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AGENDA**

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September 6, 2002

To: Members of the Executive Board

From: The Secretary

Subject: **Evaluation of the Prolonged Use of Fund Resources—  
Report on the Case Studies**

Attached for consideration by the Executive Directors is Volume II of the IEO report on the case studies on the evaluation of prolonged use of Fund resources. This subject, together with Volume I, is tentatively scheduled for discussion on **Friday, September 20, 2002**. The report is unchanged from the version that was previously circulated to the Evaluation Group as EG/02/7 on August 12, 2002.

As indicated for Volume I, the Director of the IEO proposes that after the Executive Board completes its discussion, the paper be posted on the external IEO website together with management comments, any IEO response, and a summary of the Board discussion. It would also be published in hard copy.

Questions may be referred to Mr. Goldsbrough (ext. 34735), Mr. Tsikata (ext. 39601), and Mrs. Mateos y Lago (ext. 37219) in IEO.

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INTERNATIONAL MONETARY FUND

**INDEPENDENT EVALUATION OFFICE**

**EVALUATION OF THE PROLONGED USE OF  
IMF RESOURCES**

**VOLUME II: REPORT ON THE CASE STUDIES<sup>1</sup>**

September 3, 2002

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<sup>1</sup> This report was prepared by a team headed by David Goldsbrough and including Kevin Barnes, Isabelle Mateos y Lago, and Tsidi Tsikata and was approved by Montek S. Ahluwalia, Director of the Independent Evaluation Office (IEO). Sections of the report have also benefited from comments and other inputs from Professor Graham Bird, Professor Jong-Wha Lee, David Peretz, and Professor Andreas Wimmer, but the final judgments are the responsibility of the IEO alone. Research assistance from Mwaffak Taib, Ned Rumpelstin is gratefully acknowledged.

Contents	Page
Executive Summary .....	6
Pakistan	
I. Introduction.....	11
A. Pakistan's Prolonged UFR Experience Points to a Limited Effectiveness of its IMF-Supported Programs.....	11
B. The Lack of Effectiveness of Pakistan's IMF-Supported Programs Stems from Both Design and Implementation Issues .....	16
C. Some Program Design Problems were Rooted in Deeper IMF Governance Issues .....	30
D. Conclusions and Suggested Remedies.....	41
Boxes	
1. Ownership Assessment in the Context of Pakistan Arrangements with the IMF.....	25
2. A Chronology of IMF Conditionality on Agricultural Taxation in Pakistan....	28
3. The Coverage of the Issue of Foreign Currency Deposits in IMF Staff Reports .....	37
Figures	
1. Pakistan's History of Lending Arrangements.....	13
2. Growth of GDP, Exports, Gross Domestic Savings, and Gross Domestic Investment .....	17
3. Current and Capital Account Projections and External Debt .....	19
4. General Government Balance and Tax Revenues .....	20
5. Evolution of Pakistan's Tax Revenue Structure .....	21
6. Evolution of Structural Conditionality in Pakistan .....	29
7. Evolution of Access in Pakistan IMF Arrangements.....	41
8. Political Economy Analysis Toolbox .....	47
Annexes	
I. An Illustration of Ownership and Political Feasibility Assessment in the Context of the 1993/94 Programs Through the Use of Basic Political Science Tools.....	45
II. List of People Interviewed in Connection with the Evaluation of Prolonged Use of IMF Resources .....	48
III. Pakistan's History of Lending Arrangements.....	50



Contents	Page
Philippines	
I. Introduction.....	51
II. Overview of the Philippines' Experience with IMF-Supported Program .....	52
A. The Marcos Period Prior to the 1982-83 Debt Crisis: Almost Continuous Programs that Achieved No Lasting Adjustment.....	52
B. The Debt Crisis and Subsequent Prolonged Debt Workout, 1983-1993 .....	55
C. The 1994 EFF: Restoration of Access to Private Financial Markets And the Planned "Exit" from IMF Programs .....	56
D. Asian Crisis and its Aftermath.....	59
E. Despite Some Progress, Poverty Remains High .....	62
III. Why Did the IMF Remain Involved for So Long? .....	62
IV. Implications for Program Design and Implementation.....	75
A. Program Design .....	75
B. Program Implementation .....	77
C. Improving the Tax Structure and Strengthening Tax Administration: An Example .....	80
V. Continuous Programs Have Limited the Independent Role of Surveillance.....	83
VI. Conclusions.....	86
Boxes	
1. Why Did the 1989 EFF Fail? .....	57
2. Original Aims and Outcomes of the EFF, 1994-96 .....	58
3. Many Highly Indebted Countries Took as Long as the Philippines to Resolve Their Debt Problems and Consequently Also had Repeated IMF Arrangements.....	64
4. Examples of Major Interruptions to IMF-Supported Programs in the Philippines.....	67
Tables	
1. Chronology of IMF Arrangements Since 1967 .....	51
2. Selected Economic Indicators.....	53
3. Heavily Indebted Middle-Income Countries: IMF-Supported Programs Tied to Debt-Restructuring Following the 1980s Debt Crisis .....	64
4. Tax Efficiency in Selected Asian Economies .....	81

## Figures

1. External Debt .....	54
2. National Government Tax Revenue.....	69
3. Gross National Savings .....	70
4. Implementation of Fiscal Programs .....	78

## Annex

I. List of People Interviewed in Connection with the Evaluation of Prolonged Use of IMF Resources .....	89
--	----

## Senegal

I. Introduction .....	91
II. Overview of Policies and Performance.....	94
A. Background: The 1970s and Early-1980s .....	94
B. Objectives and Policies of the IMF-Supported Programs .....	94
C. Program Implementation.....	96
D. What was Achieved Over the Extended Period of Programs? .....	98
III. Why was There Prolonged Use of IMF Resources? .....	102
IV. Effectiveness of the IMF-Supported Programs .....	104
A. Program Design: The Macroeconomic Framework .....	104
B. Structural Reforms .....	107
C. Social Policies .....	110
D. Collaboration with the World Bank.....	111
V. Ownership, Conditionality, and the PRSP Approach .....	111
A. Ownership and Capacity Issues .....	112
B. Conditionality .....	114
C. The PRSP Approach.....	115
VI. IMF Internal Governance Issues.....	115
A. Were IMF Policies to Contain “Prolonged Use” Applied to Senegal.....	115
B. Surveillance and Program Activities.....	117
VII. Conclusions and Recommendations.....	119

## Annex

I. Implementation of IMF Arrangements .....	122
II. Projections and Outturns of Selected Variables.....	125
III. List of People Interviewed In Connection with the Evaluation of the Prolonged Use of IMF Resources.....	126

Evidence from Two Countries which “Graduated” from Prolonged Used.....	128
I. Morocco .....	128
II. Lessons from Jamaica: “Implications for Ownership and the “Seal of Approval” .....	134

Tables

1. Implementation of Fiscal Programs .....	131
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Figures

1. National Saving.....	129
2. Current Account Balance .....	132
3. Central Government Balance .....	132
4. Trends in Fiscal Balance and Public Debt .....	136

## **Executive Summary of Country Case Studies**

### **Pakistan**

Since 1988, Pakistan has been almost continuously under IMF-supported programs. However, all but the last arrangement (the 2000 SBA) suffered from substantial policy slippages and soon went off-track. This intensive UFR period coincided with a marked fall in GDP and exports growth, along with a steady increase in poverty, only minor corrections of fiscal and external imbalances, and a buildup in vulnerabilities associated with foreign currency deposits. Substantial progress was achieved in a few structural reforms areas: liberalization of interest rates, trade regime and external payments; modernization of indirect taxes; and utilities pricing. However, the reform process was protracted, and considerable problems remain for lack of in-depth institutional reform, particularly in the areas of tax administration and public enterprises management. Economic governance problems also became more acute and widespread.

The limited achievements of successive programs were associated with considerable political and regional instability, but also reflected design and implementation problems. Most of the programs negotiated from 1988 onward suffered from overoptimistic assumptions regarding the path of exports, GDP and domestic savings/investment growth. They also proved to be unrealistic about the pace and breadth of the structural reform agenda which was likely to be implemented by the government, including in the area of tax reform. While it is difficult to distinguish between failure to implement agreed policies from ex ante overoptimism about key economic variables, there is little doubt that limitations on implementation ability were not fully taken into account in the program design, and the reform agenda was not sufficiently prioritized. Ex ante overoptimism was also important as some of the programs were based on projections (e.g. for tax revenues and exports) that would have been difficult to achieve even with full implementation of agreed policies.

A basic problem was that successive governments had limited ownership of the programs and were often unable to sustain the reform and adjustment effort for more than a short period of time. As a result, some of the policy prescriptions of the programs, implemented in isolation from other equally important parts of the agenda, turned out to have adverse side-effects (e.g. the net revenue shortfall—leading to excessive expenditure compression—caused by the substantial lag between the fall in revenues associated with import tariffs cuts and the full effectiveness of domestic tax reforms). Although there were limits to what an external agency could achieve in such circumstances, not all of mitigating devices at the disposal of the IMF were utilized consistently, such as track record requirements, frontloading the adjustment effort while backloading the disbursement of funds, or focusing conditionality on a few truly key objectives and pursuing them unwaveringly.

Programs with Pakistan had more than the average number of structural conditions but this structure was not effective in overcoming weak political commitment and some of the conditions were not well integrated into program design. The history of the largely

unsuccessful attempts to impose conditionality in the area of agricultural income taxation is an important example; a number of prior actions were met, but without a significant effect on the program's prospects and without yielding any significant advance in taxation of agricultural incomes. Moreover, the perception that the IMF would resume financing within a relatively short time whenever programs went off-track appears to have undermined incentives to undertake difficult adjustment decisions, especially in the fiscal area. However, the most recent programs (from late 1997 onward) do indicate some learning overtime.

Most of these design and implementation problems had their roots in institutional factors. In particular, decisions regarding the IMF's involvement in Pakistan appear to have been heavily influenced by: geopolitical considerations; the presumption of a short to medium-term involvement only; the obligation to give IMF member countries the benefit of the doubt which, in combination with relatively frequent changes of government, contributed to many programs in succession; and collaboration with the World Bank that did not always produce an effective integration of priorities and timeframes in dealing with key structural issues. As in other countries under program, IMF surveillance tended to be crowded out and, in particular, failed to give sufficient attention to the long-term implications of short-term stabilization measures for the sustainability of adjustment, to flag downside risks and to highlight sufficiently the build-up of major vulnerabilities in the capital account (associated with the foreign currency deposits). Finally, as in many other prolonged use cases, there were too few occasions when the IMF was able to "step back" and reconsider the overall strategy on the basis of candid assessments of previous programs.

The main lesson to be derived from this experience is the need for greater selectivity, based on candid ownership assessments before committing the IMF's resources, along with greater efforts to tailor program design to the specific circumstances and long-term needs of the country, focusing especially on key institutional changes.

## **Philippines**

The Philippines is the most extreme case of the prolonged use of IMF Resources, with 23 programs between 1962 and 2000. The near-continuous involvement of the IMF in the 1960s and 1970s did not prevent an unsustainable debt build-up which culminated in the early 1980s debt crisis. In this period, the IMF was dealing with a very difficult situation, epitomized by deep-seated governance problems. Although program design did not address many of the key structural problems, a lack of political commitment was the core issue, and in the circumstances, it would have been better for the IMF to have refrained from lending.

In the ten years following the 1983 debt crisis, the Philippines underwent a protracted adjustment process along with the restructuring of debt by private and official creditors tied to a succession of IMF-supported programs. As this process was completed, an EFF that was explicitly intended as an "exit program" was agreed in 1994, but before it could be completed it was overtaken by the Asian crisis. Subsequently, the IMF's program engagement lasted until 2000, even though there were growing problems with governance and doubts about

political commitment after the Estrada administration took office in 1998. Since 2000, the Philippines has been engaged in post-program monitoring with the IMF.

IMF-supported programs did encourage macroeconomic discipline and assist in the substantial transformation of the Philippines economy that occurred between the mid-1980s and the second half of the 1990s under the Aquino and Ramos administrations. Considerable progress was made in liberalizing the trade and exchange system, abolishing agricultural marketing monopolies, opening the economy to competition and eventually deregulating oil pricing. However, many of these reforms took much longer to implement than originally planned, in part because some of the original timeframes were overambitious and in part because, with the exception of some important periods when political leadership was strong, domestic ownership of the reforms did not extend to the legislative branch of government, which was critical for implementation. The 1989–91 EFF in particular, had a reform agenda that proved overambitious in retrospect. A few longstanding and critical weaknesses, including a low saving rate and weak tax collection (despite a temporary improvement in the first half of the 1990s) remained unresolved at the end of the period and contributed to prolonged use. Despite some progress, the incidence of poverty remained high.

The IMF's long involvement in the Philippines reflects a number of factors, including a difficult starting position; "seal of approval" influences; program design and implementation problems (especially difficulties of matching the timeframe of longer-term institutional reforms to shorter-term programs); and fluctuations in the degree of political commitment to and ownership of economic reforms. Toward the end of the period, the rationale for program involvement seems at times to have been too broad, reflecting the perception that surveillance was not an effective instrument for some tasks. Thus, efforts to encourage reforms and reformers or to bind an incoming administration to "sound" macroeconomic policies appear to have been important factors behind continued programs, even when a balance of payments need had become questionable.

Institutional constraints on implementation, particularly the Philippines' congressional-style political system, posed special challenges for program design and required structural conditionality to be exercised flexibly, primarily through reviews. This was probably the correct approach, but combined with the tacit understanding that the program relationship was likely to continue for an extended period, there was a tendency to "overpromise" to meet the requirements of short-term programs in the belief that recontracting would be possible. This led to some erosion of the credibility of conditionality. For some elements of reform—such as tax administration, where repeated efforts yielded some results in raising the tax effort, but which were ultimately not sustained—it would have been preferable if a longer time-frame had been adopted from the start, combined with a greater emphasis on strengthening implementation capacity, and more direct attention to governance concerns. While there were more efforts at ex post assessment of programs than in the other two country cases, not all of the results of these assessments were conveyed to the Executive Board.

## Senegal

Except for a nearly two year period during 1992-93, Senegal has had a continuous succession of IMF arrangements since 1979. From 1986, the bulk of IMF lending to Senegal has been under multi-year arrangements supported by resources from the IMF's concessional facilities—one SAF and three ESAF/PRGF.

The main reasons for Senegal's prolonged use of IMF resources include: (i) large initial imbalances, deeply rooted in structural weaknesses of the economy, which were likely to require a long time to address in a sustainable manner; (ii) a broadening of objectives of programs, in step with the evolution of the SAF to the ESAF and the transformation of the ESAF into the PRGF; (iii) the use of IMF arrangements as a seal of approval for the provision of external finance by several multilateral and bilateral creditors and donors, combined with an approach to dealing with the debt problem that only brought about a resolution gradually; (iv) weaknesses in program design—in particular, the pre-1994 programs were too optimistic about how effective the adjustment strategy being pursued would be in promoting growth and sustainable financial viability; and (v) a stop-go pattern of program implementation that weakened the effectiveness of programs and contributed to the continuing “need” for IMF arrangements.

Successfully implemented programs tended to be characterized by strong political commitment (regardless of the precise nature of conditionality), significant upfront adjustment measures, and adaptations of policies during program reviews when there were substantial actual or prospective deviations from targets (usually fiscal targets). In the cases where implementation was weak, contributory factors included election cycle pressures which led to delays in implementing measures or sometimes to policy reversals.

IMF policies aimed at containing the phenomenon of prolonged use—such as reduction in access levels in successive arrangements, comprehensive ex post assessment of programs, and the formulation of “exit” strategies—were not applied consistently to Senegal. The rules on declining access levels were applied, although the country enjoyed slightly above average access levels in its three ESAF/PRGF arrangements. *Ex post* assessments were undertaken to some extent, although the most recent example, a Country Strategy Paper prepared in 1998, did not draw lessons for program design from the non-implementation of reforms under previous arrangements. On the issue of an “exit strategy,” we found no evidence that the issue of “graduation” from IMF-supported programs has been discussed internally or with the authorities in any systematic manner.

Key lessons for improving the effectiveness of Senegal's IMF-supported programs include: (i) the need to foster greater ownership of structural reforms; (ii) capacity constraints and measures for improving implementation should be articulated more clearly; (iii) in order to help programs adapt better to uncertainty, the principal risks and how policies would adapt to them should be set out more explicitly; (iv) Bank-Fund collaboration needs to improve to address fundamental institutional/structural issues at the heart of prolonged use; and (v) surveillance discussions and reports should be used as an occasion to “step back” and

reconsider the overall strategy, including stress-testing of major vulnerabilities and downside risks, and a discussion of alternative policy options and trade-offs.

### **Morocco and Jamaica**

**Morocco** is one of the few recent prolonged users to have “graduated”. After nine arrangements starting in 1980, it has had no program since 1993. Progress, while eventually substantial, was not smooth. Programs were initially overoptimistic about the time frame needed to restore external viability. There were setbacks from exogenous shocks and periodic slippages in implementation, but policies on core issues continued to move in the right direction, although not always at the pace envisaged by programs, in part reflecting the authorities’ concerns over political feasibility. For the most part, there seems to have been little difference in the IMF’s approach in Morocco compared with other prolonged users. The real difference seems to have been made by strong domestic ownership and political stability, rather than by the structure of conditionality, which was generally exercised flexibly through program reviews. The IMF and the authorities appear to have taken a narrower view of what would justify further program engagement than in some other prolonged users- for example, it is not clear that Morocco’s situation differed greatly at the time of its graduation from that of the Philippines.

**Jamaica** is a former prolonged user that made a decision, after its last EFF expired in 1996, not to seek further financial support from the IMF, although at that time it still faced large adjustment challenges. In particular, the authorities strongly rejected the IMF’s policy advice at the time that a major adjustment of the exchange rate was necessary to restore competitiveness and favored instead a strategy based on running high fiscal surpluses to prevent the debt dynamics from deteriorating further. In the staff’s view, earlier programs had been mainly motivated by the need to obtain foreign financing and debt relief, and the weak ownership that resulted was a major reason why programs had not achieved their objectives. The authorities’ move away from a financial arrangement with the IMF was associated with much stronger domestic ownership of macroeconomic policies, which proved critical to firmer implementation of their chosen strategy. Jamaica remained able to access international capital markets at fairly low spreads, despite the absence of an IMF arrangement. In 2000, staff monitoring of the authorities’ economic program was agreed, and this has played a useful role, allowing room to combine a strong domestic policy formulation process with a healthier policy dialogue with the IMF-while providing a signal to donors and lenders, particularly the multilateral development banks, about the adequacy of the macroeconomic framework.



## PAKISTAN

### I. INTRODUCTION

1. Pakistan is one of the most prolonged users of IMF resources and has been under IMF-supported programs almost continuously since the late 1980s.

2. This report aims to cast light on what successive IMF-supported programs achieved and failed to deliver (Section A) and on the factors underlying their limited success.<sup>1</sup> In particular, two such factors, which appear to have been critical in the Pakistan case, are analyzed in depth, namely (i) program design and implementation problems (Section B); and (ii) internal IMF governance issues affecting the rationale for IMF involvement, the effectiveness of surveillance and program design itself (Section C). The report concludes by highlighting a few key lessons from this experience and outlining suggested remedies.<sup>2</sup>

3. This evaluation was conducted based on (i) reviews of IMF staff reports and internal documents (including mission briefs, internal review comments and selected technical assistance reports); (ii) interviews with IMF staff, a broad range of Pakistani stakeholders and staff of the World Bank;<sup>3</sup> (iii) a survey of relevant academic literature and (iv) independent work commissioned by the IEO from the Center for Development Research at the University of Bonn (see Appendix I).

#### **A. Pakistan's Prolonged UFR Experience Points to a Limited Effectiveness of its IMF-Supported Programs**

4. Pakistan's economic history over the last thirty years can be subdivided in two periods. From 1970 to the late 1980s, Pakistan enjoyed an impressive growth performance (6-7 percent per year on average). Fiscal and external imbalances were large during most of that period, but unlike in many other developing countries, they did not lead to hyperinflation nor to a debt crisis, which led Pakistan to be sometimes referred to as a "development puzzle".<sup>4</sup> However, the picture deteriorated markedly from the late 1980s onward, as growth faltered and the continued failure to rein in the fiscal and current account deficits led the debt which had been accumulating for over two decades to become unsustainable. Pakistan made an intensive use of IMF resources during both periods, but became continuously dependent upon IMF-supported programs only in the second one.

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<sup>1</sup> In keeping with the IEO's Terms of Reference, which prevent it from commenting on ongoing operations, the PRGF arrangement approved in December 2001 is not within the scope of this review.

<sup>2</sup> Lessons and recommendations are elaborated in greater detail in the main report.

<sup>3</sup> A full list of people outside the IMF interviewed by the IEO is provided in Appendix II.

<sup>4</sup> In fact, as the subsequent discussions will show, the achievements of that period hinged upon the build-up of partially disguised debt vulnerabilities.

## **1. Overview of Pakistan's history of use of IMF resources since 1970<sup>5</sup>**

### ***a) 1970/71–1987/88: repeated but discontinuous use of IMF resources***

5. Pakistan had four one-year stand-by arrangements<sup>6</sup> (SBAs) with the IMF between 1972 and 1977. They were followed by a three-year extended arrangement in 1980 which was to provide close to SDRs 1.3 billion (445 percent of quota) over three years. The programs supported by these arrangements were classic macroeconomic stabilization programs, which put little emphasis on structural reforms (although the program supported by the 1980 EFF did consider reforms in the areas of taxation, tariff reform and price liberalization).

6. All SBAs except the first one were entirely disbursed. However, they did not succeed in correcting durably the underlying imbalances. As the dollar (to which the Pakistani rupee was pegged) began appreciating in 1979, pressures on competitiveness increased and a new recourse to IMF resources proved necessary. In spite of strong policy implementation in the first year of the EFF-supported program, in 1981 devaluation could not be avoided. Thereafter, slippages in the fiscal and monetary area grew larger and the pace of reform slowed, so that after several delays in the completion of reviews, the program was eventually declared off-track.

### ***b) 1988-2000: almost continuous IMF arrangements***

7. Pakistan had seven different arrangements with the IMF over the 1988-2001 period,<sup>7</sup> of which four were short term and three were multi-year arrangements. All put a strong emphasis on restrictive demand management policies and a variety of structural reforms to correct financial imbalances. The total amount of funds committed under these programs amounted to over SDRs 4 billion.<sup>8</sup> All but the last arrangement (the 2000 SBA) suffered from substantial policy slippages and soon went off-track, usually after the first or second review. As a result, a large share of the committed financing was not disbursed: undrawn balances averaged a little over half the committed amounts, compared to one-third for all users of IMF resources and a quarter for prolonged users.<sup>9</sup> This suggests a rather poor implementation record overall.

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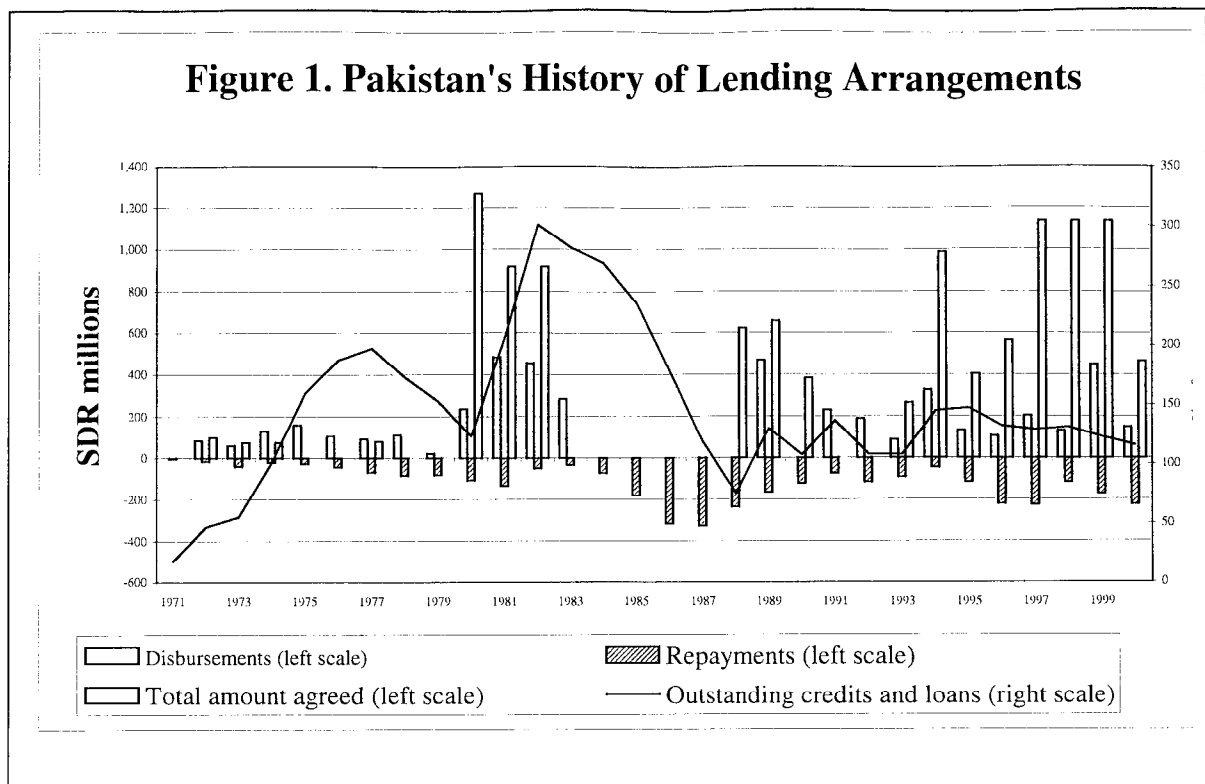
<sup>5</sup> Figure 1 provides an overview of this history.

<sup>6</sup> These arrangements were supplemented by rather large drawings under special facilities (oil facility and compensatory financing facility for export shortfalls).

<sup>7</sup> This count does not include the PRGF arrangement approved in late 2001 which, as an “on-going operation”, must be considered outside the scope of this evaluation.

<sup>8</sup> In addition, over that period, Pakistan had access to sizable resources under special facilities.

<sup>9</sup> Not taking into account precautionary arrangements, i.e. those where the authorities indicate at the outset that they do not intend to avail themselves of the resources committed under the program.



## 2. Economic performance over 1988-2000 was unimpressive compared with previous decades

### a) Macroeconomic performance deteriorated and financial imbalances largely persisted

8. GDP growth fell to a little under 4 percent per year over 1988-2000, compared to almost 6 percent in the two previous decades, with a sharp slowdown in capital formation. Exports growth slowed to under 3 percent per year, against over 10 percent in the 1970s and 1980s. Poverty rose steadily, according to most measures, after two decades of decline, and by the end of the 1990s close to 30 percent of the population lived below the poverty line, against less than 20 percent a decade earlier.

9. Only a modest correction of financial imbalances was achieved over the period. Inflation was halved to 4 percent by 2000, but the fiscal deficit declined only from 7.7 percent of GDP in 1989 to 5.2 percent in 2000. The current account deficit fluctuated around 4 percent of GDP. Gross international reserves fell as a share of imports over the period to under 1 month in June 2000, the symbolic threshold of three-month imports coverage was reached only once, and the coverage of effective short-term debt by official reserves averaged just over 15 percent over 1991-2000.

***b) Structural reforms progressed in some areas but significant challenges remain***

10. Significant progress was achieved relatively early on in the areas of interest rate liberalization and public debt management; liberalization of external transactions, both on the current and the capital account; and trade liberalization: tariffs were brought down sharply,<sup>10</sup> their structure was simplified, and quantitative restrictions on both imports and exports were substantially reduced. Nevertheless, Pakistan's trade regime, remains relatively restrictive in comparison with most Asian economies.

11. In other areas, such as the implementation of a broad based general sales tax (GST), taxation of the agricultural sector, liberalization of administered prices and the setting of utilities tariffs, the reform process was very protracted. Progress was achieved many years later than initially intended, and most of these reforms have yet to be fully effective. By contrast, very little was achieved in the areas of tax administration or income tax reform, and public enterprises were still a considerable drain on the government's finances in 2000.

12. One indicator of limited progress in bringing about core structural changes needed for longer-term sustainability is the evolution of the tax revenue to GDP ratio: in spite of all attempts to increase it under repeated IMF-supported programs, the ratio was lower in 2000 than in 1988 (12.1 percent against 13.5 percent). This decrease in the overall tax ratio reflects a shift in the structure of taxation away from international trade taxes, which *ceteris paribus* should have increased tax efficiency. But these possible gains must be weighed against the efficiency losses induced by the de facto very narrow base of domestic taxes, which fall on a very small number of taxpayers<sup>11</sup> despite significant steps taken to broaden the legal definition of the tax base.

***c) Economic institutions do not seem to have benefited from prolonged UFR***

13. In Pakistan, the 1990s has been characterized as an era of "institutional decay".<sup>12</sup> This was manifested through increased political interferences in the management of public enterprises and in the operations of the predominantly public banking sector, more widespread corruption in tax administration, and increased clout of vested interests in all areas of public policy-making. Meanwhile, statistics and public accounts remained of very poor quality, as did technical skills at all but the highest level of public administration. The

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<sup>10</sup> The weighted average rate went down from 65 percent in 1988 to 19 percent in 2000. Pakistan is rated 7 on the IMF 10-point index of trade restrictiveness (where 10 is the most restrictive), i.e. below India (10), but well above China and Sri Lanka (5) or Indonesia, Malaysia and the Philippines (4).

<sup>11</sup> In theory, broad consumption or income-based taxes should be more efficient than trade taxes, but the problem in Pakistan is that these taxes have relatively high rates to compensate for the lack of broad base: in 2000, there were less than 100,000 registered GST taxpayers and under 2 million income taxpayers (compared to 1 million in 1990), in a population of roughly 140 million.

<sup>12</sup> Cf. for instance *Economic Reforms and Macroeconomic Management in Pakistan (1999-2001)* by Ishrat Husain, Governor of the State Bank of Pakistan.

greater independence gradually granted to the Central Bank is one exception to that general trend.<sup>13</sup>

14. These problems obviously had other, deeper, causes that were not directly associated with IMF-supported programs, but they proliferated in spite of these programs, which has prompted many in Pakistan to blame the IMF for failing to tackle governance issues directly. Addressing governance issues did not explicitly become part of the agenda of IMF-supported programs until 1997, and those negotiated with Pakistan were no exception in that respect. Within that context, however, the issue of institutional effectiveness could have received more emphasis than it did, both in the design of programs and in the policy dialogue with the authorities in the context of surveillance and technical assistance.

15. Moreover, many officials in Pakistan were of the view that protracted UFR has weakened the independent policy formulation capacity, in part because the policy closure process revolved around negotiations with the Fund, with little room for domestic initiative and open discussion of policy alternatives.<sup>14</sup> Most officials also viewed as limited the capacity building effect on economic management skills sometimes assumed to be associated with IMF-supported programs, because this “skills transfer” was largely concentrated in narrow areas geared to the technical implementation and monitoring of IMF-supported programs. Likewise, the unusually large amount of resources invested by the IMF in technical assistance to Pakistan produced a considerable amount of blueprints for reform.<sup>15</sup> But, according to the authorities, they failed to have a significant impact because the knowledge transfer involved in their conception was limited, and they were not sufficiently focused on implementation.<sup>16</sup>

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<sup>13</sup> Admittedly, changes in the legal framework of the Central Bank’s operations do not necessarily imply that its *de facto* independence increased. Indeed, one former Governor of the SBP told the IEO that he had been able to perform his functions in great independence at a time when no institutional safeguards guaranteed it. However, there was broad agreement view among both IMF staff and Pakistan stakeholders that the SBP was significantly strengthened during the 1990s.

<sup>14</sup> However, former IMF mission chiefs for Pakistan pointed out that there were few cases where the authorities had approached them with viable policy alternatives. When they did, particularly from late 1998 onward, their proposals were often incorporated into the program framework (e.g. as concerns the exit strategy from the foreign currency deposit freeze or as regards the exchange rate regime).

<sup>15</sup> From 1990 to 2000, Pakistan received forty IMF technical assistance missions, with over half of them concerning fiscal issues and about a quarter on monetary and banking issues. During that period, it also benefited from the presence of resident advisors for a cumulative total of five years. Furthermore, since FY1996, IMF TA to Pakistan has represented the equivalent of the equivalent of 13 staff-years.

<sup>16</sup> Examples of such problems include the 1992 and 1997 TA reports on tax administration reform or the 1999 TA report on modernizing the income tax system. Numerous reports were also prepared on the reform of indirect taxation, with limited concrete results until the last couple of years.

## **B. The Lack of Effectiveness of Pakistan's IMF-Supported Programs Stems from Both Design and Implementation Issues**

16. At first glance, it is tempting to blame the lack of effectiveness of IMF-supported programs in Pakistan on their poor implementation by the authorities.<sup>17</sup> The prolonged political instability and regional disruptions undoubtedly weakened policies and the ability of the economy to respond to adjustment initiatives. To the extent that policy slippages prevented the full disbursement of all but one of Pakistan's arrangements since 1980, poor implementation is also undeniable. However, there is a strong perception in Pakistan that the programs had a low probability of success from the outset, owing to various design flaws and weak ownership at the highest political level. These problems were compounded by shortcomings in conditionality and program "enforcement" by the IMF that resulted in some core underlying problems remaining unresolved. Many of these difficulties reflected "systemic" issues associated with the IMF's approach in Pakistan rather than just technical issues associated with the IMF staff's analysis (cf. Section C).

### **1. Most IMF-supported programs had several design flaws**

#### ***a) Overoptimistic assumptions and unrealistic objectives***

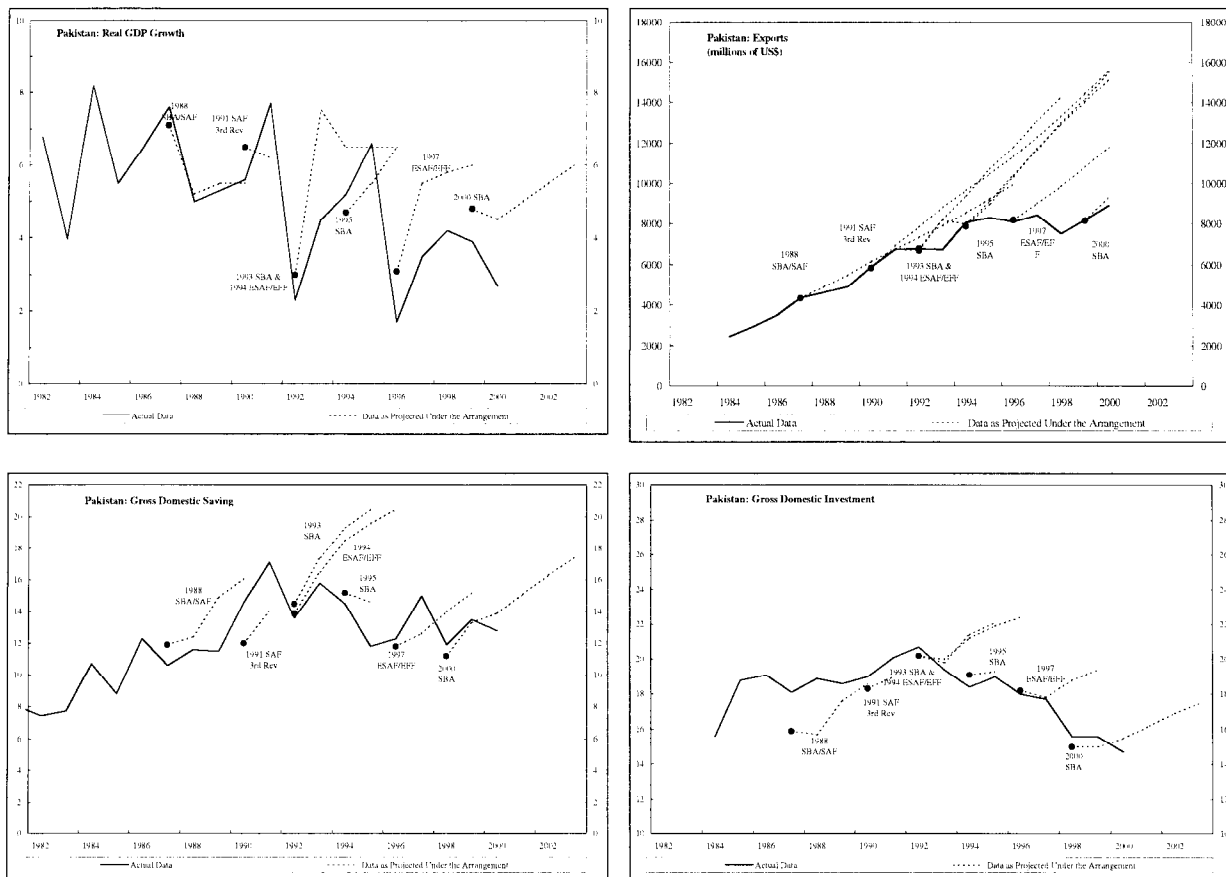
17. Most programs, particularly from 1993 onward, were based on overly optimistic projections as regards such key elements as GDP and exports growth, as well as regarding the growth of domestic savings and investment (cf. Figure 2).<sup>18</sup> Any such comparison needs to take account of the fact that macroeconomic projections made in IMF-supported programs are not unconditional forecasts: they implicitly assume that the program will be implemented as planned, which was clearly not the case in Pakistan. However, the discrepancies between projections and outturns are so large as to make it difficult to assess whether poor implementation was the cause or, at least in part, the consequence of these discrepancies.

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<sup>17</sup> This dimension was frequently emphasized in performance assessments done by the IMF. For instance, the 2000 article IV staff report notes that "Pakistan has had a series of adjustment and reform programs supported by Fund arrangements during the past decade. Policy implementation and economic performance have been disappointing... This weak performance stems in large part from the failure of successive governments to carry through sustained reforms..."

<sup>18</sup> The starting point of projections is occasionally off the "actuals" line because of subsequent revisions to the data on the which the projections were based.

**Figure 2. Growth of GDP, Exports, Gross Domestic Savings, and Gross Domestic Investment**



18. The growth rate was overestimated on average by 1½ percentage points (over 2 percentage points from 1993 on). Whether this gap resulted from an excess of optimism *ex ante* or from unforeseen exogenous shocks, the IMF generally proved reluctant to adjust the program framework and key objectives, especially the fiscal deficit target. Reviews of internal documents suggest that this reluctance reflected concerns to avoid accommodating policy slippages that would undermine the incentives to persevere with the core fiscal reforms needed for long term sustainability.<sup>19</sup> However, since most programs did not incorporate specific contingency plans to deal with the effects of lower than projected

<sup>19</sup> A justification for this reluctance is provided by the debt sustainability concerns which surfaced at the end of the 1990s. But, more than the level of the target itself, what appears to have hindered fiscal adjustment most is the stop-go process stemming from the inadequate macroeconomic framework, with the slippages that occurred during off track periods more than undoing any progress previously made.

growth, and in the absence of adequate methodology to distinguish the impact of policy slippages from that of exogenous shocks, the result was often lengthy negotiations on the scope and nature of the corrective actions needed. In most cases, this process resulted in fiscal targets generally being met at least up to the first review, at the cost of *ad hoc* efforts which were neither sustainable nor economically efficient, while negotiations on adaptations to the program framework and necessary policy changes dragged on thereafter, with lack of agreement on a suitable course of action *de facto* sending the program off track.

19. Export growth projections also proved far too optimistic: instead of rising by roughly 15 percent per year, which was the average program projection and would have represented an acceleration from the 11 percent growth rate observed in the 1970s/80s,<sup>20</sup> exports rose by barely 5 percent annually during the 1990s. As a result, current account projections typically projected a too rapid improvement, while capital account projections were, on the whole, too conservative. The outcome was a substantial underestimation of the build-up of external debt servicing charges from the early 1990s onwards (Figure 3).

20. Similarly, some program targets proved unrealistically ambitious given the timeframe and the implementation capacity available. This was especially the case for tax revenues (cf. Figure 4 below). These targets were also very ambitious compared to IMF-wide averages.<sup>21</sup> Indeed, these targets were never met over the 1988-2000 period in spite of frequent in-program downward revisions.

21. While stakeholders, including IMF staff, now generally agree that tax revenue targets were generally unrealistic *ex ante*, the reasons for it are not entirely clear. The authorities argue that the overoptimism of revenue projections reflected an overestimation of their implementation capacity. IMF staff, on the other hand, contend that the lack of realism of revenue projections reflected the authorities' pressures and was fueled by the political economy of Pakistan's budgetary process.<sup>22</sup> Staff memoranda exchanged during the internal review process indicate that they resisted what they viewed as overoptimistic projections as much as possible, but in the end had to defer to the authorities' knowledge of their own abilities on that issue. In any event, the overoptimism of revenue projections undoubtedly

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<sup>20</sup> These projections were also more optimistic than contemporaneous WEO forecasts for developing countries as a whole (9 percent) and for Pakistan's WEO country group (i.e. Asia: 10 percent).

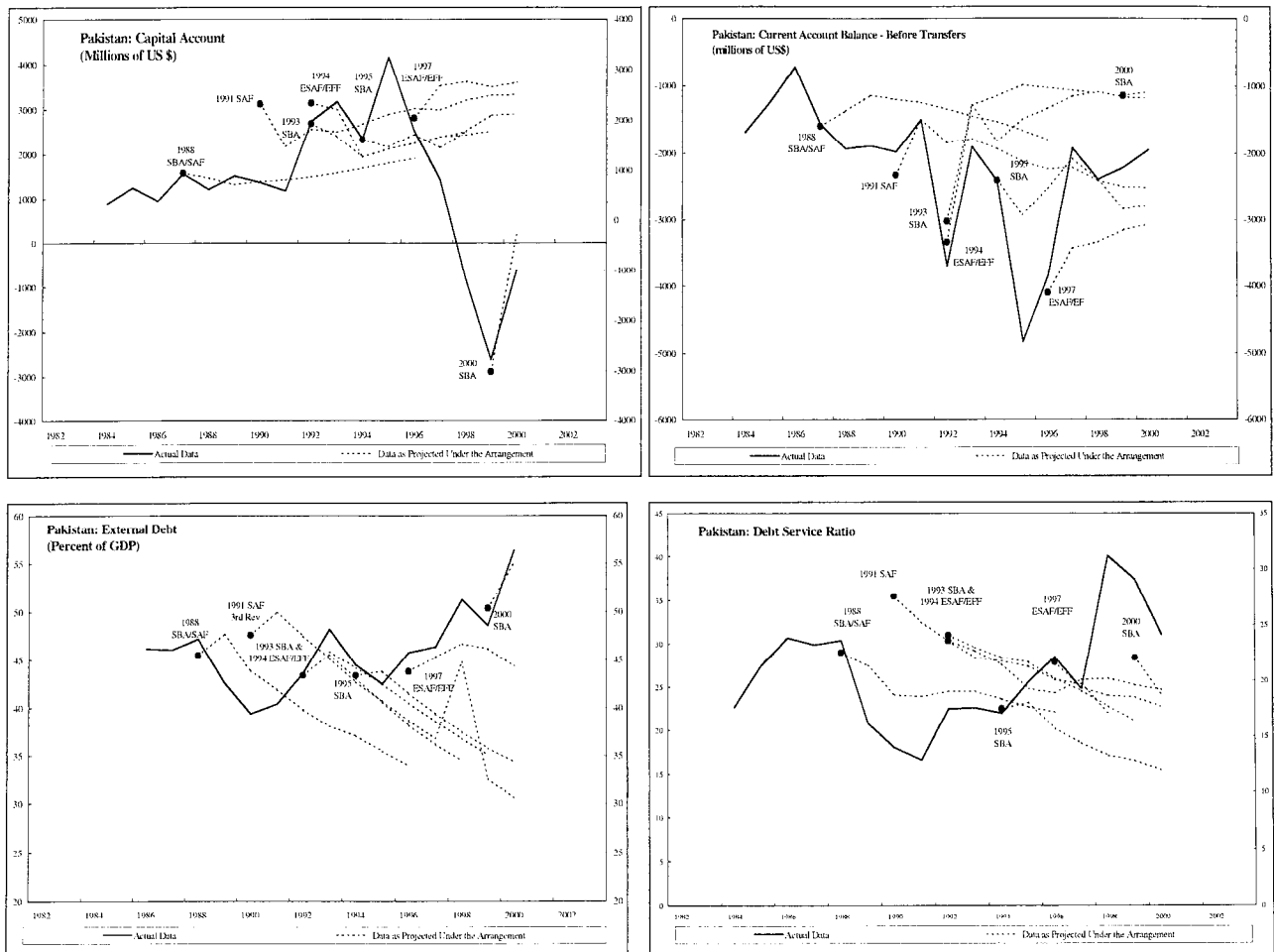
<sup>21</sup> In multi-year arrangements approved since 1993, the average targeted revenue increase over the three-year program period was 2.2 percentage points of GDP in Pakistan, compared to 0.7 points for prolonged users as a whole and 1.3 points for "temporary" users. Overall and primary fiscal balance targets were also more ambitious in Pakistan than in both "temporary" and prolonged users' programs on average. (Source: MONA).

<sup>22</sup> The logic of the argument is the following: building the budget on the basis of overly optimistic revenue projections avoids making tough decisions on expenditure at the time of the budget debate, while the deficit which inevitably arises when revenue expectations fail to materialize makes it easier for the Finance Ministry to impose a degree of expenditure restraint which would have been unacceptable before. (Nonetheless, the cuts adopted in that context may not be—and in fact often were not—optimal in terms of economic efficiency.)

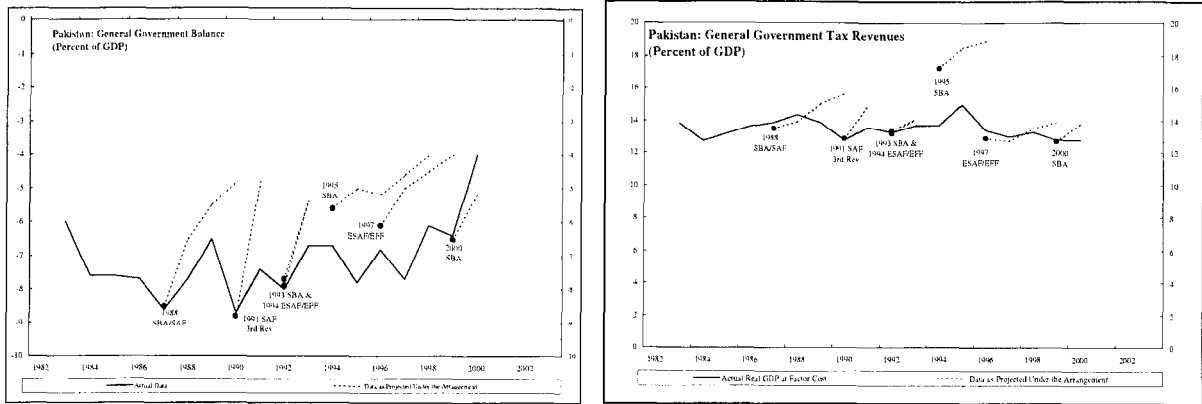


helped paper over difficult policy choices in a context of strong pressures to agree on a program.

**Figure 3. Current and Capital Account Projections and External Debt**



**Figure 4. General Government Balance and Tax Revenues**



22. As concerns structural reforms, the overoptimism was reflected in the length and diversity of the reform agenda embedded in IMF-supported programs from 1988 onwards and from the overambitious timetable envisaged for reforms which take time to implement even in countries with far more administrative resources than Pakistan.<sup>23</sup> The number of areas of economic policy covered by explicit conditions increased from four in the 1988 SBA/SAF to eleven in the 1997 EFF/ESAF. The result was insufficient prioritization and an overburdening of the policy formulation and implementation capacity of the authorities—a capacity that was limited in part by technical constraints, but mostly by the lack of political will to take measures with significant short term costs (for instance as concerns the removal of tax exemptions).

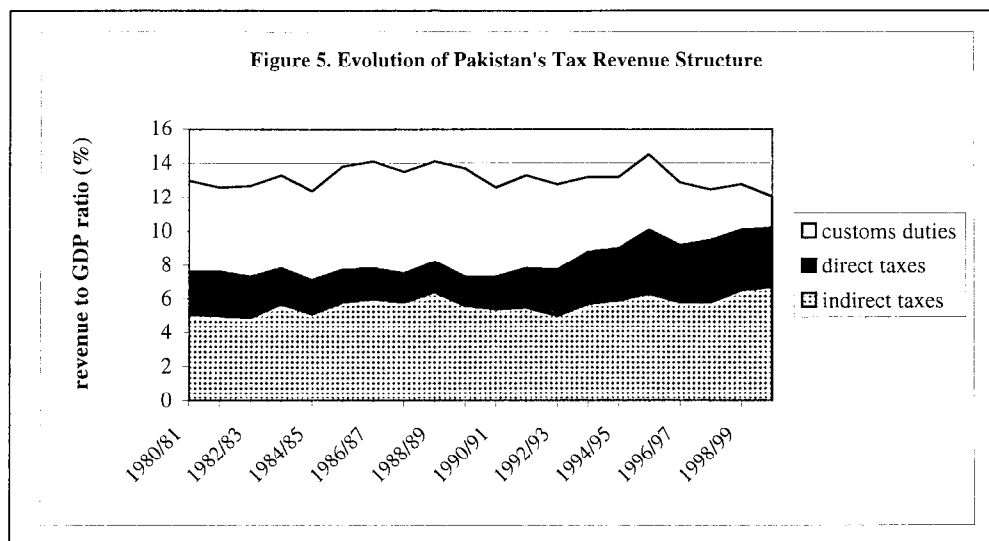
***b) Some of the policy prescriptions had adverse side effects***

23. Some of the policy prescriptions embedded in IMF-supported programs turned out, owing to implementation difficulties, to have unintended side-effects.

24. In the fiscal area, two mutually reinforcing problems occurred. First, the strategic orientation of shifting taxation from international trade to domestic activities, an important feature of all IMF-supported programs since 1980, proceeded at an uneven pace that caused *de facto* sequencing problems. While the reduction of tariffs and other taxes on international trade was relatively fast, it took much longer for the general sales tax (GST) instituted in 1990 to yield a comparable revenue, owing to numerous exemptions which took no less than

<sup>23</sup> For instance, effective taxation of the agricultural sector was expected to be put in place within one year and the implementation of a broad based GST within two years. In both cases, after ten years full effectiveness had yet to be achieved.

ten years to eliminate, and to the shortcomings of tax administration.<sup>24</sup> Likewise, income tax was prevented by poor tax administration and too narrow a base from making a sufficient contribution to the revenue collection effort. These factors explain the bulk of the revenue shortfalls which were a common characteristic of all IMF-supported programs since 1988 (cf. Figure 5).



25. The second problem was that attempts to meet the fiscal deficit targets led to the frequent adoption of *ad hoc* tax increases and expenditure cuts in the course of the program. These measures were frequently inconsistent with the medium-term strategy pursued under the program. In particular, hikes in tax rates and surcharges, which in the short term appeared to be the most effective way to fill the revenue gap, might have contributed to reducing the tax base further by encouraging taxed activities to shift to the informal sector. They also led to an increased complexity of the tax system.<sup>25</sup> Many observers in Pakistan commented that such *ad hoc* measures have had a detrimental effect on business sentiment by making tax legislation unpredictable (owing to frequent legal changes but also to the increased scope for taxpayer harassment by the employees of the Central Board of Revenue, who traditionally have large discretionary powers in the implementation of tax policy). As regards expenditure cuts, given the inflexible structure of expenditure (due to the large share of military spending and the weight of interest expenditure) cuts inevitably fell on development and social

<sup>24</sup> In theory, a shift from trade taxes to broad-based domestic taxes, such as the VAT, should be revenue-enhancing since the latter taxes would typically also include traded goods in their base. However, in Pakistan, this effect largely failed to materialize because of severe weaknesses in tax administration and of generous and widespread tax exemptions, which persisted in spite of specific conditionality to that effect in each of the programs.

<sup>25</sup> In particular in the form of multiple tax rates, cascading sales taxes, multiple withholding taxes and complex excises.

spending, which resulted in a marked decline in public investment (from about 10 percent of GDP in 1992 to 4½ percent in 2000).

26. As regards financial sector reforms, the same process of uneven implementation of a package of reforms resulted in *ex post* sequencing problems. The 1988 SAF envisaged the simultaneous implementation of a liberalization of interest rates and lending practices, a major regulatory reform of the banking sector, and a significant reduction in the borrowing requirement of the public sector. In the event, only the first leg of this tripod was delivered. As a result, the financing costs of fiscal deficits ballooned, making it ever more difficult to balance the budget, and the soundness of the banking sector deteriorated as governance weakened. This led to the accumulation of large volumes of nonperforming loans. The very deteriorated state of public banks' loan portfolios also accounts for the high level of interest rate spreads which has had a depressing impact on economic activity in recent years.

27. However, it is worth emphasizing that the two types of side effects discussed above do not imply that the fundamental policy prescriptions were wrong. In particular, it is unlikely that economic performance would have been better had tariffs not been lowered until sufficient revenue could be obtained from domestic taxes (i.e. in the late 1990s), or had interest rates not been liberalized until the fiscal deficit had been sharply reduced (i.e. not yet). Rather, these side effects demonstrate that a critical mass of reforms is needed for adjustment to take hold, and that the adjustment path chosen cannot ignore the longer timeframe needed to implement the most complex of these reforms. Nonetheless, the trade-offs and risks involved (of which internal documents suggest that IMF staff was keenly aware) would certainly have warranted a more open debate in policy discussions with the authorities and in reports to the Executive Board.<sup>26</sup>

### *c) Insufficient emphasis was placed on institutional reforms*

28. In retrospect, there is ample recognition—both in the IMF (more in the views expressed in staff interviews than in reports) and in Pakistan—that IMF-supported programs should have put much stronger emphasis on institutional reforms, particularly in tax administration, banking sector and public enterprises, all of which have only begun to be addressed in recent years.<sup>27</sup> In addition to directing attention to implementation capacity

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<sup>26</sup> For instance, an internal Country Strategy Paper prepared in early 1993 noted, in drawing the lessons from past experience of IMF-supported programs in Pakistan, that “in sequencing the program measures, primary emphasis needs to be placed on fiscal consolidation and reform, *taking full account of the budgetary costs associated with trade and financial sector reforms*”(emphasis added).

<sup>27</sup> To some extent, this criticism reflects the application of current standards to past programs. Program documents typically did say that these aspects were important, but they put little emphasis on the detailed monitoring and implementation of deeper institutional reforms, in keeping with the IMF's own institutional culture at the time. Moreover, a number of these issues were rightly identified as being the primary responsibility of the World Bank but, as will be discussed in Section C, this identification of the division of labor between the two institutions did not lead to an effective operational approach to ensure the issues were addressed.

issues, thereby making program objectives less unrealistic, an explicit emphasis on institutional reforms would have mitigated the program design problems discussed above.

29. As far as tax administration is concerned, interviews with Pakistani officials and a review of internal documents suggest that there was an implicit understanding on both sides that the revenue targets could only be met if far-reaching tax administration reforms were undertaken in addition to the changes in tax policy explicitly monitored under IMF-supported programs. However, none of the programs had an explicit focus on tax administration reform, and even though Pakistan received several technical assistance missions from the IMF in relation with tax administration problems, the actual implementation of reforms was never pursued through specific conditionality until the 1997/98 EFF/ESAF.<sup>28</sup> As a result, no significant progress in revenue collection occurred during that period, in spite of protracted but eventually significant improvements in tax policy.

30. Likewise, stakeholders on both sides now generally agree that much of the deterioration in the quality of banks' portfolios which occurred in the 1990s might have been avoided had the financial sector reforms of the beginning of the decade been designed differently. In particular, giving the same weight to regulatory improvements as to interest rate liberalization and paying due attention to banks' management flaws (in particular political interferences in lending decisions) would probably have led to a better outcome.

31. Finally, the effectiveness of IMF-supported programs would have been enhanced had public enterprises been handled from an institutional reform perspective from the start: IMF-supported programs' focus on preventing too large misalignments between public enterprises tariffs and world market prices was warranted, but it ignored the broader restructuring needs of these enterprises. The drawbacks of this approach are particularly visible in the case of the largest public enterprises (discussed further below), whose impact on the economy expand way beyond that of potentially distortionary prices and eventually took the form of a drain on fiscal resources, expensive and unreliable supply of basic utilities, accumulation of nonperforming loans in the banking system and massive cross-arrears within the broader government sector.

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<sup>28</sup> The fact that the achievement of revenue projections hinged critically on improvements in tax administration was repeatedly underscored in internal memoranda by the Fiscal Affairs Department, which also supplied abundant technical assistance in that area and frequently expressed concern that their recommendations did not appear to receive consistent follow up. At the same time, they emphasized in their comments that improvements in tax administration should not be strongly relied upon to deliver large and quick increases in tax revenue. This might explain why improvements in tax administration were not aggressively pursued through conditionality until the most recent programs.

## **2. Lack of ownership and inconsistent monitoring resulted in poor implementation**

### ***a) Ownership was generally weak***

32. Pakistan suffered from a very unstable political environment throughout most of 1988-2000. No single government managed to stay more than three years in power, with an average tenure of eighteen months.<sup>29</sup> The effects of this instability on successive governments' ability (and willingness) to implement comprehensive reforms and carry through an ambitious adjustment effort seem to have been largely underestimated—at least in reports submitted to the Executive Board. Most UFR staff reports during that period acknowledged the fluidity of the political situation, but usually stated that governments had strong ownership of the programs and were strongly committed to their implementation, even when programs were negotiated with caretaker governments and endorsed at the last minute by the incoming cabinet, as occurred for the 1988 SAF and the 1994 EFF/ESAF. While the claim made by successive IMF reports that there was a broad consensus across major political parties on economic policy matters was correct, this consensus gave no assurances as to the political ability of elected governments to carry through unpopular adjustment policies (cf. Box 1).

33. In the event, as political difficulties arose, it often appeared that the reform agenda of the economic team had little backing at the highest political level,<sup>30</sup> at least in the sense that top decision makers were not sufficiently convinced that the reforms were necessary and that the economic price of postponement outweighed the political costs of early implementation. As a result, implementation efforts often limited themselves to the minimum needed to ensure the continued disbursement of IMF resources. In many instances, what was observed was more the letter of the conditions than their spirit, and even though the tightening of conditionality over time gradually reduced the room for such practices, it was insufficient to compensate for the lack of ownership. For instance, in the fiscal area, performance criteria (PC) initially targeted bank financing of the deficit, while the overall deficit was only a benchmark. Since bank financing was not a predominant source of financing of the deficit, Pakistan was able to comply with the fiscal PC until 1994 in spite of substantial fiscal overruns.

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<sup>29</sup> By contrast, at the administrative level, there was a considerable degree of stability at the top of the two main institutions involved, namely the Central Bank and the Ministry of Finance.

<sup>30</sup> This problem was recognized in the 1993 Country Strategy Paper, which highlighted as the first lesson to be learned from past experience that “it is important that the policy dialogue involve, at an early stage, full commitment at the highest political levels in Pakistan”.

**Box 1. Ownership Assessment in the Context of Pakistan Arrangements with the IMF<sup>1/</sup>**

A brief analysis of the politico-administrative context of Pakistan at the onset of the multi-year arrangements approved in 1993/1994 and 1996/1997, undertaken by a political scientist at the IEO's request, shows that there were conflicting factors at play, making the assessment of strength of ownership and political feasibility particularly difficult:

- *On the positive side*, governments in power at the time of program approval enjoyed a comfortable majority in Parliament and in key provincial governments and the reforms they put in motion before the program's approval were consistent with its spirit; they could rely on well-structured and, at the top echelons, skillful and stable bureaucracy. Moreover, there appeared to be a broad consensus across major political parties about the main thrust of economic reforms.
- *On the negative side*, vested interests weighed heavily in the political power base of every government and were in a position to block the approval of reforms (i.e. they had a "veto power"), many of which directly or indirectly threatened their privileges; implementation capacity was weak due to severe deficiencies in the rule of law and law enforcement; decision-making style (restricted to a narrow circle), and a policy dialogue that presented reforms as IMF-imposed, were not conducive to a broad ownership of reforms. Taking all these factors into consideration, serious doubts should have been raised about the prospects for consistent implementation of the programs.

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1/ Cf. Appendix I for a more comprehensive presentation of the analysis conducted.

34. As regards structural reforms, conditionality was initially set in the form of general commitments in the letter of intent or structural benchmarks, which were at best partially observed (e.g. the removal of exemptions from excises, custom duties and other taxes targeted by the 1980 EFF and the 1988 SAF). When conditionality was "hardened", in the mid-1990s, conditions were often met in ways that minimized their impact. A few examples can illustrate the general problem:

- by enacting a law but not implementing it (e.g. extension of GST to the services sector and taxation of agricultural income);
- by adopting a new tax but with so many exemptions as to make its additional yield negligible (e.g. GST act in 1990);
- by abolishing existing tax exemptions while simultaneously creating new ones.
- In other cases, measures adopted were subsequently reversed or suspended (e.g. the petroleum price adjustment mechanism from 1995 to 1998).

35. Furthermore, during much of that period, the governments' practice was to use the IMF as a scapegoat for unpopular decisions, a strong indication of the limited degree of actual ownership. Over time, the result was that the surest way to undermine popular support for any measure was to give it an "IMF" label.<sup>31</sup>

***b) The mitigating devices available to the IMF were not used fully***

36. The extent of political instability and ensuing low ownership during the period of prolonged UFR was such that even using the whole arsenal of safeguards at the disposal of the IMF would have been unlikely to produce the results promised in successive programs. However, many of the safeguards—which the Board had established as part of a strategy for minimizing prolonged use (see Chapter III) of the main report—were not used fully until late 2000. At that stage, practice shifted to the strictest standards of track record probing.<sup>32</sup> However, ownership too was higher, which was probably more determining in the success of the program than any parameter under the IMF's control.

*Track record requirements*

37. When there are significant doubts about the authorities' commitment or ability to pursue adjustment policies over a sustained period of time—perhaps as a result of previous policy slippages—it is customary practice for the IMF to ask a government to build a track record before engaging in a multi-year arrangement. In Pakistan, however, track record requirements were often squeezed out by protracted negotiations. For example, the 1994 EFF/ESAF, for which negotiations lasted 18 months, was preceded by a stand-by arrangement, but the SBA was not allowed to run its course: it was cancelled after six months to be replaced by the multi-year arrangement, even though the first review had not been completed due to slippages.<sup>33</sup> Negotiations for the 1997 EFF/ESAF started in mid-1996, at a time when Pakistan was under a stand-by arrangement following the collapse of the previous EFF/ESAF. The EFF/ESAF was eventually presented to the Board after a six-month track record—not under the SBA, which had been irretrievably interrupted owing to very large policy slippages, but under a staff-monitored program (SMP) whose targets had been revised several times to accommodate various slippages and shocks.

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<sup>31</sup> One telling anecdote heard during the evaluation team's mission to Pakistan illustrates how a long series of weakly owned programs can lead to perverse results: when the IMF suggested including in the program supported by the current PRGF arrangement key elements of the tax administration reform prepared by the authorities, some government officials initially resisted on the grounds that these reforms were ones they truly wished to implement, whereas including them in the LOI would give the impression they were IMF-imposed and hence would reduce their chances of implementation.

<sup>32</sup> The 2000 SBA was adopted only upon completion of a unusually long list of prior actions, going beyond the unfulfilled commitments of the preceding interrupted program and its disbursements were slightly backloaded. The current PRGF arrangement was approved only after one year of satisfactory performance under a stand-by arrangement.

<sup>33</sup> End-1993 targets, however, were reportedly met, which allowed the request for an EFF/ESAF to be presented to the Board and approved in February 1994.



38. Other tools available to the IMF are prior actions and the phasing of disbursements, with a backloaded schedule providing a greater incentive to sustain the policy effort over the medium term.

- Prior actions were used in most UFR requests since 1988. However, these prior actions did not always include the key conditions whose nonobservance had sent the previous program off-track (e.g. GST base extensions in the 1994 program, or petroleum price adjustment mechanism in 1997). In addition, prior actions, like any other conditionality, are subject to superficial or temporary observance only. Two examples drawn from agricultural taxation illustrate this point: the 1993 SBA included a prior action related to the extension of taxation to the agricultural sector. The prior action was considered to be met, but legal impediments which subsequently surfaced made it necessary to impose a new prior action in the 1994 ESAF, this time related to the parliamentary approval of the ordinance on federal agricultural taxation. Neither prior action resulted in meaningful taxation of agricultural incomes (see Box 2 below).<sup>34</sup> Thus, the issue in Pakistan's programs appears to have been the prioritization of prior actions and their integration into program design, rather than their quantity.
- The tranching of disbursements was generally mildly frontloaded,<sup>35</sup> even in cases where facility specific rules allowed flexibility. This favorable tranching contrasts with the generally backloaded design of the policy agenda: even in the 1997 ESAF/EFF, which came after a series of interrupted programs, half of the structural conditions specified from the outset were related to the second program year, and several pivotal measures, such as income tax reform, civil service reform, extension of GST to the retail level, and tariff cuts were only planned for the third program year.

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<sup>34</sup> For a more comprehensive review of attempts to tax agriculture in Pakistan and impediments thereto, see *Taxing Agriculture in Pakistan*, by Mahmood Khan and Mohsin Khan, IMF Institute, 1998.

<sup>35</sup> In stand-by arrangements over the 1990s, the amount disbursed upon approval by the Board was on average 12 percent higher than what would have resulted from a division of the total amount committed under the arrangement into tranches of equal size.

***Box 2. A Chronology of IMF Conditionality on Agricultural Taxation in Pakistan<sup>1/</sup>***

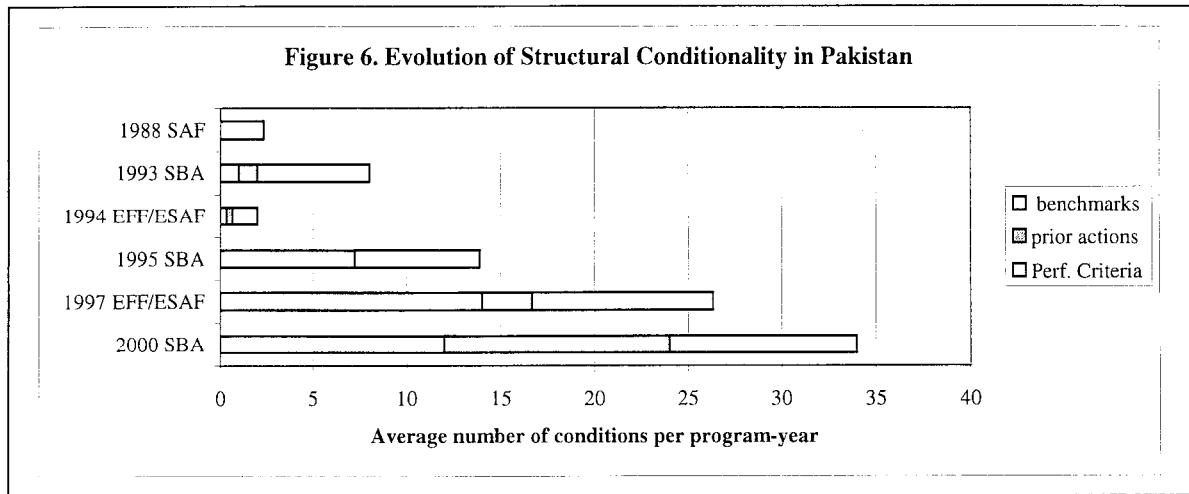
Agricultural taxation was pursued through IMF-supported programs since 1981 through the following conditionality (implementation status as reported in staff reports noted in brackets). None of this conditionality—much of which was actually observed, in a narrow sense—had substantially increased the contribution of the agricultural sector to tax revenues by the end of the decade.

- **1981** (EFF): commitment in the authorities' Memorandum of Economic Policies (MEP) to tax agricultural output within one year. (Formally implemented, but with a very low yield)
- **1991** (SAF): commitment in the MEP to extend the scope of agricultural taxation in the 1992/93 budget. (Not implemented)
- **1993** (SBA): prior action on extension of taxation to the agricultural sector (met).
- **1994** (EFF/ESAF): prior action on Parliamentary approval of ordinance relating to federal agriculture taxation (met) and PC on expansion in agricultural tax base including through Produce Index Units (PIU) adjustment, within six months (met).
- **1995** (SBA): PC on inclusion of provisions in 1996/97 budget to broaden agricultural taxation through an increase in PIU to PRs 400 and extension of its base (met).
- **1996** (SBA, revised): PC on adoption by all provinces (by end-December 1996) of ordinances on agricultural taxation (not met) ; establishment of a task force on the potential revenue from provincial agricultural taxes (met) and task force to present recommendations for 1997/98 budget and the medium term.
- **1997** (EFF/ESAF): PC on harmonizing provincial taxation of agricultural income with that prevailing in Punjab, by end-June 1998 (not met; waived and rescheduled).
- **1998** (EFF/ESAF): PC on harmonizing provincial taxation of agricultural income with that prevailing in Punjab, by end-June 1999 and SB on finalization by the same date of the rate and threshold structure for the provincial tax on agricultural income capable of yielding PRs 3.5 to 4 billion in 1999/00 (both conditions partially implemented, with delay)
- **2000** (SBA) : PCs on GST extension to urea fertilizers and pesticides by March 2001, and to all other agricultural inputs by Sept. 2001 (both PCs met); SB on full implementation of agricultural income taxes on the basis of provincial implementing regulations to become effective in each province by end-June 2001 (met with delay in 2 provinces, unmet in other 2).

1/ Agriculture accounts for roughly 25 percent of GDP, employs half of the labor force and is one of the largest earners of foreign exchange. Under the Constitution of Pakistan, farmers have been exempt from taxes on their incomes from agriculture, and only the Provincial governments are permitted to levy a land tax. The political power of large landowners has long prevented the Federal Government from seeking the legal changes needed to give it authority to tax agricultural income or land and Provincial Governments from using the authority they have to pursue the same goal. This situation has led the agricultural sector to become a legal, and sometimes illegal, shelter for other forms of income.

### *Conditionality*

39. The conditionality response to the practices induced by the low ownership of programs by the authorities was to gradually close as many loopholes as possible, through an increase in the overall number of both macroeconomic and structural conditions, through a larger recourse to performance criteria and prior actions as opposed to general commitments in the letter of intent, and through the use of continuous performance criteria and other no-reversal clauses (see Figure 6 below).



40. It is doubtful that any form or volume of conditionality would have been sufficient to compensate for the authorities' fundamental unwillingness or inability to implement many of the policies promoted by successive programs. However, two lessons can be derived from this experience. First, strict implementation and enforcement would have been easier had conditionality been more focused on truly critical areas. Second, the approach—eventually adopted with success in the areas of tax exemptions and utilities price adjustment—consisting in setting conditionality on policy rules rather than discretionary actions by the authorities might have speeded up the reform process if adopted and generalized earlier.

41. More minor problems which hindered the effectiveness of conditionality in Pakistan are the following. First, the tightening of conditionality always occurred with a lag following repeated failures to deliver on policy undertakings, a lag which in some cases was very long (e.g. conditionality on the financing of the fiscal deficit or utilities prices adjustments). Second, in some areas, such as tax administration, utilities pricing or public enterprise reform, the effectiveness of conditionality was reduced by the lack of a sustained, consistent approach. These areas, which were presented as key to the success of the programs of the 1980s, subsequently ceased to be covered by conditionality for several years, despite very limited progress and occasional backsliding. In other cases (e.g. agricultural taxation), the inconsistency stemmed from the lack of follow-up on undelivered commitments from one review or program to the next.

42. In the few cases where conditionality responded proactively and consistently, better results were eventually obtained, e.g. in the area of tax exemptions: conditionality evolved from a simple LOI commitment to phase out existing tax exemptions (in 1988), to a continuous performance criterion on the non introduction of new exemptions (in 1995), to a prior action on the passage of an act prohibiting the government from creating new exemptions (in 1998).

43. Finally, the relative generosity of the IMF in granting waivers to the authorities, or in consenting to renew its support soon after a program interruption typically caused by large fiscal slippages, led –according to many Pakistan officials- to a form of moral hazard: the expectation that the IMF would eventually provide financing weakened incentives to tackle the fiscal deficit forcefully. Indeed, of the seven program reviews completed in the 1990s, five involved at least one and generally several waivers, mostly concerning fiscal PCs.<sup>36</sup> Furthermore, in spite of the many interruptions suffered by IMF-supported programs, the interval between two disbursements of IMF resources was generally short—never exceeding twelve months over 1991-1999.<sup>37</sup>

### **C. Some Program Design Problems were Rooted in Deeper IMF Governance Issues**

#### **1. Institutional considerations weighed heavily in decisions regarding IMF involvement in Pakistan**

##### ***a) Geopolitical considerations***

44. “Most IMF-supported programs primarily served political purposes. Thus, it should come as no surprise that they did not achieve much in terms of economic results”. That view, expressed by a senior Pakistan official interviewed by the IEO, appears to be very widely shared in Pakistan, both within and outside official circles. A large proportion of IMF staff involved in Pakistan programs were also of the opinion that political considerations had, at times, prevailed over technical judgments, not necessarily on the details of program design but in terms of the overall threshold required for a program to be supported.

45. While there is no hard evidence or “smoking gun”, either in internal memoranda or in the record of Board discussions, that non economic considerations played a predominant role in IMF decisions to support a request for use of Fund resources or to complete a program review, there is no shortage of anecdotal evidence—coming from both former authorities and the IMF staff- that such considerations did matter importantly on some occasions. Moreover,

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<sup>36</sup> Over that period, Pakistan was granted 18 waivers of compliance, of which 8 concerned quantitative PCs, another 8 concerned structural PCs and 2 continuous PCs. In all three categories, half of the waivers concerned fiscal PCs (two-thirds if PCs on utilities prices are treated as “fiscal” conditionality). All the waivers on quantitative PCs were requested for reasons other than “minor technical deviation” or “exogenous shocks”.

<sup>37</sup> Somewhat longer intervals occurred at the beginning and end of the decade, and coincided with episodes of major political disorder: from December 1989 to December 1991 and from June 1999 to November 2000.

a few significant “program events” closely followed major geopolitical developments, for instance the 1980 EFF following the Soviet invasion of Afghanistan; and the mid-1998 program interruption following Pakistan’s nuclear tests.

46. More generally, until 1998, the prevailing perception within IMF staff was that principal IMF shareholders, no matter how demanding they claimed to be on the substance of programs, were not willing to take the risk of major turmoil in Pakistan which an interruption of IMF support might have caused. This resulted in a general sense, shared by staff and the authorities, that the IMF would remain involved irrespective of performance under a specific program. The succession of adverse events of 1998-99 (nuclear tests, a military coup and the unveiling of past misreporting of fiscal data to the IMF) caused a dramatic reversal in shareholders’ views, after which IMF support was perceived by IMF staff and the authorities as unlikely short of a very strong performance under an extremely ambitious program.

47. Assessing with accuracy to what extent geopolitical considerations did supersede economic ones in program or program-design decisions is virtually impossible given the element of judgment appropriately present in any UFR decision. But the simple fact that IMF-supported programs are widely *perceived* as heavily influenced by political factors—both by the authorities who sign onto them and by the economic agents whose behavior they are meant to influence—probably weakened the efficacy of these programs.<sup>38</sup>

***b) “Systemic” considerations related to the IMF mandate***

48. There are four dimensions of the IMF mandate which might account for some of the design problems discussed above. First, as a monetary institution, the IMF is traditionally viewed as primarily mandated to provide temporary balance of payment support to its members, not long-term financing. This means that its interventions are expected to allow a restoration of balance of payments viability over a relatively short period. While the creation of the EFF and, later on the SAF, ESAF and PRGF have lengthened the timeframe for the restoration of viability, until recently it would have been difficult to present for the consideration of the Executive Board a program which did not lead to a restoration of balance of payments viability within a short to medium term timeframe. This constraint is likely to have contributed to two related problems: (i) a tendency toward overoptimism both in the speed with which the real economy would respond to the policy measures and in the pace at which difficult structural reforms could be implemented; and (ii) a focus on types of structural “conditions” that can be clearly delivered within programs’ timeframe—or even in the few weeks separating the finalization of the program from its presentation to the Executive Board, in the case of prior actions. Complex institutional reforms, which are key to

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<sup>38</sup> In this connection, it has been suggested to the IEO by some IMF staff members that the program design weaknesses discussed in Section B, such as unrealistic macroeconomic projections, the pretence of toughness etc. were symptomatic of attempts to find a face-saving way to justify continued lending to Pakistan.

longer term sustainability, are much harder to fit within such a framework.<sup>39</sup> As far as Pakistan is concerned, program assumptions did not become markedly overoptimistic until the early 1990s (cf. figures in Section B). From then on, internal memoranda do suggest that several review departments had serious reservations about the optimism of program assumptions, particularly regarding GDP and export growth, as well as revenue targets. The “systemic constraint” discussed above is a plausible explanation for why programs went ahead despite these reservations.

49. Second, until the late 1980s, the IMF interpreted its mandate as narrowly focused on macroeconomic policies and a few structural areas. That conception changed dramatically when concessional facilities were created, which led the IMF to embrace a broad agenda of structural reforms, without necessarily having the expertise needed for an optimal selection, sequencing and design of these reforms, at least initially. While in theory these shortcomings could have been mitigated by a close collaboration with the World Bank (and the AsDB), in practice collaboration was imperfect. As a result, key areas, such as governance and institutional reforms in tax administration, civil service and public enterprises, ended up being handled inadequately by both IFIs for lack of emphasis and coordination of their efforts. Both institutions implicitly or explicitly recognized that these issues were central to long-term macroeconomic sustainability. But they do not appear to have reached an effective agreement, among themselves and with the government, on what the priorities should be and on coordinated action plans to address them, until the EFF/ESAF approved in late 1997.

50. The problems of the power sector provide a good illustration. Initially (i.e. in the 1988 SAF), the IMF focused on power tariff adjustments, on an “as required” basis, with the primary purpose of containing the fiscal impact of the operational losses and investment needs of the power sector. However, that condition was omitted in subsequent arrangements,<sup>40</sup> while at the same time, the World Bank was shifting its focus towards human development, limiting its interventions in the energy sector to technical aspects.

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<sup>39</sup> Examples of such difficulties include tax reform, where setting conditions on the enactment or parliamentary approval of given measures failed to ensure their actual implementation (e.g. for agricultural taxation, where the first legal changes were approved in 1994, but full implementation was an unmet structural benchmark (SB) as of mid-2001, or for the extension of the GST to traders/retailers, where the timetable was similar); improvements in tax administration, where conditionality on the creation of a given administrative structure failed to ensure that it performed effectively the tasks it had been set up for (e.g. tax audit unit, a SB for 1997); or yet again privatization, where conditionality on “bringing to the point of sale” specified public enterprises, does not guarantee that they will ever be privatized (as was done in 1996/97 for companies in the oil and gas sector, which for the largest part had yet to be sold by end 2000). In such a context, an alternative is to specify the condition in terms broad enough to give staff room for judgment in appraising the extent of progress made at the time of the program review. However, evidence from other case studies (especially the Philippines) suggests that so-called “review” conditionality is no panacea.

<sup>40</sup> Presumably because of a change of strategy, which, from 1993 onwards, focused on privatizing these enterprises.

Meanwhile, severe institutional problems intensified.<sup>41</sup> As a result, by 1996/1997, the overall borrowing requirement of the seven major public enterprises had reached 2½ percent of GDP (the bulk of which came from WAPDA and KESC, the two main public power producers). Their nonperforming loans had piled up in public banks to the point of threatening their stability and substantial cross-arrears had accumulated among public enterprises and vis-à-vis the government. At that point, the seriousness of the problem brought a greater focus on it by both IFIs. The World Bank helped the authorities draw up operational and financial restructuring plans, whose implementation was subsequently monitored through IMF-supported programs' conditionality.<sup>42</sup> By end 2000, both the financial and the operational restructuring were underway but are likely to take considerable time to yield substantial efficiency gains and cost reductions.

51. Third, the “seal of approval” function effectively given to IMF-supported programs by donors and creditors might account for the tendency to overpromise in programs and subsequently under-sanction when the authorities did not deliver. The fact that the IMF acted as gatekeeper for access to many other sources of financing in one sense gave it great leverage, but also meant that the consequences of a prolonged interruption in programs would be very severe. Ultimately the IMF—presumably reflecting the views of its shareholders—proved extremely reluctant to risk the costs of such major disruption, which meant that there was an in-built tendency not to insist too hard on the core issues.

52. Fourth, the IMF's mandate gives it an obligation to support member countries making the necessary efforts to address their economic difficulties. Thus, any government committing itself to making such efforts has to be given the benefit of the doubt, at least initially. In Pakistan, since 1988, political instability was such that each new IMF arrangement practically coincided with a new government and it would have been extremely difficult not to give such a government the initial benefit of the doubt on its declared policy intentions.

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<sup>41</sup> The World Bank diagnosed them in 1998 in the following terms: “Public enterprises suffer from operational inefficiencies, overstaffing, inappropriate incentives, misdirected investments, inadequate O&M, political intervention in their decision making, and other problems which adversely affect their performance... [they] have become a vehicle for employment creation, political patronage and corruption. ... Their inefficiency has resulted in high costs to the private sector as a result of high prices of utilities ...[and] in many cases poor quality of supply... Problems are most acute in the power sector.” (Pakistan Public Expenditure Review, 1998, pp. 15-16).

<sup>42</sup> Specific conditions included : introducing performance improvement arrangements between the government and WAPDA (by 12/97); developing action plans for restructuring seven major public ets. (by 6/98); strengthening the National Electric Power Regulatory Authority (by 6/98); reconcile and settle electricity bills of federal and provincial governments (PA, 99); implementing power sector restructuring program (by 3/99).

***c) Defensive lending considerations***

53. It has been argued<sup>43</sup> that a factor contributing to the prolonged use of IMF resources when adjustment fails to take place is the need to ensure that obligations falling due are met. The IMF did have a significant exposure to Pakistan throughout the period,<sup>44</sup> although Pakistan's record of repayment of its obligations to the IMF was impeccable even at times of severe stress on its international reserves position. The only times when there is evidence that "defensive lending" considerations could have been a significant factor, as reflected in explicit concerns about a possible default expressed in internal memoranda, were when Pakistan came closest to the brink of a foreign exchange crisis: (i) in late 1996, just before the revival and augmentation of the SBA; (ii) in the months preceding the completion, in January 1999, of the second review of the 1997 EFF/ESAF following its *de facto* interruption in May 1998; and (iii) in mid/late 2000, prior to the approval of the SBA

**2. Crowded out by UFR, surveillance played only a limited independent role**

54. In Pakistan, all but two of the article IV consultations of the 1988-2000 period were conducted jointly with UFR activities. A comparison of the depth and quality of surveillance in stand-alone article IV reports with joint article IV/UFR reports and with surveillance guidelines over 1982-2000 indicates that joint consultations tended to make a more cursory treatment of such key issues as medium-term perspectives, sensitivity to shocks and vulnerabilities.<sup>45</sup> They also tended to be less concerned about exploring trade-offs between policy options and less candid about divergences of views between the staff and the authorities.

55. Once again, this "crowding out" of aspects of surveillance appears to reflect systemic factors, rather than a particular shortcoming of the IMF staff's work on Pakistan. For example, since there is an in-built incentive not to undermine the catalytic role of an IMF-supported program in mobilizing other financing, surveillance activities that are closely

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<sup>43</sup> Cf. for instance Birdsall et al., 2001. "Will HIPC Matter? The Debt Game and Donor Behavior in Africa."

<sup>44</sup> Pakistan's average outstanding obligations over 1988-2000 were SDRs 904 million; annual repayments and repurchases averaged SDRs 148 million over the same period.

<sup>45</sup> The quality of surveillance over that period was assessed by systematically rating the performance of each surveillance report for nine functions viewed by the IEO as "key elements" of surveillance in a program context (see Chapter VI of the main report for a discussion of how these elements were identified). These nine functions are: (i) provision of realistic medium term and alternative scenarios; (ii) provision of meaningful sensitivity analyses; (iii) discussion of risks to the assumptions and projections; (iv) discussion of the risks and impact of policy slippages and of vulnerabilities; (v) balanced reporting of the authorities' views, including any significant differences with staff; (vi) cogent presentation of proposed policy course; (vii) discussion of policy alternatives and trade-offs; (viii) critical and frank review of previous UFR performance; and (ix) presentation of collaboration/interaction with the World Bank. The diagnosis is consistent with the findings of the 2002 Biennial Review of Surveillance. In other words, the Pakistan exception lies not so much in this absence of strong, independent role for surveillance as in the length of time it lasted.



associated with programs tend not to raise too many questions about alternative policy design or downside risks.

***a) Implications of short term stabilization measures for longer term growth and sustainability of adjustment were not analyzed sufficiently.***

56. There are three aspects where, with the benefit of hindsight, it appears that surveillance could have played a larger role in analyzing some of the longer term implications for sustainability. First, the consequences for long-term growth and hence sustainability of the structure of fiscal adjustment could have been given greater attention—although more analysis was undertaken in internal reports than was reflected in Board papers.<sup>46</sup> Specifically, the adverse long term effects of *ad hoc* revenue measures taken by the authorities to compensate for revenue shortfalls, or *ad hoc* expenditure cuts instead of fundamental improvements in the structure and quality of expenditure were not emphasized in surveillance reports, even when strong reservations were expressed about them in the internal review process.

57. Second, as most programs failed to deliver the required adjustment but nevertheless unlocked substantial financing flows, over time financing largely substituted itself for adjustment. To a large extent, this merely reproduced the pattern of the 1970s and 1980s, but this time in a low-growth environment with a much higher cost of financing (workers remittances and ODA flows, relative to GNP, both fell by over 40 percent in the 1990s compared with the average of the two previous decades, and the average grant also element also fell from 46 percent to 32 percent). As a result, Pakistan got trapped into a debt sustainability problem, which was not fully analyzed in IMF reports until 1997, apparently in

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<sup>46</sup> In particular, several research papers of the early 1990s (see for instance *Fiscal Policy in Pakistan Since 1970*, by Nadeem U. Haque and Peter J. Montiel, 1992) emphasized that in the Pakistan context, a deficit reduction strategy emphasizing cuts in public investment would have large output costs, because of lower public and private capital stocks, “since the smaller public capital stock would have depressed private investment as well. Crowding-in through lower interest rates does not materialize in this case because the lower public capital stock actually represents a substantial negative supply shock.” (p.9-10). Interestingly, the 1993 Country Strategy Paper for Pakistan explicitly acknowledged the findings of that paper. To be sure, it could also be argued that in a corrupt environment, the supply impact of public capital expenditure is limited and, therefore, reducing capital expenditure makes sense in the short term, provided public expenditure management reforms are undertaken at the same time.

part because of concerns about undermining the credibility-enhancing effects of programs.<sup>47</sup>

58. Third, surveillance failed to sound the alarm loudly enough at a sufficiently early stage about the gradual build up of an eventually very large uncovered exposure of the central bank to foreign currency deposits (FCDs)—a central avenue through which the debt build-up occurred.<sup>48</sup> By the time the 1997 ESAF/EFF was approved, FCDs had reached over \$11 billion, i.e. the equivalent of 17 percent of GDP and 9½ times the level of gross international reserves. This vulnerability turned into a foreign exchange liquidity crisis when capital outflows intensified in mid-1998 after Pakistan’s nuclear tests and ensuing international sanctions, leading the authorities to impose a deposit freeze.

59. Surveillance reports, while factually accurate, never gave much prominence to the issue, even when the downsides of the heavy reliance on FCDs were mentioned, and mission briefs suggest that the build-up of large uncovered foreign exchange exposure through FCDs was never a pivotal issue of either policy or program discussions with the authorities until late 1996 (see Box 3 below). However, we understand from interviews with staff and others that the potential vulnerabilities involved were raised with the authorities beginning in the early 1990s, even though the issue was not given prominence in IMF reports until much later.

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<sup>47</sup> As noted earlier, more analysis was undertaken internally—for example, in the late 1980s by economists from the IMF Research Department. However, their work was not approved for publication as an IMF Working Paper until late 1992, apparently because of concerns about country sensitivity. This paper (full reference quoted above) made it clear that “although the average cost of servicing this debt may have been low in the past, the marginal cost of debt service can be expected to rise in the coming years, since, as a result of the opening up of the economy, international interest parity is likely to prevail...The high level of government indebtedness implies that debt servicing has the potential to frustrate future deficit reduction plans”. Under assumptions of constant revenue to GNP and primary expenditure to GNP ratios and with a growth rate constant at 5.8 percent (i.e. much higher than it turned out to be), they found that the deficit to GNP ratio would rise to 8 percent over 5 years just through increased debt servicing costs. Under similar GNP growth assumptions, they also found that an average deficit of 4 percent of GDP over the next five years would be consistent with lower macroeconomic imbalances (in fact, the fiscal deficit averaged 7 percent of GDP during the 1990s).

<sup>48</sup> The deposits, after being surrendered to the SBP, were effectively on-lent to the government and therefore did not result in a corresponding build-up in reserves. Hence the uncovered foreign exchange exposure. FCDs increased at a rapid pace starting in 1991, when they were first allowed for residents, partly reflecting various price incentives for both banks and depositors, partly owing to the advantages of their “no questions asked” status.

### ***Box 3. The Coverage of the Issue of Foreign Currency Deposits in IMF Staff Reports***

From 1992 to late 1995, surveillance reports gave factual accounts of the evolution of FCDs,<sup>1</sup> and a few noted that they compounded the weakness of gross international reserves, but they did not flag them as a serious vulnerability<sup>2</sup>, nor did they offer any specific policy advice to address the problem. The IMF's approach changed dramatically in 1996: there was no article IV consultation, but the staff report on the second review of the SBA, which was completed as Pakistan was on the verge of a foreign exchange crisis partly owing to withdrawals from FCDs, clearly emphasized the risks of Pakistan's heavy reliance on short-term liabilities to finance its current account deficits and, for the first time, set specific conditionality on the preparation, at a future date, of an exit strategy from the forward exchange cover provided to banks by the SBP. In the event, the definition of a strategy took somewhat longer than initially expected, by which time the immediate crisis had passed, and the 1997 article IV returned to a relatively relaxed stance: while the presence of a large uncovered foreign exchange exposure was still identified as a "major concern", the emphasis was more on the constraint this exposure represented for the conduct of exchange rate policy and the distortions to incentives induced by the too low price of the SBP forward cover fee, than on the looming risks of foreign exchange crisis.<sup>3</sup> The EFF/ESAF arrangement approved at the same time did outline a detailed exit strategy, based on the recommendations of an IMF TA mission, which was partially supported by explicit conditionality. However, to the extent that financing needs had not diminished, it is doubtful that the authorities would have pressed ahead with its implementation even if the mid-1998 crisis had not struck.<sup>4</sup>

<sup>1</sup> However, from 1993 onward, those factual accounts were only partial, since—at the authorities' request—FCDs owned by residents were reported in the balance of payments "above the line", as part of private transfers, and even FCDs held by non-residents were not included in the stock of external debt in tables presenting key indicators. Furthermore, FCDs held by residents, even though they represented a liquid claim on the central bank's reserves, were not netted out from international reserves for the purpose of IMF monitoring of NIRs.

<sup>2</sup> The first staff report which put some emphasis on the vulnerability aspect was the background paper to the 1995 article IV report. Internal documents attest that the vulnerability aspect had been fully understood as early as 1993: a memorandum from the Research Department noted that "attempts by domestic residents to reduce their holdings of foreign currency deposits in the domestic banking system could precipitate not only balance of payment difficulties, but also a major banking crisis. Indeed, given the degree of mismatch between Pakistan's low gross international reserves and the uncovered foreign currency accounts..., even modest capital outflows could trigger a loss of confidence in the authorities' ability to sustain the convertibility of the foreign currency deposits. Avoidance of a foreign exchange crisis and reversal of the liberalization measures would be a major success at the current juncture."

<sup>3</sup> However, the paper did note, in a separate section, that "Pakistan's fragile external reserve position is compounded by the accumulation of short-term foreign currency liabilities by the banking system, mostly ...FCDs"

<sup>4</sup> Indeed, the staff report on the first review of the ESAF/EFF, completed in March 1998, noted that the authorities viewed with concern the decline in FCDs registered in previous months.

### ***b) Factors which might have undermined confidence in the programs were downplayed***

60. Discussions of risks to the program outlook and sensitivity analyses of medium term projections were generally limited, in the sense that sensitivity analyses never involved sufficiently large adverse shocks that they would push the medium-term outlook off its "sustainable" path, even though the Pakistan economy was subject to a variety of shocks of much broader magnitude.<sup>49</sup> Likewise, only exceptionally were substantive *ex ante* analyses

<sup>49</sup> For instance, the only shock analyzed in the sensitivity analysis attached to the 1997 ESAF/EFF was a one percent lower than projected cotton exports.

of the implications of policy slippages offered (the 1993 SBA request report and the 1991 and 1995 article IV consultations are the only, but welcome, counter-examples). When such analyses were provided, they did not spell out the side effects which might result from an uneven implementation of reforms intended as a package.

61. For the same reasons, most joint surveillance-UFR reports provided little analysis of trade-offs between alternative policy strategies and the divergences of views between IMF staff and the authorities as to the best option. For instance, when programs went along with the authorities' preference for imposing a turnover tax on traders instead of putting them under the GST net, as favored by staff, or for a tax registration drive instead of focused improvements in tax collection, only the retained options were presented, with no detailed discussion of their merits and downsides relative to the alternative. Likewise, disagreements between staff and the authorities (as well as within staff) on the appropriate exit strategy from the FCDs freeze, were not discussed in the reports.

***c) Only limited ex-post evaluation of UFR was undertaken***

62. Another function of surveillance which was regrettably toned down in most article IV reports—and in other Board documents—since 1988 is the *ex post* evaluation of UFR experiences. Among earlier reports, only the report on the 1991 article IV consultation provides a detailed review of performance under previous programs. Subsequent surveillance reports gave only limited factual accounts of the most recent UFR performance, and were generally silent about the recurrent implementation difficulties that were encountered, in contrast with the more critical tone of internal documents.<sup>50</sup> The 2000 article IV report represented a marked improvement in that respect, by taking a long term look at past economic performance, but it did not examine the reasons for the failures of the previous, or earlier, programs.

**3. Internal governance issues occasionally contributed to program design imperfections**

***a) Excessive attention is paid to fine tuning the financial programming framework***

63. While a sound and internally consistent macroeconomic framework is essential to the success of any adjustment program, the IMF's "financial programming" framework, as implemented in practice in Pakistan, suffered from several imperfections which took extra significance owing to one major weakness: the soundness of the framework itself is heavily

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<sup>50</sup> Even internal documents, however, did not go beyond the stage of taking note of past implementation difficulties. The only effort to take stock of past experience and draw strategic orientations for future IMF involvement was done in a 1993 Country Strategy Paper (CSP), but its close links with the briefing paper for the negotiation of what became the 1994 EFF/ESAF limited its "strategic" value, and the lessons it drew from past experience did not appear to be consistently reflected in the design of subsequent programs. No other CSP was prepared since then, even after CSPs were given new impetus in 1997 through guidelines aimed at making them a prime vehicle for staff to step back from the contingencies of program negotiations, learn lessons from past country experience and design an optimal strategy for the IMF's involvement in the country.

dependent upon the realism of growth targets. In Pakistan, for reasons discussed above, strong incentives to be overoptimistic were at play.

64. First, the precision with which quantitative targets are set (and monitored) is at odds with the severe imperfections of the data they are based on. Second, the weight attached to these targets in setting appropriate macroeconomic policies (and later appraising them) often does not recognize sufficiently the considerable uncertainties attached to the underlying behavioral relationships. In light of these considerations, the authorities and most staff were of the view that too much time had been spent on “fine tuning” the financial programming variables, at both the negotiation and subsequent monitoring stages, when the time could have been better spent on more fundamental issues.

65. Issues which, according to IMF staff members themselves, did not receive sufficient attention as a result of this process in Pakistan are real economy dynamics (in particular the links between the policy variables monitored under programs and economic outcomes), analysis of the sources of growth, and impact on economic performance of a variety of exogenous shocks.

***b) Some of the incentives to which IMF staff is subject may have perverse effects***

66. There is a rather widespread perception, shared by Pakistan officials and many IMF staff, that the decision making process of the IMF was biased toward programs that look “tough” on paper, even if there were substantial doubts about their realism. A number of IMF staff who have worked on one or more programs with Pakistan noted that the internal incentive system rewarded toughness more than realism, and that negotiating a program with ambitious objectives and few departures from the mission brief smoothed the internal review process considerably, whereas attempts to be realistic and accommodative of the authorities’ concerns—legitimate or not—did not.

67. Furthermore, a majority of staff interviewed expressed the view that the excessive attention paid to the fine tuning of the financial programming reflected the focus of the internal review process on that aspect of programs,<sup>51</sup> at the expense of much greater attention to judgments on ownership and the capacity of the authorities to implement the policy undertakings couched in the program. While the move from the ESAF to the PRGF/PRSP approach was intended to bring about improvements in that respect, it is too early to judge whether this shift in emphasis will succeed.<sup>52</sup>

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<sup>51</sup> This focus itself is in large part a reflection of the legal framework of programs, which involves cumbersome—and, from the authorities’ stand-point—embarrassing procedures in case of deviations from targets, no matter how small.

<sup>52</sup> The first PRGF for Pakistan was approved in late 2001, and the interim PRSP was finalized not long before the IEO mission to that country. As such, both are beyond the scope of this evaluation.

68. While there is no such intentional bias in internal guidelines, the fact remains that most of the concerns expressed on Pakistan's UFR requests by internal reviewers and in the record of Executive Board meetings were related to the lack of ambitiousness of the programs, in relation with both macroeconomic and structural aspects, not to their lack of realism or difficulty to implement.

69. A related problem is staff turnover, which has accelerated dramatically in the 1990s.<sup>53</sup> While Pakistan's experience is broadly in line with recent Fund-wide practice (see Chapter IV of the main report), it has led the authorities to feel that significant amounts of time are wasted, in the conduct of negotiations, as new mission members gain familiarity with the issues at stake.

70. Finally, Pakistan officials noted that IMF Resident Representatives played a very useful role, and they were generally very complimentary about their inputs. However, they felt that the Resident Representatives' better understanding of "ground realities" was not sufficiently taken into account in policy formulation at the IMF's headquarters.

***c) Several internal guidelines were not fully implemented***

71. Over time, the IMF has developed a series of internal guidelines aimed at ensuring an efficient use of its resources, either specific to prolonged users or applicable to all UFR cases (see Chapter III of the main report for a detailed discussion). While it is unlikely that a full implementation of these guidelines would have avoided Pakistan's prolonged UFR, or would have had a dramatic impact on program effectiveness, two procedural slippages are nevertheless worth mentioning.

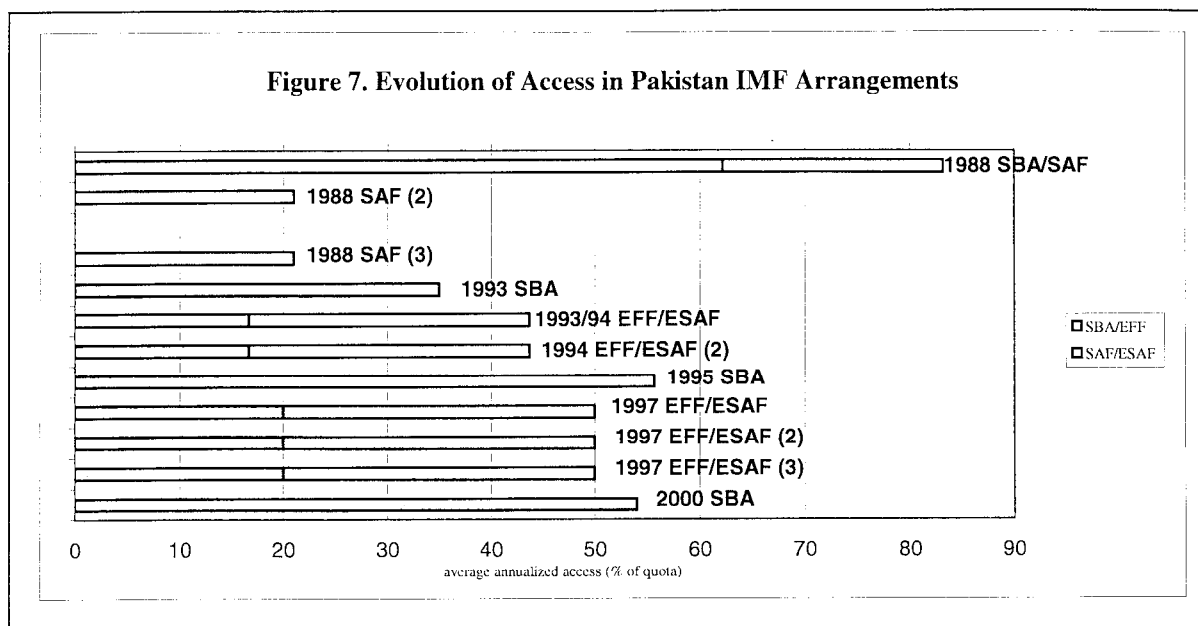
72. First, general guidelines on the justification of the level of access and the capacity to repay the Fund call for particularly strong motivation in cases involving prolonged use and/or a poor track record. In practice, such discussions have been largely superficial in successive UFR reports on Pakistan, even though approved access was always on the generous side of the range until the end of the period and increased moderately over time instead of decreasing (see Figure 7 below).

73. Second, the guidelines specific to prolonged users, as endorsed by the Executive Board in 1984 and 1991, do not appear to have been fully adhered to. These guidelines require a proactive use of program design to ensure strong implementation (track record requirements, prior actions, backloading of disbursements, diminishing access etc.), along with a critical appraisal in staff reports of performance under previous programs and an

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<sup>53</sup> Pakistan had six different mission chiefs and nine different desk economists over 1990-2000. Only two of the desk economists subsequently became mission chief. However, some greater continuity was provided by the fact that the Department Director, or another senior staff member, typically participated in key aspects of the discussions.

analysis of the reasons why their objectives were not achieved. As noted earlier, candid *ex post* assessments were undertaken only rarely.



#### D. Conclusions and Suggested Remedies

74. The various factors discussed in this report are present to some extent in many IMF-supported programs, and it is clearly their combination, more than the isolated influence of any single one of them, which resulted in a limited effectiveness of programs and a consequent prolonged use of IMF resources. Moreover, the IMF was clearly faced with an extremely difficult situation in Pakistan, and one where the ability of any external agency to achieve a better outcome would be limited. In the absence of any way of testing a counterfactual, it is impossible to state with certainty that any alternative course of action by the IMF would have led to a better outcome. However, the following lessons are worth pointing out. These issues are discussed in greater depth in the main report.

##### 1. Program design was affected by pressures to overpromise and downplay risks

75. A number of factors led IMF staff and the Pakistan authorities to agree to programs that were over-optimistic in their assumptions and that favored quick fixes over more difficult but essential reforms. At the stage of program implementation, these pressures led to actions that sometimes met the letter but not spirit of the agreements. In other cases, the agreed policies were only partially implemented, in a way that turned out to have adverse side-effects (e.g. reducing tariffs with no replacement tax in place), while other critical steps (e.g. the strengthening of domestic tax collection) were not insisted upon. A more consistent

and proactive use of conditionality, track record requirements and other monitoring devices might have improved the outcome of successive programs. But beyond that, to address these problems in future IMF programs, each of the following factors deserves some attention:

- the pressures for an IMF-supported program to produce "success" in a very short timeframe: it is counterproductive to try to cram long-term reforms into an unrealistically short timeframe, especially with regard to the implementation of complex reforms that may be central to longer-term sustainability. In some cases, this might call for more realistic assessments of the possible speed of adjustment. In this context, more thought needs to be given to the question of how to deal with the implementation of long term institutional reforms, such as reform of the tax system/ administration, that stretch beyond the time period of programs and where, by their nature, it is often not possible to condense the needed action into only a few concrete measures. This is true whether these reforms are critical to macroeconomic stability (i.e. clearly related to a core IMF responsibility) or critical to future growth/poverty reduction in some other way that is less clearly a Fund core responsibility (e.g. public enterprise reform and other forms of institutional reform). The Pakistan case illustrates that just requiring a law to be passed, for example, is not sufficient. On the latter aspects, an important lesson is the importance of the IMF engaging with partners such as the World Bank and others, to ensure that all such reforms are given appropriate external support (as a better option than trying to expand the Fund's own mandate).
- pressures to agree a "seal of approval" for other financing. This raises questions about whether the seal of approval could be given in another way, and the risks of devaluing the seal of approval if these pressures lead to poor quality Fund-supported programs.
- the perception, at least, that political influences on the IMF determined the outcome: eliminating political considerations altogether would not be realistic, since the IMF as an institution should respond to its shareholders, whose views should be taken into account in difficult cases where judgments as whether or not to proceed are finely balanced. But such political judgments should be made in as transparent a manner as possible, i.e. at the level of the Executive Board, which is accountable for them, and should be distinct from technical assessments by the staff. Candid staff reports, with a clear discussion of implementation risks and their consequences, is one way of ensuring such transparency.

## **2. Programs did not always focus on the right issues**

- Tailoring programs as closely as possible to country specific circumstances would be instrumental in "getting the program design right", i.e. (i) building as much as possible on domestic policy formulation, based on local expertise, to determine what reforms need to be made, in what sequence, what is feasible in a given time frame, and what milestones would



constitute meaningful benchmarks to measure progress (in the spirit of the strategy followed for tax administration reform in the recent PRGF); (ii) showing flexibility in the face of unexpected developments: either exogenous shocks, or when the policies agreed upon do not produce the intended/expected results. That implies being prepared to question the validity of initial assumptions and to communicate about revisions made necessary by initial design flaws in a way that clearly distinguishes them from policy slippages. Meaningful sensitivity analyses *ex ante* could help prepare adequate contingency plans.

- More attention should be devoted to debt sustainability issues. The debt crisis faced by Pakistan in late 1999/2000 rightly, but belatedly, led IMF staff to focus on that issue. Recent initiatives to bring more discipline and consistency to sustainability assessments are a further step in the right direction.

### **3. Ownership matters enormously, and should be linked to greater selectivity**

76. This issue goes beyond ownership of the program by the immediate economic team. Had the IMF insisted more on the presence of strong ownership and devoted greater efforts to promoting it, *ex ante* design flaws might have been reduced by a more substantive negotiation process, as the authorities would have refused to commit themselves to undertakings viewed as unrealistic or ill-suited to the needs of the country. Similarly, *ex post* side-effects could have been mitigated by stronger and more consistent implementation. Political and institutional factors would have still existed, but they would have become less critical.

77. This approach also implies greater selectivity: the IMF should refrain from providing resources in support of a program which is not genuinely owned by the authorities and when there is not a strong commitment to a core set of necessary adjustment and reform measures. This can imply either fewer IMF-supported programs or more focused programs. It also implies dedicating more resources and attention to assessing implementation capacity (of which ownership is a strong component) and political feasibility, and being more candid about uncertainties and downside risks in documents submitted to IMF Management and to the Executive Board. In retrospect, some of the programs with Pakistan would probably not have been entered into had these precautions been taken (especially considering that, in the absence of candid assessments of the implementation risks, the Board generally regretted that those programs were not more demanding). Clearly, greater selectivity in those circumstances might have implied a worsening of economic conditions in the short-run, perhaps to the point of a full blown crisis, and such implications are not to be taken lightly. However, such an evolution might have been more conducive to the strengthening of ownership needed for adjustment to take root than the provision of new financing in a context where it was *de facto* little more than a device to postpone hard decisions. Clearly, such a judgment is easier to make in hindsight but this does not mean that the trade-off should not have been faced in those terms at the time.

#### **4. IMF surveillance did not act as a second opinion on program design and performance**

78. This raises the issue of whether the surveillance function can or should be separated from program design and monitoring. At the very least, care must be taken in the relationship with the member country to avoid being trapped in a narrow program perspective. To that end, surveillance should be used as a tool for stepping back from time to time, to take a broader strategic look and to re-examine vulnerabilities, assess alternative strategies and foster a debate on key reforms that can help build the necessary consensus.

## **An Illustration of Ownership and Political Feasibility Assessment in the Context of the 1993/1994 Programs Through the Use of Basic Political Science Tools**

The developments below are drawn from a paper prepared at the IEO's request on Political Science Tools for Assessing Feasibility and Sustainability of Reforms.<sup>54</sup> They are meant to illustrate the type of analyses which might have been undertaken by IMF missions to make a methodical assessment of the authorities' ownership of the programs supported by the IMF and of their ability to implement them. There are essentially three different tools: (i) stakeholder analysis, which focuses on the balance of power, policy preferences and modes of interaction of key individuals and interest groups having a stake in the decision making process; (ii) institutional analysis, which looks at the institutional dynamics of this process, including the identification of institutions in a position to veto certain reforms, along with an analysis of capacity constraints; and (iii) "Delphi" study, which involves seeking the views of an experts panel in a systematic manner on each of the relevant dimensions of the political economy setting. Each of these tools can be used in three different modes, namely (i) trend extrapolation; (ii) impact analysis; and (iii) scenario building. Scenario building and "Delphi studies" are not meaningful when applied retrospectively. Therefore, they are not discussed in the following presentation.<sup>55</sup> The overall analysis summarized below and the characterizations of the Pakistan politico-administrative system contained therein are those of Wimmer et al. and do not necessarily reflect the views of the IEO.

### **A. Stakeholder Analysis**

#### **1. Trend extrapolation**

- *Reforms under way.* Since coming to power in 1990, the government of Nawaz Sharif favored economic liberalization and had already launched a deregulation program strengthening the private sector. The budget deficit had been brought down (by cutting expenditure in health and education and by reducing public works programs). However, there were no plans to introduce an agricultural tax or increase tax revenues in general. Looking at the measures already undertaken, the government thus seemed to have the political will to continue the process of reforms, and it seemed to enjoy a large enough political basis both at the national and provincial levels to do so. But, the existing reform trend was clearly selective and avoided important areas that would have touched the entrenched interests of groups on whose political support the government depended (such as the Jamoori Ittihad coalition—IJI) in Punjab, with its important landowners.

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<sup>54</sup> "Political Science Tools for Assessing Feasibility and Sustainability of Reforms" by Professor Andreas Wimmer, Director of the Department of Political and Cultural Change at the Center for Development Research, University of Bonn, with Indra de Soysa and Christian Wagner. This paper will be made available on the IEO's website at [www.ieo.org](http://www.ieo.org).

<sup>55</sup> A schematic presentation of these tools and modes is provided in Figure 1.

- *Decision-making style.* Political decision-making was mostly concentrated in the higher echelons of the government, with major reform steps being decided upon by the inner circle of a relatively isolated group of decision-makers and then left to the respective ministers to implement. Despite political rivalries, there was agreement between the main political parties about the necessity to continue reforms. Indeed, Benazir Bhutto, the leader of the opposition in 1993, had declared she would not reverse the process of privatization if she came back to power, and she did not, but under her government decision making followed the same pattern and was likewise restricted to a very small group of advisers. Given this structure of decision-making, a broad ownership of the reforms had certainly not yet developed.
- *Attribution of agency.* IMF-sponsored reforms were generally presented as a bitter pill that the country was forced to swallow by a powerful outsider. Implicitly and sometimes explicitly, however, the message was that the pill would not be consumed as bitter as it looked at the time of the negotiations, given the apparently widespread assumption in the informed public that lending was politically motivated (i.e. the reward of the political alliance with the US). The style of communication on the reforms thus does not show signs of genuine ownership by the major political forces.

## **2. Impact analysis**

The implementation of the program would not have affected the power balance between the army, the Prime minister and the President, given the generous treatment of military expenditures in the proposed agreement. However, the other parts of the political equation would have changed quite a bit. Taxation of agricultural incomes, one of the cornerstones of the agreement, would have seriously reduced the support of the government by the IJI coalition. The increase in indirect taxes may have heightened public discontent and may have strengthened opposition parties. Thanks to the broad agreement between the main parties on the broad direction of reforms, this would perhaps not have stopped them, but it would certainly bring about increased pressures for softening the consequences for the public and taking tax reforms back. The reform of credit-awarding mechanisms would have seriously limited the capacity of government employees to distribute credit along the lines of political patronage, which may have weakened the support of the bureaucracy, traditionally regarded as another important power center in Pakistan. In sum, it seems that effective implementation of the reform program would have shaken at least part of the political basis of the regime and it is doubtful whether it would have survived a comprehensive enforcement of reforms in the tax and financial sectors.

## **B. Institutional Analysis**

- *Veto point analysis.* The institutional position of the government was restricted by two factors inherited from military rule: (i) the constitution allowed the indirectly elected President to dismiss the directly elected Prime minister and his government; (ii) the army was still the most important veto actor that could influence all government decisions (as illustrated by the exclusion of the defense budget from any expenditure cuts undertaken under most IMF-supported programs). Besides these two institutional actors, the bureaucracy and the National Assembly (MNA) would be two other important veto players. Given the

strong representation of landed interests within these groups, it was highly unlikely that any law would be enforced that would seriously introduce taxation on agricultural income. Great parts of the bureaucracy would also not be in favor of privatization programs that would have implied serious cuts in their domains of political influence.

• *Implementation capacity.* Despite the long tradition of military rule, Pakistan showed a serious weakness of its law and policy enforcing authorities. Widespread corruption, clientelistic practices and recruitment procedures based on patronage explain at least in part the difficulties in enforcing basic rights and duties in different areas. Most ministries use the large discretionary powers that these deficits imply in order to build up their own network of patronage relationships and therefore enhance their standing in the all embracing web of political alliances. A good example of this is the way that the Central Board of Revenues interprets the myriads of exemptions in tax law on a case by case basis. The situation in public enterprises and in the banking sector was comparable. Every government would face the problem of such deficient implementation capacities, which weakness would also have an impact on the design of the reform programs. The rise of indirect taxes, for instance, would be favored in order to circumvent the enforcement problems of direct taxation.

### C. Overall Assessment

Serious doubts about the prospects of future implementation of the program would have had to be raised. The decision-making coalition endorsing the reform was not broadly built. It did not include large sections of the public in order to counter-balance the possible loss of support that effective implementation would have brought about from the power base of the current regime and from within the administration.

**Figure 8. Political Economy Analysis Toolbox**

Figure 8. Political Economy Analysis Toolbox				
		Tools		
		Stakeholder analysis	Institutional analysis	Delphi study
Modes	Trend extrapolation	<ul style="list-style-type: none"> <li>• <i>Reforms underway</i></li> <li>• <i>Decision making style</i></li> <li>• <i>Attribution of agency</i></li> </ul>	<ul style="list-style-type: none"> <li>• Institutional mapping</li> <li>• <i>Veto point analysis</i></li> <li>• <i>Capacity assessment</i></li> </ul>	General trends
	Impact analysis	<i>Impact on power balance</i>	Impact on institutional set-up	General impacts
	Scenario building	Scenarios of political events and trends	Scenarios of institutional reforms	General scenarios

NB: Tools in italics are those whose conclusions are reported above

**LIST OF PEOPLE INTERVIEWED IN CONNECTION WITH THE  
EVALUATION OF PROLONGED USE OF IMF RESOURCES - PAKISTAN**

***Senior Officials***

Mr. Mueen Afzal, Secretary General Finance  
Mr. Shaukat Aziz, Ministry of Finance  
Mr. A.R. Chughtai, Deputy Governor, State Bank of Pakistan  
Mr. Ishrat Husain, Governor, State Bank of Pakistan  
Mr. Ashfaq H. Khan, Economic Adviser, Ministry of Finance  
Mr. Yunis Khan, Finance Secretary  
Mr. Mushtaq Malik, Joint Secretary (External Finance), Ministry of Finance  
Mr. Riaz Ahmad Malik, Chairman, Central Board of Revenue  
Mr. Altaf M. Saleem, Minister for Privatisation  
Mr. Murtaza Ahmad Shaikh, Special Assistant to Deputy Chairman, Ministry of Planning & Development  
Dr. Abdul Naseer, Economic Adviser, State Bank of Pakistan

***Former Senior Officials***

Mr. Aitzaz Ahsan, former Minister of Law and Interior  
Mr. Qazi M. Alimullah, former Finance Secretary  
Mr. Sartaj Aziz, former Minister of Finance  
Mr. H.U. Beg, Chairman, Ad-hoc Public Accounts Committee, and former Finance Secretary  
Mr. Mushahid Hussain, former Minister for Information  
Mr. Fakhar Imam, former Minister  
Mr. Vaseem A. Jafarey, former Governor of State Bank of Pakistan and Adviser to the Prime Minister  
Mr. A.G.N. Kazi, former Governor, State Bank of Pakistan  
Mr. M. Farooq Leghari, former President  
Mr. Saeed Qureshi, former Secretary General Finance

***Academics***

Mr. Akhtar A. Hai, Senior Research Economist/Associate Professor, Applied Economics Research Centre, University of Karachi  
Dr. Akmal Hussain, Economist, Syeed Engineering  
Dr. AR Kamal, Director, Pakistan Institute of Development Economics

***NGOs***

Mr. Khadim Hussain, Senior Programme Officer, Action Aid Pakistan  
Dr. Asad Sayeed, Social Policy and Development Centre

***Journalists***

Mr. Farhan Bokhari, Pakistan Correspondent, Financial Times  
Mr. Nadeem Malik, The News  
Mr. M. Ziauddin, Resident Editor, Dawn  
Mr. Arshad A. Zuberi, Deputy Chief Executive, Business Recorder  
Mr. M.A. Zuberi, Editor, Business Recorder

***Trade Union Representatives***

Mr. M Zahoor Awan, Secretary General, All Pakistan Federation of Labour  
Mr. Raja Khalique A Khan, Vice President, Pakistan National Federation of Trade Unions

***Banking Sector***

Mr. A.R. Chughtai, Deputy Governor, State Bank of Pakistan  
Mr. S. Ali Raza, President & Chief Executive Officer, National Bank of Pakistan  
Mr. Masood Karim Shaikh, Chief Financial Officer, National Bank of Pakistan  
Mr. Zubyr Soomro, Chief Executive & Country Corporate Officer, Citibank

***Business Community***

Dr. Anwarul Haque, Secretary General, The Federation of Pakistan Chambers of Commerce & Industry  
Mr. Sheikh Javaid, Chairman, The Federation of Pakistan Chambers of Commerce & Industry  
Mr. Tahir Khaliq, Chief Executive, Chamber of Commerce & Industry, Karachi-Pakistan  
Dr. Mohammad Zubair Khan, Managing Director, Financial Techniques Internationals (and former Minister of Commerce)  
Mr. Haroon Rashid, Vice President, The Federation of Pakistan Chambers of Commerce & Industry

The mission also met with a large number of IMF and World Bank staff formerly or presently involved in the relationship of their respective institution with Pakistan.

### PAKISTAN'S HISTORY OF LENDING ARRANGEMENTS

	<b>Facility</b>	<b>Date of arrangement</b>	<b>Initial date of expiration</b>	<b>Actual date of Expiration<sup>1</sup></b>	<b>Amount agreed</b>	<b>Amount drawn</b>	<b>Percent undrawn</b>
					(In thousand of SDRs)		
1	SBA	08-Dec-58	07-Dec-59	22-Sep-59	25,000	0	100
2	SBA	16-Mar-65	15-Mar-66		37,500	37,500	0
3	SBA	18-May-72	17-May-73		100,000	84,000	16
4	SBA	11-Aug-73	10-Aug-74		75,000	75,000	0
5	SBA	11-Nov-74	10-Nov-75		75,000	75,000	0
6	SBA	09-Mar-77	08-Mar-78		80,000	80,000	0
7	EFF	24-Nov-80	23-Nov-83		1,268,000	1,079,000	15
8	SAF	28-Dec-88	27-Dec-91	15-Dec-92	382,410	382,410	0
8	SBA	28-Dec-88	07-Mar-90	30-Nov-90	273,150	194,480	29
9	SBA	16-Sep-93	15-Sep-94	22-Feb-94	265,400	88,000	67
10	ESAF	22-Feb-94	21-Feb-97	13-Dec-95	606,600	172,200	72
10	EFF	22-Feb-94	21-Feb-97	13-Dec-95	379,100	123,200	68
11	SBA	13-Dec-95	31-Mar-97	30-Sep-97	562,590	294,690	48
12	PRGF	20-Oct-97	19-Oct-00		682,380	265,370	61
12	EFF	20-Oct-97	19-Oct-00		454,920	113,740	75
13	SBA	29-Nov-00	30-Sep-01		465,000	465,000	0
Total					4,071,550	2,099,090	

1/ If different from initial date of expiration.



## PHILIPPINES

### I. INTRODUCTION

1. The Philippines is probably the most extreme case of prolonged use of IMF resources, with 23 programs between 1962 and 2000. Over the thirty-year period 1971-2000, the Philippines had programs for almost 25 years (Table 1) with credit outstanding from the IMF continuously since 1967.<sup>1</sup> The Philippines' status as a "prolonged user" was recognized by the Executive Board as early as 1984.<sup>2</sup>

**Table 1. Philippines: Chronology of IMF Arrangements Since 1967 1/**  
(in millions of SDRs)

Type of arrangement	Date of arrangement	Original expiration date 2/	Actual expiration date or cancellation	Size of arrangement	Percent drawn	Paris Club debt restructuring	Commercial bank restructuring
SBA	January 1967		January 1968	55.0	100.0		
SBA	March 1968		March 1969	27.5	100.0		
SBA	February 1970		February 1971	27.5	100.0		
SBA	March 1971		March 1972	45.0	77.8		
SBA	May 1972		May 1973	45.0	77.8		
SBA	May 1973		May 1974	29.0	0.0		
SBA	July 1974	July 1975	May 1975	38.8	100.0		
SBA	May 1975	May 1976	April 1976	29.1	99.9		
EFF	April 1976		April 1979	217.0	100.0		
SBA	June 1979		December 1979	105.0	86.9		
SBA	February 1980		December 1981	410.0	100.0		
SBA	February 1983		February 1984	315.0	31.7		
SBA	December 1984	December 1986	June 1986	615.0	65.5	December 1984	January 1986
SBA	October 1986	April 1988	August 1988	198.0	100.0	January 1987	December 1987
EFF	May 1989	May 1992	February 1991	660.6	35.7	May 1989	January 1990
SBA	February 1991	August 1992	March 1993	334.2	100.0	June 1991	December 1992
EFF	June 1994	June 1997	March 1998	791.2	100.0	July 1994	
SBA	April 1998	March 2000	December 2000	1020.8	76.7		

1/ The period 1967-2000 spans four administrations: Marcos, 1967 to 1986; Aquino, 1986-92; Ramos, 1992-98; and Estrada, 1998-2001. The following programs spilled over into succeeding administrations: 1984 SBA; 1991 SBA; and 1998 SBA.

2/ Only if different from actual expiration date.

2. This study presents an assessment of the nature of the IMF's prolonged involvement with the Philippines and attempts to draw lessons for the future. The evaluation is based on an extensive review of published and unpublished IMF documents and interviews with (i) current and former Philippine officials and a range of other stakeholders, including academics, NGOs, and representatives of the private sector, undertaken during an IEO

<sup>1</sup> Amounts outstanding were initially small as a percentage of quota, in line with general Fund policies at the time, but then rose quickly to the 250-300 percent range by the time of the 1982 debt crisis. They declined by the mid-1990s, but picked up again in the aftermath of the Asia and Russia crises.

<sup>2</sup> See "Prolonged Use of Fund Resources", SM/84/91, 4/27/84.

mission to Manila in March 2002; (ii) current and former IMF staff; and (iii) staff of the Asian Development Bank, World Bank, and some bilateral donors. The study is organized as follows: Section II presents a brief overview of the experience over three decades; Section III examines the factors which led to prolonged use; Section IV focuses on implications for program design and implementation; Section V considers the implications of prolonged use for IMF surveillance; and Section VI presents conclusions and recommendations.

## **II. OVERVIEW OF THE PHILIPPINES' EXPERIENCE WITH IMF-SUPPORTED PROGRAMS**

3. The extent of continuous involvement by the IMF in supporting programs in the Philippines is reflected in Table 1 which lists the various stand-by arrangements (SBAs) and Extended Fund Facility (EFF) programs since 1967.<sup>3</sup> Rather than provide a detailed evaluation of each program, we attempt a summary assessment of the experience in four distinct periods.

### **A. The Marcos Period Prior to the 1982-83 Debt Crisis: Almost Continuous Programs that Achieved No Lasting Adjustment**

4. In this period there were a total of 10 SBAs and one EFF in fifteen years but this near continuous involvement with the IMF did not prevent a widening of external imbalances and a sustained debt build-up that eventually resulted in a crisis.

5. The deterioration in economic performance and vulnerability is evident from Table 2. Economic growth was relatively strong during the 1970s, averaging 6 percent a year, but it fell to about 2½ percent in 1981-83. After approximate balance in the first half of the 1970s, a large current account deficit emerged from 1975—averaging 5½ percent of GNP in the second half and rising to 8 percent in 1981-83. The higher deficit was financed by rising external debt most of which was directed to financing large scale investment projects which subsequently proved to be of low efficiency. Programs struggled to deal with the aftermath of the liquidity expansion associated with the 1973 increase in commodity prices and a subsequent deterioration in the terms of trade later in the decade. The two oil price shocks of 1973 and 1980 also added to these challenges. A major structural weakness which developed over the period, and was to plague the Philippines for a long time, was a fall in gross national saving. This deterioration partly reflected a worsening fiscal balance which changed from a surplus of 0.6 percent of GNP<sup>4</sup> on average in the first half of the decade to a deficit of 3½ percent in 1981-83.

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<sup>3</sup> There were also several precautionary SBAs prior to this starting in 1962. The background paper to the 1984 review of prolonged use of Fund resources contains a detailed review of the Fund's involvement in the Philippines since the 1960s. See also James Boughton: *Silent Revolution*, The International Monetary Fund, 1979-89.

<sup>4</sup> National government balance.

**Table 2. Philippines: Selected Economic Indicators**  
(Period average, in percent of GNP, unless otherwise noted)

	1971-75	1976-80	1981-83	1984-85	1986-88	1989-92	1993-97	1998-00
Real GNP growth (in percent)	6.1	6.1	2.6	-8.0	5.3	3.5	4.9	2.9
Export growth (in billions of U.S. dollars, in percent)	15.9	20.7	2.8	-3.8	15.2	8.6	20.8	14.7
Inflation (CPI, annual average, in percent)	17.0	12.3	10.9	34.4	5.3	13.0	7.9	6.9
External current account	-0.4	-5.4	-8.1	-2.1	0.2	-3.4	-4.9	7.9 1/
External debt (in billions of U.S. dollars)	2.5	10.8	23.0	26.0	28.3	29.3	40.3	50.5
Debt service ratio (in percent, after rescheduling)	23.4	33.5	33.0	39.7	34.7	22.9	16.8	14.8
National government fiscal balance	0.6	-1.3	-3.4	-1.9	-3.5	-2.2	-0.3	-3.7
Consolidated public sector balance	...	...	-4.5	-7.2	-3.8	-3.3	-0.6	-3.7
Tax revenue	10.3	12.1	10.3	9.9	11.3	14.2	16.1	13.9
Gross national saving	n.a.	27.7	23.4	17.5	19.5	19.8	18.2	24.5 1/
Gross investment	...	...	...	16.6	15.6	19.8	23.4	17.9

1/ National saving may well be overstated in 1998-00, because of statistical weaknesses, particularly suspected underrecording of imports, which lead the current account also to be overstated.

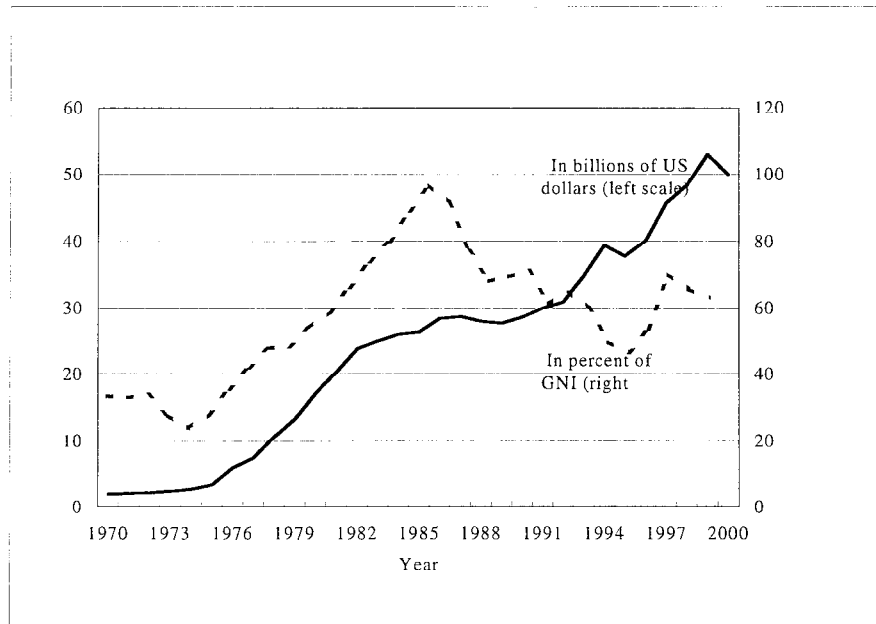
6. Several sources of structural inefficiency also prevailed in this period. A system of monopolistic practices allowed political favorites to extract economic rents especially in key agricultural marketing areas (sugar, coconuts, bananas, etc.) that weakened incentives and harmed small producers, who were among the poorest groups. Inadequate governance and supervisory controls allowed widespread lending to insiders by financial institutions, including publicly-owned banks. Several Article IV staff reports did discuss the distortions caused by the monopolistic practices, but—reflecting the general approach of IMF-supported programs at this time—there was little effort to address these issues in any of the programs prior to 1984. Some structural measures to make the economy more export-oriented were implemented in 1970-72, including liberalization of exchange controls and tariff reforms. However, the main structural component of the 1976 EFF—an effort to improve the tax effort—failed.<sup>5</sup>

7. The rapid build-up in external indebtedness in the second half of the 1970s (Figure 1), which in part reflected excess liquidity in the industrial countries, eventually resulted in a serious economic and financial crisis culminating in a standstill on external debt service in October 1983. The standstill was accompanied by widespread failure of domestic banks and corporations, and a subsequent recession. The discovery that the authorities had misstated the international reserves position exacerbated the crisis and contributed to a program agreed in

<sup>5</sup> The EFF initially targeted an increase in the ratio of tax to GNP from 13-1/2 percent in 1975 to 16 percent in 1978; the actual outturn in the latter year was under 14 percent. This largely reflected shortfalls in indirect taxes but does not appear to have been related to adverse exogenous shocks since real growth was broadly on target and the terms of trade were better than expected under the program.

early 1983 going quickly off-track. Although staff reports show an awareness of the dangers of the debt build-up, programs were not able to address in a systematic way the factors that were leading to it.<sup>6 7</sup> Moreover, the risks to the quasi-fiscal deficit implied by a series of exchange rate guarantees and forward cover arrangements were not fully recognized and eventually contributed to significant central bank losses when the exchange rate depreciated sharply following the crisis.

**Figure 1: Philippines' External Debt**



8. It is interesting to note that economic performance deteriorated and vulnerabilities increased despite the fact that most of the specific performance criteria in the various programs were satisfied and 94 percent of the amount committed in arrangements between 1968 and 1981 were disbursed. This suggests that the problem was not just one of program implementation.

<sup>6</sup> Moreover, at the time there were significant Fund-wide shortcomings in the design of limits on the external debt contracted by the public sector, in particular the exclusion of short-term debt from these performance criteria and insufficient attention paid to the impact of public guarantees on external debt contracted by the private sector. These problems are now well-recognized, and external debt ceilings generally now have a more comprehensive coverage.

<sup>7</sup> The internal 1984 review of prolonged use was quite candid in its assessment of the reasons why the long series of programs with the Philippines had failed to achieve their targets. For example, it noted that, while growth had been quite high for much of the period, "these developments reflected, in part, an unsustainable accumulation of foreign debt as the external position and domestic saving performance remained unsatisfactory... Subsequently, unfavorable external developments, inadequate structural policies, and inadequate demand-management policies, in particular in 1981-83, resulted in a sharp worsening of the balance of payments position." It also noted the problems with wasteful public expenditure but shied away from an explicit discussion of governance-related factors: "A significant part of the public investment program, which was largely financed abroad, consisted of projects with doubtful economic justification". See "Prolonged Use of Fund Resources" (SM/84/91, 4/27/84).

9. Staff and former staff interviewed who were involved with the Philippines during this period, or in its immediate aftermath, were generally of the view that the extensive IMF involvement for much of the Marcos era had been a mistake, sending the wrong signals to markets and effectively helping to postpone adjustment. This was also the view of most of those with whom the evaluation team discussed the issue in the Philippines. A number of officials as well as some staff and former staff also expressed the view that, until 1983, political factors—i.e. the close relationship between the Philippines under the Marcos regime and the U.S. as well as, to a lesser extent, some other major IMF shareholders—were important in explaining the lengthy IMF involvement during this period. We have not found any documentary evidence to support such a judgment, but the fact that such a view is held by a number of those who were close to the negotiations is, in itself, significant.

10. However, it has to be recognized that the IMF was dealing with a very difficult situation—epitomized by deep-seated governance problems and a lack of commitment to fundamental reform at the highest political level—at a time when it did not have adequate instruments, or even an explicit policy, for addressing such issues.<sup>8</sup> While greater attention at an early stage to the structural and institutional problems discussed above might have helped, it is quite likely that program design was not the core issue. In these circumstances, it would have been better for the IMF to have refrained from lending.

#### **B. The Debt Crisis and Subsequent Prolonged Debt Workout, 1983-1993**

11. In the ten-year period following the onset of the debt crisis, the Philippines had to undergo a protracted adjustment to correct the initially large external imbalances and to deal with the accumulated debt problem. There were five programs in this period, spanning the last year of the Marcos administration, the whole of the successor Aquino administration, and the early days of the Ramos administration.

12. As noted above, the 1983 SBA quickly went off-track and, after an interval of nearly a year, was followed by the 1984-86 SBA, the last of the Marcos administration, which prescribed tight macroeconomic policies combined with floating of the exchange rate. The program also made a significant effort to address some of the major structural problems, most notably to dismantle the sugar and coconut monopolies, to establish a more elastic domestic tax system to replace taxes on trade, and to rehabilitate public financial institutions and strengthen control over public sector investment decisions. The program went off-track because of policy slippages in the run-up to the February 1986 election. Fiscal policy turned sharply expansionary and implementation of reforms to the tax system and the sugar and coconut sectors and import liberalization were delayed, with several measures reversed. The program did achieve a sharp reduction in inflation, while there was an even greater current account adjustment than envisaged under the program. This sharp adjustment was driven by

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<sup>8</sup> A guidance note on governance calling for a more comprehensive treatment of governance issues and a more proactive approach in advocating policies that promote good governance were only approved by the Executive Board in 1997. See *Good Governance: The IMF's role*, IMF Pamphlet, 1997 and International Monetary Fund, *Review of the Fund's Experience in Governance Issues*, March 28, 2001.

the cut-off in private external financing and involved a large contraction in imports and in economic activity. Real GNP fell by a cumulative 17 percent during 1984-85 compared with the projected 7 percent fall.

13. The Aquino administration negotiated three arrangements with the IMF: an initial SBA in 1986 which was successfully completed; an ambitious, growth-oriented EFF covering 1989-91 that quickly went off-track as a result of major policy slippages amid considerable political instability and severe exogenous shocks (see Box 1); and finally in 1991 a less ambitious SBA—successfully completed—that focused on stabilizing the economy in the run-up to the May 1992 election, which was won by President Ramos.

14. The programs negotiated with the Aquino administration increased the focus on structural reforms with greater emphasis on dismantling the administrative and other restrictions that had hindered private sector activity and exports, distorted prices, and favored inefficient industries and vested interests. While continuing to aim at improving public sector revenue and the elasticity of the tax system, the tax reforms envisaged were more far-reaching than earlier reforms, paying greater attention to the structure of incentives and equity. There was initial success on reforms covering trade, taxes, and the agricultural sector, especially in those areas that represented a dismantling of the “crony capitalism” privileges of the Marcos era and the creation of a more level playing field. However, progress then slowed, as the administration tackled more politically sensitive structural issues.

15. The realignment of incentives for exports, arising from the exchange rate depreciation and trade liberalization in the 1980s, led to a sharp improvement in export performance as reflected in the growth rate of over 15 percent a year in the period 1986-88. Rapid export growth, combined with the series of reschedulings of commercial bank and official debt, contributed to a significant reduction in the Philippines’ external debt problems. Indicators of the debt and debt service burden started to improve markedly in the late 1980s with the debt service ratio (after rescheduling) falling to below 20 percent in the early 1990s and to 14 percent by the mid-1990s. The debt/GNP ratio fell from a peak of 100 percent in 1985 to less than 60 percent in 1992.<sup>9</sup>

### **C. The 1994 EFF: Restoration of Access to Private Financial Markets and the Planned “Exit” from IMF Programs**

16. From the time of the accession of the Ramos administration in 1992, staff and management planned a final EFF explicitly intended to be an “exit program” from prolonged use. In the view of staff, a recurrence of external financing problems could not be ruled out if the economy were to resume sustained growth of 5 percent a year or more and further structural changes were needed to ensure medium-term viability. A new three-year EFF was agreed in June 1994 after lengthy negotiations with the Ramos administration. In the interim, the Philippines had regained access to international capital markets when it floated a \$150

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<sup>9</sup> Public debt service also fell—from an average of 48 percent of central government revenue in 1986-88 to 26 percent in 1994-97.

million Eurobond issue in 1993. It also resumed servicing Paris Club debt, although it would soon seek further rescheduling.

### Box 1. Why Did the 1989 EFF Fail?<sup>1</sup>

One important development that prolonged the length of the Philippines' adjustment was the failure of the 1989 EFF to achieve its objectives. The three-year program was intended to be growth-oriented: (i) the targets for investment and saving were ambitious, while the current account deficit was projected to increase modestly rather than decline; (ii) the fiscal program allowed for a substantial increase in public infrastructure investment, to be financed by higher public saving but also by a modest increase in the fiscal deficit in the first year; and (iii) a wide range of structural reforms, including financial sector strengthening, trade reform, privatization, power tariff reform, foreign investment and exchange market reform, elimination of the Central Bank deficits, and land reform. Unfortunately, actual performance fell well short of these objectives. Rather than going through a consolidation phase with rapid growth, the economy slipped back into significant vulnerability: growth declined; inflation accelerated; and both the fiscal and current account deficits widened sharply.

Three sets of factors accounted for the disappointing performance:

- **Adverse exogenous shocks**, in the form of considerable political instability with several coup attempts; natural disasters (including a drought, typhoon, and severe earthquake); and an unanticipated 10 percent weakening in the terms of trade. While these adverse shocks put the short-term balance of payments and growth objectives out of reach, they were temporary in nature and, by themselves, should not have caused the program to fail in its longer-term objectives.<sup>2</sup> But the degree of political instability that occurred would have been hard to predict.
- **Program design issues**, including (i) a structural reform agenda that proved to be overambitious and insufficiently prioritized, especially in the context of a newly-restored Congress that wanted a substantial say in economic policy matters. In retrospect, it would have been better to have concentrated on a shorter and more specific agenda.<sup>3</sup> (ii) an overoptimistic projection of the speed of recovery in private investment, reflecting an apparent underestimation of the adverse impact of the debt overhang on investment.<sup>4</sup> (iii) The program rightly placed more emphasis on measures to improve tax administration and compliance rather than on discretionary measures. However, this posed challenges for program design since the revenue impact was uncertain in terms of both magnitude and timing—and progress proved slower than expected. (iv) The move to six-monthly performance criteria appears to have been a mistake. It permitted the build-up of large policy slippages that proved too large to correct by the time of the next test dates. Quarterly performance criteria were reinstated in June 1990.
- **Weaknesses in program implementation** were probably most important of all, although the timetable of reforms would have been difficult to deliver even without the disruptions caused by the coup attempts. The Government's ability to implement the program was hampered by its inability to pursue its economic policy agenda—particularly revenue and structural reform measures—in Congress, a constraint that had been insufficiently recognized when the program was prepared. Some actions by Congress that were opposed by the Government—notably approval of a large wage increase and a cut in oil taxes—seriously aggravated the fiscal situation.<sup>5</sup>

<sup>1</sup> This box draws in part on internal ex-post staff assessments, which were quite candid, but tended to put even more emphasis on implementation failures.

<sup>2</sup> IMF staff estimates suggest that the natural disasters accounted for about half of the deterioration in the external current account, mostly financed through foreign emergency assistance.

<sup>3</sup> For example, internal assessments by the staff suggest that the lack of specificity in the program on action to deal with the central bank deficit contributed to the lack of progress in this area.

<sup>4</sup> Overoptimistic projection of investment appears to be a common problem in program design. See IMF (1996).

<sup>5</sup> Implementation problems began at the outset of the program when the authorities indicated that the oil price increase agreed upon as a prior action would have to be delayed. Combined with an unanticipated increase in world oil prices, the delay had a significant fiscal impact. Oil price issues remained highly sensitive, since the December 1989 coup attempt was timed to coincide with the date of the postponed price increase, in order to exploit expected social unrest.

17. The 1994 EFF aimed at: fiscal consolidation; tax reform; financial sector reform; and continued economic liberalization, particularly in the fields of the deregulation of oil-pricing and the abolition of remaining quantitative import restrictions (see Box 2). In order to meet program objectives, it was judged necessary to improve the saving/investment balance significantly, and this was to be achieved through a substantial fiscal adjustment. The program aimed at increasing tax revenue by nearly 4 percentage points, to 19 percent of GNP, over the three-year period by broadening the tax base, reducing exemptions, and improving tax administration.

**Box 2: Original Aims and Outcomes of the EFF, 1994-96**

<u>Aims</u>	<u>Outcomes</u>
<b><u>Macroeconomic targets</u></b>	
Increase investment by 3 percentage points of GNP.	In 1996, investment was 23.1 percent of GNP, slightly lower than in 1994.
Reduce the current account deficit to about 3 percent of GNP from 6 percent of GNP.	The current account deficit was 4.6 percent of GNP in 1996
Increase national saving by 6 percentage points of GNP by 1996, almost all through fiscal adjustment.	By 1996, the saving rate had risen just 0.8 percentage points.
Reduce Consolidated Public Sector Deficit (CPSD) from 2.7 percent of GNP in 1993 to 0.5 percent of GNP by 1996.	Outturn in 1996 was a surplus of 0.2 percent of GNP.
Reduce <i>underlying</i> CPSD <sup>1</sup> from 4.2 percent of GNP in 1994 to 0.7 percent of GNP by 1996.	Outturn was 0.2 percent of GNP.
Raise government tax revenue by 4 percentage points of GNP between 1993 and 1996.	Tax revenue rose just 1 percentage point.
Increase real GNP growth from 2.3 percent in 1993 to 5 percent by 1996.	Real GNP growth exceeded the target, rising to 7-1/4 percent in 1996.
<b><u>Key structural measures</u></b>	
Tax reform, including adoption of a minimum business tax, phased abolition of tax exemptions, and improved VAT administration	Comprehensive tax reform was eventually passed in December 1997 but major tax exemptions and incentives remained. Minimum business tax based on sales, not assets. Tax administration weaknesses remained.
Deregulation of oil pricing and importation.	Deregulation of oil prices was completed in early 1998 and the Oil Price Stabilization Fund abolished.
Tariff reduction and elimination of nearly all quantitative import restrictions.	Quantitative import restrictions were removed (except for rice). Average tariff was reduced to 15 percent.
Public expenditure reform	Legislative action on rationalizing civil service stalled.
Local government devolution.	Devolution of public expenditure did not match large increase in transfers to local government.

1/ The underlying CPSD treats privatization receipts "below the line", rather than "above the line" as in the standard CPSD.



18. An interesting feature of the EFF-supported program is that the fiscal targets of the program were met—mainly because of lower interest payments and lower public investment than targeted—although the aim of increasing tax revenue was not achieved. Tax revenues rose by only one percent of GNP over the period. Thus it was possible to meet the fiscal targets even though the structural strengthening on the tax side had only partially occurred, leaving the economy vulnerable on this front when economic circumstances changed.

19. Considerable progress was made on some of the structural measures included in the program. Under the Ramos administration, banking, telecommunications, domestic shipping, and the oil sector were opened to new competition, and limits on foreign participation were eased in a number of sectors. Import tariffs were reduced markedly, and quantitative import restrictions largely eliminated. The privatization program was accelerated, and the central bank recapitalized under a new statute. However—as discussed in Section IV—progress in implementing tax reform proposals was slower and less complete than envisaged. The 1994 EFF was associated with improved export performance and a modest improvement in growth, but it did not bring about the sustained current account adjustment originally envisaged. Until the Asian crisis, however, the current account deficit was easily financed by buoyant capital flows.

20. In retrospect, it can be questioned whether the 1994 EFF was needed—in a balance of payments sense—and we take up this issue in Section III. In any event, since financing problems eased subsequently, the authorities began to treat the EFF as precautionary after the initial purchase—indicating their intention to refrain from further purchases. As the fourth and supposedly final review approached in early 1997, staff briefing papers noted that the authorities were looking forward to a graceful exit from a long line of IMF arrangements, but delays in the progress on the tax reform because of opposition in Congress meant that the review could not be completed as scheduled. Rather than let the program lapse, the authorities requested an extension as they wanted to “graduate” on a successful note, following passage of the Comprehensive Tax Reform Package (CTRP) by Congress. The original extension of the arrangement was not therefore driven primarily by a perception of balance of payments need, but rather the desire to end the program successfully. However, before this could happen, the program was overtaken by the Asian crisis.

#### **D. Asian Crisis and its Aftermath**

21. As the Asian crisis hit, the EFF was augmented and further extended first until December 1997 and then to March 1998 and the authorities again decided to draw on the program. The peso was floated in July 1997.<sup>10</sup> Initially, the authorities showed no interest in

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<sup>10</sup> Exchange rate policy was the subject of some disagreement between the staff and the authorities in the mid-1990s. The Philippine peso was pegged *de facto* to the dollar in late 1995, as the authorities tried to prevent a real appreciation, encouraging short-term capital inflows. The risks of this policy, particularly if capital flows were reversed, were highlighted in the Article IV consultation in December 1996. Following the float of the peso in July 1997, the authorities initially engaged in substantial one-way intervention to support the peso and took other measures designed to prevent depreciation, including limiting access to the foreign exchange market by some foreign banks, while rapidly reducing interest rates contrary to commitments in the letter of intent.

(continued)

a follow-on arrangement, in part because graduation from IMF-supported programs had become a political issue in the Philippines. However, as the regional crisis unfolded, both the authorities and IMF management became concerned about the risks of such an exit amid the turbulent financial market conditions. The IMF management was anxious to have a “follow-on” program to help ring-fence the Asian crisis and also to serve as a policy blueprint for the new administration which would take over following the May 1998 Presidential election. Fund management therefore pressed for a precautionary standby arrangement prior to the elections.<sup>11</sup>

22. The new two-year SBA entered into with the outgoing Ramos administration centered on fiscal and monetary tightening; banking sector reform; improved tax administration and other structural reforms in order to provide a framework for orderly adjustment to the reduced level of capital inflows. The program included a new emphasis on tax administration, as well as an effort to complete the original CTRP agenda, by reintroducing legislation to reduce tax exemptions and incentives. A revised version of the program<sup>12</sup> was endorsed in October 1998 by the incoming Estrada administration. The program was originally intended to be precautionary but, at the time the revised program was approved, the authorities decided to make purchases in response to reduced access to international capital markets following the Russian default and collapse of Long Term Capital Management.

23. At first, the momentum of the policy envisaged in the program was maintained, but over time policy slippages grew and concerns over governance problems mounted. Policy slippages, related in part to the privatization of the Philippine National Bank, led to a delay of almost a year in completing the Fifth Review until mid-2000.<sup>13</sup> This review was the occasion of a critical discussion in the Executive Board, which focused on persistent policy slippages, governance concerns, and the rationale for continued IMF program involvement. Some Executive Directors were highly critical of the Fund’s prolonged and, in their view ineffective, relationship with the Philippines and raised the issue of the future relationship after the conclusion of the arrangement. A few suggested that the program should become precautionary after the drawing which was the subject of the review.

24. The authorities noted that their earlier exit strategy had been frustrated by the Asian crisis and that they intended to develop a new one. They argued, however, that the reserve

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<sup>11</sup> The existing EFF could only have been further extended until June 1998.

<sup>12</sup> The program was revised to take into account weaker economic activity and a deteriorating external environment, in particular through a somewhat looser fiscal stance. It also reflected the announced policy agenda of the new government, with greater attention to corporate governance issues, power sector reform, and medium-term public sector reform in addition to existing planned reforms for the banking sector and tax administration.

<sup>13</sup> The program aimed at the full privatization of the PNB by mid-2000. However, the situation was complicated by the nontransparent acquisition of a controlling stake by a local group, headed by a close associate of then President Estrada, which owned several companies which were nonperforming debtors of PNB, and by the revelation of increasing concerns about the group’s financial position.

position remained somewhat vulnerable, implying a need for further IMF support. Staff took the view that, since the IMF's presence in the Philippines had encouraged the implementation of sounder macroeconomic policies and had had an important catalytic effect, a close policy dialogue should be maintained with the authorities, while encouraging an exit from use of Fund resources. In the event, the 1998 SBA was extended to end- 2000, but it expired without the last review being completed, as a result of further fiscal slippages, reflecting weak revenue collection and mounting governance concerns. Thereafter, the authorities requested post-program monitoring in line with the expectation of the Board for a country whose credit outstanding exceeds a threshold amount.<sup>14</sup>

25. In defense of the long involvement of the IMF, and particularly its continued involvement in the mid-1990s, it could be argued that, although not all aspects of the 1994 EFF were implemented as planned, it helped the economy to weather the Asian crisis fairly well. The Philippines did not suffer as severe a downturn as its neighbors; growth decelerated but remained positive. This was partly the beneficial consequence of the cumulative impact of structural changes that had been introduced over the years under successive programs, and which accelerated as a result of strong political leadership during the Ramos administration. The generally sound macroeconomic management under the framework of the 1994 EFF<sup>15</sup> probably also helped, although, as already noted, there continued to be differences of view about exchange rate policy. A number of the vulnerabilities which were central to the severity of the dislocation in other economies most affected by the Asian crisis were also present in the Philippines, nonetheless.<sup>16</sup> However, imbalances did not build up over as long a period as they had in other Asian countries, in part because earlier problems meant that

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<sup>14</sup> In September 2000 the Executive Board had agreed that, when a member's credit outstanding exceeds a threshold of 100 percent of quota, there should be a presumption that the member will engage in Post-Program Monitoring (PPM) by the IMF of economic developments and policies after the expiration of its arrangement. To this end, the member engages in discussions with the staff on its policies, including a quantified macroeconomic framework. The staff then reports formally to the Board, normally twice a year, on the member's policies, the consistency of the proposed policies with the objective of medium-term viability, and the implications for the member's capacity to repay the Fund.

<sup>15</sup> The question addressed in Section V is whether surveillance could also have provided the necessary framework.

<sup>16</sup> Over the years of IMF-supported programs, various efforts were made at reform of the financial sector, including the rehabilitation and restructuring of the Philippine National Bank and the Development Bank of the Philippines in the late 1980s. After the opening of foreign direct investment in 1991, most capital account restrictions were removed in a wide-ranging reform in 1992. Measures to strengthen the supervisory and regulatory regime for commercial banks and to increase competition in the banking sector were taken at about the same time. In particular, the move was accompanied by a change in the prudential formula determining the maximum net open foreign exchange position for each bank. Restrictions on entry and operation of foreign banks were eased in the early 1990s to increase competition, and other measures were taken to tighten prudential regulation, including a tightening of minimum capital requirements and the imposition of a liquid asset requirement on foreign currency deposit unit loans. Nevertheless, private credit grew very rapidly ahead of the Asian crisis, and bank supervision and regulation continued to exhibit serious shortcomings compared with best international practice. Since 1998, the authorities have adopted further financial sector reforms, with the help of the IMF and a Banking Sector Reform Loan from the World Bank. See IMF Occasional Paper 187: "Philippines: Towards Sustainable and Rapid Growth-Chapter VI: Banking System Reform" (2000).

capital inflows were smaller and did not last for as long prior to the crisis as in the other countries.

### **E. Despite Some Progress, Poverty Remains High**

26. The incidence of poverty has declined from 45 percent in 1985 to 32 percent in 1997, but remains high in absolute terms. Moreover, income distribution has not changed much in the last three decades and remains among the most unequal in South East Asia: in 2000, the richest 20 percent accounted for over one half of total expenditure and the poorest 20 percent for about 5 percent.<sup>17</sup> Significant progress was made in improving health and education indicators over the period of IMF program engagement, but these improvements did not match those in other Asian economies, in part neglecting fiscal policy shortcomings.

### **III. WHY DID THE IMF REMAIN INVOLVED FOR SO LONG?**

27. In this section we explore the main reasons why the IMF became as closely and continuously involved as it did in the Philippines over the past thirty years or so and whether the involvement was consistent with Board guidelines on the subject.

#### **1. Starting imbalances and structural problems were large**

28. Part of the explanation for prolonged involvement lies in the fact that despite the IMF's long engagement in the Marcos era, imbalances were large when the standstill on external debt service was declared in 1983. The current account deficit reached about 9 percent of GNP in 1982-83. External debt peaked at 100 percent of GNP in 1985 which was higher than in most of the other problem debtors of the time. Debt service, before rescheduling, was equivalent to about 50 percent of exports of goods and services and private transfers.

29. The Marcos administration also left its successors a daunting legacy of structural problems including severely indebted state corporations and government financial institutions, including the central bank.<sup>18</sup> A small elite controlled a large part of the economy and proved resistant to many reforms that threatened this control.<sup>19</sup> As a result, the economic system remained quite closed, with patronage playing a dominant role with a limited scope

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<sup>17</sup> According to the World Bank's World Development Indicators 2001.

<sup>18</sup> The Central Bank incurred large liabilities, due to the impact of sharp exchange rate depreciation on the cost of the exchange rate guarantees and forward cover arrangements, provided in the early 1980s. The authorities took a policy decision not to monetize these liabilities—which was of critical importance in helping the Philippines avoid high inflation in the aftermath of the crisis—but interest payments on central bank bills issued to cover the losses gave rise to continuous quasi-fiscal deficits and a highly negative net worth. It also affected the Central Bank's ability to conduct monetary policy. The central bank was eventually recapitalized and restructured, under a new statute, in 1993. This was a prior action for the EFF, which was agreed the following year.

<sup>19</sup> See, for example, John Bresnan (ed.) *Crisis in the Philippines: The Marcos Era and Beyond*, Princeton University Press, Princeton, 1987. E Gutierrez, I. Tomente, and N. Narza, *All in the Family: A Study of Elites and Power Relations in the Philippines*, Institute for People's Democracy, Quezon City, 1992.

for competition. Many industries benefited from a high degree of protection and there were barriers to the entry of foreign corporations. The Philippines was much more closed than other Asean economies even though the economy was smaller in size.

30. Moreover, staff reports were quite candid in indicating that it would take a long time to return to external viability. For example, the staff appraisal in the Request for SBA in 1984 notes that “effective adjustment will undoubtedly require time, stretching well beyond the program period.” Medium-term projections in subsequent program documents continued to imply that the restoration of external viability would take a long while, typically extending well beyond the projection period. Indeed, with hindsight the Fund was at times too pessimistic about the timing of the return to external viability, reflecting the difficulty of predicting when full access to private financial markets would be restored.<sup>20</sup>

## **2. “Seal of approval” influences on IMF program involvement**

31. “Seal of approval” considerations, linking the provision of financing or restructuring of debt from other creditors to an IMF-supported program, were particularly important during the period 1982-92 as the Philippines sought to work out its external debt problems. IMF programs were formally required in order for Paris Club creditors to reschedule debt. Commercial banks also made it clear to the Philippines’ authorities that an active IMF-supported program was the *sine qua non* for the concerted commercial bank lending and restructuring that took place between 1986 and 1992. Apart from the various commercial bank restructurings in 1986, 1987 and 1990, the release of intermediate tranches of new money by commercial banks were also dependent on IMF-supported programs. This remained so until the final Brady restructuring in 1992, which was financed in part from “set-asides” under IMF arrangements together with support from JEXIM, the Japanese export credit agency, and from the World Bank—both of which were also tied to the programs.<sup>21</sup> The timing of Donors’ Consultative Groups was also closely related to the inception of IMF-supported programs.

32. Did the debt work-out phase in the Philippines—and IMF involvement related to this factor—take longer than in most other countries that encountered debt problems in the 1980s? The answer appears to be no, in large part because the broader international strategy vis-à-vis the middle-income highly indebted countries took about a decade to evolve to the Brady plan. Therefore, most of these countries also had a series of programs lasting a decade or so, linked to debt restructuring (see Box 3).

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<sup>20</sup> Projections for the 1991 SBA foresaw financing gaps throughout the decade, noting that this pointed to the continued involvement of the Fund and further Paris Club and commercial bank financing packages through the mid-1990s. The 1989 EFF request incorporated financing gaps of \$1.7 billion a year in 1993-95, and suggested that an end to exceptional financing and a return to normal market access might not occur until after 1995.

<sup>21</sup> More recently, full activation of bilateral swap arrangements with other Asian economies have been tied to the existence of an IMF-supported program. In 1994 the program was also associated with a Paris Club rescheduling but in this case, the Philippines (uniquely in the history of the Paris Club) eventually decided to cancel the agreed rescheduling, apparently because of the implications for cover from export credit agencies and the questionable need for a rescheduling.

**Box 3: Many Highly Indebted Countries Took as Long as the Philippines to Resolve Their Debt Problems and Consequently Also had Repeated IMF Arrangements**

The Philippines is not unusual in the length of time it took to complete the debt workout after the debt crisis of the early 1980s. Most of the heavily indebted middle income countries which were affected also took about a decade to work out their debt problems with the help of Paris Club reschedulings and commercial bank restructurings, culminating in the Brady restructurings of the early 1990s. Of the seventeen highly indebted middle-income countries,<sup>1</sup> Philippines was the eleventh to complete its series of reschedulings with commercial banks and the Paris Club, in July 1994.<sup>3</sup> (see Table). Six of these countries completed their restructurings in a concentrated period between 1992 and 1994, with five earlier and six later.

**Table 3: Heavily Indebted Middle-Income Countries: IMF-Supported Programs Tied to Debt-Restructuring Following the 1980s Debt Crisis**

Country	First Program Linked to 1980s Debt Restructuring	End of Last IMF Program linked to 1980s Debt Restructuring	Last Commercial Bank Restructuring	Last Paris Club
Argentina	January 1983	March 1996	April 1993 <sup>5</sup>	July 1992
Bolivia	February 1980	Ongoing	July 1992 <sup>5</sup>	July 2001
Brazil	March 1983	August 1993	April 1994 <sup>5</sup>	Feb 1992
Chile	January 1983	Nov 1990	December 1990	April 1987
Costa Rica	March 1980	February 1994	May 1990 <sup>2</sup>	June 1993
Ecuador <sup>2</sup>	July 1983	Dec 1995	February 1995 <sup>5</sup>	June 1994
Jamaica	June 1978	March 1996	June 1990	Jan 1993
Mexico	January 1983	May 1993	March 1990 <sup>5</sup>	May 1989
Nigeria	January 1987	April 1992	January 1992 <sup>5</sup>	December 2000
Peru	June 1982	March 1999	Nov 1996 <sup>5</sup>	July 1996
Philippines	Dec 1984	March 1998	Dec 1992 <sup>5</sup>	July 1994
Uruguay	April 1983	March 1992	Feb 1991 <sup>5</sup>	...
Venezuela	June 1989	March 1993	Dec 1990 <sup>5</sup>	...
Cote d'Ivoire	February 1981	Ongoing	May 1997 <sup>5</sup>	April 2002
Morocco	October 1980	March 1993	June 1990	Feb 1992
Former Yugoslavia	May 1979	September 1991	Sept 1988 <sup>4</sup>	July 1988 <sup>4</sup>

In most of these cases, countries had a succession of IMF-supported programs lasting a decade or more linked to the need for a seal of approval for restructuring. Up until the 1991 SBA tied to the 1992 Brady deal and the 1991 Paris Club rescheduling, Philippines was fairly typical in the length of programs associated with restructuring. However, to the extent that the abortive Paris Club rescheduling was one of the rationales for the 1994 EFF, which lasted until 1998, IMF involvement linked in some way to restructuring lasted a little longer than in most other countries.

1/ The "Baker 15" countries, plus Costa Rica and Jamaica. Colombia is not shown because it did not reschedule in the relevant period, although it did benefit from concerted lending arrangements with commercial banks in 1985, 1989 and 1991.

2/ Ecuador rescheduled debt with official and private creditors again in 2002.

3/ If this Paris Club rescheduling, which was never implemented, is discounted the Philippines would rank as the sixth of the seventeen to complete rescheduling. Nevertheless, the Paris Club rescheduling was one of the rationales for the 1994 EFF although a number of Executive Directors questioned its need.

4/ These are the dates of the reschedulings of the debt of the former Yugoslavia, whose debt problems had not been resolved at the time the Federation was dissolved.

5/ Brady Deal

33. Even after the Philippines had regained market access in 1993 and IMF-supported programs were no longer required specifically for concerted debt arrangements, they were still seen to satisfy the demand for a positive signal on the macroeconomic framework to donors and private financial markets. In this situation, donors did not formally require an IMF arrangement to be in place in order to provide support, but they appear to have been more comfortable with such an approach. For example, former officials stated that one of the primary rationales for the 1994 EFF was that the authorities felt that, in the light of the Philippines checkered track record, an IMF-supported program would be helpful to reassure lenders as the country started to reaccess international capital markets. Both IMF staff and Philippine officials appear to have been concerned that a discontinuation of the prolonged relationship would be interpreted negatively by participants in the international capital markets. The EFF was therefore viewed as desirable in part because so many players in the system had become accustomed to the existence of a program.

34. Internal briefing papers and interviews with a number of staff suggest that the strong “gatekeeper” role implied by the close linkage of programs to other forms of financing has had a potentially adverse effect on the quality of programs, in two ways: (i) The severe consequences, in terms of loss of other financing, of the IMF’s potential disengagement probably caused it to be less selective in choosing to be involved only at times when a lending arrangement was likely to be most effective in advancing reform; and (ii) Since the seal of approval from IMF-supported programs has typically been linked primarily to agreement on a program, rather than to its successful implementation, it increased pressures on the authorities to agree to policy timetables that looked strong on paper, even if they were unlikely to be delivered within the agreed time frame.

35. These tensions were frankly discussed in internal briefing papers prepared when the 1994 EFF was under negotiation, at which time staff expressed a concern to resist being pressured into early agreement on a less than adequate program. The authorities were apparently keen to agree on a new program relatively quickly in order to pursue a Paris Club rescheduling, and an early meeting of official donors, both of which were linked to such a program. This wariness on the part of the staff appears to reflect a number of earlier episodes where seal of approval considerations influenced IMF agreement on programs, and where, in the staff’s judgment, these programs suffered from weaknesses as a result.<sup>22</sup> However, these internal concerns were not reflected in the Board papers for the 1994 EFF.

### **3. Fluctuations in political commitment and ownership**

36. One of the reasons why adjustment took a long time is that there was strong political resistance by vested interests to implementing some key structural changes essential for success.<sup>23</sup> The Philippines’ political system required a strong political commitment of both

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<sup>22</sup> For example, in 1992, the tight links between Paris Club rescheduling and IMF-supported programs caused the program to be extended through a change of administration, risking compromising program ownership.

<sup>23</sup> The 1993 and 2000 Country Strategy Papers—and the 2000 Occasional Paper—were quite candid in identifying these factors as key obstacles to faster adjustment and growth.

the executive and legislative branches to ensure the passage of enabling legislation to support the economic policy agenda. However, the programs supported by the IMF were based primarily on agreements between staff and the executive branch, and important elements of the reform agenda often stalled in Congress or ran into judicial challenges.

37. Strong leadership, with ownership of reform, did at times help achieve the necessary political commitment and overcome vested interests—such as in 1986-87 and during much of the Ramos administration. During these periods, much was achieved under the IMF-supported programs, even if the need to mobilize a political consensus and push reforms through Congress meant that the ambitious timetables set out in program documents could not be attained. However, when political leadership was weaker, reforms stalled despite the commitment of the direct economic ministries and the central bank. Prolonged political uncertainties—including several coup attempts during the Aquino administration—added to these problems.

38. What could the IMF have done differently during these periods of weaker ownership? In many cases, there is no clear answer. In principle, a different approach might have involved a combination of three elements: greater efforts to build consensus, greater selectivity; and changes in conditionality.

39. On the first element, IMF missions did engage in extensive dialogue on economic policy with members of key congressional committees and both officials and staff interviewed thought this dialogue had been helpful. Some missions also reached out to “civil society” more generally, and resident representatives generally engaged in a policy dialogue with a broad range of groups, within and outside government, to explain the IMF point of view. However, such contacts could not create, or serve as a substitute for, broader domestic political commitment and ownership.

40. Greater selectivity in entering into, or extending, lending arrangements would have been highly desirable during those periods when it became evident that there was no commitment at the highest political level to reforms necessary for sustainable adjustment. This was the case for much of the Marcos era and should have been evident earlier in the Estrada administration. At other times, however, when the issue was more one of the Executive’s ability to implement measures they agreed to, the IMF was faced with a more difficult situation. On a number of occasions when policies went off track, the Fund did halt programs—by not completing reviews—while seeking corrective actions (see Box 4). However, partly because of the “seal of approval” issues discussed above, pressures often grew to resume the program and a compromise was generally reached that involved some erosion of the original policy measures.

41. Finally, could a different approach to conditionality have helped overcome the periods of weak ownership and thereby reduced the length of IMF program involvement? As will be discussed further in Section IV, a greater prioritization of structural reforms—with greater flexibility on the timetable but not on the substance of those judged to be critical to macroeconomic sustainability—would probably have helped; however, as the later discussion of the efforts to improve the tax structure and strengthen tax administration will



show, there are limits to what any specific modalities of conditionality can be expected to achieve, in the absence of strong domestic ownership.

#### **Box 4. Examples of Major Interruptions to IMF-Supported Programs in the Philippines**

As discussed in the main text, conditionality in the Philippines—especially structural conditionality—relied heavily on program reviews. On a number of occasions, program reviews were delayed for extended periods—sometimes leading to permanent interruptions—as policies diverged from program commitments. By interrupting programs, the IMF was sometimes able to secure desired policy changes. However, if such interruptions took place within a context where it was tacitly understood by both sides that outside factors—including “seal of approval” considerations—would be likely to ensure the eventual restoration of a program relationship, this may have affected the efficacy of efforts to impose greater selectivity. This box examines several such episodes to examine the major reasons for program interruptions and to assess the extent to which the policy slippages were corrected by the time programs were resumed, or new arrangements agreed. The broad conclusion is that the program interruptions were partly effective in correcting policy slippages, but that substantial “recontracting” also occurred, resulting in a weakening of original commitments.

##### **Interruption of the 1989 EFF**

The IMF took contrasting approaches to successive reviews under the 1989 EFF.

- The first review of the 1989 EFF was completed on schedule in December 1989, despite significant slippage in monetary and fiscal policies that largely reflected the delayed implementation of politically sensitive oil price increases and a large public sector wage increase. The authorities eventually raised oil prices at the beginning of December, and promised to take remedial fiscal actions, including several discretionary tax increases, to permit the Review to be completed. As noted below, these promised increases did not materialize. One motivation for completing the review on time, was to free up IMF “set-asides” and linked financing from donors to help finance the “buy-back” of commercial bank debt that took place in January 1990.
- The program went more seriously off-track during 1990 in light of policy slippages and a series of large exogenous shocks. Net international reserves targets and fiscal targets were missed, the latter largely because Congress failed to pass the tax measures promised earlier as a condition for completing the first review.<sup>1/</sup> Staff decided that the original aims of the EFF were unattainable and that the second review of the program could not be completed. This decision appears to have reflected the judgment that in the political environment following the earthquake and the previous year’s coup attempt, it was unlikely that the government would be able to take the comprehensive and strong policy measures that would justify the resumption of Fund support.
- However, the IMF was keen to head off the risk of an intensifying crisis and also to free up needed financing from donors and creditors. Six months after the review was originally scheduled, agreement on a new standby arrangement was reached in January 1991. In order to meet the schedule for a donors’ group and avoid the damage to confidence that a further delay would cause, the IMF compromised on its initial requirements for a new program, accepting the President’s assurance that she would use veto powers and administrative means to keep expenditure in line with the program, as a substitute for full enactment by Congress of the budget. Reflecting political sensitivities, revenue measures were confined to a temporary import levy, rather than the measures promised under the previous program. Other prior actions were agreed, including the elimination of administrative foreign exchange arrangements that artificially supported the peso and the announcement of a power tariff increase. In the event, the politically sensitive power tariff increase was not implemented until a year later, and was subsequently partly rolled back. The band around the reference exchange rate for commercial transactions was eliminated as scheduled. More far-reaching reforms of the exchange system were introduced only in early 1992.

**Box 4. Examples of Major Interruptions to IMF-Supported Programs in the Philippines (concluded)**

**Delayed first review under the 1994 EFF**

- Policy performance in the first six months of the 1994 EFF deviated substantially from program expectations. In particular, the introduction of an automatic oil price adjustment mechanism, which was an original condition for completing the review, was postponed until late 1995, after it was determined that this would require legislation. Monetary policy also went off track. There were also delays in establishing a simplified tariff regime; revising the National Power Corporation's pricing formula; and liberalizing entry into the oil sector. To complete the review, the IMF therefore pressed for the implementation of these trade and energy reforms and for demonstrated adherence to the monetary program in early 1995. It also sought new understandings on compensatory measures that would be taken if there were unforeseen developments, such as weaker than expected capital flows, following the Mexican crisis.
- The review was eventually completed in September 1995, after a ten-month delay. The IMF settled for the administration's submitting of bills covering the measures required for completion of the review to Congress, rather than their actual implementation. The administration submitted a bill to remove quantitative agricultural import restrictions, which was passed in March 1996, and a comprehensive oil sector reform bill, as well as a tax reform bill.<sup>2/</sup> The decision to complete the review appears to have reflected the strong macroeconomic performance, recognition that the authorities had limited influence over the Congressional timetable, and the judgment that the authorities' efforts to advance structural reform deserved encouragement.
- An Oil Deregulation Bill was passed in 1996, but was subsequently judged to be unconstitutional. Replacement legislation was eventually passed in February 1998, some two and a half years later. The Comprehensive Tax Reform legislation was passed in December 1997, but suffered some important shortcomings (discussed in Section IIIC).

**Fifth review of the 1998 stand-by arrangement**

- Completion of the fifth review of the 1998 SBA, originally scheduled for September 1999, was delayed by ten months. As a condition for completing the review, the IMF sought renewed momentum in key structural reforms, with specific prior actions required in banking reform, tax administration, and power sector restructuring. Missions in September and December 1999 were unable to complete the review because of slippage in the fiscal program and because key structural reforms were delayed—particularly power sector reform legislation and the adoption of a plan for the privatization of the Philippine National Bank (PNB) by mid-2000. Growing governance concerns, including those related to the PNB privatization, also added to difficulty in completing the review.
- The program was extended beyond its original termination date of March 2000 to permit completion of the review in July 2000. This followed agreement on a fiscal program for 2000, incorporating a slightly higher targeted fiscal deficit<sup>3/</sup> as well as approval of the power sector reform by the Lower House of Congress in April (a prior action), and by the Senate in June. In the event, approval of unified legislation was delayed for much longer—until late 2001. The review went ahead despite the failure of the auction of the government's stake in PNB in June. Progress was slower than the IMF originally sought in some other areas of structural reform, including tax administration, but a General Banking Act was passed prior to the completion of the review. The arrangement was extended a second time until end-2000, but was ultimately permitted to lapse amid increasing governance concerns, without completion of the final review.

1/ In the aftermath of the June earthquake, the authorities were pressing for the early provision of emergency assistance from the IMF while Congress threatened a debt moratorium. Congress also voted a substantial reduction in oil taxes in the face of the run-up in world prices, and a tariff reform was withdrawn in the face of congressional pressure.

2/ There was also a major revision to monetary policy, as the authorities adopted a limited form of inflation targeting.

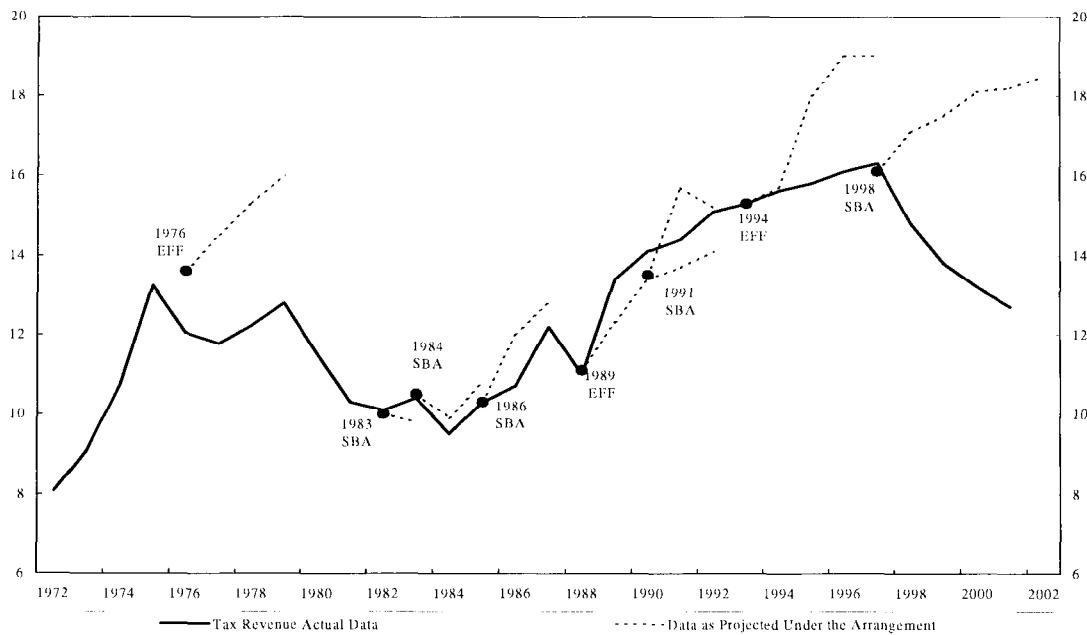
3/ To 2.9 percent of GDP compared to an original target of 2.2 percent. In the event, the actual fiscal deficit for 2000 was 4.6 percent of GDP.

#### 4. Program design and implementation

42. Several key weaknesses were consistently identified by the IMF as at the core of the longer-term adjustment problem—notably weak tax collection and low public saving, which in turn contributed to low levels of gross national saving in comparison with the Philippines' neighbors. This was long seen as a factor that limited the ability of the economy to invest and grow without running into periodic external financing constraints. Nearly all IMF-supported programs over the last thirty years identified increasing saving rates as a central aim, and sought to address this problem by improving public saving through a greater tax effort, which was also low in comparison to other economies in the region. However, programs were not consistently successful in achieving these goals, either because of overoptimism of the original projections or policy slippages.

43. As shown in Figure 2, programs generally targeted a large sustained improvement in tax revenues as a share of GNP as a means of boosting public and gross national saving.

**Figure 2. Philippines: National Government Tax Revenue  
(In percent of GNP)**

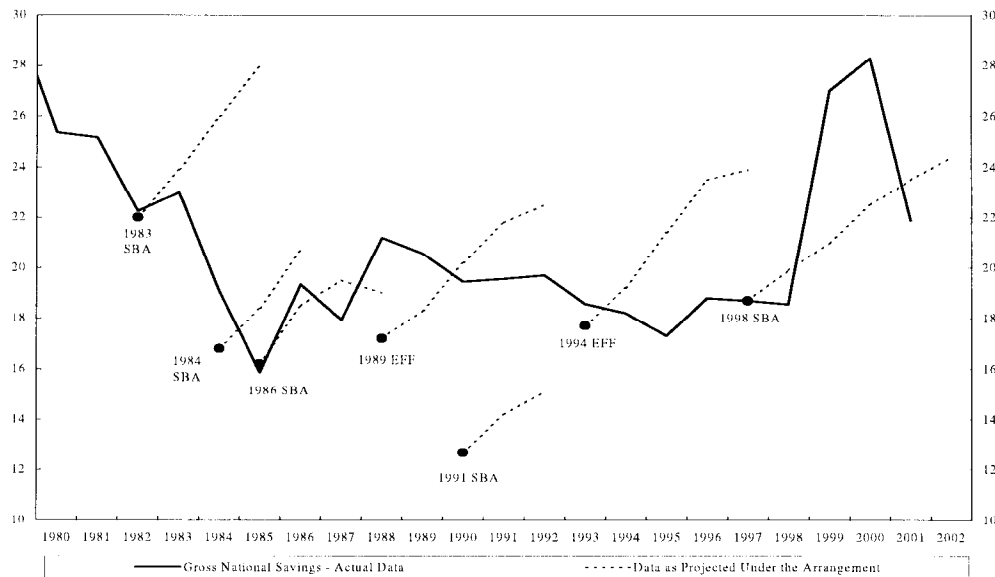


44. Tax reform and efforts to improve administration did yield some benefits in raising the tax ratio in the late 1980s and early 1990s, although progress was intermittent. The tax ratio rose from 11 percent of GNP in 1986 to 15 percent in 1993 and peaked at over 16 percent in 1997. However, except for the 1989 EFF and to some extent the 1991 SBA, actual performance still fell far short of the sharp increases in tax revenues targeted under successive programs. Perhaps more important than this overoptimism was that part of the improvements that were achieved were the result of ad hoc measures. The increase in tax revenue in proportion to GNP also owes something to the recovery in activity in the late 1980s. In any event, the revenue gains were not sustained. Performance was particularly poor

after 1998 when the tax ratio deteriorated significantly. These issues are discussed in more depth in Section IVC.

45. The gross national saving rate was also projected to rise markedly in each program but the actual outturn usually fell short (see Figure 3). Gross national saving as a percentage of GNP declined continuously in the first half of the 1980s, improved briefly between 1986 and then deteriorated again. The measured saving rate shows a sharp increase in 1999 and 2000, but there is reason to believe that this may simply reflect statistical weaknesses.<sup>24</sup> The failure of successive programs to increase the saving rate in turn left the economy vulnerable to stop-go cycles and to exogenous shocks.<sup>25</sup>

**Figure 3: Philippines: Gross National Savings  
(in percent of GNP)**



## 5. Adverse shocks

46. Bad luck—in the form of a long string of adverse shocks—also played a role in extending the period of prolonged use. A dramatic series of adverse supply shocks in the early 1990s (including an extended drought and related power shortages, a severe earthquake, and a damaging volcano eruption) and deteriorating terms of trade adversely affected the

<sup>24</sup> Private saving, which is calculated as a residual, apparently rose from 19.9 percent of GNP in 1998 to 29.2 percent in 2000, while the current account surplus rose to 11.8 percent of GNP from 2.2 percent over the same period. However, a staff analysis of partner country trade data suggests that the current account surplus may be overstated by as much as 9-10 percentage points of GNP, mainly due to the underrecording of imports. Given the method of calculation, this would imply that the saving ratio is correspondingly overstated.

<sup>25</sup> More recently, additional vulnerability concerns have focused on public sector debt dynamics and continuing weaknesses in the financial sector. Exports remain heavily concentrated in the electronics sector.

balance of payments, while political uncertainties—reflected in several coup attempts—affected investor confidence. Later in the 1990s, the timing of the Asia and Russia crises, and the associated contagion, disrupted what would otherwise probably have been a successful “exit” from use of Fund resources in 1997.<sup>26</sup>

## **6. The rationale for program involvement was sometimes too broad**

47. The rationale for IMF program involvement in the Philippines appears to have been very broad. The traditional criterion of balance of payments need was clearly evident from the onset of the debt crisis in 1983 until the restoration of market access in 1993 and, once again, during the height of contagion from the Asian and Russian crises in 1997-1998. During the 1983-93 period, IMF gross financing typically provided a relatively small proportion of projected financing gaps, but IMF involvement was necessary to catalyze other flows, mainly through reschedulings. Much of the IMF financing in fact represented a rollover of payments falling due.<sup>27</sup>

48. However, the balance of payments need was less evident from 1993, when market access was regained, until the Asian crisis. It is also doubtful for how long there was balance of payments need after 1998. Admittedly, an element of judgment was involved in such cases, since the justification for access to IMF resources can refer to a potential, as well as an actual, BOP need. In both periods, the Philippines probably could have raised from private markets the amounts that were borrowed from the Fund, but it could be argued that, at both times, this market access was not fully assured. However, two points are worth noting in this respect: first, both arrangements were extended at times when there appeared to be even less BOP need;<sup>28</sup> second, there was very little discussion in internal documents of whether such a need existed. In the Board Discussion in March 1993 relating to the augmentation of the then standby arrangement, some Executive Directors questioned the balance of payments need for the augmentation, and a few noted that they would want to carefully consider the balance of payments need for any successor arrangement. At the Executive Board discussion on the 1994 EFF, a year later, one Director noted that in spite of these reservations about a future program expressed earlier, there was no discussion of these issues in the Staff Report.

49. The broader rationale for continued program involvement at these times seems to have included three factors. First, a desire to send a positive signal to donors and creditors (discussed above). Second, IMF involvement was prolonged because of the belief that it would foster “good” policies and bolster internal groups in favor of reform. A number of staff interviewed argued that the IMF’s continued presence in a program context, even when

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<sup>26</sup> This does not imply that policies in the Philippines—including exchange rate policy, remaining financial sector regulatory weaknesses, and relatively shallow domestic capital markets—had no role in magnifying the effects of the crisis.

<sup>27</sup> Between 1982 and 1993, there were small net repayments to the IMF, which was in line with the guidelines which called for a gradual reduction in exposure to prolonged users.

<sup>28</sup> As noted earlier, the first one month extension of the 1994 EFF took place in June 1997 before the floating of the Thai Baht, and was related to the desire for a “graceful exit” after completion of the (postponed) tax reforms.

there was no pressing balance of payments need for IMF financing or a catalytic role, has still been an important pressure in favor of the “right” policies in key periods. In their view, policy implementation and economic management would have been weaker without a program. A number of staff and former officials also noted that the existence of a program had helped to increase the leverage of internal groups that favored a strong macroeconomic policy framework and continued reforms.

50. Finally, one of the major motivations for the 1998 SBA according to internal briefing papers and interviews with staff and former Philippine officials, was to sustain earlier gains and avoid “backsliding” during a change of administration. In the event, while the program helped macroeconomic policies remain prudent during the transition period itself, this was not sustained and the approach ultimately proved unsuccessful. Although the incoming President signaled his agreement to the program, ownership eventually proved weak and implementation suffered, especially after the first year. (The discussion of efforts to strengthen the tax system, in Section IV, gives a specific example of how a detailed set of measures negotiated with an outgoing team was not implemented because they were not effectively “owned” by the incoming team.)

## **7. Sponsorship by key shareholders**

51. International political factors probably also have their place in explaining the IMF’s long program engagement in the Philippines, particularly in the 1960s and 1970s. In the view of a number of officials and staff, up until about 1983, the close relationship of the U.S.—and some other shareholders—with the Marcos regime in the context of the cold war and regional tensions appears to have been reflected in the favorable attitude of IMF management and the Executive Board to the authorities’ requests for support. Subsequently, tensions in the political relationship between key shareholders and the then Philippines leadership may also have contributed to delays in agreeing a program in 1983 and to an increase in the threshold of what would be viewed as an acceptable program. The interests of key shareholders in regional stability and their support for the efforts of President Aquino to restore and maintain more democratic institutions were probably also a factor influencing decisions to continue program involvement at times when weak ownership of some core economic reforms might otherwise have argued for greater selectivity.

## **8. Borrower incentive because of low cost**

52. Some external observers have argued that continued use of IMF resources by countries which have access to private financial markets is driven by the borrowing countries’ incentives to reduce their borrowing costs, by substituting lower-cost IMF financing.<sup>29</sup> It is not possible to test this proposition directly, but the impact on the Philippines’ overall borrowing costs, if it had ceased to use IMF resources in 1994 and from 1999 onwards, would have been small. During the 1994 EFF the Philippines only made the initial SDR 36 million drawing before the Asian crisis, treating the program as precautionary

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<sup>29</sup> See, for example, Meltzer (2000) and Vasquez (2000).

for the most part. The relative cost of borrowing from the Fund and the markets might have been a more relevant consideration in 1999-2000. During this period, the Philippines borrowed SDR 491 million from the IMF. At the time, issue spreads on Philippines sovereign international bonds ranged from about 350 to 425 basis points over U.S. Treasuries of comparable maturity—implying an interest saving of about SDR 20 million a year.

53. Officials and staff interviewed were all of the view that a more important factor driving the authorities' interest in continued programs, both during and after the restoration of market access, was the belief that there was a catalytic role of an IMF-supported program—i.e. the signal it sent to other creditors and donors.

## **9. Did the IMF's approach in the Philippines match its guidelines on prolonged use?**

54. Whatever the reasons explaining prolonged use, and there are many, it is relevant to ask whether such use in the Philippines was in accord with the underlying policy governing prolonged use as articulated in Board discussions. This policy consists of the following elements (see Chapter III of the main evaluation report for a more detailed discussion):

(i) frontloading the adjustment effort, including greater emphasis on prior actions, and closely monitoring program implementation; (ii) seeking a net reduction in prolonged users' outstanding liabilities to the IMF, including through arrangements with limited access but that would still serve a catalytic role, and back loading disbursements; (iii) an analysis of the factors underlying a country's prolonged use and a candid ex post assessment of performance under previous programs at the time of new program requests; and (iv) an "exit" strategy including ex ante assessments of the time needed to complete the adjustment process and of the timeframe to disengage from Fund lending along with strengthened surveillance at the post-program stage.

55. In the Philippines' case, some elements of this strategy were implemented and some were not.

(i) It is hard to argue that the adjustment effort was "frontloaded" in practice and, as will be shown in the next section, prior actions were used sparingly. For example, fiscal adjustment and the program of tax reform in the 1994 EFF was substantially back-loaded, although expansion of the coverage of the VAT was made a prior action,<sup>30</sup> with most of the planned fiscal adjustment to occur in 1995 and 1996, after the Task Force on Tax and Tariff Reform had formulated more detailed plans for tax reform. However, as the discussion below of the various efforts to strengthen the tax effort will show, the precise structure of conditionality, including prior actions, does not seem to have been a critical factor.

(ii) Access under arrangements did in general seek a net reduction in the Philippines' liabilities to the IMF, while preserving a catalytic role, but disbursements were not always backloaded.<sup>31</sup>

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<sup>30</sup> It was not ultimately implemented until 1996 as a result of a judicial challenge.

<sup>31</sup> For example, disbursements under the 1994 EFF were evenly loaded. The guidelines appear to have been more closely followed in some respects in the case of the 1998 SBA. The arrangement was backloaded with

(iii) There was not a systematic ex post assessment of each program, although the staff did “step back” on several occasions to conduct such assessments (e.g., in 1991, 1993, and 2000)—more so than in the other country cases examined in the evaluation. However, internal assessments were much more candid than those in final Board papers.

(iv) While parts of an “exit” strategy were set out, and early Board papers were reasonably forthcoming about the timeframe involved, the rationale for the IMF’s continued program involvement once market access was restored was not fully presented in Board papers, nor does it seem to have been subject to much internal debate. In any event, the strategy was overtaken by the Asian crisis. A comparison with Morocco, which exited from 10 years of IMF-supported programs in 1993 after extended adjustment and debt restructuring, is interesting. The key macroeconomic indicators for the two countries, discussed in more detail in the main evaluation report, were quite similar by the early 1990s. While it would not be desirable to pre-establish simplistic quantitative “exit” criteria for a prolonged user, it is not obvious why such different approaches were taken in the two cases.

56. The latter two points raise a more general question about whether the internal review process played its role sufficiently. While any summary of a review process spanning several decades is bound to involve some generalization—especially since guidelines on the review process changed over time—an assessment of internal briefing papers, country strategy papers and review department comments on those papers suggests the following points. First, the diagnosis of the main problems and the content of the proposed policy framework was typically the subject of a detailed internal assessment and often considerable debate. Second, several of the ex-post assessments mentioned above did draw potential lessons for program design (e.g. the 1991 assessment pointed to the need for greater prioritization and a more realistic timeframe on structural reforms), but these lessons were not always fully absorbed or debated in the subsequent review process (see the next section for more discussion of the timeframe of program design). Third, many of the often quite sharp differences of view about the overall strategy that emerged during the review process were not reflected in subsequent Board papers, which tended to focus on an explanation and justification of the agreed consensus approach and the program as negotiated.

57. The period leading up to the 1994 EFF provides a good example of the process. From the early 1990s, the IMF did have an exit strategy for the Philippines, including an *ex ante* assessment of the time it would take to complete the adjustment process. From the time the 1989 EFF went off-track, the consistent game-plan was that an SBA, primarily focused on stabilization, would be followed by an EFF, which would include the major structural changes that would permit the Philippines to “graduate”. There was considerable internal debate, ahead of agreement on the EFF, as to how strong—particularly in terms of fiscal adjustment—any successor program would have to be to warrant IMF support.

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five percent of quota available on approval, while the first four installments each for 14 percent of quota and the remainder each for 25 percent of quota. This backloading was not maintained when the program was rephased in its later stages.



However, there was not a full discussion of timeframe and ownership/implementation issues, even in the draft 1993 country strategy paper which aimed to draw lessons from earlier experience. The area department was of the view that one lesson was that an unrealistic timetable and overcrowded agenda had contributed to implementation difficulties, whereas review departments generally took the view that strong upfront actions were needed in light of the Philippines' perceived poor record of program implementation. Nor was there an explicit discussion of whether any follow-up program was needed at all.<sup>32</sup> Although PDR implicitly questioned the balance of payments need, by drawing attention to the tenuous nature of the small financing gaps assumed, it apparently did not argue against an arrangement *per se*. In retrospect, the Strategy Paper—which was never completed—was a missed opportunity for a broader debate on the lessons from past programs and the IMF's role.<sup>33</sup>

58. As noted above, the critical nature of the Executive Board discussion at the time of the fifth review of the EFF did trigger a more comprehensive assessment of the Fund's role and approach in the Philippines, in the form of the internal (2000) Country Strategy Paper.

#### **IV. IMPLICATIONS FOR PROGRAM DESIGN AND IMPLEMENTATION**

59. This section discusses issues relating to program design and program implementation, which arise from our review of the Philippines' experience and which suggest lessons to help avoid some of the problems associated with prolonged use.

##### **A. Program Design**

60. **A recognition of the longer time frame required for adjustment could have led to a greater prioritization of structural reforms.**

61. As noted earlier, the IMF recognized at an early stage that the Philippines would require a relatively long time to restore external sustainability, but program design remained focused on a relatively short time-horizon. The short-term focus was partly a reflection of the institutional constraints requiring programs to offer evidence of concrete progress within the time-frame of the program itself. In the view of some IMF staff interviewed by the evaluation team, this excessively short-term focus caused programs to address structural issues across too broad a front and to target timetables for various structural reforms that were often

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<sup>32</sup> This may in part reflect the commitment of management to a follow-up program communicated to the Philippines authorities as early as June 1992.

<sup>33</sup> Similarly, a number of internal comments prepared by reviewing departments at the time of the various reviews of the EFF did question some of the underlying rationale for the program. In particular, the weak correspondence between the Philippines' economic performance and its compliance with program conditionality was noted, since strong capital inflows had continued despite repeated delays in completing reviews and the breaching of a number of performance criteria and structural benchmarks, suggesting that any "signaling" rationale was weak.

unrealistically ambitious. Tax reform and tax administration, examined in detail below, is one example where, in the view of many staff and officials, program design would have benefited if a longer-term perspective had been adopted from an early stage.

62. Program design may also have paid insufficient attention to political implementation capacity. The case of the 1989 EFF which went off-track is one example (see Box 1). Several IMF staff noted that the programs on which they worked would likely have been more effective if the program had been focused on a smaller number of core structural reforms. For example, in the latter stages of the 1994 EFF, the IMF was simultaneously pushing for reforms to the oil-pricing system and to tax policy, each of which required Congressional approval, as prior actions for the completion of program reviews. In the view of some staff, this may have been overambitious, exceeding the capacity of the political system to digest several major reforms at the same time.

### **1. Difficulties in strengthening key institutions were critical**

63. The issue of tax administration has featured in virtually all IMF-supported programs for the Philippines, dating back to the 1970s.<sup>34</sup> As discussed below, several different approaches were tried in successive programs, including efforts to promote ownership of these reforms through local working groups to develop detailed measures. With hindsight, while programs incorporated a wide range of measures to improve tax administration and policy, based on extensive technical assistance, they failed to achieve the strengthening of institutions, particularly the Bureau of Internal Revenue, which was critical to achieving program aims.

64. The effectiveness of the Bureau of Customs was greatly strengthened, at least temporarily, under the Ramos administration, as a result of reforms—and strong leadership of the agency—initiated in 1993.

65. Could the IMF have done more to strengthen tax institutions? It did make repeated efforts to tackle the issue—as the discussion below will illustrate. It would likely have been more effective if the IMF had focused on a limited number of measures that were critical to achieving success, along with greater on-the-ground follow-up to technical assistance missions to monitor and facilitate program implementation, and a greater willingness to halt programs when implementation of these core measures was inadequate. However, the experience may indicate the limitations of what conditionality from an outside agency can reasonably be expected to achieve, unless there is strong commitment from the country in question.

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<sup>34</sup> Tax administration was not featured prominently during the 1994 EFF, which focused more on tax policy issues, but, according to staff, even then efforts continued on the ground to improve tax administration.

## **2. Dealing with uncertainty in programs**

66. Some staff interviewed also believed that program design would have benefited from more explicit attention to contingency planning. The Philippine economy has remained vulnerable to exogenous shocks. Moreover, the revenue impact of certain tax administration measures was highly uncertain and the program would have benefited if contingency actions to be introduced in the event of revenue shortfalls had been specified at the outset.

67. In practice, program reviews were generally used to adjust programs in the light of unexpected developments, which was probably the correct approach, but the adjustments often did not occur in a sufficiently timely fashion. It would likely have been more effective if programs had paid more attention to identifying upfront the major risks—including implementation risks—upfront, along with a more systematic stress-testing of how the program framework would be affected by such risks and a discussion of how policies would respond.

68. However, better contingency planning does not require a detailed ex ante quantification in the Letter of Intent of responses to specific shocks. For example, the Philippine authorities did request access to contingent financing under the Compensatory and Contingency Financing Facility (CCFF) in association with the 1989 EFF. The view of both staff and officials was that the CCFF experiment had not been helpful. The effort consumed considerable time and administrative resources since the formulas determining eligibility were very complex and hard to check, and the mechanism proved excessively rigid and overconstrained as it simultaneously tried to satisfy a number of inconsistent considerations. As a result, the focus was more on rigid formulas rather than on the broader logic of policy adjustments.

### **B. Program Implementation**

#### **1. Implementation of IMF-supported programs has been mixed**

69. The effectiveness with which programs have been implemented has varied markedly, with phases of strong implementation—for example 1987-88, and to some extent 1991-92—alternating with periods when implementation has been much weaker. There have also been phases, such as during the 1994 EFF, when economic performance was strong and significant progress was achieved on some structural reforms, even though overall program implementation was inconsistent.

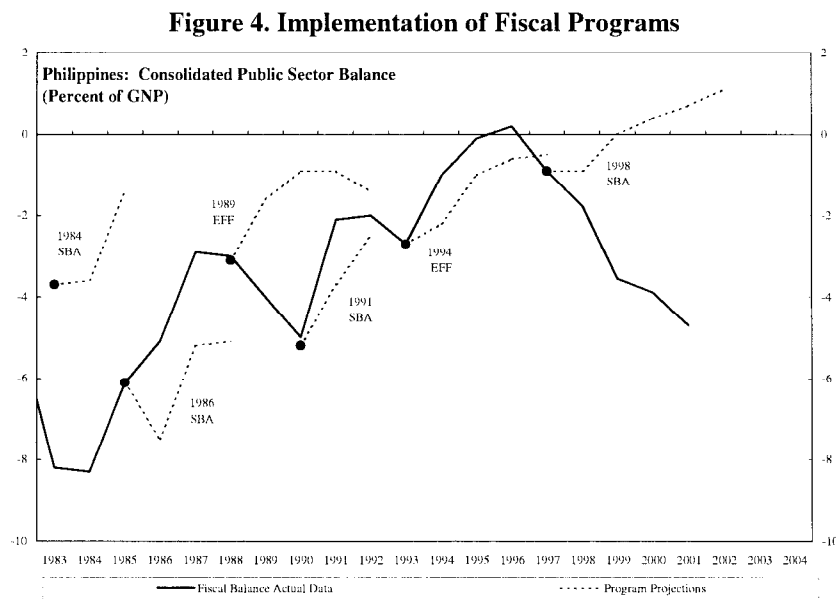
70. Over the period 1970-2000, eight of the sixteen arrangements were fully disbursed, while 77 percent of commitments were disbursed on average, a relatively high proportion by comparison with other countries (Table 1).<sup>35</sup> Four of the seven programs since 1983 were not completed. Even those programs which were completed suffered implementation problems as program reviews were subject to frequent long delays, sometimes of as much as ten

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<sup>35</sup> Over the same period, the average disbursement ratio for all arrangements using general resources was 64 percent.

months.<sup>36</sup> This reflected in part the heavy reliance on reviews to provide structural conditionality. For the same reason, the Philippines has not been a heavy user of waivers.<sup>37</sup>

71. The implementation of the fiscal component of programs has been patchy. For example, deficits were narrowed substantially in the first half of the 1990s—by more than the program targets—but have subsequently widened again (Figure 4). Moreover, as noted earlier, revenues were generally overestimated except during the early 1990s. As a result, fiscal deficit targets were often achieved at the expense of shortfalls in planned public spending, particularly on infrastructure investment. Given the typically limited scope of discretionary expenditure, such ad hoc adjustments distorted expenditure priorities and at times prevented planned increases in capital expenditure. For example, under the 1986-88 SBA, public investment remained at 3.5 percent of GNP throughout the program rather than rising to 5 percent of GNP as targeted. Public investment also remained well below program projections under each of the three arrangements in the 1990s.



## 2. Impact of prolonged use on domestic policy formulation

72. The close and continuous relationship between the Philippines authorities and the IMF also needs to be evaluated in terms of its impact on institutional development. Current and former officials and staff noted that IMF involvement had a strong influence in shaping

<sup>36</sup> For example, of the twenty-two program reviews scheduled under the seven arrangements since 1983: just six were completed on schedule, with a further three completed with a delay of three months or less. Nine were delayed for longer, including two reviews delayed for ten months each. Four of the scheduled reviews were never completed, as arrangements were cancelled.

<sup>37</sup> Over the 1987-1999 period, the Philippines ranks 54<sup>th</sup> out of 105 countries which had programs in terms of waivers per program year with just 8 waivers. None of these waivers related to structural performance criteria and all but one of these waivers related to quantitative performance criteria. In addition the Executive Board granted 3 waivers of applicability over this program period, related to delays in completing reviews.

the macroeconomic framework as well as the technical and data systems used by the Philippines authorities, which were essentially a mirror image of the IMF's financial programming framework. In the view of most officials interviewed, IMF training and technical assistance played a constructive role, most notably in enhancing the skills needed for the formulation of a comprehensive and consistent macroeconomic framework.

73. While it is impossible to judge how policy formulation processes would have developed in the absence of almost continuous programs, formulating policies around negotiations with the IMF for more than thirty years must have had an impact. Both the 1993 and 2000 Country Strategy Papers noted that there was a strong risk that the Philippines had become overdependent on the IMF and that this was an important reason why the prolonged program engagement should eventually be discontinued. The 2000 CSP stated explicitly that "Institutional development has likely been hampered in some respects by the dependence of the authorities on the IMF to articulate a consistent policy package, monitor its implementation, and provide discipline in the short-term. This may not have left room for the development of the authorities' own institutions or procedures to ensure internal accountability and discipline in policy-making and implementation." Nevertheless, the Philippines does have considerable strengths in some of its major policy-making institutions—including economic ministries, the central bank, and key congressional committees. The fact that, under the Post-Program Monitoring (PPM) Arrangement in effect since 2000, the government has continued to set goals and establish targets on key macroeconomic and financial aggregates, to ensure a forward-looking aspect to monitoring, without being required to do so under the PPM, suggests that domestic economic managers have been able to adapt quickly and prudently to the absence of an IMF arrangement.

### **3. Prolonged use has probably eroded the effectiveness of conditionality**

74. The nature of conditionality in programs for the Philippines has evolved markedly over time, as it has for programs in general. Conditionality in programs during the 1970s centered on quantitative performance criteria related to the financial programming framework and to quantitative limits on contracting medium-term external debt. The breadth of conditionality increased markedly from 1983 onwards as programs increasingly addressed structural issues. Conditionality on these issues was exercised mainly through prior actions and program reviews (often in combination). There was limited use of structural benchmarks and virtually no use of structural performance criteria.<sup>38</sup> In deciding whether to complete a review, the IMF typically exercised a high degree of flexibility in relation to original program targets, at times introducing new conditions to complete reviews in light of evolving circumstances. Reviews were often substantially delayed, but generally the program remained in existence and reviews were eventually completed.

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<sup>38</sup> Programs varied greatly in the degree of detail with which conditions on structural measures have been specified. For example, some programs incorporated highly detailed agendas for action against which progress on structural reforms could be monitored, while others were simply specified in terms of reviewing general progress in a particular area of structural reform.

75. This flexible approach was developed at least partly in response to the Philippines' congressional-style political system, whereby the Executive has limited control over the legislative agenda and therefore often cannot credibly commit to a specific timetable for measures that require legislation.<sup>39</sup> Moreover, the IMF frequently had to decide whether to compromise over shortcomings in measures passed by Congress that deviated from those that were originally envisaged (see Box 4 for examples).

76. While the reliance on reviews seems to have been broadly appropriate under the circumstances, there was inevitably a trade-off between the flexibility gained from exercising a high degree of discretion, and the consequences in terms of a lack of clarity for the authorities, markets, and the wider public over the "bottom line" on conditionality. Each review became an occasion for "recontracting" the underlying commitments, which weakened their focus and credibility. In retrospect, greater specificity on a small number of critical outcomes for completion of reviews, may have been desirable. In the words of one Executive Director, "including the most important policy commitments as formal conditions ... reduces the risk that, ex post, measures used to justify completing reviews are the ones the authorities completed rather than the ones they needed to complete." One example is the Comprehensive Tax Reform Package (CTRP), the structural centerpiece of the 1994-98 EFF, which is discussed in the next section.

77. Both IMF staff and former officials acknowledged that such factors contributed to a tendency for the authorities to "overpromise" with regard to the timing of structural measures, even when they knew that these commitments were politically unrealistic, knowing that failure to meet their commitment would be unlikely to prompt program cancellation.<sup>40</sup>

### **C. Improving the Tax Structure and Strengthening Tax Administration: An Example**

78. As pointed out earlier, virtually all IMF-supported programs have aimed at raising the tax ratio as a key to raising domestic saving. The relatively low tax ratios have in general not been the result of low statutory tax rates, but rather of a narrow tax base and poor compliance in relation to that base. Over the past thirty years, several attempts have been made to increase the tax effort through broadening the tax base and improving tax administration. Since these efforts have taken place against a background of moves to open up the economy, an increasing emphasis has been placed on taxes on domestic economic activity as trade taxes have been reduced.

79. Successive tax reforms have achieved some important gains, including a simplification and improvement of the tax structure by reducing distortions and increasing its

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<sup>39</sup> In the mid-1990s, the Philippines government formed the Legislative-Executive Development Advisory Council (LEDAC) as a vehicle to push through Congress certain bills identified as priorities by the Executive.

<sup>40</sup> The following quote illustrates the problem: "Contrary to common belief, the IMF is not really that inflexible.... The Philippines has had 25 programs covering 35 years. The first lesson I learned is you do not have to do everything the IMF wants you to do. Secondly, even if you agree with the conditions and you do not comply, you can always ask for a waiver." (Senior Philippines official, 1998)

progressivity, and have also reduced the dependency of revenue on trade taxes. The tax revenue/GNP ratio was also improved markedly between 1989 and 1997. However, continued weak tax administration and large exemptions and incentives mean that revenues remain low by international standards and inelastic with respect to economic activity (Table 3). Moreover, as noted earlier, revenue projections in many programs proved too optimistic and the considerable gains achieved in the first half of the 1990s were eroded after 1998. As will be discussed below, some of these later slippages were related to weaknesses in tax administration and governance and some to shortfalls in the tax reform program.

**Table 4. Tax Efficiency in Selected Asian Economies**

	Statutory VAT rate	VAT effort <sup>1</sup> (1994)	Efficiency Ratio 1/
Indonesia	10	4.8	.48
Thailand	7	3.18	.45
South Korea	10	4.27	.43
Philippines	10	3.33	.33

1/ The efficiency ratio is equal to the VAT effort (i.e. VAT revenue as a percentage of GDP) divided by the statutory rate of VAT.

80. The Philippines has received extensive technical assistance (TA) in this area, with nine TA missions on tax between 1984 and 2001. Moreover, efforts were made to develop reform strategies suited to the Philippine environment. A number of times,<sup>41</sup> working groups have been established within government to develop detailed proposals for tax reform with the help of IMF technical assistance, in the hope of developing proposals adapted to local circumstances and with ownership by the authorities. However, as pointed out earlier, the results have been disappointing.

81. Could the IMF have done more to improve the performance on the tax front? The Philippine experience on this issue suggests that it is not possible to correct for weaknesses in the domestic political commitment through variations in the form of conditionality. However, in retrospect one can identify several issues.

82. One set of problems arose from the authorities' strong reluctance to accept any form of direct conditionality specifying tax collection as a concrete quantitative performance criterion. Staff proposed to establish a formal performance criterion on tax revenues of the National Government under the 1989 EFF, but this was strongly resisted.<sup>42</sup>

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<sup>41</sup> This approach was followed in 1986/87, 1994/1995, and 1999.

<sup>42</sup> In the 1991 program, an unusual type of "implicit" structural benchmark was used. In order to meet pressing short-term fiscal needs a temporary (9 percent) import levy was introduced and this was to be phased out as Congress passed other tax measures submitted by the government. Completion of the reviews was made dependent on progress in phasing out the import levy and hence, implicitly, on progress in Congress in passing the alternative tax measures. However, the levy was in fact eliminated ahead of schedule in 1991, despite

(continued)

83. As a result, when tax revenue did not materialize as expected, either because the required tax structure or tax administration measures were not implemented or because other macroeconomic assumptions turned out to be inaccurate, there was a tendency to squeeze expenditure in an effort to meet fiscal targets. Under some programs, stop-gap measures to raise revenue with undesirable efficiency and equity implications—such as the special import levy in 1991—were imposed pending action on more desirable structural reforms.

84. The implementation of conditionality through program reviews was also not fully satisfactory. For example, some of the original targets for structural tax reforms under the CTRP during the 1994 EFF were achieved, but many were not and the IMF progressively agreed to a number of modifications as the authorities encountered difficulty in getting the program through Congress. For example, there was little progress in reducing fiscal incentives for investment, which was an important element of the EFF. The excise bill signed in November 1996 was expected to account for most of the revenue gains of the CTRP, but in its ultimate form it was seriously flawed because in shifting from an *ad valorem* to a specific basis, in order to make collection more effective, the provision for full indexation was eliminated. This was one of the reasons for the subsequent sharp fall in collection relative to GNP in later years as Congress proved reluctant to increase excise tax rates in line with inflation. Similarly, a minimum business tax based on gross assets for all companies above a certain asset size (which could be credited against corporate income tax due), was originally a central component of the CTRP. The version that was ultimately passed did include an alternate minimum corporate income tax, but it was based on sales rather than assets. Implementation of this tax has reportedly been very weak, partly because of this change in its structure.

85. Weak ownership presented special challenges for the design of conditionality during a transition in administration. The 1998 SBA included a renewed emphasis on tax administration, as a “structural pillar” of the program.<sup>43</sup> The Memorandum of Economic Policies, based on the advice of an IMF technical assistance team, contained a matrix of extremely detailed commitments to reorganize the Bureau of Internal Revenue (BIR) and improve its operations, focusing on increasing control over large taxpayers, strengthening audit arrangements, and completion of a computerization project. However, according to interviews with IMF staff, the package was agreed primarily with officials of the outgoing Ramos administration. With the change in administration, and the appointment of a new Commissioner for the BIR, the incoming officials did not necessarily accept what had been agreed earlier and were not necessarily committed to implementing the measures.

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considerable slippage in the authorities’ revenue efforts as some of the tax administration measures were delayed.

<sup>43</sup> The tax administration weaknesses were due to major problems with compliance and widespread corruption; weak control over granting refunds and tax credit certificates, which were major loopholes in VAT collection; a failure to implement fully the large taxpayer scheme launched in the early-1990s; and lack of an effective tax information system.



86. The detailed “matrix approach” was also not very effective because it was relatively easy to find superficial ways to meet the commitments and because judgments on effective progress could not rely on a checklist of items achieved. For example, the staff report for the Third Review of the SBA judged that “good progress” had been made with tax administration in 1998 whereas a subsequent mission noted that “The implementation of reform measures had slowed down in the second half of 1998, after the new administration took office” and that, while progress had been made in some areas, “it had become increasingly clear that the new administration has not bought into key reform elements such as the control of large taxpayers and the need to strengthen BIR’s audit and enforcement programs.”<sup>44</sup>

87. Another approach which was tried subsequently to develop a more “owned” program involved a three-day workshop with IMF staff, key officials in the Philippines and representatives from other agencies, including the World Bank and USAID, on ways of improving tax administration in the Philippines. While this is a potentially promising approach, the action plan developed in the workshop was not effectively implemented because commitment from top political leadership was lacking.

88. A more difficult question to address is whether IMF-supported programs could have done more to address the pervasive corruption that is widely seen to lie at the root of problems with tax administration in the Philippines. A World Bank study published in 2000<sup>45</sup> identified the BIR as one of the agencies which should be targeted as a priority for anti-corruption efforts. IMF-supported programs were not able to come to grips with the impact of corruption on tax administration although programs have from time-to-time touched on issues of corruption, including through pressing for tax structures which limit corruption by reducing tax collectors’ scope for discretion. More direct targeting of conditionality on governance concerns in the field of tax administration—perhaps accompanied by more specific conditionality on the collection of tax revenue, based on more realistic and conservative projections of the impact of policy changes and administrative measures—might have yielded better results. However, it should be recognized that the IMF’s decision to be more directly involved in governance issues is relatively recent. There are also difficult questions about how much any outside agency such as the IMF can realistically be expected to achieve in such areas.

## **V. CONTINUOUS PROGRAMS HAVE LIMITED THE INDEPENDENT ROLE OF SURVEILLANCE**

89. An important issue is whether surveillance functions are crowded out during periods of prolonged program involvement. In order to examine this issue systematically, the quality

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<sup>44</sup> Both missions included FAD tax experts and overlapped with FAD technical assistance missions on tax administration, although a lack of continuity contributed to the differences in judgments. One of the major area of differences between the authorities and the staff (which was complicated by the change in administration) proved to be on the scope and functions of the large taxpayer unit. In the event, many of the institutional changes took much longer to implement than originally envisaged.

<sup>45</sup> Combating Corruption in the Philippines; World Bank; May 2000.

of surveillance in the Philippines was assessed in relation to nine “key elements” of surveillance, derived from the Fund’s most recent surveillance guidelines.<sup>46</sup> Since the guidelines evolved over time, such a comparison does involve, to some extent, judging previous surveillance exercises by current standards. However, the functions highlighted have been part of surveillance requirements, or related guidelines, since at least the early 1990s. One area that has received much stronger emphasis since the 1995 Mexico and 1997/98 Asian crisis is the analysis of potential risks and vulnerabilities. In what follows, we note those areas where more recent surveillance reports have addressed these issues in greater depth.

90. Since 1986, nearly all the staff reports on Philippines’ Article IV consultations have been combined with papers relating to the Use of Fund Resources. Given the predominance of combined papers, and the almost continuous nature of IMF-supported programs, it is difficult to generalize from the Philippines experience about the relative adequacy of surveillance in program periods and outside them, and the relative merits of joint and stand-alone consultations. In general, the content and assessment of programs seems to have dominated joint reports. Surveillance reports which were combined with requests for new programs have tended to be relatively stronger in reviewing performance under previous programs, compared with those prepared along with program reviews.

91. All the Article IV staff reports included substantive medium-term scenarios for the economy. However, the related sensitivity analysis and discussion of risks to the projections were often limited to presenting the impact that relatively small changes in export growth, global interest rates or the oil price would have on the projections, rather than on presenting alternative scenarios that focused attention on the major vulnerabilities. Even in one case (1996) where the text of the paper did a good job of identifying these vulnerabilities, the formal sensitivity analysis only examined the impact of a marginally slower growth in remittances. More recent reports have improved in this respect. For example, the stand-alone staff report for the 2000 Article IV consultation examined the impact of policy slippage explicitly in an alternative medium term scenario.

92. In general, however, there was little candid discussion of implementation capacity of the authorities in any of the surveillance reports, although from time-to-time, uncertainties over a program’s prospects for success have been noted. Staff papers typically emphasized in

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<sup>46</sup> These elements and their derivation are discussed in Chapter VI of the main report. The quality of surveillance was assessed by systematically rating the performance of each surveillance report for nine functions viewed by the IEO as “key elements” of surveillance in a program context. These nine functions draw on the “minimum requirements” of article IV reports as listed in internal guidance notes. They are : (i) provision of realistic medium term and alternative scenarios ; (ii) provision of meaningful sensitivity analyses; (iii) discussion of risks to the assumptions and projections ; (iv) discussion of the risks and impact of policy slippages and of vulnerabilities; (v) balanced reporting of the authorities’ views, including any significant differences with staff; (vi) cogent presentation of proposed policy course; (vii) discussion of policy alternatives and trade-offs; (viii) critical and frank review of previous UFR performance; and (ix) presentation of collaboration/interaction with the World Bank.

general terms the importance of implementation of the agreed program for the medium-term health of the economy. By contrast, a number of internal documents did contain a substantive discussion of implementation issues.

93. For the most part, presentation of collaboration with the World Bank was confined to the standard proforma appendix setting out World Bank activities. However, the most recent papers have given greater consideration to the role of the World Bank and coordination with its activities—especially in the financial sector.

94. With a few notable exceptions, most of the staff reports on Article IV consultations do not give much sense of the long history of IMF involvement with the Philippines, and any lessons that this experience may have had for the assessment of the current situation. Many of the staff interviewed by the evaluation team believe that explicitly standing back and reviewing the history of the relationship, as was done for example in preparing internal Country Strategy Papers (CSP) in 1993 and in 2000, had been very useful. However, even these exercises had their limitations. As noted earlier, the preparation of a draft Country Strategy Paper in 1993, which was never completed, prompted a lively internal debate about the lessons from previous programs for the design of the new program. However, little of the candid flavor of this internal stock-taking showed up in the subsequent 1994 Article IV consultation report. Even the 2000 Article IV report, which had considerable strengths (see below), does not reflect much of the candid flavor of the 2000 CSP.

95. Discussion of policy alternatives and tradeoffs was typically limited, although such issues have more recently been covered in greater detail particularly when there were clear divergences between the staff's view and that of the authorities.

96. There is some sign that recent Article IV reports, even when combined with UFR issues, have become somewhat more effective at “standing back” from immediate program issues to assess the totality of the relationship and the vulnerabilities inherent in the existing situation. Some reports have also become a little franker in airing areas of disagreement between the staff and authorities. To give a few examples:

- The 1991 Article IV Report/ Request for Standby included a critical review, unusually candid for the time, of performance under the preceding EFF. It drew upon an even franker internal assessment. However, not all of the lessons—including the dangers of overloading the structural reform agenda—were fully taken into account in subsequent program design.
- The Staff Report for the 1996 Article IV consultation identified a number of key vulnerabilities facing the economy and was used to put a number of issues, which were not central to the original program, onto the policy agenda. In particular, the report noted *inter alia* the risks of the de facto exchange rate peg that the authorities had maintained since late 1995 in encouraging large short-term capital inflows; the dangers of the rapid rise in private credit in 1995-96 and its concentration in real estate and consumer-lending; and the risks in the way in which the large credit expansion was being financed, through a build-up in banks' net foreign currency

liabilities and foreign currency deposits, offset imperfectly by domestic foreign-currency lending. The report highlighted the potential market risks of this financing structure. Circumstances at the time, particularly the program's then precautionary nature, likely made it easier for surveillance to provide added perspective.

## VI. CONCLUSIONS

97. Before discussing potential lessons for the IMF from its prolonged involvement in the Philippines, the first question to ask is: Was this involvement a failure? In the sense that having lending arrangements in place for 25 years in a 30-year period is clearly not what the IMF is trying to achieve, the answer must be, at one level, yes. But this is not to deny that a number of IMF-supported programs achieved important successes: between 1984 and the second half of the 1990s a substantial transformation of the Philippine economy took place, and the programs assisted that transformation. So a more nuanced response to the question would contain the following elements: (i) the IMF-supported programs with the Marcos administration prior to the debt crisis clearly failed to achieve their objectives and a much more selective IMF involvement, conditional upon better policies, would have been desirable; (ii) the long IMF involvement from the 1983 debt crisis until the restoration of market access in the early 1990s could probably have been shortened with a program approach that insisted upon stronger implementation of a smaller set of core measures. However, considerable progress was eventually achieved—some of it masked by a tendency of programs to overpromise. Global systemic factors—especially the evolving approach to debt workouts—also extended the IMF's program involvement in this period; in this respect, the Philippines' experience was not unusual; and (iii) even after allowing for the unlucky timing of the Asia crisis, which prolonged the Philippines' use of Fund resources even further, the IMF maintained its program involvement for too long in the 1990s. In particular, the IMF should probably have disengaged earlier during the Estrada period, by not completing reviews, once it became clear that there was insufficient support from political leadership for core elements of the program, including stopping corruption.

98. With this background, the main messages arising from the Philippines' experience with prolonged use are as follows:

(i) **The rationale for continued lending arrangements needs to be spelled out clearly in each case and pressures to expand this rationale resisted.**

99. In the Philippines, the rationale for continued arrangements—well after market access had been restored, and any actual or potential balance of payments need was questionable—was too broad. The underlying motivation to support reforms and reformers or to provide a framework to guide an incoming administration was understandable. But if applied Fund-wide, such an approach would lead to many more prolonged users. While it is probably not possible or desirable to specify *ex ante* precise quantitative exit criteria, a more rigorous discussion and justification of the reasons for continued lending arrangements is needed than occurred in this case.

**(ii) The choice of the appropriate boundaries between programs and surveillance will be one of the critical determinants of the extent of prolonged use.**

100. The decisions to continue with programs in the Philippines in 1994 and again in 1998-2000 in effect reflected judgments that surveillance alone would not be adequate to the tasks of encouraging macroeconomic discipline, promoting structural reform and providing some “seal of approval” for investors and lenders. In preparing “exit strategies” for prolonged users, the IMF should consider making greater use of alternative mechanisms, which do not involve IMF financing, to ease the transition from program arrangements. Greater transparency in recent years has increased the potential for surveillance to signal the IMF’s views on the adequacy of the macroeconomic framework to the private sector as well as to official creditors and donors.

**(iii) IMF-supported programs since the 1983 debt crisis did encourage macroeconomic discipline and structural reform, but problems associated with the timeframe of programs and implementation failures during periods of weak ownership prolonged the length of the adjustment.**

101. Institutional constraints on implementation, particularly the Philippines’ congressional-style political system, posed special challenges for program design and required structural conditionality to be exercised flexibly. Moreover, programs tended to “overpromise” on both the number and timing of structural reforms—reflecting systemic pressures to show substantial progress within the relatively short time period of the program. Combined with the tacit understanding that the program relationship in the Philippines was likely to continue for a prolonged period, and that continual recontracting of conditions was possible, this overpromising led to a weakening of the credibility of conditionality. During those periods when it had become evident that there was no political commitment at the highest level to the reforms and that governance problems were themselves a major threat to macroeconomic stability, the IMF should have been more selective in agreeing to, or extending, programs. However, during other periods when the issue was more one of the authorities’ political ability to push through a wide-ranging reform program, the IMF was faced with more difficult and finely-balanced judgments. In retrospect, programs would likely have been more effective if they had focused on a narrower set of critical reforms; for some elements of reform, notably those involving deeper institutional changes such as tax administration, it would have been preferable if a longer time-frame had been adopted from the start, combined with an increased emphasis on strengthening implementation capacity and more direct attention to addressing governance concerns. Nevertheless, it should be recognized that the IMF’s role in the latter area has been clarified only relatively recently and there are clearly limits to what outside agencies can be expected to achieve.

**(iv) The IMF’s role as a gatekeeper for many other sources of financing, through the “seal of approval” element in programs, can be a two-edged sword.** It can potentially increase the IMF’s leverage on policies, but in practice, it also appears to have influenced the IMF’s reluctance to disengage, since to do so would have had severe consequences in terms of financing from other creditors and donors. As a consequence, the IMF was unable to be as

selective as would have been desirable in focusing its efforts on periods of crisis management or when political circumstances were ripe to advance reform.

(v) **The Executive Board's guidelines for dealing with prolonged use were only partly followed.** Although there was no general common agreed definition of prolonged use, the Philippine has been unambiguously identified as a prolonged user since the early 1980s. In spite of this, the policy governing prolonged use as articulated in Board discussions was not fully implemented. In particular, there was too little systematic candid assessment of program experience in papers for the Executive Board. Opportunities to reconsider the overall strategy and learn from experience were too limited. The staff did step back a few times to review strategy, informed *inter alia* by fairly candid *ex post* assessments of programs. This stepping back went further than in the other countries subject to case studies, but the most candid elements of the assessments and of the internal review process generally were often not communicated to the Board. Consequently, they were not used by the institution as a whole to critically reconsider the IMF's overall strategy in the Philippines. A more regular and systematic approach to appraising the overall strategy, on the basis of frank assessments of previous programs, and in a manner that involved the country authorities and the Executive Board would have been desirable.

**LIST OF PEOPLE INTERVIEWED IN CONNECTION WITH THE EVALUATION OF  
PROLONGED USE OF IMF RESOURCES –PHILIPPINES**

***Government Officials***

Mr. Jose Insidro N. Camacho, Secretary of Finance  
Mr. Rafael B. Buenaventura, Governor, BSP  
Mr. Amando M. Tetangco, Jr., Deputy Governor, BSP  
Mr. Nestor A. Espenilla, Jr., Managing Director, BSP  
Mr. Gil S. Beltran, Assistant Secretary, Department of Finance  
Ms. Emilia Boncodin, Secretary, Department of Budget and Management  
Ms. Laura Pascual, Department of Budget and Management  
Mr. Maribel D. Ortiz, Economic Research Department, Social Security System

***Former Senior Officials***

Mr. Fidel V. Ramos, former President of the Philippines  
Mr. Cesar E.A. Virata, former Prime Minister and Secretary of Finance  
Mr. Gabriel Singson, (former Governor, BSP) Chairman/President, JG Summit Capital Markets Corporation  
Dr. Jesus P. Estanislao, (former Secretary of Finance) President & CEO, The Institute of Corporate Directors  
Mr. Victor Macalincag, former Under Secretary of Finance  
Dr. Felipe Medalla, former Chairman of NEDA  
Mr. Roberto De Ocampo, (former Secretary of Finance) President, Asian Institute of Management  
Mr. Jose L. Cuisia, Jr., (former Governor, BSP) President & CEO, PHIL-AM  
Mr. Romeo L. Bernardo, (former Budget Secretary) Managing Director, Lazard Bernardo Tiu & Associates, Inc.  
Ms. Nene Guevara, (former Under Secretary of Finance) Ford Foundation

***Academics***

Mr. Mario B. Lamberte, President, Philippine Institute for Development Studies  
Mr. Ponciano Intal, Professor, de la Salle University  
Mr. Rupert Alonzo, Professor, University of the Philippines School of Economics

***Banking Sector***

Dr. Placido L. Mapa, Jr., President, Metropolitan Bank & Trust Company  
Dr. Vaughn F. Montes, Senior Vice President, CitiBank, N.A.  
Mr. Don Hanna, Salomon Smith Barney  
Mr. Tim Condon, Chief Economist, Asia, ING

***Business Sector***

Mr. Raul Concepcion, Chairman, Federation of Philippines Industries

***Representatives of Donors***

Mr. Khaja H. Moinuddin, Director General, Southeast Asia Department, ADB

Mr. Ricarda Rieger, Deputy Resident Representative, UNDP

Ms. Jennifer Navarro, UNDP

***NGOs***

27. Mr. Carlito T. Anonuevo, Action for Economic Reforms

28. Ms. Jessica Reyes Cantos, Action for Economic Reforms

29. Ms. Maria Teresa D. Pascual, Freedom From Debt Coalition

30. Mr. Jose Luis Gascon, National Institute For Policy Studies

31. Mr. Ed Tongson, World Wildlife Foundation

32. Mr. Carlos H. Aquino Jr., Philippines Peasant Institute

The mission also met with a large number of IMF and World Bank staff formerly or presently involved in the relationship of their respective institution with the Philippines.



## SENEGAL

### I. INTRODUCTION

1. Growing external imbalances and diminished prospects for continuing private external financing led Senegal to seek its first IMF arrangement in 1979. Since then, the country has had an almost continuous succession of IMF arrangements, except during 1992-93 (Table 1). A short-lived arrangement under the Extended Fund Facility (EFF) was followed by four stand-by arrangements (SBAs) during 1981-85. Since 1986, the bulk of IMF lending to Senegal has been through concessional facilities—a Structural Adjustment Facility (SAF) arrangement and three Enhanced Structural Adjustment Facility (ESAF) arrangements—with resort to regular facilities/resources limited to supplementing access levels (1986, 1987) or in a transition to a multiyear concessional facility arrangement (1994). Following the transformation of the ESAF into the Poverty Reduction and Growth Facility (PRGF), Senegal's third ESAF arrangement was converted to a PRGF arrangement in 2000; it expired in April 2002.<sup>1</sup>

2. Senegal has had outstanding IMF credits and loans continuously since 1975.<sup>2</sup> They increased from SDR 110 million (174 percent of quota) at end-1980, to SDR 221 million (260 percent of quota) at end-1990, and then fell to SDR 205 million (127 percent of quota) at end-2001, partly reflecting Senegal's net repayments to the IMF in recent years (Figures 1 and 2).

3. What factors contributed to this prolonged use of IMF resources, and what have been the effects? In particular, to what extent were the objectives of the programs supported by these arrangements achieved? To the extent that key objectives have not been achieved (or achievements have not been sustained), do the failures represent weaknesses in policy implementation or in the design of programs? What can be learned about improving the effectiveness of IMF-supported programs and avoiding permanent reliance on IMF financing? These are the main questions addressed in this evaluation.

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<sup>1</sup> The authorities are expected to request a new PRGF arrangement as part of the process towards reaching completion point under the enhanced HIPC Initiative.

<sup>2</sup> Including loans from special facilities—Oil Facility, and Compensatory Financing Facility—which did not require a formal arrangement to be in place.

Table 1. Senegal: IMF Arrangements

Arrangement 1/	Date of arrangement	Original expiration date	Date of expiration or cancellation	Amount agreed (SDR million)	Amount agreed (In percent of quota) 2/	Average annual access level (In percent of quota)	Amount drawn (In percent of agreed amount)
SBA I	March 1979	March 1980	March 1980	10.5	25.0	25.0	100.0
EFF 3/	August 1980	August 1983	September 1981	184.8	440.0	146.7	22.2
SBA II	September 1981	September 1982	September 1982	63.0	100.0	100.0	100.0
SBA III	November 1982	November 1983	September 1983	47.3	75.0	75.0	12.5
SBA IV	September 1983	September 1984	September 1984	63.0	100.0	100.0	100.0
SBA V	January 1985	July 1986	July 1986	76.6	90.0	60.0	100.0
SBA VI	November 1986	November 1987	September 1987	34.0	40.0	40.0	100.0
SAF 4/	November 1986	November 1989	November 1988	54.0	63.5	21.2	78.7
SBA VII 5/	October 1987	October 1988	October 1988	21.3	25.0	25.0	79.8
ESAF I 6/	November 1988	November 1991	June 1992	144.7	170.0	56.7	100.0
SBA VIII	March 1994	March 1995	August 1994	47.6	40.0	40.0	65.0
ESAF II 7/	August 1994	August 1997	January 1998	130.8	110.0	36.7	100.0
ESAF/PRGF III 8/	April 1998	April 2001	April 2002	107.0	90.0	30.0	90.2

1/ Roman numerals are used to indicate the sequence of arrangements, by type.

2/ The size of Senegal's quota at the IMF increased from SDR 42 million to SDR 63 million in December 1980, to SDR 85.1 million in December 1983, to SDR 118.9 million in December 1992, and to SDR 161.8 million in February 1999.

3/ Approved as a three year arrangement. The first review, envisaged for completion by Dec 1980 was not completed

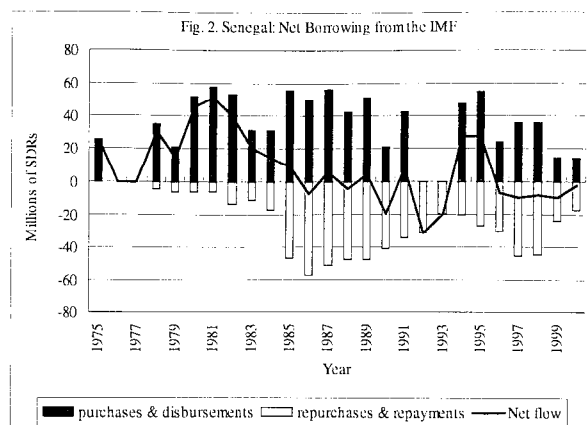
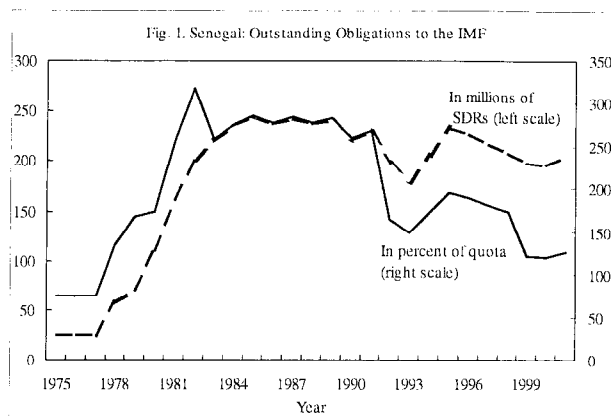
4/ The approved amount was increased from SDR 40 million in July 1987. The second annual arrangement was approved on 10/26/87.

5/ Combined with 2nd annual SAF arrangement

6/ The second and third annual arrangements were approved in December 1989 and June 1991, respectively.

7/ The second and third annual arrangements were approved in December 1995 and January 1997, respectively.

8/ The second and third annual arrangements were approved in July 1999 and February 2001, respectively.



4. The evaluation is based largely on an extensive review of (published and unpublished) IMF documents, and interviews conducted in Dakar (during an IEO mission in March 2002) and in Washington with: (i) current and former senior officials of the Senegalese government and of the Banque Centrale des Etats de l'Afrique de l'Ouest (BCEAO); (ii) a broad range of other Senegalese stakeholders, including leaders of political parties and representatives of trade unions, NGOs, and journalists; (iii) representatives of the donor community based in Senegal; (iv) the IMF Executive Director for Senegal; (v) current and former IMF staff; and (vi) World Bank staff.

5. Senegal's membership of the CFA franc (CFAF) zone limits the authorities' scope for independent exchange rate and monetary policy actions.<sup>3</sup> Arrangements for pooling international reserves, limits on central bank financing of government operations, and support of the French Treasury have succeeded in maintaining the convertibility of the CFAF. Monetary policy is set at the regional level by the central bank, BCEAO. Since 1993/94, the principal instruments of monetary policy have moved away from administratively set interest rates and country-specific credit ceilings, to indirect instruments; this change further narrowed the scope for country-specific monetary policy. Thus, fiscal policy and structural reforms are the principal means available to the authorities for effecting macroeconomic adjustment. Not surprisingly, these two policy areas feature prominently in this evaluation.

<sup>3</sup> Senegal is a member of the eight-country West African Economic and Monetary Union (WAEMU), which together with the six-member Central African Economic and Monetary Union and the Comoros form the CFAF zone. Each of the three parts of the zone has its own central bank. The other members of WAEMU are Benin, Burkina Faso, Cote d'Ivoire, Mali, Niger, Togo, and Guinea Bissau (which joined in 1997).

## **II. OVERVIEW OF POLICIES AND PERFORMANCE**

### **A. Background: The 1970s and Early-1980s**

6. Senegal's external current account deficit almost doubled in the 1970s from an average of about 4½ percent of GDP in the first half of the decade to over 8½ percent in the second half, and the rising deficit was financed by public sector foreign borrowing. Total external debt rose from about US\$130 million in 1971 to almost US\$1 billion in 1979 (going from 19 percent to 35 percent of GDP). Real GDP growth averaged 2 percent per year but with wide fluctuations that partly reflected the impact of exogenous shocks, especially weather conditions and fluctuations in the international terms of trade. Favorable developments in the world prices of two of Senegal's main exports (groundnut oil and phosphates) helped temper the effect of rising international oil prices on the terms of trade; on average, the terms of trade improved by about 15 percent in the second half of the 1970s, compared with the first half. Inflation followed an upward trend in the first half of the decade, peaking at over 30 percent in 1975, and then subsided to an average of less than 7 percent during 1976-80.

7. Senegal faced a severe financial crisis in the late-1970s and early-1980s, when deteriorating terms of trade and the government's pricing policies produced a large external current account deficit (averaging 13 percent per annum during 1979-83) and an expansion in the public sector deficit.<sup>4</sup> The staff estimated that at the end of the 1980/81 fiscal year, internal arrears accumulated by the central government and public enterprises exceeded total government revenue during the year.

### **B. Objectives and Policies of the IMF-Supported Programs**

8. The principal medium-term objective of Senegal's IMF-supported programs during 1979-85 was to reduce internal and external financial imbalances to sustainable levels. With respect to external imbalances, the objective was to reduce the current account deficit to a level that could be financed without recourse to debt rescheduling or accumulation of arrears. The objective was to be achieved mainly through policies that restrained aggregate demand. The structural weaknesses that underlay Senegal's macroeconomic imbalances—for example, a large inefficient public sector, extensive subsidies through controls on producer and consumer prices—were recognized at an early stage, and the early programs included measures to deal with them.<sup>5</sup> In particular, they included measures to contain financial losses associated with government intervention in sectors such as agriculture and energy, policies to limit growth in public service employment, and attempts to strengthen tax administration.

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<sup>4</sup> The pricing policies which led to problems were: (i) not passing on to consumers increases in import costs of several consumer goods; and (ii) setting the producer price of groundnuts above world market prices.

<sup>5</sup> The 1980 EFF was an attempt at a comprehensive approach to tackling Senegal's financial imbalances using the IMF's only available "structural" facility at the time; the authorities had expressed a strong preference for an EFF over an SBA. In the event, the EFF was short-lived and was replaced by a succession of SBAs.

The operations of agencies performing quasi-fiscal functions (e.g., the Caisse de Péréquation et de Stabilisation des Prix (CPSP)) received particular attention.<sup>6</sup>

9. Structural reforms and social policy issues received greater prominence under the arrangements supported by the concessional facilities, beginning with the 1986 SAF. The advent of the Policy Framework Paper (PFP)—associated with SAFs and ESAFs—provided a vehicle for incorporating the authorities’ sectoral and social programs into IMF-supported programs. The PFP for the first ESAF arrangement (1988) indicated a “two-pronged medium-term strategy entailing: (a) a reduction in the obstacles to private sector initiative and growth; and (b) the achievement of greater efficiency in public resource management, including a strengthening in government finances.” Policies to be implemented included: a public investment program to support directly productive sectors, abolition of virtually all price controls, reduction in labor market rigidities, strengthening of the government budget through shifting to a more stable revenue base (including reform of taxation and pricing policies for petroleum products), and reinforcing efforts to improve the delivery of basic services (e.g., education, health care) to the population.

10. With the transformation of the ESAF into the PRGF, programs continued to emphasize structural reforms to remove impediments to growth, but also made poverty reduction a more central goal. Furthermore, they have paid greater attention to the allocation of resources to priority social sectors and to rural infrastructure. In May 2002, Senegal submitted to the IMF and the World Bank, a PRSP that was produced from an extensive consultation process involving a wide range of domestic stakeholders and international development partners.<sup>7</sup>

11. The World Bank supported Senegal’s adjustment efforts in the 1980s and 1990s with, among other operations, four Structural Adjustment Loans (SALs), and several sectoral adjustment credits (including in the financial, agriculture and energy sectors). The first SAL, which was approved in 1980, was closely aligned with the 1980 EFF.<sup>8</sup> The second and third SALs, approved in 1986 and 1987, respectively, run in parallel with SBA and SAF arrangements. The fourth SAL, approved in 1990, aimed to build on achievements under the 1986 and 1987 SALs and to tackle some of the remaining challenges. To that end, it sought to help the authorities “restore Senegal’s competitive position and achieve growth with

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<sup>6</sup> The CPSP was responsible for administering producer prices for agricultural products, notably groundnuts and cotton. Its financial position went from substantial surpluses in the 1970s to large deficits in the early 1980s.

<sup>7</sup> Preparation of the PRSP is one of the conditions for reaching completion point under the enhanced HIPC initiative.

<sup>8</sup> A program performance audit report of the SAL prepared by the World Bank’s Operations Evaluation Department (OED) reported that “full cooperation between the staffs of the Bank and the Fund was achieved” during the preparation of the SAF and the EFF, and that some of the performance targets in the EFF and the SAL were identical or very similar. The authors did not think this overlap in conditionality was appropriate, arguing that failure to meet “short-term IMF performance criteria” should not automatically lead to disruption of a SAL.

macroeconomic equilibrium ...” It was to focus on, among other things, measures to improve production incentives (e.g., reducing tax burdens, costs of production, and labor market rigidities), and to rationalize the public sector (e.g., through civil service reform, reducing government subsidies to public enterprises, and privatization). A Financial Sector Adjustment Credit (approved in 1989) was instrumental in restructuring the banking system in Senegal and strengthening the BCEAO’s banking supervision capabilities. Adjustment credits to the agriculture and energy sectors (in 1995 and 1998, respectively) endeavored to tackle long-standing structural problems in those sectors and included some that had featured prominently in IMF arrangements.

### **C. Program Implementation**

12. Senegal’s record shows a stop-go pattern of program implementation as measured by compliance with performance criteria and benchmarks (hereafter referred to as “performance targets”) and timeliness of the completion of program reviews. Implementation was generally weak in the early programs during 1979-82. Two of the programs in this period (the 1980 EFF and the 1982 SBA) went off-track soon after they were approved, because of policy slippages (especially in price liberalization and tax measures) and the failure of IMF staff and the authorities to agree on policy adaptations required to attain program objectives in the face of unanticipated shocks. In the case of the EFF, part of the problem appears to have been weaknesses in the data used for establishing performance targets, which understated the magnitude of prevailing and prospective financial imbalances. By contrast, all the arrangements approved between 1983 and 1987 (two stand-alone SBAs and two combined SBA/SAFs) were characterized by high compliance with performance targets and timely completion of program reviews. This period was also marked by significant deregulation of the economy, including a reduction in the scope of price controls, partial liberalization of the agriculture sector, and the phasing out of most quantitative restrictions on imports.

13. Program implementation weakened again between 1988 and 1992. Under the first two annual arrangements of the 1988 ESAF, performance targets linked to mid-term reviews were observed, but were followed by a loosening of fiscal policy after completion of the reviews. These policy slippages were judged by IMF staff to be sufficiently serious to warrant a re-establishment of a track record of good performance under a six month staff-monitored program (July-December 1990) before the request for a third annual arrangement was submitted to the Executive Board. Under the latter arrangement, implementation was once again satisfactory prior to the completion of the mid-term review (in November 1991) but this was not sustained.

14. Discussions on a successor ESAF arrangement started in 1992, before the expiration of the 1988 ESAF, but no agreement was reached over a period of nearly two years.<sup>9</sup> In this

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<sup>9</sup> The staff report on the 1992 Article IV consultation noted that “it had not been possible to reach understandings with the authorities on the required set of strong measures that would permit a resumption of credible adjustment, and thus establish a firm basis for a new Fund-supported program.”

intervening period, some measures that had been delayed under the ESAF were implemented, including extension of the coverage of VAT to the transport sector, and the starting of operations of a company hired to improve the system of valuation of imports in order to curb underinvoicing. Measures envisaged under a banking system reform program were also fully implemented. On the other hand, the authorities took several steps that worsened the public finances: an increase in the producer price of groundnuts (contrary to understandings under the ESAF) widened the deficit of the groundnut sector, and a reduction in selected customs tariff and VAT rates, lowered revenues. Furthermore, an agreed mechanism for automatic adjustment of domestic petroleum prices to reflect developments in world prices was not implemented.

15. Legislative and presidential elections in the first half of 1993 constrained policy actions needed to address the re-emergence of severe financial problems. In August, the authorities announced a package of corrective “internal” (i.e. nonexchange rate) measures that included a 15 percent cut in most public sector nominal wages, increases in import duties, and increases in the retail prices of petroleum products. The reduction in wages was not implemented, following strong protests by trade unions.

16. Discussions between the staff and the authorities during 1992-93 covered the issue of devaluation as a policy option for the CFAF zone. Similar discussions were held with the authorities in other CFAF countries, against a background of real exchange rate appreciation and persistent adverse terms of trade developments in most of the member countries. An historic 50 percent devaluation of the CFAF in January 1994 paved the way for new arrangements in support of a renewed adjustment effort—initially, an SBA to provide quick financial assistance, followed by a new multi-year ESAF arrangement five months later. Implementation of policies was generally good during 1994-99, although the pace of structural reforms was slow and there were policy slippages in the period leading up to legislative elections in 1998 and presidential elections in 2000.

17. The incumbent president, Mr. Diouf, was defeated by the veteran opposition leader, Mr. Wade, in presidential elections in early 2000 to end 40 years rule by the Socialist Party. President Wade’s Senegalese Democratic Party won a majority of seats in legislative elections for a new national assembly held in April 2001. Significant slippages in the time table for structural reforms, occurred during the political transition which extended into the period covered by the third annual PRGF arrangement (approved in February 2001). On the strength of some corrective measures taken by the new government, the IMF Executive Board completed the second of three envisaged reviews in April 2002, shortly before the expiration of the PRGF arrangement.

#### **D. What Was Achieved Over the Extended Period of Programs?<sup>10</sup>**

18. Over the period of Senegal's prolonged use of IMF resources there has been a significant reduction in macroeconomic imbalances and less volatility in real GDP growth (Figures 3 and 4). Inflation has followed a downward trend, except for a spike in the rate following the large devaluation in the exchange rate in 1994 (Figure 5). The impact of terms of trade shocks on the overall economy has also declined, although there continue to be large fluctuations in the world prices of two commodities—crude oil and groundnut oil—which have been associated with periodic adjustment problems and linked in part to government policies (Figures 6-10).<sup>11</sup>

19. Table 2 presents selected indicators of macroeconomic performance during the three years before Senegal's first IMF arrangement and five sub-periods during 1979-2001. The sub-periods are broadly based on "adjustment effort" as judged by consistency of program implementation (discussed above):<sup>12</sup>

(i) 1979-83; characterized by weak implementation.

(ii) 1984-88; characterized by strong implementation.

(iii) 1989-93; spanning the period of the 1988 ESAF arrangement (uneven implementation) and a period when there was no IMF arrangement.

(iv) 1994-99; during which there was strong implementation of macroeconomic policies, and modest progress on structural reforms.

(v) 2000-01; marked by some policy reversals but continuing relatively good macroeconomic performance.

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<sup>10</sup> The data on which the tables and graphs in this section are based are mostly from the IMF's World Economic Outlook (WEO) database supplemented by data from the following databases: the African Department's WETA database, International Finance Statistics (IFS), and the Information Notice System (INS).

<sup>11</sup> The "impact of terms of trade shocks" measures the effect (in percent of GDP) of annual changes in export and import prices, holding trade volume constant. See McCarthy Neany, and Zanalda (1994).

<sup>12</sup> A summary of the factors considered in coming to a judgment on each of Senegal's IMF arrangements, including annual arrangements within multiyear arrangements, is presented in Annex I.



**Table 2. Senegal: Selected Economic Indicators**  
(In percent of GDP, unless otherwise indicated)

	1976-78	1979-83	1984-88	Period averages		
				1989-93	1994-99	2000-01
Real GDP growth (percent per annum)	0.8	4.0	2.1	0.4	4.8	5.7
Inflation (percent per annum)	5.3	10.6	5.0	-0.3	7.8	1.9
Terms of trade (percent change per annum in US\$ price indices)	7.2	-5.9	2.8	-1.8	0.9	-2.5
External current account balance, including transfers (b-o-p)	-6.6	-13.2	-8.9	-8.3	-4.9	-6.3
of which: Official transfers 1/	...	4.9	4.9	1.3	3.0	1.4
Gross national saving 2/	5.8	-2.4	3.0	5.3	12.8	11.9
Gross investment	12.3	10.7	11.8	13.5	17.7	18.1
Central government balance	-1.4	-6.9	-2.3	-1.5	-0.6	-2.1
Total government revenue and grants	19.1	21.1	19.4	19.4	19.7	19.8
of which: grants	...	0.8	1.2	1.5	3.2	1.8
Total government expenditure and net lending	20.5	28.0	21.8	20.9	20.3	21.9
Final consumption expenditure	98.6	103.7	97.4	93.4	88.9	90.7
Public consumption expenditure	19.2	19.3	16.2	14.8	11.5	13.6
Private consumption expenditure	79.4	84.5	81.2	78.7	77.4	77.1
Gross capital formation	12.3	10.7	11.8	13.5	17.7	18.1
Gross public capital formation	4.7	4.7	4.0	4.5	6.3	6.9
Gross private capital formation	7.6	6.1	7.8	9.1	11.5	11.3
Imports of goods and services	48.7	48.3	38.9	31.7	38.1	38.7
Exports of goods and services	37.2	33.8	29.6	24.7	31.4	30.0
<b>Memorandum items</b>						
Decomposition of external adjustment (change, in percent of GDP)						
Current account		-6.6	4.3	0.6	3.3	-1.3
Fiscal balance		-5.5	4.6	0.8	0.9	-1.5
Private sector S-I balance 3/		-1.1	-0.3	-0.2	2.4	0.2

Source: Calculated from WEO and WETA databases.

1/ The decline between 1994-99 and 2000-01 partly reflects a reclassification of project grants from the current account to the capital account.

2/ Calculated as the difference between the external current account balance (b-o-p) and gross investment.

3/ Calculated as change in current account balance minus change in fiscal balance.

Fig. 3. Senegal: External and Fiscal Balances, 1971-2001

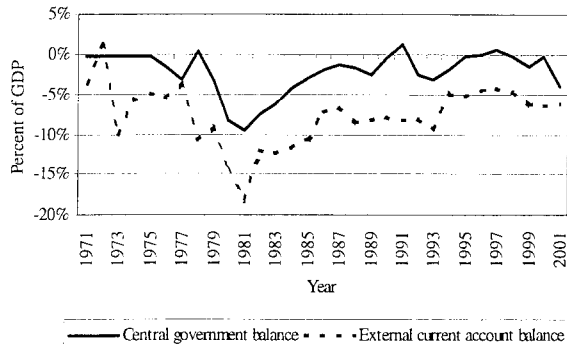


Fig. 4. Senegal: Real GDP Growth (percent per annum)

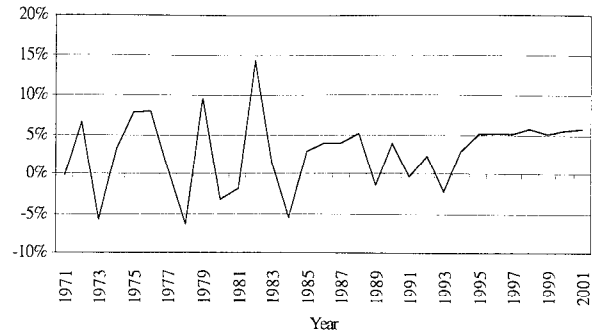


Fig. 5. Senegal: Inflation (percent per annum)

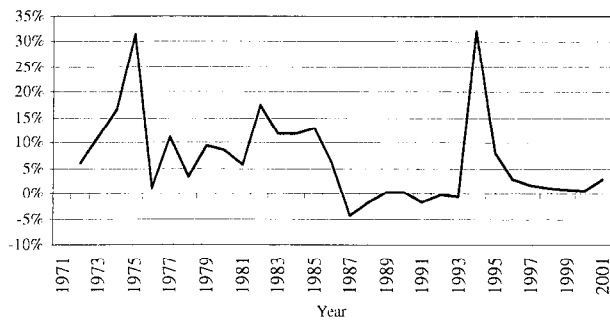


Fig 6. Senegal: Impact of Terms of Trade Shocks  
(In percent of GDP)

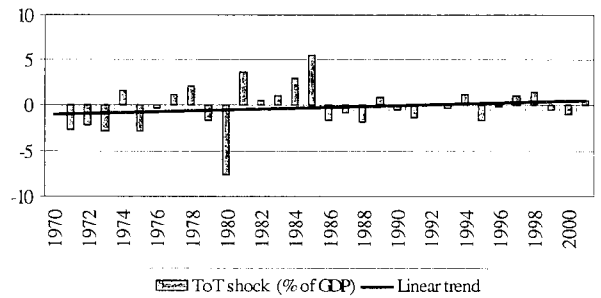


Figure 7. Senegal: Terms of Trade Indices (1995=100)

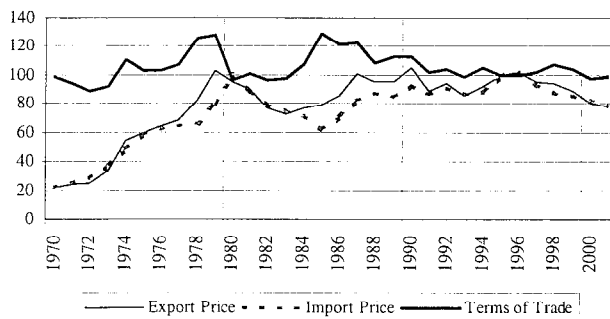
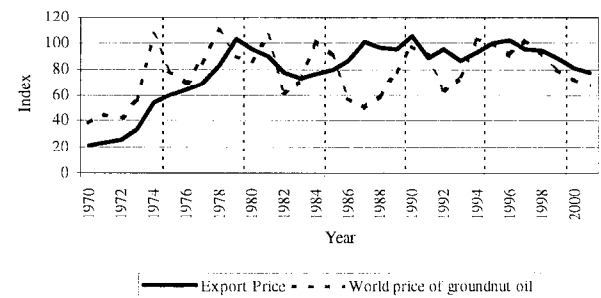
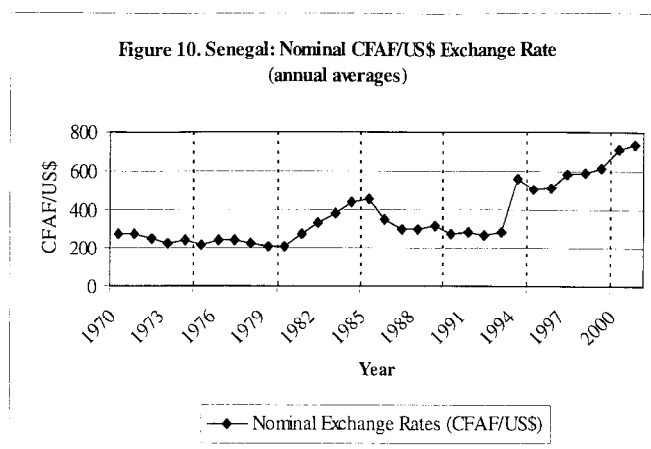
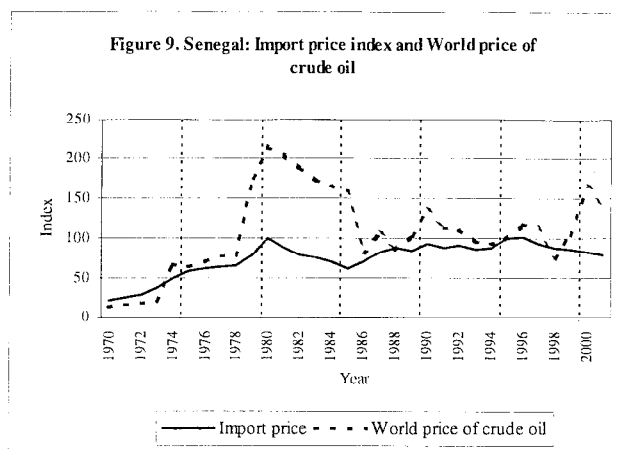


Figure 8. Senegal: Export price index and World price of  
groundnut oil



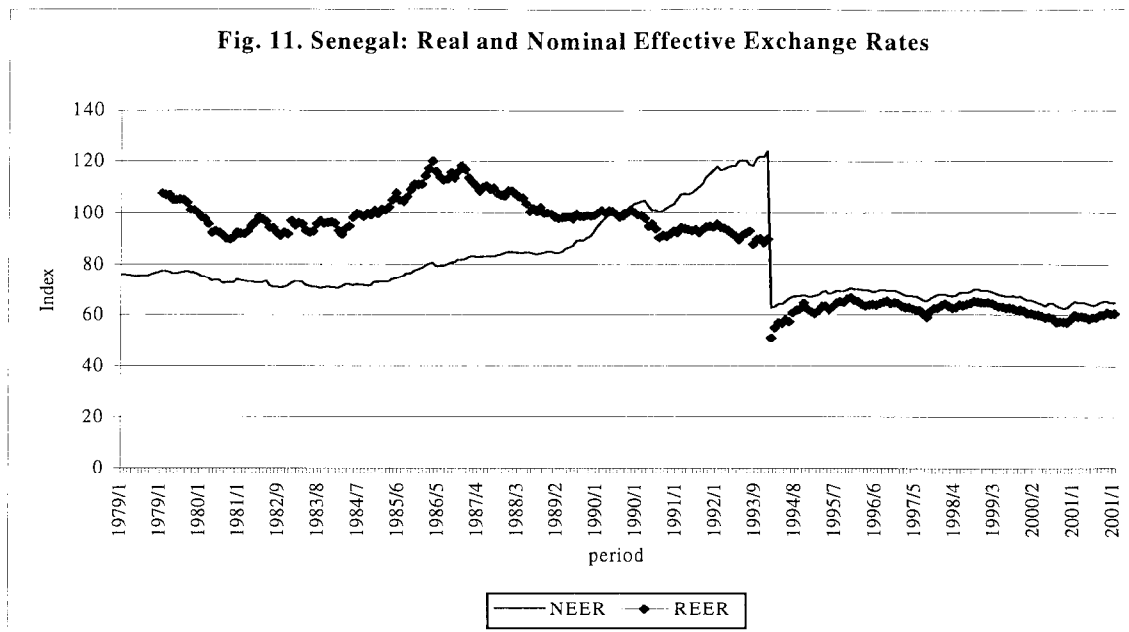


20. The most significant adjustment took place during 1984-88, when the average annual current account deficit improved to about 9 percent of GDP from 13 percent of GDP during 1979-83 and average inflation was halved. An improvement in the fiscal balance—driven by a 6 percentage point reduction in the expenditure/GDP ratio—was the principal contributor to that outturn. The adjustment achieved during the period was aided by relatively favorable developments in the terms of trade. During 1989-93, there were slight improvements in average fiscal and current account deficit compared to 1984-88.<sup>13</sup>

21. Another significant adjustment in the external and fiscal balances occurred during 1994-99, following the devaluation of the CFAF. This time, in contrast to 1984-88, the adjustment was accompanied by significant and sustained growth and progress on structural reforms. The period 2000-01 was marked by continued growth in spite of some backsliding on structural reforms and a reversal of the downward trend in fiscal and external imbalances. The authorities success in sustaining most of the real depreciation achieved in 1994, contributed to the better growth performance. At the end of 2001, the real effective exchange rate was at about the same level it was at the end of 1994, implying a real depreciation of about 30 percent compared to its pre-devaluation level (Figure 11).<sup>14</sup>

<sup>13</sup> This comparison of averages obscures trend improvements that were partially reversed, especially in 1993.

<sup>14</sup> NEER and REER are indices of the nominal effective exchange rate and the real effective exchange rate, respectively.



22. There was a banking crisis in the late 1980s, brought about by severe liquidity problems that reflected government payments arrears and a sizeable (and growing) share of nonperforming loans in banks' portfolios. A regional (WAEMU-wide) banking system restructuring project, financed by the World Bank and other donors, succeeded in cleaning up the sector and strengthening banking supervision. A Financial Sector Stability Assessment undertaken by a joint IMF-World Bank team in 2001 concluded that the banking system in Senegal had recovered from the crisis and was in good health. However, it highlighted as a significant risk factor in the system, the high exposure of banks to parastatals in the agriculture and energy sectors—reflecting the continuation, after two decades of programs, of problems with restructuring the groundnuts sector and inefficiencies in the energy sector—with significant macroeconomic impact.

### III. WHY WAS THERE PROLONGED USE OF IMF RESOURCES?

23. Five main reasons were found for Senegal's prolonged use of IMF resources.

24. First, the initial imbalances were large and deeply rooted in structural weaknesses of the economy which were likely to require a long time to address in a sustainable manner. The weaknesses included the vulnerability of the economy to weather and terms of trade shocks, and the heavy burden on public finances exerted by a large inefficient public sector, by extensive price controls over both consumer and producer prices, and by a heavy external debt service burden.

25. The second reason was a broadening of objectives associated with programs supported under the IMF's concessional facilities. The introduction of the SAF and its evolution to the ESAF, and the latter's transformation to the PRGF, were accompanied by an elevation of growth, social policy issues, and poverty reduction, as explicit goals in programs. This evolution has been accompanied by a lengthening of the time frame within which users of these resources are expected to achieve goals specified under programs.

26. A third factor is the use of IMF arrangements as a seal of approval for the provision of external finance by several multilateral and bilateral creditors and donors.<sup>15</sup> One example of this is the Paris Club of official creditors which requires the existence of an IMF arrangement for its debt rescheduling agreements. Senegal has had 13 such agreements. The earlier approach to debt rescheduling—with its focus on restructuring of debt service falling due within the limited period covered by the IMF arrangement—provided only temporary respite, and required a succession of programs to continue to receive debt relief. Senegalese officials confirmed in interviews that this catalytic role of IMF arrangements was an important consideration in the country's continuing requests for use of IMF resources. There is some evidence from internal documents that, on occasion, the "seal of approval" role was a factor in efforts by the staff to keep programs afloat when slippages occurred, and to try to work on corrective measures rather than interrupt the program. Senegal's good standing among donors, based in part on its historical role as the administrative center of French West Africa and its tradition of regular democratic elections may also have earned it the benefit of the doubt from time to time.<sup>16</sup>

27. Weaknesses in program design also contributed to prolonged use. In particular, the pre-devaluation programs were too optimistic about how effective the adjustment strategy being pursued would be in promoting growth and sustainable financial viability. For example, the successful stabilization during 1984-88 was accompanied by low growth and, in retrospect, programs during this period may have been too sanguine about the scope for achieving growth and external viability objectives without an exchange rate adjustment. Furthermore, the programs could have paid more attention to the consequences for growth of some of the measures employed to contain public sector deficits. For example, Rouis (1994) argues that a persistent focus on addressing short-term financial imbalances with ad hoc revenue measures and a lack of attention to needed structural reforms (e.g., to address tax administration and international competitiveness problems) produced a fiscal adjustment that hurt growth.<sup>17</sup> Although there is a limit to how much an IMF arrangement by itself can

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<sup>15</sup> See Chapter VI of the main report.

<sup>16</sup> During the period under review (1979-2001), presidential and legislative elections were held in 1983, 1988, and 1993. In line with changes in electoral laws, presidential elections were also held in 2000, and legislative elections in 1998 and in 2001. Governments of national unity (which included members of opposition parties as cabinet ministers were formed in 1991 and 1994 in efforts to diffuse rising social and political tensions in the country.

<sup>17</sup> Rouis (1994) and Tahari et al (1996) provide comprehensive analyses of economic performance in Senegal during this period.

address structural reforms, the persistence of problems in areas such as the energy and groundnut sectors, civil service reform, labor market regulations, and public enterprise reform, raise questions of the effectiveness of IMF-World Bank collaboration in program design (including measures to enhance implementation prospects).

28. Finally, the stop-go pattern of program implementation weakened the effectiveness of programs and thus contributed to the continuing “need” for IMF arrangements. The wide variations in the degree of implementation under different arrangements reflected several factors. Successfully implemented programs tended to be characterized by strong upfront adjustment measures, and adaptations of policies during program reviews when there were significant actual or prospective deviations from targets (usually fiscal targets).<sup>18</sup> In the cases where implementation was weak, contributory factors usually included social and political concerns of the authorities which translated into: (i) non-implementation of agreed measures (e.g., the contingency mechanism of freezing lower priority expenditure in the event of a shortfall in government revenues during the 2nd annual arrangement under the 1988 ESAF, was not implemented, because of concerns about social unrests); (ii) delays in implementing measures (e.g., weakening in macroeconomic management and slippages in the time table for structural reforms in late 1999 and early 2000, ahead of Presidential elections); or (iii) policy reversals, which were also often linked to the electoral cycle (e.g., suspension of the petroleum pricing mechanism in February 2000).

#### **IV. EFFECTIVENESS OF THE IMF-SUPPORTED PROGRAMS**

##### **A. Program Design: The Macroeconomic Framework**

29. Against the backdrop of very low (and sometimes negative) saving rates in the late 1970s and early 1980s, increasing the domestic saving rate has been a key objective in Senegal’s IMF-supported programs. This was not only to contribute towards narrowing the external current account deficit, but also to help boost investment and, ultimately, growth. The efficiency of investment was to be enhanced through various structural reforms.

##### **Realism of key assumptions and projections in the macroeconomic framework**

30. Between 1986 and 1992 (spanning two combined SBA/SAF arrangements and three annual arrangements under the 1988 ESAF), programs projected sharp drops in the external current account and the government budget deficit over the medium term. There were improvements in both balances, but outturns tended to fall short of projections. In particular, exports consistently fell short of projections; and budgetary revenues tended to be lower than envisaged. Projections of domestic saving and investment were consistently higher than the outturns, and the projected real GDP growth also tended to be higher than actual growth (Annex 2).

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<sup>18</sup> Examples include the 1983 and 1985 SBAs and the 1994 ESAF (See Appendix I) The upfront measures in the earlier programs included increases in the administered prices of consumer goods and petroleum products.

31. Under the immediate post-devaluation ESAF (1994-97), the divergence between medium term projections and outturns narrowed considerably for several variables, most notably real GDP growth, current account balance, government balance, domestic saving, and exports. Significant deviations between projections and outturns re-appear under the 1998 ESAF/PRGF for the current account balance (i.e. outturns worse than projected) even though export performance was better than projected. In contrast to the earlier period, government revenues have tended to be higher than projected.

*Progress toward external viability*

32. The first six rescheduling agreements concluded between Senegal and the Paris Club (between 1981 and 1987) provided non-concessional flow relief in successive program periods. Between 1989 and 2000, Senegal concluded another seven agreements with the Paris Club on increasingly more concessional terms, reflecting the evolution of Paris Club policies with respect to low-income countries.<sup>19</sup> Throughout the 1980s, programs repeatedly indicated that Senegal would be able to stop reliance on “exceptional financing” (rescheduling and accumulation of arrears) within a few years. For most of the 1990s, programs suggested that once account was taken of traditional debt relief mechanisms, Senegal’s external debt would be sustainable. For example, as recently as 1998, a debt sustainability analysis (DSA) conducted by IMF and World Bank staffs and the authorities indicated that Senegal’s debt burden was sustainable when gauged against the thresholds under the initial HIPC Initiative. However, an updated DSA done in early 2000 indicated that the country’s debt burden was not sustainable when judged against the lower sustainability thresholds of the “enhanced” HIPC initiative.<sup>20</sup> Senegal reached the decision point under the enhanced HIPC Initiative in June 2000, and was, at that time, expected to reach completion point in 2002.

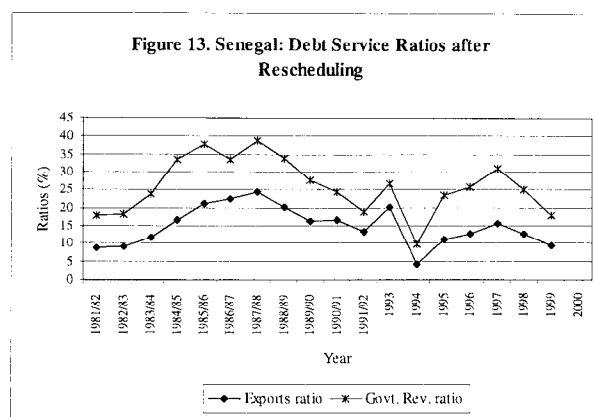
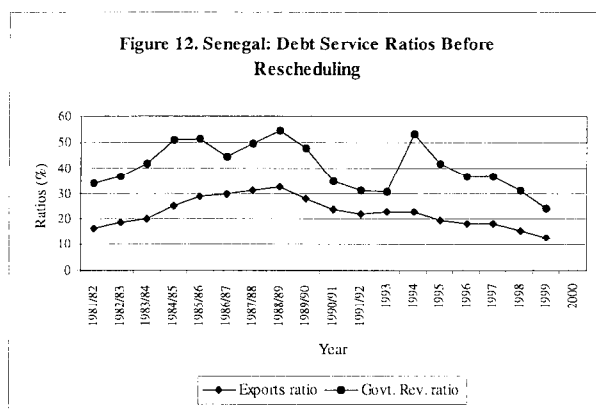
33. Several staff members interviewed acknowledged that the medium-term balance of payments projections and debt sustainability analyses prepared for Senegal had been influenced by an incentive to “over promise” on the pace of restoration of sustainability which stemmed from internal guidelines requiring that there be significant progress toward external viability by the end of three year arrangements. A second factor that contributed to this over-optimism was the heavy weight given to export-based indicators in HIPC thresholds; this focus on “external” burden indicators, rather than “fiscal” burden indicators

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<sup>19</sup> Three were on “Toronto” terms (one third reduction in the net present value of eligible debt); one was on “London” terms (50 percent reduction), two were on Naples terms (two-thirds reduction) and the last was on “Cologne” terms (up to 90 percent reduction).

<sup>20</sup> Under the original HIPC Initiative, the sustainable threshold was the range 200-250 percent for the ratio of NPV-of-debt to exports. Countries with very open economies (export/GP ratios of 40 percent or higher) and which had government revenue/GDP ratios of at least 20 percent, were eligible for assistance if the ratio of their NPV-of-debt to government revenue exceeded 280 percent. Under the enhanced HIPC initiative, the threshold for the NPV-of-debt to export ratio was lowered to 150 percent (no longer a range), and the requirements for eligibility for assistance through the fiscal window were changed to an export/GDP ratio of 30 percent, government revenue /GDP ratio of 15 percent, and NPV-of-debt /revenue ratio must exceed 250 percent. For further details, see for example, Andrews et al (1999) [IMF Pamphlet Series, No. 51].

tended to downplay the extent of Senegal's debt problems (Figures 12 and 13). Indeed, it was consistently pointed out in staff reports that the debt service burden was much heavier when viewed in relation to government revenues rather than to export earnings.<sup>21</sup> A number of Senegalese officials interviewed indicated that program limits on nonconcessional borrowing have been a useful device for instilling discipline in external debt management. The share of total debt owed to private (commercial) creditors fell from a peak of nearly 50 percent in 1978 to 8 percent ten years later (1988) and to less than 1 percent in 1999.<sup>22</sup>



## Dealing with uncertainty

34. For the major shocks that Senegal is susceptible to—droughts and terms of trade—programs have tended to deal with their effects in the context of program reviews, rather than through pre-specified contingencies. The 1994 SBA and 1994 ESAF arrangement went a limited way towards pre-specifying contingency measures for some terms of trade shocks (discussed below). In principle, program reviews provide greater flexibility than pre-specified contingencies, but if there is not a broad understanding of how policies will respond to the major risks, they increase the chances of disagreements over and hence delay in the appropriate policy response which may push programs off-track.

35. Virtually all the arrangements have had some mechanism for automatic adjustment of selected quantitative financial performance criteria in the event of deviations from underlying program assumptions. Typically, ceilings on net domestic assets of the banking system and on the banking system's net claims on the government, were automatically adjusted for

<sup>21</sup> Foreign exchange restrictions are sometimes cited as a reason for favoring export-based debt burden indicators over GDP- and government revenue-based indicators (see for example, Staff response to the External Evaluation of the ESAF (IMF (1998)). For Senegal, the convertibility of the CFAF removes this concern, and allows other factors to come to the fore (e.g., dominance of public debt in total debt, a "reasonable" revenue/GDP ratio, and considerations of debt service crowding out "productive" government spending).

<sup>22</sup> The ratios were calculated from the World Bank's Global Development Finance database.



deviations in: (i) the amount of crop credit extended by the banks; and (ii) external financing of the budget (excluding grants). There tended to be full accommodation for crop credit deviations. For external financing, there tended to be a requirement to either use “excess” amounts to reduce domestic debt (especially expenditure arrears) or to save such amounts and discuss their use during subsequent missions. Shortfalls tended to be partially adjusted for, up to pre-specified amounts; shortfalls beyond these amounts were to be offset by additional measures.

36. Since 1994, programs have contained quarterly benchmarks for government revenue and the government wage bill, deviations from which were to be corrected by additional tax measures or reduction in nonpriority expenditures, in order to achieve the fiscal objectives of the programs. This feature was deemed by IMF staff to be an important device to ensure that the fiscal policy stance was appropriately supportive of the devaluation. The 1994 SBA and the 1994 ESAF (but not the 1998 ESAF) contained pre-specified contingencies in the event that world prices for groundnut products and cotton turned out to be lower than projected under the programs; they required that the fiscal implications of such shortfalls be offset fully by additional revenue-raising or expenditure-reducing measures. This was too rigid an approach, since it implied that there would be no situation in which a higher fiscal deficit would be allowed to accommodate a temporary adverse terms of trade shock. Moreover, the lack of a clear indication of the types of revenue and expenditure actions increased the risks of ad hoc adjustments that would be unsustainable and inconsistent with the medium-term growth-oriented strategy.

## **B. Structural Reforms**

37. Senegal has made major strides in some structural reforms (notably in the areas of price liberalization, trade liberalization, and simplification of the tax system). But reforms aimed at restructuring the groundnut sector, and at liberalizing petroleum product prices have proved to be intractable, resurfacing periodically with significant adverse effects on the government budget and on production incentives in the economy. Moreover, tax reforms have not yielded significant increases in revenue (measured in relation to GDP), reflecting, in part, the short-term revenue-reducing effects of some of the reforms (e.g., tariff reduction).

### **Restructuring of the groundnut sector**

38. A lack of clarity on the aims of restructuring (expansion of production, diversification of agricultural output, or stabilization of farmers’ incomes), and socio-political sensitivities explain the lack of progress on restructuring the groundnut sector. The recurring issues about the groundnut sector in programs have revolved around government interventions that contribute to financial losses of the sector—namely subsidization of inputs, and the setting of producer prices above world market prices. However, there have been periods when the sector has been in surplus (reflecting favorable developments in world prices that were not passed on to producers). During 1984/85 and 1985/86, producer prices were increased in order to improve production incentives. A subsequent sharp drop in the world price of groundnut oil led to the re-emergence of a financial deficit for the sector in 1986/87, just as

output was responding positively to the increased incentives (and good weather). The government was reluctant to reduce producer prices so soon after they were raised, and in any case, expected that financial assistance from STABEX would compensate for the revenue loss (which it did for 1986/87).

39. Under the 1988 ESAF, the government reduced producer prices and undertook to adopt a flexible system for the determination of producer prices that would take account of developments in the world market. Under the 1994 ESAF, attention shifted towards privatization of SONACOS (the groundnut milling and marketing parastatal). After a delay of about a year from the initial target date, bids were issued in December 1995, but the authorities did not consider the bids received to be satisfactory. A second call for bids in 1997 also proved unsuccessful.<sup>23</sup>

40. After adhering to a producer pricing policy based on world prices for about four years, the Government returned to a more interventionist policy in 2000. In response, the third annual arrangement under the PRGF stipulated as performance criteria a return to the pricing mechanism based on world market prices (by end-September 2001), and the withdrawal of SONAGRAINES (a wholly owned subsidiary of SONACOS) from the collection and transportation of groundnuts (by December 2001). Both measures were implemented but the dissolution of SONAGRAINES did not lead to the liberalization envisaged in the program, as the authorities continued to set indicative margins rather than allow the market to determine transport and collection costs.

41. Although the sector's share in the economy has dwindled since the 1960s, it remains a source of income for the majority of the population in the rural areas, and the authorities regard it as a key sector in the fight against poverty. The failure to deal permanently with the problems in the sector contributed to periodic fiscal pressures, as in 2001 when the government took over obligations of SONACOS to the tune of about 2 percent of GDP. Over the years, programs have applied various types of conditionality with little lasting effect, reflecting wavering political commitment of the authorities to the reforms. The move away from the earlier ad hoc discretionary adjustments worked for a while but did not prove a permanent solution because the underlying institutional approach remained unchanged.

### **Petroleum pricing policy**

42. As was the case with groundnuts, the early IMF-supported programs were concerned with establishing a pricing mechanism for petroleum products that would reflect world market prices and obviate the need for a subsidy from the budget; the 1983 and 1984 SBAs each had a benchmark to that effect. However, in 1986 (under the SBA/SAF), the policy changed to "mobilization of prospective surpluses of the oil sector in support of the budget,"

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<sup>23</sup> A World Bank evaluation of performance under the 1995 Agriculture Sector credit noted that SONACOS was not privatized because the conditions imposed by the government (e.g., requirement to provide seeds and fertilizers to farmers on credit and to maintain the integration of the industry) were not attractive to potential investors.

by maintaining retail prices while import costs were falling. While this change was prompted by revenue difficulties, it damaged the credibility of the system of automatically linking retail prices to developments in the international market. Eventually, this system was reinstated in 1998, but it was suspended once again in 2000, this time in order to avoid passing on rising costs to consumers in a period leading up to Presidential elections—at a cumulative cost to the 2000 and 2001 budget of about 1 percent of GDP.<sup>24</sup> While the focus of programs on the issue was appropriate (given its macroeconomic implications), use of ad hoc discretionary deviations for revenue purposes, rather than a consistent approach to establishing the pricing mechanism, probably undermined the strategy.

### **Tax reform**

43. Since the mid-1980s (following the recommendations of an IMF technical assistance mission in 1985), the authorities have endeavored to modernize the tax system, as well as broaden the base and increase yields. Measures undertaken through 1991 included introduction of a new tax code (with most specific duties converted to ad valorem rates), simplification of the structure of the tax system (by reducing the number of rates for import taxes and VAT), and increased coverage of VAT (to include the service sectors). However, the reforms did not yield much improvement in revenues for reasons that included pervasive exemptions and weak tax and customs administration.

44. There have been further significant reforms since the 1994 devaluation, mostly in the context of a harmonized tariff regime and domestic taxes within the West Africa Economic and Monetary Union (WAEMU). The 1994 and 1998 ESAF/PRGF arrangements contained several measures aimed at strengthening tax administration and expanding the tax base (e.g., computerization and expansion of coverage of VAT).

45. Conditionality (in terms of performance criteria and benchmarks) on tax reform measures was virtually absent in programs until 1997. Since then there have been several, including on the elimination of hundreds of tariff lines, the establishment of a large taxpayer unit, the implementation of a single taxpayer identification number in all revenue collecting agencies, and a single rate VAT.<sup>25</sup>

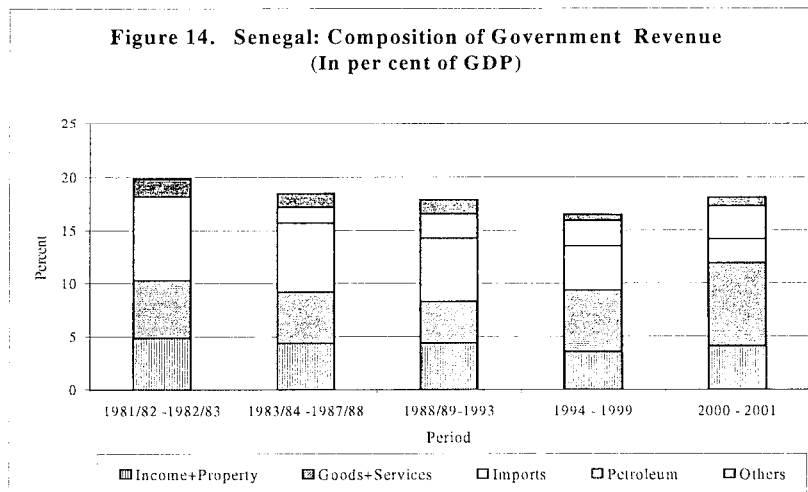
46. In the event, the revenue effort did eventually show some improvements—rising from an average of about 16.5 percent of GDP in 1994-99 to 18.1 percent in 2000-01 in spite of a

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<sup>24</sup> The pass-through mechanism was reinstated in June 2001.

<sup>25</sup> Most of the measures were specified as performance criteria, except the establishment of the large taxpayer unit, which was a benchmark. Most were observed on time or with slight delays. One measure that was delayed and which became a prior action for completion of a review was the introduction of the single VAT rate which was implemented in September 2001 (instead of May).

lowering of tariffs in the context of a common external tariff in WAEMU (Figure 14).<sup>26</sup> However, greater emphasis in the early programs on improving tax administration and reducing exemptions could have yielded significant additional benefits and would have reduced the reliance on various ad hoc revenue and expenditure measures at times of fiscal pressure.



### C. Social policies

47. While several programs contained social safety net measures to cushion the impact on the poorest groups of some price increases, problems with targeting of the measures limited their effectiveness. Two examples are:

(i) Under the 1988 ESAF, a reduction in the producer price of groundnuts was a key measure for eliminating the deficit of the sector. In order to provide some relief to farmers, administered prices of selected “key” consumer goods (rice, sugar, groundnut oil) were subsidized.

(ii) Both the post-devaluation SBA (1994) and the subsequent ESAF arrangement that replaced it contained budgetary provisions for subsidizing the price of a number of products deemed “sensitive” for low-income households (e.g., bread, rice, medicines).

48. Neither of the two programs was well-targeted. An internal World Bank evaluation of the Bank’s Economic Recovery Credit (approved in March 1994 to provide emergency

<sup>26</sup> Figure 14 breaks down government revenue into: (a) income and property taxes; (b) taxes on domestic goods and services; (c) taxes on nonpetroleum imports; (d) petroleum revenues; and (e) other revenues. For the period 1981/82-1982/83, petroleum revenues are distributed between import taxes and “other” revenues.

support to the post-devaluation reform program) concluded that the subsidies designed to limit the impact of price increases of basic consumer goods had been poorly targeted and not delivered the expected benefits to the most vulnerable groups.

#### **D. Collaboration with the World Bank**

49. Program documents presented to the IMF's Executive Board convey the impression of close collaboration between the staffs of the IMF and the World Bank, especially on sectoral issues (e.g., the banking system, agriculture, energy, and industry). Discussions with staff members of the two institutions confirm that there have always been regular contacts and exchange of information, including in areas not highlighted in staff reports (e.g., the preparatory work that informed the staffs' advice to the authorities of the CFAF zone in the period leading up to the 1994 devaluation). A recent staff report contained a Box that clearly described the division of responsibilities between the two institutions.<sup>27</sup>

50. Nevertheless, there have been some problems in matching the timeframe and priorities of the two institutions, which affected the timeliness of World Bank inputs on some sectoral issues in IMF-supported programs. Some of the differences in timetable may be related to the World Bank's attempts to encourage internal consensus on structural reforms before going ahead with lending programs (see Box 1).

51. Several Senegalese officials interviewed emphasized the need for better collaboration between the IMF and the World Bank, especially with respect to the structural reform and social policy content of programs. The PRSP and the recent formalization of the "lead agency" approach are the major instruments for improving such collaboration, although in the case of Senegal it is too early to judge their impact.

#### **V. OWNERSHIP, CONDITIONALITY, AND THE PRSP APPROACH**

52. The evaluation sought views on what impact, if any, prolonged engagement in IMF arrangements has had on: (i) "ownership" of programs and on the economic policy making process; (ii) capacity building in institutions responsible for formulating and implementing macroeconomic policies; and (iii) the effectiveness of IMF conditionality.

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<sup>27</sup> Box 4 in EBS/02/50, 3/21/2002.

### **Box 1. Selected Lessons from World Bank Evaluations**

The World Bank employs a range of evaluation reports to take stock of achievements and failures, and to draw lessons from experiences under its lending operations. At the completion or termination of such operations, a “project completion report” or “implementation completion report” is prepared. The Operations Evaluation Department (OED) may comment on these reports, and/or undertake a “performance audit” of its own. This Box draws on a range of such evaluation reports on the four SALs and the Agricultural Sector Adjustment Credit (AGSAC) extended to Senegal, since a number of the lessons highlighted are also relevant for the IMF’s operations.

- Under the first three SALs, incomplete and tenuous links between proposed measures and objectives gave rise to overestimation of likely performance and underestimation of constraints (e.g. in agriculture and industry).
- Notwithstanding significant achievements, including transformation of the economy away from excessive state intervention, about one third of measures envisaged under SAL II & SAL III were not implemented as scheduled. These measures were concentrated in areas—labor regulations, parastatal reform—where there was strong political opposition from vested interests. The lesson drawn was that politically sensitive reforms are unlikely to be implemented unless a prior internal debate has taken place and consensus reached on key issues. It is important to encourage internal agreement on key issues, and based on that formulate upfront measures to be implemented under programs.
- A basic design flaw in SAL IV was expecting a positive supply response to improvements in regulations and incentives at a time when demand compression was being relied on to achieve external equilibrium. By the time of SAL IV (1990) work undertaken in the World Bank suggested that devaluation would be essential for restoring competitiveness and boosting growth.
- Lack of consensus among donors and the government on the strategy for restructuring the groundnut sector has contributed to the slow pace of reform. In retrospect, too much emphasis may have been placed on privatization of SONACOs, at the expense of other reforms to improve the efficiency of the sector.

### **A. Ownership and Capacity Issues**

53. Interviews with many Senegalese officials and with IMF staff indicate a striking difference in perceptions about the degree to which policies had been “imposed” on the authorities without sufficient consultation. However, there was broad agreement that the successful programs had been those to which there was strong domestic political commitment, regardless of the precise nature of IMF conditionality. The main lesson drawn by the World Bank from a review of its structural adjustment loans to Senegal was that politically sensitive reforms are unlikely to be implemented unless there has been prior internal debate and consensus building on key issues (see Box 1).

54. A number of Senegalese officials who have participated in negotiations with the IMF over time thought that the level of “country ownership” of programs has generally been low. In their view, the “seal of approval” role of IMF arrangements in unlocking other sources of financing gave the IMF the upper hand in negotiations with the authorities, and that sometimes the authorities went along with these proposals—even though they had doubts

about their ability to deliver on implementation—in order to secure urgently needed resources. Several indicated that, more often than not, they were in agreement with the IMF's diagnoses of the country's financial problems, but sometimes differed on the pace of implementation of measures. In their view, the IMF tended to underestimate implementation constraints and overestimate the speed with which some structural reforms (e.g., privatizations) could be brought to conclusion. However, a few officials put the onus of responsibility for the content of programs and for implementing them on the authorities (including themselves), noting that while it was convenient to blame the IMF for implementation failures, the primary responsibility for difficulties in addressing some well-recognized problems belonged at home.

55. The IMF staff appears to share the characterization of weak ownership of programs, at least with respect to structural reforms: the staff report for the 2001 Article IV Consultation noted that the new Government that took office in April 2000 “inherited a legacy of weak implementation and ownership of the structural reforms program, particularly the long-standing structural problems of the groundnut and energy sector.”

56. A number of staff interviewed thought that officials tended to underestimate the scale of quasi-fiscal activities and the risks such activities pose to macroeconomic stability. However, they noted that there had been periods when senior Senegalese officials clearly were convinced of the merits of addressing these issues in IMF-supported programs and had been able to persuade the highest political authorities to implement difficult reforms. They accepted that there was a need to bring greater transparency to discussions with officials and other stakeholders about financial constraints in the broadly defined public sector, highlighting the risks of disorderly adjustment in the absence of measures to tackle the financial problems. It appears that the active involvement of senior political leaders in program negotiations can help increase political commitment to programs.

57. With regard to the effects of “prolonged use” on the policy making process, there was broad recognition by those interviewed in Senegal that the IMF had contributed importantly to an “internalization” of the need for prudent fiscal management. However, many pointed to problems in the way programs had been negotiated, notably that they: (a) tended to undermine the policy-making processes of the government, especially parliament's role in economic decision making; and (b) provided an excuse for government to stifle domestic policy debate.

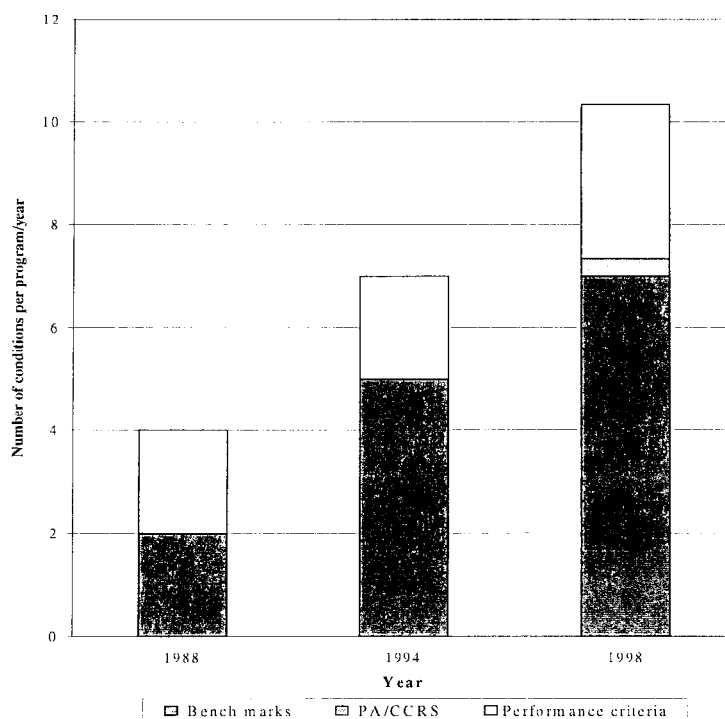
58. On capacity building, many officials interviewed thought there had been significant knowledge transfer from IMF staff at the technical level. At the same time they felt that a lack of flexibility in the formulation of IMF-supported programs had discouraged local initiative, and that the system had become too dependent on the IMF for diagnosing and proposing remedies to the country's macroeconomic problems. Several also expressed regret that an excessive focus on short-term solutions to financial problems had led government officials to abandon medium-term “planning” and long-term strategic thinking about Senegal's development challenges. The response of staff to these criticisms was that programs are usually constructed in a medium-term framework with growth as one of the key

planks, and that the PRSP process had been designed to help improve the integration of programs with the longer-term strategy into PRGF arrangements (see below).

## B. Conditionality

59. The evolution of the IMF's concessional facilities has been marked by significant changes in conditionality: from the low-access, low-conditionality SAF; to the relatively high-access, high-conditionality ESAF; to the PRGF which has been accompanied by efforts to streamline structural conditionality but at the same time has introduced some new conditionality (e.g., preparation of PRSPs through a participatory process). The average number of structural conditions (prior actions, performance criteria, and benchmarks) per program year increased steadily in successive multiyear ESAF/PRGF arrangements, from 4 in the 1988 ESAF to 10 in the 1998 ESAF/PRGF (Figure 15).<sup>28</sup>

Figure 15. Senegal: Structural Conditionality Under ESAF/PRGF Arrangements



60. With regard to the impact of “prolonged use” on the effectiveness of conditionality, views ranged from “conditionality had lost its bite over time” to “effectiveness of conditionality had been strengthened, as officials have learned from experience the

<sup>28</sup> The increase in the 1998 ESAF/PRGF partly reflects the effect of carrying over missed performance targets from one annual arrangement to a successor annual arrangement.



importance of compliance.” On balance, the evaluation found no clear evidence of weakening; there was some evidence of “elevating” targets from benchmarks to performance criteria and prior actions in response to implementation slippages. However, as noted earlier, in the discussion of several “intractable” structural problems, a “hardening” of conditionality does not appear to have been successful in fostering permanent changes if political commitment was weak. For example, prior actions were effective in the early programs in bringing about once-off discretionary changes (several increases in administered prices were effected before programs were presented to the Board), but they did not permanently change the price-setting systems. Prior actions have also been extensively used recently in conjunction with completion of reviews for measures whose implementation had been delayed.<sup>29</sup> But they cannot ensure that there will be no policy reversals, as demonstrated by the abandonment of the mechanism for setting petroleum product prices in the lead-up to elections in 2000 when world prices were on the rise.

### **C. The PRSP Approach**

61. In many respects, changes underway at the IMF—most notably, the transformation of the ESAF to the PRGF (and related to that, the PRSP approach), the increased emphasis on country “ownership” of programs, and attempts to streamline structural conditionality—already have begun to respond to many of the criticisms of the IMF that the IEO mission heard in Senegal (and reported above).

62. Most of those interviewed in Senegal for this evaluation welcomed the PRSP process as an appropriate way of promoting country ownership and hence increasing the likelihood of consistent implementation of IMF-supported programs. A common view was that it goes some way to address criticisms of the process of formulating previous programs. However, most argued that the jury was still out on whether the PRSP (which has only recently been completed) will significantly influence the policy content of the next PRGF arrangement. A number of people interviewed stressed the key role IMF resident representatives can play in the implementation of the PRSP approach by widening the range of stakeholders with whom the IMF interacts on a regular basis.

## **VI. IMF INTERNAL GOVERNANCE ISSUES**

### **A. Were IMF Policies to Contain “Prolonged Use” Applied to Senegal?**

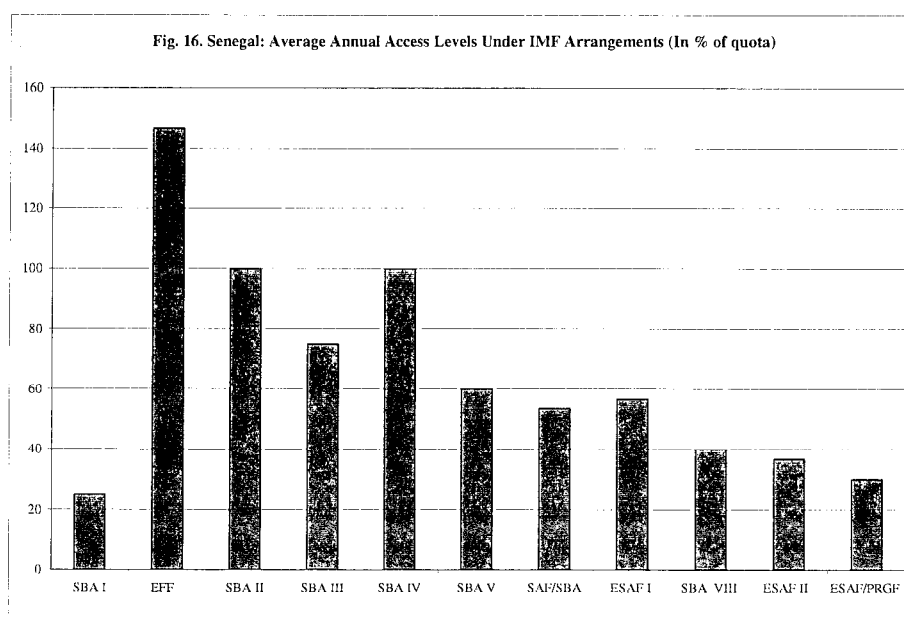
63. The IMF has developed policies aimed at containing the phenomenon of prolonged use, the main elements of which are: (i) reduction in access levels (in relation to size of IMF quota); (ii) frontloading of adjustment effort and close monitoring of program

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<sup>29</sup> The reintroduction of the pass-through mechanism for petroleum product prices and the submission to parliament of a draft bill introducing VAT at a single rate were performance criteria for May 2001 which were missed. They became prior actions for the completion of the first review under the third annual PRGF which was completed in September 2001.

implementation; (iii) comprehensive ex post assessment of programs; and (iv) the formulation of “exit” strategies.<sup>30</sup>

64. Average annual access levels in Senegal’s IMF arrangements have followed a declining trend, although the country has enjoyed above average access levels in its three ESAF/PRGF arrangements (Figure 16).<sup>31</sup> Over the course of the 1998 ESAF/PRGF, there was a move towards closer monitoring (more reviews in annual arrangements), and conversion of measures that had not been implemented at the time of review missions into “prior actions” for the completion of reviews.



65. With regard to *ex post* assessments, a Country Strategy Paper prepared in early 1998, before the negotiations for a new three year ESAF, took stock of performance under previous arrangements and set out an agenda of remaining challenges to be tackled under the new arrangement. However, it had little discussion of lessons from the non-implementation of earlier reforms. Nor did it have a forward-looking medium-term macroeconomic framework and a discussion of alternative scenarios and policy options. Another ex post assessment, this time limited to Senegal’s pre-devaluation IMF-supported programs, was contained in the background paper to the 1995 Article IV consultation. It contained a comprehensive analysis of the relative roles of shocks and policies in Senegal’s economic performance from the late

<sup>30</sup> These policies are discussed at greater length in Chapter III of the main report.

<sup>31</sup> Access under the 1988, 1994 and 1998 ESAFs was 90 percent, 81 percent and 66 percent, respectively. This compares with Fund-wide averages for first, second, and third 3-year ESAF/PRGF arrangements of 85 percent, 72 percent, and 65 percent. Current access norms under the PRGF are 90 percent of quota over three years for first time users and 65 percent of quota over three years for second time users.

1970s through the early 1990s. However, it is not clear what impact the analysis had on the design of subsequent programs.

66. One set of “stepping-back” exercises that definitely influenced the design of a subsequent program was work done during 1992-93, some of it in close collaboration with the World Bank, which informed advice given to CFA franc countries prior to the 1994 devaluation. The key issues tackled related to the limits of a purely “internal” adjustment strategy for dealing with loss of competitiveness and low growth. The analysis presented in internal documents was significantly more comprehensive than that contained in subsequent staff papers to the Board. However, we were told that the Board was briefed at greater length in an informal session.<sup>32</sup>

67. We found no evidence that the issue of an “exit strategy” from the use of ESAF/PRGF resources had been discussed in any systematic manner within the staff (e.g., in the internal review process) nor with the authorities.<sup>33</sup> On the occasion of Board consideration of the request for the 1998 ESAF arrangements, one Executive Director expressed the hope that the third set of ESAF arrangements would represent an “exit” arrangement for Senegal. The absence of systematic discussion of the issue of exit from the use of concessional facilities may have reflected an implicit acceptance that the deep-seated structural problems of Senegal would require its continued use of IMF resources for some time—but it also probably reflected the fact that overall, Fund-wide criteria and strategies for exit are not well-defined in such cases.

## **B. Surveillance and Program Activities**

68. To assess whether program activities have “crowded out” surveillance, the evaluation examined how staff reports on Senegal measured up against a checklist of “best practices” inferred from various internal IMF guidelines on reporting on Article IV consultations.<sup>34</sup> Virtually all such consultations with Senegal have tended to be combined with either requests for arrangements or program reviews during 1980-2001; there were only two stand alone Article IV consultation discussions at the Board (out of a total of 16) during this period.

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<sup>32</sup> The staff report for the 1992 Article IV consultation contained some discussion of the issue, in rather general terms, leading to some discussion at the Board meeting of the appropriateness of using a purely “internal” adjustment strategy to address external competitiveness issues in Senegal and other CFAF countries.

<sup>33</sup> The issue of IMF long-term involvement in Senegal arose during the process of clearing briefing papers in 1987. The remedy for the “problem” of the country’s prolonged use of “regular” IMF resources was to shift to arrangements under a concessional facility (at the time, the SAF).

<sup>34</sup> The factors considered were: (i) presentation of alternative medium-term scenarios; (ii) quality of sensitivity analyses; (iii) discussion of risks of deviations from assumptions and projections; (iv) discussion of risks and impact of policy slippages; (v) reporting on the views of the authorities; (vi) cogent presentation of proposed/recommended policy course; (vii) discussion of policy alternatives and trade-offs; (viii) critical and frank review of performance under (previous and ongoing) IMF-supported program(s); and (ix) account of collaboration with the World Bank.

69. For a persistently active program country like Senegal, the line between program and surveillance activities becomes blurred; indeed, an effective program design process should cover all the issues on the surveillance “best practice” checklist. But regardless of how and in what context, there should be opportunities to step back periodically, from the details of designing and monitoring compliance with program targets, so as to review the overall adjustment strategy underpinning programs. A natural point to do this for “prolonged users” is between arrangements and in the context of surveillance. In this context, the main points from the review are as follows:

- Staff reports generally did a reasonable job on the presentation of medium-term scenarios, but sensitivity analyses tended to consider relatively small shocks—in other words, they did not “stress test” the consequences of markedly different, but still possible, outcomes. Nonetheless, the reports from the mid-1980s through the early 1990s demonstrated how even small adverse changes in the external environment could significantly delay the attainment of external viability. The sensitivity analyses in recent reports have tended not to include any stress testing of major vulnerabilities and downside risks. Consequently, they have been somewhat perfunctory.
- In general, there was relatively little discussion of risks of deviations from assumptions and projections, and how programs might be adapted. A handful of reports contained candid discussions of the risks of policy slippages and policy reversals.<sup>35</sup>
- Reports usually provide an indication of the authorities views; in most cases, however, there were no reports of significant differences and so no sense of any compromises that might have been reached between the staff and the authorities. Two exceptions to this were the 1992 Article IV staff report (which covered a period when there was no IMF arrangement in place), and the 2001 Article IV consultation report (which indicated differences on the timing of an increase in electricity tariffs).
- Presentation of the reform strategy and reviews of performance under previous or ongoing programs were broadly satisfactory. However, discussion of alternative options and trade-offs was almost completely absent from reports, except in the 1992 report which presented an account of the authorities’ internal adjustment efforts.
- Little detail was provided in reports about the substance of the collaboration with the World Bank; often there were statements affirming close collaboration and—as is general practice—an appendix listing World Bank operations in Senegal, but with no sense of how the strategies of the two institutions were integrated and what the mutual priorities were. In a few cases, where there had been a recent World Bank

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<sup>35</sup> Examples include the report on the midterm review under the 3<sup>rd</sup> annual arrangement under the 1988 ESAF and the 2001 Article IV consultation report.

operation with objectives that were similar to those in IMF arrangements—for example Structural Adjustment Loans—a summary of the content of the authorities Letter of Development Policy to the World Bank was provided.<sup>36</sup>

70. In terms of topics covered, it is striking how little explicit discussion of exchange rate misalignment there was in the reports before the 1994 devaluation, with most of the focus on traditional measures of the real effective exchange rate.<sup>37</sup> This was explained by the staff as the result of a deliberate decision by management to keep discussion of a possible devaluation of the CFAF confidential. As discussed above, the issue was analyzed extensively in internal documents during 1992-93.

## VII. CONCLUSIONS AND RECOMMENDATIONS

71. Five main reasons were found for Senegal's prolonged use of IMF resources.

- First, the initial imbalances were large and deeply rooted in structural weaknesses of the economy, including vulnerability to terms of trade and weather-related shocks, which were likely to require a long time to address in a sustainable manner.
- Second, Senegal's prolonged use of IMF resources can also be attributed to the broadening of objectives associated with programs supported under the IMF's concessional facilities.
- A third factor is the use of IMF arrangements as a seal of approval for the provision of external finance by several multilateral and bilateral creditors and donors.

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<sup>36</sup> For example, in the reports for 1983, 1988, 1989, and 2001.

<sup>37</sup> The staff report for the 1989 Article IV Consultation indicated that the authorities held the view that “the benefits of full convertibility and stability of the CFA franc afforded by membership of WAMU outweighed the potential advantages of a more flexible exchange rate policy.” The 1991 Article IV staff report elaborated on the benefits (promotion of confidence in the currency/country and contribution to domestic price stability—essential factors for attracting foreign investment and mobilizing domestic saving), and on how the authorities intended to support the system (appropriate financial and structural policies, notably a restrained incomes policy, a restructuring of energy pricing, and reforms designed to increase productivity). In neither report were the staff's own views spelt out. However, the latter report noted that there had been a 5.7 percent depreciation in the real effective exchange rate between 1985 and 1990, at a time when the terms of trade had improved, thus betraying no “over-valuation” concerns. Even the 1992 Article IV report which went beyond the standard presentation of real effective exchange rate indices to consider other indicators (e.g., relatively high cost of labor), stopped short of advocating an exchange rate adjustment, though it did provoke a discussion of devaluation of the CFA franc at the Board discussion. The inadequacies of the real effective exchange rate index as an indicator of international competitiveness are well known. Using a method that incorporates terms of trade shocks, Devarajan (1997) estimates that on average the real exchange rate was overvalued by about 30 percent for 12 countries in the CFA franc zone prior to the January 1994 devaluation. He estimates the real exchange rate in Senegal was 22 percent overvalued.

- Fourth, overoptimism about the effectiveness of the pre-devaluation adjustment strategy on promoting growth may have contributed to prolonged use.
- Weaknesses in program design that were compounded by a stop-go pattern of program implementation, especially with regard to structural reforms, undermined program effectiveness.

#### Ex-post assessments and exit strategy

- We recommend that guidelines on ex-post assessments be applied more consistently and forcefully for countries that have had a succession of multiyear arrangements.
- A more explicit strategy for eventual exit from use of IMF resources is needed. Attainment of the completion point under the enhanced HIPC Initiative would be one possible opportunity for discussion of such a strategy for Senegal, drawing on the assessments of previous programs

#### Program design

- Successful programs have been those to which there was strong political commitment, regardless of the precise nature of conditionality.
- Key lessons for improving the effectiveness of Senegal's IMF-supported programs include: (i) fostering greater ownership of reform programs; (ii) reflecting capacity constraints more realistically in implementation schedules; and (iii) articulating measures for improving implementation—including through a greater flow of technical assistance on implementation aspects.
- Programs need to be set in a realistic timeframe that avoids overpromising on the pace of adjustment toward external viability; if the adjustment is realistically expected to extend well beyond the period of a three-year arrangement, then the consequences for IMF involvement should be discussed explicitly as part of a medium-term strategic framework.
- To help programs adapt better to uncertainty, the principal risks to the program, and how policies would adapt to those risks, should be set out explicitly.
- There is room for improving Bank-Fund collaboration to address fundamental institutional/structural issues at the heart of prolonged use. The PRSP provides an instrument to that end, but will need to be matched by operational changes to ensure that the work priorities and timeframes of the two institutions mesh effectively.
- In countries like Senegal where quasi-fiscal activities are significant, the macroeconomic framework needs to focus on a broad coverage of the public sector accounts (instead of focusing mainly on central government balances), in order to

provide a more comprehensive and more transparent basis for considering public sector financial problems, and for discussing risks of disorderly adjustment in the absence of corrective measures.

#### Surveillance

- Surveillance discussions and reports should be used as an occasion to “step back” and reconsider the overall strategy. While such reconsiderations should be a normal part of any effective program process, a natural time to reconsider the overall strategy is between arrangements and in the context of surveillance. Such a strategic review should include an assessment of performance under previous programs, including a frank appraisal of previous assumptions about implementation; a stress-testing of major vulnerabilities and downside risks; and a discussion of alternative policy options and trade-offs. The results of such reassessments should be reported candidly to the Executive Board.

#### Outreach

- Persistence of criticisms of the IMF, in spite of its embrace of the PRSP approach, suggests that many people do not believe that the IMF has changed the way it does business. The IMF has increased its outreach activities in Senegal in recent years, including through the role of the resident representative. These efforts need to be sustained and broadened, including more public discussion of the rationale for policy advice, especially on sensitive issues.

### Senegal: Implementation of IMF Arrangements

Arrangements 1/	Financial and structural PCs and benchmarks 2/	Program reviews	Slippages & proximate causes	Shocks	Comments
SBA I (1979)	No formal PCs, but significant deviations from indicative targets.	None			
EFF (1980/81-1982/83)	Observed at 1st test date only	1st review was not completed.	Non implementation of price liberalization measures and lack of agreement on policy adaptations; political changes took focus away from economic policy.	Drought	President Senghor (President since independence in 1960) retired in Dec.80; replaced by Mr. Diouf (Prime Minister at the time).
SBA II (1981/82)	Original program set PCs for first half of program year only. These were observed.	Midterm review completed 4 months behind schedule.	Delay in completion of midterm review. Original program stipulated that additional measures to reduce projected fiscal deficit be agreed during midterm review mission and implemented in January 1982.	Good weather. Decline in world price of groundnut oil.	Original program envisaged only one (midterm) review. Delay in completing that review led to modification of arrangement to add a second review and rephase disbursement.  Decision to modify rather than cancel arrangement partly influenced by link to Paris Club agreement.
SBA III (1982/83)	Most not observed.	Midterm review was not completed.	Tax measures envisaged for Nov82 not implemented; election pressures.	Sharp downturn in world price of groundnut oil.	Presidential and legislative elections held in February 1983.
SBA IV (1983/84)	Observed.	Midterm review was completed on time		Severe drought. Higher than expected export price for groundnut products (partly offset large fall in output and export volumes).	Measures implemented before Board approval included significant increases in prices of several consumer goods.  Expenditure cuts more than compensate for revenue shortfall.  Increase in some petroleum product prices to avoid deficit in National Energy Fund

1/ Roman numerals are used to indicate the sequence of arrangements, by type. For multiyear arrangements, number suffix refers to arrangement year (first, second or third).

2/ PCs = Performance criteria.



# Senegal: Implementation of IMF Arrangements

Arrangements 1/	Financial and structural PCs and benchmarks 2/	Program reviews	Slippages & proximate causes	Shocks	Comments
SBA V (1984/85-1985/86)	Almost all observed.	Envisaged reviews (3) were completed on time.		Improved weather conditions.	Significant policy adaptation in response to shortfalls in export earnings and government revenue. (e.g., extension of service tax to telecom services, tightening of credit independence in 1996) retired in Dec.80;
SBA VI and ESASF_1 (1986/87)	All PCs under SBA observed; nearly all benchmarks under SAF observed.	Midterm review under SBA completed on time.	Delay in formulation of action plan for determination of producer prices of cereals (benchmark under SAF).	Sharp decline in export price of groundnuts Decline in import price of petroleum products.	Windfall profits from petroleum sector and from rice imports mobilized for the government budget.
SBA VII and ESASF_2 (1987/88)	All PCs under SBA observed. Benchmarks under SAF observed, with slight delay in one.	Midterm review under SBA completed on time.	Slight delay in removal of remaining quantitative restrictions on imports (benchmark under SAF)	Good weather conditions Sharp deterioration in the terms of trade.	Presidential and parliamentary elections held in February 1988.
ESASF_L_1 (1988/89)	Observed	Midterm review completed on time.	Slippages in implementation of tax reform measures in the second half of the year (after midterm review).	Locust infestation of crops. Uneven distribution of rainfall	Social unrest in second half of program period. Reduction in groundnut producer price
ESASF_L_2 (1989/90)	Observed	Midterm review completed on time.	Slippages after midterm review: --delay in implementing tax reform measures (expanding VAT base). --contingency mechanism for freezing lower priority expenditures, in the event of a revenue shortfall, not implemented		Measures to increase tax revenue implemented prior to approval of arrangement. Tighter monitoring: introduction of monthly revenue targets, and a PC on minimum revenue collection.
ESASF_L_3 (1991)	Observed	Slight delay (1 month) in completion of midterm review.	Weakening of performance after environment. Delays in implementation of structural measures.	Sharper drop in export Poor weather conditions	Request for 3rd annual arrangement year (first, second or third) action of 6 month staff monitored program.

1/ Roman numerals are used to indicate the sequence of arrangements, by type. For multiview arrangements, number suffix refers to arrangement year (first, second or third).

1/ Roman numerals are used to indicate the sequence of arrangements, by type. For multiyear arrangements, number suffix refers to arrangement year (first, second or third).

2/ PCs = Performance criteria.

# Senegal: Implementation of IMF Arrangements

Arrangements 1/	Financial and structural PCs and benchmarks 2/	Program reviews	Slippages & proximate causes	Shocks	Comments
SBA VIII (1994)	All PCs for March 1994, were met, except accumulation of new arrears.				Only the purchase associated with approval of the arrangement was made before the SBA was replaced by an ESAF.
ESAF II_1 (1994/95)	Observed	Midterm review completed slightly behind schedule (2 months)			
ESAF II_2 (1995/96)	Most observed	Midterm review completed slightly behind schedule (2 months)	Delays in reform of energy sector. Pace of privatization program (slow).		
ESAF II_3 (1997)	Most observed.	Midterm review completed slightly behind schedule (2 months)	Delays in public enterprise and energy sector reforms; resistance from interest groups.	Unfavorable weather conditions	
ESAF III_1 (1998)	Most observed.	Midterm review completed slightly behind schedule (1 month)		Drought Declining oil prices	
ESAF III_2 (1999/00)	Most of targets prior to Dec99 test date were met. Thereafter, most structural and some financial benchmarks were not observed.	Completion of 1st review delayed by 6 months. Envisaged 2nd review was not completed.	Slippages in the implementation of fiscal program and structural reforms in the run up to presidential elections.		Presidential elections held in February and March 2000; won by opposition candidate (Mr. Wade). New dates for meeting structural benchmarks agreed with new government.
ESAF/PRGF III_3 (2001)	Several PCs related to 2nd and 3rd reviews were not observed.	Delays of 2 months and 4 months for 1st and 2nd reviews, respectively. Envisaged 3rd review was not completed.			8 months elapsed between completion of review under second annual arrangement and approval of year (first, second or third) arrangement. Legislative elections held in April 2001 year (first, second or third). allowed completion of 2nd review, but not the 3rd review, just before the expiration of the arrangement.

1/ Roman numerals are used to indicate the sequence of arrangements, by type. For multiyear arrangements, number suffix refers to arrangement year (first, second or third).

2/ PCs = Performance criteria.

Senegal: Projections and Outturns of Selected Variables (In percent of GDP, unless otherwise indicated)

	Current account deficit			Export growth			Government balance			Government revenue			Real GDP growth			Gross domestic saving			Gross domestic investment		
	Proj.	Outturn	Diff. 1/	Proj.	Outturn	Diff. 1/	Proj.	Outturn	Diff. 1/	Proj.	Outturn	Diff. 1/	Proj.	Outturn	Diff. 1/	Proj.	Outturn	Diff. 1/	Proj.	Outturn	Diff. 1/
<b>Medium-term projections 2/</b>																					
<b>SAF/SBA</b>																					
1986/87	9.2	10.8	-1.6	13.2	-0.4	13.6	-0.9	-1.5	0.6	18.4	18.8	-0.4	4.4	4.2	0.2	6.3	6.9	-0.6	14.0	13.7	0.3
1987/88	7.8	11.4	-3.6	11.1	-5.2	16.3	0.5	-1.2	1.7	18.0	17.5	0.5	3.3	4.4	-1.1	8.0	7.2	0.8	14.0	12.5	1.5
1988/89	6.6	10.0	-3.4	10.4	13.4	-3.0	1.3	-2.1	3.4	17.7	16.8	0.9	3.5	-0.5	4.0	9.5	7.5	2.0	14.0	12.6	1.4
1989/90	5.5	8.4	-2.9							17.5	16.9	0.6				10.5	8.5	2.0			
<b>ESAF I</b>																					
1988/89	9.1	10.0	-0.9	11.8	13.4	-1.6	0.2	-2.1	2.3	17.7	16.8	0.9	4.2	-0.5	4.7	10.6	7.5	3.1	14.5	12.6	1.9
1989/90	7.8	8.4	-0.6	12.2	13.1	-0.9	0.6	-3.2	3.8	18.1	16.9	1.2	3.5	3.6	-0.1	11.8	8.5	3.3	14.6	13.4	1.2
1990/91	6.5	8.9	-2.4	13.3	2.9	10.4	1.9	2.0	-0.1	18.8	18.9	-0.1	3.6	1.3	2.3	13.2	8.8	4.4	14.9	13.7	1.2
1991/92	5.4	8.4	-3.0	12.6	-3.4	16.0	2.7	0.2	2.5	19.0	18.6	0.4	3.8	2.3	1.5	14.1	8.5	5.6	14.9	13.5	1.4
<b>ESAF II</b>																					
1994	9.8	9.3	0.5	6.5	9.5	-3.0	-0.7	-1.8	1.1	14.4	14.0	0.4	2.4	2.0	0.4	9.3	9.6	-0.3	15.1	16.2	-1.1
1995	7.8	9.2	-1.4	13.5	15.1	-1.6	-1.4	-0.2	-1.2	15.0	15.1	-0.1	4.7	4.8	-0.1	11.2	11.3	-0.1	15.5	16.9	-1.4
1996	7.3	8.0	-0.7	7.3	6.4	0.9	-0.6	-0.2	-0.4	15.3	16.0	-0.7	4.8	5.2	-0.4	12.6	12.8	-0.2	16.7	16.3	0.4
1997	6.8	7.8	-1.0	7.9	-0.3	8.2	0.8	0.5	0.3	15.7	16.9	-1.2	4.5	5.0	-0.5	14.0	11.6	2.4	17.8	17.3	0.5
<b>ESAF/PRGF III</b>																					
1998	7.3	5.3	2.0	7.1	8.2	-1.1	-1.0	-0.3	-0.7	15.6	16.8	-1.2	5.3	5.7	-0.4	13.8	10.4	3.4	19.2	17.5	1.7
1999	6.8	7.9	-1.1	6.1	10.7	-4.6	-0.1	-1.4	1.3	16.0	17.3	-1.3	6.5	5.0	1.5	14.7	11.8	2.9	19.9	19.4	0.5
2000	6.7	9.0	-2.3	6.1	3.6	2.5	0.1	0.1	0.0	16.1	18.1	-2.0	6.0	5.6	0.4	15.4	8.4	7.0	20.7	18.4	2.3
<b>Annual projections 3/</b>																					
1986/87	9.2	10.8	-1.6	13.2	-0.4	13.6	-0.9	-1.5	0.6	18.4	18.8	-0.4	4.4	4.2	0.2	6.3	6.9	-0.6	14.0	13.7	0.3
1987/88	9.2	11.4	-2.2	19.5	-5.2	24.7	-0.4	-1.2	0.8	18.0	17.5	0.5	4.2	4.4	-0.2	9.5	7.2	2.3	14.0	12.5	1.5
1988/89	9.1	10.0	-0.9	11.8	13.4	-1.6	0.2	-2.1	2.3	17.7	16.8	0.9	4.2	-0.5	4.7	10.6	7.5	3.1	14.5	12.6	1.9
1989/90	8.2	8.4	-0.2	-0.4	13.1	-13.5	-1.3	-3.2	1.9	17.6	16.9	0.7	4.6	3.6	1.0	10.2	8.5	1.7	15.2	13.4	1.8
1990/91	7.2	8.9	-1.7	13.7	2.9	10.8	1.5	2.0	-0.5	18.8	18.9	-0.1	1.3	1.3	0.0	9.2	8.8	0.4	12.9	13.7	-0.8
1991/92	7.3	8.4	-1.1	-0.9	-3.4	2.5	1.6	0.2	1.4	18.0	18.6	-0.6	5.1	2.3	2.8	10.1	8.5	1.6	12.3	13.5	-1.2
1994	9.8	9.3	0.5	6.5	9.5	-3.0	-0.8	-1.8	1.0	14.4	14.0	0.4	2.4	2.0	0.4	9.3	9.6	-0.3	15.1	16.2	-1.1
1995	7.7	9.2	-1.5	10.6	15.1	-4.5	-0.9	-0.2	-0.7	15.3	15.1	0.2	4.5	4.8	-0.3	11.3	11.3	0.0	15.6	16.9	-1.3
1996	7.3	8.0	-0.7	7.4	6.4	1.0	-0.8	-0.2	-0.6	15.5	16.0	-0.5	4.5	5.2	-0.7	12.8	12.8	0.0	16.9	16.3	0.6
1997	6.7	7.8	-1.1	6.9	-0.3	7.2	0.5	0.0	0.5	15.5	16.9	-1.4	4.5	5.0	-0.5	11.7	11.6	0.1	16.5	17.3	-0.8
1998	7.3	5.3	2.0	7.1	8.2	-1.1	-1.1	-0.3	-0.8	15.6	16.8	-1.2	5.3	5.7	-0.4	13.8	10.4	3.4	19.2	17.5	1.7
1999	7.0	7.9	-0.9	7.5	10.7	-3.2	-1.9	-1.4	-0.5	16.8	17.3	-0.5	6.4	5.0	1.4	13.9	11.8	2.1	19.7	19.4	0.3
2000	6.6	9.0	-2.4	15.0	3.6	11.4	-1.6	0.1	-1.7	17.3	18.1	-0.8	5.5	5.6	-0.1	14.2	8.4	5.8	19.6	18.4	1.2

Source: Staff reports

1/ Projection minus outturn.

2/ Projections in the document for the initial request for the multiyear arrangement.

3/ Updated projections for the year.

**LIST OF PEOPLE INTERVIEWED IN CONNECTION WITH THE EVALUATION OF THE PROLONGED USE  
OF IMF RESOURCES - SENEGAL**

***Current Senior Officials***

Mr. A. Boucar, Deputy Governor, BCEAO  
Mr. Ababacar Diop, Cabinet Director  
Mr. Serigue Babacar Diop, Directeur de Cabinet, Ministère des Mines  
Mr. Pape Diouf, Minister of Agriculture  
Mr. A. Fall, President, Power Sector Regulatory Commission  
Mr. Alioune Gassama, Director of Analyses, Forecasting and Statistics  
Mr. Ambroise Koné, Director of Research, BCEAO  
Mr. Seyni N'Diaye, National Director, BCEAO  
Mr. Souleymane Saib, Director of Administrative and Financial Affairs  
Mr. Macky Sall, Minister of Energy  
Mr. Abdoulaye Sene, Technical Advisor  
Mr. Chiekh Soumare, Minister of Budget

***Former Senior Officials***

Mr. Serigne Lamine Diop, Minister of Finance  
Mr. Mamadou Lamine Loum, Prime Minister, Minister of Finance  
Mr. Famara Ibrahim Sagna, Minister of Finance  
Mr. Djibril Sakho, National Director, BCEAO  
Mr. Magatte Pathé Sené, National Director, BCEAO  
Mr. Mamoudou Touré, Minister of Finance

***Representatives of Political Parties***

Parti pour l'Indépendance et le Travail (PIT), Mr. Amath Dansokho  
    Mr. Sakhma Diouf Faye (PIT)  
    Mr. Sémun Pathé Gnèye (PIT)  
    Mr. Makhtar Mbay (PIT)  
    Mr. Ibrahima Sène (PIT)

Mr. Dibo Ka, Ūnion pour le Renouveau Démocratique  
    Mr. Amath Wade (PIT)  
Mr. Landing Savane, Jef/PADS

***Representatives of the Business Community***

Mr. Amath Benoit Gaye, Secretary General, National Union of Chambers of Commerce, Industry & Agriculture  
Mr. Nor Talla Kane, Executive Secretary, Conseil National des Employeurs du Senegal  
Mr. Mamadou Lamine Niang, President, National Union of Chambers of Commerce, Industry & Agriculture

***Representatives of Non-Governmental Organizations***

Mr. Mame Gueye, President, Civil Forum, National Chapter of Transparency International  
Mr. Jacques Habib Sy, Founder, Aid Transparency

***Representatives of Trade Unions***

Mr. Pape Diallo, UNSAS  
Mr. Madia Diop, President, CNTS  
Mr. Abdoulaye Gueye, President, Union Nationale des Syndicats Autonomes du Sénégal (UNSAS)  
Mr. Mody Guiro, Secretary General, Confédération Nationale des Travailleurs du Sénégal (CNTS)  
Mr. Jhohume Kout, Secretary General, AGHTS  
Mr. Waly Ndiaye, Confédération des Syndicat Autonomes  
Mr. Mademba Sock, Secretary General, UNSAS

***Journalists***

Mr. Abdou Diarra, Le Matin  
Mr. Malik Diaw, Le Soleil  
Ms. Aissatou Fall, Walf-FM  
Mr. Mounirou Fall, Sud Quotidien  
Mr. Amadou Gueye, Le Journal de l'Economie  
Mr. Josias Toba Tanama, Le Journal de l'Economie

***Academic***

Mr. Abdoulaye Diagne, Director of Research, Economics Faculty, Cheik Anta Diop University

***Representatives of Donors***

Mr. Jean de Glinasty, Ambassador of France  
Mr. Matar Fall, Senior Sanitary Engineer, World Bank Acting Country Director, and water sector lead specialist  
Mr. Alain Frossard, Counselor, French Embassy  
Mr. Xavier Rose  
Mr. Jean-Luc Supera, Country Director, Agence Française de Développement  
Mr. Daniel Voizot, Conseiller économie et finances, Ambassade de France au Senegal  
Mr. Richard Young, European Commission

The mission also met with a large number of IMF and World Bank staff formerly or presently involved in the relationship of their respective institution with Senegal.

## EVIDENCE FROM TWO COUNTRIES WHICH “GRADUATED” FROM PROLONGED USE

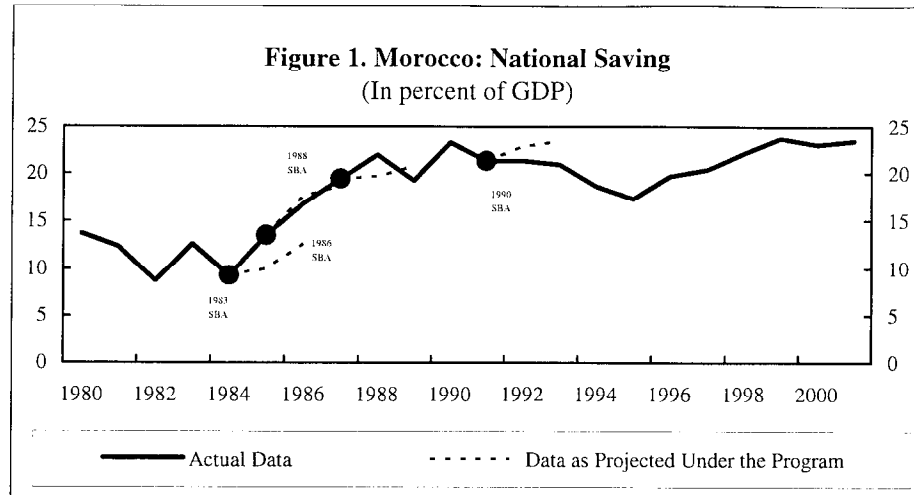
### I. MOROCCO

1. Morocco is one of the few recent prolonged users of IMF resources to have “graduated”. It had a series of nine arrangements between 1980 and 1993,<sup>1</sup> but has not had an IMF-supported program since then and completed repaying its borrowing from the IMF in 1997.
2. After a temporary sharp increase in phosphate prices in the early 1970s that led to a boom in expenditures, the Moroccan economy ran into major problems in the late 1970s, as the global recession and falling phosphate prices led to sharp declines in exports and budgetary revenues. At first, the government maintained spending and this resulted in very large current account and budget deficits, financed mainly through external borrowing on commercial terms. Consequently, the imbalances Morocco faced as it entered a series of IMF-supported programs were very large. In 1981, the external current account deficit (excluding grants) exceeded 12 percent of GDP, while the central government budget deficit reached 14 percent of GDP. Between 1982 and 1984, the stock of external debt averaged over 100 percent of GDP, while the external debt service ratio, before rescheduling, averaged 50 percent of exports of goods and services. In addition, Morocco faced major structural weaknesses, with heavy government regulation, including on consumer prices and credit allocation, a strong inward economic orientation, and considerable vulnerability to exogenous shocks due to its dependence on the agricultural sector, and on phosphates exports.
3. Programs in the early 1980s had only a moderate impact in reducing these imbalances. Fiscal adjustment was achieved mainly through expenditure reduction, but domestic payments arrears rose. At first, progress on structural reforms was slower than planned, in part due to concerns over the social acceptability of a more rapid pace of reform. For example, there were serious riots over increases in the prices of some heavily-subsidized consumer goods.
4. In the second half of the 1980s, as the structural reforms started to reach maturity, the contribution of the private sector to investment and growth increased as it benefited from deregulation and improved access to credit. Moreover, financial adjustment policies and structural reforms became mutually reinforcing, as for example tax reform contributed to a greater tax effort, and as export growth accelerated. Over the course of its IMF programs, Morocco eventually achieved significant structural changes, including the liberalization of most foreign transactions and consumer prices; reform of public enterprises; tax and public expenditure reform; and the removal of administrative impediments to private investment. Moreover programs were successful in raising saving: the ratio of gross national saving to

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<sup>1</sup> Two EFFs in the early 1980s, both of which quickly went off-track and were cancelled, followed by seven SBAs between 1982 and 1993. (See Chart 1 in Chapter III). Morocco also had six nearly continuous annual SBAs between 1965 and 1972.

GDP rose from an average of 16 percent during 1980-82 to almost 23 percent during 1990-92 (Figure 1). Tax reforms contributed to this change, with the tax effort rising from 19¼ percent of GDP to 22¼ percent of GDP over the same period.<sup>2</sup>



Progress, while eventually substantial, was not smooth. There were a number of setbacks in the face of exogenous shocks and periodic slippages in policy implementation.

5. This experience suggests a number of questions. Were there elements of the design and implementation of programs which helped Morocco achieve greater external sustainability and dispense with IMF support more quickly than many other prolonged users? Why did core policies continue to move in the right direction? And compared with the other case studies were there any differences in terms of “exit strategies” once Morocco had reached a certain threshold in terms of external viability? The following aspects help to cast light on these issues:

**(i) No obvious differences in the timeframe of programs from other prolonged users.**

6. As in Pakistan and Senegal (but less so in the Philippines), programs were initially overoptimistic about the time frame needed for external viability to be restored.<sup>3</sup> For example, the 1983 staff report stated that despite large disequilibria, Morocco “must aim at reaching a sustainable position in a relatively short period. ... the medium-term scenario in which the program is set aims at reaching this sustainability by 1988....which, in the view of

<sup>2</sup> Morocco’s adjustment experience is described in more detail in “Resilience and Growth Through Sustained Adjustment: the Moroccan Experience.” IMF Occasional Paper, No. 117, October 1995.

<sup>3</sup> The first programs in 1980 and 1981 turned out to be particularly unrealistic, assuming as they did that commercial banks would continue to lend on a significant scale.

the staff is an appropriate time horizon.”<sup>4</sup> Later, programs appear to have become more realistic about the timetable for restoring external viability: by the 1986 program viability was not expected until about 1993. Medium term projections in subsequent programs broadly maintained this time horizon.

7. Programs from 1982 onward were supported by 12-18 month SBAs, but there was some recognition on both sides that this was part of a more medium-term effort. Nevertheless, the Moroccan authorities have expressed the view that programs still had an overly short-term time-horizon, particularly as far as structural reforms were concerned and that, at least formally, staff could not candidly position programs within the longer term framework. Thus, initial programs were too ambitious about the timetable for structural reform.

8. For example, the 1983 program called for a Value Added Tax (VAT) to be implemented by July 1984, and for draft bills for reform of the General Income Tax and the Corporate Income Tax to be submitted along with the 1984 budget. In the event, VAT was not implemented until 1986, after extended consideration in Parliament, and a global personal income tax was only implemented in 1989. Despite this initial “overpromising” on the timetable of tax reform—which appears to have reflected institutional pressures to demonstrate concrete progress within the timeframe of the program—one factor that helped maintain progress was that an initial “Loi Cadre” adopted by Parliament had defined the overall framework for tax reform, so that the ultimate objectives remained clear despite slippages in the timetable of individual components. Indeed, officials and staff interviewed were of the view that, with hindsight, the additional time taken for preparation and debate, including in Parliament, on the VAT and the income and profits taxes contributed to their eventual successful implementation by helping to secure greater popular support.

**(ii) Program design and the nature of conditionality showed no major differences in approach from that in other prolonged users**

9. Until 1985, IMF-supported programs focused on fiscal adjustment, primarily through large reductions in capital spending and public-sector wage restraint, tight monetary policy through credit controls, and a flexible exchange rate. Structural reforms were also envisaged, but in practice were largely limited to preparatory work. From 1986 on, programs gave greater emphasis to structural reform, including of the fiscal system and trade regime. Programs continued to target moderate strengthening of the fiscal position, while the nominal exchange rate was fixed in relation to a basket of the currencies of Morocco’s principal trading partners.

10. Programs generally took a fairly gradual approach to adjustment. On average, the six IMF-supported programs between 1983 and 1992 targeted a reduction in the fiscal deficit by

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<sup>4</sup> However, even then the medium term projections showed large overall balance of payments deficits (equivalent to 6 percent of GDP) persisting through 1987. The staff report claimed that “beyond 1987, the situation could be regarded as more sustainable in the light of the resumption of normal capital inflows...”.



an average of 1.3 percentage points of GDP between the year in which the program started and the next,<sup>5</sup> while the current account deficit was projected to narrow on average by 1.4 percentage points of GDP over the same period (see Table 1 and Figures 2 and 3). In both cases, the targeted adjustment was somewhat greater in the earlier programs than in later ones, in part reflecting the scale of the initial imbalances. Although there was considerable slippage in individual programs, there was a substantial reduction in the fiscal deficit over the period of IMF-supported programs, from 14 percent of GDP in 1981 to a little over 2 percent in 1992.<sup>6</sup>

Table 1. Morocco: Implementation of Fiscal Programs<sup>1</sup>

Year	Program	T-1	T		T+1	
			Projected	Actual	Projected	Actual
1981	EFF	10.1	7.4 <sup>2</sup>	14.5 <sup>2</sup>	..	12.4
1982	SBA	12.4	8.2 <sup>2</sup>	12.5	...	12.1
1983	SBA	12.1	8.7	12.1	7.2	11.2
1985	SBA	11.2	6.0	9.6	4-4.5	5.4
1986	SBA	9.6	6.6	5.4	4.3	5.9
1988	SBA	4.6	4.5	4.6	3.5	6.0
1990	SBA	5.7	2.8	3.5	2.0	3.1
1992	SBA	3.1	0.8	2.2	0.0	4.0

1/ Central government deficit, payments order basis, excluding grants; unless otherwise stated.

2/ Budget deficit, excluding grants, and excluding changes in "Fonds réservés."

<sup>5</sup> That is, between the projection or estimate for year T, and the projection for year T+1.

<sup>6</sup> Year to year comparisons are complicated by the existence of arrears and by other data issues. Much of the fiscal adjustment apparently occurred in 1986, after the 1985 program went off-track and before a new program was approved in December of that year.

Figure 2. Morocco: Current Account Balance<sup>7</sup>  
(In millions of U.S. dollars)

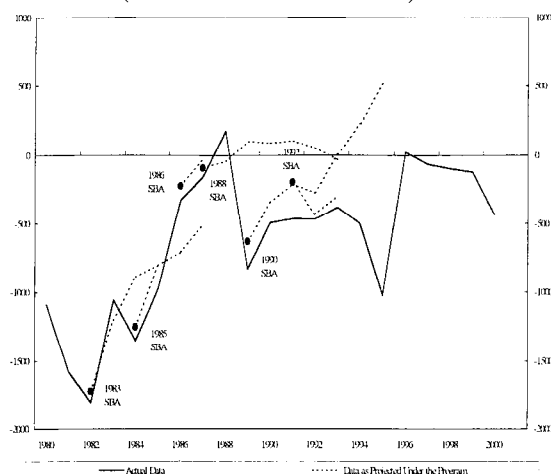
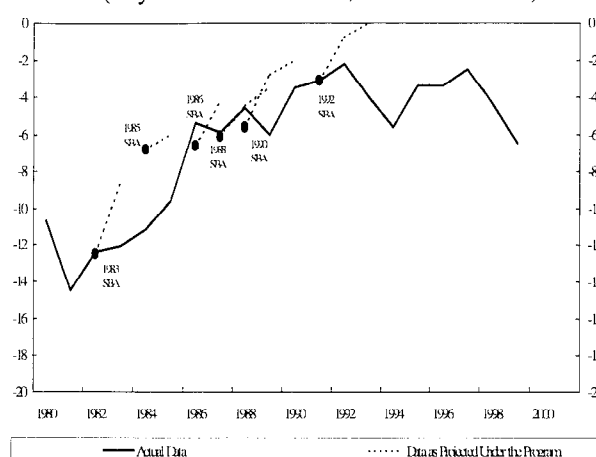


Figure 3. Morocco: Central Government Balance<sup>1</sup>  
(Payments Order Basis; Percent of GDP)



11. Conditionality in most programs concentrated on the standard macroeconomic quantitative performance criteria. Programs typically also included indicative benchmarks for government revenue, which would trigger consultations on corrective actions if they were missed. Conditionality on structural measures was exercised primarily through the review process, with little use of specific benchmarks. There seems to have been relatively limited use of prior actions even though the guidelines on prolonged use called for greater emphasis on such actions.<sup>8</sup>

12. Given the basic commitment of the authorities, the IMF's flexibility in exercising conditionality—with the focus on reviews to judge whether sufficient progress was being made in key structural areas—was probably appropriate. However, there is no evidence that the Fund was more “flexible” than in many other cases; for example, programs with the Philippines also relied primarily on reviews for structural conditionality.<sup>9</sup>

<sup>7</sup> The starting point of projections is occasionally off the “actuals” line because of subsequent revisions to the data on which the projections were based.

<sup>8</sup> However, they were used on occasion. For example, parliamentary approval of a revised budget, upward adjustment of retail prices of subsidized commodities and partial reversal of recently introduced import restrictions were required as “prior actions” for approval of the 1983 SBA arrangement. The 1992 SBA also included a number of prior actions relating to fiscal issues and the reform of interest rate policy, open market operations, and consideration of a new banking law.

<sup>9</sup> The Executive Board did grant waivers of fiscal performance criteria in the 1983, 1986 and 1988 programs, in addition to waivers for primarily technical breaches of performance criteria relating to external arrears.

**(iii) Ownership and Implementation: despite slippages in timing, political commitment to the broad direction of the reforms and good implementation capacity appear to have been the critical factors**

13. Implementation of the programs was somewhat mixed, but despite periodic slippages, particularly in relation to fiscal targets, policies on core issues continued to move in the right direction, although not always at the pace envisaged in programs.<sup>10</sup> Implementation of the monetary aspects of programs was generally strong. This consistent direction appears to have owed much to a high degree of commitment by the economic team to the underlying aims and content of successive programs, with the backing of the highest levels of government, and to a high degree of political stability. Interviews with staff also suggest that the strength of Morocco's civil service was a major factor in successful implementation of key reforms. Increasing transparency in putting information and policies out for public discussion also appears to have helped develop a broader consensus, although this consensus was by no means complete since some measures—especially price increases on consumer goods—continued to meet considerable social resistance.

14. In this context, the pace of adjustment and reform was set to some degree by the authorities' perceptions of the domestic political acceptability of reform. In practice, the IMF accommodated this approach by tolerance of minor policy slippages and a flexible attitude to progress on structural reform in completing program reviews. But this approach does not seem to have differed fundamentally from that in the case study countries where there was also considerable de facto flexibility. The real difference appears to have been made by strong domestic ownership, rather than by the structure of conditionality.

**(iv) The economy was highly vulnerable to exogenous shocks, but the approach of programs to this uncertainty was not different from that in other prolonged users<sup>11</sup>**

15. However, although exogenous developments led to some relaxation of adjustment efforts in 1981-82 and caused temporary problems in other programs, more generally shocks do not seem to have distracted the authorities from their broad commitment to advancing reform. For example, there was no major erosion of earlier gains even in the face of the Middle East crisis in 1990-91 and episodes of severe drought. Nevertheless, in their questionnaire responses, the Moroccan authorities said that programs were insufficiently flexible with regard to exogenous shocks. In their view, advance agreement on how supply shortfalls would be dealt with in programs would have made the process smoother and programs less subject to interruption.

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<sup>10</sup> Both the 1980 and 1981 EFF programs went off-track quickly and were cancelled, with less than 20 percent of the planned disbursements made. The remaining SBAs were more successfully implemented; on average 78 percent of planned disbursements were made. However, neither of the last two programs in 1990 and 1992 was completed as performance criteria were missed and program reviews were not completed.

<sup>11</sup> However, unlike for example in Senegal, there was only very limited use of automatic adjustments to quantitative performance criteria. The 1990 and 1992 programs did include adjusters in relation to net external financing and to privatization proceeds.

**(v) With regard to the exit strategy, the authorities and the IMF appear to have adopted a narrower rationale for continued program involvement than in some other prolonged users**

16. The staff appraisal for the 1992 SBA request noted that Morocco was poised to achieve viable budgetary and external sector positions, and that with the help of the program in 1992 and a further concerted effort in 1993, Morocco would graduate from the use of IMF resources, restore normal relations with its creditors, be able to service its future debt obligations and achieve current account convertibility in 1993. This “graduation” certainly did not mean that all structural adjustment problems had been solved. Indeed, the economy continued to face major challenges, including in the areas of public enterprise reform, the regulatory environment for private investment, and reform of the financial system. Moreover, the economy remained insufficiently diversified, with its heavy reliance on rain-fed agriculture leaving it still very sensitive to weather variations.

17. However, it is not clear that common standards were applied with respect to different countries when judging when an exit from IMF-supported programs was justified. For example, a comparison of Morocco’s situation in 1993 with that of the Philippines, where the IMF judged that a further EFF arrangement was justified, does not suggest any obvious reasons for the differences in approach (see box in Chapter V of main report).

## **II. LESSONS FROM JAMAICA: IMPLICATIONS FOR OWNERSHIP AND THE “SEAL OF APPROVAL”**

18. Jamaica is a former prolonged user of IMF resources that made a decision not to seek further financial support from the Fund. The current evaluation has not attempted to investigate all aspects of IMF-supported programs with Jamaica, but focuses on two issues: (1) how did the authorities’ decision not to enter into new lending arrangements with the IMF affect the nature of the policy dialogue and “ownership”; and (2) what lessons does Jamaica’s recent experience suggest for the IMF’s role in signaling a “seal of approval” on the macroeconomic framework to donors, including other IFIs. The evaluation is based on reviews of internal and published IMF documents, interviews with IMF staff and a senior Jamaican representative as well as written responses by the authorities.

19. Since the 1960s, Jamaica has had nine standby and four extended arrangements with the IMF. The last EFF expired in March 1996, after which the Jamaican government announced its “independence from the IMF”, indicating that it would not borrow again. The authorities explained in interviews with the IEO that this decision was taken in large part because of their assessment that previous IMF-supported programs had not achieved success and that they had consequently prepared a “home grown” macroeconomic program.

20. At the time the EFF expired, Jamaica still faced large adjustment challenges. Public debt was high (over 100 percent of GDP, with over two-thirds external); inflation was over 20 percent; the real effective exchange rate was appreciating under the combined impact of sizeable wage increases in the public and private sectors and an anti-inflationary monetary

policy that had pushed up real interest rates;<sup>12</sup> growth remained weak (recorded GDP rose by only 3 percent during the decade of the 1990s);<sup>13</sup> and the first stage of a major financial sector crisis was underway. The IMF policy advice at the time was that (i) a major adjustment of the exchange rate was necessary in order to restore competitiveness and thereby contribute to higher sustainable growth, along with (ii) some fiscal adjustment (i.e. small overall surpluses). Later, IMF staff also recommended a workout strategy for the financial sector that involved the separation of banks from insurance companies and the intervention and closure of all insolvent institutions. The authorities strongly rejected the advice on the exchange rate, arguing that, with a wage formation process that was heavily influenced by the exchange rate, a sizeable devaluation would only accelerate the wage-price spiral so that the best way to assure competitiveness was through a tight monetary policy. The IMF staff initially doubted that, in the likely protracted low-growth environment that such a stabilization strategy would involve, the authorities would be able to maintain the sizeable fiscal effort necessary to avoid unsustainable public debt dynamics. On the financial sector, the government feared that outright intervention and closure of banks would lead to a crisis of confidence and capital flight. They opted instead for a strategy based on guaranteeing all deposits and other liabilities; keeping all institutions open; and dealing with problem institutions more gradually, albeit at a high fiscal cost. An off-budget institution, FINSAC, was created and gradually acquired shares in a number of institutions in return for official liquidity support until it effectively controlled all domestically-owned commercial banks; a process of merger, reorganization and gradual privatization then followed.

21. In the event, the government did manage to generate and maintain large primary fiscal surpluses (see Figure 4), involving some difficult budgetary decisions, including a squeeze on capital spending. As the authorities' "homegrown" policy strategy was seen to be implemented quite forcefully, and the IMF backed away in subsequent Article IV surveillance reports from its previous insistence on an initial large depreciation while still encouraging greater exchange rate flexibility, the nature of the policy dialogue gradually improved. In July 2000, it was agreed that there would be staff monitoring of the government's economic program. The authorities have indicated that they sought the SMP specifically in order to obtain policy-based loans from the multilateral development banks by sending a signal on their macroeconomic framework.<sup>14</sup>

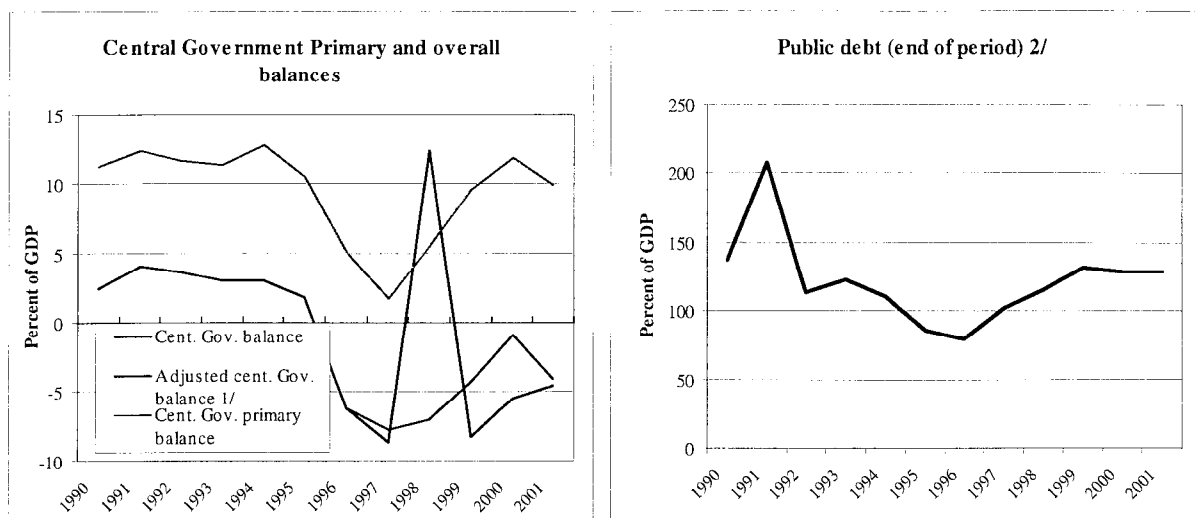
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<sup>12</sup> The real effective exchange rate appreciated by over 20 percent in the two years prior to March 1996 and appreciated by a further 30 percent in the next two years, before leveling off.

<sup>13</sup> However, GDP growth was probably under-recorded because the sizeable informal sector appears to have grown much faster.

<sup>14</sup> A staff-monitored program (SMP) is an informal agreement between the authorities and the IMF staff to monitor the implementation of the authorities' economic program; such monitoring does not imply endorsement of the program by the IMF Executive Board, management, or staff, but management and staff should consider that the program is capable of achieving its targets if it is consistently implemented. See "*Guidelines for the Use of Staff Monitored Programs*". While SMPs can serve several purposes, the objective of Jamaica's SMP was to serve as a signal to official lenders—specifically, the World Bank, as the text notes and the Inter-American Development Bank (IDB) and the Caribbean Development Bank (CDB)—about the authorities' commitment to sound macroeconomic policies. While the minimum requirement of the World Bank to proceed with policy-based adjustment (as opposed to project) lending is that IMF management provide a "comfort"

**Figure 4: Jamaica: Trends in Fiscal Balance and Public Debt**  
(in percent of GDP)



1/ Includes FINSAC interest payments on a full year base. Fiscal year starts in April.

2/ Excluding Bank of Jamaica's external debt, and net of public enterprises' holding of FINSAC and government securities.

22. The authorities' program achieved some important results, although Jamaica's problems are far from resolved.<sup>15</sup> High primary fiscal surpluses prevented the public sector debt dynamics from deteriorating further; real interest rates declined moderately, although they are still extremely high; and the cushion of external reserves improved. However, the public sector debt (at around 130 percent of GDP) remains a major source of vulnerability and real GDP growth has only recently begun to recover moderately, after a number of years of stagnation. Nevertheless, given the extremely difficult starting conditions and the consequences of the financial sector crisis, any adjustment was bound to be protracted and difficult, with or without IMF support.

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letter indicating that, in its view, macroeconomic policies are being conducted in a satisfactory manner, in the case of Jamaica the World Bank had initially indicated that it preferred an IMF-supported program to be in place. It eventually agreed to accept the SMP as the necessary seal of approval.

<sup>15</sup> See the staff report for the 2001 Article IV Consultation and Review of Staff-Monitored Program, available on the IMF's website, for further details.

23. This experience suggests some interesting lessons:

*On ownership*

- The staff's own assessment was that one of the main reasons earlier programs had failed to achieve their objectives was a lack of ownership. In their view, as reflected in an internal review prepared in 1998, the authorities' agreement to programs had been mainly motivated by the need to obtain foreign financing and debt relief—a view shared by the authorities. Under these conditions, program implementation, when it was successful, was geared to meeting specific quantitative performance criteria rather than to the implementation of the underlying policy approach. Indeed, a principal conclusion of the internal assessment was that unless the authorities made a future economic program a matter of national political priority, it was unlikely that any such program would achieve the stated objectives.
- In this case, the move away from a financial arrangement with the IMF—at the authorities' initiative—was associated with much stronger domestic ownership, which proved critical. The policy strategy they pursued, while not in accord with the IMF's recommendations on some key points, does not appear to have been a less appropriate strategy in Jamaica's circumstances, especially since it was implemented with commitment. Although any counterfactual cannot be assessed with rigor, it seems likely that, if Jamaica had been obliged at that time (for example, in order to unlock other sources of financing) to adopt a program along the lines proposed by the IMF staff, the eventual outcome would have been worse than the current situation, especially because a lack of ownership would have led to weak implementation. It is more difficult to judge which set of policies might have been preferable, abstracting from political commitment.<sup>16</sup>
- With the benefit of hindsight, the IMF should not have been so dogmatic in insisting upon its preferred strategy, which also involved substantial risks. However, the IMF was prepared to modify its position, once it was clear that the authorities had a strong commitment to an alternative strategy and were prepared to back it up with action, especially on fiscal policy. Indeed, records of the surveillance Board discussions in May 2001 suggest that a number of Executive Directors expressed sympathy for the authorities' position on the exchange rate/monetary policy framework.
- The authorities' strong commitment to transparency was a major advantage. They agreed to the publishing of a (rather critical) Public Information Notice (PIN) following the 1997 Article IV consultation—an action that had a favorable effect on

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<sup>16</sup> Kirkpatrick and Tennant (2002) attempt to assess what the outcome would have been if an alternative financial sector strategy, closer to one like that recommended by the IMF, had been adopted. However, their counterfactual assumes that the Fund strategy would have led to a major currency crisis and output collapse and hence an obviously inferior outcome. There is no way to test this assertion. It is also possible that the counterfactual would have been a stronger flow of funds into foreign-owned domestic banks.

private financial markets (reflected in quite narrow spreads)—and have consistently agreed to the publishing of Article IV consultation mission’s concluding statements, including information on performance relative to SMP targets, as well as staff reports for the consultations and SMPs. Their normal practice has been to issue, around the time of publication, their own “commentary” on the staff reports, emphasizing both points of agreement and disagreement, which has helped foster a more open debate.

*On the seal of approval*

- Internal IMF documents and staff interviews suggest that the need for an IMF arrangement in order to have access to Paris Club rescheduling was a major motivation behind the authorities’ proceeding with many earlier programs.<sup>17</sup> But, as noted above, many of the programs appear to have been weakly owned. By the time the government decided to forego any further lending arrangements with the IMF, any further rescheduling of (pre cut-off date) official debt would have had little impact, and Jamaica was able to access private financial markets without an IMF-supported program. Therefore, the initial lack of a “seal of approval” from the IMF mainly affected program lending by the multilateral development banks.
- The ambiguous nature of the staff-monitored program (SMP) as a seal of approval on the macroeconomic framework caused some initial problems. On the one hand, the authorities were concerned that the IMF might become an impediment to their access to much needed resources from other sources, notably the World Bank and the IDB, while the latter institutions were concerned that the Fund staff might not be as rigorous in their policy advice and assessments if no IMF financial resources were involved. The World Bank also had burden-sharing concerns. Eventually, both institutions did undertake lending for financial sector restructuring, using the SMP as the basis for the signal on the macroeconomic framework.
- Despite these initial concerns about the role of the SMP, it does appear to have played a useful role in the case of Jamaica—allowing some room for maneuver to combine a strong domestic policy formulation process with a healthier policy dialogue with the IMF. Fund staff expressed the view that the authorities became more receptive to a discussion on alternative policy mixes—within their own overall framework—once the SMP route became an option, and the authorities have also indicated that they found the approach useful. The point is not that the SMP as an instrument necessarily had any major advantages over a lending arrangement. Although the IMF did have initial reservations about the authorities’ approach, these reservations diminished, and the IMF might have been willing to agree a lending arrangement in support of the authorities’ program rather than a SMP. But in this case a SMP did provide an alternative approach to signaling on the “seal of approval”, more acceptable to the authorities, and hence more likely to foster ownership.

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<sup>17</sup> Jamaica reached 7 rescheduling agreements with the Paris Club between 1984 and 1993.