

EBS/83/215

CONFIDENTIAL

October 4, 1983

To: Members of the Executive Board

From: The Secretary

Subject: Review of Upper Credit Tranche Arrangements Approved in  
1981 and of Some Issues Related to Conditionality

Attached for consideration by the Executive Directors is a paper on a review of upper credit tranche arrangements approved in 1981 and of some issues related to conditionality. A draft decision appears on page 12.

This subject has been scheduled for discussion on Friday, November 4, 1983.

If Executive Directors have technical or factual questions relating to this paper prior to the Board discussion, they should contact Mr. Gerhard, ext. 74987.

Att: (1)

INTERNATIONAL MONETARY FUND

Review of Upper Credit Tranche Arrangements Approved  
in 1981 and of Some Issues Related to Conditionality

Prepared by the Exchange and Trade Relations Department

(In consultation with other departments)

Approved by C. David Finch

October 3, 1983

I. Introduction

At the time of the last general review of upper credit tranche arrangements, Executive Directors decided that the Fund should examine the experience with upper credit tranche stand-by and extended arrangements no later than December 31, 1983 (Executive Board Decision No. 7257-(82/93), July 7, 1982). This paper, along with a report analyzing in detail developments under the 27 upper credit tranche stand-by and extended arrangements approved in 1981 (EBS/83/216, 10/4/83), provides discussion material for that review as well as for consideration of some issues generally related to the application of conditionality. Section II contains a discussion of the principal factors that over the years appear to have influenced the progress toward balance of payments viability achieved under stand-by and extended arrangements. Section III follows with an examination of the implications of this experience for the Fund's policies on use of its resources and with suggestions for improvements in the design of adjustment programs, and in the application of conditionality. Section IV briefly discusses the special criteria to be observed in extended arrangements under the extended Fund facility. Suggestions for the scope of the next review are presented in Section V. The paper concludes with certain questions to which Executive Directors may wish to direct special attention during the discussion and with a draft decision (Section VI).

The Executive Board has already reviewed external debt management policies at EBM/83/85, April 6, 1983, on the basis of the paper on "Fund Policies and External Debt Servicing Problems" (SM/83/45, 3/8/83). Issues relating to these policies, which are an important part of adjustment programs, are not treated further in the present paper.

II. Recent Experience with Stand-By and Extended  
Arrangements

In the accompanying paper reviewing the arrangements approved in 1981, the staff has described a wide variety of experience with Fund

supported adjustment programs. In view of the continuing changes in the economic environment and the continuing reappraisal of economic policies being undertaken in many member countries, it seemed inappropriate for the staff to attempt assigning explicit labels denoting "success" or "failure" to the programs reviewed. However, the tentative assessment of the amount of adjustment remaining to be accomplished at the end of the programs reviewed (see Background paper, pages 40-43) suggests that there were many cases where adjustment was insufficient to cope with pre-existing or newly emerging balance of payments strains. For this assessment the staff focused on medium-term balance of payments viability rather than the narrower question as to whether performance criteria were observed and whether the immediate objectives of a program (viz. targets for the balance of payments, economic growth, and inflation) were attained. While the nature of such judgments precludes exact quantitative comparison, it would appear that in this respect the experience in the present review was similar to that with arrangements reviewed on previous occasions. While progress toward balance of payments viability does not necessarily follow upon attainment of the more immediate program objectives--either because the objectives were not ambitious enough or were attained primarily because of temporary improvements in exogenous factors--most of the cases where little or no progress toward medium-term balance of payments viability was made were cases of insufficient implementation of intended policy measures.

Countries where sustained implementation of adjustment measures was achieved were generally successful in moving toward a better balance of payments position, although the extent of improvement sometimes fell considerably short of what had been intended at the outset. The association between policy implementation and results is frequently quite clear; in some cases the relationship is blurred because satisfactory progress in the initial stages of the program (often as a result of policy changes implemented as prior actions) may be eroded or more than offset by subsequent policy lapses.

The early adoption of planned policy measures appears to have increased the likelihood that an adjustment program would contribute to improve the balance of payments position. Delays in adoption of policy action in either single or multiyear arrangements frequently led to a departure from program objectives. The implementation of many of the envisaged policy measures near the beginning of the program period seems to have been one of the reasons for the relatively higher degree of success of single-year arrangements. The experience with certain multiyear arrangements in which the first program year represented only a short-term palliative or a holding operation while necessary policy measures were in preparation was not encouraging. In general, the effectiveness of multiyear arrangements was enhanced by substantial early policy action.

Another factor that appears to have played an important role in promoting movement toward a viable balance of payments position is the degree of flexibility in policy formulation in response to emerging circumstances. This flexibility was more often apparent among those countries with stronger administrative systems and/or a firm and persistent political commitment to the adjustment process. Flexibility was of particular importance for those countries that had to absorb adverse internal and/or external shocks during the program period. Countries that were willing and able to adapt their policies to a deterioration in their overall position were generally more successful in achieving the initial objectives of the adjustment program. By contrast, several of the cases in which an early departure from program objectives occurred were those in which the authorities were unable to make the necessary adaptations.

The degree of success of adjustment programs in promoting progress toward balance of payments viability was also influenced by the adequacy of program design (i.e., the appropriateness of the types and strength of the planned policy measures in light of actual developments). There are two broad categories of problems which have arisen in this context. Firstly, the impact of adverse exogenous developments, often unanticipated in the design of the program, was a significant factor in many cases. However, although such developments clearly added to the adjustment burden, they did not appear to have a systematic effect in terms of whether or not progress was made toward balance of payments viability, and therefore do not allow for generalizations to be drawn on account of this factor. A number of countries affected by severe adverse internal and/or external exogenous developments were reasonably successful in moving toward a viable balance of payments position, and the absence of adverse exogenous developments does not seem to have been sufficient in itself to ensure good results. In the 1981 arrangements for instance, initial projections of export growth during the program period proved to be overoptimistic in many instances, reflecting in part incorrect anticipation of the duration and severity of the recession in the industrial countries. In several cases, it can be argued that the relatively favorable view of export prospects at the initiation of a program may have contributed to the adoption of policies aimed at a more gradual adjustment path than proved to be appropriate under the circumstances. Other unanticipated exogenous

factors (e.g., high international interest rates) may also have led to a need for a different adjustment path than had been envisaged in certain instances. <sup>1/</sup>

Secondly, the inadequacy of the program design may have related to conditions within the country itself. Programs for some countries were difficult to design owing to a lack of data, the fragility of the administrative system, and limitations on the effectiveness of certain policy instruments imposed by the stage of development or type of economic system. The contribution of an adjustment program to progress toward viability of the balance of payments accordingly varied widely and was sometimes less than anticipated in such instances. Finally, the policy changes that were planned and implemented were sometimes inappropriate or not sufficiently strong to redress the problems to which they were directed. This tended to occur more frequently in programs aimed at overcoming structural inadequacies; the complexity of the problem or the difficulty in altering structural relationships to improve production incentives was apparently underestimated in several instances.

In general, implementation of adjustment measures and movement toward balance of payments viability coincided with observance of performance criteria. Similarly, most countries that achieved little or no progress toward balance of payments viability owing to inadequate implementation of planned policy measures saw their drawing rights interrupted for extended periods owing to nonobservance of performance criteria. However, as in the past there have also been a few instances in which performance criteria were observed and all or almost all of the purchases were made, but there was no clear progress toward balance of payments viability. Conversely, there were several cases where certain performance criteria were breached, sometimes by wide margins,

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<sup>1/</sup> Prospects for an early world economic recovery seemed considerably more favorable in early 1981 than proved to be the case. For example, the World Economic Outlook paper that was prepared in early 1981 (Occasional Paper No. 4) contained forecasts that compared with actual 1981-82 developments as follows:

	<u>Forecast</u>	<u>Actual</u>
Industrial countries		
Real GDP	1.5	0.4
Import volume	1.5	-1.5
World trade prices		
Oil	12.1	2.5
Non-oil primary commodities	2.4	-13.5
Terms of trade for non-oil LDCs	-1.3	-3.3
Interest rates (3-month LIBOR, in percent per year)	12.0	15.0

and purchases were interrupted, and yet some progress toward balance of payments viability was made. These were generally cases in which the authorities persevered with the adjustment effort even though the assumptions underlying the program did not hold.

### III. Some Means of Enhancing the Prospects for Adjustment

The large amount of adjustment that remained to be accomplished at the end of the program period in many arrangements is a matter of some concern, and this concern is heightened at present in the light of developments in the Fund's liquidity prospects. Whatever the reason, the absence of clear progress toward balance of payments viability in these countries implies that their capacity to effect timely repurchase of drawings from the Fund was not significantly enhanced during the period of the arrangement.

In the period since the 1981 arrangements were approved, Executive Directors have discussed ways of improving the application of conditionality on several occasions. The modifications to conditionality practices that were introduced in the past two years aimed at ensuring that adjustment policies are implemented as planned through the greater use of one-year arrangements, prior actions, reviews, and performance criteria applying to specific policy changes. This section outlines a number of additional steps that might be considered to ensure that programs supported by the Fund do promote adjustment. The first involves possible improvements in the identification of a sustainable balance of payments position in each program and the selection of an adjustment path to achieve it. The second issue is the speed with which this adjustment is to be undertaken. Thirdly, there is the question of improving the monitoring of policy implementation so as to ensure that disbursements of Fund resources are associated with achievement of the planned adjustment. Finally, the following section also deals with the issue of the accumulation of undrawn balances in multiyear arrangements.

#### 1. The identification of a viable external payments position

The aim of the adjustment policies must be the attainment of external viability over the medium term. <sup>1/</sup> In practice, however, the main operational focus of programs has often been on the immediate problem of matching claims on resources with available financing during relatively short program periods or subperiods. This has sometimes

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<sup>1/</sup> External viability implies that following the adjustment period during which Fund resources are being used, the overall balance of payments is brought into equilibrium, net of any intended changes in foreign reserves. In most situations this would mean the attainment of a current account deficit that can be financed by normal capital flows, given the foreign reserve target.

resulted in insufficient attention being paid to the delineation of the path to external payments viability over the medium term. In particular, the analysis of the expected strength of the balance of payments at the time when repurchases fall due has sometimes received insufficient attention even in cases of three-year arrangements.

To provide a single set of quantitative projections for all relevant variables to describe the prospective path to balance of payments viability over any extended period is rarely possible. Such projections must be based on the most realistic assumptions; wishful thinking may misguide such projections as much as they may misguide the choice of policy instruments suitable for accomplishing the degree of adjustment that is required. Projection of variables which are known or can be targeted presents relatively few problems; these are scheduled external debt service payments and the desirable development of the country's international reserves. Other variables such as plausible magnitudes of capital inflows and of export prospects have to be based on various assumptions with regard to the external environment and domestic policies. Estimates of the amounts of imports can then be obtained corresponding to these alternative projections. In this manner the policy measures envisaged may be examined for consistency within a likely range of expected positions and in the light of actual outcomes, the program could serve as a continuing frame of reference for any policy adjustments that need to be made. In that sense it would be helpful if it could be stated in advance what specific additional measures would be taken over the course of the arrangement should that prove necessary. The point to be emphasized is that an assessment of the adequacy of adjustment programs will always have to hinge upon a qualitative evaluation of the underlying policy commitment and the credibility of measures already undertaken and policies already set in train.

## 2. The speed of adjustment

The presentation of medium-term scenarios for the achievement of a viable balance of payments position is also an important element in determining the appropriate speed of adjustment. Adjustment can only be orderly if it is programmed to take place sufficiently fast to keep the demand for exceptional finance over the projection period within the limits of the prospective supply. In light of the general reduction in the access of developing countries to financing from commercial sources since mid-1982 and the uncertainties surrounding future financial flows, there is a clear need at present for adjustment in many countries to take place promptly to reduce financing requirements. The programs under review show clearly the costs that delayed adjustment can involve for countries. The continued existence of arrears and failure to restore the confidence of potential creditors disrupts trade flows, interrupts the extension of normal trade credits, raises the price of imports, and creates incentives for capital flight. The

prompt restoration of normal trading conditions in these circumstances has been shown to have considerable and immediate benefits to offset the costs associated with rapid adjustment.

Faster adjustment means that more of the necessary measures would have to be taken at the outset of the program and not deferred until later years. However, the nature of certain measures may be such as to require implementation over an extended period. Even when measures are taken promptly in such situations, their results and thus the process of adjustment may take several years to be completed, and it is important to ensure that the thrust of the measures is sustained in the intervening period.

### 3. Monitoring adjustment programs

The guidelines on conditionality mention several techniques for ensuring and monitoring the implementation of adjustment programs supported by Fund resources. These include prior actions, performance criteria, consultations, and the use of reviews. Performance criteria relating to macroeconomic variables remain the primary monitoring instrument, although criteria relating to other important variables have been used on those occasions when they were judged essential for program effectiveness. Prior actions and review clauses have assumed increasing importance in current circumstances, characterized as they are by deep-seated imbalances and distortions, uncertainties, and the need for prompt adjustment. The use of prior actions was reviewed by the Board on previous occasions when it discussed the staff reports on the "Review of Upper Credit Tranche Stand-By Arrangements Approved in 1978-79 and Some Issues Related to Conditionality" (EBS/81/152, 7/14/81, page 21) and "Review of Recent Extended and Upper Credit Tranche Stand-By Arrangements" (EBS/82/97, 8/9/82, pages 14-17). While recognizing that prior actions do not guarantee that an adjustment program will be implemented as planned, Executive Directors agreed that pre-conditions could usefully be applied on a case-by-case basis; the experience of the countries under review confirms this judgment.

Program reviews have also become an increasingly common feature of Fund arrangements, and serve three main purposes: (i) to examine policy implementation and the appropriateness of policies requiring continuous monitoring (e.g., the exchange rate, interest rates, budgetary control); (ii) to discuss specific policy actions required to implement undertakings made in general terms at the outset of the arrangement, but scheduled to be made effective at a later stage; and (iii) to establish performance criteria at the beginning of each program year in multiyear arrangements, or for a subsequent portion of a program year in those cases when projections for the entire period could not be made with a sufficient degree of certainty at the outset.

Reviews are not generally substitutes for predetermined quantified performance criteria but are often required as supplementary monitoring devices. Quantitative performance criteria are needed to give form to



a program and can provide a focus for the necessary political commitment. Reviews can be an essential adjunct to these performance criteria, since they provide an opportunity for ensuring that actual developments do not invalidate the assumptions underlying the performance criteria. In particular, they may permit an earlier detection of departures from the planned adjustment path than is possible when exclusive reliance is placed on the quantitative criteria. The review process is essentially a cooperative effort between the Fund and the authorities. While in some cases the reviews allow an early identification of additional measures needed to keep adjustment on course, in other cases, where policies have proved more effective than expected and adequate financing is available, they may indicate the possibility for some relaxation.

Review clauses have often proved to be especially useful in cases where the magnitude of the imbalance is large, or the quantification of the impact of policy changes is unusually difficult, and where the past record of adherence to an adjustment program is poor. A review would be of particular importance for programs involving structural adjustment measures including exchange rate action because those measures often result in improvements in economic performance only after a considerable delay. Similarly, the inadequacy of economic performance takes time to be manifested. In such cases, more emphasis should be placed on monitoring implementation in a direct fashion, either through mid-term reviews or through more use of prior actions or performance criteria that are linked to explicit policy implementation tests at specific dates.

Reviews can also be especially useful when the main instruments for influencing the behavior of the individual economic units are direct administrative intervention or when the response to changes in financial policy instruments cannot be clearly predicted. In these cases quantitative performance criteria cannot be relied upon to the same extent as in predominantly market-oriented economies to achieve the objectives of the program. Furthermore, in such cases it can be difficult to identify precisely the relevant financial variables for monitoring the progress of adjustment. Consequently, while efforts are being made to improve monitoring of such adjustment programs through performance criteria, reviews are often the most effective means of ensuring that adjustment takes place.

The policy on waivers and modifications of performance criteria was treated in the paper on "Waivers and Modifications of Performance Criteria in Upper Credit Tranche Arrangements - Fund Experience, 1974-80" (EBS/81/70, 3/23/81). <sup>1/</sup> The practice has been to approve waivers and modifications only when the basic thrust of the program remained unchanged and when the deviations from initial targets were not very substantial. In applying this policy in current conditions,

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<sup>1/</sup> See also "Review of Upper Credit Tranche Stand-By Arrangements approved in 1978-79 and Some Issues Related to Conditionality," (EBS/81/152, 7/19/81), pp. 21-22.

particular attention has to be paid to the timing of capital inflows in connection with debt reorganization. This timing has become increasingly difficult to forecast, leading to some cases in which capital inflows have been delayed without a change in the fundamental availability of finance. In these circumstances, flexibility in the use of waivers and modifications is appropriate to permit such programs to continue despite what may be relatively large deviations from performance criteria, whenever it is clear that deviations are both transitory and reversible and provided that policy implementation is adequate and adjustment is on track. Owing to the considerable uncertainty associated with projections of such inflows, waivers of performance criteria should probably be granted only after a return to an adjustment path consistent with available financing has been ensured.

#### 4. Undrawn amounts in multiyear arrangements

A problem has been found to arise in multiyear arrangements when purchases are postponed or interrupted and large undrawn balances accumulate. Even when balance of payments need is not an issue, as a result of a prolonged failure to meet performance criteria, the member may have an inappropriately large amount available when drawing rights are restored. The cumulative nature of the drawings in multiyear arrangements arose as an extension of the procedures applied in one-year arrangements. The problems it entailed were not immediately apparent but have become clear with experience since the establishment of the extended Fund facility in 1974, and the introduction of multiyear stand-by arrangements. Executive Directors may wish to consider ways and means to avoid situations of this sort.

One possibility might be to include a provision in all multiyear arrangements that would allow for rephasing of purchases as part of a review after a prolonged interruption to a member's right to request purchases under the arrangement. Where found to be appropriate in the course of such reviews, rephasing would aim at limiting the access during any period remaining under the arrangement. It should be noted that in some cases such rephasing of purchases would involve a reduction in the total use of Fund resources under the arrangement.

#### IV. The Special Criteria Applicable to Arrangements under the Extended Fund Facility

The circumstances in which three-year extended arrangements are preferable to a series of one-year stand-by arrangements have been discussed on several occasions. Extended arrangements require the adoption of a comprehensive adjustment process aimed at correcting structural imbalances in production, trade, and prices. In line with the decision establishing the facility, such programs must contain policy measures for mobilizing resources and improving their utilization, and for reducing reliance on external restrictions, and their

aim should be to complete the adjustment process by the end of the program period. It is, therefore, of particular importance that the timing of policy actions and their intended effect throughout the program period be set out clearly at the time when the arrangement is to be approved. Moreover, it is necessary to ensure that substantial policy action is taken either prior to or in the early stages of the arrangement; of critical importance is substantial progress in reducing price distortions, including the establishment and maintenance of an appropriate exchange rate. Since the efforts involved in carrying out a comprehensive three-year program of structural adjustment are likely to make great demands on political support, it must be ascertained that this support exists and that the requisite administrative structure is in place. In this context, the record of performance under previous arrangements with the Fund would be an important consideration.

The experience with extended arrangements has been reviewed from time to time as stipulated by the Decision establishing the extended Fund facility (Decision No. 4377-(74/114). Earlier reviews have been conducted in 1976, 1979, 1981 and, most recently, in conjunction with a review of experience under stand-by arrangements in 1982 (EBM/82/92-93, July 7, 1982). On these occasions, the validity of the principles underlying the establishment of the extended Fund facility has been reaffirmed by Executive Directors. While it has been noted that the distinction between extended arrangements and other types of arrangements has, at times, been blurred, the need for observance of the particular criteria contained in the Decision has been stressed. Experience with extended arrangements approved in recent years suggests that these criteria have generally been met in the design of the programs. Thus, the ten extended arrangements approved in 1981 contained significant elements of policy aimed at overcoming structural maladjustments. Policies aimed at improving investment and saving performance and the sectoral allocations of resources, growth and export prospects, and the capacity to service external debt. That is not to say that in all of these cases significant or sufficient structural adjustments were, in fact, accomplished, but in those instances where it became apparent that policies actually implemented did not warrant Fund support under the extended Fund facility, requests for subsequent purchases were not entertained and five arrangements were canceled (see Background Paper, Table 1). Similarly, of the six extended arrangements approved in the year before 1981 that were to continue into 1981, 1982, and 1983, three were canceled. A full assessment of the extended arrangements approved in 1981 or more recently is not feasible at this time since none of these arrangements has as yet expired. However, it may be noted that only six extended arrangements were approved in 1982 and 1983.

## V. Suggestions for Further Work

The present paper, together with the accompanying report (EBS/83/216, 10/4/83), provides material for the fourth review by the Executive Board of adjustment programs supported by upper credit tranche arrangements in compliance with paragraph 12 of the revised guidelines on conditionality adopted in 1979 (Decision No. 6056-(79/38), 3/2/79). These reviews have covered on a chronological basis the arrangements approved in the five-year period, 1977-81. They have enabled a number of important improvements to be made in assessing the appropriateness of adjustment programs and in evaluating the effectiveness of policy instruments and monitoring techniques. At the same time, some limitations of the chronological approach to reviews have become apparent. One aspect of this approach has been that while focusing on timeliness it has tended to sacrifice attention to the lagged effects of some policy action. In some cases these can only be observed several years after a program has been implemented. Another area which has received insufficient attention partly as a result of adopting a chronological approach is the cumulative use of Fund resources over extended periods in the case of some members.

All recent reviews have noted that a number of countries achieved little or no progress toward balance of payments viability during the period covered by an arrangement with the Fund. There were also a number of cases in which some progress was achieved, yet the amount of adjustment remaining to be accomplished was still substantial, as highlighted in the background paper for the present review of arrangements approved in 1981. In such circumstances, several countries have made continuous use of Fund resources over an extended period. This raises questions concerning the adequacy of safeguards to maintain the revolving character of Fund resources.

In the light of these considerations, it may well be desirable to modify the format of future background papers so as to capture longer periods for the analysis of program experience. In any case, the question of sequential arrangements and prolonged use of Fund resources would warrant special attention. Accordingly, it is suggested that the staff examine this question in the context of the next review of stand-by and extended arrangements.

## VI. Issues for Discussion and Draft Decision

The adjustment programs presently reviewed have been adopted in difficult world economic conditions. While many of the arrangements achieved substantial progress toward balance of payments viability, in others the picture was mixed or unsatisfactory. The paper provides a number of suggestions for ways in which future arrangements might be strengthened in order to ensure the revolving character of Fund resources. Among other propositions, Executive Directors may wish to react to the following:

- More use should be made of medium-term scenarios to identify for each program a feasible path to a viable external payments position.
- In view of the costs to countries of delays in normalizing their commercial and financial relations and the present reduced availability of commercial balance of payments finance, early policy actions are needed to promote rapid adjustment.
- Extended arrangements are the appropriate form of Fund support in the particular circumstances addressed by the Decision establishing the extended Fund facility. The need to formulate a medium-term adjustment strategy, to set the direction and basic stance of policy for the whole three-year period of the comprehensive programs required, is to be especially emphasized in connection with requests for extended arrangements.
- The next review paper should focus on the experience of those members that have used Fund resources continuously for several years and the ways in which the revolving character of these resources can be ensured.

In the view of the staff, the guidelines on conditionality remain a suitable basis for application of the Fund's policy on the use of its resources under stand-by and extended arrangements. Consequently, no amendment to the guidelines is proposed at present. Similarly, the provisions of the extended Fund facility remain suitable for dealing with particular payments problems of a more structural nature.

The following draft decision is therefore proposed for adoption by the Executive Board:

1. Pursuant to Decision No. 7157-(82/93) adopted July 7, 1982, the Fund has reviewed the provisions of the extended Fund facility further, together with a review of the Fund's stand-by arrangements, and decides that the provisions of the extended Fund facility remain appropriate in present circumstances.

2. The Fund will again review programs supported by stand-by and extended arrangements, not later than December 31, 1984. This review will examine the appropriateness of the provisions of the extended Fund facility and the guidelines on conditionality, with particular reference to the importance of ensuring the revolving character of the Fund's resources.