivated civil service. But are these and other measures in the same spirit sufficient to set the private sector on the road toward economic expansion?

In a recent paper, Dornbusch (1990) has presented a theoretical construct to support the proposition that "even with major adjustment efforts in place, countries do not fall back on their feet running; they fall into a hole". He argues that once having landed in a low-investment, low-output situation, countries tend to remain stuck there, unable to move to another equilibrium situation with higher investment and growth. Once stuck, they require an external push of resources and confidence — mostly the latter, he implies — to shock them into a more satisfactory, higher orbit.

More specifically, Dornbusch's (1990 p. 24) proposition is that "in the aftermath of [a] major macroeconomic shock there may simply be no equilibrium that is politically safe and economically rewarding on a scale that induces the return of growth as the response of competitive markets" (Dornbusch 1990, p. 24). Whether or not this is the case is ultimately an empirical question on which Dornbusch presents some material — but not enough to convince me that his construct represents the typical case. (I would agree with Dornbusch that the model by Khan and Knight (1985) does not suffice to demonstrate the opposite proposition, viz. that stabilization does <u>not</u> have lasting effects on economic performance.) The data that Dornbusch presents for a number of Central European countries in the early 1920s show that they snapped back rather quickly ("perhaps even surprisingly", Dornbusch adds) from their stabilization crisis. Later in that decade, these countries received large inflows of foreign capital; but the only foreign financial support that they received initially came from League of Nations stabilization loans (the League's role in the affairs of these countries was much the same as that of the IMF now — complete with conditionality, resident representatives, and finance ministers who put the blame for necessary adjustment measures on the demands of the institution).

The evidence that can be drawn from Latin America in the 1980s is not extensive, because so many Latin American countries (Argentina, Brazil, Peru) have

not taken more than transitory stabilization action and others (such as Venezuela) have had only a short run of convincing adjustment measures. Chile, which stabilized earlier, is generally agreed to be doing rather well. It did not succeed quickly, but it also committed important policy slippages early in the decade. More recently, Mexico and Trinidad and Tobago provide two encouraging examples.

Dornbusch bases his argument almost entirely on the case of Bolivia. That country, he says, implemented all essential reforms "and now waits for recovery and growth" (Dornbusch, p. 3). That is one way of looking at the Bolivian experience. At the other extreme one finds Sachs (1990), not generally an admirer of Fund programs ("The IMF's recent record in the debtor countries is one of failure." (p. 103)) commenting on the Bolivian program as having been "... among the most successful in the world, with continued low inflation and rising growth, based on a strategy of liberalization and budget austerity. Bolivian politics have become far more stable and supportive of stabilization...and the role of the IMF is widely accepted" (p. 109)[19]. In any event, even Bolivia does not conform to Dornbusch's theory of immiserization through adjustment. Hit by a catastrophic decline in its exports just after taking its stabilization action, Bolivia still managed to return to positive growth one year later and then achieved an annual growth rate of about 2-1/2 per cent four years in a row. Far from satisfactory for a country with a population increase of 3 per cent per year; but also not indicative of an inescapable misery trap, given the circumstances, including the political uncertainties caused by the 1989 election (*The Economist*, October 20, 1990, p. 48).

Drawing from a wider sample than Latin America only one can point to a lengthening list of countries that are emerging from the adjustment process with substantially strengthened economies. The Bank lists five top performers in the 1980s: Korea, Mauritius, Chile, Thailand and Ghana (Corbo 1990, p.20). All five had the benefit of Fund programs. Other countries deserve to be mentioned in the same context, including the Gambia, Malawi and Morocco.

To conclude this discussion on the impact of Fund programs on the growth and adjustment experience of member countries, it may be of interest to look somewhat more closely at the cases of Mexico and Venezuela. Among other things, these cases shed light on the length of time it took these countries to move from the debt crisis to the resumption of growth.

Viewed from the outside, the Fund's role in these two countries seems almost entirely different. Mexico entered into an SDR 3.4 billion EFF arrangement in January 1983, which became inoperative in mid-1985 as Mexico's policies slipped. It took until November 1986 before an 18-month stand-by arrangement (for SDR 1.4 billion) could be approved. This arrangement expired, fully drawn, in April 1988. There was another lapse of a year until a new three-year EFF arrangement for SDR 3.3 billion was concluded in May 1989; the bulk of the money available under this arrangement has been drawn down on a regular basis.

Venezuela, by contrast, did not make its first IMF drawing ever (and then only of its reserve tranche) until December 1988 and had its first Fund program, for the amount of its first credit tranche, in April 1989. Only in June of that year did it receive

large-scale Fund assistance under an SDR 3.7 billion, later increased to SDR 3.9 billion, extended arrangement.

On closer consideration, however, collaboration between the Fund and these two countries showed pronounced similarities. In 1982-83, when both countries were struck by the debt crisis, each held extensive discussions with the Fund about a financial arrangement. Mexico had no choice: only the highly visible application of Fund conditionality would make it possible to obtain the refinancing of commercial bank credit necessary to stave off insolvency. The Fund revived the technique of an EFF arrangement (with which it had become rather disenchanted and which it had used for only one country in 1982) as a way to announce very large assistance (425 per cent of quota) to become available over a three-year period. The Fund negotiated satisfactory demand-management conditions, but as far as structural policies were concerned, Mexico was not prepared to go beyond rather broad promises, which led to little action in the short run.

Venezuela still had large reserves and was in a stronger position than Mexico. It managed to stick to its tradition of avoiding Fund support by taking sharp fiscal action on its own. This was sufficient to satisfy the banks. Public opinion in Venezuela, unlike that in Mexico, was unfamiliar with the Fund, and it would have been politically difficult for Venezuela even to announce structural remedies (with respect to exchange rate unification or import liberalization) that the Fund would have required for an arrangement. Since the banks were in any event not particularly interested in such measures, Venezuela managed to deal with the crisis by itself. It was able to stick to this course for the next few years. By the mid-1980s, however, the banks wanted a greater degree of IMF involvement as a precondition to a multi-year restructuring accord (MYRA). The Fund obliged by accepting the country's request for "enhanced surveillance", in accordance with a procedure for such a service that it had recently adopted. In essence, "enhanced surveillance" in support of MYRAs amounted to semi-annual, instead of the usual annual, consultations, combined with an undertaking to send the staff reports to the country's creditor banks. Since the Fund did not commit resources on the basis of these reports, the implied conditionality of its "candid assessments" was not demanding,[20] but it served to establish closer working relations between the country's technicians and the Fund staff, which formed the basis for the 1989 program.

In the meantime, with Fund arrangements on and off, Mexico's performance in the mid-1980s was also far from satisfactory. Little was done in terms of structural policies and when reserves increased sharply in early 1987, the peso was allowed to become overvalued.

Thus it was not until late in the decade that Mexico and Venezuela became sufficiently convinced of the need for comprehensive financial and structural adjustment programs. In both countries, five or six years of active discussion with the Fund had prepared the ground. As it was, Mexico in the end designed its own independent program in 1988/89 and then persuaded the Fund to support it. The program had important heterodox elements but it had also a strong orthodox basis in fiscal and monetary policy. Although with some hesitation, the Fund accepted the program essentially as presented, because it contained a wide array of favorable

components: a major fiscal reform, trade liberalization, a much improved climate for direct investment, financial liberalization and the eventual denationalization of the commercial banks; monetary policy run by open market policy instead of credit controls, and a positive attitude toward privatization of government enterprises. Venezuela was also anxious to show that its program was its own, not imposed by the Fund; it knew the structural actions that the Fund would require, and it took them before entering into negotiations with the Fund.

By 1989, both countries had adopted a set of policies that gave them a good structural basis for sustained growth. The Fund's conditionality played a role — but, as shown, by no means a simple or direct role — in achieving this result. In Mexico, it is evident that adjustment has taken hold, with perhaps the strongest evidence provided by the recovery of private investment. As a percentage of GDP, private investment touched a low of about 11 per cent in 1983 and 1984. Since then, it has risen to a level of about 14.5 per cent in 1988 and 1989, a little above the peak achieved just before the debt crisis (Pfeffermann and Madarassy, 1991)[21]. In Venezuela many of the major adjustment measures were not taken until early 1989. As a result, the country suffered a severe adjustment shock in 1989, with an 85 per cent rise in prices, a decline in real non-oil GDP of over 10 per cent , a very sharp fall in investment and a large improvement in the current account balance (International Monetary Fund, 1991 (a)). Recovery began in 1990, when real GDP rose 4.4 per cent, and the policies now in place with respect to domestic prices, import liberalization, tariffs and foreign investment are impressive. But it will require further evidence during 1991, with respect to policies (in particular tax reform) as well as the responses of the private sector to the new policy setting, before one can feel fully confident that Venezuela too has achieved the transition from stabilization to growth.

Looking at developments in the two countries year by year since 1982, one would register far more failures than successes; but looking at the period as a whole, one can register some satisfaction with the probably final outcome — while regretting that it took so long to achieve.

VII. LOOKING AHEAD: FURTHUR CHANGES IN FUND CONDITIONALITY?

7.1 Facilities, objectives and instruments

The process of change in Fund conditionality described in the preceding chapters is unlikely to have run its course. Many of the adaptations of conditionality to the economic conditions that unfolded in the course of the 1980s still have some way to go. And times will continue to change, impelling the Fund to change with them.

The need for further adaptation runs through all aspects of conditionality discussed in this study. There is, for example, widespread recognition in the organization that the multiplicity of Fund financial arrangements has led to excessive complexity and that it may inhibit understanding of the Fund's role. As mentioned in chapter II, the differences between EFF and ESAF arrangements (apart from the interest rate charged) have become minor, and now seem to reflect mostly accidents of history. As both stand-by and EFF arrangements increasingly contain structural elements, there is also a question whether these two arrangements deserve to be maintained as separate facilities with a number of (often rather minor) different features.

Credit under SAF will in any event have to cease as its resources run out, at least until a new cycle can be resumed in 1996 as repayments start flowing in[22]. The continuation of ESAF credit on concessional terms will within a few years require an act of "replenishment" (to use IDA terminology for a facility that closely resembles IDA in its financial aspects) which will raise serious problems.

Further developments can also be expected in the objectives that the Fund pursues by means of its conditionality and in its appraisal of the effectiveness of various policy instruments used by members to achieve these objectives. A few examples will elucidate the range of issues with which the Fund will have to deal.

The Fund will have to come to a clearer position as to how strongly it wants to insist on structural measures necessary for long-run growth when dealing with members that are willing to adjust their payments position, but are hesitant to make radical changes in their economies.

Among policy instruments, the trend toward an increasing role for Fund advice on fiscal policy, largely through fiscal technical assistance, is likely to persist. With respect to the exchange rate, the debate signalled in the opening paragraph of a recent Fund staff paper (Aghevli *et al*, 1991, p. 1) on its dual role as an instrument to achieve and maintain international competitiveness and as an anchor for domestic prices, will without doubt remain active for many years to come.

With respect to some of the "secondary objectives" discussed in chapter IV a number of straws in the wind suggest that the tide continues to run in the direction of greater Fund activism.

- The charter of the EBRD commits that organization to "the fundamental principles of multi-party democracy, the rule of law, [and] respect for human rights". In a recent World Bank paper, Richard Feinberg, of the Oversees Development Council, expects these elements of political conditionality to spill over to other multilateral lending institutions. Citing both the 1990 World Development Report and the Managing Director of the Fund, he foresees that in the 1990s both institutions will be under pressure to incorporate into their conditionality considerations of social equity as well as political variables such as the quality of economic governance, the avoidance of corruption and the observance of human rights. He notes the dangers of developments in this direction, but he urges the organizations "to seize the initiative and become positive forces in promoting these worthy objectives" (Feinberg, 1991).

- In its April 1991 communique, the Development Committee addressed for the first time the question of military expenditures, emphasizing "the need to re-examine the possible reallocation of public expenditures, including excessive military expenditures, to increase their impact on poverty reduction".

- Again with respect to military expenditures, it may be noteworthy (at least that was the reaction of *Reuters*, May 6, 1991) that the Fund has turned its attention to the measurement of such expenditures, assembling data for 125 countries from 1972 to 1988; to the impact of such expenditures on economic development, and to their trade-off against social and development expenditures (Hewitt, 1991(a) and 1991(b)). One of those papers concludes that "military expenditures are quite reactive to financial constraints. Therefore, without controls or pressure, foreign financial assistance both enables and encourages a nation to spend more on the military" (Hewitt, 1991(b)). In much the same vein, Robert S. McNamara has urged, in a paper presented to the 1991 World Bank Conference on Development Economies, that conditionality be applied to financial flows to developing countries to cut down on the waste represented by excessive military spending (McNamara, 1991).

7.2 Monitoring performance

The aspect of Fund conditionality that tends to provoke the widest attention is its system of monitoring performance. In the best of cases, where the member and the Fund are at one about objectives and instruments, the policy discussions that precede an arrangement may raise few issues between the two parties and conditionality may dissolve painlessly into a common effort to design the most effective program. But these cases are rare. More typically, at least some — and sometimes many — of the Fund's requirements embodied in its proposals for conditionality are difficult for the member to accept, raise tensions and cause delays in the negotiations for an arrangement, and may even lead to a prolonged breakdown of relations. The problems encountered are, moreover, not limited to the initial negotiations. If performance clauses are not met, further drawings on the Fund automatically cease and this interruption may extend to other credits — e.g. from commercial banks — that have

been tied to the Fund's performance criteria. Thus the member may be faced with new cash-flow problems, new embarrassments and new rounds of disagreeable negotiations.

Up to a point, the difficulties mentioned are unavoidable. But it is worth asking the question whether the Fund could adjust its practices so as to mitigate some of these difficulties while continuing to ensure the proper use of its resources.

Guidelines for Conditionality

In the 1960s and 1970s, members of the Executive Board, and those from developing countries in particular, were ever vigilant to constrain the Fund's management and staff as to the scope of conditionality that they could pursue in their negotiations with prospective borrowers. Rules on this touchy subject were finally codified in a set of *Guidelines on Conditionality* adopted in 1979. At that time, the relevance of some of the guidelines was already being undermined by developments in Fund practices. But whatever the slippage that increasingly accompanied their application, the guidelines were considered valuable as a collection of unexceptionable principles. Accordingly, the periodic reviews of the guidelines have, on each occasion, led the Board to conclude that they "remain appropriate in the present circumstances".

A number of guidelines reflect the principle that conditionality should interfere as little as possible with the preferences of the borrower. Guidelines 4, 7 and 9 are particularly explicit on this point. Their main points are cited below.

> "In helping members to devise adjustment programs" [i.e. in letting members know what programs it would or would not accept] "the Fund will pay due regard to the domestic social and political objectives, the economic priorities, and the circumstances of members..." (Guideline 4)
>
> "...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..." (Guideline 7)
>
> "...Performance criteria will normally be confined to (i) macroeconomic variables, and (ii) those necessary to implement specific provisions of the Articles or policies adopted under them. Performance criteria may relate to other variables only in exceptional cases when they are essential for the effectiveness of the member's program because of their macroeconomic impact." (Guideline 9)

It is clear from these citations that the guidelines do not attempt to change the structure of conditionality; their aim is limited to making that structure less intrusive by limiting the number of performance criteria, insisting on their macroeconomic character, circumscribing the cases for reviews, and keeping preconditions to a minimum. Yet these restraining provisions have not prevented the intensification of conditionality in every direction that the guidelines attempted to block.

A more promising approach toward reducing the controversial aspects of conditionality may therefore be in focusing directly on its content, rather than merely on its instrumentation. A number of suggestions to this end are discussed in this section[23].

Before coming to these, we may mention one suggestion which, coming from the side of public choice economics, does not readily fit into the literature on the IMF.

Ex ante vs. ex post conditionality

Roland Vaubel (1988) argues that the IMF's "*ex post* " conditionality is "an inefficient way of giving policy advice." He asks why the Fund does not favor "*ex ante*" conditionality. "Why does it not, for example, exclude all applicants who have exceeded some limit for monetary expansion in excess of trend real economic growth, or for the budget deficit relative to GDP, or who have imposed unacceptable exchange restrictions, trade barriers, minimum wages, price controls or interest ceilings, or who have expropriated investors without adequate compensation?"

Vaubel's own answer to this question, in true public-choice style, is that the IMF staff would be against *ex ante* conditions because they would cut the amount of Fund lending, which justifies the staff's employment.

Perhaps a more plausible answer to Vaubel's question would marshall two arguments. First, public-choice theory may well help to explain why governments sometimes adopt economic policies that are clearly detrimental to the welfare of the population as a whole, and thus to resolve the "paradox" posed by Paul Streeten who finds it odd that an international agency imposes conditionality[24]. But *ex-ante* conditionality would be unlikely to work. It seems too much to hope that a government interested primarily in its own survival would be held back from unwise policies by the knowledge that the IMF would not stand ready to mitigate the severity of the eventual adjustment crisis. Second, the international community of governments has an interest in coaxing countries back from irresponsible policies and, acting through the Fund, is willing to pay for that the modest subsidy inherent in providing credit at prime interest rates to less-than-prime borrowers. The case for doing so is particularly strong when a new government can be induced to reverse the policies of its predecessor, but it is also strong when a government remaining in office credibly admits its previous sins.

External performance criteria only

Although the Fund's — and the member's — objective lies in the attainment of a viable balance of external payments, Fund conditionality is mostly directed toward internal instruments, such as credit creation or the budget deficit. As the links between instruments and targets are, at best, subject to uncertainty, it has been suggested that the Fund limit itself to targeting external variables, such as the current account balance and the change in reserves (International Group of Twenty-Four on International Monetary Affairs, 1987, following Diaz Alejandro, 1984 and Spraos, 1984)[25].

This proposal has one fundamental weakness which makes it inconsistent with the very principle of conditionality. Agreement on external targets without an understanding of the domestic policies to achieve them would amount to the Fund accepting on faith the member's unstated adjustment policies. Since the typical country that turns to the Fund for credit has a record of recent inadequate policies, the promise to the Fund to deliver better external results without allowing the Fund to verify the plausibility of the outcome would have a definitely hollow ring. If the Fund proceeded along these lines it would disregard the requirement for "adequate safeguards" for use of its resources required by Article I(v). The likely outcome would be that the member would make its first drawing, fail (except by luck) to reach the next external target and then have to engage in the painful negotiations that it had wanted to avoid in the first place. (There is ample evidence of this outcome from Fund arrangements, especially in 1980-81, where an important policy ingredient, such as the exchange rate, was left to be agreed before the *second* drawing.)

Reduced frequency of performance tests

Performance criteria serve the double function of monitoring a country's adherence to its program and ensuring or interrupting the right to draw according to whether the targets set are or are not satisfied. The second function is automatic and absolute (although it can be amended by waivers); the first is no more than prescriptive and is open to analysis.

What can be said about the comparative merits of quarterly and semi-annual performance criteria? Recent experience with ESAF arrangements is relevant. Their quarterly "benchmarks" ensure that there is no diminution in the intensity of monitoring. Yet the monitors act as potential interrupters at half-yearly intervals only, so the probability of chance interruptions is cut in half and so is the tension that accompanies the test dates.

After more than two years of experience with this new mechanism in ESAF arrangements, it would seem advisable for the Fund to shift to semi-annual performance criteria and, consequently, to semi-annual drawings for its stand-by and EFF arrangements. The Fund decided in June 1988 that this could be done, but only in extended arrangements; even in such arrangements it happened in only one case in the next three years.

Reviews vs. performance criteria

The initial purpose of reviews was to delay the setting of certain performance criteria to a later date, when more information would be available. But the more recent practice of incorporating mid-term reviews in all programs has extended their scope to the reconsideration and possible revision of performance criteria set earlier. Reviews have thus taken on a new character. They involve discretionary judgement by the Fund concerning a member's performance. The effect has been to qualify the guarantee of access under precisely specified conditions, which members have always regarded as the redeeming feature of performance criteria.

The actual or potential lack of clarity about a member's position and the double risk of interruptions to drawings resulting from the superimposition of reviews on initial performance criteria has led some observers to argue for an either/or solution. Killick (1984, p. 288) suggests that continuing access be determined not by performance criteria but by "an overall judgement by the Fund about the extent of programme execution" — unless governments preferred the certainty of conventional performance criteria. Kafka (1991, para. 29) would also give members the choice between reviews and performance criteria.

Would borrowing countries or the Fund be better off by relying entirely on wholly judgemental reviews? The experience of the World Bank is instructive in this connection. It initially based its conditionality for structural adjustment lending (SAL) on reviews appraising a large number of, frequently non-quantitative, targets (Polak, 1989(b), pp. 167/8). That approach proved less than satisfactory to the borrowing member and to the Bank. The borrower was left in uncertainty as to the degree of leeway it had to deviate from the multiple targets and yet be able to count on getting the second and third tranche of a SAL. From the Bank's point of view, the approach was seen as failing to impose consistency in the treatment of different countries. In response to these drawbacks, the Bank has, in a number of recent SALs, moved toward the incorporation of specific numerical indicators to guide it in judging whether the borrowing country is proceeding along a satisfactory macroeconomic path.

Against this background, it seems unlikely that Fund members would benefit from sole reliance on reviews without the protection of objective criteria. A more satisfactory course would seem to lie in a careful definition of the scope of reviews. To the maximum extent possible, performance criteria should be set at the outset of an arrangement; and where this is not possible (e.g. with respect to improvements in expenditure control), the clearest possible understanding should be reached at the outset on the nature of the progress that has to be made.

"Reciprocal conditionality" or "development contracts"

Although Fund programs have increasingly in recent years incorporated structural elements and the promotion of growth, the main focus of conditionality remains on the balance-of-payments. A number of suggestions have been made to steer conditionality toward a more even balance between adjustment and growth.

The Group of Twenty-Four (1985) (following Bacha 1987[26]) suggests that in order to provide Fund programs with a growth perspective, they should contain not only "financial exercises" of the traditional type, but "growth exercises" as well. These latter exercises would derive estimates of the foreign credit needed to achieve acceptable growth targets, and creditor countries would accept the concept of "symmetry in adjustment", by committing themselves to provide the credit required under "reciprocal performance criteria" (G-24 1985, paras. 35-45). Under the somewhat more ambitious version proposed by Bacha (1987, p. 1465), the country would be entitled to an automatic increase in IMF or World Bank credit if the creditor countries failed to honor their obligations.

A comparable idea, designated as "a system of development contracts", was put forward by Thorvald Stoltenberg, at that time the Norwegian Minister for Foreign Affairs (Stoltenberg 1989, pp. 241-2). He notes that the developing countries carry the full burden of responsibility for the success of their adjustment program, "even though that success depends fundamentally on the trade and economic policies adopted in other countries". Therefore, he suggests replacing adjustment programs by comprehensive "development contracts" for the financing of medium- and long-term development plans, which "would bind both the recipient government and the other parties (donors, banks, and international organizations) to follow the agreed policy framework". Unlike the G-24 report, Stoltenberg provides some indication on the *modus operandi* envisaged:

> "One possibility is to prepare a financing package composed of IMF loans for balance-of-payment support, Development Bank loans for sectoral adjustment support, bilateral grant elements for basic needs components, co-financing from a bilateral donor and export credits for the imports of special foreign products and capital goods and services required. Some of the financing should be quick disbursing, whereas others should require conventional project cycle reviews. Burden-sharing should be arranged on the basis of explicit assumptions about the roles to be played by the participating parties."
>
> The institutional machinery could be an improvement of the present consultative groups and round tables. Arrangements would have to ensure a balanced and fair partnership and a central role for the developing countries in question. The overall co-ordination of the political and economic aspects of the system of the "Development Contract" should be carried out within the UN system." (p. 242).

In attempting to appraise these suggestions it may be helpful to separate their broad objective from the particulars proposed for their implementation.

There can be no doubt that one of the conditions (but only one, see below) for successful growth-oriented adjustment is an adequate and assured supply of foreign capital. That is why the IMF has actively involved itself in the effort to bring together total financing packages that would permit both growth and adjustment.

The first broad effort in that direction occurred on behalf of Jamaica in 1978. The country was prepared to undertake a major adjustment program involving devaluation and a massive fiscal improvement, but the program was not viable without new government aid and refinancing of commercial bank credit. Working against considerable odds, the Fund staff managed to line up both sources of external capital (Finch 1989, p. 4). Subsequently, in the negotiations that began in the summer of 1982 under the shadow of the debt crisis, the Fund performed a similar function on a much wider scale.

The preparation of Policy Framework Papers (PFPs) in preparation for SAF and ESAF credits has tended to give a more formal aspect to the Fund's involvement with the supply of credit other than its own to borrowing members. The collaboration with

the World Bank on these PFPs frequently serves to firm up understandings on planned Bank or IDA credits to be integrated in the Fund's financial programs. The working out of PFPs also requires a knowledge of the aid plans of donor countries — although often lack of precision on these plans forces the incorporation of "assumptions" on aid in lieu of firm predictions. One of the causes of the breakdown of Fund programs has been that aid deliveries were smaller, or later, than what the country and the Fund had had reason to anticipate at the time the program was drawn up.

The difficulty of pinning down future flows of capital is one of the major handicaps to a country's attempts to steer a clear path of growth with payments balance. It is an important function of the Development Assistance Committee to minimize the uncertainties in this area, as well as to maximize the flow of aid. There is much room for improving the practices of donor countries in the direction of firmer commitments with respect to country distribution, amount, and timing of aid. But it is by no means clear that these and similar desirable improvements in the supply of aid funds could be promoted by reciprocal conditionality or development contracts.

For one thing, there is no point in constructing symmetrical arrangements where the basic positions of the partners are not symmetrical. The Fund's performance criteria have a precise meaning: unless they are met, on the specified date, the next disbursement does not take place. There can be no comparable sanction on a donor government that does not live up to its stated intention to lend, give aid, or ensure export credits; on a commercial bank that fails to restructure a loan; or on a development institution that fails to engage in the wide variety of financial support measures that were cited in the Stoltenberg plan.

Secondly, there is a real danger that this perfectionist approach will slow down the convoy to the speed of the slowest (or the least daring) ship. The Fund in particular often deals with situations in which policy remedies are urgent. Sometimes, it may be wise tactics for a country to hold up its agreement with the Fund until all accompanying credit arrangements have been lined up. But this can hardly be a general prescription. Indeed (as was discussed in section 2.1) the Fund has found it advisable in some recent instances to proceed with an arrangement with a country before receiving financial assurances from commercial banks.

There is a third reason why it would be counterproductive to aim at a symmetrical contract between a developing country on the one hand and all its potential creditors and donors on the other hand. Contrary to the manner in which the G-24 report poses the issue, growth is not only a function of the available financial resources; it also depends on the way a country uses its resources, and thus on its structural policies (Polak, 1989). When I observed in Section 3.4 that the Fund has often found it impossible to insist on growth conditionality, the reference was to the conditions for growth that were under the country's own control — not its ability to obtain finance from abroad. Providers of capital from abroad would no doubt want satisfaction with respect to a country's structural policies before accepting their own reciprocal "performance criteria". Unless the Fund embraced in its conditionality the whole range of macro- and micro-structural policies the simple two-part deal envisaged in the G-24 report — adjustment policies, against capital commitments — could not be completed.

Contingency provisions in conditionality

Even the best compact linking of policies with money would not guarantee a happy outcome in terms of growth and the balance of payments. Stoltenberg refers to the risk to developing countries of inappropriate trade and economic policies in the industrial countries, but then ignores this aspect in his design of a contract. Or perhaps he assumes that "a global system of monitoring and examination of economic policies by the OECD, the IMF, and others" would provide the answer by producing "more concrete and coherent solutions to the economic, developmental and environmental problems of the 1990s" (p. 240). Instead of waiting for these mechanisms to be perfected, it would seem to make eminent sense to seek a partial solution to the problems of global instability by the introduction of contingency elements in the Fund's conditionality.

Since 1988, the Fund has provisions under which it can authorize additional access during the course of a stand-by or EFF arrangement if certain specified components of the borrowing country's balance of payments develop less favorably than was assumed in a baseline scenario (see Section 2.2 above). It is to be noted, however, that contingency finance is only a partial answer to the problems of a country hit by unexpected external developments. Disappointing payments developments of external origin affect not only the country's supply of foreign exchange, and hence its ability to maintain the flow of imports and to keep the economy on a growth path; they also have a direct impact on the country's ability to meet the Fund's performance criteria and may thus lead to a secondary reduction in the availability of foreign exchange as Fund disbursements are interrupted by "non-performance". For example, a fall in the price of a major export commodity, such as oil in Mexico or Venezuela, or copper in Chile, may cause a major reduction in government revenue. A rise in LIBOR may force an unavoidable increase in government expenditure. If unexpected changes of this nature are large and abrupt, they may make it virtually impossible for the country to meet a budget performance criterion under an IMF arrangement — apart from the fact that the effort to meet the target would have undesirable deflationary effects on the economy.

A borrowing country thus needs two-pronged protection against unfavorable external contingencies: enough elasticity in performance criteria to ensure that the arrangement remains operative and its previously agreed access continues, and provision for additional access. The second prong without the first may be useless.

A movement toward contingency-adjusted performance criteria has been underway in the Fund since 1986. Like so many new ideas in the Fund (Gold, 1988 (a)), it found its origin in the Fund's relations with Mexico. In the negotiations for a new stand-by arrangement with that country, held in the course of 1986 immediately after the sharp fall in the price of oil, Mexico sought to protect the new arrangement against the consequences of a decline in the oil price below $9 per barrel. If that occurred, Mexico would want to be able, on a formula basis, to draw a larger amount and to receive a corresponding automatic adjustment in the performance criteria: an increase in the limit on the government deficit, and a reduction on the minimum net international reserves. Mexico was prepared to make all proposed changes

symmetrical (lower drawings and more ambitious fiscal and reserve targets), again on a formula basis starting from an oil price in excess of $14 per barrel.

Agreement between the Fund and Mexico on these contingency provisions became the origin of further developments along two lines. At the 1987 Annual Meetings, U.S. Treasury Secretary James A. Baker III made his proposal for an external contingency facility in the Fund. As mentioned, the end product of this suggestion, the CCFF, did not provide for automatic variations in access; correspondingly, the Board decision on the CCFF made no more than a passing reference to the possibility of adjustment of performance criteria,[27] as such adjustments would be agreed in the same review that would be necessary to activate additional access.

The CCFF has, at least until recently, been little used, but the idea of adjusting performance criteria from major balance-of-payments shocks has begun to spread through the Fund. The extensive discussion of the modalities of the CCFF had made members and the staff more aware of the risks to members that Fund arrangements might become non-performing by developments beyond their control. This awareness has led to the introduction of formula-adjustable performance criteria in a number of arrangements that do not contain provision for contingency financing. Recent arrangements with a number of oil exporting countries contain such built-in adjustment for fluctuations of the export price of oil; similarly, with Chile, for fluctuations in the copper price. In a number of other arrangements, including some under ESAF, countries were given similar protection against possible shortfalls of aid flows from baseline assumptions. While adjustable performance criteria are still somewhat experimental, they are likely to become more widely accepted over time. This tendency could be speeded up if the Fund could find the courage to streamline the CCFF decision by making the provision for supplementary contingency access automatic[28].

VIII. THE RELATIONSHIP BETWEEN THE FUND AND ITS MEMBERS — FROM CONDITIONALITY TO PROGRAM DESIGN

Although the subject of this paper is conventionally known as the Fund's "conditionality", exploration of this subject makes one increasingly aware of the fact that that term is too narrow to put into proper focus the relationship between the Fund and a member in the context of a stand-by or similar arrangement.

The term conveys the impression of a country in acute payments difficulties but with little realization that there is anything wrong with its policies, or at least manifesting little willingness to make major policy changes. In swoops an all-knowing Fund mission, armed with a set of precise macroeconomic conditions for financial assistance: "Devalue your currency by x per cent , cut credit expansion to y per cent of the money supply, cut the budget deficit by z per cent of GDP, liberalize at least q per cent of imports in the first year....". After two weeks of talks the country, strapped for money, negotiates a few percentage points off some of the Fund's initial numbers — which contained some margin for this contingency in the first place — and the Finance Minister signs a letter of intent (drafted by the mission). Or, if the country is not ready to accept the main thrust of the Fund's conditions, no agreement is reached and the mission leaves. In the absence of adequate policy changes, the country's situation worsens, especially if donor governments follow the Fund's lead and cut down on aid. Desultory talks with the Fund resume, and may stretch over years; in the end, agreement is reached with the Fund, broadly on its terms, and the newly adopted policies, together with resources from the Fund and from donors ("catalyzed" by the Fund arrangement), put the country on the road to recovery.

One can probably point to some instances that fit this caricature of Fund/member relationships, but it does not describe the overwhelming majority of Fund arrangements. Developments in member countries and in the institution have brought about, in a wide range of countries on all continents, a relationship of mutual respect and common purpose between member countries' technicians and their opposite numbers on the Fund staff.

Technicians in member countries have increasingly become the equals of the Fund staff members with whom they deal. They hold degrees from the same universities, they have served on the Fund staff or Fund Board, or have taken elementary and advanced courses in the IMF Institute. In brief, they know the Fund inside out, including its negotiating tactics. As was observed by a senior member of Ghana's team negotiating with the Fund, countries have learned the necessity to enter discussions with the Fund with "a strong and technically competent team ... able to articulate the concerns of the authorities ...[and] to take advantage of the experiences of other countries that have undertaken adjustment programs ..." (Abbey, 1989, p. 15).

An even more important contribution to the effective collaboration between member countries and the Fund derived from a significant change in policy attitudes on the part of economists and policy makers in developing countries. That change sprang from many sources. In Europe and the United States, the disappointing stagflation experience if the 1970s provided the policy consensus that was required to decisively attack inflation and to give greater freedom to markets. The impressive

economic performance of Asian economies, from Japan to Hong Kong and Taiwan, in contrast to the poor performance of most other developing regions, helped to overturn confidence in traditional development models that dated back to the 1940s and 1950s. This movement was supported by new winds blowing in the research activities of the World Bank. By the early 1980s, some countries in Latin America began turning their backs on the failed strategies of import substitution and "structuralism". In Africa, too, there was a dawning recognition of the cost of excessive government intervention and distorted price systems. These changes spread across Latin America and Africa during the 1980s. And the surge toward capitalism in Eastern Europe can be seen as a further confirmation of the same trend.

Many observers in the industrial countries were slow to recognize this sea change in attitudes in the developing countries, and the labels under which it has been welcomed have so far been less than inspiring. The Managing Director of the Fund has characterized this development as a "silent revolution" in attitudes, which he found most notably in Latin America but also in Africa and in some of the centrally planned economies of Eastern Europe (Camdessus, 1989). As elements of this "revolution" he named acceptance of the need for sound fiscal and monetary policies and of structural measures to raise productivity; greater scope for market forces; and reforming the machinery of state and the role of government. Williamson (1990) describes the same development as a convergence of policy views in Latin America toward the "Washington consensus" — the views generally held by the Washington establishment, United States and international organizations, on effective policies for adjustment and growth.

With a convergence of ideas between national policy makers and the Fund staff, the issues to be resolved have tended to move from hard-to-reconcile matters of principle to the practical ones of the detailed specification of policies, the pace of their implementation, the need for governments to persevere in their adjustment policies and the marshalling of sufficient external financial support. Moreover, as political leaders became convinced of the need for a broad range of adjustment policies — in part by the failed experience of non-adjustment — civil servants or technicians became free to follow their economic convictions in their discussions with opposite numbers in Fund teams.

On the Fund side, one might perhaps have feared that four decades of experience with stand-by and similar arrangements would have led to the cementing of increasingly orthodox positions on the correctness of Fund policy advice. However, available evidence would appear to point in the opposite direction.

The 1980s experience of frequent failures of Fund arrangements appears to have had a sobering influence. In the search for explanations, the Fund's analysis focuses attention not only on countries' failure to implement agreed programs and on unfavorable external factors (terms of trade, weather, world interest rates and, especially in Africa, underperformance of aid donors), but also on weak program design. Especially in the early part of the 1980s, there were frequent instances where the Fund underestimated the seriousness of countries' problems and for this reason failed to insist on programs of sufficient scope and severity. In other cases, the Fund knowingly accepted an inadequate program in the interest of making at least partial

progress toward adjustment. In some typical instances of weak programs, too great a burden was put on fiscal policy not supported by an appropriate exchange rate policy. The reverse policy imbalance occurred more frequently: a flexible exchange rate policy, insufficiently backed by fiscal and monetary restraint, leading to accelerating inflation.

How does it come about that the Fund agrees to arrangements that it recognizes *ex post* — and also sometimes *ex ante* — as weakly designed? Apart from political considerations discussed in section 4.4, there are at least two broad groups of reasons.

The first group relates — perhaps surprisingly — to uncertainties among Fund staff on the suitability of particular policy measures to achieve desired ends. On the question of exchange rate policy (section 5.2), recent years have seen the Fund advising different countries (or the same country at different times) to target a low real exchange rate, to use the exchange rate as an anchor, and to adopt market-determined fluctuating rates or crawling pegs. It has also accepted fixed rates in its dealings with countries of the French franc zone, and insufficiently depreciated rates as a transitional device. It is by no means clear that the widely varying exchange rate policies applied in Fund arrangements have always reflected the different requirements of each case or the different preferences of national authorities.

On monetary policy (section 5.1), the staff has generally followed its long-standing concentration on credit creation, rather than the money supply, as the target variable. This approach protects the balance of payments against unfavorable shocks but — unless targets are adjusted downward — risks inflation in the event of unexpected favorable balance-of-payments shocks. But in other cases, the staff has accepted the inflation risk as the most serious and thus endorsed a money supply (or base money) target rather than a credit target.

With respect to another major policy issue, speed and comprehensiveness of adjustment toward a market economy in Eastern European countries, the Fund has tended to accept each country's view on the magnitude of the "bang" that the authorities preferred. As a result, the Fund supports a radical program in Poland and a much more gradualist program in Hungary.

The differences of view prevalent within the staff with respect to major policy issues greatly reduce the risk of the Fund imposing standard recipes across countries and enhance the possibility of an outcome that reflects the requirements of the particular case (assuming always that they are well understood by the staff and the member's teams) and the policy preferences of the member.

The second group of reasons relates to more pragmatic considerations. The Fund has sometimes entered into arrangements that it knew to be below standard because it judged the alternative — breaking off negotiations — to be even worse. In some instances, failure to reach agreement with the Fund, and the consequent drying up of other sources of funds, might induce a government to engage in even less satisfactory policies than those it was ready to agree to under a Fund arrangement. In others, the Fund feared that a breakdown in negotiations could bring

into office an economic team even less tractable than the current one. Finally, the Fund has sometimes been swayed by the desire to maintain the confidence of the international community in a country and to avoid the accumulation of external arrears, including arrears to the Fund. When the country had large Fund credits outstanding, management in recent years has sometimes found itself weighing the risk of arrears against the risk of opening up some additional exposure through a less-than-satisfactory new arrangement — an unthinkable choice a decade ago. (But the arrears of some members may also have had a restraining effect on transactions with other members; arrears are said to be have led the Fund to an "even stronger emphasis on the quality of programs and increased concerns with the capacity of countries to meet their obligations to the IMF" (Mohammed 1991).)

In brief, changes that have occurred in member countries and in the Fund have put their stamp on the character of the Fund's conditionality, but their impact is far from uniform. When some of the negative factors mentioned have dominated, discussions between the Fund and the member have become increasingly tense and the arrangements produced have often been unsatisfactory. But when the approaches of the member and the Fund were broadly in line, working out an arrangement, including the agreement on performance criteria, has become a common exercise in program design, and the concept of conditionality has lost much of its adversary content. Indeed, in this more satisfactory situation, the distinction between "conditionality" (the minimum program content that the Fund must insist on) and "program design" (the program most suitable for the member) tends to vanish. One should note that the two terms are used virtually without distinction by Azizali Mohammed, until recently the Director of the Fund's External Relations Department (1991).

What also stimulates the co-operative approach in the negotiation of an arrangement between the Fund and a member is the commonality of interests (up to a point) between the negotiating partners. The country's team, typically composed of senior treasury and central bank officials, will often seek alliances with the Fund staff in order to strengthen its own policy prescriptions. Not infrequently, letters of intent contain commitments that are there only because the country wanted them. The Fund staff is interested in a positive outcome of the negotiations that only the country team can provide. The two sides cannot but be aware of their mutual dependency in producing recommendations that will be acceptable to higher decision-making levels — in the country and in the Fund.

NOTES

1. The Fund now uses the term "credit" (a term which its Articles studiously avoid mentioning) to indicate money made available under the first two of the four arrangements; for some unfathomable reason, it labels SAF and ESAF credits as "loans". The Fund's nomenclature is the reverse of that of the World Bank Group: The Bank makes "loans" and IDA grants "credits".

2. An explicit proposal for two-track conditionality in the Fund was recently made by David Finch, who had been the director of the IMF department responsible for conditionality from 1980 to 1987 (Finch, 1989, p. 35). The main purpose of his proposed new low-conditionality facility is to ensure that countries with serious debt problems and less than satisfactory adjustment policies do not fall into arrears to the Fund and other international agencies, although they might well stop servicing commercial bank loans. Access under this facility would be kept smaller than the repayments due to the Fund "in order to maintain openly the principle of IMF priority".

3. SAF's resources go back to gold sales by the Fund from 1976 to 1980, where part of the profits (market price minus book value) was destined for the poorest countries. The original plan had been to distribute these profits, in proportion to quotas, as grants; but this approach was replaced by the idea of putting the profits in a Trust Fund to make loans in the same proportions to the same countries. The loans had low conditionality, bore an interest rate of 1/2 per cent per annum, and were repayable over a ten-year period. In 1986, reflows of these loans began and SAF was started to recycle these funds to the same category of countries. On the plausible assumption that these funds would continue to circulate among the low-income countries, perhaps in successive 10-year cycles, the other members of the Fund had no proprietary interest in them.

4. The Fund at the same time widened the range of the eligible invisible exports under the CCFF, by adding receipts from pipelines, canals, shipping, transportation, construction and insurance to the earlier categories of workers' remittances and travel receipts.

5. Stiles' observation that the Indian government "was able to effectively nullify much of the Fund's leverage" thus badly misses the point: the Fund could wish no better than that it could exercise its leverage with all prospective borrowers the Indian way.

6. As a result of the French-American compromise of the autumn of 1975, the term "economic growth", qualified in one instance by the modifier "sound" and in another by "orderly", made its entry into Article IV, Section 1 under the second amendment. These expressions formed part of the avalanche of words designed to sugarcoat the transition from the purpose of "exchange stability" in Article I(iii) to that of "a stable system of exchange rates" (no definition provided) in the new Article IV. To promote such a system, each member undertook the spongy commitment to "endeavor to direct its economic and financial policies

toward the objective of fostering orderly economic growth with reasonable price stability, with due regard to its circumstances". As Sir Joseph Gold has pointed out, "the most remarkable feature of this clause is its softness" (1988(b), p. 104).

7. The Fund's second purpose reads: "(ii) To facilitate the expansion and balanced growth of international trade, and to contribute thereby to the promotion and maintenance of high levels of employment and real income and to the development of the productive resources of all members as primary objectives of economic policy."

8. It should be added that in such cases the country might take the view that maintenance of a traditional fixed rate might promote growth in the long run.

9. By now the original distinction between growth as a purpose and growth as an effect seems to have been lost sight of even when the Articles of Agreement are invoked. A recent survey paper begins: "The Articles of Agreement of the International Monetary Fund (Fund) state that the promotion of trade, increasing the levels of employment and real income, and the development of productive resources are to be the primary objectives of economic policy (Article I). While the Fund's major area of concern may *in practice* be balance-of-payments disequilibrium, the policies it recommends to reduce the degree and duration of external and internal imbalances must be set within the context of achieving and maintaining satisfactory rates of economic growth. In general, therefore, the Fund aims at assisting its member countries establish conditions that would yield balance-of-payments viability, price stability, and a growth rate that would support a steady improvement in living standards. In analyzing Fund policies designed to achieve these *multiple objectives*, ..." (Frenkel and Khan, 1990, emphasis added).

10. The Fund also uses the predicate "second best" to characterize some programs that have turned out to be inadequate and should have been recognized as such *ex ante*.

11. In practice the Fund has tended to <u>add</u> the operational deficit to the overall deficit. This could provide the country with an opportunity to ask for a waiver of its non-performance on the overall deficit on the ground that this was due to inflation only.

12. It would follow from this characterization of the Fund's decision-making process that I cannot follow Stiles (1990) in his attempt to distinguish separate modes of "functionalism" and "neo-functionalism". The former would be based on objective rationality, the latter would recognize that decisions are the outcome of the interaction of human beings. I do recognize the importance of Stiles' third mode in which decisions are dominated by political considerations.

13. The same U.S. legislation uses similar language to bar U.S. support for drawings by "Communist dictatorships". There is no evidence that this provision has had any operational significance. Yugoslavia, for example, received new stand-by arrangements in 1984, 1985, and 1987.

14. For a short description of how Fund missions actually apply this approach, see Goreux (1989, pp. 142-146).

15. The author once had an opportunity to explain this elementary truth of monetary analysis in the Fund's annual consultations with a European country that suffered frequent balance-of-payments difficulties. In the final session, the minister of finance observed that monetary policy could not be the origin of its payments problems; he recounted with some pride that the growth of the money supply had been kept to 10 per cent per year. "Yes indeed", was the Fund staff's answer; "whenever money leaked out through the balance of payments, it was promptly replaced through new credit creation so that it could leak out again."

16. For many years, Peru and Lebanon were the rare exceptions to the general rule.

17. Tanzi mentions a further advantage to the member of designing its fiscal adjustment in a manner that raises the productive capacity of the economy, *viz*. a trade-off between the quality and the quantity of fiscal adjustment (1987, p. 132). With increases in supply, less reduction in demand would be necessary to achieve balance. But it should be noted that this trade-off is subject to a major qualification: it is not one-for-one, but the moderation that becomes possible in the necessary reduction in demand is only $\underline{s}$ /(1 - $\underline{s}$) times the increase in supply, where $\underline{s}$ is the marginal propensity to save.

18. One possible element in the reconciliation of the two studies mentioned might be the following. While the Bank study compares two groups of countries (25 Early Intensive-Adjustment-Lending countries with 53 other countries), the Fund study compares 315 country-program *years* with 85 country-nonprogram *years*, and its sample includes only those 79 countries that had at least one program during the 16-year period covered.

19. For a more detailed analysis of the aftermath of Bolivia's adjustment measures, see Cariaga's account in Williamson 1990.

20. Conditionality was only implied since no program was agreed under enhanced surveillance. But the Fund's role was nevertheless designed to be activist, *viz.* to influence the adoption and maintenance of "appropriate policies through a close process of consultation and of helping the review and decision process of creditors through the provision of candid assessments" (*1988 Annual Report*, p. 45).

21. An even sharper recovery of private investment is shown for Chile — from a low of 10 per cent of GDP in 1983 to over 20 per cent in 1989.

22. This problems relates to burden sharing and thus falls outside the scope of this study. For some discussion, see Polak, 1989(a) p. 51.

23. One suggestion can be quickly disposed of, namely that criteria should not be set in terms of a single number but as a range. As Kafka (1991, paragraph 30) points out, under this approach the upper limit would be the operative one and the change would thus be meaningless.

24. Streeten (1988, p.107) poses the paradox in the form of a question: "If the policy prescriptions which form the conditions are truly in the interest of the receiving country, why are they not already pursued by the policy makers?". He suggests ten possible answers, except the obvious public-choice one that policy makers might pursue some objective other than the interest of the receiving country.

25. The two named authors present their suggestions as improvements in the technique conditionality; in the G-24 report, on the other hand, the main emphasis appears to fall on softening conditionality.

26. Bacha's paper, which was published in 1987, had been written as a background paper for the G-24 report.

27. Paragraph 25 (a) of the decision stipulates that contingency purchases "shall be subject to the observance of any applicable performance criteria, adjusted by the Fund as may be necessary...".

28. The ideas indicated in this section have also found support from the G-24 in their 1987 report (para. 68):

> "68. Contingency mechanisms to protect a country's program from any threat resulting from exogenous events should be related to the financial exercise. The amounts that the country is entitled to draw, as well as the performance criteria and the design of the program, should be made dependent, in a predetermined manner, on a set of critical exogenous variables, such as the price of primary commodity exports, the rate of market growth for nontraditional exports, receipt from nonfactor services such as workers' remittances, the prices of key imports, and the interest rate on foreign debt. The choice of the specific set of exogenous variables would depend upon the characteristics of the country adopting the program. It may, however, be advisable to begin with only a few such variables that are considered most critical."

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