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February 25, 1987

To: Members of the Executive Board

From: The Secretary

Subject: External Adjustment, Financing and Growth - Issues in  
Conditionality

Attached for consideration by the Executive Directors is a paper reviewing the Fund experience with adjustment programs supported by stand-by and extended arrangements, as well as the guidelines on conditionality. A draft decision appears on page 30.

Mr. G. G. Johnson (ext. 8779) is available to answer technical or factual questions relating to this paper prior to the Board discussion, which is scheduled for Monday, March 23, 1987.

Att: (1)

External Adjustment, Financing and Growth:  
Issues in Conditionality

Prepared by the Exchange and Trade Relations Department

(In consultation with other departments)

Approved by C. David Finch

February 23, 1987

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## I. Introduction

This paper, together with two forthcoming background reports, 1/ is the seventh of the studies of the experience with adjustment programs supported by stand-by arrangements called for in Guideline 12 of the 1979 Guidelines on Conditionality, which states that: "The staff will from time to time prepare, for review by the Executive Board, studies of programs supported by stand-by arrangements in order to evaluate and compare the appropriateness of the programs, the effectiveness of the policy instruments, the observance of the programs, and the results achieved. Such reviews will enable the Executive Board to determine when it may be appropriate to have the next comprehensive review of conditionality." 2/ Beginning with the 1982 report, these studies have also covered the experience with programs supported by the extended Fund facility, and thus have also served as a basis for the Executive Board's reviews of the decision establishing that facility. In the Executive Board's discussions of previous studies, Executive Directors have noted the evolution over time of the practices of conditionality, but have concluded that the 1979 guidelines continued to provide a satisfactory and sufficiently flexible basis for the Fund's policies on the use of its resources.

The present paper addresses a range of policy issues that emerge from the adjustment experience, described in the accompanying papers, of the countries for which stand-by or extended arrangements went into effect in 1983. Besides their strictly economic aspects, these issues also underscore the importance of political considerations. They will be examined under four broad headings. Following this introductory section, Section II briefly reviews the experience of the sample countries with respect to progress towards external viability and considers consequent issues in the design and implementation of adjustment programs. Section III considers issues associated with the prominent role the Fund has played since 1983 in coordinating external financing for countries undertaking adjustment. Given the strong role that external adjustment plays in maintaining or renewing economic growth, Section IV examines a number of issues from that vantage point. As recently as last December, the Executive Board considered

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1/ "External Adjustment and Growth in Fund-Supported Programs--Recent Experience"; and "Program Monitoring--Recent Experience." (Referred to hereafter as Background Papers on, respectively, Adjustment and Monitoring.)

2/ The Guidelines, which were adopted in March 1979 following a comprehensive review of conditionality, are reproduced in Appendix I. Past studies are listed in Appendix II.

issues in program monitoring, <sup>1/</sup> and Section V provides a further examination of some of those issues. Section VI summarizes recent experience with the extended Fund facility. Lastly, Section VII provides a summary and identifies topics for discussion, and the paper concludes with a proposed decision.

## II. External Adjustment <sup>2/</sup>

### 1. Experience of countries for which arrangements went into effect in 1983

The 34 countries that undertook Fund-supported adjustment programs in 1983 (see Table 1) started from an exceptionally adverse set of initial conditions. By 1983 most of the non-fuel exporting countries had faced several years of declining terms of trade, slow growth in their principal foreign markets, and rising real interest rates. Many of the poorer countries, moreover, were experiencing drought or other natural disasters. With the debt service payments difficulties that had developed in the course of 1982, most countries heavily dependent on bank lending were experiencing a sharp cutback in the availability of credit. For the poorer countries that had been dependent on concessional aid and other official credit, the flow of resources was increasing slowly, if at all.

The magnitude of adjustment required had its roots in the environment of global inflation that had prevailed in the 1970s. During much of that period, many developing countries had experienced a strong market for commodity exports, which had in some cases led to the adoption of strongly expansionary policies. These had been facilitated by the ready availability of external finance, particularly from the growing international capital markets, at low real interest rates. As finance had continued to be readily available into the early 1980s, many countries had postponed, for a time, the adjustment required to deal with the progressively less favorable external environment, and their external debt had continued to increase at an unsustainable rate. As time went by, however, the scope to postpone adjustment became progressively limited and the need to begin adjustment efforts was recognized by an increasing number of countries, including most of the major debtor countries.

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<sup>1/</sup> EBM/86/91, 12/3/86, which considered "Program Design and Performance Criteria," EBS/86/211, 9/8/86; "Program Design and Performance Criteria--Supplementary Information," Supplement 1, 9/11/86; "Program Design and Performance Criteria - Automatic Adjustments in Response to Developments in Commodity Prices and Economic Growth," Supplement 2, 11/11/86.

<sup>2/</sup> More detailed discussion of the experience with external adjustment may be found in the Background Paper on Adjustment, Part A.

Table 1. Countries for which Upper Credit Tranche Stand-By and Extended Arrangements went into Effect in 1983: Adjustment Programs, 1983-86 1/

	1983	1984	1985	1986
Argentina	SBA	SBA <u>2/</u>	*	*
Bangladesh	SBA		SBA	*
Brazil	EFF	*		
Central African Republic	SBA	SBA	SBA <u>3/</u>	*
Chile	SBA <u>3/</u>	*	EFF <u>3/</u>	*
Dominican Republic	EFF		SBA	
Ecuador	SBA		SBA	SBA
Ghana	SBA	SBA	*	SBA
Guatemala	SBA			
Haiti	SBA <u>3/</u>			
Kenya	SBA <u>3/</u>	*	SBA	
Korea	SBA <u>3/</u>	*	SBA <u>3/</u>	*
Liberia	SBA	SBA <u>3/</u>		
Malawi	EFF	*	*	
Mali	SBA <u>3/</u>	*	SBA	*
Mauritius	SBA		SBA <u>3/</u>	*
Mexico	EFF	*	*	SBA
Morocco	SBA <u>3/</u>	*	SBA <u>3/</u>	SBA
Niger	SBA	SBA	SBA	SBA
Panama	SBA <u>3/</u>	*	SBA <u>3/</u>	*
Philippines	SBA	SBA <u>3/</u>	*	SBA <u>3/</u>
Portugal	SBA	*		
Senegal	SBA	*	SBA <u>3/</u>	SBA
Solomon Islands	SBA			
Sri Lanka	SBA			
Sudan	SBA	SBA		
Togo	SBA	SBA	SBA	SBA <u>3/</u>
Turkey	SBA	SBA		
Uganda	SBA			
Uruguay	SBA <u>3/</u>		SBA <u>3/</u>	*
Western Samoa	SBA	SBA	*	
Zaire	SBA	*	SBA	SBA <u>3/</u>
Zambia	SBA	SBA <u>3/</u>		SBA <u>3/</u>
Zimbabwe	SBA <u>3/</u>			

Source: Background paper.

1/ An asterisk indicates an economic and financial program approved under an existing arrangement. Grenada is excluded from the sample because its 1983 extended arrangement was canceled only five months after its entry into effect.

2/ Approved on December 28, 1984, originally to expire on March 27, 1986; extended to May 31, 1986 and to June 30, 1986.

3/ Intended duration of 18 months or more.

The immediate need was in most cases to adopt measures to reduce current account deficits and to arrange for financing that would permit the reduction to take place in an orderly fashion. Thus for the 34 countries for which Fund arrangements went into effect in 1983, the median current account deficit declined from almost 10 percent of GDP in 1982 to less than half that level in 1984. 1/ As even the latter figure was higher than could be spontaneously financed, coordinated financing, in which the Fund and its arrangements also played a key role, was an essential aspect of the adjustment process, as is discussed in the next section.

Beyond the immediate need for prompt reduction of current account deficits and for securing their orderly financing, the adjustment programs for these countries also needed to envisage sustained progress toward balance of payments viability 2/ over the medium term. 3/ At the present time, as discussed in the Background Paper on Adjustment, seven of the 1983 arrangement countries appear to be relatively close to reaching viability. 4/ Twenty-one other countries are somewhat further from achieving viability, but appear to be on track to achieving it within, say, five years; in a few instances, however, this would require major further shifts in policies. The outlook for six other countries 5/ on present indications is that it may take a still longer period to reach viability; these comprise countries where adjustment efforts appear to have seriously faltered (particularly Liberia and Sudan, both of which have been declared ineligible to use Fund resources) as well as countries for which the needed adjustment is so large that the process may be prolonged beyond five years even with strong efforts and adequate external assistance. Most of these countries have made very little progress since undertaking their 1983 adjustment programs.

These assessments are of course highly judgmental and are subject to change over time. Among the countries that are considered to be close to viability, for example, Turkey's success in combining external adjustment with internal restructuring and a rapid rate of growth was

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1/ Background Paper on Adjustment, Table 2.

2/ "For developing countries, a viable balance of payments typically means a current account deficit that can be financed, on a sustainable basis, by net capital inflows on terms that are compatible with the development and growth prospects of the country and, therefore, with its debt-carrying capacity." (Gutián, Manuel, Fund Conditionality: Evolution of Principles and Practices, IMF Pamphlet No. 38, 1981).

3/ The "medium term" has usually been associated with the repurchase period for the Fund's general resources. In the difficult circumstances of the 1980s it has been recognized that envisaged periods of adjustment needed to be lengthened. (See "Fund Policies for Adjustment Under Current Conditions," EBS/80/146, 6/30/80.)

4/ Bangladesh, Korea, Mauritius, Portugal, Togo, Turkey, and Uruguay.

5/ Haiti, Liberia, Sudan, Uganda, Zaire, and Zambia.

praised at the recent conclusion of the 1986 Article IV consultation, but the need for adhering to the adjustment effort was also emphasized. 1/ Togo, another country in this group, is currently experiencing terms of trade deterioration as well as appreciation of the currency it shares with other countries, so that attention to the strength of adjustment policies is needed. Among countries that have been placed in the middle group, Morocco in the past has encountered difficulties in program implementation, but has recently entered into a new Fund-supported program that with strong and sustained implementation will involve rapid progress toward viability. Similarly, among the group of countries that still appear to be significantly far from viability, Haiti has very recently embarked on a major adjustment effort that holds the promise of rapid progress; but this effort will need to be sustained to overcome the legacy of many years of economic mismanagement, one sign of which has been problems in remaining current on obligations to the Fund.

While most of these countries have not progressed as rapidly as had been hoped for in 1983, to a considerable extent this can be attributed to an external environment that has not improved to the extent originally foreseen. Terms of trade for most of these countries have remained weak; growth in industrial countries, the principal market for most of the exports of the sample countries, has been neither particularly robust nor sustained; and real interest rates (deflated by export prices) have remained high. Partly in consequence of these developments, financial flows to adjusting countries have remained critically low, and only in a few cases has spontaneous lending by commercial banks reappeared, and then often only on a limited scale.

For many individual countries, moreover, the external environment has in fact deteriorated further since 1983, and this accounts in some cases for the considerable further adjustment that is needed to achieve viability. Fuel exporters (of which there are two in the group of countries under review) are the most obvious examples, but the situation of some producers of other primary commodities (such as copper in the cases of Zaire and Zambia) is also extremely unfavorable.

The 1983 arrangement countries varied not only with respect to their external circumstances but also with respect to their level of development. The six countries considered to still remain a considerable distance from viability have low incomes, 2/ while all but two of the seven countries for which viability is relatively close to being attained are among the developing countries with the highest income levels. To a substantial extent these differences reflect the fact that middle-income countries, with their more diversified

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1/ SUR/87/10, 2/4/87.

2/ All are eligible for the SAF.

economies, often have a greater capacity to adjust promptly. <sup>1/</sup> In the cases of Brazil and Mexico, for example, the improvement in their current account positions took place substantially faster than had been envisaged at the start of the adjustment program, though in both cases there have since been setbacks. In these and some other instances, such as Argentina, it is considered that the potential capacity of the economy to adjust, if implementation of appropriate policies is sustained, would permit the attainment of external viability within, at most, a few years.

While the large differences in both external environment and initial resource endowment among the 1983 arrangement countries have had major effects on the progress they have made toward balance of payments viability, examination of their specific adjustment experiences indicates that differences in the design and particularly in the implementation of adjustment programs have also been important factors.

## 2. Program design <sup>2/</sup>

Issues in program design may generally be expressed in terms of the relationship between adjustment objectives and the instruments to be used in attaining those objectives. Given the international character of the Fund's responsibilities, the particular focus of the Fund's support is the objective of balance of payments viability. Considerations relating to other objectives of adjustment programs, most particularly growth, are set out in Section IV, which notes that perseverance in program implementation may be endangered by a lack of progress with respect to growth and other domestic objectives.

### a. Evolution of current account objectives

A key aspect of the design of Fund-supported adjustment programs is a determination of the current account deficit that, in the medium term, appears to be consistent with efficient use of the external financing

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<sup>1/</sup> In this connection, it may be noted that the aggregate current account balance of the "market borrowers"--largely countries with relatively high income levels--shifted from a deficit in 1982 equivalent to over 20 percent of exports of goods and services to a surplus of 2 percent in 1985. In contrast, the deficit of official borrowers--which did not, of course, face such an abrupt reduction in the availability of external resources in 1983--declined over the same period by only 2 percent of exports of goods and services, from an initial level of 30 percent (World Economic Outlook, October 1986, Table A35).

<sup>2/</sup> The discussion here relates to broad issues that have arisen in recent adjustment programs. For a review of specific issues related to such questions as the choice of policy instruments, see "Theoretical Aspects of the Design of Fund-Supported Adjustment Programs," (SM/86/162, 7/2/86).

expected to be available. The scale of reduction in current account deficits required for the 1983 arrangement countries implied that to reach external viability, adjustment efforts would have to be sustained over a number of years. This was associated with a sharper focus on medium-term considerations in the design of Fund programs, as evident since 1983 in the inclusion of medium-term scenarios in analyses of proposed adjustment programs. <sup>1/</sup> The scenarios initially developed in 1983 and 1984 were predicated on improvements in the external environment which, for most countries, have not materialized. Meanwhile, for some countries, debt and external payments problems have increased. The willingness of commercial banks to provide external financing has continued to be limited, and fiscal concerns in industrial countries have kept the availability of finance from official sources below original expectations as well. The determination of the levels of current account deficits that can be considered viable thus remains an issue, particularly when the availability and terms of financing are not consistent with expectations at the time the adjustment efforts began.

Under the circumstances of recent years, it has often proved necessary to progressively reduce the level of the current account deficit specified as a medium-term target in successive programs, and even within program periods. In some of the cases where progress has been disappointing, moreover, it has proved difficult to adapt the strength and mix of adjustment policies commensurately. To the extent that these aspects of program design have been important, therefore, it is not surprising that even after three or more years of adjustment efforts a number of the countries under review remain a considerable distance from viability.

b. Policy adequacy

Another question regarding program design is whether the policies specified were adequate to the achievement of program objectives. In some instances, analytical or empirical problems rendered the design difficult--for example, the response of export diversification to program policies was often different from what had been expected, though not always in a negative direction. <sup>2/</sup> A different type of problem has arisen when the stated program objectives, originally predicated on a certain stance of policies, were left unchanged even though the policies actually incorporated in the program turned out to be significantly weaker, at times because of the urgency of finalizing program negotiations to facilitate the completion of the required concerted

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<sup>1/</sup> Appendix IV of the Background Paper on Adjustment notes some aspects of the methodology of medium-term scenarios.

<sup>2/</sup> A related issue concerns the specification of assumptions on exogenous variables. While such assumptions always involve judgment and can be expected to vary from case to case, in a few instances attainment of current account objectives could not have been expected unless exogenous developments turned out to be very favorable indeed.

financing package. To the extent that the objectives of the program were not correspondingly modified, the design became inconsistent. Yet another problem in this area relates to the quality and strength of the policies specified, with the actual measures in some key domains, such as fiscal policy, sometimes being more in the nature of "quick fixes" than the fundamental improvements needed to achieve the objectives.

c. Adjustment strategy

While adjustment policies are inherently difficult to implement, the policy paths specified in certain types of program design are slower to yield fundamental improvements than others, so that they become more vulnerable to adverse exogenous developments and more difficult to sustain.

One aspect of this question is the mix of policies. Demand management policies, which are essential to bring domestic demand to sustainable levels, often lead to domestic pressures to relax the adjustment effort particularly if, because of inadequate attention to efficiency and supply expansion, they are perceived as the cause of recession. Aside from its external adjustment aspect, this issue is intimately related to the question of growth discussed in Section IV.

A second aspect is the extent to which the design of the program favors a flexible response when exogenous developments turn out to be less favorable than anticipated or when targeted variables respond to policies more slowly than expected. Exchange rate flexibility can be particularly important in this regard. Given the uncertain external environment in which the adjustment efforts of the 1983 arrangement countries have had to be undertaken, it is not surprising that those countries that have followed flexible exchange rate policies (particularly where exchange rate action was envisaged as a quasi-automatic response to reserve declines) have tended to be considerably more successful in achieving their objectives (on both the external current account and the growth fronts) than have others. At the same time, of course, supporting adaptations in other policy areas, less susceptible to quasi-automatic correction, must be pursued for such gains to be consolidated into external viability over the medium term.

A third aspect which entails important issues for consideration is the programmed pace of policy implementation. A strategy of rapid adjustment requires strong measures at an early stage, which can provide a margin for the economy to be in a better position to deal with unexpected adverse developments. If such a strategy is followed, moreover, the inevitably difficult process of adjustment will be over more quickly. Among the 1983 arrangement countries, for example, Portugal exercised strong demand restraint; a relatively short-lived recession ensued, but the overall result was that Portugal achieved external viability and a return to sustainable growth more quickly than most of the other 1983 arrangement countries.

### 3. Policy implementation

Last year's review, which examined the adjustment experience of the 1982 arrangement countries, <sup>1/</sup> focused particularly on the link between implementation of policies and achievement of adjustment objectives. It was clear from the experience that sustained implementation was critical to progress toward viability, although given the adverse external environment even countries that had persevered most strongly still were some distance from achieving their objectives.

The experience of the 1983 arrangement countries again demonstrates the importance of persistence in implementation; further, those countries that have had the best record of implementation do appear to be achieving their adjustment objectives. Only one quarter of the 1983 arrangement countries, however, can be said to have a consistently strong record with respect to implementation, though for most of the others the lapses have not been so great or so lasting as to negate the progress made at other times.

Problems with implementation are hardly surprising, given the adverse external environment and the fact that some of the countries had had difficulties in maintaining external viability even under more propitious circumstances. Nonetheless the experience suggests that one of the most important challenges for Fund conditionality is to find ways of overcoming the obstacles to adjustment posed by lack of sustained implementation. Section V below considers a number of issues in program monitoring that have a bearing on this question.

### 4. Issues for the Fund

The experience of a number of the countries that entered into Fund arrangements in 1983 and that appear to be succeeding in their efforts to achieve viability, as well as that of many others which have made substantial progress in that direction, testifies to the efficacy of their adjustment policies. This result is particularly impressive, given the severe external environment under which it has been achieved. Nonetheless a number of program countries that have accumulated substantial debt to the Fund remain far from external viability--and in fact some may be further from external viability now than they were in 1983. In a few cases, moreover, maintenance of the revolving character of Fund resources is in question. These experiences, though limited, are a matter for concern and, should they become more general, would raise serious issues for the Fund.

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<sup>1/</sup> "Issues in the Implementation of Conditionality: Improving Program Design and Dealing with Prolonged Use," (EBS/85/265, 12/5/85); and "Aspects of Program Design - A Review of the Experience in the 1980s of Countries with Upper Credit Tranche Arrangements Approved in 1982," (EBS/85/277, 12/17/85).

Adjustment programs need to be tailored to the particular circumstances of the countries involved, and it will rarely be the case that, in retrospect, they will appear to have been perfectly designed and implemented. The design of any program, moreover, must be based on assumptions about the future, and clearly the failure of the external environment to improve as expected has been a major factor in the problems a number of countries have had in making progress in adjustment. In this respect it is noteworthy that past reviews of the experience with Fund-supported adjustment programs reported similar difficulties in progress toward viability when exogenous developments turned out less favorably than had been expected. A study of the experience with the Fund arrangements approved in 1973-75 (a difficult period for many developing countries), for example, noted that only one third of the programs reviewed could be deemed to have been broadly successful. <sup>1/</sup> What kept the problems of the other countries contained over the rest of the decade, of course, was the favorable trend of commodity prices and the ready availability of external finance at low real interest rates, although such ready availability of resources at relatively low cost also contributed, as noted earlier, to delays in needed adjustments. Under current circumstances, however, the availability of external finance on an appropriate scale and terms remains a critical issue.

Attention to issues in program design and to strengthening policy implementation, as discussed above, can raise prospects for achievement of external viability and thereby help provide a better safeguard for the revolving character of Fund resources. What always needs to be kept in mind, however, is that the politics of adjustment is often as important as the economics. Some countries are able to move rapidly with the formulation and implementation of adjustment policies, but in other cases time is needed to permit a coherent approach to emerge, and nothing is gained by trying to rush the process. With benefit of hindsight, it appears that in some particularly difficult situations the capacity to implement adjustment policies was not sufficient.

In such cases a question that arises is whether use of the Fund's credit tranche resources is appropriate. In such circumstances, both the Fund and the member might benefit by working toward realistic understandings on a feasible adjustment process based on concessional assistance from donors. Fund support in these circumstances might be based on the provision of technical assistance to help with the process of policy formulation and monitoring, which could be particularly relevant as donors place more emphasis on policy-based assistance.

With some progress by this route, conditions might be created where, for low-income countries, the Fund could provide its own

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<sup>1/</sup> "Experience with Stabilization Programs Supported by Stand-By Arrangements in the Upper Credit Tranches, 1973-75," DM/78/16, 1/28/78.

concessional support through the Structural Adjustment Facility (SAF), which in turn could help to catalyze further concessional flows 1/. Eventually the capacity to carry out the rapid adjustment required for use of nonconcessional resources could emerge.

It should be noted that the issue here is not the level of development, as many countries that rely on concessional aid for their development efforts are in fact in a position to avail themselves of the SAF and, further, the Fund's credit tranche resources when they encounter balance of payments problems. The issue, rather, is whether a process of external adjustment consistent with such use can be expected to be sustained. For example, the fact that, among the 1983 arrangement countries, Bangladesh and Togo both appear to be close to achieving balance of payments viability testifies to the appropriateness of their use of credit tranche resources.

### III. Financing

The adjustment experience of members with Fund arrangements that went into effect in 1983 saw significant adaptations in the way balance of payments financing was linked to balance of payments adjustment, which affected both the design of adjustment programs and the mechanisms for providing financial support for them. The Fund's conditionality has always emphasized the need for adjustment to be supported with appropriate financing: financing eases the path of adjustment and, when linked to an adjustment program, provides the member with the assurance required to follow an orderly adjustment process that benefits both the adjusting country and the global economic community. These considerations are reflected in concrete technical links between adjustment and financing. The current account balances programmed for the adjustment period are reflected in a programmed use of foreign exchange reserves and external financing that is consistent with the achievement of balance of payments viability over the medium term.

This section addresses a number of issues that financing difficulties have posed for conditionality since 1983. More general financing issues and specific financing techniques are reviewed in a forthcoming paper on current issues in implementation of the debt strategy and the Fund's relations with creditors.

#### 1. The mix of adjustment and financing since 1983

As was noted in Section II, a major aspect of the need for adjustment by many developing countries in 1983 was an abrupt decline in the availability of commercial bank credit, at a time when fiscal pressures in industrial and capital surplus oil exporting countries were

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1/ A paper reviewing the experience to date with the SAF is shortly to be discussed in the Executive Board.

slowing the rate of increase in aid and official credits. Under the circumstances, it was clear that an early return to spontaneous financing by private creditors could not be expected, and that official support would be spread thin. The magnitude of the current account deficits that prevailed made it difficult to envisage an orderly process of adjustment that would reduce those deficits to the limited levels of prospective financing.

In developing their adjustment programs under these circumstances, countries clearly had to envisage a particularly strong adjustment effort, but there were also implications for the way program design dealt with external financing. Either because of an urgent need to put a Fund arrangement in place (particularly in the case of systemically important countries) or because the difficult circumstances of the time made arranging for debt rescheduling or other forms of coordinated external financing a lengthy process, it sometimes was necessary for an arrangement to go into effect before there was full assurance that an ex ante financing gap would be filled. Consistency in program design called for such an assurance through provision of sufficient additional external financing or further adjustment efforts by the member. This resulted in a number of technical adaptations in the process of approval and monitoring of Fund arrangements, as described below.<sup>1/</sup> It was also associated with the Fund undertaking a major role in coordinating external financing for countries with Fund-supported programs.

## 2. Fund practices for dealing with financing uncertainties

The Fund's technique for dealing with situations where prior actions critical to an adjustment program are not yet in place is to wait for those actions to be put into effect before the request for an arrangement is submitted to the Board for approval. A similar principle has been followed when it was considered critical that the financing envisaged in the program be in place. Two complementary variants on this technique have been developed to deal with the particular uncertainties that have prevailed since 1983: a "critical mass" approach, which, like the prior action technique, withholds Board approval of a request for use of Fund resources until sufficient explicit assurances regarding financial commitments are received from creditors, particularly commercial banks, to provide the Fund with reasonable assurance that the total financing required will be made available; and an "approval in principle" approach which makes the effectiveness of Board approval (rather than the approval itself)

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<sup>1/</sup> These adaptations and other aspects of the Fund's approach to external debt servicing problems were reviewed and endorsed by the Executive Board at EBM/83/58 (4/6/83), which considered a staff report on "Fund Policies and External Debt Servicing Problems" (SM/83/45, 3/8/83). (That meeting also resulted in certain adaptations of the 1979 guidelines on performance criteria with respect to foreign borrowing.)

dependent on securing the requisite assurances. 1/ The critical mass technique has been used in 13 of the arrangements reviewed (for 8 different countries) while approval in principle has applied to 9 of them (for 7 different countries). 2/

In the past, the formulation of a policy response to unexpected developments in the course of an adjustment program was dealt with through new understandings reached in the course of developing a request for waiver or modification of performance criteria affected by the developments. Since 1979, however, Conditionality Guideline 10 has provided for program reviews "in those exceptional cases in which an essential feature of a program cannot be formulated as a performance criterion at the beginning of a program year because of substantial uncertainties concerning major economic trends" 3/ and beginning in 1983 reviews of financing have been incorporated in arrangements to limit the extent of the resources committed until financing uncertainties are cleared up. 4/ The incidence of such reviews, which in many cases also served to establish performance criteria on variables that depended critically on external financing, was discussed extensively in the staff report on program design and performance criteria (EBS/86/211) on the basis of evidence contained in Supplement 1 to that paper.

### 3. Consequences for adjustment

The Fund's role in coordinated financing was crucial to the containment of the debt crisis, and the conditional use of Fund resources was the focal point of that role. Given the magnitude of the financing requirements, the resources the Fund could provide (including borrowed resources) were far short of what was needed. The fact that the Fund was able to coordinate financing from other sources, therefore, made it possible to design programs with an orderly pace of adjustment.

Only a few adjusting countries have regained access to spontaneous lending by commercial banks, and even then on a very limited scale.

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1/ The Executive Board reviewed some of the issues involved in application of "approval in principle" at EBM/84/155 (10/24/84), and concluded that it should be resorted to only in exceptional cases and subject to certain informal guidelines. The staff paper prepared for that review "Approval in Principle of Fund Arrangements" (SM/84/217, 9/25/84) provided an extended review of the treatment of the adequacy of external financing in Fund arrangements.

2/ In all, one or both techniques applied to 19 arrangements for 12 countries (Argentina, Brazil, Chile, Ecuador, Kenya, Mexico, Panama, the Philippines, Senegal, Uruguay, Zaire, and Zambia).

3/ See Appendix I.

4/ Automatic adjustments to performance criteria have also been used in some cases where the implications for the program of small deviations from financing assumptions could be clearly spelled out in advance.

Concessional aid, moreover, remains constrained by fiscal and other domestic problems in donor countries. Coordinated financing has thus continued to be associated with Fund stand-by arrangements. This approach has provided an effective transitional response to the problems confronting member countries. Its continued effectiveness, however, will require that all parties live up to their respective responsibilities, with regard to both adjustment and financing. Regarding the issue of program design, the experience of the 1983 arrangement countries gives rise to a number of observations on how the adjustment process has been affected.

Urgency of developing adjustment programs: The 1983 programs and supporting Fund arrangements were developed in an atmosphere of extreme financial scarcity, and priority had to be given to arranging financing quickly; given the central role of Fund arrangements in that process, adjustment programs had to be put together equally quickly, and in some cases weaknesses developed as a result in program design and initial implementation. In principle this need not have been a critical problem, since there were later opportunities for correcting such weaknesses. But in the event, it has sometimes proved difficult to adapt the thrust and strength of adjustment policies to changing needs and conditions in the context of successive coordinated financing operations. This has reflected the fact that the nature of adjustment programs is such that it often takes time for country authorities to work out an appropriate design (or change in design) and to develop the domestic consensus essential to the adjustment process. When large amounts of financing from other creditors are contingent on approval of the Fund arrangement, however, the dynamics of the situation is such that sufficient time may not be available.

Shortening of policy time horizon: As noted earlier, the overall design of adjustment programs increasingly extends into the medium term. In certain instances, however, financing uncertainties and the use of reviews to set performance criteria have resulted in a shortening of the effective time horizon for policy formulation, and a tendency has developed toward ad hoc responses to current financing problems or other developments under the program.

Complexity of discussions of program design: The close links between the Fund arrangement and the provision of financing by other creditors naturally has meant that the latter are closely interested in the operation of a proposed program and, in particular, the details of it that affect their own financial position. This has sometimes tended to complicate the discussions between the Fund and the country.

Delays: Despite the urgency associated with arranging coordinated financing, problems regarding its availability have sometimes led to delays in approval of requests for arrangements or completion of reviews. While critical mass was quickly achieved in the crisis atmosphere of 1983, it has become more difficult to attain in 1985 and 1986. Delays in completion of reviews due to external financing

difficulties also have occurred but in most cases they have been combined with a lack of policy implementation which would have led to delays in any event. Nonetheless, the result has been some disruption of financial planning, as well as extra workload for the Fund and country authorities, and, on occasion, problems with the implementation of adjustment policies.

#### 4. Issues for conditionality

The consequences of coordinated financing noted above have complicated the process of negotiations but have not, by and large, posed critical problems for conditionality. But there are other issues that carry particular implications for conditionality and for its main purpose, which is to help members achieve balance of payments viability and thereby preserve the revolving character of Fund resources. (Other aspects of the Fund's role in coordinated financing are addressed in the staff report on the debt strategy and the Fund's relations with creditors.)

Preservation of the revolving character of Fund resources is a critical issue for the Fund, and the financial evolution of the Fund's relationship with a number of the countries whose experience is reviewed in these reports sheds some light on how problems have developed. <sup>1/</sup> In cases of coordinated financing, the determination of the adjustment and financing mix assumes an explicitly tripartite character, involving not only the Fund and the country, but also the country's creditors. In such circumstances, it is important for creditors to be supportive of the Fund's emphasis on the achievement of external viability over the medium term. Private creditors may sometimes put greater emphasis on short-run cash flow considerations, in which case it is incumbent on the Fund to persuade such creditors of the importance of adhering to the medium-term objectives. A more critical issue arises with respect to official creditors and donors, which can have a direct influence in determining the policies of the Fund. The support of such countries for the Fund's emphasis on external viability is vital both for adjusting countries and for the safeguard of the revolving character of Fund resources.

The issue for the Fund, for creditors, and for donor countries is that erosion of the revolving character of the Fund's resources threatens the ability of the Fund to assist members in their future adjustment efforts. Access to credit tranche resources thus needs to be limited to situations where use of such resources is consistent with achievement of viability over the medium term, the assessment of which takes into account sustainable financial flows expected from other sources, including concessional aid. As noted in Section II, however,

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<sup>1/</sup> A number of the countries under review have had repeated problems in remaining current with the Fund, and in two instances the problems have become so severe as to result in ineligibility.

in some instances time may be required for a strategy to emerge that is consistent with domestic political realities. Until such a strategy does emerge, the provision of nonconcessional resources, including those of the Fund's credit tranches, may only serve to increase the magnitude of the adjustment problem.

#### IV. Economic Growth

Helping members to achieve and maintain a high rate of economic growth has always been a major objective of the Fund's conditionality. Article I notes that the Fund's purpose in making general resources available to members "temporarily . . . under adequate safeguards" is "to give confidence to members . . . thus providing them with opportunity to correct maladjustments in their balance of payments without resorting to measures destructive of national or international prosperity." <sup>1/</sup> In recent years, however, some countries' efforts at balance of payments adjustment have been associated with prolonged periods of economic stagnation or decline, and this has led to increasing attention to the growth objective in discussions of the Fund's conditionality. A review of the experience of the 1983 arrangement countries in achieving growth in the context of external adjustment is included in one of the background papers to this study, which also discusses the basic elements of growth-oriented adjustment strategies. <sup>2/</sup> The present paper draws on this background to examine some of the conceptual issues posed for conditionality when the growth objective is highlighted.

##### 1. Objectives of Fund-supported adjustment programs

Adjustment programs have a variety of objectives, and the importance attached to particular objectives varies from country to country. When the Fund supports a member's program by making its general resources available, however, the Fund is required by its Articles of Agreement (Article V, Section 3(a)) to emphasize the objective of assisting members "to solve their balance of payments problems in a manner consistent with this Agreement and that will establish adequate safeguards for the temporary use of the general resources of the Fund." This objective stresses the external aspects of the member's adjustment program, in particular the achievement of medium-term balance of payments viability. Once satisfied that the member's program can be expected to achieve this objective, the Fund has been prepared to support the program, providing the member with ample latitude regarding both the priority given to other objectives, and the policy instruments employed. This reflects the Fund's long-standing

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<sup>1/</sup> See Article I, paragraph (v), in the Articles of Agreement.

<sup>2/</sup> "Fund-Supported Adjustment Programs and Economic Growth" (IMF Occasional Paper No. 41, November 1985) provides a wide survey of the literature on this subject.

emphasis on the need "to pay due regard to the domestic social and political objectives, the economic priorities, and the circumstances of members including the causes of their balance of payments problems." 1/ This has not meant that the Fund is indifferent to the other objectives or to the instruments employed. Indeed, growth has generally been sought in the adjustment process, but growth-oriented policies may not always have appeared to country authorities as compatible with attainment of other domestic objectives such as those regarding income distribution 2/; they may also have involved allocative mechanisms that differed from those preferred by the authorities; or they may have evoked severe resistance from particular interest groups. In those cases, the Fund has relied on the authorities' judgment as long as the program remained consistent with the achievement of balance of payments viability. The only exception to this principle has been to rule out the use of new or intensified exchange restrictions except on a temporary basis, as the elimination of restrictions is one of the purposes of the Fund (Article I, paragraph iv).

## 2. Links between external adjustment and growth

The extent to which external adjustment benefits growth, which is discussed in detail in the background paper, depends on the efficiency of the adjustment strategy chosen--that is, the extent to which it moves the economy toward its production frontier--and, in the medium term, the extent to which it contributes to increases in the productive capacity of the economy. Efficient adjustment, by definition, implies optimal utilization of resources during the adjustment process, and thus sets growth on a sound path during the adjustment period. At any point in time, however, trade-offs can arise between "growth today" and "growth tomorrow", and the choice of the exact policy path chosen will depend on the characteristics of this trade-off.

In general, the basic policy instruments of external adjustment are also critical for growth: demand-management policies, as well as any necessary action on the exchange rate and related prices, are conducive to the productive use of resources. Over the medium term, the key issues are the mobilization of domestic savings and external resources, and the rate of return on investment relative to the cost of those resources. In this connection, a critical question is how adjustment is achieved: policies that increase savings are clearly more favorable to

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1/ Guideline 4 (see Appendix I). Earlier references to this precept can be found in, for example, "Fund Policy with Respect to the Use of its Resources and Stand-By Arrangements." (SM/68/128, 7/23/68, p. 8).

2/ A frequent issue in this regard, for example, is the fact that rationalization of agricultural prices, while benefiting the rural poor and promoting growth, may have the short-run effect (until growth efforts are fully realized) of lowering urban real incomes.

growth than those which, in the short run, reduce investment. 1/ (Over the medium term, viability will, in any case, permit a higher level of sustainable investment.) Structural reforms in restrictive systems, domestic allocative mechanisms, and public sector activity are also important for the productivity of investment and the attainment of higher growth.

Beyond the issues of the range of policy instruments to be used in growth-oriented adjustment, the issues discussed in Section II with respect to external adjustment are also critical for growth. Attention thus needs to be given to the strength, the mix, and the pace of implementation of policies.

### 3. Conditionality and growth

As noted in the background paper, the experience with growth under Fund-supported adjustment programs has been considerably more positive than it is sometimes perceived to be, but many of the programs supported by the Fund may not have been as favorable to growth (or to external adjustment, for that matter) as they could have been. The question for the Fund is whether in the exercise of conditionality, it should insist on stronger and more specific measures as well as on more determined implementation of policies required to improve growth and balance of payments performance. As noted above, insistence on growth-oriented policies may be perceived to be in conflict with members' other domestic social and political objectives, and therefore, it could raise issues in the context of Conditionality Guideline No. 4, which calls for due regard to be paid by the Fund to those objectives. If specific performance criteria were to be involved in this process, moreover, issues would also arise regarding Guideline No. 9, which calls for normally confining such criteria to macroeconomic variables. 2/ The arguments for a more active role for Fund conditionality thus need to be considered carefully.

One argument is that the Fund's purposes imply a need for growth-oriented adjustment. Since virtually all members in fact wish to raise their growth rate, it could be argued that in the interest of both the member and the global economy the Fund should emphasize a growth-oriented approach. There are obviously limits to the extent to which the Fund can insist upon a country acting in what the Fund perceives to be the country's own best interest. But there is also a specific issue concerning the Fund's right to insist on policy actions (other than those that fall within the institution's jurisdictional sphere, such as exchange restrictions), even on grounds of their global implications. Such a stance would be particularly difficult to sustain in the absence

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1/ Although it must be noted that cuts in investment in projects with low rates of return may not be inimical to growth.

2/ As well as those necessary to implement specific provisions of the Articles or policies under them (see Appendix I).

of better success of surveillance in persuading other countries to correct features of their economies that damage the prospects for adjusting countries, such as large fiscal deficits, structural impediments to growth and, above all, barriers to imports from adjusting countries.

A more powerful argument for conditionality to include growth as a direct objective is that without such an approach medium-term viability (and the revolving character of Fund resources) may be elusive. One aspect of this concern is adjustment fatigue--problems in sustaining implementation. <sup>1/</sup> While putting together a comprehensive policy package for rapid and efficient balance of payments adjustment may be difficult politically, so is sustaining policies through a long period of slow growth and gradual adjustment. There is thus a question of whether viability can be attained without a more growth-oriented approach.

There is also a question as to whether the situation of a country that has managed to contain its balance of payments problems, but whose economy is still characterized by severe restrictions on external transactions, can be said to represent viability. Aside from the fact that elaborate restrictive systems remain a permanent impediment to efficiency and growth, their continuing existence means that emerging balance of payments problems may be masked for a time, and when a policy shift is eventually required a likely initial response is to increase the restrictiveness of the system. This implies not only that the eventual adjustment requirement will be larger than would otherwise have been the case, but also that the overall adjustment process will be less efficient, and hence less growth-oriented.

#### 4. Growth-oriented adjustment and financing: the role of the Fund

The issues discussed above will be developed further in a forthcoming staff paper on the monitoring of structural adjustment, which will also consider the relative merits of various growth-oriented adjustment strategies and the role that can be played by particular policy instruments. In the present context, the issues to be focused on are the same as those addressed in previous sections: the role of conditionality in adjustment and financing.

The discussion in subsection 2 above, as amplified in the background paper, deals with a number of technical considerations

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<sup>1/</sup> This problem has long been recognized. "Conditionality in the Upper Credit Tranches" (SM/78/103, 4/19/78, p.3), argued that in the case of export stagnation, there needed to be a reorientation toward sustained trade-oriented growth: "In the absence of an improvement in the growth prospects for the economy, political and social pressures will in the course of time cause a reversal of these policies with the result that the task of eventual correction may become formidable."

related to the attainment of growth in a context of external adjustment. As with external adjustment as such, however, a critical issue is the fact that implementation of a growth-oriented strategy is at bottom a political issue. Because of the necessary focus of such a strategy on efficiency, even more is required in the way of far-reaching and determined policies than would be needed if external adjustment were the only consideration. The experience described in the Background Paper on Adjustment indicates that some countries have been able to begin dealing with such sensitive issues as, for example, the efficiency of public enterprises, but many others are clearly some distance from being able to do so. In such situations, it will be particularly important for the Fund to maintain its focus on the basic policy issues that are critical not only for growth, but also for external viability, and consequently for the revolving character of Fund resources.

Similarly, the critical role of financing needs to be borne in mind. Under conditions of efficiency, the important factor for growth is the amount of resources available, much of which can come from domestic sources, if there is an appropriate stance of macroeconomic policies. All developing countries also need external resources, which are critical for the poorest countries; but these must be on a scale and terms consistent with the capacity of the country to absorb and service them.

#### V. Program Monitoring

At its December 1986 discussion of Program Design and Performance Criteria, 1/ the Executive Board addressed a number of issues that have arisen in program monitoring. This section provides additional material on some of those issues, based on recent experience as described in the Background Paper on Monitoring. The latter includes a detailed examination of program monitoring in the arrangements since 1983 for the countries whose adjustment experience is reviewed in these reports.

##### 1. Link between adjustment performance and purchases under arrangements

The monitoring of adjustment programs is an essential aspect of the Fund's support for members' efforts to achieve balance of payments viability. All monitoring techniques, including those that do not involve direct links to purchases (such as consultation clauses and reviews that refer to, among other things, developments in indicative targets and intermediate variables), help to provide a coherent

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1/ EBM/86/190-191 (12/3/86), based on EBS/86/211 (9/8/86), Supplement 1 (9/22/86) and Supplement 2 (11/11/86). Supplement 1 provided a summary of trends to the specification of performance criteria and a detailed description of the criteria in individual arrangements since adoption of the Guidelines on Conditionality in 1979.

framework for policy action and can trigger a reappraisal of the adjustment program when it does not appear to be going according to plan in terms of specific actions taken or not taken, or in terms of the behavior of specific key indicators. Key monitoring techniques also establish links between implementation of the member's adjustment program and the disbursement of resources committed by the Fund under the arrangement it grants in support of the member's program. Such links provide specific encouragement for members to take the necessary policy actions, and in the last analysis serve to protect the revolving character of Fund resources by limiting the extent to which purchases can take place in the event of difficulties with the program. Thus it is to be expected that there would be a strong correlation between, on the one hand, the extent of purchases under Fund arrangements and, on the other, progress in adjustment.

Table 2 summarizes, for the first and third groups of 1983 arrangement countries defined in Section II, the circumstances under which purchases were made in relation to the total amounts committed by the Fund. <sup>1/</sup> The first group comprises countries that are judged to be close to achieving external viability. Most of these countries were relatively consistent in their implementation of adjustment policies. By contrast, all the countries in the other group, for which viability is judged still to be more than five years away, were relatively weak in terms of sustained policy implementation. While the data in the table are subject to a number of qualifications in individual cases <sup>2/</sup>, they nonetheless highlight some important issues in program monitoring.

The most significant statistics appear in the last line, cumulative gross purchases under arrangements approved since 1983. While the first group appropriately has made larger purchases than the second, even the latter has been able to make purchases that have cumulated to almost 100 percent of quota. More than one third of this amount consisted of initial purchases made upon approval of arrangements (see line 1), which raises the issue of whether in some cases stronger prior actions were needed to provide an adequate start for the program.

A further comparison is provided by line 2, which indicates the extent to which committed resources were purchased on the basis of timely completion of reviews (i.e., without the delays that may result from a need to resolve major policy differences) or observance of performance criteria as originally specified. The fact that the second

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<sup>1/</sup> Note that the middle group of countries, for which viability has not yet been achieved but is thought likely to be attained within five years, includes countries that have made considerable progress in dealing with very large adjustment problems, as well as countries with lesser problems that made relatively little progress under their Fund-supported programs. Aggregate data therefore have little to reveal about the efficacy of program monitoring in this group.

<sup>2/</sup> See Section II of the Background Paper on Monitoring.

Table 2. Circumstances of Purchases Under Fund Arrangements

(Average for arrangements since 1983  
in percent of amounts committed)

	Country group 1/	
	Close to viability	More than 5 years from viability
1. On approval	19.3	21.7
2. Purchases on schedule, without waiver or modification.	31.9	17.0
After review concluded on time	(7.4)	(7.9)
After performance criteria met <u>2/</u>	(24.7)	(9.0)
3. Purchases following waiver, modification, or seriously delayed review	24.3	17.0
4. Amount undrawn <u>3/</u>	18.4	38.4
Memorandum items:		
5. Number of countries	7	6
6. Arrangements per country	2.0	2.0
7. Cumulative gross purchases under the 1983 and subsequent arrangements (percent of quota)	120.0	90.5

Source: Background Paper on Adjustment.

1/ See Section II.1 for definition of groups.

2/ Excludes purchases also subject to review.

3/ Excludes amounts scheduled to be drawn after December 31, 1986.

group made such purchases equivalent to 17 percent of the total amounts committed partly reflects some relatively brief periods of satisfactory implementation of adjustment policies, but also raises the question of whether some programs should have envisaged more vigorous policy actions, given the need for adjustment.

Line 3, which shows that for both groups there were substantial purchases resulting from waivers and modifications (often, for the first group, of a technical character) or from delayed reviews (generally on account of the need to develop new policies to deal with unforeseen developments), indicates the extent of the need for flexible adaptation of policies as events unfold, particularly amid the uncertainties of recent years. The lower incidence of such purchases for the second group implies that in a number of instances it was not possible to reach new understandings on which to base requests for waivers or modifications, or conclusions of reviews; questions could still be raised as to whether, for this group, those waivers or modifications that were approved and the reviews that were completed did, in fact, reflect an adequate adaptation of policies. 1/

## 2. Prior actions

Prior actions may be defined as any policy steps taken before an arrangement goes into effect, whatever their genesis. They are, of course, all policy decisions taken by the member, with the extent of Fund involvement in the decision varying widely over a range of consultative decision-making. Strictly speaking, it is only actions taken after they have been made preconditions for approval of the agreed programs that are subject to "monitoring". In practice, however, no distinction is made in the way the program is presented to the Executive Board.

Prior actions ensure that the program has a strong beginning and thus generates confidence on the part of the Fund, foreign creditors, and the public that a serious attempt is being made to address the need for adjustment. From the technical point of view, it is difficult to judge, even with benefit of hindsight, whether or not more and stronger prior actions would have helped members better to achieve their objective; although when performance criteria are not met even at the first test date (which, as the background paper notes, was not uncommon in the arrangements with some of the countries that have not made adequate progress toward viability), it suggests that there was a need for earlier and more rigorous policy implementation than was in fact the case. More generally, understandings on the timing of specific measures

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1/ As is noted in the Background Paper on Monitoring, questions regarding the design and monitoring of adjustment programs for the second group of countries appear to apply mainly to some of the 1983 arrangements, and more recent arrangements appear to be stronger in these respects.

are a necessary complement to quantitative performance criteria, since without such understandings it is difficult to evaluate the evolution of the intermediate variables that are monitored by such criteria.

### 3. Specification of performance criteria

At the December Board meeting, there was considerable discussion of the issue of proliferation of performance criteria. It was noted at the meeting that the increase in the average number of performance criteria in recent years can be accounted for largely by general trends such as the widespread practice of mandatory reviews, the general application of external debt ceilings, and the increasing incidence of arrears. While the increase is explicable in these terms, the fact remains that the desirable features of performance criteria set out in EBS/86/211 favor small, not large, numbers of performance criteria. A large number of performance criteria, moreover, does not necessarily ensure progress under an arrangement, for a variety of reasons. In some cases important specific policy measures to be taken during the program period are subject to performance criteria, when ideally they would have been taken as prior actions. In other cases, performance criteria are added because of observed weaknesses in previous programs. A not uncommon example in recent years applies where policy measures taken have not been sufficient to meet a ceiling on credit to government, so that an attempt to meet the ceiling through postponing payments gives rise to government arrears. Subsequent arrangements have thus included a performance criterion on government arrears, where feasible, but if the basic policy measures required are still not implemented, the program outcome will be no more favorable (though the additional criterion may serve to interrupt purchases in that case). A similar issue arises in cases where institutional complexities and rigidities (perhaps reflecting past efforts to contain the consequences of inadequate policies) make it necessary to specify program paths for a number of component variables, rather than an aggregate variable.

A second issue regarding performance criteria is the horizon for which they are specified. Ideally, they should be specified for the whole of the members' basic annual policy period, but because of the prevailing uncertainties in recent years, particularly with respect to external financing, the average period for which they are specified has been shortened considerably. This has been a way of dealing with major uncertainties affecting coherent adjustment programs, but it has sometimes developed into a process that has tended to divide the negotiations into a variety of stages, which has not always helped the outcome and has sometimes led to policy formulation that has taken the form of ad hoc responses to the latest economic events.

### 4. Waivers and modifications

The data reported in Table 2 indicate an important consideration regarding waivers and modifications--that they need not be a sign of problems in a country's implementation of policies. In fact the

particular strong performers in the first group of countries made more purchases based on waivers or modifications than did those countries whose record was characterized by serious difficulties in adjustment. Thus the fact that, as noted in the background paper, the incidence of waivers and modifications for the sample countries is more than double that recorded previously <sup>1/</sup> is not in itself a sign of increasing policy problems, but rather is indicative of the pervasive uncertainty, particularly regarding financing, with which adjustment programs have had to cope since 1983.

Two thirds of the waivers and modifications granted in the recent period are of a largely technical character or are related to temporary financing problems. Waivers and modifications have also reflected more substantive policy adaptations in response either to unforeseen weakness of program design (where the policy measures in the program were not sufficient for the performance criteria to be observed) or to difficulties in implementing program policies. In some instances, however, continuing adjustment problems after approval of waivers or modifications suggest that a sufficiently comprehensive view of the adverse implications of slippages in particular areas for the policy program as a whole was lacking.

#### 5. Reviews

Much of the December Board discussion focused on the issue of mandatory midyear program reviews. While reviews have been an essential aspect of the Fund's response to the financial and other uncertainties, it was suggested in the December meeting that too high an incidence of planned reviews could shorten the focus of policy planning and could also result in differing expectations of the Fund and the member regarding the policy path to be followed for the later segments of the program. Thus, while delays in reviews because of financing problems can pose difficulties for adjustment, as noted in section III, a more pervasive problem has been the difficulties experienced in reaching understandings on policies for periods following reviews.

At the December Board meeting it was suggested that in some cases review papers could be presented to the Board for lapse-of-time approval. Such a procedure could be appropriate where a review is limited to, say, the adequacy of financing, and has concluded that financing is in fact adequate, so that no strengthening of policies is required. It could also be appropriate where any new understandings on policies do not involve setting performance criteria, proposing waivers or modifications, or, more generally, establishing new directions for policies.

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<sup>1/</sup> In "Waivers and Modifications of Performance Criteria in Upper Credit Tranche Arrangements--Fund Experience, 1964-80," (EBS/81/70, 3/23/81).

## VI. Review of Extended Fund Facility

The decision establishing the extended Fund facility (Decision No. 4377-(74/144) as amended by Decision Nos. 6339-(79/179) and 6830-(81/65)) noted that the special circumstances in which use of the facility could be considered include those of a member suffering serious payments imbalances relating to structural maladjustments in production and trade, where price and cost distortions have been widespread and where it is expected that the needed improvement in the balance of payments can only be achieved in an extended period. Programs under the facility must contain policy measures for mobilizing resources and improving their utilization, and for reducing reliance on external restrictions.

Since 1980, extended arrangements have been approved for ten of the countries whose recent adjustment experience is reviewed in the present papers. Except for the 1985 arrangement with Chile, all of these arrangements have been canceled or have expired with, in most cases, a substantial undrawn balance. In six of these instances 1/ overall developments were not in accordance with the targets envisaged and the programs went off track within the first year. Given that the original program targets were no longer attainable, and with the inadequate track record of sustained policy implementation, these extended arrangements were subsequently replaced by stand-by arrangements.

In three other cases 2/, considerable progress was achieved in the first two years, but the arrangements became effectively inoperative in the third year for a variety of reasons, including slippages in policies and changes in the external environment which made the original objectives unattainable. In the case of Chile, its 1985 extended arrangement followed satisfactory policy implementation under an earlier stand-by arrangement, and to date has remained operative.

The provisions of the extended Fund facility appear to remain appropriate for dealing with problems of a structural nature, and, given the importance currently being attached to structural adjustment, such arrangements potentially have a significant role to play. An important consideration for approval of extended arrangements, however, is the member's capacity for sustained policy implementation. Another key consideration is that such arrangements can only be feasible when the nature and the time frame of corrective policies over the medium term can be clearly specified in advance and can be expected to remain broadly appropriate for the life of the arrangement.

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1/ Bangladesh (1980), Dominican Republic (1983), Morocco (1981), Senegal (1980), Zaire (1981), and Zambia (1981).

2/ Brazil (1983), Malawi (1983), and Mexico (1983).

## VII. Summary and Topics for Discussion

### 1. Summary

This study of the experience with Fund-supported adjustment programs has focused on the experience to date of the countries for which upper credit tranche stand-by or extended arrangements went into effect in 1983. The programs supported by these arrangements were developed against the background of the debt crisis of 1982-83, and thus needed to deal not only with a difficult and uncertain environment for current account adjustment, but also with a major cutback in the availability of external finance, particularly for many of the countries that had relied heavily on credit from foreign commercial banks.

At the time these programs were designed, there was a general expectation that the external environment would improve over the medium term, but for most countries such improvements have fallen below expectations and for some others there has been a further deterioration. Against this background, the achievement of external viability by a significant number of adjusting countries is impressive, and the progress made by most of the others in that direction is also encouraging. In a number of countries, however, progress has been limited and they appear to be farther from viability now than they were in 1983; indeed, for some the overhang of external debt is now so large that it is difficult to see how viability can ever be achieved without large infusions of concessional aid. In some of these cases the revolving character of Fund resources is currently in question. Against this background, the study has attempted to identify ways in which, in retrospect, the Fund might better have supported the adjustment efforts of its members, particularly those that have had particular difficulties in making progress toward viability.

Besides examining the experience of countries with respect to external adjustment, this study has examined the adaptations in the policies and practices of conditionality that have been associated with the central role the Fund has played since 1983 in coordinating external financing for adjusting countries. As financing shortfalls and the unfavorable external environment have meant that most developing countries have had difficulty maintaining economic growth in recent years, the study has also examined the ways by which programs of external adjustment can help promote economic growth. Other subjects addressed by the study include program monitoring (extending the examination begun with the Executive Board's December 1986 discussion of Program Design and Performance Criteria) and recent experience with the extended Fund facility.

### 2. Topics for discussion

a. There are two broad and interrelated themes on which Directors may wish to focus in their discussion of the issues raised in this paper: first, external adjustment, in all its dimensions, involves

questions of the political will and capacity to develop and implement a coherent strategy as much as it does questions of technical economic relationships; and second, access to Fund resources needs to be addressed to situations where the policies it supports are consistent with achievement of sufficient progress toward balance of payments viability and protection of the revolving character of Fund resources.

b. With respect to external adjustment as such, discussed in Section II, Executive Directors may wish to discuss lessons from the experience regarding:

-- the specification of current account objectives, given the prevailing uncertainties with respect to prospects for financial flows;

-- the need for program design to be consistent with achievement of the external objectives in terms of the strength, the mix, and the pace of implementation of policies, as well as the flexible adaptation of policies in the face of adverse events;

-- the need for persistence in implementation;

-- the need to avoid commitment and disbursement of credit tranche resources where prospects for external adjustment are not compatible with their use, in which case financing needs to be restricted to concessional resources.

c. Section III describes the complexities that coordinated financing has posed for conditionality (such as pressures to complete negotiations, shortening of policy horizons, and delays in disbursements by creditors and associated delays in approvals or reviews of Fund arrangements). While full consideration of the issues raised by coordinated financing will need to await the forthcoming discussion of the debt strategy and the Fund's relations with creditors, on the present occasion Directors may wish to consider the importance of support from creditors and donors that is required for the Fund to maintain its focus on and attain the twin objectives of helping members achieve balance of payments viability and preserving the revolving character of Fund resources.

d. In discussing the growth issues raised in Section IV, Directors may wish to consider, on the one hand, the importance of efficient policies of external adjustment for the achievement of economic growth and, on the other, the contribution that growth-oriented adjustment can make to the achievement of external viability. They may also wish to consider the implications of more directly stressing growth for the pervasiveness and attention to detail involved in the practice of conditionality.

e. With respect to the experience with program monitoring, discussed in Section V and examined in detail in a background paper,

Directors may wish to follow up their December discussion by considering such issues as:

- the importance of prior actions;
- the need to set performance criteria for the whole of the member's basic policy period;
- the usefulness of waivers and modifications in promoting flexible adaptation to unexpected events, provided that they are based on a consistent and comprehensive examination of the whole of the policy package;
- in the same connection, the usefulness of reviews, provided that they do not result in a process of policy-making through ad hoc responses to the latest developments. Directors may also wish to consider the circumstances under which lapse-of-time approval procedures could be appropriate for completion of reviews.

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

1. Pursuant to Decision No. 8192-(86/13), adopted January 27, 1986, the Fund has reviewed the conditionality that the Fund applies for transactions in the upper credit tranches with particular reference to the Fund's experience from recent programs supported by stand-by and extended arrangements from the Fund. In this context, the Fund has also reviewed the provisions of the extended Fund facility and the guidelines on conditionality.
2. The Fund finds that the conditionality of the Fund, including provisions of the extended Fund facility and the guidelines on conditionality, remains appropriate in the present circumstances.
3. The Fund will again review the experience relating to programs supported by stand-by and extended arrangements, and the provisions of the extended Fund facility and the guidelines on conditionality, at an appropriate time pursuant to paragraph 12 of the guidelines on conditionality.

Guidelines on Conditionality

1. Members should be encouraged to adopt corrective measures, which could be supported by use of the Fund's general resources in accordance with the Fund's policies, at an early stage of their balance of payments difficulties or as a precaution against the emergence of such difficulties. The Article IV consultations are among the occasions on which the Fund would be able to discuss with members adjustment programs, including corrective measures, that would enable the Fund to approve a stand-by arrangement.

2. The normal period for a stand-by arrangement will be one year. If, however, a longer period is requested by a member and considered necessary by the Fund to enable the member to implement its adjustment program successfully, the stand-by arrangement may extend beyond the period of one year. This period in appropriate cases may extend up to but not beyond three years.

3. Stand-by arrangements are not international agreements and therefore language having a contractual connotation will be avoided in stand-by arrangements and letters of intent.

4. In helping members to devise adjustment programs, the Fund will pay due regard to the domestic social and political objectives, the economic priorities, and the circumstances of members, including the causes of their balance of payments problems.

5. Appropriate consultation clauses will be incorporated in all stand-by arrangements. Such clauses will include provision for consultation from time to time during the whole period in which the member has outstanding purchases in the upper credit tranches. This provision will apply whether the outstanding purchases were made under a stand-by arrangement or in other transactions in the upper credit tranches.

6. Phasing and performance clauses will be omitted in stand-by arrangements that do not go beyond the first credit tranche. They will be included in all other stand-by arrangements but these clauses will be applicable only to purchases beyond the first credit tranche.

7. The Managing Director will recommend that the Executive Board approve a member's request for the use of the Fund's general resources in the credit tranches when it is his judgment that the program is consistent with the Fund's provisions and policies and that it will be carried out. A member may be expected to adopt some corrective measures before a stand-by arrangement is approved by the Fund, but only if necessary to enable the member to adopt and carry out a program consistent with the Fund's provisions and policies. In these cases the Managing Director will keep Executive Directors informed in an appropriate manner of the progress of discussions with the member.

8. The Managing Director will ensure adequate coordination in the application of policies relating to the use of the Fund's general resources with a view to maintaining the nondiscriminatory treatment of members.

9. The number and content of performance criteria may vary because of the diversity of problems and institutional arrangements of members. Performance criteria will be limited to those that are necessary to evaluate implementation of the program with a view to ensuring the achievement of its objectives. Performance criteria will normally be confined to (i) macroeconomic variables, and (ii) those necessary to implement specific provisions of the Articles or policies adopted under them. Performance criteria may relate to other variables only in exceptional cases when they are essential for the effectiveness of the member's program because of their macroeconomic impact.

10. In programs extending beyond one year, or in circumstances where a member is unable to establish in advance one or more performance criteria for all or part of the program period, provision will be made for a review in order to reach the necessary understandings with the member for the remaining period. In addition, in those exceptional cases in which an essential feature of a program cannot be formulated as a performance criterion at the beginning of a program year because of substantial uncertainties concerning major economic trends, provision will be made for a review by the Fund to evaluate the current macroeconomic policies of the member, and to reach new understandings if necessary. In these exceptional cases the Managing Director will inform Executive Directors in an appropriate manner of the subject matter of a review.

11. The staff will prepare an analysis and assessment of the performance under programs supported by use of the Fund's general resources in the credit tranches in connection with Article IV consultations and as appropriate in connection with further requests for use of the Fund's resources.

12. The staff will from time to time prepare, for review by the Executive Board, studies of programs supported by stand-by arrangements in order to evaluate and compare the appropriateness of the programs, the effectiveness of the policy instruments, the observance of the programs, and the results achieved. Such reviews will enable the Executive Board to determine when it may be appropriate to have the next comprehensive review of conditionality.

Adopted by the Executive Board on March 2, 1979  
(Decision No. 6056-79/38)

Executive Board Meetings and Fund Documents Relating to  
Reviews of Experience with Programs Supported by  
Stand-By Arrangements, 1979-1986 1/

Executive Board Meeting Number/ Date	Document Title	Document Number/ Date of Issue
1. EBM/80/21 2/8/80	Adjustment Programs Supported by Upper Credit Tranche Stand-By Arrangements, 1977	EBS/79/635 (12/26/79)
2. EBM/81/121 9/9/81	Review of Upper Credit Tranche Stand-By Arrangements Approved in 1978-79 and Some Issues Related to Conditionality	EBS/81/152 and Sup. 1 (7/14/81)
3. EBM/82/92 7/7/82	Review of Recent Extended and Upper Credit Tranche Stand-By Arrangements <u>2/</u>	EBS/82/97 and Sup.1 (6/9/82)
	Adjustment Programs--Broad Design and Key Indicators	EBS/82/98 (6/9/82)
4. EBM/83/156 11/6/83	Review of Upper Credit Tranche Arrangements Approved in 1981 and of Some Issues Related to Conditionality	EBS/83/215 (10/4/85)
	Upper Credit Tranche Stand-By Arrangements Approved in 1981	EBS/83/216 (10/4/83)
5. EBM/84/175 12/5/84	Review of Upper Credit Tranche Arrangements and of Some Conditionality Issues	EBS/84/227 (11/7/84)
	Experience with Adjustment Policies	EBS/84/228 (11/13/84)
6. EBM/86/13 1/27/86	Issues in the Implementation of Conditionality; Improving Program Design and Dealing with Prolonged Use	EBS/85/265 (12/3/85)
	Aspects of Program Design: A Review of the Experience in the 1980s of Countries with Upper Credit Tranche Arrangements Approved in 1982	EBS/85/277 (12/17/85)

1/ As called for in 1979 under Guideline 12 of the Guidelines on Conditionality.

2/ Since 1982, these reviews have incorporated reviews of the provisions of the extended Fund facility.