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Minutes of Executive Board Meeting 84/175

3:00 p.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 |
| | G. E. L. Nguyen, Temporary |
| | T. Alhaimus |
| | K. Murakami, Temporary |
| G. Grosche | |
| J. E. Ismael | Jaafar A. |
| R. K. Joyce | |
| | J. R. N. Almeida, Temporary |
| R. N. Malhotra | A. S. Jayawardena |
| | S. M. Hassan, Temporary |
| F. L. Nebbia | B. Jensen |
| | J. E. Suraisry |
| | G. Ortiz |
| J. J. Polak | T. de Vries |
| | A. V. Romuáldez |
| G. Salehkhou | O. Kabbaj |
| J. Tvedt | |
| | T. A. Clark |
| S. Zecchini | N. Coumbis |
| Zhang Z. | Wang E. |

L. Van Houtven, Secretary
J. C. Corr, Assistant

Also Present
Exchange and Trade Relations Department: C. D. Finch, Director; W. A. Beveridge, Deputy Director; G. Belanger, J. Berengaut, C. Brachet, E. H. Brau, H. W. Gerhard, G. G. Johnson, S. Kanesa-Thasan, D. A. Lipton, P. Newhaus, R. L. Sheehy, P. M. Thomsen, E. J. Zervoudakis. External Relations Department: R. M. Stough. Fiscal Affairs Department: W. R. Mahler. Legal Department: G. P. Nicoletopoulos, Director; W. E. Holder, Ph. Lachman, A. O. Liuksila. Research Department: W. C. Hood, Economic Counsellor and Director; A. D. Crockett, Deputy Director; R. R. Rhomberg, Deputy Director. Treasurer's Department: S. I. Fawzi, Q. M. Hafiz. Western Hemisphere Department: C. M. Loser. Personal Assistant to the Managing Director: S. P. Collins. Advisors to Executive Directors: D. Hammann, P. Péterfalvy, A. Steinberg, E. M. Taha, A. Vasudevan. Assistants to Executive Directors: H. Alaoui-Abdallaoui, I. Angeloni, Chen J., L. E. J. M. Coene, V. Govindarajan, N. Haque, G. D. Hodgson, S. Kolb, A Koné, M. Lundsager, A. Mustafa, E. Olsen, T. Ramtoolah, J. Reddy, D. J. Robinson, J. E. Rodríguez, A. A. Scholten, Shao Z., A. J. Tregilgas, E. L. Walker, B. D. White, A. Yasseri.

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

The Executive Directors resumed from the previous meeting (EBM/84/174, 12/5/84) their consideration of 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. Clark observed that the previous decade had seen dramatic changes in the economic fortunes of many countries. The policies that had been followed in the 1960s and early 1970s had proved unsustainable in the face of external price shocks, widening fiscal deficits, faster inflation, accumulating debt, volatile exchange rates, and so on. Perhaps as important, structural problems--for example, misalignment of relative prices, overextension of public spending programs, institutional rigidities--that had previously been hidden or ignored had been brought starkly into the open. Against that background, the process of adjustment had become much more difficult. It was not surprising, albeit disappointing, that so many countries had yet to restore economic viability. Of the sample of 25 countries mentioned by the staff in EBS/84/228, only 3 were classified as having a "small" balance of payments deficit and "low" inflation four years after initiating adjustment. Although the external environment had played a role, as Mr. de Maulde had suggested, it was not clear that the situation would have been much different if the environment had been more favorable. The staff's analysis of the adjustment experience in those 25 countries confirmed the validity of the three basic principles of adjustment. First, adjustment measures had to tackle the underlying sources of imbalances; second, comprehensive action was better than partial action; and, third, the probability of eventual success was proportional to the strength and the promptness of the initial policy measures. Although those principles were easier to state than to follow, they remained the right basis for the design of adjustment programs.

The staff did not give a clear indication of how far the disappointing adjustment experience in a number of countries had reflected inadequate program implementation, failure to react to external circumstances, or poor design of the program, Mr. Clark continued. The question was difficult, perhaps impossible, to answer with confidence at present. Even in countries where much time and substantial resources had been devoted to building models of the economy, tracing the effect of external shocks and policy changes often remained as elusive a goal as ever. However, it would be surprising if there were not room for improvement in program design--whatever the role of other factors--and, in that regard, the staff made a number of useful suggestions.

He fully agreed with the staff's views on structural problems, Mr. Clark stated, which had assumed increased importance in recent years. Appropriate structural policies made adjustment less costly in terms of foregone output, thereby enhancing the chances of success and improving the prospects for longer-term growth. It was somewhat surprising, therefore, that the staff had not referred in its conclusions to the role of the World Bank in that area, particularly since the staff had emphasized the difficulty of diagnosing structural problems accurately and of formulating the appropriate policy response.

Medium-term scenarios had two main uses, Mr. Clark considered. First, they served as a frame of reference for judging the current stance of policies. However, any set of projections was a reflection of the assumptions on which it was based. He agreed with the staff, therefore, that those assumptions needed to be spelled out clearly, and not only policy assumptions but also other major assumptions, in particular, those relating to external prices. A second role of medium-term projections was to help to evaluate the robustness of programs. As the Chairman had said at the conclusion of the Executive Board discussion of conditionality in 1983 (EBM/83/156, 11/16/83): "I also agree with the idea of sensitivity alternatives [sic] for medium-term scenarios. It will be useful to have a set of alternative assumptions regarding some sensitive key parameters. Among other things, it could help us detect early slippages, and facilitate contingency action to cope with situations that turn out to be quite different from what we had expected." It was therefore disappointing to find that, with some exceptions, there had been relatively few sensitivity analyses in the papers presented to the Board during the past year. In that period, the Executive Board had discussed papers relating to use of Fund resources by 40 countries; medium-term scenarios had been included in almost all those papers, but a quantitative sensitivity analysis had been attempted only for 9 countries. For 3 of those countries, some indication of the effects of changes in key assumptions had been given; for 5 others, some quantification of the effect of stronger or weaker adjustment efforts had been presented; and in 1 case, both approaches had been included. He hoped that in the future it would be possible to include sensitivity analyses much more frequently.

Speaking personally, Mr. Clark recalled that reference had frequently been made in the Executive Board to the prolonged use of Fund resources. While it would be idle to pretend that there was a simple remedy either to existing cases or to the prevention of further cases, it would be helpful if proposed programs were judged against a medium-term scenario that gave a plausible indication of how external balance could eventually be restored. If it was not possible to construct such a scenario--even under generous assumptions about external prospects--the Fund could hardly be surprised if the problem of prolonged use persisted.

Contingency measures could usefully be included in programs in certain circumstances, Mr. Clark went on, especially if a program was vulnerable to an easily identifiable shock, such as a fall in copper prices. However, if it was less easy to define contingencies, attempts to specify policy packages in advance might not be useful. Nevertheless, it would only be sensible for the authorities and the staff to establish a clear understanding in advance of what policy measures could be adopted if further adjustment was needed. A suitable policy package could then be put together promptly in response to unexpected developments.

Commenting on program monitoring, particularly the question of supplementary monitoring criteria, Mr. Clark said that, in accordance with the guidelines on conditionality, the variables essential to the implementation of a program that were effectively monitorable and that were reasonably accessible to the authorities' control should be specified as formal performance criteria. In most programs, those conditions would be sufficient, but there were two important cases in which they might not be met. First, the linkages between the variables traditionally used in performance criteria and the ultimate program objectives could be broken, unstable, or uncertain. Such a situation might occur when, for example, past economic relationships had broken down because of high inflation, or because one objective of the program itself was to achieve changes in the economic structure. The problem might also arise where significant parts of an economy were subject to direct government control. In such cases, it could be appropriate to make sparing use of supplementary monitoring criteria that could trigger consultations or, exceptionally, a review. However, if effective program design proved particularly difficult, the best course might simply be to hold regular reviews.

A second occasion on which supplementary criteria might be considered would be if the linkages were reasonably well understood but the preferred performance criterion could not be monitored satisfactorily, Mr. Clark went on. A second-best performance criterion would, therefore, be necessary even though it might be less closely related to the ultimate objective. An example might be the use of net domestic assets of the central bank--rather than of the banking system as a whole--in a number of programs. In such instances, an improvement in statistical reporting was an obvious requirement, perhaps with technical assistance from the Fund or the Bank. However, that approach would not produce immediate results; in the meantime, the first-choice variable might be designated as a supplementary monitoring criterion, it being understood that slippages would trigger discussions with the authorities.

The staff suggested that Article IV consultations could be held within six months of the conclusion of arrangements when the outstanding use of Fund resources was unusually large, Mr. Clark noted. While that innovation might be useful, the question of adding further to the staff's work load was pertinent. Perhaps it would be helpful to bring Article IV consultations forward in cases where there had been a significant economic deterioration since the previous discussion with the authorities.

Commenting on EBS/84/232, Mr. Clark remarked that the staff clearly showed that, if exchange rates were out of line, prompt and vigorous action was crucial. He agreed with the view that a comprehensive discussion of exchange rate action and its likely effects were desirable when programs were proposed for Executive Board approval; he encouraged the staff to indicate clearly any doubts or uncertainties that it might have in that regard. While the need for confidentiality was an important and genuine constraint, as much information as possible on exchange rate plans should be reported to the Board, preferably in the staff paper. When "last minute" prior actions were required, the staff should consider delaying circulation of papers until the action had been completed, even though doing so might delay a purchase. Exchange rate policy was crucial in the adjustment process; further work could usefully be carried out on a number of aspects. Finally, the guidelines on conditionality set out in Decision No. 6056-(79/38), adopted March 2, 1979 and the provisions of the extended Fund facility remained appropriate.

Mr. Alhaimus commented that in its review of upper credit tranche arrangements and issues of conditionality in EBS/84/227, the staff pointed out that experience thus far confirmed that substantial adjustment frequently remained to be accomplished at the end of the program period. In EBS/84/228, the staff concluded that relatively few of the 25 countries sampled had achieved domestic and external balance. The staff also attempted to recognize the complex and multifaceted nature of the difficulties impeding better performance, although it had perhaps not fully recognized the impact of recessionary conditions in the world economy on performance in recent years, as Mr. de Maulde had observed. Experience had shown that many of the difficulties encountered could have been overcome if a better understanding of the working of the economic system and the behavior of the main variables had led to programs better adapted to the particular problems facing a country. Unfortunately, certain aspects of the staff's suggestions seemed to assume that better results could be ensured by adding new instruments and further provisions of both a formal and informal nature. In that regard, he shared many of the concerns expressed by other Directors.

The wider use of medium-term scenarios, which the Executive Board had encouraged on the occasion of the 1983 review of conditionality, had already added a new dimension to the analysis of countries' programs and raised useful issues for discussion, Mr. Alhaimus continued. It was understandable that the staff should emphasize the need for more clarity in the policy assumptions underlying those scenarios. In his concluding remarks at the end of the previous year's discussion, the Chairman had stated that the staff should be more explicit than it had been in indicating the major assumptions on which those exercises were based. The one aspect of the exercise that appeared to have been explored only in a limited number of cases was the preparation of alternative scenarios. Again, the Chairman's concluding remarks had been explicit in calling for sensitivity analysis in medium-term scenarios and on the need for a set of alternative assumptions regarding "some sensitive key parameters." Perhaps some of the difficulties in determining the appropriate set of assumptions could be eased if more than one alternative was considered. Of course, the staff was correct when it stated that there were "inherent limitations of medium-term projections and...future conditions and policies are often very uncertain...." Consequently, the highly tentative nature of the exercise in the present state of the art might not be a suitable basis for definite policy action of the kind suggested by the staff to handle the problem of ex ante balance of payments financing gaps. The need to avoid a "dogmatic or mechanistic" approach had been affirmed during the 1983 discussion and should be stressed again. A more elaborate presentation of medium-term scenarios in staff papers on individual members should improve understanding of the various issues involved. Thus far, treatment of those scenarios had been somewhat sketchy in some staff reports.

The second issue raised by the staff in EBS/84/227, namely, the need for flexible policy implementation, posed a legitimate question with regard to the course of action to be taken if unexpected adverse circumstances should threaten to disrupt a program and possibly lead to its eventual termination, Mr. Alhaimus considered. In such circumstances, and because adverse developments were hard to predict, provision for further consultation with the authorities might be sufficient to address the difficulties that might have arisen. One problem with precise contingency measures was that future unexpected developments might involve not only one factor, such as an export commodity, but a number of other factors having a bearing on the overall picture. Consequently, it would be particularly difficult in such cases to prescribe contingency measures that took into account all the key elements of the new environment. In some cases, however, where unexpected developments had led repeatedly to incomplete adjustment under previous arrangements, an understanding on contingency measures, rather than a formal requirement, might prove to be a sufficient assurance that actions would be set in motion to address a problem if it arose.

The significant impact of structural factors on developing countries' abilities to adjust had been repeatedly pointed out in various forums, including the Executive Board, Mr. Alhaimus observed. A better understanding of such factors should contribute to a more realistic approach to the reform and pace of adjustment in those countries. An encouraging feature of the papers before Directors was the broader concept of structural issues and the recognition that the difficulties extended well beyond the price system normally emphasized in Fund programs. Various other factors had been cited by the staff, including the inadequately developed productive base, weak infrastructure, low absolute levels of income, and fragile administrative capacity. More attention should certainly be devoted to a deeper understanding of structural factors and to the conditions most conducive to easing structural constraints. However, there were serious questions with regard to some of the staff's ideas in that area, particularly the suggestion to incorporate in staff papers on requests for the use of Fund resources a reference to the set of policy measures that, in the absence of structural limitations, "would provide the best means to redress the particular economic and financial imbalances faced by the country." Such an approach might be possible where structural limitations could be dealt with through normal policy measures, but it could be fruitless if structural limitations were deeply entrenched in the social or cultural fabric. Obviously, in those circumstances, such limitations should be treated as part of the environment in the country and not brought within the scope of a particular model of adjustment.

The issues raised by the staff on performance criteria related essentially to the circumstances in which supplementary criteria would be used and the kinds of procedures that would be initiated, Mr. Alhaimus noted. The staff indicated that thus far recourse to supplementary monitoring had been confined to exceptional circumstances. It would be appropriate to continue that cautious approach, which maintained the primacy of traditional criteria that had worked fairly well. The use of supplementary criteria as a trigger of supplementary reviews that could lead to modification of performance criteria should be avoided because it added a considerable element of uncertainty to Fund programs. Problems could also rise if objectives were to be used as performance criteria. In the words of the guidelines on conditionality, "performance criteria will be limited to those that are necessary to evaluate implementation of the program with a view to ensuring the achievement of its objectives." Logically, therefore, objectives themselves could not be used as performance criteria without blurring the lines between objectives and the process of monitoring.

With regard to the monitoring of progress beyond the period covered by an arrangement, Mr. Alhaimus went on, it was reasonable to assume that both the country and the Fund would be interested in further contacts beyond the program period. There was no obvious need to formalize procedures for special consultations that could very well be left to the initiative of the member. However, there was a need for the Fund to evaluate progress made by the country in achieving the objectives of the arrangement. It would be useful in that respect, as Mr. Zecchini had already suggested, if subsequent staff reports following the arrangement could include an assessment of performance and the suitability of the program design. Such an approach might eventually supplement the present annual review of upper credit tranche arrangements by a continuous process of reviews.

The staff noted that "the number of extended arrangements has declined sharply in recent years, to only six since 1981," Mr. Alhaimus said. At the same time, one of the conclusions in EBS/84/228 was that the prospects for adjustment were enhanced when corrective policies "addressed simultaneously significant problems in most major areas of policy." In light of that conclusion, an extended arrangement might be the more suitable format for a comprehensive effort to tackle a broad spectrum of major policy areas. It was also regrettable that, whereas experience had argued for more emphasis on structural aspects of adjustment, as demonstrated by the staff in the papers before Directors, Fund arrangements had increasingly shifted in the opposite direction, away from extended arrangements.

Mr. Alfidja remarked that the present review gave Directors the opportunity to draw lessons from the experience with stand-by and extended arrangements and the application of conditionality and, thus, to decide how best the Fund could continue to play its general surveillance role and the related role of providing financial support for members' adjustment programs. Judged against the background of the recent financial problems confronting many member countries in the developing world, especially those in Africa, the inescapable conclusion was that some of the ideas and suggestions contained in the staff papers were discouraging. The staff first gave the impression that the present guidelines on conditionality were to be tightened further and, second, that the provisions governing the use of Fund facilities would be more mechanistic in their application than before. The staff also gave the impression that an attempt was being made to codify Fund procedures and practices so as to make them more restrictive, thereby weakening the flexibility and pragmatism with which those procedures had been followed. However, the staff did not propose--and rightly so--that its suggestions should be codified and adopted in the form of a decision. Such a proposal would have been inconsistent with the staff's own conclusion in paragraph 7 of Section IV of EBS/84/227. In that connection, he shared the views expressed by Mr. Ismael.

He agreed with the staff that there were several cases showing that at the completion of stand-by or extended arrangements the degree of adjustment remaining to be accomplished or undertaken had been found to be substantial, Mr. Alfidja continued, and that there were other cases that showed that the degree of adjustment needed had been underestimated. Those examples underscored the need to improve the contribution that Fund programs could make to ensuring the durability of members' adjustment. Therefore, changes were necessary. However, the changes should not result in a tightening of conditionality and a further reduction in the use of the Fund's resources.

He also agreed with the view that the adoption of medium-term scenarios had been helpful in identifying the size and the appropriate speed of needed adjustment, Mr. Alfidja said, although there could not be a uniform speed of adjustment applicable to all countries under different circumstances. The staff was suggesting that to enhance the usefulness of medium-term scenarios, the underlying stance of policies should be clearly specified, especially in cases where protracted imbalances were envisaged. It was not clear what the staff had in mind, because medium-term scenarios were only useful as projections of reasonable expectations about the path of some macroeconomic aggregates and eventually of policies over a specified period. As mentioned by the staff, "given the inherent limitations of medium-term projections and the fact that future conditions and policies are often very uncertain...," it would be extremely difficult to demand action far ahead of time. Moreover, it did not appear appropriate to enhance the usefulness of medium-term scenarios based on a very short period of experience. The Fund should continue to use medium-term scenarios to identify the size and appropriate speed of adjustment programs aimed at achieving viable balance of payments positions.

He would have some difficulty with the staff's proposal to discuss contingency measures, to be implemented in response to unfavorable developments, at the time of the formulation of an adjustment program, Mr. Alfidja stated. He doubted the ability of the national authorities to foresee unfavorable developments far ahead of their occurrence. In the past, national authorities had stated their commitment to pursue flexible policies to cope with changing circumstances. There did not appear to be evidence that the existing general practice had not worked in the interest of the Fund or members. The mutual trust between the Fund and members should not be disturbed by including unrealistic expectations in the adjustment programs. He did not favor the adoption of the proposal.

Mr. Nebbia commented that in EBS/84/227 the staff was attempting to codify Fund practices and render them more restrictive. The mechanistic approach used by the staff was a matter for concern. Flexibility was necessary to deal with the economic problems of developing countries. On page 4 of the paper, the call for a safety margin to allow for the uncertainty of the current international economic environment was difficult to justify. Indeed, in some countries such safety margins could involve measures that would reduce the standard of living. The increased uncertainty of the current economic environment was the result of some of the economic policies of industrial countries. Therefore, he could not support a proposal to provide for contingencies that might involve a more rapid reduction of external current account deficits.

It was also difficult to accept the staff's proposal on page 9, Mr. Nebbia continued, namely, that, "When a country's normal consultation cycle would not result in a consultation being held within a relatively short period after the end of an arrangement not followed by a new one, it might be appropriate to hold a consultation within six months after the conclusion of the arrangement in cases in which the outstanding use of Fund credit is unusually large." The staff appeared to be attempting to establish a permanent system of more frequent consultations with countries that were indebted to the Fund. However, there appeared to be no present legal basis for that approach. He invited the staff to clarify the issue.

The proposal to stipulate contingency measures was difficult to understand, Mr. Nebbia considered. The staff stated that, "While care needs to be taken that contingency measures not become substitutes for the early implementation of needed corrective policies, the stipulation of such measures in appropriate circumstances may facilitate prompt responses to unexpected unfavorable developments." The adoption of additional measures was implied in the performance criteria. He strongly opposed any change in that respect.

He also could not accept the suggestion that there should be supplementary formal monitoring, Mr. Nebbia went on. The present guidelines on conditionality were sufficiently strong to guarantee adequate monitoring of programs. The idea of increasing intervention in a country's economic decisions should be rejected as inappropriate. In the past, supplementary criteria had been used in very exceptional circumstances to monitor a program more closely. However, he strongly opposed the adoption of formal guidelines that would imply greater conditionality for developing countries. In sum, although the staff concluded that the guidelines on conditionality remained adequate and proposed no amendment to them, he reiterated his concern about some of the ideas that had been expressed in EBS/84/227.

Commenting on EBS/84/228, Mr. Nebbia noted that the staff concluded that the widening imbalances during the period immediately preceding the initiation of adjustment primarily reflected domestic factors. It emphasized, in particular, the importance of large fiscal imbalances and overvalued exchange rates as the major source of difficulties in the majority of countries. He invited the staff to indicate whether that conclusion was also valid for the period 1980-84. He believed that the results might be different during those years. Furthermore, growth performance had been poor in the sense that countries had experienced a slowdown of growth following the initiation of adjustment efforts. The present strategy appeared to sacrifice growth for adjustment. If structural adjustment was to be successful, it would have to be integrated into a growth-oriented investment program.

He supported the adoption of measures aimed at promoting supply and relieving the burden borne by the adjustment of domestic demand, Mr. Nebbia stated. Fund conditionality continued to rely too heavily on domestic demand management and on restrictive policies. Although supply-oriented measures were not easy to implement, the Fund should put more emphasis on them in future. Finally, adjustment in the developing countries had become difficult because of exogenous factors. Adjustment policies and the review of performance should, therefore, attach due weight to circumstances and factors beyond the control of the countries concerned and to the time required to effect successful adjustment.

Mr. Templeman said that there were no real mysteries to the causes of adjustment problems or about the correct approach to program design, implementation, and monitoring. The crucial elements of a successful adjustment program were clear: early identification of key problems; prompt, sustained, and comprehensive action; and adaptation of those policies when circumstances changed. A firm political commitment was also essential to success.

Taking up the issues in EBS/84/228, Mr. Templeman considered that some of the staff's most interesting findings with respect to the causes of imbalances included: first, the problems that the 25 sample countries encountered had not been very different from those of nonsample countries; second, the imbalances had primarily reflected domestic factors; third, growing fiscal deficits, particularly resulting from spending increases, had clearly been the main problem area; fourth, the related expansion of credit to the public sector had been a common weakness of monetary policy; and, fifth, exchange rate overvaluation and exchange system complexities had been primary causal factors in some cases.

As for program design, Mr. Templeman continued, the determination of the appropriate speed of adjustment required the identification of the underlying sources of the problem. Thereafter, success depended significantly on early, comprehensive, and sustained policy actions. A good data base was important. Reductions in fiscal imbalances, especially on the spending side, were necessary in almost every case. Corresponding restraint on credit to the public sector, combined with the provision of adequate credit to the productive private sector and the achievement of positive real interest rates were also required in almost all programs. Countries should pay increasing attention to the development of modern financial instruments and institutions that depended principally on the play of market forces. Formulation of appropriate exchange rate policy and liberalization of the system of trade and payments should also have high priority, both to correct present imbalances and to encourage the diversification and expansion of the economy.

Actual performance under the programs examined had been disappointing, Mr. Templeman stated. The failure thus far of Fund-supported programs in many countries to achieve the goal of restoring sustainable payments positions in the short to medium term struck at the very heart of the Fund's role in the international monetary system. It contributed to prolonged use of Fund resources, which weakened the Fund's liquidity; undermined the Fund's credibility as a promoter of adjustment, with important consequences for its catalytic function; and threatened the Fund's ability to foster the sound international monetary system on which all members depended. For example, in only 6 of 22 cases had the fiscal deficit in the latter stages of the adjustment period been equal to or lower than it had been in the third and fourth years preceding initiation of adjustment. The ratios of credit and money to GDP had generally increased. Real effective exchange rates for the typical country in the sample had remained roughly unchanged during the four-year period following initiation of adjustment measures. In addition, the typical country had experienced poor growth of export volume. Experience with supply-oriented policies had shown mixed results, mainly because of lags in the effects of such measures and the inadequacy of the measures themselves. Trade liberalization had sometimes had a noticeably favorable impact on economic recovery. Improvement in the savings/investment balance had been small and difficult. In that area, closer cooperation with the World Bank could be particularly helpful with respect to microeconomic policy advice, assessment of public investment programs, and reviews of the climate for foreign and domestic private investment.

Achievement of the principal final objectives of policy, such as balance of payments equilibrium, price stability, and economic growth had generally been disappointing, Mr. Templeman went on. The result was not surprising, given the policy inadequacies that he had just noted. Nevertheless, more than half of the 25 countries had reduced the ratio of the current account deficit to GDP, with 8 countries having relatively little further to go toward balance of payments adjustment. It was interesting that those countries that had not made much progress had not been subject to less favorable exogenous developments than those that had made progress. On the inflation front, 9 countries had achieved an inflation rate of less than 11 percent by 1982-83; some of the cases of higher rates reflected necessary price deregulation, especially with respect to the exchange rate and administrative prices. In the typical case, economic growth had fallen sharply upon initiation of the adjustment program, which was not surprising, given that foreign and domestic imbalances had been allowed to accumulate and that the lagged supply response tended to shift the burden of adjustment toward demand restraint in the early stage of the adjustment process. That phenomenon highlighted the need to address supply-side problems promptly.

Commenting on the seven main points made by the staff in EBS/84/227, Mr. Templeman emphasized the importance of a medium-term framework for adjustment. Such an approach was crucial to assessing the progress toward sustainability of the balance of payments. As the staff indicated, medium-term scenarios would be more useful if the assumptions about the underlying stance of policies were specified clearly, and the scenario exercises would be improved, as other speakers had suggested, if the staff was more specific about how the adjustment path negotiated with the authorities might differ under different policy assumptions. He supported the idea that the specific reasoning behind the staff's selection of a particular pace for adjustment should be included in staff papers and that there should also be an explanation for why the adjustment effort was not stronger, especially when the medium-term forecast projected continuing unfinanced balance of payments gaps. Neither the borrowing country nor the staff should assume that extraordinary financial assistance could be counted on from the Fund or other creditors over extended periods.

Policy adaptation was crucial to success in an uncertain world economic environment, Mr. Templeman remarked. He supported, therefore, the inclusion of safety margins in Fund programs with respect to both the strength of policy action and the setting of specific performance criteria and targets, such as foreign reserve targets. The idea of contingency planning was attractive, but it was an innovation and a sensitive issue. It was probably not possible to decide beforehand in all cases that specific contingency packages needed to be spelled out formally in letters of intent or by other means. However, there could be cases in which such an approach was not only useful but essential.

The relatively poor performance of structural, supply-side measures, both during the period of Fund financial support and afterward, might be the result in part of a less rigorous approach by the Fund, Mr. Templeman considered. Whereas the Fund traditionally took a firm stance on the need for demand restraint, the relative newness of the supply-side approach might mean that it was not being given sufficient attention. Perhaps more specific obligations in that respect should be included in Fund programs. Although some observers might assume that increased focus on that aspect of adjustment implied Fund financial involvement over extended periods, the contrary view could be argued--that countries paying sufficient and early attention to those matters should be less likely to need prolonged financial help from the Fund. Of course, there were limits to the extent to which the Fund should get involved in structural reforms. It was an area in which the World Bank could provide useful assistance. Nevertheless, if prompt restoration of economic growth was to be achieved, too much of the adjustment burden should not rest on demand restraint. Supply measures, particularly to foster realistic price signals through market forces, to improve savings and investment rates, to reduce trade restrictions and foster direct investment could play an important role in relieving domestic and foreign imbalances.

With regard to performance criteria and monitoring, Mr. Templeman said, the member and the staff should discuss fully the need for procedures at the outset. All members should be aware that the Fund was concerned fundamentally with both external and internal adjustment, not merely with the formal observance of quantitative performance criteria. In light of the relatively weak adjustment performance in many countries, it was doubtful whether there had been sufficient correspondence between performance criteria and ultimate economic objectives, such as growth, inflation, and balance of payments equilibrium, and whether sufficient attention had been given to the stability of the relationships between policies and targets. The issue was difficult, and perhaps more attention needed to be given by the staff and the Executive Board to evaluating the theoretical underpinning of the Fund's approach to adjustment. As to supplementary monitoring, he could support the use of more disaggregated performance criteria or targets, including their use in some nontraditional policy areas. However, such use should be carefully tailored to particular circumstances. It was difficult to specify in the abstract the circumstances that would warrant such an approach, but supplementary monitoring might be justified, especially for countries with nonmarket economies, where traditional policy instruments and institutions differed from those found in market economies. Such approaches to monitoring might also be useful where the data was weak in the traditionally important areas. Furthermore, where past performance had not been good, there might also be reason to employ supplementary monitoring techniques. However, the extent to which loopholes could be plugged in the absence of a basic determination to adjust was limited. Extension of performance criteria to final economic objectives, such as the inflation rate, was tempting, but it could be difficult. The relative lack of success in getting inflation rates under better control suggested that it would be worth considering such a step; he remained open minded on the subject and invited the staff to comment further on it.

It would be helpful if in the papers prepared for Board consideration of a program the staff could be explicit about the policy changes that were likely to be needed after the program ended if such policy shortcomings were not fully addressed in the program, Mr. Templeman stated. He could support the selective use of accelerated Article IV consultations in order to continue monitoring recently terminated adjustment programs and, in some cases, the related enhanced surveillance approach based on more frequent consultations along the lines of the recent agreement with the Mexican authorities. Finally, he agreed that there was no need to amend the guidelines on conditionality, which were sufficiently flexible to permit the Fund to adapt its practices to changing circumstances. Furthermore, the decision on the extended Fund facility continued to be valid, although experience with programs under extended arrangements had not been happy and the Executive Board would need to observe carefully the criteria for their use whenever any new arrangements under the facility were presented for approval.

Mr. Ortiz said that it was important to review performance under Fund-supported programs as a basis for examining the criteria according to which programs were implemented and what could realistically be expected from them. The use of medium-term scenarios could help to assess better the magnitude of the problems facing a country and the expected intensity of its adjustment effort, which depended crucially on a correct diagnosis of the current situation and the outlook for the years ahead. Medium-term scenarios normally included projections of variables with respect to the balance of payments, fiscal accounts, and so on, and depended both on a set of assumptions concerning the external and internal environment over the relevant time horizon and on the underlying policy measures. He agreed with the staff that, given the natural limitations of such projections and the uncertainty surrounding certain assumptions and policies, the projections should not be considered forecasts or precise estimates but simply scenarios on which discussion and policy analysis could be based.

Although an analysis of the longer-term outlook could be useful in selecting performance criteria and targets, Mr. Ortiz continued, it was doubtful whether more restrictive application of the guidelines on conditionality would contribute to improved economic performance of a country in relation to the original target. It had been amply documented in previous studies and in the papers before Directors that in many cases there was a lack of correspondence between observance of the performance criteria and achievement of the program's objectives. The ultimate objective of Fund programs was to restore the conditions that would permit a country to resume or, in some cases, to initiate sustainable economic growth. In some cases, although a country adhered strictly to the established performance criteria, it failed to produce the expected results in terms of better balance of payments performance, higher economic growth, or lower inflation. Thus, it was not clear how the application of closer surveillance or tighter conditionality clauses would generally help to bring about the desired results.

There appeared to be a discrepancy between the staff's conclusion on page 11 of EBS/84/227 that the guidelines on conditionality remained a suitable basis for the Fund's policy on the use of its resources and that, consequently, no amendment of the guidelines need be proposed at present, and some of the suggestions elsewhere in the paper, Mr. Ortiz considered. In particular, on page 4, the staff suggested that the increased uncertainty surrounding the assumptions on which programs were based might make it useful to build into programs a safety margin or provision for contingencies, either through faster adjustment or through the specification of measures to be adopted contingent on the occurrence of a certain event. That proposal could be interpreted as a modification of the current guidelines on conditionality. Incorporation of explicit safety margins in program design was both impractical and risky. It was impractical because a choice would have to be made between many possible scenarios at the same time that a decision would have to be reached regarding the specific variables or elements of the program in which the safety margin would be incorporated. For example, would the expected variation of the price of the primary export commodity of the country be taken into account in relation to the reserve accumulation objective? What other criteria could be utilized? The proposal was risky because bias on the side of stricter than necessary adjustment would be built into the program and, given the extent of the present problems facing developing countries, the costs of overadjusting would be too great.

Specification of contingent measures could suffer from some of the same inoperative defects, Mr. Ortiz went on. How many possible states of the world economy could be contemplated in the design of a program? Although the construction of scenarios might be used as a framework for policy discussions, the exercise could become complicated if different reaction functions of authorities were excluded from the projected path of relevant variables. Rather than building safety margins or making provisions for contingencies, which in many cases were included in the letters of intent anyway, efforts should be directed toward improving the programs so that they were based on more realistic assumptions. In addition, the expected results of the programs should be viewed more realistically; in that respect, the formulation of two or three relevant scenarios might produce ranges, instead of fixed points, within which the variables used as peformance criteria could be allowed to move.

Although the use of supplementary monitoring criteria might be helpful in some cases, Mr. Ortiz observed, they should be considered exceptional and be utilized only in cases where it was not possible to apply traditional performance criteria. He agreed with Mr. Yamashita that supplementary criteria should be considered on a case-by-case basis. They implied a deeper and more precise knowledge of the workings of the economy and a more correct evaluation of the initial conditions and of the targets to be achieved. The behavior of the variables that had been mentioned as possible supplementary performance criteria, such as the rate of inflation, could be interpreted quite differently according to the circumstances of the case, as Mr. de Groote had pointed out at EBM/84/174. For example, if structural changes were adopted early in the program--a point strongly recommended by the staff and some Executive Directors--such as the adoption of more flexible domestic pricing, the elimination of subsidies for basic commodities, corrections to the prices of goods and services produced by state enterprises, or adjustments to such key prices as exchange rates or interest rates, an initial acceleration of the inflation rate could occur. Thus, although the reduction of inflation might be deemed essential to the medium- or longer-term success of the program, incorporating the rate of price increase as a supplementary criterion would require accurate judgments to be made on the dynamics of prices in the country in question and on the relation of price developments to other variables. Such a task was most difficult. In many instances, the staff was optimistic about the possibility of achieving substantial declines in inflation rates, based on experience with a number of programs. If the ability to model and to predict something as difficult as the rate of inflation became an essential element in negotiations, uncertainty and undesirable complications could be added to the already difficult process of implementing Fund programs.

Mr. Malhotra, commenting on EBS/84/227, said that medium-term scenarios could certainly help to improve the understanding of national authorities and the staff regarding the future evolution of a particular economy. Such scenarios should indicate how, under varying circumstances, economic variables might evolve differently. However, in making projections, it was not sufficient only to delineate policy assumptions. In the case of two countries in his own constituency, the outcomes of the balance of payments scenarios for as little as six months to a year ahead had turned out to be very different from what had been projected. The reason was easily understandable--developments had occurred that had not been anticipated, sometimes not even by the authorities themselves. Similar examples could be cited from other medium-term scenarios presented to the Executive Board in the course of Article IV consultations or for discussions on the use of Fund resources. Thus, if scenarios projected financing gaps for several years ahead, they had to be treated with care and be considered tentative in nature.

Furthermore, it would be unscientific to use such scenarios as a basis for advance policy changes in addition to the measures normally agreed in the course of negotiations on a program, Mr. Malhotra added. A financial gap projected over the medium term might not in fact emerge, whereas action taken on that basis could involve greater sacrifice than necessary. The staff had, in fact, pointed out that, in many cases, adoption of adjustment programs did result in declines in output rates. The usefulness of normative scenarios was also of doubtful value because the state of the art could not handle effectively the diversity of circumstances of member countries.

He agreed with those Directors who had opposed the building of extra margins of adjustment into programs or the stipulation in advance of contingency measures, Mr. Malhotra continued. The staff had referred to "unexpected developments." It was difficult to predict what measures should be taken when the extent of such unexpected developments, their impact, and, indeed, their nature and incidence, were unknown. Such a two-tier approach to conditionality was impracticable and the Fund should avoid it completely. Moreover, far-reaching suggestions of that kind were not compatible with the staff's general conclusion that the current guidelines on conditionality were appropriate.

The tackling of structural problems in Fund-supported programs was a difficult matter, Mr. Malhotra remarked. The term structural was often used loosely; for the Fund, it appeared to refer primarily to the pricing mechanism, broadly defined, including the exchange rate, interest rates, administered prices, and so on. It could not be said that present Fund programs paid inadequate attention to prices, which indeed, were a basic element of those programs. The term structural was also being used to refer to a country's infrastructure, an area where the Fund did not involve itself much; it did not have the resources to do so, nor, for that matter, were the World Bank's resources adequate. If such infrastructural problems were to be tackled more vigorously, the members of the two institutions would have to provide them with larger resources.

In a general sense, infrastructural inadequacies lay at the heart of the problem of effective adjustment in developing economies, Mr. Malhotra commented; and the relatively short period of Fund programs--a year or 15 months in most cases--was not sufficient to resolve them. Authorities in most countries had a genuine commitment to improving their economies and reaching a point of sustainable growth. However, especially in the poorer economies, the lack of capital and of other resources were major constraints. The countries of sub-Saharan Africa, for example, would find it almost impossible to resolve their fundamental structural problems under Fund programs as presently designed.

The staff's conclusion that in normal circumstances the traditional quantified performance criteria supplemented by midterm reviews provided adequate monitoring was correct, Mr. Malhotra considered. That conclusion underlined the importance of maintaining the flexibility implicit in the present approach to program monitoring, under which negotiations between the staff and the authorities were followed by consideration and approval by the Executive Board, certain important elements in the program were then monitored on a periodical basis, reviews were held at appropriate stages, and emerging problems tackled by appropriate measures. However, the technology advocated in the staff papers was far too mechanistic. The staff appeared to be suggesting further conditionality to deal with events that might or might not materialize. Such an approach was analogous to the way in which some countries handled their taxation systems, by attempting to plug one small loophole after another until the entire system became so complex as to verge on the unworkable. He hoped that the Fund would not allow a similar process to develop with respect to conditionality. While it was important to maintain an appropriate degree of flexibility to deal with problems as they arose, attempting to anticipate every problem in advance and prescribe conditions therefor would be counterproductive.

The question of additional or supplementary monitoring criteria raised similar considerations, Mr. Malhotra went on. The staff already designed programs in a comprehensive fashion. Indicative targets were set for such objectives as the rate of inflation, the current account and the overall balance of payments, official reserves, and monetary growth. In the course of reviews, the staff examined the developments in light of those objectives. Problems could arise if the so-called supplementary monitoring criteria were to become, in practice, additional performance criteria. As other speakers had pointed out, it was exceedingly difficult to control certain variables, such as the rate of inflation, or even the rate of growth of money. Furthermore, in many cases, when targets had not been met, the Executive Board had examined the situation carefully and concluded that the deviations had been acceptable in the circumstances of the country. It could not be argued, therefore, that the program's objectives were not receiving adequate attention in the course of reviews; it would be unfair to the staff, to management, and to the Executive Board to suggest that such was the case. Of course, if major difficulties arose, the Fund could discuss them with the member at any time; in that regard, there was no evidence of reluctance on the part of members to receive Fund missions. He hoped, therefore, that the use of supplementary monitoring criteria would remain exceptional and, indeed, become even more exceptional than at present.

The intent behind the proposal that Article IV consultations might be accelerated in certain circumstances was not clear, Mr. Malhotra suggested. The regularity of consultations had improved in recent years in line with the guidelines laid down by the Board. If the proposal was intended to establish two regular consultations in the course of a year, however, it would be difficult to accept. First, it would present a serious additional burden on the staff. Second, while the example of Mexico might be cited, Mexico was a special case. Of course, if other members requested similar treatment, such proposals could be considered on their merits. In many cases, the regular annual consultation would fall within the the six-month period after the end of a large program; if it did not, it would be preferable to advance the regular annual consultation rather than have two consultations within the course of a year.

He agreed with the view that the current guidelines on conditionality remained suitable, Mr. Malhotra stated, and that the provisions of the extended Fund facility also remained appropriate. On the latter point, the staff had stated that there had been only six arrangements under the facility since 1981. It appeared that extended arrangements were being progressively de-emphasized. That trend was not compatible with the increased emphasis on placing programs in a medium-term context, on structural policies, and on closer monitoring after the program was completed. He hoped, therefore, that extended arrangements would be given greater consideration.

Taking up the issues in EBS/84/232, Mr. Malhotra said that he agreed with many of the observations made by Mr. Zhang, who had emphasized the need for caution regarding exchange rate policy, especially in economies where the supply response to changes in the exchange rate was slow. The circumstances of each case should be looked at carefully. The staff had stated that

> ...[it] often has reservations about the adequacy of the exchange rate policies being followed. These are seldom noted in request papers, though sometimes subsequent staff reports do so. It might be helpful to indicate explicitly the favorable assumptions needed if a weak action is to prove successful, or compensating actions taken such as lesser amount in arrangement, shorter program period, or tighter review clauses.

That statement was particularly worrisome because it suggested that an entire program should hinge on a single policy instrument, whereas programs were usually thought to be comprehensive, dealing with fiscal imbalances, monetary policy, and many other important areas of policy. Lesser amounts or shorter program periods would also be counterproductive and would not help either the member or the Fund.

He agreed with the comment by Mr. Salehkhou on EBS/84/228, Mr. Malhotra stated. By concentrating on adjustment, the design of Fund programs did not pay proper attention to objectives such as growth and employment. Furthermore, the staff gave the impression that when a program ran into difficulties, the fault lay with the country rather than with exogenous developments or the design of the program. The staff almost always took the view that, for example, action had not been taken at an early stage, had not been sufficiently comprehensive, or that there had been some other inadequacy on the part of the authorities. However, as Mr. Romuâldez had pointed out, it was necessary to consider how the Fund itself had responded to the various developments affecting the country; for example, the Fund did not always provide the required amounts of financing. A little self-criticism would do no harm; in that respect, he reiterated the suggestion that he had urged or supported on other occasions, namely that an evaluation unit should be established within the Fund to review the design and adequacy of programs. As a number of speakers had observed, the staff's remark that the difficulties facing countries lay primarily in the domestic policy area did not attach due weight to the reality of the current world economic environment. Indeed, the data provided by the staff indicated that in almost half the cases examined exogenous factors could be said to have contributed almost as much as domestic factors to the problems of the country. Thus, both domestic and external factors should be given their due weight in assessing programs.

Mr. de Groote remarked that although he had used the term "additional" consultations in his statement at EBM/84/174, he had had in mind voluntary additional consultations aimed at enhancing the dialogue between the Fund and a member that had, for example, been a user of Fund resources over several years and that wished to submit its continuing adjustment program to the Fund for review. His proposal had been put forward in the hope that the Executive Board would be willing to consider the policies of a member after the completion of a financial program, when it was no longer subject to conditionality. Such an approach would help to move the Fund away from association only with financing in times of crisis.

Mr. Hassan observed that the staff's assessment of recent experience with adjustment policies under Fund-supported programs showed that overall performance had been less than satisfactory despite continued tightening of conditionality and modest use of Fund resources in recent years. The problem of unsatisfactory performance could not be solved by tightening conditionality still further, as suggested by the staff. It would have been more helpful if the staff had considered more effective solutions to the problem by emphasizing ways in which members could be assisted in overcoming the difficulties that hindered their adjustment efforts and by examining how to make the adjustment process more efficient in economic terms and less costly in social and political terms.

Medium-term scenarios could provide a useful framework for analysis, Mr. Hassan continued. However, such scenarios should be used pragmatically, with awareness of the realities of the case under consideration and responsiveness to the particular circumstances of the country concerned.

Moreover, given the high degree of uncertainty in those scenarios, caution and flexibility were required in using them as a basis for policy actions. The staff recognized the structural nature of the problems facing many members and the need for more supply-oriented policies in Fund programs. However, it stopped short of recommending the most appropriate approach to the problem. First, structural adjustment required adoption of programs that would continue over a number of years. In contrast, there had been a sharp drop in the use of medium-term arrangements in recent years--only six since 1981. Continuation of that unjustified bias against medium-term arrangements, despite repeated assurances by management and staff, was most unfortunate. Second, supply-side policies involved much more than higher producer prices and exchange rate adjustment. They included the removal of bottlenecks and other rigidities that prevented supply from responding to market incentives, including resource constraints and foreign exchange shortages. The Fund, in cooperation with the World Bank, could provide meaningful assistance in that regard by encouraging increased medium- and long-term capital inflows.

He had major difficulties with two of the staff's conclusions, Mr. Hassan stated. With regard to the use of safety margins or contingency measures to safeguard against unforeseen developments, it was impossible to lay down in advance the appropriate specific response to unforeseen or unpredictable developments. The only reasonable approach was for the Fund to pre-empt certain reserve powers to enable it to reappraise the situation and to set down provisions permitting it to cope with new developments. Such powers and provisions already existed in the review clauses that virtually all arrangements and letters of intent presently contained. The provisions could be enhanced by the adoption of a more flexible approach to the implementation of programs. Furthermore, the staff's suggestion ignored the social and political costs borne by the adjusting countries. Safety margins would impose greater hardship and lower further the already low standard of living in many of those countries. Contingency measures would require national authorities to specify policy responses to future uncertain events well in advance in a world full of speculation and at a time when they were facing major difficulties in agreeing on policy measures to deal with already existing problems. Such an approach represented a futile attempt to avoid the undesirable effects of future developments that might or might not occur. In addition, increased conditionality was no substitute for improvements in program design and flexibility in implementation.

The staff's remarks with regard to supplementary monitoring criteria presented a second major difficulty, Mr. Hassan went on. In EBS/84/227, the staff first stated that under normal circumstances, the usual quantified performance criteria--supplemented as appropriate by midterm reviews--provided adequate monitoring. It then went on to propose what amounted to a second tier of conditionality. There was no justification for supplementary criteria, which had been used in exceptional circumstances, becoming a standard feature of Fund programs. It would be more appropriate to improve the definition and design of performance criteria and their relationship to the program's objectives. Furthermore, it was not clear how members would interpret such conditionality and the extent to which they would consider supplementary criteria as examples of increased encroachment into a country's affairs. In sum, the staff claimed that the existing guidelines on conditionality remained appropriate and required no change, while attempting to make existing practices more restrictive by putting forward a number of recommendations that represented tighter conditionality. They amounted to changes in existing policy that his chair could not support.

Mr. Tvedt said that he was in broad agreement with the views expressed by the staff in EBS/84/227. There continued to be a need to improve the Fund's programs in light of the insufficient adjustments that had taken place in the recent past. Therefore, modifications might be required with respect to medium-term analyses and monitoring techniques. Medium-term analyses were important in dealing with economic imbalances so that the needed strength and speed of adjustment could be identified at an early stage and the tendency toward a "stop-and-go" policy might be reduced. He welcomed the staff's suggestion that the usefulness of medium-term scenarios would be improved if the underlying policy stance was defined more clearly. A better indication of the principal policy changes required would thereby be given. The consequences of changes in the major forecasting assumptions should also be made clear in the scenarios. In that regard, he agreed with Mr. Clark that more frequent use of sensitivity analysis was called for. Such analysis would provide a better basis for fruitful policy discussion with the authorities of a country concerned, as well as in the Executive Board, and would permit existing uncertainties to be taken into account.

The possibility of unforeseen disturbances in the economic environment called for greater flexibility in the use of economic policy instruments in the adjustment process, Mr. Tvedt continued. For that reason, he sympathized with the staff's notion that contingency measures ought to be included in programs agreed with authorities, without however--as other speakers had mentioned--using agreement in that respect as a reason for accepting less ambitious programs. Policies agreed in the context of Fund programs had often been inadequately implemented; thus, virtually all the elements of a policy package should be negotiated before a program became effective. It was important that measures should be formulated at an early stage, particularly structural measures, because they often took time to implement and to yield results.

In view of the inadequacy of policy implementation in many cases, Mr. Tvedt commented, the continuation of the recently adopted practice of using supplementary criteria to broaden the overall monitoring process was welcome. That approach might to some degree act as an early warning system. In general, he favored the introduction of mechanisms that would trigger discussions with the Fund at an earlier stage, thereby reducing the risk of an automatic interruption of a Fund program. He hoped that the staff would examine the issue further. It would also have been interesting if the staff had described experience thus far with respect to supplementary monitoring criteria, the procedures that had been used to implement them, and their relationship to the standard performance criteria and targets of a program.

The Fund should encourage a sustained implementation of measures adopted in connection with a financial arrangement even after the formal expiration of the arrangement, Mr. Tvedt considered. Therefore, he agreed with the staff that it might be appropriate for countries with large outstanding drawings on the Fund to accept consultations within six months of the expiration of an arrangement. Finally, he agreed with the view that the present guidelines on conditionality were appropriate and that no changes were needed at present.

Mr. Salehkhou stated that he supported Mr. Malhotra's remarks on the need for an evaluation unit in the Fund.

Mr. Zecchini inquired whether it would be possible to receive background papers for Executive Board discussions six weeks in advance of a Board meeting. Such papers were often relatively lengthy and required close analysis.

The Secretary replied that the standard rule was that the main paper for a Board discussion should be circulated four weeks in advance of the meeting. There were no firm rules with respect to background papers, except reports on recent economic developments for which a circulation period of two weeks applied. While the staff tried to circulate background papers as far in advance as possible, the pressures of work needed to be taken into account.

The Director of the Exchange and Trade Relations Department added that, in view of the inevitable time constraints, the staff would be happy to respond directly to any Director's questions on background papers in advance of a meeting. In the specific case under consideration, while the main policy paper (EBS/84/227), which was aimed at completing the annual review of conditionality, stood on its own, the issues it dealt with were closely related to those in the background papers (EBS/84/228 and EBS/84/232). Once the background papers had been completed, it had been felt appropriate to consider them together with EBS/84/227.

The staff recognized that it had not been possible to address adequately all the theoretical issues involved in the design and implementation of adjustment programs in EBS/84/228, the Director noted. The paper had been an attempt to respond to points raised by Directors on various occasions by summarizing and trying to draw a few general lessons from a wide array of members' experiences. The staff had not intended to suggest that the countries should be blamed for the difficulties that arose in the course of adjustment programs and that the Fund should be absolved. Indeed, the staff had drawn on examples of countries that had undertaken adjustment efforts without financial support from the Fund as well as cases of countries that had entered into Fund arrangements. The analysis had, therefore, aimed at pointing out what the effects of certain policies were and how various countries had responded to different developments. Of course, as one Director had suggested, the overall results might have been different if more financing had been available. However, that issue involved the question of access to Fund resources, which was an issue for separate consideration.

Commenting on the policy issues raised in EBS/84/227, the Director observed that the staff had been conscious of the difficult circumstances of members, whether attributable to domestic or exogenous factors. However, it had to be recognized that a number of the countries undertaking adjustment with the support of the Fund had not been able to deal with their problems successfully and continued to face serious imbalances. The staff had sought to examine ways to improve the success of programs in a spirit of cooperation with members. For example, on the question of medium-term scenarios, if the authorities in a country were aiming to return the economy to a sustainable growth path, they would wish to have a sense of the medium-term outlook. Thus, in suggesting that the policy assumptions should be made clear in medium-term scenarios, the staff had been seeking to assist members--and the Executive Board--in assessing the likely impact of existing policies, rather than attempting to prescribe policies in a normative sense. It would thereby be easier to make a judgment about the relationship between existing policies and the anticipated outcome.

The question of supplementary monitoring criteria was perhaps even more complex than the staff had indicated, the Director continued. For example, a program might have as an objective an increase in foreign assets based on specified developments in the exchange rate; alternatively, the objective might include room for flexibility as regards the specified exchange rate policy if the foreign assets position recovered to an appropriate degree. While including both credit aggregates and money aggregates as performance criteria could imply a view about exchange rate developments, it might be more important to reach an understanding in advance about the form and the degree of policy adjustment that would take place if the recovery in foreign assets turned out to be more rapid or larger than expected. Appropriate credit tightening could further progress on inflation. It was not an easy issue; success depended to some extent on the authorities' political judgment about the best way to structure the recovery.

The proposal that there might be an accelerated Article IV consultation with a country after the completion of a program drew on the experience with Mexico, the Director commented. It had not been an attempt to impose a particular procedure on members; rather, it might enable the Fund to help a member to continue to sustain a viable external position. Many lenders had faith in the Fund's judgment; in that regard, it could be useful to a member if the Fund provided confidence, through its review process, that recovery would continue, particularly in the period of transition immediately following completion of a program. On the legal aspect, there was provision in stand-by arrangements for consultation with a member while outstanding resources remained above a certain level.

The role of the Fund in structural adjustment had been addressed in part in the course of the Executive Board discussion of ways to enhance cooperation with the World Bank (EBM/84/170 and EBM/84/171, 11/28/84), the Director of the Exchange and Trade Relations Department recalled. The staff's remarks in EBS/84/227 should be seen against that background; the staff was fully conscious of the important contribution that international agencies other than the Fund made to the process of structural adjustment and it had not intended to minimize their role. The staff recognized that structural adjustment took a long time and that the problem of poverty in many countries was particularly difficult to solve. It believed, nevertheless, that balance of payments problems were amenable to solution. For that reason, the Fund did not rule out access to its resources for any country. Although there were areas that were beyond the control of the Fund, the areas within its competence remained important and the Fund should, therefore, continue to be ready to assist any member, provided that there was a prospect of a recovery in the balance of payments that would safeguard the revolving character of Fund resources.

The staff representative from the Exchange and Trade Relations Department said that, in suggesting that the policy assumptions underlying a medium-term scenario should be clearly specified, the staff had intended simply to suggest that existing policies should be clearly delineated; it had not been seeking to request authorities to specify policies for a long time into the future. With regard to supplementary monitoring criteria, the staff had sought to describe what the practice had been in a number of special cases in recent years when certain variables had been upgraded to the status of monitoring criteria although they had not been used as performance criteria. The purpose of focusing on such variables was to emphasize that certain areas were particularly important and that unexpected departures from the expected path of developments could be used to trigger early discussions about progress under the program. It was hoped that the use of such criteria could lead to a more continuous monitoring of developments in those areas rather than intermittent analysis at the time of regular discussions.

It was true that domestic factors had accounted for less than half of the emerging imbalances in 9 of 22 cases examined in EBS/84/228, the staff representative from the Exchange and Trade Relations Department added. However, in remarking that domestic factors had been primarily responsible for the difficulties encountered in programs, the staff had been attempting to reflect the experience of what might be called a typical country, taking into account not simply the number of countries that had been affected by particular factors but also the relative impact of such influences. In a number of countries, the influence of domestic factors had been very large relative to that of external factors. Overall, as the data in Table 4 of EBS/84/228 indicated, domestic factors had been important in contributing to imbalances.

The Chairman made the following summing up:

All Executive Directors noted with concern that relatively few countries in the sample reviewed in the report on experience with adjustment policies (EBS/84/228) had achieved sustainable domestic and external positions. Many of those countries continue to experience large imbalances, although some of them have made virtually uninterrupted use of Fund resources since the initiation of their adjustment efforts.

In their comments, one group of Directors stressed their concern that such a situation was threatening to impair the credibility of the Fund and could, if it was not checked, lead to more prolonged use of Fund resources, which would be incompatible with the main purposes of the Fund. They emphasized, therefore, that it was important that the authorities of the countries undertaking adjustment should take early action, demonstrate political commitment to the adjustment effort, and implement comprehensive policies vigorously, while maintaining flexibility to deal with unexpected unfavorable circumstances. As for action by the Fund, those Directors stressed the need for better design of programs, clearer theoretical underpinnings, and improved monitoring.

Another group of Directors thought that the staff had underplayed the impact of harsh external conditions and had not paid sufficient attention to the responsibilities of other members of the Fund in the making of the external environment. Interest rates and protectionism were mentioned in that context. They also believed that in designing programs the staff had not taken sufficiently into account what they stressed to be indispensable considerations, such as growth, employment, income distribution, and the social consequences of adjustment.

All Directors agreed that the present guidelines on conditionality provide an appropriate basis for the application of the Fund's policy on the use of its resources in stand-by and extended arrangements. It was suggested that some of the proposals contained in the staff paper on upper credit tranche arrangements and issues related to conditionality (EBS/84/227) might be formally included in the guidelines, but that was not the view of the majority of the Board. While there were clearly differing views concerning some of the suggestions made by the staff, the Board decided to continue with the present policy setting, which is sufficiently flexible to allow for adaptation to the particular circumstances of each case.

In addition to the basic issue of the appropriateness of the guidelines, a wide range of issues was addressed in the discussion. I shall attempt to summarize Directors' remarks under the seven headings contained in the "Summary and Conclusions" section of EBS/84/227.

1. Medium-term scenarios

Directors welcomed the increased use of a medium-term framework of analysis in staff reports for the use of Fund resources. Some speakers indicated that such an approach was also appropriate in reports for Article IV consultations. Given the large and protracted imbalances in a wide range of cases, the presentation of medium-term scenarios had facilitated the understanding of the longer-term adjustment strategies underlying the shorter-term economic and financial programs prepared by members. Directors stressed that it was essential that the assumptions underlying such scenarios, in particular, assumptions concerning the stance of policies, but also those relating to exogenous variables, should be as clear as possible and spelled out in the reports.

More use should be made, many Directors noted, of sensitivity analyses and alternative scenarios to illustrate the range of uncertainty regarding sensitive key assumptions or parameters, with the aim of helping the authorities in their future action. I noted the regret expressed by some Directors about the relatively rare use of sensitivity analysis; we shall try to correct that situation. Scenarios should include, when possible, the input of World Bank medium-term assessments of the consequences of investment programs. A number of Directors noted that, although they were interested in the enhancement of this aspect of the Fund's work, scenarios had their limitations. They were not forecasts; they were only a frame of reference and should be treated with care. Several Directors suggested that in some cases the staff should be using normative scenarios, but that idea was not generally accepted.

2. Contingency measures and safety margins

The suggestion that there should be greater specification of contingency measures to respond to unforeseen unfavorable developments received mixed, and generally negative, reactions. Indeed, a number of speakers expressed concern that contingency measures might become a substitute for early implementation of needed policies. Others feared that procedures such as contingency measures or safety margins could become an excuse for the Fund to press for harder or faster adjustment on the basis of very uncertain assumptions about possible developments. On the whole, Directors thought that periodic, and perhaps in some cases more frequent, reviews would be the appropriate way to judge whether there was need for additional measures. However, a few Directors who favored specification of such contingency measures could point to specific country cases where the application of such devices might have proved useful.

Among the important policy recommendations stressed by many Executive Directors was that realism should guide the staff and the authorities when assessing the external variables; in that regard, some Directors thought that the staff had sometimes had a tendency to be overoptimistic in its assumptions concerning the external environment.

It should also be stressed that if slippages arose or basic changes in underlying conditions occurred, the authorities should be ready to act promptly and flexibly in order to keep the program on track and to cope with the unforeseen circumstances. Such flexibility and readiness to act are major factors in successful adjustment.

3. Formulation of structural and related measures

There was broad support for the attention that has been devoted and is being devoted to the formulation of structural or supply-side oriented measures in support of members' adjustment efforts.

Many speakers noted that, thus far, results of supply-side policies had frequently been considerably less than satisfactory. Some Directors argued that, since comprehensiveness and timeliness are keys to the success of programs, the Fund should insist more strongly on early and decisive structural actions, particularly, but not only, in cases such as those involving major exchange rate action that needs to be buttressed by strong domestic measures in demand management and on the supply side.

Several Directors noted that supply-side policies are relatively new in the context of Fund programs and that improvements are necessary with regard to how they are framed and applied. In particular, a number of Directors stressed the importance of the World Bank's input in the framing of structurally oriented policies. I completely share that view, which I have expressed a number of times in the Board and publicly. We have to better mesh supply-side measures financed by the World Bank with the macroeconomic policies advocated by the Fund.

I also noted the suggestion that constraints preventing the use of certain policies, or limiting responses to these policies, should be clearly identified in staff reports for the use of Fund resources.

4. Performance criteria

The Board gave broad support to the present practice concerning the application of performance criteria. Performance criteria must be objectively measurable; they have to be capable of being monitored on a timely basis; they must reflect the institutional and economic characteristics of the country in question; and, of course, they have to be geared to the goal of achieving the program objectives.

I noted the remarks of some Directors on the case for multiple performance criteria on monetary policy. Although there ought not to be contradictions between performance criteria geared to the money base and performance criteria geared to international reserve assets, in some cases such contradictions do arise, for example, when net international assets exceed the level contained in the program. The staff and management are working on this complex question and are considering ways to improve the relationship between those two parameters. The aim is not to tighten conditionality but to achieve the necessary cohesiveness and consistency of program elements. When further work has been undertaken on the issue, which involves a good many practical and theoretical questions, a staff paper will be circulated.

5. Additional or supplementary monitoring criteria

This paragraph received a mixed reception. A number of Directors regarded the introduction of such criteria as useful, for example, to trigger reviews, particularly in high inflation cases. However, they stressed that such criteria should not become a substitute for the basic performance criteria. Other Directors viewed this mechanism unfavorably because of their concern that its introduction would constitute excessive interference in the member's affairs and would result in tightening of conditionality or a reinterpretation of the existing guidelines.

I can assure the Board that the staff had no such intention in writing paragraph 5. Supplementary monitoring criteria shall continue to be used sparingly, only to enhance understanding of what might be going wrong with a program and, thus, to trigger meaningful discussions with the authorities so as to improve program implementation and the realization of the program's objectives.

6. Article IV consultations after termination of an arrangement

Most Directors agreed that consultations provided the primary means for the assessment of policies after termination of an arrangement. Some countries might find it useful in the absence of such a program with the Fund to have six-monthly reviews; the Fund should be ready to provide that service, and the matter will be explored further in the forthcoming paper on the surveillance review, which will also seek to answer the questions of those Directors who asked for clarification of the legal or procedural basis for more frequent reviews.

7. Guidelines on conditionality and the extended Fund facility

As I noted earlier, the Executive Board agreed that the guidelines on conditionality should remain the basis for the application of the Fund's policy on the use of its resources.

Several Directors also referred to the extended Fund facility. To a large extent, the comments on that issue were similar to those made during the review of conditionality in 1983 (EBM/83/155 and EBM/83/156, 11/16/83). Several Directors believed that the structural problems facing many countries, the need for longer periods of adjustment, and the emphasis put on medium-term prospects should have resulted in a more intensive use of extended arrangements. In contrast, several other Directors believed that a continued need for caution in the application of that policy is required.

I wish to assure Executive Directors that management and staff remain committed to the extended Fund facility policy. However, I must give a word of caution: unless proper care is taken to ensure that the policy is used in support of well articulated, comprehensive, and implementable longer-term programs, greater use of extended arrangements could result in failures that would subsequently make it more difficult to utilize that type of facility. Such a development would not be in the interest of members nor of the Fund.

Only a few Directors commented on the staff paper on formulation of exhange rate policies in Fund-supported programs (EBS/84/232). It would not be appropriate, therefore, to sum up the views of the Executive Board. I note, however, that Mr. Polak stated that he essentially agreed with the staff's analysis and would like to see the paper published. Mr. Zhang, on the other hand, said that the Fund should be cautious in generally advocating a marked real depreciation of the exchange rate to restore competitiveness. That action might well be inappropriate if, for example, applied simultaneously to a number of countries exporting a commodity for which world demand is not price elastic. Moreover, he added, the data used to calculate the real effective exchange rate were often unreliable and, in any event, a sharp discrete decline in the rate could trigger reactions in the domestic economy, offsetting any potential gains from the exchange rate adjustment.

The Executive Directors then took the following decision:

1. Pursuant to Decision No. 7558-(83/156), adopted November 16, 1983, the Fund has reviewed the programs supported by stand-by and extended arrangements, as well as the appropriateness of the provisions of the extended Fund facility, and of the guidelines on conditionality, and decides that the provisions of the extended Fund facility and the guidelines on conditionality remain appropriate in the present circumstances.

2. The Fund will again review the programs supported by stand-by and extended arrangements, and the appropriateness of the provisions of the extended Fund facility, and of the guidelines on conditionality, not later than December 31, 1985.

Decision No. 7857-(84/175), adopted
December 5, 1984

APPROVED: August 28, 1985

JOSEPH W. LANG, JR.
Acting Secretary