

EBS/84/227

CONFIDENTIAL

November 7, 1984

To: Members of the Executive Board
From: The Secretary
Subject: Review of Upper Credit Tranche Arrangements and of Some
Conditionality Issues

Attached for consideration by the Executive Directors is a paper on the review of upper credit tranche arrangements and of some conditionality issues.

It is proposed to bring this subject to the agenda for discussion on Wednesday, December 5, 1984.

If Executive Directors have technical or factual questions relating to this paper prior to the Board discussion, they should contact Mr. Gerhard (ext. (5)8779).

Att: (1)



INTERNATIONAL MONETARY FUND

Review of Upper Credit Tranche Arrangements
and of Some Conditionality Issues

Prepared by the Exchange and Trade Relations Department

(In consultation with other Departments)

Approved by C. David Finch

November 6, 1984

I. Introduction

At the time of the last general review of upper credit tranche arrangements, Executive Directors decided that the Fund should again review programs supported by stand-by and extended arrangements not later than December 31, 1984 (Executive Board Decision No. 7558-(83/156), November 16, 1983). It was also decided that the review should examine the appropriateness of the provisions of the extended Fund facility and the guidelines on conditionality, with particular reference to the importance of ensuring the revolving character of the Fund's resources. This paper, together with an accompanying report analyzing in detail the adjustment experience over a longer time span of 25 countries that have used Fund resources on a large scale (document to be issued shortly), provides background material and suggests issues for discussion in conducting the review. Section II presents some general observations about factors influencing the degree of success achieved under adjustment programs, based on the examination of several years of adjustment experience. ^{1/} Some suggestions are made for improvements in the design of adjustment programs and the application of conditionality, with a view to enhancing the prospects for achieving adequate and durable adjustment. Section III then briefly reviews the special criteria to be observed in connection with arrangements under the extended Fund facility. Finally, Section IV summarizes several questions to which Executive Directors may wish to direct special attention during the discussion.

^{1/} See the accompanying study, "Experience with Adjustment Policies," (to be issued), as well as earlier studies, including: "Adjustment Programs Supported by Upper Credit Tranche Stand-By Arrangements, 1977," (EBS/79/635, 12/26/79); "Review of the Extended Fund Facility," (SM/80/278, 12/29/80); "Review of Upper Credit Tranche Stand-By Arrangements Approved in 1978-79 and Some Issues Related to Conditionality," (EBS/81/152, 7/14/81); "Review of Recent Extended and Upper Credit Tranche Stand-By Arrangements," (EBS/82/97, 6/9/82) and Supplement 1 (6/10/82); "Upper Credit Tranche Stand-By and Extended Arrangements Approved in 1981," (EBS/83/216, 10/4/83).

II. The Application of Conditionality

Since the last general review of upper credit tranche stand-by and extended arrangements, which covered arrangements approved in 1981, Executive Directors have had the opportunity to discuss specific aspects of the application of conditionality on a number of occasions. During the consideration of the papers on reporting problems, the prolonged use of Fund resources, the general policy on access and the determination of access in individual cases, Directors made a number of suggestions aimed at enhancing the prospects for adjustment. This section recommends several changes in practices and procedures to incorporate these suggestions and also outlines additional steps that might be considered as ways to promote adequate and durable adjustment in programs supported by the use of Fund resources.

1. The appropriate speed of adjustment

Earlier annual reviews as well as the accompanying study have highlighted the fact that, frequently, despite the progress achieved during the period covered by an arrangement or a succession of arrangements with the Fund, the amount of adjustment remaining to be accomplished at the end of the period was substantial. In some cases, initial assessments underestimated the size of the needed adjustment. In other cases, the adoption of early steps which, given the large size of initial imbalances, amounted at best to a tentative beginning required that adjustment measures be sustained over an extended period. Frequently, subsequent unfavorable developments or the abandonment of the gradual process of policy implementation meant that little or no progress was achieved toward the elimination of domestic and external imbalances. ^{1/} Key elements which would clearly increase the likelihood that the required adjustment will be achieved are a correct identification of the size of the needed adjustment, early and sustained implementation of the needed policy measures, and a prompt adaptation of policies to changing circumstances.

Identification of the size of the needed adjustment and the appropriate speed of adjustment are facilitated by the adoption of a medium-term framework of analysis in discussions with member authorities and in presentation of adjustment programs. Such scenarios generally include projections with respect to macroeconomic accounts, the balance of payments and external debt, and are normally linked, although at times only in general terms, to the revenue, expenditure, credit, interest rate, exchange rate, and trade policies that implicitly underlie them. Given the inherent limitations of medium-term projections and the fact that future conditions and policies are often very uncertain, these scenarios are clearly not intended to be forecasts or precise estimates.

^{1/} These conclusions were also highlighted in "Prolonged Use of Fund Resources," SM/84/91 (4/27/84).

Experience during the past year with the preparation and presentation of such scenarios has raised several issues that need to be addressed. Firstly, the policies underlying the medium-term scenario must be made clear. In principle, projections are based on the current policy stance of the authorities (including planned changes when these are known). Medium-term scenarios should not be normative, based on policies substantially different from the current stance of policies followed or envisaged by the authorities. Frequently, however, not all of the measures consistent with the current stance of policies of the authorities and underlying the medium-term scenario have been adopted or yet fully articulated, and some change from the set of policies that is currently in place is anticipated. The discussion of medium-term prospects in such cases needs to identify clearly the areas in which such modifications or adaptations to the current stance of policies have been assumed. Such a discussion would be particularly useful in those cases in which serious short-term financial imbalances have been addressed with emergency measures that are not suitable within a longer term context (e.g., exchange and trade restrictions, revenue measures that create inappropriate incentives). A discussion and some quantification, if possible, of the principal policy changes required would also be especially useful for other instances in which the amount of assumed adjustment of policies is substantial or the necessary policy changes are expected to be adopted over an extended period. Similar considerations would also apply to cases in which major adjustments in structural policies are indicated, in light of the difficulties in quantifying the magnitude and timing of the response to such policy changes.

A second issue is whether adequate attention is devoted to all relevant aspects of adjustment. In particular, although flexible exchange rates make it possible to narrow external payments imbalances despite continued large domestic imbalances as reflected in high rates of inflation, such high rates of inflation clearly undermine the basis for sustainable growth. In the absence of early and sustained reductions of inflation, policies are not sustainable even if offsetting exchange rate changes will limit the impact of continued domestic imbalances on the external payments position.

A third issue has arisen in connection with several cases in which medium-term scenarios indicate the presence of significant ex ante balance of payments financing gaps over the foreseeable future. Although the Fund can postpone the effective date of an arrangement until adequate financing is obtained to cover the gap in the program period, assurances about the availability of additional finance further in the future are not generally possible to obtain. Discussions of such cases should clearly indicate the nature of the constraints that make it necessary to rely on uncertain exceptional financing for an extended period rather than planning from the outset for a further adjustment of policies. It must also be stressed in such instances that the unfinanced gaps will ultimately need to be eliminated by a combination of further adjustment measures and additional financing,

taking into account in particular the limitation on availability of additional financing from the Fund and the need to ensure the revolving character of Fund resources. Care must be taken in such cases not to prejudge the amount or terms of possible future debt relief.

A different kind of issue concerns the need to adapt policies to changing circumstances. Previous reviews and the accompanying background study have noted that, because exogenous events rarely occur exactly as foreseen at the time adjustment programs are designed, flexibility in policy formulation to accelerate adjustment in response to emerging adverse circumstances has contributed importantly to the successful implementation of adjustment programs. This issue has been raised recently by some Directors, who have noted that the increased uncertainty of the current international economic environment may make it useful to build into programs a safety margin or provision for contingencies. This would presumably take the form of either a more rapid reduction of the external current account deficit and greater allowance for reserve accumulation (i.e., faster adjustment) or the specification of contingency measures that would be implemented in the event subsequent developments differed significantly from the basic assumptions of the program. In the latter case, the conditions under which the strengthening of corrective policies in specified areas should be implemented would be discussed at the time of formulation of the adjustment program. These conditions and the policies to be implemented could be described in letters of intent or memoranda of understanding, although the need for confidentiality may require that such descriptions be couched in appropriately general terms. Care would have to be taken to ensure that such contingency measures do not become substitutes for or result in delays in implementing needed policy adjustments. Provision for the adoption of such measures, the adequacy of which could be reviewed subsequently, would make more specific the current general undertaking to adopt such additional measures as might be required to achieve the objectives of the program and could facilitate a prompt response to unexpected adverse developments. Such a provision might be a requirement in certain cases where unanticipated developments had led repeatedly to incomplete adjustment under earlier arrangements with the Fund.

2. Program design

As pointed out both in previous reviews and in the accompanying study, the degree of success of adjustment programs in promoting progress toward balance of payments viability has depended in the first instance on the adequacy of program design. Several key considerations have been highlighted in this regard. Firstly, the prospects for adjustment are enhanced when policies are directed to the elimination of the ultimate source of the economic imbalance, rather than solely to the correction of the immediate short-term disequilibrium. Key conclusions of the present background study in this regard are that inappropriate fiscal and exchange rate policies were primary factors underlying the emergence of domestic and external imbalances. The role

of monetary and other policies has also been highlighted. The failure in many cases to introduce early significant corrections in these areas of policy precluded or delayed the achievement of sustained progress toward a viable balance of payments. ^{1/} Secondly, comprehensive programs aimed at resolving simultaneously important problems in most major areas of policy have generally met with more success than those which addressed only selected aspects of the economic imbalance. Finally program design must take adequately into account administrative and other constraints on particular policy instruments and their effectiveness. However, when such constraints preclude the use of certain policy measures, efforts to achieve the early removal of these constraints and a strengthening of corrective measures in other areas are essential.

Program design relates both to the policy changes that are to be implemented as part of an adjustment program supported by the use of Fund resources and to the establishment of the performance criteria that serve as monitoring devices under the arrangement; considerations related to the monitoring of programs are discussed in the following subsection. To evaluate the appropriateness of design of policies to be adopted in an adjustment program, it must be determined, in light of actual developments, whether the amount of adjustment required was accurately identified, whether policies were of the type, strength, and comprehensiveness necessary to redress the source of the economic imbalances, and whether constraints on policy instruments and their effectiveness were taken adequately into account. Such an evaluation is a difficult task that cannot be reduced to a comparison of projected and actual values of certain key parameters.

Considerable effort has been made in recent years to improve the identification of the appropriate amount of adjustment and of the necessary policy changes to achieve a viable external payments position. An important result has been the increased attention devoted to resolution of structural problems that reduce the ability of the economy to supply goods and services for export and domestic use at a level consistent with its full potential. Because such problems also limit the supply response of the economy to changes in general macroeconomic conditions, they increase the adjustment burden that must be borne by policies aimed at restraining demand and therefore make more difficult the achievement of a viable balance of payments position. Experience with efforts to resolve such problems, however, has frequently been considerably less than satisfactory. The late recognition of the source and importance of supply constraints, the complexity of the issues involved, or administrative and other problems frequently delayed the formulation and implementation of corrective policies. As more experience has been acquired, greater emphasis has been placed on early

^{1/} An extensive review of exchange rate policies is presented in the forthcoming paper on "Formulation of Exchange Rate Policies in Programs Supported by the Fund."

implementation of corrective measures in these areas, the large majority of programs approved in recent years involving strategies giving significant weight both to demand and supply considerations.

A related consideration has been the need to focus more attention in general on the constraints affecting economic policy instruments and their effectiveness (including the speed at which they can be implemented). The fragility of the administrative system and limitations on the effectiveness of certain policy instruments stemming from the stage of economic development or structural characteristics of many members are the most common constraints that affect the choice and mix of policies in an adjustment program, and the results that these policies achieve when implemented. The policy measures in an adjustment program supported by the use of Fund resources must be realistic and appropriate to the circumstances of the member, although it is recognized that in most circumstances such considerations will influence only the policies selected and not the speed or size of adjustment; the latter is generally predetermined by other factors such as the prospective availability of foreign capital inflows. The discussion of the factors underlying the design of specific programs would be enhanced if papers presenting requests for the use of Fund resources were more forthcoming in explaining how the limitations of particular policy instruments have influenced program formulation and indicating when appropriate how such limitations are expected to be overcome. This could perhaps best be accomplished by reference to the set of policy measures that, in the absence of these limitations, would provide the best means to redress the particular economic and financial imbalances faced by the country.

3. Improvements in monitoring techniques

The relationship between the sustained implementation of corrective policy measures and success in moving toward a viable balance of payments position was quite clear in previous reviews and is confirmed by the accompanying study. Various devices are used by the Fund to ensure that appropriate policies are implemented and sustained under adjustment programs supported by the use of Fund resources. In accordance with the guidelines on conditionality, such techniques can include prior actions, performance criteria, consultations, and reviews. Prior actions and reviews are appropriate in a range of cases, 1/ and the more frequent use of such techniques has clearly contributed to better implementation and monitoring of adjustment programs. Performance criteria, however, remain the principal monitoring devices. 2/

1/ The circumstances under which these techniques should be used were reviewed most recently by Executive Directors at EBM/83/155-156, 11/16/83, when they discussed the staff paper on "Review of Upper Credit Tranche Arrangements Approved in 1981 and of Some Issues Related to Conditionality," (EBS/83/215, 10/4/83).

2/ Recent experience and several issues concerning the application of performance criteria are examined in the forthcoming paper on "Relationship Between Performance Criteria and Phasing of Purchases Under Fund Arrangements."

Performance criteria normally refer to macroeconomic variables, but in some cases criteria are linked to other important variables or to explicit policy implementation tests at specific dates when these policies are judged to be essential for program effectiveness.

Several key considerations underlie the selection of macroeconomic variables monitored as performance criteria. These include, in particular, the structure of financial institutions, the instruments of policy usually employed by the authorities, the stability of the relationship between these variables and broader macroeconomic aggregates, and the possibility of timely monitoring. In terms of the frequently made distinction between targets and indicators, quantified performance criteria typically relate to indicators associated with the implementation of policies. In assessing the usefulness and adequacy of performance criteria in monitoring the implementation of a program, due consideration must be given to the fact that a program is necessarily subject to uncertainty and error, including those stemming from an inadequate knowledge of the working of the economy, the lack of exact correspondence between instruments and effects, or unanticipated developments in key variables not subject to the direct control of the authorities. In addition, in some cases, the considerations outlined above for the selection of variables to be monitored as performance criteria may require that a somewhat less than perfect indicator be monitored in cases where reliable reporting on alternative variables is not possible on a timely basis or if such variables reflect policy actions with a longer or less reliable time lag. For these reasons, quantified performance criteria are intended in most cases to give not absolute, but reasonable assurance that the program is being implemented, and that the objectives will be achieved.

The focus of all adjustment programs supported by the use of Fund resources is the achievement of key objectives with regard to overall macroeconomic performance (e.g., increase in domestic savings, higher economic growth, stronger balance of payments, and lower inflation). Instances of a lack of correspondence between observance of performance criteria and achievement of these broader program objectives have been noted in most previous reviews. Efforts have been made by the staff to increase its understanding of the basic economic relationships and linkages in such cases and to improve monitoring techniques. In several recent cases, when monitoring of the usual performance criteria was not considered sufficient, supplementary monitoring of certain macroeconomic aggregates was specified, not however as performance criteria. Two broad types of cases can be identified. First, the supplementary criteria were aimed in some cases at monitoring more closely certain specific aspects of the economic program, the implementation of which was considered essential to the adjustment strategy adopted by the authorities (e.g., total or selected budget expenditures). Second, there have also been a number of cases in which the supplementary criteria were used to monitor developments in variables other than those covered by performance criteria where such variables were believed to be related more reliably to the achievement of the overall

targets of the program (e.g., money or credit aggregates other than those monitored as performance criteria). In some cases the supplementary monitoring criteria triggered discussions with the staff while, in others, the behavior of the relevant aggregates was to be a key focus of the midterm review. In some circumstances, provision has been made for failure to observe the supplementary monitoring criteria to trigger a consultation with the Fund for the purpose of reaching new understandings as necessary.

Several issues could be considered with respect to the use of such supplementary monitoring criteria: first, the circumstances in which such a practice would seem appropriate; second, the range of variables that could appropriately be used as such criteria; and, third, the scope of actions triggered by failure to observe the supplementary criteria. Under normal circumstances, the usual quantified performance criteria provide adequate monitoring. However, in exceptional circumstances such as those described earlier, closer and more formal monitoring of certain additional indicators may be appropriate to highlight key areas of concern regarding the achievement of program targets or the link between such targets and the performance criteria of the program. In stressing the supplementary character of such indicators, it is emphasized that under no circumstances are they to be taken as substitutes for performance criteria or as fallback positions against the implementation of all the policy measures required for effective adjustment.

The review of recent experience shows that supplementary monitoring criteria have been specified for variables not appropriate to be used as performance criteria, either because of delays in obtaining reliable information or because they are not as easily amenable to immediate control or correction as those aggregates typically used as performance criteria. Supplementary monitoring might also be extended when appropriate to cover targets such as inflation in cases in which significant early improvements in these areas are essential to the achievement of the adjustment objectives of the program. Such an approach, where appropriate, would provide better balance to the monitoring of the achievement of program targets, which is now restricted to the balance of payments (when balance of payments tests or arrears ceilings are specified).

Supplementary monitoring criteria have been used in recent practice as a basis for discussions with the staff, as a focus of midterm reviews, and as a trigger for "supplementary" reviews to examine and possibly modify performance criteria. The first alternative formalizes some of the circumstances which may indicate that consultation with the authorities may be appropriate while the second alternative focuses attention on key developments to be taken into account in assessing the prospects for achievement of the objectives of the program at the time of a midterm review. The third alternative clearly should remain exceptional, but could be appropriate in certain cases in which there

is a possibility that the program could get significantly off track, without for some reason there being an immediate lack of observance of the normal quantitative performance criteria.

A separate issue concerns the monitoring of progress beyond the specific period covered by particular arrangements with the Fund. The longer time perspective of the accompanying study has highlighted in particular the importance of persistence in policy implementation over periods beyond the resolution of the immediate balance of payments problem. Countries that have persisted in their adjustment efforts even after severe imbalances were eliminated and the initial objectives of programs were achieved have been relatively more successful in sustaining the improved balance of payments position that had been attained. Although the direct link between policy implementation and access to Fund resources terminates with the expiration of the arrangement (with the exception of those cases in which there is a succeeding adjustment program supported by the use of Fund resources), staff reports and the views expressed by Directors in Article IV consultations provide an important means through which the Fund can encourage the sustained implementation of measures initiated under a stand-by or extended arrangement. In this context, the presentation of medium-term scenarios for nonprogram countries with current or prospective external payments difficulties should help to highlight cases of countries that continue to require further changes in policies following the termination of an arrangement with the Fund. When a country's normal consultation cycle would not result in a consultation being held within a relatively short period after the end of an arrangement not followed by a new one, it might be appropriate to hold a consultation within six months after the conclusion of the arrangement in cases in which the outstanding use of Fund credit is unusually large.

III. Special Criteria Applicable to Arrangements Under the Extended Fund Facility

Earlier reviews and the present background study have highlighted several conclusions relevant to the assessment of the circumstances in which three-year extended arrangements are preferable to a series of one-year stand-by arrangements. These include, in particular, the need for (1) the adoption of a comprehensive adjustment process extending through the period of the arrangement; (2) a well articulated time schedule of implementation of necessary corrective policies and a clear administrative ability to carry them out; and (3) substantial early policy actions, especially in areas where long lags are likely to intervene before intended effects become apparent. In line with the decision establishing the facility, such programs must contain policy measures for mobilizing resources and improving their utilization, and for reducing reliance on external restrictions.

The experience with extended arrangements has been reviewed from time to time as specified by the Decision establishing the extended Fund facility (Decision No. 4377-(74/114)). Most recently, the experience with such arrangements was reviewed in conjunction with reviews of programs supported by stand-by arrangements (EBM/82/92-93, July 7, 1982; EBM/83/155-156, November 16, 1983). On these occasions, both the validity of the principles underlying the establishment of the facility and the need for observance of the criteria specified in the Decision were stressed. Although the number of extended arrangements has declined sharply in recent years, to only six since 1981, the provisions of the Decision remain appropriate to give medium-term assistance in the special circumstances of balance of payments difficulty specified in the Decision.

IV. Summary and Conclusions

The main points that have been addressed in preceding sections may be summarized as follows.

1. The more frequent use of medium-term scenarios during the last year has facilitated assessments of the need for and the proposed speed of adjustment and has provided a useful framework for assessing the appropriateness of current and prospective policies. The usefulness of these scenarios would be enhanced if the underlying stance of policies was specified clearly and, especially in cases when protracted imbalances are envisaged, if a discussion of the factors underlying the programmed speed of adjustment was included.
2. The large imbalances faced by many members have greatly increased the need for flexible policy implementation in response to unfavorable developments. Frequently, however, appropriate responses have been delayed, limiting the progress achieved during the period covered by an arrangement. Attention at an early stage to the specification of contingency measures to be implemented in response to unfavorable developments could help prevent such slippages. While care needs to be taken that contingency measures not become substitutes for the early implementation of needed corrective policies, the stipulation of such measures in appropriate circumstances may facilitate prompt responses to unexpected unfavorable developments.
3. Substantial attention has been devoted in recent years to the formulation of structural and other measures in support of member adjustment efforts. Although structural difficulties only infrequently were the immediate source of the large domestic or external imbalances experienced by many members, the large size and protracted nature of these imbalances greatly increased the need for measures aimed at promoting supply, thus relieving the burden of adjustment borne by measures to restrain domestic demand. The frequent difficulty of formulating and implementing such policies as well as the long lags before substantial results are achieved clearly indicate that appropriate attention

must be devoted to these areas at an early stage. In particular, constraints preventing the use of certain policies or limiting responses to these policies should be clearly identified and efforts directed at mitigating their effects.

4. Consistent with the guidelines on conditionality, performance criteria are limited to those necessary to evaluate implementation of the program with a view to ensuring achievement of its objectives. Performance criteria are normally confined to macroeconomic variables which are clearly linked to policy implementation and can be monitored on a timely basis. Under normal circumstances, the usual quantified performance criteria, supplemented as appropriate by midterm reviews, provide adequate monitoring.

5. In several recent cases, additional or supplementary monitoring criteria have been specified, related to aggregates not appropriate to be used as performance criteria. These supplementary criteria have been used in exceptional circumstances to monitor more closely or formally certain essential aspects of the economic program of the member or certain macroeconomic aggregates related more reliably to the achievement of the overall targets of the program than the variables which could be used as performance criteria. Supplementary criteria have been used to trigger discussions with the staff, to highlight key developments to be examined during a midterm review, or to trigger a supplementary review to examine and possibly modify performance criteria. Directors may wish to comment on the circumstances in which such supplementary formal monitoring of certain macroeconomic variables (including program targets) would be appropriate as well as the range of procedures that such monitoring criteria could initiate.

6. Article IV consultations provide the primary means for continued assessment of the stance of policies following the termination of an arrangement or arrangements with the Fund. The presentation of medium-term scenarios and regular consultations with nonprogram countries with current or prospective balance of payments difficulties should help promote the sustained implementation of adjustment efforts beyond the immediate period of use of Fund resources.

7. In the view of the staff, the guidelines on conditionality remain a suitable basis for application of the Fund's policy on the use of its resources under stand-by and extended arrangements. Consequently, no amendment to the guidelines is proposed at present. Similarly, the provisions of the extended Fund facility remain suitable for dealing with particular payments problems of a more structural nature. The appropriateness both of the guidelines on conditionality and the provisions of the extended Fund facility will be reviewed further not later than December 31, 1985.

