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CONFIDENTIAL

INTERNATIONAL MONETARY FUND

Committee of the Whole for the Development Committee

Meeting 89/2

12:20 p.m., March 10, 1989

M. Camdessus, Chairman
R. D. Erb, Deputy Managing Director

Executive Directors	Alternate Executive Directors
	C. Enoch
Dai Q.	
	M. E. Hansen, Temporary
	J. Prader
	L. B. Monyake
	R. J. Lombardo
	G. García, Temporary
	N. Kyriazidis
M. Finaish	
M. R. Ghasimi	O. Kabbaj
	B. Goos
J. E. Ismael	E. Kiriwat
	L. E. N. Fernando
A. Kafka	
	W. N. Engert, Temporary
Mawakani Samba	
	I. A. Al-Assaf
	M. Fogelholm
	D. Marcel
	G. P. J. Hogeweg
	C. Y. Legg, Temporary
	S. Yoshikuni

J. W. Lang, Jr., Acting Secretary
B. J. Owen, Assistant

Also Present

Y. L. Fortin, Executive Secretary, Development Committee. IBRD: M. F. Carter, Policy, Planning and Research Staff; V. Corbo, Office of Development Economics: C. Humphreys, Africa Regional Office. African Department: M. Touré, Counsellor and Director; C. Briançon, A. Jbili, R. C. Williams. Exchange and Trade Relations Department: H. B. Junz, Deputy Director; M. G. Gilman, H. Hino, K. M. Meesook, G. Oliveros, C. Puckahtikom, R. L. Sheehy, B. C. Stuart. External Relations Department: E. Ray. Legal Department: R. H. Munzberg, Deputy General Counsel. Research Department: Y. Harada, D. Villanueva. Treasurer's Department: H.-C. Kim. Advisor to the Managing Director: A. K. Sengupta. Personal Assistant to the Managing Director: H. G. O. Simpson. Advisors to Executive Directors: M. Al-Jasser, P. E. Archibong, P. O. Montórfano, P. D. Péroz, M. Pétursson, A. Vasudevan, J. E. Zeas. Assistants to Executive Directors: R. Comotto, A. Y. El Mahdi, S. K. Fayyad, B. R. Fuleihan, M. Hepp, P. Kapetanovic, K.-H. Kleine, R. Marino, T. Morita, N. Morshed, M. J. Shaffrey.

1. PROBLEMS AND ISSUES IN STRUCTURAL ADJUSTMENT; STRUCTURAL REFORM IN *FUND-SUPPORTED PROGRAMS; AND PROGRESS OF INITIATIVES BENEFITING* SUB-SAHARAN AFRICA

The members of the Committee of the Whole for the Development Committee considered a staff paper on structural reform in Fund-supported programs (EB/CW/DC/89/3, 2/15/89), and a paper prepared by the World Bank staff on the Bank's experience with structural adjustment lending (EB/CW/DC/89/4, 2/16/89), together with a summary, prepared jointly by the staffs of the Fund and the World Bank, of the problems and issues raised in those two papers, and a joint staff paper on progress with initiatives benefiting sub-Saharan Africa (EB/CW/DC/89/5, 2/16/89). Mr. Y. Fortin, Executive Secretary, Development Committee was present.

The Executive Secretary noted that the papers before the Committee members had been prepared in response to a request from the Development Committee in the communiqué issued following the September 1988 meeting in Berlin. The innovation, in 1988, of reports prepared jointly by the staffs of the Fund and the World Bank provided an opportunity to present succinct general conclusions and selected key policy issues to Ministers, thereby permitting a more focused discussion of the topics under consideration. The President of the World Bank had prepared his usual report to members of the Committee covering, in addition to structural adjustment--problems and issues--and a review of progress of initiatives intended to benefit sub-Saharan Africa, other issues on the agenda--development prospects in severely indebted countries, recent trade developments, and trends in resource transfers to developing countries, as well as a status report on the IDA-9 negotiations. The Executive Directors of the World Bank had reviewed the staff papers and the President's report on March 2, and their comments on some of the policy issues would be taken into account in the final versions.

Finally, the Executive Secretary said that the Chairman's opening statement, which was also part of the documentation for the meeting, and which had been released that day, covered a number of broad policy questions on structural adjustment and debt that members of the Committee might want to address themselves at the spring meeting of the Development Committee.

Mr. Goos remarked that his authorities' reading of paragraph 12 of the September 1988 Communiqué of the Development Committee, in which the two institutions were requested to present background documentation in a closely coordinated and integrated manner, was that a common joint paper was to have been presented. While the joint cover note was helpful, the view of his authorities was that in general, if the two institutions were dealing with common subjects, they should try to cover them in one paper.

With respect to the World Bank President's report, Mr. Goos added, his authorities wished to know whether the Managing Director of the Fund, whose advice on the topic of structural reform would be particularly helpful, intended to make a similar report.

The Managing Director responded that he would make a personal report to the Committee in which he would focus on the matter.

The Deputy Director of the Exchange and Trade Relations Department explained that it was considered more useful, when the Bank and Fund staffs had different perspectives on a particular issue, for Ministers to have separate papers joined by a summary and issues paper. Rather than leading to duplication, that would help illuminate the issues under consideration. Where the two institutions' perspectives and experiences were more similar, it was obviously useful to present one paper. Accordingly, there were two papers on structural adjustment joined by a summary issues paper, and one joint paper on sub-Saharan Africa.

The Executive Secretary commented that the wording of paragraph 12 of the September communiqué was in a way an attempt to compromise on the question of joint papers. He recognized that what was meant by integrated papers was open to discussion, but in the end, what seemed most important was for the institutions to summarize their findings, and present the issues in a coherent manner. Joint covering papers on issues took on added importance in that respect, and he hoped that the concept underlying them could be developed further so that Ministers were given a common view of subjects under discussion, without of course precluding the expression of different approaches to a specific problem or set of problems.

Mr. Goos said that he fully appreciated the reasons for the approach that had been followed. To facilitate the understanding of the procedural issues involved, he suggested that the communiqué of the Development Committee should be drafted more clearly in the future.

Mr. Hogeweg said that he wished to focus primarily on the paper prepared by the Fund staff on structural reform in Fund-supported programs, which, like the companion paper of the World Bank staff could not be seen in isolation from the current debate on the roles of the two institutions and collaboration between them. Pending the Board's discussion of the understanding reached between the Managing Director and the President of the World Bank on the respective roles of the institutions, he wished to use the occasion to indicate the point of view of his chair on such matters, with reference also to his statement, covering essentially the same subject, when the Board discussed the fiscal aspects of Fund-supported programs (EBM/88/81, 5/20/88). The view of his chair remained that the Fund, on the basis of its surveillance function, was indeed primarily responsible in the macroeconomic field. But the Fund should also give the signal--for instance, by stressing the short-term character of its responsibilities--that it was not intending to expand Fund activities outside those fields that had been in its domain for more than 40 years.

The documents under discussion were most revealing as to why both institutions were intruding on each other's turf, Mr. Hogeweg considered. The essence of their reasons was provided on page 2 of both of the papers on experience with structural adjustment, and in similar wording. The Fund staff paper said that: "Demand management and structural adjustment are viewed as complements not substitutes." The Bank staff paper stated that "Adjustment lending is a complement to rather than a substitute for investment or project lending." Both statements were, of course, true.

The Fund staff paper provided the rationale for the increasing emphasis on structural elements in growth-oriented Fund programs framed in a medium-term context, Mr. Hogeweg remarked. The paper pointed to the ingrained nature of imbalances, rigid economic structures which impeded growth, and impediments to the efficient transmittal of macroeconomic policy signals. Thus, in those circumstances, too heavy reliance on demand management might only cure the symptoms and not the underlying causes of imbalances, and structural reforms had to be pursued consistently over extended periods.

He agreed that structural reforms were desirable and even necessary in many instances, Mr. Hogeweg went on, but the issue was rather the role of those reforms in Fund-supported programs. In the view of his chair, that role should be a limited one only. The monetary character of Fund resources set limits to their use for financing balance of payments deficits during the time-consuming process of structural reform. The staff paper noted that the Fund's best successes in structural adjustment had been in areas like pricing reform, which could be introduced relatively quickly and which also had the most direct bearing on macroeconomic stability. He considered that only those structural reforms that were either essential for the effectiveness of macroeconomic policy instruments, or that had a clear direct linkage with external viability, should be included in Fund-supported programs. The staff paper admitted that such linkage had not always existed. Other structural adjustment issues--for instance, privatization of public enterprises--should be left for other institutions, most notably the World Bank. However, account should be taken of the valuable contribution that had been made in some cases by the Organization of Economic Cooperation and Development, even though it was not a global institution. The best way to ensure smooth cooperation between different institutions was, in the view of his chair, a clear delineation of responsibilities, with room being given to others if they were already doing a good job.

It was essential for the Fund to avoid too much gradualism in the programs it supported, Mr. Hogeweg observed. Fund programs and financing should remain essentially short term in nature. If adverse external developments or sweeping adjustment efforts--as opposed to weak implementation--necessitated a more prolonged Fund involvement, consecutive short-term arrangements should of course be possible. The staff paper stressed the growth orientation of Fund-supported programs, rightly so, but the Fund's point of view should be that restoration of internal and external equilibrium itself provided that orientation.

Mr. Ismael made the following statement:

My intervention will be focused on problems and issues of structural adjustment based predominantly on the case of Indonesia which has had the most intensive experience with this matter within my constituency during the past five years.

Let me start off with the most valuable lesson from our experience, namely, that sound macroeconomic management comes before all other economic policies--during a boom period, and even more so during a period of more difficult circumstances. Structural adjustment is unlikely to take root in an unstable, inflationary economic environment, for three reasons.

First, inflation distorts the price incentives that are at the core of structural adjustment. In an inflationary economy, investments and other activities are directed toward taking advantage of inflation, and less rewarding activities that increase efficiency and boost productivity are necessarily ignored. Inflation drains resources away from productivity growth, which is essential to economic development. There is little point in starting market-based reforms when inflation nullifies their impact.

Second, the crises that abound in an unstable economy absorb most of the attention and energies of policymakers and economic managers. Little capacity is left for the tasks of steering reforms through the political and economic system.

Third, many of the features of a stabilization program are also essential for structural adjustment. Alignment of an overvalued exchange rate, adjustment of interest rates to yield positive real returns, the balancing of budgets to shift more resources into private hands--these and other components of stabilization are the beginning of the structural adjustment process itself.

Structural adjustment is a broad concept covering many aspects of economic management. There are three basic components to structural adjustment, as we generally use the term. These are getting prices right, letting markets work, and reforming public institutions.

"Getting prices right" means that key prices have to be adjusted to reflect the real values of scarce commodities and resources. Most economists assume that the market is the best arbiter of "right" prices. But this is not necessarily the case. Indeed, most governments carefully manage some of the most important prices: the exchange rate, interest rates, and basic food prices are often controlled or influenced by government rather than left to be determined solely by market forces. Still, these and other controlled prices can be gotten "right" through sound management.

That leads to the second component of structural adjustment: letting markets work. One advantage of letting markets determine prices is that it frees the energies of economic managers to concentrate on other essential reforms. But a more important advantage is that freer markets induce more competition. Competition, in turn, forces all producers to watch their costs, and in the process, to increase their productivity. Open economies that face foreign competition, and those that give free rein to competition from within, often enjoy large productivity gains and hence more rapid economic growth. This lesson, once confined to the mixed economies of the west and the developing world, has now been learned by the socialist countries as well. In a competitive environment, the profit motive becomes the very instrument by which productivity can grow, incomes can be raised, and welfare can be increased.

However, it is not possible to give freer rein to the market with a stroke of the pen. Permitting more decisions to be made by the market requires that fewer decisions be made by government bureaucracies. Not only must there be less bureaucracy, but bureaucrats must take on a new role. Instead of intervening to control private economic agents, bureaucrats need to avoid intervention, and instead, to facilitate private activity. This change of both function and attitude constitutes the third component of structural adjustment, reforming government institutions. Economists often overlook this component, and managers often shun the task, because it can take years to transform bureaucracies. But unless institutional reforms are made, the old bureaucracies, acting in the old ways, can stifle the competitive effects of other measures and thwart the intentions of economic reformers.

Some countries, especially in Latin America, have run into trouble when they freed both domestic financial markets and the flow of foreign capital. One prescription from experts on Latin America, therefore, is not to relax controls on foreign capital flows until the domestic financial market has been deregulated, and interest rates have settled down to some long-term equilibrium. In Indonesia, however, we did the opposite. With foreign exchange having been freely convertible for 15 years, we freed up domestic interest rates in 1983 and further deregulated the financial markets just three months ago. As in Latin America, domestic interest rates have been high ever since, with deposit rates some 7-9 points above the rate of inflation, and lending rates another 5 points higher. Yet we have not had the destabilizing flows of foreign capital experienced in Latin America. Given cautious fiscal, monetary, and foreign exchange management, the financial markets seem to be in equilibrium with these rates. Of course, one task for the future, and an objective of financial reform, is to bring these high rates down as the financial system becomes more competitive, more efficient, and better integrated.

On the issue of timing, Southeast Asia, indeed Asia in general, seems to stand apart from the experience of many countries of Latin America and Africa, where "windows of opportunity" for fundamental restructuring seem to occur mainly when governments change, especially when the outgoing government's economic policies have been discredited by events and by public opinion. In many countries in Asia, we have had reforms with a stable government--in Indonesia, for more than two decades.

Instead, the spur to reform has been the price volatility that has faced oil exporters to this day. The Government has been associated with sound macroeconomic management for many years. So when we faced declining oil prices, public opinion could be easily mobilized in support of necessary measures, including reforms. There is a difference between now and a decade ago. Then, as now, we could gain support for macroeconomic measures to stabilize the economy. Today, more so than a decade ago, it is evident to everyone that we need sound microeconomic management as well, because export growth requires a low-cost economy.

With the extended oil crisis, gradualism has been a possibility for us in Indonesia. This is fortunate because it has enabled policymakers and implementors to work within their capacities to plan and execute reforms. Moreover, gradualism has the advantage of progressively winning over a new constituency for further reform. As businessmen, especially exporters, begin to recognize the benefits of a low-cost economy, new voices appear in support of further structural adjustment.

In concluding, let me also draw another valuable lesson from our experience. The benefits of deregulation and economic growth must be widely and evenly spread among the population. In particular, development of the rural areas should continue to be emphasized in any set of economic reforms.

Mr. Kafka said that he wished to give particular emphasis to three points that had been suggested by the joint staff paper on problems and issues in structural adjustment. The first concerned the need to cushion the impact of programs on the poorest classes of society. The second point concerned the need for longer and more comprehensive financial assistance in structural reform programs, without prejudice to the principal responsibility, which falls on the program country itself. The third point concerned the need for sustained improvement of the external environment if those structural programs were to be successful. In referring to financial assistance, he had in mind not only the restructuring of amortization and new money, but also debt and interest reduction, in the interest of both creditors and debtors, as had been so well explained in the staff paper on the debt strategy (EBS/89/31, 2/24/89) and in the most recent World Economic Outlook.

With respect to the five issues suggested for discussion at the end of the joint staff paper on problems and issues in structural adjustment, Mr. Kafka observed, first, that whether a program should comprise both macroeconomic measures and structural as well as institutional reform could not be defined in terms of general rules; a case-by-case approach would have to be followed.

On the second and third issues for discussion, Mr. Kafka considered that it would be helpful if the benefits as well as costs to program countries as a whole, and to the different social groups within the country, were to be carefully explained. That was a task exclusively for the government concerned as far as supplying information to its own public was involved. The technical assistance of the Fund, and, as the case might be, of the Bank, would of course be welcome in helping a government to formulate its explanation. Social measures to lighten any major, even transitory burden, particularly on the poorer groups, would be helpful. Any link between program implementation and provision of external finance must be formulated so as to avoid as much as possible interrupting the flow of finance as a result of minor deviations from the program. The use of review clauses, not only as complements but also as substitutes for more precise performance clauses, should be reconsidered.

On the fourth and fifth issues for discussion, the conditions for the success of a program included an adequately long time frame and adequate financing--in the widest sense of the term, Mr. Kafka said. They also included symmetrical action on the part of other countries, namely, a program of trade liberalization by a program country must be met by corresponding initiatives by its trading partners. Measures in the chosen areas of reform would have to be implemented within a prudent amount of time, allowing some flexibility to the implementing country. In the area of fiscal reform, for example, it had been suggested that countries would be better off reducing import tariffs and increasing domestic taxes. That approach might sometimes require a degree of devaluation additional to what might otherwise be necessary, possibly creating, in the short run, an excessive burden on the structural reform program. There would also be the obvious administrative problems, even though the Fund's technical assistance in that area could be very helpful.

Therefore, in addition to his comments on the general questions, Mr. Kafka concluded, it became clear that the Fund's, and as the case might be, the Bank's technical assistance would have a particularly important role to play in the case of structural reform programs.

The Committee members agreed to resume the discussion in the afternoon.

APPROVED: September 7, 1989