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September 8, 1986

To: Members of the Executive Board
From: The Secretary
Subject: Program Design and Performance Criteria

Attached for consideration by the Executive Directors is a paper on program design and performance criteria which will be brought to the agenda for discussion after the Annual Meetings, on a date to be announced.

Mr. G. G. Johnson (ext. 8779) or Ms. Puckahtikom (ext. 8780) is available to answer any technical or factual questions relating to this paper prior to the Board discussion.

Att: (1)

INTERNATIONAL MONETARY FUND

Program Design and Performance Criteria

Prepared by the Exchange and Trade Relations Department

(In consultation with other departments)

Approved by C. David Finch

September 8, 1986

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I. Introduction

Performance criteria have been a fundamental feature of upper credit tranche stand-by arrangements virtually from the outset. They nonetheless remain an often contested aspect of the Fund's financial assistance to its members. From the member country's point of view, they are sometimes seen as posing undue constraints on their policy choices; from the Fund's point of view, they give rise to continuing questions regarding their effectiveness in safeguarding the revolving character of the Fund's resources. During the last review of issues in the implementation of conditionality and aspects of program design, 1/ for example, the continued relevance and appropriateness of Conditionality Guideline 9, which deals specifically with the subject of performance criteria, was one of the issues raised frequently in the discussion. Similarly, much of the exchange of views at the Executive Board seminar on issues in the design of Fund programs conducted a month later 2/ related to performance criteria.

The present paper has been prepared in response to questions raised on these and other occasions. As it is intended to be a companion piece to the staff study "Theoretical Aspects of the Design of Fund-Supported Adjustment Programs" (SM/86/162, 7/2/86) the paper addresses from a general standpoint those issues that arise with respect to performance criteria at the stage of designing Fund-supported adjustment programs which are of particular relevance for their negotiation with member countries. Given the characteristics of the imbalances to be redressed or averted and other program objectives, the paper describes the considerations involved in selecting certain global or specific instrument variables for monitoring through performance criteria or other techniques. It also addresses the question of how current practices in the specification of performance criteria could be adapted in the light of changing circumstances to continue safeguarding effectively the revolving character of Fund resources. A number of other issues that arise largely at the stage of implementing Fund-supported adjustment programs will be reviewed in the context of staff papers prepared for the next regular review of experience with adjustment programs supported by Fund resources. These include the empirical aspects of some of the subjects covered in this report, as well as specific aspects of certain policies, such as those on waivers and modifications of performance criteria, which are only broadly referred to here.

The plan of the paper is as follows. Section II provides background concerning the general evolution of techniques of program monitoring. Section III discusses characteristics and types of performance criteria, addressing in particular questions that arise with respect to their definition and coverage. Against this background,

1/ EBM/86/13 (1/27/86). (See Appendix II, item 11.)

2/ Executive Board Seminar 86/2 (2/15/86). (See Appendix II, item 17.)

Section IV considers certain issues that relate to the selection and mix of monitoring techniques. Section V, finally, provides a summary and a list of issues for discussion. Appendix I reproduces the Executive Board decisions that were adopted following the 1968 and 1978-79 conditionality reviews, and Appendix II provides a selective bibliography of Fund documents that have addressed issues in connection with performance criteria. By way of empirical background, a supplement to this paper provides a review of the experience with specification of performance criteria since the Guidelines on Conditionality were adopted early in 1979, including a detailed listing of performance criteria in all arrangements approved since May 1977. 1/

II. Performance Criteria and Other Techniques for Monitoring Program Implementation

Strictly speaking, although related to the design of adjustment programs, performance criteria are not a part of those programs, but rather part of the design of the financial arrangements by which the Fund supports members' adjustment efforts. An adjustment program consists of a set of policies that a country has undertaken; a supporting stand-by or extended arrangement spells out the specific terms of the Fund's commitment to provide financial assistance and the conditions under which the assistance will be extended. In approving the arrangement, the Fund indicates that the program meets the standards established for access to Fund resources, that any prior actions taken represent a satisfactory beginning in implementation of the program, and that on those grounds the member is entitled to make the initial purchase of resources specified in the arrangement. 2/ Further purchases, which are phased according to a cumulative schedule specified in the arrangement, can be made within certain specific dates without additional Board review, 3/ provided that certain aspects of the

1/ Performance criteria that were used in upper credit tranche stand-by arrangements from 1957 to 1967 were listed in SM/68/128, Supplement 2, (8/12/68). The listing was updated for stand-by and extended arrangements through April 1977 in SM/77/128 (6/6/77). (See Appendix II, items 2 and 3.)

2/ In a first credit tranche stand-by arrangement, the full amount is available once the arrangement is approved. As performance criteria do not feature in such arrangements, references to stand-by arrangements in the remainder of this paper should be taken as relating to those in the upper tranches.

3/ This reference to absence of specific Board reviews relates to drawings that are contingent only on observance of performance criteria. Often, however, specific review clauses are included in arrangements on which purchases may be dependent. The issues posed by such review clauses, which will be discussed later in the paper, are different from those posed by performance criteria.

member's policies, as measured by the performance criteria, have evolved in accordance with the member's stated intentions and commitments.

Performance criteria thus provide a key link between the disbursement of resources under a financial arrangement with the Fund and the implementation of the member's program. Their proximate purpose is twofold: they provide the member country with concrete assurances about the circumstances under which it may obtain the Fund's financial assistance; at the same time, they provide a safeguard regarding the member's use of Fund resources by ensuring that purchases will be requested only when the member's policy implementation is on track.

Since performance criteria first appeared in stand-by arrangements there has been continuous adaptation to improve their effectiveness. From time to time, this experience has been reviewed by the Executive Board either in the context of general examinations of conditionality or of particular aspects of it, and such Board reviews have led to a degree of codification of the practices and procedures concerning the use of Fund resources. As background to the exploration of current policy issues later in the paper, the remainder of this section will place the practices regarding performance criteria and other program monitoring techniques in the context of their historical evolution. This section also describes the evolution of other program monitoring techniques employed by the Fund; that is, the other techniques by which the Fund observes and influences policy implementation in the programs it supports financially.

1. Origins

During the early years of its existence, the Fund wrestled with the question of ensuring that members' use of its resources would be consistent with the provisions and purposes of the Articles of Agreement. An important step in the evolution of Fund practices on this front was an Executive Board decision adopted in 1948 according to which if, after reviewing a request for a purchase, the Fund found that the member's representation was not consistent with the provisions of the Articles, it might reject or postpone the request or accept it only subject to certain conditions. ^{1/} This decision, however, left members uncertain as to the circumstances under which they could count on prompt financial assistance from the Fund in time of need, and consequently the Fund began to develop policies aimed at clarifying (and, over time, broadening) the terms and conditions that would govern a member's access to Fund resources. Initially resources were made available in the form of outright purchases, but consideration was given to means of providing a member that did not have an immediate need for resources with the

^{1/} Executive Board Decision No. 284-4, adopted March 10, 1948. A more detailed discussion of the evolution of Fund practices up to 1968 may be found in SM/66/14 (1/14/66) and SM/68/128 (7/23/68). (See Appendix II, items 1 and 2.)

assurance that, for a specific period, funds would be available if needed. This resulted in the development of stand-by arrangements (the first of which was approved in June 1952) that could be requested by members in actual or potential balance of payments need.

As with outright purchases, before approving a stand-by arrangement the Fund needed to be satisfied that the member's position, policies, and prospects were consistent with the Fund's objectives and purposes. The member's right to purchase during the period of the stand-by arrangement--which under the initial decision ^{1/} was limited to six months--would only be suspended in the case of ineligibility of the member or suspension of transactions; the latter provision still appears in stand-by arrangements today. The member thus received strong assurances of its ability to make purchases.

The strength of these assurances gave rise to the question of whether it was proper for the Fund, even for a period of six months, to take the risk that its resources might be used improperly. Thus, in a 1953 Board decision, under which stand-by arrangements for periods longer than six months were first provided for, it was noted that the Fund and the member might find it appropriate to reach understandings additional to those that would be expected for a shorter period. ^{2/}

Over the next few years the Fund experimented with a variety of "additional understandings." With the forward-looking character of the financial assistance provided through stand-by arrangements, there had begun to be a focus on the future time path of policies--i.e., a program of policy action to correct the member's balance of payments problem. As experience accumulated, it became standard practice for a member requesting use of Fund resources to accompany such a request by a policy program. This notion that the Fund's resources were to be used to support the adoption of a program of action to be implemented over a specified period of time soon led to the phasing of purchases. Phasing, which was first applied in March 1956, provided the Fund with the possibility of withholding the resources if the additional understandings contained in the stand-by arrangement were not observed; at the same time, it gave the country that observed those understandings certainty of the availability of resources at particular times over the period of the arrangement. By 1960, phasing had become a feature of virtually all stand-by arrangements in the upper credit tranches, as had the formulation of additional understandings in the form of performance criteria.

^{1/} Executive Board Decision No. 155-(52/57), adopted October 1, 1952, Selected Decisions of the International Monetary Fund and Selected Documents, Eighth Issue, Washington, D.C., May 10, 1976, pp. 42-43.

^{2/} Executive Board Decision No. 270-(53/95), adopted December 23, 1953, Selected Decisions, Eleventh Issue, pp. 55-56.

These basic characteristics of upper tranche stand-by arrangements remain in place today. There has, however, been a considerable evolution in the specific forms and modalities of their application. Some aspects have been codified from time to time, both as a result of the 1968 and 1978-79 reviews of conditionality and as a result of Board discussions of particular performance criteria and other specific aspects of conditionality.

2. Performance criteria--evolution of general policy

a. Early development

During the 1960s, the role of performance criteria and other features of stand-by arrangements were discussed from time to time in the Executive Board in contexts such as the preparation of Annual Reports. In 1968 the Executive Board decided to hold a comprehensive review of the various procedures and provisions that had developed in connection with the use of Fund resources. The conclusions of that review were reflected in an Executive Board decision 1/ that provided a broad setting for codification of practices with respect to performance criteria and other aspects of program monitoring. The decision indicated that performance clauses were to be included in all upper credit tranche stand-by arrangements and provided general guidance on the scope and number of performance criteria. 2/ This was intended to emphasize the need for uniformity of treatment, an issue that had been raised in the course of the discussions, while still providing leeway for adaptations in the light of the diversity of members' circumstances.

b. The 1978-79 review of conditionality

Since the 1968 Executive Board decision, all upper credit tranche stand-by arrangements and, since the establishment of the extended Fund facility in 1974, all extended arrangements have included performance criteria. Over the ten-year period that led up to the next comprehensive Board review of conditionality, there were a number of Board reviews of particular types of performance criteria and other aspects of the conditional use of Fund resources. 3/ By 1978, a degree of standardization in the types of performance criteria had developed, so that the average and the variance of the number of performance criteria were reduced relative to the earlier period.

The 1978-79 conditionality review thus surveyed a well-developed body of practices and procedures with respect to performance criteria.

1/ Executive Board Decision No. 2603-(68/132), adopted September 20, 1968, which is reproduced in Appendix I.

2/ See conclusion number 6 of the decision referred to in the previous footnote.

3/ See items listed in Section III of Appendix II.

There was extensive discussion in the Board of the proper scope for performance criteria and the results of that discussion were summarized in a new set of "Guidelines on Conditionality." ^{1/} After setting out the importance of early action to cope with balance of payments difficulties and elaborating on the period and other characteristics of stand-by arrangements (Guidelines 1 to 3), the guidelines provided a broad description of the setting against which the design of adjustment programs is to take place. In this connection, Guideline 4 stressed the importance of avoiding undue interference in members' decision-making process. Consistent with this provision, Guideline 9, dealing with the specific subject of performance criteria, emphasized the desirability of focusing on macroeconomic aspects. The Guidelines also envisaged circumstances where performance criteria for later parts of the program periods could be replaced by program review clauses. This subject is discussed later in this section.

Since 1979, there have been a number of general policy discussions in the Board in connection with regular reviews of experience with adjustment programs supported by the Fund that have adapted or modified to some degree the practices with respect to performance criteria. To a large extent such adaptations have been the result of the experience gained through the very large number of stand-by and extended arrangements approved by the Fund in recent years.

3. Other monitoring techniques

Over time other techniques of monitoring the implementation of policy programs have been developed. These include: "prior actions" which relate to monitoring the adoption of certain policy actions prior to presentation of the member's request for a stand-by arrangement to the Board for formal Fund approval; "reviews," which together with the now discontinued "prior notice clause," ^{2/} are monitoring techniques that, like performance criteria, may lead to interruptions of the member's right to purchase under an existing arrangement. Finally, there are a variety of circumstances where developments under the

^{1/} Executive Board Decision No. 6056-(79/38), adopted March 2, 1979, which is reproduced in Appendix I. The guidelines were adopted following a number of Executive Board meetings. (See Appendix II, item 3.)

^{2/} A clause used to limit the right to purchase under a stand-by arrangement in circumstances specified and in accordance with an Executive Board decision. Under such a clause, the member had the right to make purchases under the arrangement unless the Fund gave prior notice to the contrary. Although it was in fact invoked only once, it was subject to criticism because it was not used generally and because it was not clear under what circumstances it would be applied, leaving the member without the precise assurances that performance criteria conveyed. The Executive Board discussed the prior notice clause in February 1961 and concluded it would no longer be used (see SM/68/128, pp. 9-11).

arrangement can lead to a request by management or by the member for "consultation," but which do not have direct consequences for the member's right to make purchases.

a. Prior actions

When the Fund approves a stand-by or extended arrangement in support of a member's adjustment program, it often does so after some measures envisaged under the program have already been implemented. Sometimes such measures are taken at the initiative of the member; in other cases they are suggested by the Fund. ^{1/} Whenever the nature and timing of the actions are considered critical for the effectiveness of the program, they are made preconditions for consideration of the member's request by the Executive Board.

Although constituting a critical part of the member's program, these actions, because of their nature and in contrast to performance criteria, are not included among the specific terms and conditions of the supporting arrangement. From the standpoint of policy execution, policy measures undertaken as prior actions reduce uncertainty regarding the member's intentions. Since they are taken up front, moreover, they begin yielding results from the outset of the program, thereby increasing the likelihood of attainment of sought-after objectives.

The key issue for Fund policy on stand-by arrangements in this area is the extent to which it is appropriate for the Fund to require certain policy actions to be taken prior to its approval of the arrangement. This issue was discussed at length in the course of the 1978 review of conditionality. While it was considered desirable to keep the use of preconditions to the minimum necessary, it was felt by most Executive Directors that there existed circumstances which rendered them unavoidable. It was noted that in situations of protracted imbalances, it was very difficult to design a credible program unless the ground for it had been laid by prompt adoption of certain basic measures. Serious erosion of competitiveness, for example, typically required an immediate exchange rate adjustment; similarly, disequilibria originating from large and persistent fiscal deficits might require the timely adoption of measures with respect to taxes or public sector tariffs. Decisive actions in such areas were often necessary not only as a starting point for the member's program, but as a means for the authorities to inspire confidence at home and abroad (including the Fund) that a break with past policies was clearly intended.

The outcome of the 1978-79 discussion on these issues was summarized in Guideline 7 of the Guidelines on Conditionality. This

^{1/} In the specific context of the discussions of the program, such suggestions are made by management and staff, but against the background of discussions in the Executive Board with respect to previous programs or Article IV consultations.

guideline also refers to the need for "judgment that the program is consistent with the Fund's provisions and policies and that it will be carried out"; in this connection, the importance of prior actions in establishing the credibility of the member's program cannot be overstressed.

In practice, the types of policy actions that are the object of preconditions are normally limited to concrete measures that can be taken at a point in time, that is, measures the implementation of which can be immediately and objectively ascertained (such as a discrete exchange rate action or the adoption of tax measures), as opposed to policies that can only be monitored in terms of developments over time (such as limitations on credit expansion or foreign borrowing).

The possibility of seeking a positive record of policy implementation before approval of an arrangement has sometimes been advanced. Such an approach could be useful in assisting countries where experience with policy implementation is so weak that it would not be advisable for the Fund to commit its resources until the member has demonstrated a reasonable measure of capacity to sustain policy implementation over time. This approach represents an extension of the notion of "prior action" to the broader area of general policy implementation, in the sense that evidence of pursuit of policies on a variety of fronts would be required prior to submission to the Board of a request for an arrangement. 1/

b. Reviews 2/

Reviews of developments under the member's program have long been a feature of many Fund-supported programs, involving discussions in the field and staff reports discussed in the Executive Board. However,

1/ In 1984, for example, the Executive Board examined such a "shadow" program for Haiti when the 1983-85 stand-by arrangement had become inoperative. While no Board approval was involved (the program was described in the context of the 1984 Article IV consultation report), the staff appraisal noted that it was agreed with the authorities that "the presentation of a formal program to the Fund's Executive Board would be delayed until such time as significant compliance with the interim program had been established" (EBS/85/2, 1/4/85, p. 22). The Chairman's summing up noted that "Several Directors indicated that the prospects for further use of Fund resources would hinge on the demonstration of the authorities' commitment to implement the necessary policy adjustments" (EBM/85/18, 2/4/85, p. 7). There have been similar, though less well-defined, approaches taken in other country situations, where presentation of a program to the Board was deferred until a record of policy implementation over time had been established.

2/ As with nonobservance of performance criteria, failure to complete a review formulated as a performance clause can result in interruptions of the member's right to purchase.

until the establishment of the extended Fund facility in 1974, completion of such reviews was rarely made a condition for further drawings under arrangements. 1/ In providing for three-year arrangements, the facility required the completion of annual reviews to establish the policies and measures that would be followed during the second and third years of the arrangement. This practice was extended to the multiyear stand-by arrangements that were envisaged under the supplementary financing facility and that are provided for in the Guidelines on Conditionality (Guideline 2).

The staff papers for the 1978-79 conditionality review examined the pros and cons of the use of reviews in place of the traditional quantitative performance criteria. 2/ In their discussion, most Executive Directors expressed their preference for quantitative performance criteria and stressed the advantages to the member of the objective way in which they operate, as compared with the uncertainty involved in a review clause, which made continued access to the Fund's resources contingent on a discretionary judgment by the Fund that the member's performance had been satisfactory. 3/ There was, however, support for the idea of combining performance criteria and review clauses, where appropriate, and this was reflected in Guideline 10 of the Guidelines on Conditionality.

Besides providing for annual reviews as a normal feature of multiyear arrangements, this guideline endorsed the practice of conducting reviews within one-year arrangements in lieu of specifying performance criteria in certain circumstances; for example, reviews could be used as a means to reach understandings at a later point in the year on performance criteria that could not be set in advance. Exceptionally, reviews could also substitute for an essential feature of the program when such a feature could not be formulated as a performance criterion at the beginning of a program year, because of uncertainties about major economic trends; such reviews would encompass the member's macroeconomic policies and would provide a basis to reach any new understandings that were necessary.

1/ The only exception was the 1969 arrangement for the United Kingdom. In that arrangement quantified targets set out in the program were not incorporated as performance criteria; but after the initial purchase the United Kingdom was to consult and reach understandings with the Fund before each further request for a purchase, a process which involved explicit review by the Executive Board, before each purchase, of the right of the United Kingdom to make the purchase. These reviews were concluded against the background of quantified objectives with respect to financial aggregates that had been submitted as part of the member's program at the time the arrangement was approved.

2/ SM/78/103 (4/19/78), pp. 17-18. (See Appendix II, item 3.)

3/ SM/78/230 (8/29/78), p. 8. (See Appendix II, item 3.)

Since the adoption of the Guidelines on Conditionality, reviews have in fact become a widely used technique of program monitoring. ^{1/} This proliferation of reviews reflects the complexity of problems that have confronted member countries in recent years in their adjustment programs, and the consequent need for closer monitoring of policy implementation. It nonetheless raises a variety of policy issues that need to be considered carefully, and which will be discussed in Section IV.

c. Consultation

A principal activity of the Fund is consultation, as the process of discussion between the Fund and its members promotes mutual understanding and helps in the development of policies that contribute to the achievement of goals common to the Fund and to its membership. Consultation with members of course goes on regularly before approval of arrangements, and during arrangements as called for by review clauses. Reflecting the provision of the Guidelines on Conditionality (Guideline 5) and, before their adoption, the conclusions incorporated in the 1968 Board decision on use of the Fund's resources and stand-by arrangements, those arrangements include a standard consultation clause:

In accordance with paragraph -- of the attached letter (member) will consult the Fund on the adoption of any measures that may be appropriate at the initiative of the government or whenever the Managing Director requests consultation because any of the criteria in paragraph -- above have not been observed or because he considers that consultation on the program is desirable. In addition, after the period of the arrangement and while (member) has outstanding purchases in the upper credit tranches, the government will consult with the Fund from time to time, at the initiative of the government or at the request of the Managing Director, concerning (member's) balance of payments policies.

Nonobservance of performance criteria can thus trigger consultation, but a consultation may also be initiated for other reasons and at any other time by the member or by the Managing Director. Provision is also made for consultation from time to time after the arrangement expires as long as purchases remain outstanding in the upper credit tranches. This latter provision is normally fulfilled through regular Article IV consultations, but may also be a basis for special consultations.

In recent years consultation under stand-by arrangements has in fact become relatively frequent. This reflects the need for more continuous contact because of the severity of the adjustment problems faced by program countries, as well as the ease with which such

^{1/} See the supplement to this paper where the experience with reviews is discussed.

consultations can now take place given technological progress in communications.

A particular type of consultation that has developed in recent years relates to supplementary monitoring of policies. Where key broad macroeconomic variables are covered by performance criteria, supplementary monitoring of developments in the components of the overall variables can serve to provide early signals concerning the probability of observance of performance criteria. Supplementary monitoring exercises have encompassed intermediate variables such as government expenditures, tax and other revenues, monetary expansion, domestic arrears, credit to specified public enterprises, reserve requirements of commercial banks, and developments in gross international reserves. Typically, monthly or quarterly indicative targets for these variables are established and significant deviations can trigger consultations with Fund staff and management. During these discussions, the implications for the program's objectives of the divergences from the indicative paths for those intermediate variables are assessed, and an effort is made to reach additional understandings as necessary. Failure to reach or observe such understandings does not, however, interrupt the member's right to purchase.

III. Performance Criteria: Characteristics and Policy Coverage

1. Relation of performance criteria to program objectives

In undertaking an adjustment program, a country generally has objectives with respect to a number of areas such as external balance, economic growth, control of inflation, and so forth. In providing financial support for a member's program through a stand-by or extended arrangement, the Fund needs to be satisfied that the objectives of the program are consistent with the Fund's purposes, and that they will be attained by means that are in accordance with the Articles of Agreement. In these circumstances, the Fund will support the member's efforts to attain its objectives, subject to the constraint imposed by the Fund's obligation to safeguard the revolving character of its resources. The formulation of performance criteria thus reflects not only the design of the member's program, but also the Fund's particular concern with those policies that are considered crucial to meeting this constraint and, more broadly, that are required for consistency with the Articles of Agreement.

The constraint of safeguarding the revolving character of the Fund's resources is met if the balance of payments is viable over the medium term. A key aspect of viability is financeability: that is, an inflow of capital large enough to cover prospective current account deficit and scheduled debt repayments, including repurchases to the Fund, on a sustained basis. Reserves, moreover, must be large enough to permit unexpected adverse balance of payments developments to be handled without strain. The other key aspect of viability is that the policies

to keep the current account in line with capital flows be sustained over the medium term. 1/

The counterpart of a sustainable level of net capital inflows is a sustainable balance between aggregate demand and aggregate supply, 2/ and Fund-supported programs typically contain policies designed to restrain demand and to expand supply by raising economic efficiency and the growth of potential output. The basic financial programming approach underlying Fund-supported programs focuses on achieving the proximate objective of maintenance or, in most cases, restoration of such a sustainable aggregate demand-supply balance in the light of the availability of finance from domestic and external sources, as well as of the need to take into account the allocation of the available finance between the government and the private sector. 3/ In line with the prescriptions of the Articles of Agreement, moreover, Fund-supported programs eschew the use of restrictions on current transactions as a means of reaching the desired balance of payments outcome. These considerations are reflected in four basic types of performance criteria that appear in virtually all upper credit tranche stand-by and extended arrangements: (i) a ceiling on total domestic credit expansion, either on the net domestic assets of the monetary authorities or on the net domestic assets or domestic credit of the entire banking system; (ii) a ceiling on financing of the budget deficit, usually in the form of a subceiling on net bank credit to the government; (iii) ceilings on some forms of external borrowing, particularly medium-term and long-term commitments; and (iv) an injunction against the introduction of new, or the intensification of existing, exchange and import restrictions. Given the importance of exchange rate policy in relation to external balance, arrangements also may include understandings monitored by a performance criterion, often in the form of a balance of payments test. Where appropriate, other types of policies are also subject to performance criteria. Subsections 4-9 below discuss some aspects of Fund policy on performance criteria in these various areas.

The fact that performance criteria relate not only to the design of the member's program but also seek to safeguard the revolving character of the Fund's resources and consistency with the Articles of Agreement is reflected in the way they operate. They typically constrain the

1/ In this context, the medium term relates to the time when repurchases fall due with respect to purchases under the arrangement. The period between the date of purchase and the date of scheduled repurchase varies from as little as three to as much as ten years for financial support provided under stand-by and extended arrangements.

2/ Alternatively, a sustainable balance of absorption relative to output.

3/ The accompanying paper on "Theoretical Aspects of the Design of Fund-Supported Adjustment Programs" sets out the theoretical underpinnings of the financial programming approach to balance of payments adjustment.

member's policies in only one direction. Thus they may be specified in terms of maxima, as in the case of domestic credit expansion and external borrowing, or of minima, as with balance of payments tests, which set a floor on the level of net international reserves.

In a medium-term context, efficient balance of payments adjustment and the establishment of conditions for sustained economic growth go hand in hand. Thus, adjustment paths that emphasize increased production, rather than those that simply focus on restraining absorption, are more likely to be sustained. An appropriate balance between absorption and production is under most circumstances a necessary condition for sustained growth as well as price and external stability. Such a general setting also preserves the country's access to external savings, thereby increasing the availability of resources for investment. Efficient use of these resources is at the core of the adjustment process and in general the Fund has sought to enhance "efficiency" through policies monitored by performance criteria. Sustained implementation of appropriate macroeconomic policies is necessary to ensure the efficient achievement of balance of payments viability, but policy action on other policy fronts may on occasion also be required. 1/

2. Basic characteristics

Performance criteria may be described in terms of four essential characteristics.

(i) They provide assurance to the member about the prospective availability of Fund resources. As discussed in Section II, the key purpose of performance criteria is to provide the member country with clear assurance of the circumstances and conditions under which it will be able to make purchases under the stand-by or extended arrangement.

(ii) They provide substantial assurances to the Fund that the implementation of the program is consistent with the Fund's purposes and with safeguarding the revolving character of the Fund's resources. 2/ The Fund's concern is that its resources are being used consistently with its purposes, which requires that the program's objectives be met by appropriate means. Performance criteria are not placed on the policy objectives themselves (for reasons discussed below), and to obtain the necessary assurances, the Fund relies on monitoring the instruments of

1/ Guideline 9 of the Guidelines on Conditionality notes that there may be a need for performance criteria that are not macroeconomic, but it is also noted that such situations are exceptional.

2/ In this connection, it is to be noted that the member, in adopting a program for which it requests an arrangement from the Fund, does not enter into a legal contract. In general, the only consequence of nonobservance of a performance criterion is the interruption (possibly temporary) of purchases under the arrangement.

policy implementation. Some criteria are intended to ensure that policy instruments that are inconsistent with the Fund's purposes, such as exchange restrictions, are not used. Other performance criteria are designed to indicate whether the policy actions most essential to preservation of the revolving character of the Fund's resources are being implemented.

(iii) They permit a flexible response to changing circumstances. Failure to meet performance criteria has the consequence that the member's right to purchase under the stand-by arrangement is interrupted. The right to purchase is not, however, canceled. For some performance criteria the right to purchase is restored if they are observed subsequently; and for any deviation, the Fund may grant a waiver, which is typically extended ex post if there are grounds to support the assessment that the deviation is minor or reversible so that it does not threaten the achievement of the program's objectives, or that the member is implementing appropriate compensating policies. Alternatively, when deviations have occurred and continue in prospect, modified understandings may be reached that would permit the resumption of purchases under an existing arrangement (possibly with revised access and phasing) or, as need be, under a new arrangement.

(iv) They promote dialogue between the Fund and the member in the event of difficulties in program implementation. As discussed in Section II, consultation with members has always been a principal aspect of Fund activity, and is the main vehicle by which the institution tries to achieve its objectives. Members' requests for arrangements are preceded by intense consultation with Fund management and staff, and the Executive Board's consideration of the request also adds input from the whole membership. Performance criteria also serve as signals that can lead to consultation, when nonobservance leads to interruption of purchases and understandings need to be reached regarding the circumstances under which they can be resumed; that is, performance criteria serve to promote consultation when policy implementation runs into difficulties.

3. Other important features

Besides these basic characteristics of performance criteria, there are a number of other features that are important, although they may not always be achieved in practice. These features reflect two general desiderata to which both the Fund and the member country subscribe but which may to some extent conflict in particular situations: enhancing the probability of achievement of the program's objectives and minimizing the degree of Fund involvement in the details of policy decision making and implementation. The Fund also needs to ensure uniformity of treatment across Fund members, and yet respond flexibly to the needs and circumstances of each individual member. Aside from balancing these objectives, the process of policy negotiation and the design of performance criteria need to focus on practical issues such as

timeliness and comprehensiveness of data availability and the member country's capacity for policy planning and implementation.

a. Timeliness of data availability

The longer the lags in the availability of data, the less assurance there can be at the time the purchase is effected that the program remains on track. The general standard is that data relating to performance criteria should be subject to reporting lags of no more than two months. 1/

b. Definitional aspects

(i) Monitoring of broad aggregate variables is preferable to monitoring their components. Unless achievement of the program's objectives is judged to depend critically on the behavior of the individual components of an aggregate variable, 2/ besides the behavior of the aggregate itself, the latter should be the instrument chosen for monitoring because it provides the authorities with freedom to choose among the means available to meet the performance criterion.

(ii) Definition of performance criteria should be comprehensive. If some component of a variable is excluded from the definition, there is a possibility that performance criteria may be met on account of unforeseen developments in the excluded components, which could distort the relationship between the monitored instrument variable and the program's objectives.

(iii) Definitions should be clear and simple. Variables that are aggregative and comprehensive will usually also be clear and simple. Clarity and simplicity are also desirable characteristics in their own right, as they facilitate mutual understanding between the Fund and the country of the role played in the program by the variable in question.

c. Focus should be on policy instruments, not objectives

While the purpose of the program and the supporting arrangement is the achievement of the program's objectives, performance criteria are placed on policy instruments rather than on the objectives themselves. A practical argument for this approach is that data on some of the basic objectives of programs may not be available on a timely basis, so that

1/ Executive Board Decision No. 7925-(85/38), adopted March 8, 1985 (Selected Decisions, Eleventh Issue pp. 74-76; see Appendix II, item 16c). In particular, Guideline 2 of the Decision notes that in very exceptional cases where reporting lags exceed two months, the staff will explain the reasons for such lags as well as the steps being taken to reduce them.

2/ Such as when credit to government, as well as overall credit, is subject to a ceiling.

the monitoring would facilitate neither timely adjustment of policies nor the disbursement of Fund resources at the time they were needed. From a more fundamental perspective, program objectives are influenced by factors that are not under the authorities' control, as well as by policy instruments, so that performance criteria on objectives would not provide the authorities with strong assurance of the availability of Fund resources even if they followed their declared policy intentions. Also, performance criteria, and Fund arrangements in general, are intended to ensure that program objectives are not attained through inappropriate means such as the use of controls or restrictions.

"Instrument" here is used in the broad economic policy sense rather than in relation to the specific measures involved. Reflecting the desirability of comprehensive, aggregative measures, for example, performance criteria in relation to the fiscal budget are usually formulated as a ceiling on the financing of the deficit, which may be met through various combinations of a wide variety of revenue or expenditure measures. This has the consequence that the monitored instrument has more of the character of an intermediate variable, which, like the program's ultimate objectives, is influenced by exogenous factors, although to a lesser degree. It also implies that policy implementation needs to be flexible in response to exogenous developments.

d. Avoidance of proliferation

The 1968 and 1978-79 reviews of conditionality both emphasized that performance criteria should be limited to those "necessary to evaluate implementation of the program with a view to ensuring the achievement of its objectives," but they also avoided referring to minimizing the number of performance criteria as an objective in itself. Rather, the Board affirmed that "the number and content of performance criteria may vary because of the diversity of the problems and institutional arrangements of members". As discussed in the supplement, in the 1980s there has been a substantial increase in the average number of performance criteria in arrangements (after a decline in the 1970s), most of which is accounted for by the particularly difficult policy problems faced in this period. The fact remains that most of the desirable features of performance criteria discussed here favor small, rather than large, numbers of performance criteria, and the need to avoid unnecessary proliferation of performance criteria should always be kept in mind.

4. Monetary and credit policy

Since balance of payments difficulties often stem from unsustainable expansions in aggregate demand, particular attention is paid to effective financial restraint to ensure that aggregate spending is kept in line with resource availability. The requisite expenditure control typically calls for close monitoring over available sources of borrowing, both domestic and foreign. Fund arrangements generally

include performance criteria on broad domestic credit aggregates supplemented by limits on foreign borrowing by the public sector and, where appropriate, the banking system.

a. The use of credit ceilings

In order to bring aggregate expenditure to a sustainable path, a measure of control over the sources of domestic financing and, in particular, over the rate of domestic credit expansion is required. The underlying rationale of this proposition is based on the close relationship that obtains between the rate of expansion in domestic credit and money supply increases and through these, with the level of aggregate expenditure and demand in an economy. On the other hand, an important and well-established determinant of the demand for money balances is the economy's global income. Thus, a discrepancy between money supply and demand can be translated into an imbalance between expenditure and income. The process of bringing the latter in line with one another will entail keeping credit expansion in balance with the prospective path of money holdings in the economy. Since those holdings are typically determined by the public, the performance criterion in this policy area is formulated on the rate of expansion of domestic credit, which is under the control of the country authorities. From the Fund's standpoint, it is also important to note that the link between balance of payments outcomes and ceilings specified in terms of domestic credit expansion is strong and well defined, whereas sharply different balance of payments results may be consistent with broadly the same stock of money. In particular, the choice of the appropriate monetary instruments of control hinges, inter alia, on the trade-off in the main program objectives between the inflation goal and the balance of payments target. With a credit ceiling, an unforeseen improvement in the balance of payments performance could be reflected in domestic monetary expansion, which if not related to the demand for cash balances, could have potentially adverse inflationary consequences, but in the process would raise international reserves. Inflation might be kept on track by seeking to limit monetary expansion directly but this would be at the cost of foregoing a strengthening of international reserves and possibly subsequent pressure on the balance of payments.

In Fund arrangements, an improvement in the foreign reserve position typically associated with credit policy is either essential or highly desirable because it provides strong safeguards for the revolving character of Fund resources. Accordingly, the practice that is universal in Fund arrangements has been to set a ceiling on the expansion of domestic credit (or net domestic assets) by the monetary authorities or the banking system.

b. Definition of credit aggregates

Whether the appropriate credit aggregate for control should be that of the monetary authorities or the banking system as a whole depends primarily on the way in which the authorities influence the availability

of credit and on the prompt availability of reliable data on the selected aggregate. The subject of the choice of credit variables for control was discussed by Executive Directors in 1971. ^{1/} Since then, practices on the use of credit ceilings have been flexible, in response to the circumstances of each case. The advantage of ceilings on central bank credit expansion is that it is under the direct control of the authorities, but the effectiveness of such ceilings depends on the existence of predictable relationships between narrow and broad monetary aggregates and their credit counterparts in the economy. The trend in recent years has been to set the ceiling on the credit aggregate of the entire banking system, in many cases reflecting the existence of direct controls on bank credit expansion through mandatory ceilings or other instruments. ^{2/}

A further choice needs to be made as to whether the monitored variable should be limited to domestic credit or should encompass the more comprehensive concept of net domestic assets. With domestic credit ceilings, limits are placed on selected assets and liabilities items in the balance sheet; usually, they cover net credit to the public sector and credit to the private sector. Alternatively, with ceilings on net domestic assets, limits are placed on a more comprehensive set of assets and liabilities which includes, in addition to those items comprising domestic credit as defined above, all other assets and liabilities items (referred to as "other items net"). Thus, net domestic assets of the banking system are usually defined as the difference between the money supply and net foreign assets, and those of the central bank as the difference between currency or the monetary base and the monetary authorities' net international reserves.

The use of the narrow concept of domestic credit could result in a greater-than-planned expansion in expenditure and threaten achievement of the balance of payments target if increases in other items net occur that are in fact the counterpart of increases in domestic liquidity. The increasing incidence of financial losses incurred by central banks on account of quasi-fiscal operations or exchange rate adjustments, indicates the desirability of setting the ceiling on net domestic assets. This would also avoid the complications that may stem from issues of classification, such as the inclusion of certain credit operations in the capital account.

^{1/} See SM/71/145 (6/11/71) (Appendix II, item 12). For details on the experience with credit ceilings at that time, see R. C. Williams: "Evolution of Alternative Forms of Credit Ceilings" (DM/71/42, 5/26/71).

^{2/} For details of the specification of credit ceilings in arrangements approved during the period 1979-June 1986, see the supplement to this paper. See also Eliot R. J. Kalter: "The Formulation of Credit Ceilings and the Achievement of Balance of Payments Objectives" (DM/85/45, 8/7/85).

Thus, given the objective of achieving comprehensiveness of coverage in defining performance criteria, the broader aggregate of net domestic assets has been preferred in principle over the narrower concept of domestic credit. ^{1/} In practice, problems in understanding the behavior of other items net have often led to use of domestic credit. In such cases, a more prudent approach would be to combine a performance criterion on net domestic assets with supplementary monitoring of other items net, in which case unexpected behavior of the latter could trigger a consultation that, if necessary, could result in appropriate modification of the performance criteria.

5. Fiscal policy

The intermediate objective of restoration or maintenance of an appropriate degree of overall balance to the public sector's finances can typically be monitored, on the domestic side, by way of limits on net bank credit financing of the budget. In particular, given an overall rate of credit expansion consistent with attainment of the balance of payments objective, and given the need to provide an adequate flow of credit to the private sector to support economic growth, the amount of credit financing of the budget can be derived. If supplemented by a limitation on government external borrowings, a limit on bank credit provides an effective boundary to the size of the fiscal deficit, provided that recourse to nonbank sources of domestic financing is not significant. Thus, since the issue of fiscal provisions as performance criteria in stand-by arrangements was discussed in the Executive Board in 1968, ^{2/} overall credit ceilings have generally been accompanied by performance criteria in the fiscal area in the form of subceilings on the expansion of net bank credit to the government or the public sector.

a. Coverage of nonbank financing

A ceiling on domestic bank credit cannot effectively check public sector imbalances in situations where the public sector has access to foreign credit or to domestic nonbanking credit sources. Foreign financing for the government is, as described below, normally subject to a separate performance criterion. Where domestic nonbank financing is--or could become--significant, however, it may also be desirable to define the fiscal performance criterion on the basis of the overall fiscal deficit--the net borrowing requirement from all sources--of the government or the public sector.

^{1/} When the subject of the formulation of credit ceilings was last reviewed in 1971 (SM/71/145), it was considered that the definition of the credit ceiling should be defined to include all assets and to net out appropriate liabilities. Liabilities in the form of advance import deposits and other financial aspects of exchange and trade operations had by that time been netted out of the credit ceilings in a number of arrangements.

^{2/} See SM/68/141 (8/29/68) (Appendix II, item 13).

This more comprehensive formulation has been adopted increasingly in recent years. 1/ Where more comprehensive monitoring, though desirable, is considered impractical because of data inadequacy (e.g., the absence of timely government accounts or balance sheets for some public enterprises) or for other administrative reasons, other suitable adaptations have been made. These have included, for example, combining limitations on the overall deficit of the central government with limitations on bank credit to all or certain key public enterprises. Where problems of domestic payments arrears are recurrent or considered imminent, moreover, it is important that there also be ceilings on domestic payments arrears (in terms of a phased reduction and avoidance of new arrears). 2/

b. Monitoring of composition of fiscal aggregates

In principle, aside from being more effective in monitoring fiscal performance, comprehensive fiscal tests should also be more efficient in permitting the number of performance criteria in the fiscal policy area to be kept to a minimum. Nonetheless, mainly owing to data inadequacy, there may be occasional need for further close monitoring, although often this can be accomplished through supplementary monitoring criteria or periodic reviews, rather than through additional performance criteria. For example, it may be necessary to complement a comprehensive ceiling on the public sector overall borrowing requirement with a subceiling on bank credit to the public sector, where possible

1/ For details of the specification of fiscal ceilings in arrangements approved since 1979, see the supplement to this paper. A technical reason for preferring the comprehensive formulation is that performance criteria on external debt are often expressed in terms of commitments, not disbursements, and hence are not strictly complementary to the domestic financing ceiling.

2/ This applies when the overall fiscal ceiling is defined on a cash basis, the usual practice. It should be noted in this connection that, with respect to domestic payments arrears of the public sector, operational difficulties have been encountered in their data collection, monitoring, and reporting. To overcome these difficulties, it is essential to ensure at the outset that fiscal recording mechanisms are in place to record such arrears should they arise, and that monitoring is practical on a timely basis. Where such arrears are covered by a performance criterion, a clear definition of these arrears and a schedule for their elimination need to be established. With regard to members of currency unions, payments arrears of the government to external creditors are (for institutional reasons) strictly speaking not covered by the standard clause on exchange restrictions. Nonetheless, they should be covered routinely under a subceiling within the schedule of overall domestic arrears reduction because of the special importance of regularizing such arrears to restore normal debtor-creditor relations.

shortfalls in foreign financing are considered likely to lead to a crowding out of bank credit to the private sector.

While performance tests in the fiscal policy area have typically been formulated in terms of financing aggregates such as bank credit to the government or the overall borrowing requirements of the government, this does not imply that the underlying composition of such aggregates should never be monitored directly. Particular elements such as public sector wage policy or subsidy policy that have a far-reaching macro-economic impact have often been monitored as prior actions or through reviews. The composition of government expenditure and revenue can also have important implications for the effectiveness of the adjustment effort, and has sometimes been monitored through performance criteria or, more commonly, through supplementary understandings.

6. External debt management policy

Given the requirement in an adjustment program that total financing flows--from both foreign and domestic sources--be consistent with the level of aggregate demand that is compatible with the program's overall objectives, ceilings on external borrowings represent a logical complement to ceilings on domestic credit. ^{1/} Moreover, for a viable balance of payments position over the medium term, there is a need to limit external borrowings to amounts and terms consistent with avoidance of future debt servicing difficulties. Accordingly, performance criteria relating to the amount and maturity structure of foreign borrowings have been typical features of Fund arrangements.

Specific guidelines for performance criteria on foreign borrowing were adopted by the Executive Board in the context of a general discussion of issues relating to external debt management in 1979. ^{2/} In brief, the 1979 guidelines called for the need to ensure consistency between external debt management policies and domestic financial policies in formulating external debt criteria. The performance criterion was normally to be related to official and officially guaranteed foreign borrowing, up to a common maturity limit; it was also to cover private sector borrowing in cases where such borrowing was covered by the member's external debt management policy. In exceptional circumstances where nontrade-related short-term debt was becoming a source of difficulty, such debt was to be included in the limitations.

In a subsequent review of issues of external indebtedness ^{3/} when difficulties associated with excessive buildups in short-term debt had become more widespread, Directors generally supported the inclusion of

^{1/} For a fuller discussion, see SM/79/125 (5/11/79) (Appendix II, item 14).

^{2/} The guidelines are reproduced in Appendix I.

^{3/} For further details, see SM/83/45 (3/7/83) (Appendix II, item 14).

short-term debt in the criterion, while allowing for some flexibility in light of different institutional reporting procedures employed by members and the statistical difficulties of recording that category of debt. It was also considered that normally it would be better to impose ceilings on disbursed rather than on contracted debt, although some flexibility should continue to be used. Both concepts may be used at the same time, since disbursements affect present expenditure while contracts will influence future spending.

7. Exchange rate policy

Another important element of an adjustment program is exchange rate policy. Until comparatively recently, action on the exchange rate was generally monitored as a prior action or, where a policy of continuing flexibility was envisaged, through a balance of payments test, which involves setting floors for net foreign assets for specified points or periods in time. This is equivalent to the formulation of an official intervention policy in the exchange market to guide the degree of exchange rate flexibility. 1/ Since the 1978-79 conditionality review, active exchange rate policies have also been monitored through mandatory reviews.

In recent years there has been a substantial increase in the proportion of Fund-supported programs incorporating an active exchange rate policy, 2/ reflecting a need to maintain or increase the member's external competitiveness. With widespread exchange rate flexibility, less sensitivity has come to be attached to the specification of explicit commitments on the path of the exchange rate, and a number of recent programs have incorporated performance criteria in that area, often expressed in terms of specifying the future path of the real effective exchange rate or of progress towards unification of a multiple rate system. Balance of payments tests and review clauses also continue to be widely used. 3/

The choice among these alternative methods of monitoring exchange rate action depends largely on the circumstances of the case and the nature of the active exchange rate policy being monitored. Where the aim is to ensure that the appropriateness of the rate be restored and

1/ The experience of the Fund with the formulation and operation of balance of payments tests in stand-by arrangements was last discussed in SM/73/22 (2/1/73) (see Appendix II, item 15).

2/ This experience and the factors behind it were discussed in EBS/84/232 (11/16/84) (see Appendix II, item 15) and is further reviewed in the supplement to the present paper.

3/ Of the arrangements approved since 1983, 65 percent have been in support of programs involving an active exchange rate policy during the program period monitored through balance of payments tests (26 percent), exchange rate rules (15 percent) or reviews (24 percent), see the supplement.

maintained, monitoring through prior actions and periodic assessments through reviews may be adequate. Where there is a clear idea of the level of the real exchange rate required to meet the proximate objective with respect to external competitiveness, a rule may be appropriate. Where the basic policy is to let the market determine the rate, the balance of payments test is appropriate.

In practice, the conduct of exchange rate policy cannot always be fitted precisely into any of these categories. For example, there may be a general commitment to a market-determined rate, but the authorities are not prepared to accept extremely large fluctuations in the rate, which thus could lead to compensatory intervention in the exchange market. While no simple performance criterion can fully capture the authorities' policy intentions in such a case, the balance of payments test may still be useful. While it must be recognized that severe exchange market pressures could well lead to nonobservance of the performance criterion, it must also be noted that such nonobservance could trigger a review of the program that would be appropriate if in fact such severe pressures developed. This review could result in a waiver, if the problem was transitory, or in new understandings, if some more fundamental problem was revealed by the behavior of the market.

The balance of payments test is also useful through its focus on the level of gross reserves, and hence on reserve management policy. This can be particularly important where the level of reserves is a key proximate objective of the program, and can be a critical element in the context of safeguarding the revolving character of the Fund's resources.

8. Exchange and trade policies

Consistent with the basic purposes of the Fund, performance criteria relating to the exchange and trade system feature in all upper credit tranche arrangements. At one time, these took the form of separate performance criteria covering the specific elements of the restrictive system that were important in the particular situation in question. In the 1970s, however, a standardized performance clause was developed in the interests of uniformity of treatment, and such a clause remains a feature of all upper credit tranche stand-by and extended arrangements today. Reflecting the Fund's basic principle that the use of restrictions to deal with balance of payments problems be avoided, arrangements also normally call for removal of recently imposed restrictions.

One of the purposes for which the Fund can make its resources available is to support a member's efforts to achieve liberalization of

its external sector. 1/ As is noted in the supplement, however, performance criteria involving major liberalization in the context of Fund-supported programs have not been frequent. One of the most important issues faced by the Fund in its advocacy of structural reforms is thus the extent to which external liberalization should be pursued.

Performance criteria relating to the elimination of external payments arrears are also required when such arrears exist. In addition, in recent years, specific performance criteria barring members from incurring new arrears have applied where there are fears that arrears might arise. In this context, specific performance criteria relating to satisfactory conclusion of debt rescheduling arrangements with official and commercial bank creditors have sometimes been used to ensure that the program remains financeable and that debt service is kept current. 2/

9. Other policy areas

Beyond the main areas described above, there are performance criteria that relate to other policy areas or to microeconomic variables. As the Fund needs to avoid taking positions on matters of social equity and on detailed decisions on the allocation of resources, its approach in these areas must be circumspect. However, on a case-by-case basis, understandings have been reached on these domains in instances where they were considered essential for the effectiveness of the adjustment program because of their macroeconomic impact--for example, performance criteria relating to particular pricing actions, including interest rate policy.

Monitoring of microeconomic variables, when necessary, has generally been in the form of prior actions, reviews, or supplementary monitoring. Reviews have often been used to monitor broad structural reforms, such as changes in tax systems, financial systems, and the structure of the public sector. For specific structural measures, prior actions are generally preferred, since it is seldom the case that

1/ An early proposal in this area, approved by the Board in May 1951, was that the Fund's resources would be made available to members undertaking practical programs of action designed to achieve the purposes of the Fund Agreement, especially the relaxation and removal of restrictions and discrimination, and the simplification of multiple currency practices (Annual Report, 1951, p. 81). It was hoped that the availability of assistance from the Fund would give greater confidence to member countries and thereby encourage them to take more decisive policy measures.

2/ A related provision is the now standard clause that purchases may not be made when the member is in arrears to the Fund. Executive Board Decision No. 7908-(85/29), adopted February 20, 1985 (Selected Decisions, Eleventh Issue, p. 70.)

anything is to be gained by postponing the action to some point during the program period.

10. Statistical considerations

Problems have arisen from time to time regarding the measurement and reporting of performance criteria under Fund arrangements. 1/ Changes in definitions of the policy instruments subject to performance criteria can in some cases, as discussed above, help to alleviate these problems. Beyond that, improvements in statistical techniques for measuring and reporting in relation to performance criteria are often needed. Particular areas where statistical problems have arisen in the past and which may need special attention include the definition and accounting of external and domestic payments arrears, the treatment of entries for other items (net) in financial balance sheets, and the coverage of performance criteria on net foreign assets and external debt.

In formulating performance criteria, allowances need to be made for the availability and reliability of the data concerned. If the member's system for collecting and reporting relevant information is deficient, a first priority is the adoption of measures to correct the deficiency. At times, there might be need for Fund technical assistance to help improve the member's administrative and statistical apparatus. Where an adequate correction is not yet practical, the definition of the performance criteria concerned can be adapted to make allowances for the shortcomings that can be foreseen in advance. In any event, potential issues of definition should be clarified at the outset and should to the extent possible be discussed in technical memoranda attached to arrangements. As noted above, the most comprehensive definition is often the simplest and clearest, and can help to avoid misunderstandings at a later stage. Exclusions to the coverage of those aggregates chosen for performance criteria should thus be avoided as much as possible. Where such exclusions are necessary they should be clearly indicated in technical memoranda attached to arrangements. Moreover, by minimizing the number of performance criteria, the data reporting requirement should be lightened.

IV. Issues in the Selection and Mix of Monitoring Techniques

The difficult global economic environment that member countries have had to confront in the first half of the 1980s has meant that a significant number of them have found balance of payments adjustment to be a longer and more arduous process than had generally been the case in the past. Marked shifts in terms of trade, variations in capital flows, and other external factors have rendered the implementation of adjustment programs difficult and have also had implications for their

1/ See EBS/84/94 (4/27/84) (Appendix II, item 16b).

design. As a result, the outcomes of adjustment programs that have been undertaken with Fund support have sometimes proved disappointing. It is against this background that issues in the selection of instruments and techniques for program monitoring are to be evaluated.

The general principles underlying the design of Fund-supported adjustment programs are by now well established, and by and large the experience with those programs indicates that they remain appropriate to the attainment of their objectives. Of course, individual instances have arisen where the design and implementation of policies have fallen short of the ideal; this has been partly on account of difficulties such as those noted above, but on occasion it has also reflected the political compromises inherent in the process of economic policy formulation. It is also the case that questions are currently being raised about the relative priority to be assigned to economic policy objectives, particularly to growth, in the design of adjustment programs. But these concerns have not involved fundamental questions about the appropriateness of the links that the design of programs establishes between the implementation of economic policies and the adjustment objectives.

Rather a key issue at stake is how to provide a better assurance that implementation takes place, because, in general, determination in policy implementation will bring about progress toward the achievement of program objectives. The Fund's monitoring of program implementation is intended to guard against further use of resources, when there are slippages in implementation, until assurances have been re-established that the objectives will be attained and that the resources will be used appropriately.

In considering the issue of selection of monitoring techniques, it is important to bear in mind the fundamental limit to the efficacy of program monitoring imposed by the degree of commitment of the member to the policies that make up the program. The commitment of members to their programs is essential to their success. While the Fund's role in providing policy advice is important to the formulation and design of the program, it can only be effective if the member is committed to it and implements it with the consequent resolve.

In practice, of course, the commitment of country authorities to program implementation, as noted above, is often affected by domestic political difficulties as well as by exogenous developments. It is when such pressures are strongest that close monitoring can be crucial, because it can help encourage members to persist and follow through with policy implementation. Close monitoring can also limit, by the consequent interruption of purchases if policy implementation falters, the amount of the Fund's resources put at risk.

1. Program reviews in relation to prior actions and performance criteria

As discussed in Section II, satisfactory completion of midyear ^{1/} reviews has become a common feature among the performance clauses in stand-by and extended arrangements in recent years. Beyond their traditional role of consultation concerning progress under the program, such reviews have served a number of other purposes. In some cases, when the quantitative aspects of some or all performance criteria can be determined initially for only a segment of the program year, the review has been used as a substitute device through which the criteria are set for the rest of the year. In instances where policy actions to be taken in the course of the year are not considered amenable to formulation as quantitative performance criteria, the review has served as a complement to the existing criteria by assessing implementation and progress made in these policy areas. Reviews have also been instrumental as supplements to performance criteria by providing an opportunity to assess developments in certain important intermediate variables, such as the rate of monetary expansion in the area of credit policy or the flow of government revenues and expenditures. Finally, reviews have served as a means to adjust the parameters of the program as necessary in light of changing circumstances, particularly with respect to the external financing available to the member.

In general, given the magnitude of the uncertainties faced by countries undertaking adjustment programs in recent years, the flexibility provided by reviews has proved to be helpful in program monitoring. In hindsight, however, it may be noted that the incidence of such reviews may have been greater than was originally envisaged when Guideline 10 was formulated. ^{2/}

An important issue with respect to reviews is their role in the formulation of basic policies for the program period. An essential aim of the design of an adjustment program is to set a well-defined course for economic policy within an appropriate time frame. The broad outline and thrust of policies will generally need to be framed in a medium-term context and pursued over a period of years for the objectives to be attained on a sustained basis; but within such a setting, specific policies and their immediate objectives need to be formulated for a period ahead, the duration of which should not be unduly short.

^{1/} That is, reviews in the course of a program year. Annual reviews are considered to be essential features of multiyear arrangements, but midyear reviews are only included in arrangements if required for the reasons discussed in Section II. In some cases, there may be more than one review in the course of a program year; all such reviews are referred to here as "midyear."

^{2/} As noted in the supplement to this paper, the incidence of arrangements with performance clauses specifying midterm reviews has been around 90 percent since 1983.

Macroeconomic policies in most member countries are formulated on an annual cycle and a year has typically been used as the basic policy planning period for Fund arrangements. Policy formulation over periods significantly shorter than a year runs the danger of being turned into a set of ad hoc responses to the latest events and pressures. For this reason, it is important to stress that an adjustment effort would not be well served by reviews that substitute for comprehensive and precise policy formulation for the basic program period. The design of adjustment needs to encompass the formulation of measures that are to be adopted during the annual program as well as provide opportunities to ensure that their implementation gets under way.

These considerations imply that reviews should not be used to postpone the process of formulation of the basic policies that are monitored through the aggregates selected in the form of performance criteria. The most straightforward way to prevent reviews from assuming too large a role, and perhaps slow down or erode the process of policy implementation, would be for performance criteria to be set normally for the whole of the program year on the basis of the information and projections available at the time of inception of the program. Such an approach would provide both the Fund and the member with a clear understanding of the quantitative framework within which policies are to be carried out and corresponding purchases of Fund resources are to be made. This should not be interpreted to mean that performance criteria would be indelibly fixed for the whole of the program period, regardless of developments. In this connection, an appropriate measure of flexibility will be required to prevent imparting undue rigidity to adjustment programs. The implementation of the procedure in waivers and modifications will play a role in this regard. Also, reviews would continue to fulfill a useful function in their role of complementing performance criteria and to provide, whenever appropriate, an occasion for Board consideration of possible waivers and modifications. 1/

Similarly, reviews should not normally have to involve consideration of a wide range of discrete policy measures. In general, essential discrete policy measures would be best taken at the outset of the program in order to maximize their effectiveness in yielding their

1/ In some cases, an intermediate solution has been to set "indicative targets" for the variable to be monitored, the continued validity of which for the later part of the program period is to be assessed as part of the review. While this type of approach can be helpful, it would generally be better to set them as performance criteria, with the possibility of later modification. The desirability of performance criteria covering a full 12 months was noted at the conclusion of the Executive Board's discussion of phasing and performance criteria, which established the minimum standard that as a normal rule performance criteria needed to cover 6 months, with indicative targets for the the later part of the period (Appendix II, item 16c).

results without delays. It is often the case that whenever the implementation of such measures is postponed until some time during the program period, uncertainty develops about whether the measures will actually be taken on schedule. Together with the adverse impact of delays in implementation on progress toward the program's objectives, such delays make it more difficult to see clearly the policy path for the program period.

The advantage of keeping the scope of reviews appropriately confined is that it gives a clearer picture of what can be expected from its completion; otherwise, there is a danger that the review effectively becomes equivalent to negotiation of a program for increasingly shorter periods of time. Too broad a scope for reviews, moreover, often leads to delays in their completion (this issue, which has been raised in the Executive Board on various occasions, is discussed in subsection 2, below). More generally, the open-ended character of the review in effect leaves the member without a clear understanding of what will be needed during the remainder of the program year to be in a position to continue to make purchases. The pressure to reach understandings so as to complete the review can also eventually result in a weaker program than would have been the case had the policy path been clearly laid out from the outset.

2. Responses to delays in completing reviews

Questions have been raised by a number of Executive Directors concerning the implications of failure to complete program reviews by the deadline specified in the particular arrangements. The general implications of and the issues involved in delays in review completion will be examined, as part of the overall assessment of experience with the review provision, in the upcoming annual conditionality review. But some of the issues that have been raised in this context will be discussed here in a preliminary fashion.

Delays in the completion of program reviews are attributable to a number of reasons and they may not always imply that major difficulties are being encountered in the implementation of the program. In some instances, delays have been caused by lags in the completion of the requisite external financing arrangements (such as debt rescheduling and new bank money packages) which not infrequently prove to be more time consuming than anticipated. Delays have also arisen because of deviations in policy implementation from the time path envisaged at the program's inception, such as when legislation of difficult budgetary measures takes longer than expected. When delays do not have major policy consequences they need not impair the prospects for adjustment. ^{1/}

^{1/} In view of the heavy demands that the increase in the number of reviews has placed on staff resources, on occasion staffing constraints have also been a factor in delays in completion of reviews.

In certain instances, however, delays occur in review completion that reflect fundamental difficulties and extend the review process beyond a reasonable period. Such delays are a cause for serious concern as they signal the presence of major policy slippages or of significant deviations from initial policy intentions. These problems may be traced to a number of exogenous factors, including unforeseen adverse external developments, but they often also reflect difficulties in reaching necessary policy understandings promptly, which can effectively mean that through the consequent delay the program irreparably slides off track.

Responses to undue delays in completion of reviews have included modification of the program within the existing arrangement, whenever the review could be completed, or the eventual replacement of the existing arrangement with a new one, typically after a relatively long period had elapsed. In determining the appropriate response, a number of considerations are involved, including the prospects for attainability of the original program objectives, which, under most circumstances, are related to the nature and magnitude of the policy deviation. While there are no hard and fast rules in this regard, the presumption would be that continuation of the existing arrangement would be appropriate whenever the original program targets remain attainable. This approach has entailed (when the period of interruption has been relatively long) a rephasing and at times a modification of the amount of access, together with an extension of the period of the arrangement.

In this context, issues that have arisen concern the period between the interruption of the member's right to purchase on account of the lack of completion of the review and the restoration of such a right. One issue is whether it would be appropriate to establish a maximum period within which reviews are to be completed at the Executive Board. Under current practice, while the maximum period in principle is the remaining length of the arrangement, in effect it is more limited, since the prospects for continued attainability of program objectives become increasingly improbable as the time left within the arrangement shortens. For a maximum period to be effective in maintaining the standards of conditionality, it would need to be sufficiently short to minimize policy slippages. Too short a maximum period, however, could be counterproductive in situations where the program objectives remain attainable. Thus, a common maximum period may not permit an appropriate response to the wide variety of circumstances that lead to delays. The pragmatic approach may be to continue with current flexibility in responses to the member's particular circumstances, without setting a maximum period for review completion.

Another issue in this connection is the concern that lack of completion of a review leaves the Executive Board uninformed of developments under some arrangements. A possible procedure for this type of situation may be to extend to them the possibility envisaged in the Guidelines on Conditionality (in particular, Guideline 10) that the

Managing Director keep Executive Directors informed in an appropriate manner of the status of discussions with a member.

More generally, factual reporting to the Executive Board of the emergence of delays in review completion could be triggered on the basis of an appropriate uniform lapse of time. Such reporting, however, might not be sufficiently informative, as the preparation of papers of an analytical nature, involving details of the areas under discussion, might prove to be impractical in the face of incomplete ongoing negotiations. Alternatively, selective reporting to the Executive Board of particular difficult cases might also prove problematic, not only on grounds of comparability of treatment, but also because of the danger that the absence or presence of such reports could be construed by sources of capital flows as on-off signals for their continued involvement.

3. Reviews as an alternative to automatic adjustments of quantitative performance criteria

Practical difficulties in program design and monitoring frequently arise from the inability to forecast with sufficient precision the evolution of certain key exogenous variables (e.g., the prices of main export commodities or the levels and timing of certain capital flows). At times, difficulties in formulating performance criteria also arise from an imperfect data base for those variables that are to be thus monitored, e.g., domestic and external payments arrears. Therefore, automatic adjustments have been provided for certain quantitative performance criteria in some arrangements to deal with some of these difficulties.

Resort to automatic adjustments has become more frequent since 1983, primarily reflecting greater uncertainties in the availability and timing of external financing. ^{1/} In particular, almost half of all arrangements since 1983 have included provisions for automatic adjustments of one or more performance criteria for deviations in the actual values of certain key variables from programmed levels. Frequently, automatic adjustments have been provided for deviations from the program assumptions concerning the flow of new external assistance and balance of payments financing. Adjustments have also been provided for deviations in the level and timing of external financing resulting from debt reschedulings. Typically, credit ceilings (usually on both total credit and credit to the government) and, where appropriate, targets on net foreign assets were to be adjusted by deviations in external financing over the programmed level. In a few programs, the provision for automatic adjustments in the credit ceilings was symmetrical so that shortfalls in external financing from the programmed level were also to automatically raise the credit ceilings up to a

^{1/} The supplement provides factual background to this discussion.

specified amount. In a few arrangements, automatic adjustments were provided to correct for revisions in the original data base.

Automatic adjustments of performance criteria may be appropriate for dealing with minor deviations of exogenous variables from program assumptions that are clearly reversible over a relatively short period and that can be anticipated with a reasonable measure of certainty. They may also be appropriate where the envisaged adjustments in the ceilings are marginal and where the basic thrust of the policy effort remains intact.

Aside from these general considerations, in practice the effectiveness of automatic adjustments for purposes of program monitoring will depend on the nature of the deviation for which they are intended. Adjustments automatically provide for accommodation of possible variations in a specified exogenous variable, generally, without policy adaptations. For example, where shortfalls in foreign financing or commodity prices turn out to be lasting, automatic adjustments would defer the needed policy correction.

These considerations and recent experience suggest that program implementation would be strengthened by limiting the use of automatic adjustments, particularly in those cases where there is little room for policy slippages. Such use could be confined to those for purely technical, data-related reasons and those involving delays in well-identified capital inflows, e.g. World Bank loans, government-to-government loans and assistance, and debt relief from multilateral rescheduling arrangements. In these cases, the range of possible outcomes is better known than other forms of foreign financing. Fluctuations in other exogenous variables such as key commodity prices could be too large and not reversible within a short time for such an approach to be effective. Thus, aside from accommodating small variations in such fluctuations as a matter of course in the financial programming exercise, the program should be monitored through reviews or waivers or modifications as appropriate. More fundamentally, expanding the scope of automatic adjustments to cover more exogenous variables would render less meaningful the exercise of designing a program to meet overall objectives given normal uncertainties in external developments. This is a particularly important point, as one of the difficult judgments to be formulated in relation to exogenous developments concern their temporariness, on which the whole validity of ex ante automatic adjustment hinges.

4. Monitoring of structural policies

Current emphasis on "structural adjustment" as a desirable feature of Fund-supported programs raises the issue of how best to monitor "structural" policies. This is part of the broader issue of the extent to which the Fund should insist on the implementation of such policies in the programs it supports.

Structural adjustment has long been an objective of Fund-supported programs, as they have sought the attainment of a viable external payments situation in a setting of macroeconomic balance and efficiency. In this connection, the Fund has consistently urged members to adopt the most efficient path to macroeconomic balance--that is, the path that is most favorable to growth in the medium term, as shown by emphasis on maintaining an appropriate exchange rate and avoiding restrictions on external transactions. It has not always been possible for member countries to pursue growth-oriented policies, given their other economic and social objectives. In such cases, the Fund has supported the member's program whenever such a program offered an adequate assurance of the achievement of macroeconomic balance and of a viable external position. The recent increase in emphasis on growth as a key policy objective stems from the fact that, although it requires the generation of domestic savings, growth also contributes to the capacity of a country to increase those domestic savings and fosters the mobilization of foreign savings, both of which help to bring about future economic expansion. Prolonged periods of slow growth while struggling toward macroeconomic balance, moreover, can lead to "adjustment fatigue" and its attendant danger of slippage in adjustment policies. Nevertheless, while it would be appropriate for the Fund to stress in its discussions with members the advantages of a growth-oriented approach, the choice of the relative importance to be attached to this objective remains with the member.

Many of the "structural" policies that are advocated as part of a more growth-oriented approach fall largely within the domain of the World Bank, but some are clearly the responsibility of the Fund, while others are of common interest. Among the issues the Fund faces in the fiscal area, for example, are the relative role of revenues and expenditures in achieving fiscal balance, and the emphasis to be given to the composition of expenditures and the structure of taxation, not just their levels; there is often a particular focus on the possibility of reducing expenditures (or raising revenues) through correcting price distortions, or of protecting public investment, or maintenance of the capital stock, from bearing too much of the burden of expenditure restraint. ^{1/} In the area of the Fund's jurisdictional responsibilities, moreover, there is the issue of the extent to which the Fund should press for major dismantling of restrictive systems, as opposed to the more passive approach of eliminating only newly imposed restrictions; such an opening up of the economy could prove to be a catalyst for more broad-based institutional reforms.

Apart from the general question of the extent to which the Fund should press for structural measures, there is the more specific issue

^{1/} One proposal that has been made, in the context of ensuring local currency funds to implement World Bank projects, is to include selective credit guidelines to direct financial resources toward development in the context of public sector investment programs.

of the techniques that should be applied to monitoring such policies. While the practice has been to avoid excessive insistence on structural policies, the Fund has nonetheless generally sought to understand the details of the policy intentions of the authorities. On the fiscal front, for example, the Fund has needed to reach clear understandings of the nature and extent of the revenue and expenditure measures to be implemented, in order to reach a judgment on whether fiscal policy would follow the path intended in the program. While the authorities remain by and large free to adopt alternative means of meeting the fiscal ceilings, it often is the case that some measures need to be taken as prior actions to ensure an adequate start to implementation. If the Fund were to focus more on the precise character of the fiscal measures involved, presumably this would require identification of the types of additional steps that needed to be taken as prior actions or, when they were not taken at the outset, as conditions for completion of program reviews. More generally, most structural policies can be defined in terms of discrete actions for which, depending on their timing, prior actions or reviews provide the best monitoring technique. Reviews can also serve to monitor policies that are less amenable to measurement in terms of specific actions. For example, some structural policies, such as the maintenance of public investment and related expenditures at appropriate levels--of course within the overall fiscal constraint--could possibly be formulated as quantitative targets to be monitored through reviews.

5. The integral nature of performance criteria,
reviews and other monitoring instruments

There is an aspect of performance criteria and other instruments used to monitor policy implementation that continues to warrant close attention. Experience indicates that where arrangements exhibit partial compliance with performance criteria, or where significant delays take place concerning the conduct and completion of scheduled reviews, program objectives are rarely attained. Such experience underscores the integral nature of policy instruments and their close relationship with policy reviews. The subject is one of increasing concern because partial breaches of observance that impair program objectives, when accompanied by the application of the waiver procedure or by the exercise of the policies on modification of performance criteria, may put at risk the revolving character of Fund resources.

While waivers and modifications are useful techniques which serve to prevent understandings under the arrangements from becoming unduly rigid, they also influence the quality of performance and therefore the appropriateness of the use of Fund resources. The experience of the last few years would appear to advocate a good measure of caution in the extension of waivers or in the acceptance of modifications of performance criteria. The underlying reason is the set of "virtuous" and "vicious" circles that bind together the instruments of an economic policy program. For example, observance of agreed performance criteria (such as those on credit and fiscal policy) and the undertaking of

agreed actions (such as those on pricing) in and of themselves influence positively the quality of performance in other policy areas (such as arrears and restrictions) as well as the attainment of policy objectives. On the other hand, inappropriate performance on certain fronts (such as continued incurrence of arrears and resort to controls and restrictions) may render the observance of certain performance criteria (such as those on domestic credit expansion or on the public sector finances) virtually meaningless as the progress, if any, which can be made toward the attainment of program objectives cannot be sustained.

A similar process also unfolds during the conduct under pressure of unduly delayed reviews. As the delays often are caused by policy slippages and difficulties in undertaking the sort of actions that would be required for a prompt correction of the policy departures, this process on occasion only serves to weaken the resolve of the authorities and the strength of their policies. While procedures have been devised to contain the impact of policy erosion on the use of Fund resources through modification in the level of access and in the phasing of purchases, these may not be sufficient because the process of policy erosion undermines the attainment and maintenance of policy objectives, which provide the ultimate safeguard for the revolving character of Fund resources.

The considerations discussed in this section revolve around a specific manifestation of the fallacy of composition. Assessment of performance under programs and the consequent evaluation of progress made toward policy objectives cannot be solely based on separate analysis of each specific component. On the contrary, assessment of developments in each specific policy area must be set against the background of developments in other areas of the program to ensure that views formed on the basis of the component parts do not distort the prospects that follow from an assessment of the whole.

6. Deviations from understandings on supporting policies 1/

In some programs, policy actions have been taken that are clearly contrary to the understandings reached between the Fund and the member and that imply that the objectives of the program cannot be achieved without major policy adjustments. Ultimately, such major departures from declared policy intentions will be captured by nonobservance of performance criteria; but this may take some time, given the inevitable

1/ Important and specific aspects related to this subject were addressed in the context of the Executive Board discussion on misreporting and noncomplying purchases under Fund arrangements, EBM/84/81 (5/24/84) and EBM/84/165 (11/16/84), on the basis of EBS/84/94 and EBS/84/196 (9/13/84) (Appendix II, item 16). A paper is under preparation on legal options dealing with the problems relating to deviations from understandings on supporting policies.

lags in the effects of specific measures on monitoring aggregates and in reporting on those aggregates. This could permit further purchases to be made without an adjustment in policies. The Fund's traditional practices with respect to stand-by arrangements do not appear to offer satisfactory recourse, 1/ and it may be useful to discuss briefly some possible adaptations to deal with such situations.

The strongest response to clear evidence of major policy deviations would be to cancel the arrangement and require an immediate repurchase of any drawings made. A lesser response would be to interrupt drawings under the arrangement until new understandings are reached with the member and necessary corrective action has been taken. 2/ If the member did in fact make any purchases after the policy action had been taken, a requirement of immediate repurchase akin to that which applies to noncomplying purchases could be established. Development of either of these procedures would of course need to involve consideration of the nature and magnitude of deviation that would lead to such a response, since allowance for minor policy adjustments is a basic feature of stand-by arrangements.

7. Problems of data availability

A problem that has arisen, particularly with some of the least developed members of the Fund, is the absence of reliable data through which the path of key policies can be monitored. The difficulty of economic analysis and prescription in such situations makes the design of an adjustment program particularly problematic. The availability of data that are partial or incomplete also poses difficulties for program monitoring. Generation of better data has a high priority, and the Fund can help by providing technical assistance. In the meantime, the Fund needs to face the question of how to ensure that the design and implementation of the member's adjustment program meets Fund standards.

Reviews can play a particularly useful role in such cases. Despite the scarcity of reliable statistics, it is still essential to set out an overall policy framework in quantitative terms, based on whatever balance of payments, monetary, and fiscal data are available. These need not be established as performance criteria, but they can provide

1/ For example, requiring reviews before each purchase, as in the case of inadequate data discussed below, would immediately pose the problem of how to decide to which arrangements the procedure would be applied.

2/ This procedure would be somewhat similar to the discontinued "prior notice" clause (see p. 6, footnote 2), but would need to be carefully defined and limited to cases where the Fund had clear grounds to believe that specific policy actions or inactions that deviated in a major way from previous understandings seriously threatened the achievement of the program's objectives. The operational modalities would also need to provide the member with clear safeguards.

the primary focus for quarterly reviews, the completion of which would be a prerequisite for purchases. In carrying out the review, considerable stress would be placed on understanding the shortcomings of the data in tracking policy implementation, a process that in itself would serve to promote the generation of better data. The quantitative focus would, moreover, prevent the arrangement from becoming simply a series of purchases based on sets of ad hoc measures, the significance of which would be difficult to interpret.

V. Summary and Issues for Discussion

This paper has traced the evolution of practices and procedures regarding performance criteria and other monitoring techniques included in stand-by and extended arrangements. After outlining the basic characteristics and other important features of such performance criteria and other monitoring tools, the paper has examined, on the basis of the experience since the adoption of the Guidelines on Conditionality in early 1979, the policy coverage of performance criteria and the resort that has been made to review clauses. Against this background, the paper has examined a variety of issues that have arisen with respect to the selection and use of monitoring techniques.

Among the issues that Executive Directors may wish to focus on in their discussion are the following:

(1) The importance of comprehensiveness in the definition of quantitative performance criteria. Section III has noted the general desirability of comprehensive definitions as a means of avoiding the distorting effects on the achievement of program objectives that may occur on account of unforeseen developments in components excluded from narrower definitions. This issue arises particularly with respect to overall credit ceilings, where the broader concept of net domestic assets would normally be preferable to the concept of domestic credit, and in the fiscal area, where a broad definition of the public sector borrowing requirement would normally be preferable to one limited to net bank credit to the government. Comprehensive definitions also help to reduce the number of performance criteria needed for program monitoring.

(2) The desirability of a clear specification of the path envisaged for the key intermediate variables that underlie the formulation of quantitative performance criteria. Such concrete specification of intermediate variables can permit a timely evaluation of the nature of deviations in those variables in order to ascertain whether policy adaptations and consequent modifications to the performance criteria are warranted, and can provide a more specific focus for program reviews.

(3) The role of program reviews in relation to prior actions and performance criteria. Section IV.1 notes that the difficulties of program implementation in the face of adverse exogenous developments

have recently resulted in a marked expansion in the number of arrangements incorporating midyear reviews. While such reviews of progress have been essential to flexible adaptation of policies in the light of unexpected developments, it is important that they not be allowed to detract from the basic process of policy planning and implementation. This concern has three aspects. (i) Since the basic policy planning period for most countries is one year, as much as possible performance criteria should be established for the full program at the time the arrangement is approved. Besides the normal assessment of progress in program implementation, reviews would thus be limited to assessment of those policies that were not amenable to monitoring through performance criteria rather than becoming a vehicle for embarking on a new financial programming exercise. (ii) Necessary discrete policy measures should as much as possible be taken at the outset of programs, rather than being left for reconsideration in program reviews. (iii) Too broad a scope for reviews can result in uncertainties on the part of the member about expected policy implementation over the program period, and consequently to difficulty in reaching policy understandings regarding the period following the review. This can result in erosion in policy implementation and consequent delays in reviews.

(4) The appropriate approach to be taken in dealing with delays in completing reviews. Narrowing the scope of reviews, as discussed above, would alleviate the problems of delays, but delays may still occur as a result of significant policy slippages. A possible approach, noted in Section IV.2, has been to follow the suggestion of the guidelines of informing the Executive Board on a uniform basis of the reasons for delays in completing a program review. In general, however, given the variety of situations, there appears to be a continuing need for flexibility in dealing with delays.

(5) The desirability of using reviews, rather than automatic adjustments, in determining the need for modifying performance criteria in the light of unexpected developments, as discussed in Section IV.3.

(6) The role of program monitoring in promoting structural adjustment. This issue, discussed in Section IV.4, involves the extent to which techniques such as performance criteria should be used in monitoring structural measures. Increasing attention to structural aspects of economic policy could necessitate further use of reviews.

(7) The need for continuing attention to the potential of individual departures in specific criteria, or of delays in reviews, to affect adversely the effectiveness of the whole policy program, as discussed in Section IV.5. The well-established general principle that the evaluation of components be also related to the situation of the whole warrants restatement.

(8) Procedures for dealing with major deviations from policy understandings that are not directly subject to any of the Fund's

current monitoring techniques. Section VI.6 notes two possible procedural adaptations for responding to clear evidence of such deviations: cancellation of the arrangement and requirement of immediate repurchase of any drawings made, or, on a lesser scale, immediate interruption of the arrangement until new understandings are reached.

(9) The modalities of assisting members in policy formulation and implementation in the absence of data sufficiently reliable for definition of performance criteria. In such cases, discussed in Section IV.7, an important feature of the programming exercise would be the setting up of improved data generation and collection schemes. In the meantime, quantification, even if incomplete, remains desirable and could be the basis for reviews, as an acceptable substitute for performance criteria, to examine the available quantitative data.

Executive Board Decisions following the
1968 and 1978-79 Reviews of Conditionality

I. Use of Fund's Resources and Stand-By Arrangements

The Executive Board has reviewed the Fund's policy with respect to the use of its resources under stand-by arrangements (SM/68/128 and Supplements 1-4, SM/68/141) and agrees that the Fund shall be guided by the approach in the conclusions set forth in SM/68/128, Supplement 4 as revised.

Decision No. 2603-(68/132)
September 20, 1968

Conclusions

In the light of experience over the past years and taking into consideration the necessity of adequate safeguards for the Fund and the need for flexibility while ensuring uniform and equitable treatment of all members, it is proposed that Fund policies and practices on the use of its resources, including tranche policies, shall continue to apply subject to the following:

1. Appropriate consultation clauses will be incorporated in all stand-by arrangements.

2. Provision will be made for consultation, from time to time, with a member during the whole period in which the member is making use of the Fund's resources beyond the first credit tranche whether or not the use results from a stand-by arrangement.

3. Phasing and performance clauses will be omitted in stand-by arrangements that do not go beyond the first credit tranche.

4. Appropriate phasing and performance clauses will be used in all stand-by arrangements other than those referred to in paragraph 3, but these clauses will be applicable only to purchases beyond the first credit tranche.

5. Notwithstanding paragraph 4, in exceptional cases phasing need not be used in stand-by arrangements that go beyond the first credit tranche when the Fund considers it essential that the full amount of the stand-by arrangement be promptly available. In these stand-by arrangements, the performance clauses will be so drafted as to require the member to consult the Fund in order to reach understandings, if needed, on new or amended performance criteria even if there is no

amount that could still be purchased under the stand-by arrangements. This consultation will include a discussion by the Executive Directors which could culminate in a communication of their views to the member under Article XII, Section 8.

6. Performance clauses will cover those performance criteria necessary to evaluate implementation of the program with a view to ensuring the achievement of its objectives, but no others. No general rule as to the number and content of performance criteria can be adopted in view of the diversity of problems and institutional arrangements of members.

7. In view of the character of stand-by arrangements, language having a contractual flavor will be avoided in the stand-by documents.

II. Guidelines on Conditionality

The Executive Board agrees to the text of the guidelines on conditionality for the use of the Fund's resources and for stand-by arrangements as set forth [below].

Decision No. 6056-(79/38)
March 2, 1979

Use of Fund's General Resources and Stand-By Arrangements

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 macro-economic 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.

III. Guidelines on Performance Criteria with Respect to Foreign Borrowing

The Executive Board approves the Chairman's summing up on external debt management policies as set forth [below].

Decision No. 6230-(79/140)
August 3, 1979

The Chairman's Summing Up on External Debt Management Policies

In the context of a general discussion of the issues relating to external debt management policies, the Executive Board considered the following guideline on the performance criteria with respect to foreign borrowing:

When the size and the rate of growth of external indebtedness is a relevant factor in the design of an adjustment program, a performance criterion relating to official and officially guaranteed foreign borrowing will be included in upper credit tranche arrangements. The criterion will include foreign loans with maturities of over one year, with the upper limit being determined by conditions in world capital markets; in present conditions, the upper limit will include loans with maturities in the range of 10 to 12 years. The criterion will usually be formulated in terms of

loans contracted or authorized. However, in appropriate cases, it may be formulated in terms of net disbursements or net changes in the stock of external official and officially guaranteed debt. Normally, the performance criterion will also include a subceiling on foreign loans with maturities of over one year and up to five years. Flexibility will be exercised to ensure that the use of the performance criterion will not discourage capital flows of a concessional nature by excluding from the coverage of performance criteria loans defined as concessional under DAC criteria, where sufficient data are available.

Adoption of this guideline will be subject to the understanding that the staff will be guided also by the following points:

1. The above guideline will be applied with a reasonable degree of flexibility while safeguarding the principle of uniformity of treatment among members. The external debt guideline should be interpreted in the light of the general guidelines on conditionality (Decision No. 6056- (79/38)), especially guideline No. 4, which states:

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.

Also, guideline No. 9 includes the following:

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.

Furthermore, guideline No. 8 states:

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.

2. While uniformity of treatment indicates a need for a common upper-maturity limit, this limit will be reviewed annually by the Executive Board at the time of its consideration of staff papers on conditions in international capital markets. In analyzing the amount and terms of new borrowing that would be appropriate--in the member's circumstances--over the medium term, the staff will take into account prospective developments in the member's external payments situation and the profile of its external indebtedness.

3. In formulating external debt criteria, the staff will be mindful of the need to ensure consistency between external debt management and policies and domestic financial policies. Where external debt per se is not a matter for concern, but adjustment programs have as a main objective to reduce excess demand pressures and restore overall balance to the public sector finances, the credit ceiling for the public sector would cover both domestic and foreign financing of the overall public sector deficit.

4. Normally the performance criterion will relate to official and officially guaranteed foreign borrowing. The coverage will include official entities for which the government is financially responsible as well as private borrowing for which official guarantees have been extended and which, therefore, constitute a contingent liability of the government.

5. In cases where the member's external debt management policy covers private sector borrowing without official guarantee and there is an established regulatory machinery to control such borrowing, it will be proposed that the performance criterion on foreign borrowing should be adapted accordingly.

6. Normally, loans of less than one-year maturity will be excluded from the borrowing limitations. In exceptional circumstances where nontrade-related loans of less than one year of maturity become a source of difficulty, such loans will be included in the limitations. The Managing Director will inform Executive Directors in an appropriate manner of the reasons for including such loans in the limitation.

7. The last sentence of the guideline provides for excluding from the coverage of performance criteria those loans defined as concessional under DAC criteria. Available information on loans by multilateral development institutions indicates that all of the recent loans of the IBRD and the Inter-American Development Bank have been outside the 10 to 12-year limit and that most of the loans by the Asian and African regional development banks have also been outside the upper limit. In discussing with member countries the total amounts of permissible borrowing of less than 10 to 12 years' maturity, the staff would take into account possible lending of less than this maturity range by multilateral development institutions. In some cases, member countries utilize credits associated with concessional loans. The staff will take into account these developments in discussing the appropriate amount of borrowing.

A Selected Bibliography of Executive Board Meetings and Fund Documents
Relating to Program Design and Performance Criteria, 1966-June 1986

Executive Board Meeting <u>1</u> / Number	Date	Document	Document Number	Date of Issue
I. <u>Reviews of Conditionality, 1966-1979</u>				
1. <u>1966</u>				
EBM/66/13	2/23/66	Policies on the Use of Fund Resources	SM/66/14	1/14/66
2. <u>1968</u>				
EBM/68/122	8/14/68-	Fund Policy with Respect		
EBM/68/123	9/20/68	to the Use of its		
EBM/68/127		Resources and Stand-By	SM/68/128	7/23/68
EBM/68/128		Arrangements	Sup. 1	7/29/68
EBM/68/131		Table on Performance		
EBM/68/132		Criteria	Sup. 2	8/12/68
		Supplementary Tables	Sup. 3	9/4/68
		Redraft of Conclusions	Sup. 4	9/23/68
3. <u>1978-79</u>				
		Performance Criteria Used in Stand-By Arrangements in Upper Credit Tranche	SM/77/128	6/6/77
EBM/78/79	6/2/78	Conditionality in Upper		
EBM/78/80		Credit Tranches	SM/78/103	4/19/78
EBM/78/81	6/5/78			
EBM/78/82				
EBM/78/157	10/13/78	Conditionality in the Upper		
EBM/78/158		Credit Tranches--Issues for Further Consideration	SM/78/230	8/29/78
EBM/79/29	2/16/79	Conditionality in the Upper		
EBM/79/35	2/28/79	Credit Tranches--Suggested		
EBM/79/36		Guidelines	SM/78/296	12/15/78
EBM/79/37	3/2/79		Sup. 1	1/12/79
EBM/79/38			Sup. 2	2/28/79
		Final Text	Sup. 3	3/1/79

A Selected Bibliography of Executive Board Meetings and Fund Documents
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Executive Board Meeting Number	Meeting Date	Document	Document Number	Date of Issue
II. <u>Reviews of Experience with Upper Credit Tranche Stand-By and Extended Arrangements and Conditionality, 1979-1986 2/</u>				
4.	EBM/79/84	6/1/79	Review of the Extended Fund Facility	SM/79/122 5/9/79
5.	EBM/80/21	2/8/80	Adjustment Programs Supported by Upper Credit Tranche Stand-By Arrangements, 1977	EBS/79/635 12/26/79
6.	EBM/81/7	1/12/81	Review of the Extended Fund Facility 3/	SM/80/278 12/29/80
7.	EBM/81/121	9/9/81	Review of Upper Credit Tranche Stand-By Arrange- ments Approved in 1978-79 and Some Issues Related to Conditionality	EBS/81/152 and Sup. 1 7/14/81
8.	EBM/82/92	7/7/82	Review of Recent Extended and Upper Credit Tranche Stand-By Arrangements	EBS/82/97 6/9/82
			Supplementary Material	Sup. 1 6/10/82
			Adjustment Programs--Broad Design and Key Indicators	EBS/82/98 6/9/82
9.	EBM/83/156	11/16/83	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

A Selected Bibliography of Executive Board Meetings and Fund Documents
Relating to Program Design and Performance Criteria, 1966-June 1986 (Continued)

Executive Board Meeting <u>1</u> / Number	Date	Document	Document Number	Date of Issue
10. 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
11. EBM/86/13	1/27/86	Issues in the Implemen- tation 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

III. Selected Topics Relating to the Specification
of Performance Criteria

12. Monetary and credit policy

EBM/71/118	11/22/71	Formulation of Credit Ceilings in Stand-By Arrangements	SM/71/145	6/11/71
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13. Fiscal policy

EBM/68/127		Fiscal Provisions as Performance Criteria in Stand-By Arrangements	SM/68/141	8/29/68
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A Selected Bibliography of Executive Board Meetings and Fund Documents
Relating to Program Design and Performance Criteria, 1966-June 1986 (Continued)

Executive Board Meeting Number	Meeting Date	Document	Document Number	Date of Issue
14. <u>External debt management policy</u>				
EBM/71/33	4/21/71	External Debt Management and the Use of Limitations on Foreign Debt: Recent Fund Experience	SM/71/80	4/5/71
EBM/76/155	11/5/76	Avoidance and Resolution of Debt Servicing Difficulties	SM/76/202	9/27/76
EBM/79/106	7/16/79	External Debt Management Policies	SM/79/125	5/11/79
EBM/83/58	4/6/83	Fund Policies and External Debt Servicing Problems	SM/83/45	3/7/83
15. <u>Exchange rate policy</u>				
		Balance of Payment Tests	SM/69/63	5/16/69
		Experience with Balance of Payments Tests	SM/73/22	2/1/73
EBM/84/175	12/5/84	Formulation of Exchange Rate Policies in Programs Supported by the Fund	EBS/84/232	11/16/84
16. <u>Other operational topics relating to the specification of performance criteria</u>				
a.	EBM/76/151 EBM/76/152	Requirement of Need for the Use of Fund Resources and Special Drawing Rights	SM/76/197	9/17/76
		Requirement of Need--Some Further Observations	Sup. 1	2/4/77
b.	EBM/84/81	5/24/84 Reporting and Other Problems on Performance Criteria in Fund Arrangements--Legal and Policy Issues	EBS/84/94	4/27/84

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Relating to Program Design and Performance Criteria, 1966-June 1986 (Concluded)

Executive Board Meeting <u>1/</u> Number	Date	Document	Document Number	Date of Issue
16.	Other operational topics relating to the specification of performance criteria (cont'd.)			
EBM/84/165	11/16/84	Misreporting and Noncomplying Purchases Under Fund Arrangements--Guidelines on Corrective Action	EBS/84/196	9/13/84
		Secretary's Understanding of Decision	Sup. 3	11/16/84
c. EBM/84/177	12/6/84	Relationship Between Performance Criteria and Phasing of Purchases Under Fund Arrangements	SM/84/259	11/20/84
EBM/85/38	3/8/85	Relationship Between Perform- ance Criteria and Phasing of Purchases Under Fund Arrangements--Supplementary Paper	SM/85/39	2/4/85
		Relationship Between Perform- ance Criteria and Phasing of Purchases Under Fund Arrangements--Operational Guidelines	Sup. 1	3/8/85
17.	<u>General program design</u>			
Executive Board Seminar 86/2	2/15/86	Issues for the Seminar on Design of Fund Programs	SM/86/31	2/19/86

Source: Fund documents.

1/ For some items, Executive Board discussion continued at subsequent meetings; where no date is indicated, the document concerned was prepared for information only.

2/ Includes all annual reviews since 1979 of programs supported by upper credit tranche stand-by and extended arrangements, as called for under Guideline 12 of the Guidelines on Conditionality.

3/ Since 1982, reviews of the extended Fund facility have been combined with reviews of conditionality and stand-by arrangements.