MASTER FILES

ROOM C-120

04

NOT FOR PUBLIC USE

INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 84/174

10:00 a.m., December 5, 1984

J. de Larosière, Chairman
R. D. Erb, Deputy Managing Director

Executive Directors	Alternate Executive Directors
A. Alfidja	
	D. C. Templeman, Temporary
J. de Groote	H. G. Schneider
B. de Maulde	X. Blandin
	T. Alhaimus
	T. Yamashita
G. Grosche	
J. E. Ismael	Jaafar A.
R. K. Joyce	L. Leonard
	C. Robalino
	J. R. N. Almeida, Temporary
R. N. Malhotra	A. S. Jayawardena
	A. Abdallah
F. L. Nebbia	B. Jensen
Y. A. Nimatallah	J. E. Suraisry
P. Pérez	G. Ortiz
J. J. Polak	
	A. V. Romuáldez
G. Salehkhou	O. Kabbaj
J. Tvedt	
N. Wicks	T. A. Clark
S. Zecchini	N. Coumbis
Zhang Z.	Wang E.

L. Van Houtven, Secretary
K. S. Friedman, Assistant

Also Present

Administration Department: J.-P. C. Golle. African Department: A. D. Ouattara, Director; L. M. Goreux, Deputy Director; N. Abu-zobaa, R. T. Stillson. Central Banking Department: L. M. Koenig, Deputy Director. European Department: L. A. Whittome, Counsellor and Director. Exchange and Trade Relations Department: C. D. Finch, Director; W. A. Beveridge, Deputy Director; M. Guitián, Deputy Director; G. Belanger, E. H. Brau, H. W. Gerhard, G. G. Johnson, S. Kanesa-Thasan, D. A. Lipton, R. L. Sheehy. External Relations Department: H. P. Puentes, R. M. Stough. Fiscal Affairs Department: A. A. Tait, Deputy Director; W. R. Mahler. IMF Institute: O. B. Makalou, C. Tognetti. Legal Department: G. P. Nicoletopoulos, Director; W. E. Holder, Ph. Lachman, A. O. Liuksila, S. A. Silard. Research Department: W. C. Hood, Economic Counsellor and Director; A. D. Crockett, Deputy Director. Treasurer's Department: S. I. Fawzi, Q. M. Hafiz. Western Hemisphere Department: E. Wiesner, Director; M. Caiola, C. Cha, J. Ferrán, C. M. Loser, S. Umana. Personal Assistant to the Managing Director: S. P. Collins. Advisors to Executive Directors: A. A. Agah, G. R. Castellanos, D. Hammann, S. M. Hassan, G. E. L. Nguyen, P. Péterfalvy, T. Sirivedhin, A. Steinberg, E. M. Taha, A. Vasudevan, M. A. Weitz. Assistants to Executive Directors: I. Angeloni, J. Bulloch, M. B. Chatah, Chen J., L. E. J. M. Coene, J. de la Herrán, N. Haque, G. D. Hodgson, Z. b. Ismail, S. Kolb, A. Koné, M. Lundsager, R. Msadek, K. Murakami, E. Olsen, J. K. Orleans-Lindsay, M. Rasyid, J. Reddy, D. J. Robinson, A. A. Scholten, Shao Z., S. Sornyanyontr, A. J. Tregilgas, A. H. van Ee, E. L. Walker, A. Yasseri.

1. EL SALVADOR - 1984 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1984 Article IV consultation with El Salvador (SM/84/246, 11/5/84). They also had before them a report on recent economic developments in El Salvador (SM/84/247, 11/6/84).

The staff representative from the Western Hemisphere Department said that the staff did not have sufficient information to assess the affects of the authorities' decision to transfer all imports of consumer goods from the official to the parallel exchange market. The staff had requested additional data from the authorities. In principle, the Government's action seemed consistent with the staff's suggestion to increase the scope of the parallel market through periodic transfers of operations to that market.

Mr. Pérez made the following statement:

> On behalf of my authorities, I would like to express appreciation to the Fund staff for the comprehensive work done during the recent mission. The staff reports deal in depth with the political and economic problems that have afflicted El Salvador since the previous Article IV consultation in October 1983 (EBM/84/147).
>
> Like most other Latin American countries, El Salvador has been severely affected by the deterioration of world economic conditions since the end of the last decade. The combination of the decline in economic activity experienced by industrial countries, sharp increases in interest rates, and falling commodity prices had a first-order impact on the economies of the region. The shrinkage of the Central American Common Market--a by-product of the contraction of world trade and the political uncertainties of the region--has also had a decisive effect on the recent performance of the country. In addition to these adverse factors, El Salvador has suffered an internal armed conflict for a number of years. The effects of this conflict have been felt in practically every aspect of economic activity, placing significant strains on the social and political fabric of the country. In this situation, the severe economic setbacks suffered by El Salvador during the last few years should not be unexpected. Moreover, it is somewhat surprising that, in the circumstances, economic activity has not been more severely disrupted.
>
> As noted in the staff reports, during the last quinquennium output has dropped by a cumulative 22 percent, bringing real GDP in 1984 to the level prevailing in 1974--a setback of a decade. Unemployment has behaved accordingly, rising to an estimated 30 percent of the labor force in 1983 from about 4 percent in 1978. As is normally the case in economies experiencing negative

growth, capital formation in El Salvador has suffered a drastic decrease. Investment declined a cumulative 58 percent in 1980-82. This is especially worrisome as the armed conflict has also resulted in a significant destruction of the existing infrastructure, obviously damaging the present and future productive capacity of the country. Both private and public investment have been substantially reduced.

Capital expenditures by the public sector have fallen substantially in relation to GDP, in spite of the rise of overall public expenditures, which jumped from 22.5 percent of GDP in 1980 to 27.1 percent in 1982 and 1983. It is clear that all the expenditure increase has been devoted to defense-related activities. In addition to the decreasing profitability of business activity caused by the drastic reduction of real income, private investment has been further discouraged by the erosion of confidence associated with the internal conflict. Capital flight acquired important proportions in recent years, introducing additional complications in the external sector.

The balance of payments situation remains difficult. Traditional exports--coffee, sugar, cotton, and shrimp--still represent about 70 percent of total exports, coffee being the most important, accounting for nearly 50 percent of total export receipts. The value of coffee exports declined substantially in 1982 and 1983 as a result both of lower production and sagging prices. Although imports have risen in 1983 and are expected to increase further in 1984, the fall of export receipts has been the main factor behind the relatively large trade deficits which, together with the sizable interest payments, have been reflected in significant current account imbalances that have been largely compensated by grants from the U.S. Government.

The authorities recognize the growing importance of grants and concessionary finance in reducing the current imbalances of the public sector deficit and of the balance of payments. However, they are convinced that export diversification is an essential step in providing the Salvadoran economy a firmer base for economic growth in the future. To this end, the authorities have been gradually transferring transactions from the official to the parallel market--a measure that depreciates the effective exchange rate, since the parallel market rate is 60 percent higher than the official rate. It should be noted that, apart from exchange rate considerations, exports have been hurt most by the effects of the political uncertainties implied by the internal problems on production activities and, as noted above, by extremely unfavorable world economic conditions.

The authorities are aware of the difficulties of managing an exchange rate system in which such a wide differential exists between the official and the parallel rates, and it is their intention to continue following a flexible exchange rate policy. In fact, the authorities introduced some important modifications in the operation of the foreign exchange market, with effect from December 3, which point in the direction of greater flexibility and simplification of the existing scheme. These measures include the transfer of all imports of consumer goods and about 50 percent of intermediate goods. Some important exceptions are petroleum, fertilizers, medicines, and pesticides. Also, 50 percent of nontraditional exports will be transferred to the parallel market. The authorities estimate that between 45 percent and 50 percent of the balance of payments transactions will now take place in the parallel market as a result of these measures.

The authorities recognize that only limited progress has been made in the fiscal area and have noted that the present political and economic circumstances impose serious limitations on fiscal policy both on the revenue and on the expenditure side. Thus, a comprehensive tax reform along the lines suggested by the staff, although desirable at the present time, would have to be implemented under a more sedate environment if negative political reactions are to be avoided. On the revenue side, the most significant measure undertaken for some time was the doubling of the stamp tax in mid-1983, a measure that should strengthen the financial priorities of the Government in 1984. The higher rate, however, implies that the incentives for evading the stamp tax are greater, and additional measures to improve tax administration are called for. Some of these have been already implemented, while others are being considered for implementation in the near future. The armed conflict has imposed increasing demands on the expenditure side, although the authorities are prepared to take additional measures to improve the budget outlook for 1985, since the overall government deficit in 1984, as a proportion of GDP, is expected to be slightly higher than the deficit registered in 1984. In particular, expenditures will be carefully revised, and some reductions will also be undertaken. The room for action on the expenditure side, however, is also very limited. This point is clearly illustrated by the figures on capital expenditures.

Monetary policy will be prudently oriented toward facilitating and sustaining the incipient recovery of economic activity; the authorities will be careful not to rekindle inflationary processes of balance of payments pressures. Credit from the banking system to the public sector is to be further reduced, avoiding the crowding out of private borrowers from financial markets, since the demand for credit from the private sector is expected to rise as economic recovery gathers momentum. This task will be facilitated by the recovery of financial intermediation which, in turn, constitutes an encouraging sign that wealth holders are responding to a more active interest rate policy and some measure of confidence is being recovered.

The efforts undertaken by the Salvadoran authorities to prevent a worsening of economic conditions while pursuing policies leading to the correction of internal and external disequilibria have to be evaluated in the context of the very difficult situation resulting from world economic conditions and the armed struggle. The expected GDP rise in 1984 of 1.5 percent--after six years of negative growth--is encouraging. The authorities have decided to continue following adjustment policies in the short run while undertaking important structural reforms that aim at strengthening the productive sector. The restoration of economic stability and confidence on the part of the private sector is seen by the authorities as an essential part of the structural change.

Finally, the authorities expect that the Board will recognize the adjustment efforts of the country and look forward to further useful exchanges of views with the staff on the policies being pursued.

Mr. Robalino said that he broadly agreed with the staff appraisal. The Fund should not pay excessive attention to technical matters in dealing with a country that had faced serious internal political difficulties. The economy had also been seriously affected by the world recession, which had caused major distortions in the regional common market and had undermined production and employment in El Salvador, thereby worsening the internal and external imbalances.

Despite the unfavorable conditions, the authorities had demonstrated their commitment to improving the economic situation, particularly by maintaining a flexible exchange rate policy, Mr. Robalino continued. They were to be commended for the recent additional exchange rate measures introduced, including the decision to transfer transactions from the official to the parallel market.

Efforts should be made to improve tax administration before widening the tax base, Mr. Robalino considered. In general, the authorities were clearly interested in improving the economic situation and in following the Fund's advice--when circumstances permitted--to implement economic policies aimed at restoring confidence.

Mr. Nebbia remarked that the economic situation in El Salvador had been very difficult in recent years because of the armed conflict in the country, the world recession, and problems facing the Central American Common Market. The internal armed conflict had affected almost every aspect of economic activity and had caused significant social and political strains. Unemployment had risen from 4 percent in 1978 to 30 percent in 1983, and investment had declined drastically in 1980-83.

It was important to appreciate the constraints on the implementation of restrictive fiscal and monetary policies in El Salvador, Mr. Nebbia considered. Given the political and social difficulties in the country, economic growth should be a key policy objective, but a prudent fiscal policy was nevertheless required to achieve a gradual reduction in the fiscal deficit. It would be difficult for political reasons to undertake the tax reform suggested by the staff, but some reductions in expenditures would improve the budgetary outlook for 1985. As for monetary policy, he agreed with the authorities that the basic objective should be to support economic activity without fueling inflation and weakening the balance of payments. Reducing credit from the banking system to the public sector would prevent crowding out of private borrowers from the financial markets.

The decline in the value of coffee exports in 1982 and 1983 had caused the trade balance to deteriorate, and the authorities should encourage export diversification, Mr. Nebbia remarked. While he agreed with the staff that the exchange system had become complex, and that the large spreads between the official and parallel exchange rates and the accumulation of arrears were not welcome, he noted that the authorities were trying to solve those problems gradually. The recently adopted exchange rate measures were encouraging, particularly the gradual but persistent shift of transactions from the official to the parallel market. In the light of those actions, El Salvador's exchange restrictions and multiple currency practices should be approved. After all, any country facing internal problems like those in El Salvador had no choice but to introduce some restrictions. Finally, restoring the confidence of the private sector was crucial to improving the overall economic situation in El Salvador.

Mr. Templeman considered that little progress had been made in reforming El Salvador's economy since the expiration of the stand-by arrangement in mid-1983. However, the Government had a new opportunity to address the difficult economic problems facing the country. Given the particularly uncertain political environment prior to the recent national elections, the authorities' inability to make far-reaching changes in fiscal policy was understandable. However, in the coming period, they could introduce certain measures in the monetary and external sectors to stimulate growth and reduce unemployment. The single most effective policy change would be to move most foreign exchange transactions to the parallel market.

The authorities hoped to encourage private sector activity, Mr. Templeman noted. Agriculture was still very important, and incentives to production could be increased by permitting exporters of traditional products to sell their output in the parallel market. In addition, higher local currency revenues might permit the first wage increase in four years in the agricultural sector, thus giving labor an incentive to remain productively employed in agriculture instead of migrating to urban areas where there was already considerable unemployment.

Because of large expenditures on military and reconstruction-related items, the budget might well be difficult to control, Mr. Templeman remarked. The increase in wages and salaries had been limited to 3.5 percent in 1983 but had been 27.5 percent in 1984, and much stronger restraint would be needed in 1985. The public enterprise sector had generated operating surpluses, although the Supply Regulation Institute in particular had not. He wondered whether the Institute and other loss-making public enterprises planned to adjust their prices. Given the low proportion of taxes in relation to GDP--less than 12 percent in 1984--he agreed with the staff that the budget deficit might also be effectively attacked on the revenue side. In that event, however, the authorities should avoid creating tax disincentives to savings and investment. An exchange rate adjustment could restore the profitability of the export sector, thereby reducing its need for government subsidies.

A reduction in the fiscal deficit would facilitate greater monetary and credit restraint and help to reduce the growing inflationary pressures in the economy while permitting a relaxation of price controls, Mr. Templeman said. Those developments could positively affect domestic supply.

The staff had noted that the interest rate adjustments in 1982 had generated an increase in financial savings, but that the authorities were unwilling to increase rates again to compensate for the acceleration in the rate of inflation, Mr. Templeman commented. The authorities should be urged to make a further adjustment to interest rates to provide a stronger incentive to savings and to reduce aggregate demand. The present national savings rate was less than 6 percent, and a stronger savings base was needed to rebuild the infrastructure and to provide the resources to enable the private sector to grow, particularly as substantial foreign investment was unlikely in the foreseeable future.

Increasing national savings might seem to be of secondary importance at a time when the economy was receiving substantial foreign assistance, but that assistance might not last indefinitely, and the sources of foreign exchange should be broadened, Mr. Templeman said. In that connection, the decision on December 3 to transfer all imports of consumer goods and 50 percent of intermediate goods to the parallel market was welcome, although, as the staff had mentioned, the full significance of that measure was not yet clear. The official market would continue to cover a substantial portion of international transactions, even though the exchange rate in that market was only 60 percent of the rate in the parallel market, and the demand for foreign exchange in the official market would probably continue to exceed the supply. Hitherto, that situation had resulted in a reported increase in smuggling and in the accumulation of external arrears which, if permitted to continue, would harm the country's already weak credit rating and raise the cost of all forms of foreign financing. Unification of the exchange markets would reduce the large current account deficit and limit the increase in the debt service ratio, which was expected to reach 30 percent of exports of goods and services in 1985. The authorities' recent important steps toward exchange rate unification were welcome.

Mr. Leonard commented that conventional analysis of economic developments in El Salvador was difficult. The references in the staff report to armed conflict, guerrilla activity, the unsettled political situation, and other factors strongly suggested that any detailed conclusions were necessarily tentative; the staff's decision to concentrate its analysis on fairly general policy guidelines, rather than on specific recommendations, was appropriate. The staff had presented two scenarios and, unfortunately, the one based on the assumption that the present troubled conditions would continue was probably the more realistic.

Given the present uncertainties, the staff suggested that the authorities' efforts to keep economic management on reasonably secure ground should be concentrated on fiscal policy, the interest rate structure, and the exchange system, Mr. Leonard noted. After improving in 1983, the fiscal operations of both the Central Government and the public sector as a whole had deteriorated, and the domestic current account and overall deficits in absolute terms were larger in 1984 than in 1982, although there had been a slight improvement in relation to GDP. The authorities still relied heavily on foreign grants to finance the budget, and he agreed with the staff that they needed to strengthen their efforts to narrow the fiscal gap by raising revenues and revising the prices of goods and services sold by state agencies. In that connection, the armed conflict in the country had probably significantly limited the ability of the authorities to collect revenues. He wondered to what extent the tax reforms, aimed at dealing with the difficulty in collecting revenues, were likely either to result in an inequitable sharing of the tax burden or to provide disincentives to growth and efficient resource allocation. In any event, the authorities' access to foreign grants might well encourage the authorities to lessen the vigor of their fiscal effort. They needed to guard against that danger, and for that reason, the staff's suggestion that the authorities should increase their reliance on domestic revenues was welcome.

The present exchange system had resulted in an overvalued rate for most foreign trade transactions and had been the source of administrative and other inefficiencies as well as illegal activities, Mr. Leonard remarked. He fully agreed with the staff that the authorities should be urged to reform the system by accelerating the reunification of the exchange rate. That effort would directly benefit trade and would help to improve the fiscal balance because of its effects on domestic coffee prices and other prices and on the income of a number of state agencies. The recent decision to transfer additional transactions to the parallel market was welcome, and he hoped that further reform measures would follow as soon as possible.

The staff representative from the Western Hemisphere Department noted that the position of the public enterprises had deteriorated somewhat in 1984; their overall surplus was expected to decline by about 34 percent compared with 1983, mainly because of the increased operating deficits of the Supply Regulation Institute and the telephone company. Thus far, only the electricity company had adjusted its tariffs, increasing them in March and June 1984 by a total of 16 1/2 percent. However, that rise had been offset by a 21 percent increase in wages, thereby preventing any increase in the current account surplus of the electricity company in 1984.

As to the effort to contain the fiscal deficit, the staff representative from the Western Hemisphere Department said, there was some room to increase revenues--mainly through revisions of prices and tariffs of public enterprises--and to limit transfers from the Government to the rest of the public sector. A thorough tax reform would require considerable time to prepare and implement and, given El Salvador's circumstances, probably would not provide much respite in the short term. As indicated on page 8 of SM/84/246, the staff believed that reform of the exchange system would help to bolster revenues and to cut certain expenditures. Moreover, greater use of the parallel market and an increase in the collection of import taxes on transactions in that market would increase revenues, and greater exchange rate flexibility would enable the authorities to eliminate export subsidies.

The Deputy Director of the Exchange and Trade Relations Department said that, in principle, the recent transfer of some transactions from the official to the parallel market appeared to be in the right direction. However, there was no indication that the present exchange restrictions were temporary in character; therefore, the staff could not recommend their approval. Such approval could only be recommended when there were sufficient grounds to conclude not only that a country had a need to establish restrictions, but also that the restrictions in question were clearly temporary in nature.

Mr. Pérez remarked that Executive Directors clearly appreciated the difficulty in managing the economy in the present circumstances. The authorities had carefully considered appropriate measures to simplify the exchange system that could be effectively implemented. In line with the staff recommendations, they had decided that, as of December 3, 1984, the Monetary Board should transfer from the official market to the parallel market 50 percent of the imports of intermediate goods and chemical products, except medicines, fertilizers, pesticides, and insecticides; all services related to those imports; all consumer goods, except certain specified commodities; 30 percent of exports of medicines; and 50 percent of other exports, except fertilizers, pesticides, and their inputs. The objective was to improve the financial system, give greater weight to market forces in the determination of the exchange rate in the parallel market, and phase out exchange restrictions as soon as possible.

The authorities firmly intended to persist in making the needed adjustments in the economy, Mr. Pérez said. To that end, they would introduce additional measures to improve both the fiscal and external sectors. The recent decision on transactions in the parallel market would strengthen the receipts of the public sector and help to achieve the eventual unification of the exchange rate.

The Chairman made the following summing up:

Executive Directors were in general agreement with the thrust of the staff appraisal contained in the report for the 1984 Article IV consultation with El Salvador.

Directors acknowledged the severe impact on the country's economic performance of the internal security problems as well as the world recession and the shrinkage of the Central American Common Market. The sharp fall in output, incomes, investment, and employment in recent years was noted with concern. Recognizing these difficult circumstances, Directors observed that El Salvador's performance under the 1982/83 stand-by arrangement with the Fund had yielded positive results.

Directors noted, however, that slippages in policy implementation since that time threatened to undo the gains made under the last stabilization program. Directors stressed the need to strengthen the efforts to improve resource use, to widen the export base, and to stabilize the economy. Directors were of the view that fiscal policy, the interest rate structure, and the exchange rate system required the immediate attention of the authorities.

They noted that fiscal performance remained weak and posed the greatest threat to the stabilization effort. Directors, therefore, urged the authorities to explore ways to widen the tax base and to raise government revenues and to scrutinize all categories of government spending in order to reduce the fiscal deficit and to minimize its domestic bank financing. Directors also were of the view that a more flexible interest rate policy could play a significant role in encouraging the accrual of private savings to the financial system.

Directors noted that El Salvador's exchange system had become exceedingly complex. Directors commended the authorities for widening the scope of the parallel market and welcomed their intention to continue on this path. Directors were of the view that actions in this direction needed to be accelerated. They urged the authorities to move more forcefully toward a reunification of the exchange rates.

It is expected that the next Article IV consultation with El Salvador will be held on the standard 12-month cycle.

2. UPPER CREDIT TRANCHE ARRANGEMENTS AND SOME ISSUES RELATED TO CONDITIONALITY - REVIEW

The Executive Directors considered a staff paper on the review of upper credit tranche arrangements and of some conditionality issues (EBS/84/227, 11/7/84). They also had before them staff papers on experience with adjustment policies (EBS/84/228, 11/13/84) and on the formulation of exchange rate policies in programs supported by the Fund (EBS/84/232, 11/16/84; and Cor. 1, 12/3/84).

Mr. Salehkhou made the following statement:

The staff paper on experience with adjustment policies contains useful information and data regarding member countries' experience with Fund-supported adjustment programs. Because of the apparent importance of the paper's conclusions in shaping the staff approach to conditionality issues, I shall comment on the methodology and the results incorporated in the paper before considering the paper on the formulation of exchange rate policies and the main points on conditionality mentioned in EBS/84/227.

First, a realistic evaluation of Fund-supported adjustment programs is admittedly a complex task that not only involves opportunity costs and value judgments, but also falls into the domain of welfare economics involving social and political considerations and the evaluation of alternative scenarios. Nevertheless, an attempt must be made to address such basic issues as unemployment and income distribution if a purely mechanistic approach to the problem is to be avoided. Furthermore, since in the preparation of the present and previous papers of this kind a great deal of staff time and energy have already been spent, a start should now be made on addressing fundamental issues if a balanced and logical conclusion is to emerge. Such issues are whether adjustment has indeed led to a shift of resources to a particular sector; whether cost-price relationships have changed for the better as a result of adjustment; or whether positive real interest rates have encouraged real savings. The whole preoccupation of the staff seems to be with finding out if some arbitrarily determined performance criteria or other objectives were met, or to prove that, among members with adjustment programs, those with greater devaluations scored more economic points. However, even according to these yardsticks, the staff admits that "relatively few of the countries in the sample have achieved sustainable domestic and external positions."

Second, no attempt has been made to assess the costs of demand contraction policies in those few cases in which members did achieve a positive balance in the external accounts. It is a fact beyond dispute that, if demand management policies are carried out rigorously enough, in conjunction with other restrictive measures, a viable and sustainable domestic and external position will eventually be reached, perhaps at great social and political costs. The ultimate question, therefore, should be whether it was necessary to pay those costs in a singleminded pursuit of a specific adjustment strategy, or whether other alternative solutions could have achieved the same or even better results, at far reduced social and political pain. One cannot find an answer to such crucial questions in the staff paper.

Third, exogenous factors have been allowed to maintain their influence on the outcome of a program with no attempt to isolate those factors to achieve direct attributive relationships. For example, Table 12 of EBS/84/228 indicates that sample countries with significant real exchange rate depreciation, following the initiation of adjustment, enhanced their export performance, while those with significant real appreciation did not. This categorization, useful as it may be, ignores at least two points. No attempt is made to isolate the positive effects of other factors that could have contributed to the export surge, such as favorable international commodity markets for certain products, a bumper harvest, or regional political and strategic considerations. In at least two countries in Table 12--Mauritania and Turkey--exogenous factors played a leading part in enhancing their exports. If these factors were isolated, the postadjustment average export growth figure would drop significantly, thus showing that devaluation was not as effective as it might have seemed. According to the same table, some countries listed under the heading "others," for example, Pakistan, have experienced marked export reductions despite significant real devaluations. Furthermore, it cannot be ascertained from such analyses whether devaluation resulted in any significant shift of resources to the export sector.

On a different note, it is usually assumed that correction of price distortions results in the promotion of liberalization of the exchange and trade system. The sample survey mentioned in the paper does not shed any light on this issue. Still, other prevalent expectations associated with Fund-supported adjustment programs should have been tested. For example, in how many of the sample countries was the inception of the program closely followed by an increase in capital inflows--both concessional and commercial--which is crucial to the progress of developing countries? Apart from some big borrowers, for whom commercial banks have reluctantly resumed "forced" lending, there is precious little else that one can detect in terms of lenders maintaining even the earlier reduced flow of real financial resources to where they are needed most--the low-income developing countries.

There are other methodological considerations that are relevant but which I will leave out for the sake of brevity.

Before I turn to the need to consider a shift of emphasis, it is interesting to ponder some of the results and conclusions that appear in the staff papers and which are based on the staff's own framework and criteria. In fact, the picture that emerges is far from satisfactory. The performance has been mediocre in areas such as growth and inflation, and the results of the efforts at reducing balance of payments deficits or increasing exports--supposedly the main goals of adjustment--are clearly inadequate.

The staff draws at least two broad conclusions from this analysis: first, it implicitly suggests that, in the less successful cases, more rigorous adjustment would have led to better outcomes; and second, an early resort to adjustment would have meant less painful measures and hence smoother sailing. It must be borne in mind that, while the outcome of Fund-designed adjustment is so far inconclusive, members could not logically be asked to pay yet a greater price, in terms of more restrictive measures, for achieving economic viability that has largely proved illusive. For many developing countries, the Fund has become the lender of both first and last resort. The social, economic, and political burden of carrying out adjustment is so heavy, and the outcome so uncertain, that developing countries understandably prefer to postpone harsh adjustment as long as possible.

If the thrust of adjustment has so far focused on anti-inflationary demand management policies, the improving global inflationary outlook surely calls for new priorities and emphases. With adjustment now going from an import-compression phase to an export-enlargement phase, there is a need to shift the emphasis, within the broad guidelines of the present programs, toward investment and the real sector of the economy. Some feel that such issues as unemployment, income distribution, and welfare are beyond the Fund's terms of reference; in fact, they are relevant to the Fund's objectives. The achievement of a viable balance of payments is a means to a broader end, namely, economic prosperity through the balanced growth of international trade leading to "the promotion and maintenance of high levels of employment and real income" as mentioned in the Articles of Agreement. Article 55 of the United Nations Charter also calls for the promotion of higher standards of living and conditions of economic and social progress. The pursuit of an anti-inflationary and restrictive monetary stance beyond the point at which reasonable trade-offs with other objectives are even considered brings into the adjustment process elements of inflexibility and rigid, doctrinaire economic dogmatism. This the Fund should avoid at all costs.

The latest economic projections point toward a global situation in which developing countries will be forced to live with their present debt burden for an indefinite period. The prospects for meaningfully reducing the debt burden are not bright. It is therefore imperative that every step be taken to enhance deficit countries' debt-servicing capacity. This necessitates increased exports and sustained real growth of at least 4 or 5 percent annually to allow for a high rate of population growth. This, in my view, should form the main framework of the IMF adjustment programs in the second half of this decade.

A related consideration is whether adjustment policies cannot be made more symmetrical by including both deficit and surplus countries under their terms of reference. If surplus countries continue to run huge balance of payments surpluses, deficit members, unable to compete with the former in the face of growing protectionism, must increasingly compete with one another for a greater share of the ever-shrinking pie. This is a zero-sum concept and, unless countries with persistent surpluses are pursuaded to accept adjustment, the overall picture will not improve.

An important point is to change the policy mix to distinguish between that part of a balance of payments deficit for which a developing country has not been responsible, and other elements. The burden of adjusting that part of the deficit should not be borne by the member. Indeed, the concept of the compensatory financing facility and the oil facility was based on the belief that it was improper to impose stereotype adjustment on countries in circumstances for which they were not in the least responsible.

As to EBS/84/232 on the formulation of exchange rate policies, I wish to make two main points. First, in describing the performance criterion related to exchange rate adjustment, the paper starts off with the assumption that, if the exchange rate is freely determined by market forces, indicators are not needed to gauge the extent of adjustment. It goes on to say that the need for such indicators, and the subsequent adjustment based thereon, therefore becomes paramount. This reasoning would have been more acceptable had there not been, particularly in recent years, unexplicable imperfections in the exchange and commodity markets making certain currencies overpriced or underpriced. The existing currency parities, therefore, become less than indicative of the optimum free market rates. Using such rates as yardsticks--to shape developing countries' exchange rate profile--will prove more abstract and mechanistic, in the light of the purchasing power parity formulation, a theory which has often been criticized. In the case of developing countries with as yet undeveloped exchange markets and the existence of necessary exchange restrictions, the formulation of indicators based on abstract equilibrium rates, to which the misaligned currency is supposed to gravitate, increases the degree of approximation in the whole exercise. Furthermore, often such free market rates that are used to design performance criteria are those prevailing in the illegal parallel markets in the developing countries. Such rates are far from true indicators of optimum exchange rates and are often based on political and social constraints and the outcome of the activities of the elements in the markets engaged in dishonest practices.

My second point relates to the ultimate aims of exchange rate changes, namely, to optimize the structure of relative prices and to shift resources to the traded goods sector. In the absence of definite conclusions as to whether these aims were reached in the sample cases reported in the staff papers, attention is naturally focused on the costs associated with devaluation. A common feature of the developing countries is the low elasticities of supply and demand in foreign trade. A more definite outcome of devaluation is a fall in real income and a shift in income distribution. Furthermore, most indicators point to the fact that retaliatory measures by other countries, mostly primary commodity exporters, usually wipe out any positive gains that may at first appear for the depreciating country.

Finally, I have the following observations on the conditionality issues mentioned on pages 10 and 11 of EBS/84/227.

While I agree with the staff regarding the assertion in paragraph 1, I would caution against excessive reliance on medium-term scenarios in influencing the present policies of member countries because of their highly uncertain nature. At best, such scenarios should be treated as rough indicators or signposts of future events. I would, however, entirely agree that further discussions on the speed of adjustment and the stance of policies would be useful.

My understanding of paragraph 2, vaguely phrased as it is, is that we are perhaps trying to second-guess the authorities and tread along uncharted territory.

Any advance formulation of as yet uncertain future developments is bound to greatly increase the inflexibility of the adjustment program and run counter to national priorities. "Unexpected unfavorable developments" by definition require ad hoc, tailor-made solutions; therefore, I cannot go along with the suggestion. By the same token, I am against introducing a safety margin or a provision for contingencies in the program. Such codification of as yet unknown future events will manifest a serious disregard for the independent policies and goals of sovereign member states.

As to paragraph 3, although structural difficulties may not have been the immediate source of the large domestic or external imbalances, they certainly made the task of adjustment arduous and, in a majority of cases, ineffective. The supply-side concept should receive broader, more realistic, consideration. Such broadening of the term should go beyond the full implementation of market mechanisms and toward strengthening the poor resource base of the country and the adoption of realistic institutional reforms.

While I support the continuation of the present policy based on the usual quantified performance criteria suggested in paragraph 4, I urge the staff to consider alternative scenarios and criteria that are more aligned with the ultimate aim of adjustment, which is economic prosperity. The improved international climate demands that at least a start should now be made on studies to replace some of the existing yardsticks with new, more meaningful and less painful ones. Single-minded pursuit of stereotype policies will only add to the rigidity of our suggested solutions.

I cannot agree with the implicit reasoning in paragraph 5 that more rigorous and restrictive monitoring of programs will yield more favorable results, even in exceptional cases. This approach fundamentally ignores the underlying basic deficiencies in the present formulation of adjustment policies. If, as the staff mentions on page 7 of EBS/84/227, fulfillment of all the performance criteria by a member may nevertheless fail to achieve the stated goals because of "uncertainty and error" of a program or "an inadequate knowledge of the working of the economy," the fault cannot be corrected by yet more frequent monitoring of economic variables, while the original, incorrect design and performance criteria are still in place and operative. By the same token, allow me to make a related observation on the paper "Relationship Between Performance Criteria and Phasing of Purchases Under Fund Arrangements" (SM/84/259). Among the recommendations, one makes the last purchase under an annual program conditional on the member reaching agreement with the Fund on a new program. Such tightening of conditionality is unwarranted.

As to paragraph 6, Article IV consultations remain a useful exercise to assess the stance of policies, and the present timing and frequency of such consultations are appropriate.

In paragraph 7, while I agree, for the time being, with the necessity to keep the present guidelines, I reaffirm my categorical objection to any reinterpretation of the present guidelines along the lines implicitly suggested in the paper, and I once again call for a thorough review of the fundamental issues embodied in our approach, including viable alternatives and discussions along the lines that I tried to explain. Pending this thorough review, any further restrictions or conditionality will prove self-defeating.

Mr. Polak considered that the staff paper on the formulation of exchange rate policies in programs supported by the Fund should be published, suitably edited. However, the staff paper on experience with adjustment policies lacked a clear focus, made inefficient use of a considerable amount of data, and, as a result, contained few solidly established findings. As to the review paper, the Executive Board had stressed on previous occasions that adequate, timely, and determined actions, together with a flexible response to unfavorable external factors, were the keys to successful adjustment.

Commenting on the staff's summary and conclusions in EBS/84/227, Mr. Polak said that Executive Directors clearly had considerable interest in medium-term scenarios, and the proposed improvements in the presentation of such scenarios were acceptable. In particular, he agreed that the usefulness of the scenarios would be enhanced if the underlying stance of policies mentioned in them were clearly specified. In addition, the scenarios should have an appropriate theoretical base; accordingly, to the extent possible, they should be based on autonomous domestic variables, such as the fiscal deficit and credit creation, and on autonomous external variables, such as interest rates and exports. Income growth should not be treated as an autonomous variable; instead, it should be derived from other factors, especially as governments were unlikely to persist in attempting to achieve a particular rate of income growth in any circumstances. In general, the scenarios should reflect the Fund's policy advice and its instruments for monitoring program performance.

In many instances--in addition to cases in which a country was heavily dependent on one or two commodity exports--more than one scenario could usefully be provided, Mr. Polak continued. Multiple scenarios had appropriately been used in the recent cases of Zambia, Cyprus, Italy, and Portugal. Such scenarios were particularly helpful when contingency measures seemed needed at an early stage of the adjustment effort. Moreover, they could usefully include a normative scenario, based on the policies needed to obtain certain desired results. Multiple scenarios could help to avoid prejudging the amount or terms of possible debt relief for the member country concerned.

A scenario based on unfavorable assumptions could encourage the authorities concerned to consider appropriate contingency measures, Mr. Polak remarked. Those contingency measures must not become substitutes for the early implementation of needed corrective policies and should not be seen as evidence that creditors could press a member country further, for example, by being less generous in rescheduling debt under the Paris Club. Great caution should be applied in including contingency scenarios in a staff report for a member country, although it would be helpful to make them available to authorities.

Administrative and legal difficulties cited by authorities should not be automatically accepted by the staff as an excuse for the authorities' failure to formulate and implement important structural measures, Mr. Polak said. At the same time, the staff should avoid becoming excessively committed to administrative and legal changes; some governments could conceivably make such changes as substitutes for a genuine commitment to achieving adjustment program objectives. In effect, excessive emphasis on removing legal and administrative impediments could gain the Fund a merely pyrrhic victory.

He agreed with the staff conclusions in paragraph 4 on page 11 concerning the role of performance criteria in the implementation of adjustment programs, Mr. Polak said. However, on page 7 the staff stated that "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 first part of that statement was acceptable. However, the achievement of program objectives depended not only on the observance of quantified performance criteria but also on the evolution of external factors in line with the assumptions underlining the program. In a number of recent instances, a member country had met the performance criteria but external developments had been much more unfavorable than anticipated, and the actual outcome under the program had differed greatly from the planned outcome.

Careful consideration should be given to the definition of appropriate performance criteria for member countries where a high rate of inflation was the main problem facing the economy, Mr. Polak continued. In such cases in the past--for instance, Brazil--the overperformance of the balance of payments had conflicted with the effort to meet the monetary targets, thereby causing the inflation targets to be missed. One possible solution was to have two performance criteria on the monetary side, namely, a limit on domestic credit creation to ensure that the balance of payments targets would be met, and a limit on the growth of the monetary base to ensure that the inflation target would be met. That approach would give the adjustment effort the credibility needed to break inflationary expectations, as it would be clear from the start that the adjustment program had been designed to reduce the high rate of inflation in the country concerned.

The supplementary monitoring criteria mentioned in paragraph 5 on page 11 were acceptable, Mr. Polak said. They would be particularly useful for triggering a review of a country's performance. At the same time, they might well suggest that relatively few reviews were needed for a particular member country.

As to paragraphs 6 and 7, Mr. Polak remarked, he agreed with the staff that Article IV consultations provided the primary means for continued assessment of a country's policies following the termination of an arrangement with the Fund, and that the guidelines on conditionality remained a suitable basis for the application of Fund policy on the use of its resources under stand-by and extended arrangements.

Mr. Joyce commented that EBS/84/228 provided a useful analysis of the factors that had contributed to the persistent balance of payments difficulties in member countries and of the reasons why members' adjustment efforts had succeeded or failed. Although the paper dealt primarily with experience in 1977-80, its conclusions were applicable to the present situation.

The present guidelines on conditionality, applied with flexibility and discretion, still provided a suitable basis for the operation of stand-by and extended arrangements, Mr. Joyce considered. The extended

Fund facility was an appropriate and useful means of helping member countries to deal with deep-rooted structural payments problems, although there was room for improving extended arrangements. Too many recent Fund-supported programs had been unsuccessful even though the economic position of many developing countries had strengthened during the previous year. In a number of cases, adjustment had not been sustained, or a country's various adjustment policies had not been consistent. Moreover, despite the increased attention in borrowing countries to the medium-term outlook, there had apparently been a tendency to place undue emphasis on immediate financial problems; being determined to handle the immediate crisis, member countries had perhaps been sanguine about the future. Accordingly, they had often assumed that the considerable exceptional financing they were likely to need in coming years would be available if they could weather the immediate difficulties. As a result, some countries had found themselves in a tight position when assumptions about available financing had proved inaccurate. In other cases, however, program design had apparently been inadequate, as the Fund had been overoptimistic about either the future conditions in the country or the government's ability or willingness to make necessary changes. Moreover, some programs had been designed with particular objectives in mind, and insufficient attention had been paid to the steps that would be required to achieve other important objectives. In all those instances, the Fund had to accept some blame for the failure of the adjustment effort.

He had been particularly struck by four main points made in the staff papers, Mr. Joyce said. First, relatively few of the member countries studied had achieved a sustainable payments position within the program period. Given the uncertainties about the external environment and the heavy debt of many member countries, there was no guarantee that the success rate would be better in the future. Second, although external developments had had a particularly adverse effect on the economies of many member countries in recent years, large or growing fiscal imbalances--which were highly sensitive to discretionary policy changes--and overvalued exchange rates had been the major causes of the payments difficulties in a majority of the countries examined by the staff.

Third, Mr. Joyce continued, the success of programs had been closely related both to the degree of seriousness--perhaps even aggressiveness--with which specific policy measures had been implemented to deal with the fundamental causes of payments imbalances, and to the extent to which adjustment had been maintained, if necessary, over a prolonged period. Fourth, failure to adjust adequately had often been due to the authorities' decision to pursue adjustment in a piecemeal fashion. As a result, adjustment had been excessively slow and, in some instances, too little too late. Rather than addressing problems in several areas simultaneously, the countries concerned had implemented individual policy measures over a long period in an attempt to follow what they had hoped would be a smooth adjustment path. In fact, however, the delays in implementing important policy measures had not made the adjustment easier; indeed, they had reduced the chances of successful adjustment.

The staff papers gave the strong impression that the speed and determination of policy correction were the keys to strengthening the adjustment process, Mr. Joyce said. It had become clear that attaining a viable balance of payments position often took a relatively long time, which was an argument for undertaking adjustment as soon as possible rather than delaying it. It had also become clear that there was no single appropriate path of adjustment for all member countries; the proper path must be worked out on a case-by-case basis. If an adjustment program were to be realistic and successful, it must reflect the technical and political factors that affected a country's ability to implement it effectively. In that connection, the Fund sometimes failed to be sufficiently sensitive to the circumstances of a member country. It was also important to bear in mind that the adjustment process in a member country was highly sensitive to changes in the underlying assumptions about the country's prospects. The main overall conclusion was that, given the considerable uncertainty about the economic environment that most member countries would face in coming months, the large size of their payments imbalances, and the protracted nature of their payments problems, it was increasingly important for countries facing payments problems to take broad policy action as early as possible.

The staff papers provided solid evidence that the considerable attention usually paid in Fund-supported programs to the reduction of fiscal imbalances was warranted, Mr. Joyce considered. Such imbalances were often one of the main--if not the main--source of balance of payments problems. However, as the staff noted, in recent years there had been an increased need for supply-side measures, so that the burden of adjustment need not fall entirely on demand management. The greater focus on supply-side measures was welcome, although the results thus far had admittedly been less than encouraging: many countries had experienced excessive delays in implementing structural changes, in adjusting prices, exchange rates, and interest rates, and in sustaining the changes where necessary. As a result, the proper working of the economies concerned had been inhibited, and attempts to control budgetary expenditure and to increase revenues had been jeopardized. Basic structural changes were needed not only to achieve stabilization but also to give a firm foundation to a country's medium-term and longer-term development strategy. Structural changes were of course difficult to make, and adjustment programs often failed because of a government's sheer inability to meet program requirements on time, rather than because of a lack of will to act. Economic policy managers often faced not only political difficulties but a lack of qualified staff.

The increased emphasis recently given to medium-term and longer-term scenarios in Fund arrangements was welcome, Mr. Joyce said. The same emphasis should be a feature of Article IV consultations. He agreed with the staff that the usefulness of the scenarios would be increased if they included a discussion of the factors underlying the likely speed of adjustment over the medium term. He also agreed with Mr. Polak that multiple scenarios were useful for a country where the economic outlook was highly sensitive to changes in the underlying assumptions.

He had mixed feelings about the staff conclusions concerning contingency measures in paragraph 2 on page 10 of EBS/84/227, Mr. Joyce commented. Such measures might well be beneficial when the country concerned faced considerable risks in successfully implementing needed policies during the adjustment period. At the same time, however, the great uncertainty about the country's economic outlook would make it difficult to formulate precise contingency measures. On balance, it seemed best to rely on frequent program reviews, rather than contingency plans, to identify new measures and other steps that should be taken in response to changed conditions.

As to program monitoring, Mr. Joyce said, the present policies on the use of performance criteria, program reviews, and prior actions were appropriate. Supplementary monitoring might well be useful in some instances, but it should not be a substitute for formal performance criteria. In general, supplementary criteria should be the basis for discussions with staff on certain subjects or the focus of analysis during reviews; they should actually trigger reviews only in exceptional circumstances. If the staff felt that normal quantitative performance criteria could not be used to monitor adequately a program, the appropriate response would be, first, to attempt to find better criteria, and second, to schedule more frequent reviews of the relevant policy areas.

He agreed with the staff that Article IV consultations should be scheduled with a country within six months after the conclusion of the member's arrangement with the Fund in order to encourage the authorities to sustain their adjustment effort, Mr. Joyce commented. Greater emphasis on medium-term developments in Article IV consultations would increase the Fund's awareness of problems before they reached the crisis level. He looked forward to discussing that matter further during the scheduled review of surveillance.

Mr. de Groote remarked that reviews of upper credit tranche arrangements gave Executive Directors an opportunity to assess their policy advice to member countries in the framework of financial arrangements. Although the application of conditionality had been considerably improved during the previous year, the success rate of Fund-supported programs was still unsatisfactory. The staff papers were particularly useful because of their rigorous analysis of policy areas requiring qualitative judgments.

The use of medium-term scenarios had considerably facilitated the assessment of borrowing countries' balance of payments needs and proposed pace of adjustment, Mr. de Groote considered. In general, however, the stance of policies described in such scenarios should be spelled out more clearly, so that Executive Directors could better understand which specific measures the staff felt the country concerned should implement. In sum, a more systematic approach to medium-term scenarios was required. To that end, the Fund's policy suggestions had to be within the realm of the measures to which the authorities would agree. Given that constraint, a blueprint of the measures required in the medium term would, as a rule, greatly improve the effectiveness of Fund-supported programs, and it might be useful to consider employing medium-term scenarios of a normative character. Accordingly, the staff paper on a member country could include both a normative scenario and a scenario based on unchanged policies in order to highlight the need for adjustment and the possible results of alternative approaches. It might be necessary to quantify the desired policy changes under those different possible outcomes. Alternative scenarios showed the combination of adjustment and financing that a member country could achieve in principle, but, in the final analysis, the actual adjustment effort would be dictated to an important extent by the financing constraint facing the country.

Including a normative blueprint would be particularly useful if it was formulated with the cooperation of the World Bank, which was responsible for the assessment of member countries' development policies in a medium-term framework, Mr. de Groote went on. The need for such cooperation brought to mind Mr. Wicks's recent proposal to provide a joint Fund-World Bank diagnosis of a member country's position. Medium-term balance of payments projections would be realistic only if they incorporated the World Bank's normative analysis of a country's development objectives, including their attainability and their financial and balance of payments implications.

Unforeseen changes in internal and external circumstances had been a recurring problem in the implementation of Fund-supported programs, Mr. de Groote noted. On a number of occasions, he had stressed the need for contingency measures that would be implemented when actual developments differed significantly from the basic assumptions underlying a program. That point was particularly applicable to the recent stand-by arrangements for Turkey and Brazil, and was relevant to the situation in Ghana. He did not agree with the staff that the use of contingency measures should be limited to certain countries. Instead, they should become a part of all financial arrangements concluded with the Fund. Too many programs had gone off track because contingency measures had not been available when actual developments had significantly differed from program forecasts. In those instances, the authorities had sometimes had to restart their adjustment efforts, and with a considerable delay, after reviewing existing policies and negotiating new ones. Contingency measures did not preclude the need for early implementation of corrective policies; they would ensure that such policies remained adequate even when conditions changed.

The staff had appropriately stressed the importance of structural measures in the design of adjustment programs, Mr. de Groote remarked. It was not surprising that past efforts to solve structural problems had, in the staff's view, "frequently been considerably less than satisfactory." Member countries were typically reluctant to introduce structural measures in the initial stage of an adjustment program; required structural changes were usually implemented only in the later stages.

Those conclusions had been confirmed by the two background papers, which showed that the success of adjustment programs greatly depended on whether or not they were comprehensive, Mr. de Groote continued. The delay in implementing structural measures and in making the needed changes in supply conditions explained why growth rates had fallen considerably in the early period of adjustment under a number of programs. One of the main conclusions of the experience of the previous year was that authorities' hopes that stretching out the pace of implementation of needed policies would smooth the adjustment process were generally unfounded. That conclusion was important because it affected outsiders' perception of the Fund's role: some of the criticism of the Fund was due to its occasionally having given in to authorities who wished to postpone structural measures and who subsequently had to engineer even larger income reductions than would have been necessary if supply-oriented measures had been introduced at the outset. In that connection, Mr. Salehkhou had usefully underscored the Fund's impact on the social fabric of member countries, but he himself believed that Fund policies and member countries' social objectives could only be reconciled when adjustment was undertaken rapidly and with sufficient intensity. There was no alternative to adjustment, and the main task for the Fund and individual member countries was to shorten the period of adjustment and reduce its intensity in terms of income and employment reductions as much as possible. Experience clearly showed that real income losses could be avoided or moderated in member countries that acted rapidly through a combination of demand-oriented and supply-oriented adjustment policies.

The lack of structural change under Fund-supported programs was also traceable to the timidity of the adjustment efforts of a number of countries, Mr. de Groote went on. There were of course often institutional and administrative difficulties in making structural changes, particularly those involving relative prices, but they should not be an excuse for delaying attempts to implement required measures. Despite the increase in recent years in the number of exchange rate measures designed to improve relative prices in deficit countries, the real effective exchange rate of most developing countries had appreciated above the level in 1978, preventing a significant improvement in relative prices. Indeed, the numerous downward exchange rate adjustments by various individual countries had tended to offset each other. Countries continued to face the need to maintain competitiveness through appropriate internal measures; recent experience in such countries as Turkey and Zaïre had clearly shown that substantial exchange rate adjustments supported by comprehensive complementary measures could significantly affect the external balance and place an economy on a more growth-oriented adjustment path. Downward exchange rate adjustments could be made--as Zaïre had recently demonstrated--with relatively minor and temporary effects on domestic inflation, provided that they were part of a global approach that included supportive domestic measures.

The Fund's approach to monitoring performance criteria should perhaps be more flexible, Mr. de Groote said. For instance, if balance of payments developments were more favorable than expected, the ceiling on net domestic assets could be adjusted to avoid excessive expansion of the monetary aggregates. Such readjustments should be seen as a natural consequence of an unexpectedly favorable external performance. In fact, authorities should be prepared from the outset to restrain internal liquidity if the balance of payments results under the program were unexpectedly favorable. Such an agreement could avoid difficult negotiations with member countries when the balance of payments outcome threatened the authorities' compliance with ceilings on monetary aggregates.

Supplementary monitoring of certain macroeconomic aggregates could help a member country to broaden its program objectives, Mr. de Groote remarked. The current account deficit, the public sector deficit in relation to GDP, total public expenditure, and wages in the public sector and in the whole economy could not be the subject of regular performance criteria, but they could be the subject of supplementary criteria that would be examined during midterm reviews or would trigger supplementary reviews that could lead to changes in regular performance criteria. Supplementary performance criteria should be used carefully to avoid extending them to program targets whose achievement did not depend directly on the introduction of specific policy measures. For instance, a supplementary performance criterion concerning inflation probably would not be appropriate. Experience with Brazil underscored the difficulty in monitoring the evolution of an aggregate that depended on many factors over which the country had little control, and in general, the Executive Directors apparently wished to place less emphasis than hitherto on legal criteria. Further thought should be given to Mr. Kafka's proposal to hold more frequent reviews so that performance criteria could be regarded as guidelines rather than rigid targets. The staff had implicitly made the same recommendation.

The persistence of policy implementation was an important element in successful adjustment, Mr. de Groote considered. It was particularly difficult to ensure after the completion of an arrangement with the Fund. Hence, scheduling an Article IV consultation as soon as possible after the expiration of an adjustment program with a member country might well be helpful, although the potential positive effects of such an approach should not be overestimated. After all, the Fund had no way of ensuring that the recommendations made during Article IV consultations would be implemented. It might be more helpful to maintain the Fund's involvement in a country through a follow-up arrangement for moderate use of Fund resources once the member country had agreed not to purchase any of the resources unless unforeseen developments occurred. Alternatively, the country could request the Fund's advice in creating policies for the period following expiration of its arrangement with the Fund, thereby bolstering market confidence in the country. That possible area of new cooperation between the Fund and member countries could be particularly important for the countries in which the Fund had been substantially involved and which had succeeded in correcting their payments problems. The cooperation could take place in the period between Article IV consultations.

Mr. Polak agreed with Mr. de Groote that normative scenarios on the desired trend in income would be a good starting point for the regular use of normative scenarios.

Mr. Ismael said that he would concentrate his comments on the summary and conclusions in EBS/84/227. Medium-term scenarios could usefully be employed in adjustment programs and in staff reports for Article IV consultations. If used flexibly--and not mechanistically--such scenarios could help Executive Directors evaluate member countries' policy stance. However, medium-term scenarios should be used cautiously, as the conclusions they contained were necessarily tentative, being subject to a number of uncertainties; such scenarios should be regarded merely as an indication of the likely outcome of economic developments and policies.

Projections for medium-term scenarios should be based on a government's current policy stance, Mr. Ismael continued, and the usefulness of the scenarios would be enhanced if the underlying stance of policies was specified more clearly than hitherto. However, if the staff also intended to require a member country's authorities to specify precisely and explicitly their medium-term policy stance, careful consideration of the practical implications was clearly warranted. For instance, the authorities could conceivably be required to state explicitly the policy stance they intended to maintain over the medium term, in effect, requiring a member country with a Fund-supported program to stipulate its policy intentions for the period after the termination of the program, something that should certainly be avoided. Any requirement of postprogram action--which, in principle, would be similar to prior action--would be entirely inappropriate, as it would deny the authorities any flexibility to respond to changing circumstances. He could accept the staff proposals in paragraph 1 on page 10 only if he received assurance that they were meant merely to refine the use of medium-term scenarios and not to introduce additional conditions on the use of Fund resources.

The staff had mentioned on page 3 (EBS/84/227) that an "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," Mr. Ismael noted. As he understood it, the staff had gone on to suggest that, in such cases, the member country concerned must immediately introduce additional adjustment measures if there was uncertainty about the availability of exceptional financing beyond the program period. That proposal was unacceptable. Medium-term scenarios were merely an indication of possible future developments and should not be the basis on which immediate additional adjustment was required.

He agreed with the staff's conclusion in paragraph 2 on page 10 that the large imbalances faced by many member countries had greatly increased the need for a flexible policy response to unfavorable developments, Mr. Ismael commented. The present procedures for program preparation by the staff and member countries were adequate. The proposal to broaden them by including contingency measures was entirely inappropriate. Such measures would introduce uncertainty and arbitrariness into program preparation. The appropriate time at which to evaluate and, if necessary, to suggest modifications of a program was during a scheduled review.

On page 9 the staff had suggested that, when a country's normal consultation cycle would not result in a consultation being held fairly soon after the end of the country's arrangement with the Fund, it might be appropriate to hold a consultation within six months if the country's outstanding use of Fund resources was unusually large, Mr. Ismael noted. Such consultation could be held only if the member country concerned agreed. As a rule, special consultations should be avoided to the extent possible. Finally, any changes resulting from the present discussion in the practices dealt with in the staff paper should be formally stipulated in an Executive Board decision.

Mr. Zecchini recalled that on previous occasions the Executive Directors had discussed the need to preserve the revolving character of Fund resources and had agreed that it should be a major topic during the present review. Despite earlier discussions of the matter, the Executive Board still did not have a fully satisfactory understanding of the problems involved, and particularly the underlying causes of the increasingly long use of Fund resources by many member countries. In that connection, the present papers--including the various proposals to improve the application of conditionality--were not very helpful. The Executive Board had concluded that prolonged use of Fund resources by a member country was not a problem unless the country had failed to make significant progress toward reaching a sustainable payments position. The matter should be given further thought, so that agreement could be reached on the appropriate degree of Fund involvement in the financing of medium-term adjustment. In particular, thought should be given to a better definition of structural adjustment, the circumstances in which such adjustment should be required, and the design of programs to achieve such adjustment.

He agreed with the staff that medium-term scenarios were useful, Mr. Zecchini said. The scenarios need not be normative, but should be realistic. The factual information and theoretical assumptions on which they were based, the sensitivity of the forecasts to the assumptions, and the degree of uncertainty about the forecasts should be clearly indicated. Sensitivity analysis could be employed to provide alternative scenarios summarizing the two extreme likely outcomes. Those scenarios should indicate the most appropriate courses of action for a member country, thereby eliminating the need for contingency measures that might become a substitute for the early implementation of needed corrective policies.

Supply-side measures were a delicate issue in the field of program design, partly because of the Fund's limited experience with such measures, Mr. Zecchini remarked. The Fund had only recently devoted increasing attention to structural deficiencies that reduced a country's ability to achieve a viable external position over the longer run. He wondered whether adequate attention was paid to the microeconomic conditions that were required for a successful macroeconomic strategy. For example, the

Fund might not have sufficiently examined the structure and working of the domestic markets for products and factors of production--particularly labor--that played a major role in sustaining and intensifying inflationary pressures. Collaboration between the Fund and the World Bank--which had considerable experience with microeconomic issues--could be fruitful. The Fund should insist that, in the context of programs it supported, member countries adopted pricing policies that would ensure that adequate incentives were given to producers, particularly in trade-related sectors. At the same time, the Fund should bear in mind that the responses to supply-side policies significantly differed from one country to the next, depending on their economic structure; accordingly, no single policy prescription would be appropriate in all circumstances. Similarly, a country's response to exchange rate adjustment was shaped by its economic structure and institutional setting, for instance, the degree of indexation in the economy.

As to program implementation and control, Mr. Zecchini said, Executive Directors had insisted that a clear distinction be made between the performance criteria that determined whether a country was entitled to make purchases under a program and the program targets, such as those for the overall balance of payments and the rate of inflation. Policy implementation could be aimed at achieving intermediate targets and final objectives. Intermediate targets were related to the final goals, but as timely data on them were usually available, they could be reviewed in the short run even though they had been set in a longer-term policy framework. Accordingly, it was appropriate to include intermediate targets among the subjects of performance criteria. Policy variables that were seen as final objectives, however, usually could not be influenced with any degree of precision in the short run. When selecting appropriate variables to be subjects of performance criteria, the Fund should ensure that they could be brought under the authorities' control within the period in which they were subject to review, even in the most adverse circumstances. In some recent cases, that principle had not received sufficient attention, particularly when the overall balance of payments or changes in total foreign reserves had been among the performance criteria. In that connection, the staff's suggestion to monitor certain supplementary macroeconomic variables was useful. Those variables could be defined as program targets and regarded as final objectives of economic policy. They could play a particularly important role when a member country had met the program targets but not the performance criteria, or vice versa. In those cases, the program design and the performance criteria should be reconsidered; to the extent possible, the policies that should be adopted in such critical cases should be specified in advance.

More attention should be paid to the need for ex post analysis of Fund-supported programs in order to identify the causes of their success or failure and to suggest possible areas of improvement in program design, Mr. Zecchini considered. That analysis had occasionally been undertaken in an informal fashion, but in future it should be more systematic. For instance, it could be part of a member country's first Article IV consultation following the termination of the country's arrangement with the Fund.

Commenting on Mr. Polak's proposal to include performance criteria for both money and credit expansion for member countries with a high rate of inflation, Mr. Zecchini said that a country facing an external shock could not hope to control both variables at the same time. The growth of credit could be controlled if the demand for money remained stable and the pattern of external factors remained unchanged. However, when an external shock occurred and the authorities concerned wished to ensure both that adequate credit would be available and that an intensification of inflationary pressures would be avoided, the performance criteria would have to be revised to shift the emphasis from controlling credit creation to controlling the growth of money.

Mr. Polak said that he agreed with Mr. Zecchini's final point.

Mr. de Maulde remarked that the conclusions in the staff paper reviewing upper credit tranche arrangements and some conditionality issues seemed to be based on the staff paper on experience with adjustment policies (EBS/84/228). That approach seemed valid in principle, but it was not helpful in practice. The staff had concluded in EBS/84/228 that relatively few of the member countries it had examined had achieved sustainable domestic and external positions; indeed, most of them still had large imbalances. The period covered by the staff's study, essentially 1982-83, was the trough of the worldwide recession that had had particularly adverse effects on users of Fund resources. The poor adjustment record described by the staff was probably attributable as much to the deteriorating world economic environment as to the policies of the member countries concerned; therefore, the results of subsequent adjustment programs were likely to be better, given the improvement in overall economic conditions in 1984.

The proposals in Section IV in EBS/84/227 to improve the design and monitoring of Fund-supported programs--particularly through the use of medium-term scenarios and supplementary monitoring criteria--were appropriate, Mr. de Maulde considered. He hoped that the Fund's approach to adjustment programs would continue to be flexible, and that the proposed improvements would not lengthen staff reports on individual countries.

In paragraph 6 on page 11, the staff seemed to suggest that the Fund should only occasionally provide advice, through the usual Article IV consultations, to member countries that continued to have sizable balance of payments problems following the termination of an arrangement with the Fund, Mr. de Maulde commented. In his view, a much more active approach was warranted. The Fund's main task was to encourage adjustment, and it was obliged to continue to do so after a member had attempted to achieve adjustment under a Fund-supported program. Accordingly, after the completion of a Fund arrangement with a country that still required adjustment, the Fund should provide technical assistance where necessary; and, if the payments disequilibria continued to worsen, the Fund should consider a new adjustment program for the country supported by further access to an appropriate amount of Fund resources.

He agreed with the staff that the provisions of the extended Fund facility remained suitable for dealing with the structural payments problems facing member countries, Mr. de Maulde remarked. The decline in the number of extended arrangements in recent years and the growing preference for one-year arrangements over multiyear arrangements were regrettable and seemed inconsistent with the emphasis the staff had placed on medium-term scenarios and with the goal of increasing cooperation with the World Bank on supply-side measures. Experience suggested that there was no need to change the present guidelines on conditionality, but the implications of the medium-term approach to adjustment programs should not be ignored.

Mr. Almeida said that he had no difficulty accepting the conclusions in paragraphs 1, 3, 4, and 7 on pages 10 and 11 of EBS/84/227. However, the proposal in paragraph 2, regarding specification of contingency measures to be implemented in response to unfavorable developments, showed a lack of understanding of, or sensitivity to, circumstances in many member countries, where the additional measures would decrease the standard of living for populations that had already been strained by the demands of adjustment. The Fund could not hope to foresee every conceivable development in a member country. In any event, since there was considerable uncertainty about most medium-term scenarios, they were not an appropriate basis on which to plan contingency action.

As to paragraph 5, Mr. Almeida went on, the Fund should avoid excessive intervention in the affairs of member countries. Conditions on the use of Fund resources should be spelled out only in clear and simple regular performance criteria, and not in supplementary monitoring criteria.

The proposal in paragraph 6 seemed unnecessary, Mr. Almeida remarked. After all, the Fund already held regular Article IV consultations with most member countries on an annual basis, a practice that had been basically satisfactory. In any event, the reference to "regular" consultations in paragraph 6 was unclear to him. If the staff had in fact meant to suggest holding special consultations within six months following the termination of an arrangement with a member with current or prospective balance of payments difficulties, the staff would have to show that such consultations were legally permissible. Finally, the staff apparently was attempting to use EBS/84/227 to codify the present practices reviewed in the paper. Any codification might well increase the restrictiveness of those practices and should be clearly spelled out in a formal decision.

Mr. Romuâldez said that he agreed with the staff that there was no need to amend either the guidelines on conditionality or the provisions of the extended Fund facility. However, the staff papers had essentially failed to address satisfactorily certain key issues. Apparently the staff felt that only some change in emphasis in present practices might be required, even though it had shown that most Fund-supported programs had fallen considerably short of achieving their objectives. The staff's analytical method in EBS/84/228 was unsatisfactory, and the thrust of some of its suggestions raised fundamental questions about the adequacy of some of the current practices reviewed by the staff. At the present stage, he did not have in mind proposals other than those put forward by the staff, but some of the issues that had not been satisfactorily dealt with in the staff report should be further discussed by the Executive Board in the near future.

The record of achievement under upper credit tranche arrangements had been unsatisfactory, as the paper on experience with adjustment policies (EBS/84/228) clearly showed, Mr. Romuáldez remarked. On page 49, the staff had noted that relatively few of the countries in the sample had achieved sustainable domestic and external positions and that many of them still had large domestic or external imbalances, even though some of the countries had made virtually uninterrupted use of Fund resources since the initiation of their adjustment efforts. In EBS/84/227, the staff had frankly noted that earlier annual reviews had highlighted the fact that, although member countries had made some progress in their adjustment efforts, the amount of adjustment remaining to be accomplished at the end of the period concerned had been substantial. Although the Executive Board had examined the issue of prolonged use of Fund resources on previous occasions, the Board was still in the process of devising ways of handling the issue. More important, the Fund had only an imperfect understanding of the causes of programs' limited success in achieving sustainable improvement in the economies concerned.

In EBS/84/228, the staff had attempted to explain why relatively few member countries sampled had achieved sustainable domestic and external positions, Mr. Romuáldez continued. The conclusions in the paper were similar to those of previous studies. First, the success--or lack of it--of adjustment efforts clearly depended on the adequacy and strength of a country's policies and on the manner in which they were implemented. Larger reductions in external imbalances were typically associated with relatively strong and broad-based adjustment policies. Second, the large and growing domestic and external imbalances in member countries prior to the initiation of adjustment programs usually were due primarily to domestic factors. Hence, sustained reductions in budget deficits, and the introduction of measures aimed at reducing overvalued currencies and at simplifying complex exchange rate systems, were prerequisites for successful adjustment. Third, countries that did not succeed in sufficiently reducing their external current account deficit during the adjustment program period were not always the same countries that faced particularly unfavorable exogenous factors during that period. Fourth, in principle, measures aimed at increasing supply lessened the burden of adjustment borne by domestic demand management, but, in fact, they had frequently been unsatisfactory, partly because of delays in recognizing supply-oriented problems and partly because of the difficulty in formulating and implementing appropriate measures.

The relevance of those conclusions by the staff was questionable, because the staff's analytical method was based on empirical analysis that was insufficiently vigorous and left many key questions unanswered, Mr. Romuáldez continued. The staff paper (EBS/84/228) focused on the issue of the relative roles of program design and implementation. In so doing, it asked mainly two questions, namely, whether Fund-supported programs were well designed for correcting the problems facing the economies of member countries, and whether the authorities concerned had both observed the performance criteria and remained on the adjustment path stipulated by programs. However, the staff paper failed to provide the information and analysis needed to address other important questions. For instance, were member countries with Fund-supported programs able to respond to changing circumstances? Had the Fund's response to the non-observance of performance criteria been appropriate? Had waivers and modifications of performance criteria been granted too readily, and had interruptions and cancellations of programs been excessively rapid? Did programs contain sufficient conditions to ensure that the program targets would be achieved? Was the Fund able to monitor adequately the progress under adjustment programs? Moreover, the staff had paid little attention to the length of time needed for adjustment to be completed. Was the typical period such that consecutive stand-by arrangements were inevitably required? Might the period of adjustment under present Fund practice be contributing to the failure of many authorities to implement programs? Moreover, the staff had provided little additional information with which to analyze the relationship between the degree to which performance criteria were observed and the progress a member country made toward achieving medium-term balance of payments viability. All those matters should be kept under constant review, and the staff's methodology should be improved so that the staff's findings would be more widely acceptable. In passing, the issues raised in the staff papers had led him to support Mr. Kafka's proposal to establish an evaluation unit in the Fund to review programs.

Although EBS/84/228 contained considerable factual material, the staff's empirical analysis did not add much to the debate on the importance of program design versus program implementation, Mr. Romuáldez considered. The focus of the present staff papers reflected suggestions made by Executive Directors during the previous review of upper credit tranche arrangements (EBM/83/156, 11/16/83), when analysis in a longer-term framework had been requested. However, that framework had been requested mainly because of Executive Directors' dissatisfaction with the emphasis under previous reviews on the experience with individual short-term adjustment programs, and on the situation of member countries at the conclusion of a particular arrangement with the Fund, rather than at the time the repurchases in respect of the purchases under the arrangement fell due.

The emphasis in the present papers on a member country's economic position before and after an adjustment period did not fully meet the concerns that had been expressed by Executive Directors about the excessively short-term perspective of the staff's earlier analysis, Mr. Romuáldez went on. While some Executive Directors might well find many of the staff conclusions intuitively appealing, the authorities in a number of member countries would probably find the factual evidence for these conclusions insufficient. The staff's strategy of comparing the situation in member countries before and after adjustment programs were implemented, and of comparing adjustment efforts across countries, was hardly rigorous enough to achieve the staff's limited aim of identifying the effects of policy changes on the attainment of key adjustment objectives. The staff's analysis was flawed because it relied heavily on judgment to isolate the effects of a single policy initiative or response on a number of variables.

It was admittedly difficult to devise broad empirical tests of the staff conclusions, but an effort to do so should certainly be made, Mr. Romuáldez commented. To that end, a more rigorous statement of the principles of program design would be helpful, and the tests of key relationships should be less ambitious and only partly empirical in nature.

The proposals in EBS/84/227 concerning medium-term scenarios were acceptable, Mr. Romuáldez stated. In addition, it would be appropriate to hold a consultation with a member country within six months of the conclusion of its arrangement with the Fund if the country's outstanding use of Fund resources was unusually large, although he sympathized with previous speakers who had said that they were worried that such a practice might result in the overinvolvement of the Fund in a member country's economic affairs.

Many of the other suggestions in Section IV of EBS/84/227 were interesting but were essentially unrelated to the conclusions in EBS/84/228, Mr. Romuáldez observed. Those suggestions seemed to be based on the recognition that exceptions to the rules frequently had implications for adjustment policy design that were as important as the implications for the rules themselves. The suggestion that contingency measures should be available in the event of unfavorable developments seemed attractive in theory but might not be feasible in practice. The proposal reflected the staff's recognition that exogenous developments could undermine the successful implementation of a Fund-supported program. However, the chances that the original corrective measures would be implemented could be reduced by the very existence of contingency measures, partly because they might well introduce rigidities into the process of program implementation. To prevent slippages in implementation, the Fund should approach programs flexibly; accordingly, it should be prepared to revise programs that had been significantly affected by unforeseen developments.

If the idea of contingency measures was to be further examined, certain clarifications would be required, Mr. Romuáldez said. For instance, it was not clear to him where the responsibility would lie in the event a member country did not implement contingency policies. Would the authorities be blamed for having failed to implement policies in a flexible manner, or would the designers of the adjustment program be blamed for having failed to build flexibility into the formulation and implementation of adjustment policies? In his view, the formulation of contingency measures should be regarded as a shared responsibility. He doubted whether it would be appropriate to base a requirement for contingency policies on the present general undertaking by a member country to adopt additional measures as necessary to meet the objectives of its Fund-supported program. It might be worthwhile to explore the possibility of determining, at the time of the formulation of an adjustment program, contingency actions that would be triggered when economic conditions had become less favorable than assumed by the drafters of the program.

At first glance, the proposal to introduce supplementary monitoring of aggregates that were not suitable subjects of normal performance criteria seemed sensible, Mr. Romuáldez remarked. However, on closer examination, it seemed inconsistent with the indication given by the staff during the previous review that there was a clear correlation between the observance of performance criteria and the achievement of adjustment objectives. The implication that supplementary monitoring criteria were required in some cases was an obvious admission that the design of conventional Fund-supported programs was often inadequate, a possibility that should be examined in greater detail. The use of supplementary monitoring criteria in some recent cases seemed to constitute a de facto change in the guidelines on conditionality.

The staff's suggestion to pay appropriate attention to the formulation and implementation of supply-side measures went to the heart of the challenge posed by the gap between the expectations for, and actual experience with, many Fund-supported programs, Mr. Romuáldez considered. As the staff had noted, efforts in recent years to identify the appropriate amount of adjustment for member countries had led the staff and authorities to pay greater attention to the need to solve structural problems. At the same time, the analytical distinction between balance of payments issues and medium-term economic development issues had become more blurred than in the past, as it had been increasingly recognized that balance of payments problems could have both structural and short-term demand dimensions. Although increased attention had been paid under adjustment programs to improving the ability of member countries' economies to supply goods and services for export and domestic use, the staff had clearly concluded that experience with efforts to solve structural problems had frequently been considerably less than satisfactory. He agreed with the staff that, if adjustment programs were to be more successful in solving the economic and financial payments problems facing member countries, the source and importance of supply constraints had to be recognized at an early stage, and greater recognition would have to be given to the administrative and other problems that delayed the formulation and implementation of corrective policies.

However, those steps alone were unlikely to be sufficient, Mr. Romuáldez continued. The Fund would have to reconsider its role in tackling the structural balance of payments problems in member countries; indeed, the time was ripe for a fundamental examination of the relevant Fund policies. The Fund might have to decide whether it should either withdraw from its involvement in helping member countries to solve basically structural problems and concentrate instead on dealing with temporary balance of payments difficulties, or adopt policies better suited to achieving medium-term structural adjustment. In his view, a greater effort should be made to formulate programs that had a good chance of helping member countries to solve structural problems. To that end, the duration of Fund-supported programs might well have to be extended. After all, by definition, structural adjustment took more time than changes in demand management. The years following a normal stand-by or extended arrangement were of critical importance for member countries but were not characterized by the extensive monitoring typical of periods of adjustment under a Fund-supported program. In any event, in all the program design and implementation areas he had mentioned, closer and more extensive cooperation between the Fund and the World Bank would make a significant contribution, particularly in the light of the World Bank's experience and interest in institution building, sector development, and medium-term development strategies. Moreover, the World Bank was usually involved on a continuing basis in a member country, maintaining a close dialogue with the authorities.

Mr. Yamashita said that he broadly endorsed the thrust of the staff conclusions. Early implementation of required adjustment measures was one of the keys to success under Fund-supported programs. The experience with adjustment policies suggested that rapid adjustment clearly reduced the risk that the size of the remaining adjustment would be substantially increased by unforeseen unfavorable developments. In general, the authorities of a country with a Fund-supported program should respond to unexpected adverse developments in a flexible manner, implementing measures that would accelerate adjustment.

The suggested inclusion of a safety margin to provide for rapid adaptation of policies to changing circumstances might well be useful, Mr. Yamashita remarked. However, the extent and form of safety margins should be determined on a case-by-case basis. Contingency measures specified when an adjustment program was formulated should also be determined on a case-by-case basis. He strongly agreed with the staff that contingency measures should not become substitutes for the early implementation of needed corrective policies.

On program design, Mr. Yamashita noted that domestic factors, such as large or growing fiscal imbalances and overvalued exchange rates, were primary factors underlying the difficulties faced by many member countries. Adjustment policy should be directed toward eliminating the ultimate sources of such economic imbalances. In that context, due attention should also be paid to structural problems.

In most cases, the usual quantified performance criteria provided an adequate means of monitoring program performance, Mr. Yamashita said. Supplementary monitoring might be necessary in exceptional circumstances, particularly for a country where a high rate of inflation had jeopardized the implementation of the adjustment program. In that connection, Mr. Polak's proposal to include double performance criteria to ensure that both external balance and inflation targets were achieved, warranted further consideration. The present procedures under which supplementary monitoring criteria triggered discussions by the staff with authorities were appropriate.

Adjustment measures might well be needed even after the termination of an arrangement with the Fund, Mr. Yamashita remarked. Article IV consultations were the primary means of continuing to assess a member country's policy stance after the termination of its arrangement with the Fund. Accordingly, he agreed with the staff that it might be appropriate to hold such a consultation with a member country within six months of the conclusion of its arrangement. Finally, he agreed with the staff that the guidelines on conditionality and the provisions of the extended Fund facility remained suitable and should be reviewed again no later than December 31, 1985.

Mr. Grosche stated that he broadly agreed with the staff. In particular, the guidelines on conditionality and the provisions of the extended Fund facility remained a suitable basis for the application of Fund policies on the use of its resources in general and for dealing with structural payments problems in particular. However, the rate of success of Fund-supported adjustment programs was unsatisfactory, and he fully agreed with the staff that several changes in present practices and procedures might be worth considering to improve the design and implementation of programs. Most of the staff's suggestions provided for realistic and efficient remedies to the various problems described in the staff papers.

As to the proposals on pages 10 and 11 of EBS/84/227, Mr. Grosche went on, medium-term scenarios had proved a valuable instrument for evaluating the desirable intensity of current and prospective adjustment policies. As Mr. Polak had suggested, more than one medium-term scenario should be presented in each case, if possible. The scenarios should be used flexibly, and adaptable to changing circumstances, and should take into account the advice of the World Bank. Although medium-term scenarios might well have limited value in forecasting developments in many countries, they would probably continue to be helpful because they clearly showed the likely results on the basis of specified assumptions, and the need for, and desired speed of, adjustment.

In principle, the contingency measures proposed by the staff could be implemented promptly when unfavorable developments suggested that slippages might occur, Mr. Grosche commented. In fact, however, he doubted whether such measures would prove necessary or helpful. After all, program reviews already provided an opportunity to examine a country's policy stance in depth and usually brought to light the need for prompt policy changes. Furthermore, the stipulation of contingency measures ran the risk that the actual program measures might not be sufficiently stringent. In sum, there was no strong need to include contingency measures. When the successful implementation of a program was threatened by particularly adverse developments, the appropriate response by the Fund might well be to shorten the period between program reviews.

Commenting on the design of adjustment programs, Mr. Grosche said that he welcomed the staff's intention to pay more attention to the constraints on the application of policy instruments. The staff's intention to provide a more detailed explanation of the reasons why it gave more weight to some policy instruments than to others in various individual adjustment programs was also welcome.

The staff had appropriately stressed the importance of quantitative performance criteria in monitoring a Fund-supported program, Mr. Grosche commented. In some instances, the performance criteria had been observed, but the program objectives had not been achieved. The staff's efforts to devise means to indicate at an early stage when a member country was having difficulty in implementing its program were certainly helpful. In that context, the staff had noted that supplementary monitoring criteria had been used in exceptional circumstances and, in the most serious cases, their nonobservance had triggered a supplementary review to examine and possibly modify the performance criteria. Supplementary monitoring was particularly appropriate for member countries with a high and volatile rate of inflation that made it particularly difficult to determine meaningful normal performance criteria. Hence, he could accept the staff's proposal to make supplementary monitoring criteria more binding on member countries. Additional consultations and reviews of regular performance criteria whenever supplementary criteria were not observed should become standard procedure. Moreover, supplementary criteria could be applied more frequently, on an experimental basis, to determine whether they improved program implementation evaluaton; that approach admittedly might be thought to involve an excessively heavy burden on the staff and on the authorities concerned.

He fully endorsed the staff view that Article IV consultations should remain the primary instrument of Fund surveillance, Mr. Grosche remarked. The proposal to hold a consultation within six months after the end of an arrangement with a country whose outstanding use of Fund resources was unusually large had merit; although he agreed with Mr. de Groote that the expected benefits of that approach should not be overemphasized, further analysis of it in the near future might well be useful. Finally, the proposed presentation of medium-term scenarios for nonprogram countries with current or prospective external payments problems was welcome.

Mr. Nimatallah said that recent experience showed that, in some cases, program objectives had not been achieved even though all the performance criteria had been observed; therefore, the staff proposals in EBS/84/227 to increase the effectiveness of Fund-supported programs were welcome.

Both the Fund and member countries shared the objective of making adjustment programs more effective, Mr. Nimatallah continued. The staff had not suggested that its proposals should be included forthwith in the guidelines on the use of Fund resources; however, the possibility of incorporating the proposals accepted at the present meeting was worth exploring. Whatever the Executive Board decided, two points should be borne in mind. First, the Fund should continue to apply the relevant procedures flexibly and with discretion. Second, it should ensure that, to the extent feasible, member countries were aware in advance of all the possible conditions that could apply to their use of Fund resources.

Some Executive Directors believed that there was no need to formalize the relevant existing procedures, Mr. Nimatallah noted. They had argued that, if the procedures were formalized, they would become applicable in all cases as a matter of course. Other Executive Directors felt that the procedures should be formalized in an Executive Board decision to ensure uniform treatment of all member countries; however, those Directors believed that the agreed procedures would not have to be applied in all cases but should be used only when necessary and with discretion, so that no member country to which the procedures were being applied would feel that it was being discriminated against. He had an open mind on the matter, although he tended to agree with the second group, since member countries undertaking adjustment programs should be aware of uniform treatment as well as of the procedures that could be applied.

It was with those goals in mind that he had considered the staff proposal to include supplementary monitoring criteria in Fund-supported programs, Mr. Nimatallah continued. He agreed that every effort should be made to avoid a lack of correspondence between the observance of performance criteria and the achievement of program targets; otherwise, the credibility of Fund-supported programs might well be undermined. Contingency measures had been a familiar, albeit informal, feature of many Fund-supported programs and had apparently worked well. In principle, therefore, it could be useful to have formal supplementary monitoring devices available for use when needed. That approach would be consistent with the principles of uniform treatment. The supplementary monitoring should be applied with flexibility and discretion.

As to the assessment of the size and speed of adjustment, Mr. Nimatallah remarked, medium-term scenarios provided a useful analytical framework, and he endorsed the staff proposals to enhance their effectiveness. One way to do so was by monitoring progress on adjustment beyond the period covered by an arrangement with the Fund; in that connection, more frequent consultations would be useful, where appropriate. The Fund could then continue to play its role as a catalyst for additional financing needed by member countries. Finally, he looked forward to the staff's comments on Mr. Polak's suggestions concerning the size and speed of adjustment.

Mr. Zhang considered that Fund conditionality had been further tightened during the previous year. The use of medium-term scenarios was welcome, but it was not always clear to him which model for projecting medium-term changes in member countries was used in individual cases and how the parameters of major variables were determined. The most uncertain factor in medium-term projections was the world economy; unforeseen developments could upset the forecasts underlying even the best-designed adjustment program. Hence, while the medium-term approach was admittedly useful, its limitations should be borne in mind. Normative medium-term scenarios should not be used.

He doubted whether contingency measures and "safety margins" would be beneficial, Mr. Zhang continued. The staff had contended that they introduced flexibility into a program. In fact, the opposite seemed likely, as it was impracticable to design contingency measures to deal with all possible unexpected developments, and establishing such measures at the beginning of a program period substantially limited the authorities' room for maneuver later. In any event, experience had shown that, whether or not contingency measures had been established, a government implementing an adjustment program usually had difficulty in altering its content and direction in response to an unexpected payments deficit generated by exogenous factors. More important, it was generally recognized that the short-term shock treatment required under Fund-supported programs already pushed member countries' adjustment efforts to the limit. It was unrealistic to speed up or intensify the pace of adjustment, particularly in low-income countries. Requiring contingency measures in the initial stage of adjustment was tantamount to increasing conditionality, something that should be avoided. The normal review procedures seemed sufficient to examine any need for program modifications or additional measures that might arise.

Strengthening a country's payments position was invariably the main objective of Fund-supported programs, Mr. Zhang said, while growth, development, and income distribution were ignored. It had become increasingly clear in recent years that that set of priorities did not help to solve the problems facing many member countries that had been attempting to increase their debt servicing capacity and to reduce high rates of domestic inflation. Moreover, Fund-supported programs reflected essentially purely economic analysis and were based on the assumption that macroeconomic instruments would be effectively and properly implemented.

A rigid interpretation of the principle of uniform treatment of members was also inherent in the concept of program design, Mr. Zhang considered, because there was no recognition of the important fact that adjustment methods must vary according to the level of economic development of individual member countries. Similarly, the characteristics and special needs of planned economies had often been underplayed. In particular, the supply-oriented structural adjustment measures advocated by the Fund had been designed mainly to eliminate so-called rigidities and required a reduction in the role of the government in economic activity and the restoration of the full play of market forces. The assumption was that the supply response of agricultural and other traditional exports could then be expected to be highly price elastic. In fact, meaningful medium-term supply policies should take into account needed steps to increase, or change the pattern of, investment and productivity in those sectors. In his view, Fund-supported programs had not included genuinely supply-oriented policies.

The discussion on performance criteria in paragraph 4 on page 11 of EBS/84/227 was acceptable, although it was inconsistent with actual practice, Mr. Zhang commented. In some recent cases, the number and complexity of performance criteria had been increased, thereby becoming significantly greater than normal and compounding the difficulties in implementing adjustment measures in countries lacking well-developed financial institutions and management. In addition, structural reform measures had sometimes been required as prior actions, resulting in an increase in conditionality that was a departure from the Fund's regular practice.

In principle, he opposed the formal introduction of supplementary monitoring criteria, Mr. Zhang remarked. They would involve excessive interference in a country's internal economic policies. Regular reviews were generally sufficient to deal with the problems that supplementary criteria were meant to address.

The staff had suggested holding special consultations in certain cases within six months after an arrangement had ended, Mr. Zhang noted. Presumably the decision to hold such consultations would be made by the Fund. The staff should comment further on the circumstances in which such consultations would take place and the staff's intentions for them. He wondered whether the purpose of such consultations would not be served by regular Article IV consultations.

He agreed with the staff that no change in the guidelines on conditionality was required at present, Mr. Zhang said. Appropriate conditionality must be applied under Fund-supported programs. However, it was not always realistic and reasonable to expect full implementation of programs by developing countries that had to contend with adverse economic, political, and social conditions when highly developed countries often had difficulty in maintaining appropriate policies.

The analysis in EBS/84/232 raised the question whether it was appropriate for the Fund simultaneously to give a number of member countries the same exchange rate policy advice, Mr. Zhang continued. The staff believed that nearly every country with a Fund-supported program should aim to improve its competitive position through a sizable real depreciation of the exchange rate, compared with the rate in, say, 1978, in response to the general worsening of external conditions since then, including adverse terms of trade, higher interest rates, and reduced international lending. That advice was appropriate as long as it was applied to a small number of countries whose payments problems had been caused by the particular conditions in those countries, rather than by generally adverse external conditions. In those instances, it was realistic to assume that a country's export competitiveness could be increased without affecting the world market prices for its principal export. That assumption did not hold when, because of a general worsening of external conditions, many countries used Fund resources and several major producers of important export commodities were advised by the Fund to improve their competitive position through a large real depreciation of the exchange rate. For instance, if several copper exporting countries were advised to lower their exchange rate substantially, he doubted whether the profitability of the copper industry in those countries would be increased and the output and activity of those countries would be protected. If the world demand for copper was not price elastic in the short run, copper companies in the various producing centers might compete with one another by lowering copper prices, thereby worsening the terms of trade in those countries.

In some instances, the devaluation recommended by the Fund was aimed mainly at restoring the real value of export producers' prices to compensate for the effects of movements in relative inflation rates and for a worsening of the terms of trade, Mr. Zhang noted. Restoring the real value of prices was a reasonable objective, but trying to maintain profitability in the face of a secular decline in world demand might be unreasonable. If the decline in export prices was cyclical, an exchange rate adjustment would not be the appropriate instrument for achieving price stabilization.

The Fund should proceed cautiously in advocating attempts to improve competitiveness through exchange rate depreciation in countries with a relatively small range of feasible exports in the short run, particularly if the demand for those exports was not price elastic, Mr. Zhang commented. The Fund should not overlook elasticity considerations. Although elasticities were difficult to estimate, they must be taken into account in the formulation of a medium-term scenario for any developing country. Medium-term gains from strengthening competitiveness could not be assessed unless the elasticity of supply in response to changes in relative prices for tradables and nontradables in the country concerned, and the elasticity of the export markets to increases in supply, were taken into account.

The principle of uniformity had been overemphasized in the design and implementation of Fund-supported programs, while insufficient attention had been paid to the need for a variety of methods of adjustment, depending on the level of development of individual countries, Mr. Zhang remarked. It was important to distinguish between countries that were capable of producing a considerable range of goods and had ready access to world markets, and countries that lacked those advantages.

The discussion in Section IV of EBS/84/232 gave the impression that the analysis of the need for exchange rate changes was usually based on the trend in competitiveness as measured by estimates in the movement of the real effective exchange rate which in turn was based on the consumer price index, Mr. Zhang said. The staff had clearly described the shortcomings of an indicator of changes in competitiveness based on the consumer price index. Nevertheless, the staff had concluded, it preferred the real effective exchange rate as an indicator of the need for depreciation because "competitiveness--relative profitability--as a concept is relatively easy to interpret and discuss." In fact, however, measures of competitiveness based on estimates of the real effective exchange rate--and thus on the consumer price index--were difficult to interpret, and in most developing countries they were not a rational basis on which to make exchange rate decisions.

The staff had concluded that a devaluation recommended by the Fund was based on the need for export expansion and market-oriented allocation of imports as a means of achieving external adjustment, thereby reducing the need for policies that were detrimental to growth, Mr. Zhang noted. He wondered whether, when foreign exchange was scarce and trade restrictions were in force, market-oriented allocation of imports did not in fact undermine growth.

The staff's argument that a member country should decide on a large initial devaluation--rather than a gradual change--was unconvincing, Mr. Zhang said. Such a decision would send a clear signal to producers only if they did not expect it to cause an intensification of inflation or an increase in hoarding of imports. The staff apparently meant to suggest that a sharp devaluation was not painful, and that a more gradual approach slowed adjustment and increased the pain it caused. That conclusion might well be unwarranted. While a country might be able to devalue by a moderate extent without provoking any resistance among domestic groups, a sharp devaluation was likely to be followed by widespread pressures for compensatory wage and price adjustments that would intensify the inflationary forces that had persisted in many countries in recent years.

The Executive Directors agreed to continue their discussion in the afternoon.

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/84/173 (12/3/84) and EBM/84/174 (12/5/84).

3. MAURITIANIA - 1984 ARTICLE IV CONSULTATION - POSTPONEMENT

Notwithstanding the period of three months specified in Procedure II of the document entitled "Surveillance over Exchange Rate Policies" attached to Decision No. 5392-(77/63), adopted April 29, 1977, the Executive Board agrees to extend the period for completing the 1984 Article IV consultation with Mauritiania to not later than December 10, 1984. (EBD/84/306, 11/30/84)

Decision No. 7856-(84/174), adopted
December 4, 1984

4. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors as set forth in EBAP/84/258 (11/30/84) and EBAP/84/259 (12/3/84) is approved.

APPROVED: August 28, 1985

JOSEPH W. LANG, JR.
Acting Secretary