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Minutes of Executive Board Meeting 86/190

10:00 a.m., December 3, 1986

J. de Larosière, Chairman
R. D. Erb, Deputy Managing Director

Executive Directors	Alternate Executive Directors
A. Abdallah	E. T. El Kogali
Dai Q.	
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	H. G. Schneider
	J. J. Dreizzen
M. Finaish	
	M. Sugita
G. Grosche	
J. E. Ismael	J. Reddy
A. Kafka	
	M. Foot
H. Lundstrom	
M. Massé	
Mawakani Samba	C. V. Santos
Y. A. Nimatallah	I. Al-Assaf
G. Ortiz	L. Filardo
H. Ploix	S. de Forges
	J. de Beaufort Wijnholds
	C.-Y Lim
G. Salehkhou	
A. K. Sengupta	
	N. Kyriazidis

L. Van Houtven, Secretary
K. S. Friedman, Assistant

Also Present

African Department: S. N. Kimaro. Asian Department: L. H. De Wulf. European Department: L. A. Whittome, Counsellor and Director. Exchange and Trade Relations Department: C. D. Finch, Counsellor and Director; W. A. Beveridge, Deputy Director; M. Guitián, Deputy Director; E. Brau, J. Berengaut, J. T. Boorman, J. Hicklin, G. G. Johnson, P. Neuhaus, M. Nowak, C. Puckahtikom. External Relations Department: B. Nowzad, M. Goldstein. Fiscal Affairs Department: A. A. Tait, Deputy Director; A. Cheasty, E. S. Kreis. Legal Department: F. P. Gianviti, Director; A. O. Liuksila, J. M. Ogoola, S. A. Silard. Research Department: J. A. Frenkel, Director Designate; A. D. Crockett, Deputy Director; R. R. Rhomberg, Deputy Director; J. M. Boughton, W. M. Corden, P. Isard, M. D. Knight, A. Lanyi, J. J. Soladay. Western Hemisphere Department: E. Wiesner, Director; S. T. Beza, Associate Director; D. N. Lachman. Personal Assistant to the Managing Director: R. M. G. Brown. Advisors to Executive Directors: E. Ayales, A. Bertuch-Samuels, L. P. Ebrill, S. M. Hassan, G. D. Hodgson, J. Hospedales, Khong K. M., R. Morales, K. Murakami, A. Ouanes, I. Puro, M. Z. M. Qureshi, Song G., A. Vasudevan. Assistants to Executive Directors: J. R. N. Almeida, O. S.-M. Bethel, J. de la Herrán, F. Di Mauro, V. Govindarajan, G. K. Hodges, L. Hubloue, A. Iljas, J. M. Jones, S. King, K.-H. Kleine, M. Lundsager, T. Morita, C. Noriega, J. K. Orleans-Lindsay, S. Rebecchini, H. van der Burg, E. L. Walker, Wang X., Yang W.

1. REPORT BY DEPUTY MANAGING DIRECTOR

The Deputy Managing Director said that he had recently participated in the Development Assistance Committee (DAC) high-level meeting in Paris. The meeting had given him and the Senior Vice President for Operations of the World Bank, Mr. Stern, an opportunity to make a number of points. Mr. Stern in particular had reported in detail on the efforts that had been made by a large number of the low-income developing countries to implement major structural adjustments and the progress that they had made in that connection. Both he and Mr. Stern had expressed the need for bilateral donors in particular to be more forthcoming in supporting the adjustments that were being made by a large number of countries.

In his own presentation, the Deputy Managing Director continued, he had stressed the importance of donors providing in a timely way financial resources that would support major structural and macroeconomic adjustment programs. He had explained that, in the Fund's experience, in many cases in which a country had introduced a major adjustment program and had received commitments from bilateral donors, many months had passed before the commitments were fulfilled through actual disbursements; in that period, the government implementing the adjustment program was under great strain because of the lack of sufficient external financing. In that connection, he had outlined the development of the structural adjustment facility and the policy framework papers. Mr. Stern had discussed those papers from the World Bank's perspective. They had both indicated that the bilateral donors might find, and could use, the policy papers as a vehicle or tool for assessing in individual cases the external financing requirements needed to support major adjustment programs. They had both indicated that the policy framework paper and the accompanying structural adjustment arrangements were, from the Fund's perspective, part of an evolving process, and that they were prepared to stay in close communication with aid agencies to see how they could improve their working relationship, so that the aid agencies themselves would know on a more timely basis of the financing need of adjusting members.

2. PROGRAM DESIGN AND PERFORMANCE CRITERIA

The Executive Directors considered a staff paper on program design and performance criteria (EBS/86/211, 9/8/86). They also had before them as background material a staff paper summarizing experience with the specification of performance criteria in stand-by and extended arrangements approved since 1979 (EBS/86/211, Sup. 1, 9/11/86) and a staff paper containing a general review of the issues involved in the oil price and growth contingencies in the stand-by arrangement for Mexico (EBS/86/211, Sup. 2, 11/11/86).

Mr. Kafka made the following statement:

1. The paper before us deals with performance criteria (and clauses) as instruments for monitoring (and ensuring) the faithful execution of programs.1/ It is of major operational importance. The staff has obviously labored carefully, hard and long at it, and for this they deserve our gratitude.

2. Yet, the paper is somewhat disappointing. As description, it is less informative than it might be. Critical stages of the development of performance criteria and of the associated technique of phasing, are glossed over. As analysis or explanation or critique of the use of performance criteria and phasing, there are also difficulties. An apparent reluctance to examine in depth the relationship between the use of performance criteria and phasing on the one hand, and the role of the Fund on the other hand, is, perhaps, the main reason for these difficulties.

3. Let us first examine the paper as description of the evolution and present use of performance criteria (whether or not applied as performance clauses) and of the associated technique of phasing.

(a) In tracing the origin of monitoring techniques (in the last sentence on page 4) the paper states that 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." One may question the claim: "virtually all." For the 1967 stand-by arrangement granted to a major member was a water shed. That stand-by arrangement brought the Fund holdings of the member's currency practically to the 200 percent mark, which was then considered the effective maximum available. Nevertheless, the staff proposed neither phasing nor performance criteria. While their proposal was supported by the Executive Board, it was also noted that a similar absence of conditionality had not been available to most other members. The Executive Board objected to this asymmetry; it insisted that--basically--either all countries or none should be subject to phasing and performance clauses. It took, however, more than a year before the proposed text of what eventually became Decision No. 2603-(68/132) of September 20, 1968 was submitted to the Executive Board; it was this decision that for the first time somewhat restricted the scope for asymmetry. I do not wish at all to suggest that we have solved this problem; we are all aware of cases of program design or the use of monitoring techniques which are not applied in an obviously symmetric fashion.

1/ As designed, without prejudice to modifications as they appear to become necessary in the course of a program's execution.

(b) During the next ten years "the average and the variance of the number of performance criteria were reduced relative to the earlier period" (see page 5). This tendency culminated in conditionality guideline 4 adopted in 1979 (Decision No. 6056-(79/38)), which stressed the importance of avoiding undue interference in members' decision-making processes. However (page 16) in the 1980s the proliferation of performance criteria as well as other monitoring techniques started up again and, one may say, it did so with a vengeance. This is attributed in the paper to "the particularly difficult policy problems faced" more recently. Examples are given in Supplement 1 (pages 18-19) but no analysis is provided of why there was a need for a larger number of performance criteria. In fact, the paper goes on to state that "most of the desirable features of performance criteria discussed...favor small rather than large numbers" of performance criteria.

(c) Prior actions are represented in the paper as a monitoring technique (page 34). Such a description flies in the face of the normal use of language.1/ Beyond this semantic aspect, the essential nature of prior actions is glossed over; insofar as prior timing itself is not required by the very nature of a program--and that is by no means always or even often the case--prior actions can be viewed as an expression of the Fund's distrust of a member's promises. It may be mentioned that shadow programs are related to prior actions, but they have so far been used sparingly.

(d) A genuine kind of monitoring technique is represented by reviews, whether or not mandated by performance clauses. Review clauses were initially conceived as either complements to or as substitutes for substantive performance clauses; the paper reminds us that they were used in the latter way only once, a long time ago (in 1969; see page 9). We shall return to the problem of the choice between (substantive) performance clauses and review clauses later.

4. Let us now turn to the discussion of the characteristics and policy coverage of performance clauses. The paper, in this part, touches upon matters that could have been discussed as appropriately under the heading of program design or of the bases of program design. This part of the paper contains a lot of valuable information, but, I will limit myself to a few points.

(a) The main problem of performance clauses is due to the limits that they impose on the ability of a government to adapt its policies speedily and in a sense, therefore, to govern effectively.

1/ After all, monitoring implies watching whether a commitment (contractual or not) is carried out and thus partakes of an ex post character. Prior actions, by contrast, being ex ante, are designed to avoid the need for monitoring.

I will return to this problem in the context of the selection and mix of monitoring techniques. Here, only a few remarks are necessary. It is true that waivers and modifications of performance clauses are available to overcome the rigidities that would prevail in their absence. It is stated (page 14) that waivers are granted if a deviation is minor or reversible, or if appropriate compensating policies are implemented. We have even--rightly--had cases in which waivers and modifications have been granted in the absence of these conditions. But even this is no solution. Obtaining waivers and modifications and, obviously, the replacement of a program by a newly negotiated one are all time consuming. Therefore, these do not genuinely meet the criticism that a government's ability to adapt policies is damaged by performance clauses. The extent of this damage is a function of the frequency of test dates. In this respect, also, there has been proliferation--quarterly ceilings predominate, although nobody has demonstrated any correlation between the frequency of testing dates and the "success" of programs or the avoidance of arrears to the Fund.

(b) Another general question concerns the choice between targets and instruments as objects of monitoring. It is generally accepted that performance clauses, whose violation carries with it sanctions, should address only policy instruments, because the achievement of targets cannot be guaranteed. In fact, however, the Fund has come a long way from guaranteeing automatic access to Fund resources to those who fulfill their obligations in terms of instruments only. The review clauses qua performance clauses allow the Fund to demand changes in program design or in the values of policy instrument variables to be achieved if the original values (or instruments) do not seem able to achieve the desired targets. I will return to the problem of review clauses in the following section.

(c) Regarding the coverage of performance clauses (or monitoring techniques generally) it is particularly necessary that countries requiring financial assistance from the Fund should aim at a sustainable medium-term balance between overall supply and demand. Appropriate monitoring techniques for this objective, including performance criteria can therefore be justified.

(i) As mentioned in our previous discussion of the theoretical bases of program design, the Fund cannot, however, limit itself to requiring adequate demand control; it cannot disclaim responsibility for the supply of both goods and factors of production. We have, indeed, been concerned with promoting improved allocation of a program country's own factors of production. We have also been concerned about making available to program countries a supplement of factors of production--loans--whether drawn from the Fund's own resources, obtained by it and on-lent by it in its role as a financial intermediary, or lent by others with the Fund acting as a so-called catalyst.

(ii) When we act as a so-called catalyst we have, however, been at least insufficiently concerned about the manner in which resources are supplied to our program countries. We do insist, in the case of very poor countries, that they should obtain concessional loans rather than loans on commercial terms. But we have never asked which of the various forms of supplying resources--for instance, loans or relief--is preferable in different states of the world economy--rapid growth or slow growth, for example--and which of those forms is likely to permit a more rapid return to normal market borrowing (if any).

(iii) One may ask whether any of this has anything to do with program design and performance criteria. It seems clear that there is a very direct connection and not just in a purely formal sense. The more limited the external resources that can be made available to program countries, in appropriate fashion, the more must program design and performance criteria face up to possibly inconvenient alternatives.1/

(d) Another aspect of monitoring techniques, and, particularly, performance clauses addressed to the public sector concerns the effective power which the national government has over subordinate governments. The increasing insistence of the Fund on "public sector borrowing ceilings" rather than central government ceilings may force a member to give undertakings that it cannot securely enforce. Of course, the same macroeconomic results as can be attained by such ceilings can also be attained by different techniques, e.g., a central government ceiling combined with domestic asset ceilings for the banking system or even the central bank, though detailed control over the disbursement of credit will be lost. But is such control really necessary for the Fund's programs?

(e) Still with respect to the coverage of performance clauses, etc., the need to preserve an appropriate balance between overall supply and demand justifies, as already mentioned, performance clauses or other monitoring techniques addressed to this objective. As already indicated in our comments on the companion paper on the design of Fund programs, it is very much more doubtful whether it is also necessary for performance clauses or, more generally, monitoring techniques to be addressed to the balance between private and public sector demand (see page 12). One cannot simply justify a public sector ceiling because of an assumption that the absence

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1/ It could be suggested that members in balance of payments surplus could be persuaded to enter into reverse stand-by arrangements with the Fund, under which they commit themselves to adopt policies designed to eliminate their surpluses. Reverse stand-by arrangements could also commit countries to supply resources to the Fund. Such action was contemplated in the Canadian proposals to the Bretton Woods Conference.

of the ceiling mentioned will necessarily lead to an excessive expansion of total credit even where the debtor is (also) subject to a total credit ceiling; nor can one justify it because of the fear of crowding out the private sector. Insofar as the private sector is crowded out by the public sector, one would still have to ask whether--rather than assume that--the effect on overall productivity of this process was negative or otherwise undesirable. I do not say this because I have much confidence in the public sector, but rather to stress that the problem is more complicated than the paper suggests.

(f) The staff also suggests, in line with what they conceive to be the Articles of Agreement, the need in programs for eschewing "restrictions" (page 12). As a matter of law, the staff's attitude seems to go beyond the Articles. The Articles, after all, do not forbid "restrictions." Even if one could argue that the spirit of the Articles is contrary to permanent "restrictions," one must not forget that the Articles merely require that "restrictions" should not be imposed without authorization of the Fund. As a matter of economics, "restrictions" are probably in most cases less advantageous to the program country and to the international community than other methods of restraining demand for foreign exchange, but this is partly a matter of semantics: there is often little practical difference between the direct balance of payments impact of a "restriction" (e.g., a multiple rate) and an equivalent nonrestriction (e.g., a trade tax), but there may be embarrassing and inefficient indirect repercussions of the latter. No general rule against restrictions can reasonably be formulated.

5. The section dealing with the selection and mix of monitoring techniques presents a number of serious problems as well.

(a) This section begins with a statement (page 26) that the "general principles" underlying program design are recognized to be "appropriate." It is not clear what is meant by "general principles," or by "appropriateness." One would have thought that the ultimate test of adequacy of program design was the "effectiveness" of Fund programs. Fund papers themselves raise considerable doubt about the effectiveness of Fund programs. There are certainly major conceptual difficulties involved in assessing effectiveness.1/ Moreover, ineffectiveness need not reflect faulty design but merely deficient implementation. On the other hand, deficient implementation may itself be a reflection of faulty design.

1/ The locus classicus of published information is The Quest for Economic Stabilization, directed and edited by Tony Killick, Heiseman Education books, London, in association with the Overseas Development Institute. Other published literature includes "Experience with Programs of Balance of Payments Adjustment: Stand-by Arrangement in the Higher Credit Tranches, 1963-72," by

(iii) Finally, there is a suggestion--already mentioned earlier--that deviations from clear understandings (which are not performance clauses) should nevertheless authorize the Fund to interrupt drawings or demand repurchases. This is an extremely curious proposal. It may mean a plea for proliferation of performance clauses under a different name. This should be rejected. Or it may be addressed to matters that are not proper objects of performance clauses, particularly, perhaps, because they cannot be formulated with sufficient precision. In that case, adoption of the proposal would mean the end of automaticity of drawings.

6. None of the criticisms of present Fund practices should be taken to imply that the Fund could be indifferent to the violation of the programs that it has supported with the use of its resources. However, the Fund must balance the extent of control it imposes on countries it assists financially against the extent to which it can become, or appear to become, to all intents and purposes a participant in the government of those countries rather than a lender. The Fund cannot and should not try to run a world government from Washington, particularly a world government limited to those countries that receive its financial support. Such an attempt is bound to reduce the acceptability even of justified Fund advice. The Fund must learn to trust that its member countries will conscientiously follow programs that are intelligently aimed at promoting their own welfare, on a reasonable "social welfare function," which includes their ability to repay their creditors, among them the Fund. It is relevant to repeat here what was already said earlier: the success of Fund programs can never be guaranteed, and its probability raises questions; even the complete absence of current Fund programs does not imply arrears to the Fund. Nor can the strictest program guarantee their avoidance or even make them less likely. The practical upshot of this discussion is not, of course, that we should abandon monitoring or replace substantive performance clauses by review clauses qua performance clauses or by more prior actions. It is, rather, that we should retrench on excessive monitoring or prior actions. What we should rely on is improvement in program design, including the design of financial assistance.

7. It may be appropriate briefly to mention a matter that is operationally related to the problem of performance criteria and clauses. This is the matter of the Fund's negotiating technique. Two extremes suggest themselves: beginning with a maximal demand, from which concessions are made, or beginning with a minimal demand, from which no concessions can be made unless clear errors of analysis or clearly mistaken assumptions on the part of the Fund can be demonstrated to it. Both techniques are irritating, although the latter has not, to my knowledge, been used (a fact

that, I am sure, would be denied by many of our staff). It seems to me that attempts to employ the latter technique would be worthwhile, even though it could appear--though it is not--ultimative; but the former technique is too likely to be interpreted as a lack of respect for the member's own social welfare function.

Mrs. Ploix made the following statement:

The main objective of our discussion today is to review the guidelines for selecting appropriate techniques for monitoring Fund programs in light of the current practice and of the more rapidly changing circumstances.

I will therefore focus first on the various techniques used by the Fund to monitor Fund programs: performance criteria, prior actions, understandings, and reviews. My main purpose here is to specify their respective use and their consequences for the relationship between the Fund and the country under a program. Second, I will comment on the current approach of the Fund to changing circumstances, namely, automatic adjustments and the contingency clauses of the Mexican program, outlining their positive aspects but also setting limits on their further use.

1. Techniques for monitoring Fund programs

a. Performance criteria

I will not deal with the characteristics of performance criteria nor with their policy coverage, as I fully agree with the staff. However, given their importance, I want to emphasize the features, that must always be kept in mind when designing a program. First, the coverage should be comprehensive enough in order not to rely too heavily on one particular instrument. Being more balanced, a "full scope" program will be more responsive to the changing environment. Second, the focus must be on instruments and not on objectives, and performance criteria should never be directly linked to primary policy instruments. As the staff rightly indicates, the elements being monitored are intermediary variables rather than basic policy instruments. This approach allows the Fund to take into account the institutional setting of each particular country when designing a program, and it gives the authorities the possibility of choosing among the various policies compatible with the targets.

Such leeway may loosen the management of some programs, given the differences in transmission mechanisms from one economy to another and from one period to another. However, this appears to me to be a tolerable risk, since the Fund must avoid involvement in the details of policy decision making and implementation. One way of addressing this issue would be to draw more heavily on the Fund's experience accumulated with individual countries, as previously mentioned by the Managing Director in our debate on theoretical aspects. It could lead the Fund to use the mix of performance criteria with a more differentiated approach by country, taking into account each country's basic institutional features and the lessons of recent history.

Finally, although we will not discuss it until we review the structural adjustment facility, I want to emphasize the difference between performance criteria under credit tranche policies and benchmarks under the structural adjustment facility. Although both focus on instruments of economic policies, their consequences are not comparable as far as monitoring and funding are concerned.

b. Prior actions

I concur with the staff opinion that some measures have to be implemented as "prior actions." This is particularly true of structural measures. They are usually introduced all at once and cannot be phased in over time. Moreover, their main thrust is to restore confidence. Therefore, they cannot be monitored through performance criteria. If taken in a significant area (price reform, trade liberalization, or exchange rate adjustment), structural measures indicate a real political commitment to the whole program. By the same token, a supply-side action that has a decisive bearing on the macroeconomic policies covered by performance criteria can be considered as a precondition for an arrangement. Therefore, if an agreed prior action is not actually implemented, it should be clearly understood that the program itself cannot be agreed upon, or, if the program is already agreed, it will have to be suspended. On the other hand, even though the design of prior actions may prove difficult, it should not lead to undue postponement of the Fund's assistance to a country.

Furthermore, several risks have to be avoided. First, even in a country with a strong political will and with good control of the main policy instruments, the authorities may experience difficulties after introducing a number of structural measures in a short period. This suggests that in a one-year Fund program the scope of structural measures should be limited so as to prevent disruptive changes in the operating conditions of the economy. Second, the staff paper rightly underscores the fact that structural policies also fall within the World Bank's expertise. This is another reason for both institutions to strengthen their cooperation. Finally, I do not favor the development of shadow programs and I would like to see their scope strictly limited to "a positive record of policy implementation before approval of an arrangement." I think that a basic rule in the relationship between the Fund and a country is the full commitment of both parties.

c. Understandings

I would like to express some words about deviations from understandings on supporting policies. This delicate problem, which is very accurately presented in the staff paper (pages 35 and 36), has to be tackled with flexibility in order to avoid useless strains on the membership. I want to emphasize a basic point: as long as no deviation has been reported on a performance criterion, the Fund remains committed to the member country even if evidence exists that there is no longer compliance with the understanding. This rule should, of course, be followed on a case-by-case basis in order to allow for remedial action in some very difficult circumstances.

d. Reviews

An important recent development in Fund monitoring is the increasing use of reviews. We feel that these reviews introduce more uncertainty in the relationship between the Fund and the member country than do performance criteria. Here let me quote the staff's description of the first and most important characteristic of performance criteria: "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 and extended arrangements" (page 13, EBS/86/211). In stressing this point, I do not intend to radically contest the use of reviews; indeed, for the various reasons expressed clearly by the staff, such as the increasing uncertainties regarding major economic trends, the use of reviews as specified by Guideline No. 10 remains necessary and sometimes unavoidable.

As pointed out by the staff, the proliferation of reviews raises a broad variety of policy issues.

As far as the setting of performance criteria by reviews is concerned, it is our opinion that such cases must remain rare. Countries must be given a framework that will provide a structure for the Fund's assistance for the period of the arrangement. This framework has to be quantified to the extent possible, even if both parties agree that the figures are very sensitive and subject to revisions when underlying assumptions are later disproven. A review is a technique to update performance criteria; it is not a technique to establish them. Reviews will be necessary to set performance criteria for the latter part of programs, if Fund programs are extended to better meet the countries' needs and to draw more out of Fund/Bank collaboration.

I turn now to the issues raised by the staff.

(1) It appears to me necessary to provide a specific focus for program reviews. This focus can be provided by clearly specifying the path envisaged for the key intermediate variables that underlie quantitative performance criteria. This should not lead us to an implicit increase in the number of performance criteria or in the involvement of the Fund in deciding domestic policies. If clearly specified at the outset of the program, reviews could be used as timely appraisals in order to indicate whether the policies are adequate and to create appropriate responses to current external and domestic developments.

(2) To the extent feasible, reviews should concentrate on assessing those policies that cannot be monitored by performance criteria. I agree on all the points presented by the staff in paragraph 3 of its "Summary and Issues for Discussion." However, we must keep in mind the necessary flexibility built into the guidelines.

(3) As far as delays in completing reviews are concerned, I consider that since long delays never arise without serious cause, flexibility is all the more needed and no uniform procedure can be designed. Nevertheless, I would like to stress that delays clearly have operational limits, especially in cases in which new performance criteria must be set.

2. Fund's approach to changing circumstances in the design of monitoring techniques

The recent history of the relationships between the Fund and member countries shows that most programs are very sensitive to external circumstances. It often appears that programs are going off track, at least partially, because of unforeseen developments (unforeseen in their magnitude more than in their occurrence) and because the authorities are not in a position to rapidly counteract in order to comply with performance criteria.

I would like to discuss two different instruments to address these difficulties: automatic adjustment clauses, and contingency clauses.

a. Automatic adjustment clauses

On a purely theoretical basis, the only difference between these clauses and waivers lies in the fact that the clauses represent built-in or predetermined waivers. Therefore, their use helps to reduce the disruptive influence of uncertainties on performance criteria.

I thus welcome the statement made in Supplement 2 that "contingency mechanisms need not pose major issues for Fund policy." But we must not overlook the associated issues, particularly those mentioned on page 13 of this supplement. For my part, I would like to add the following four points:

(1) Such adjustments should be limited to deviations of exogenous variables of great importance to the country's economy.

(2) Automatic adjustment clauses are particularly necessary when the whole program entails reducing a country's dependency on one crop or one export that causes those major uncertainties--for example, through the development of nontraditional exports, if we consider export shortfalls.

(3) Automatic clauses should cover minor deviations only, since major deviations would generally call for modifying policies.

(4) Reviews would remain necessary for taking stock of the reasons for the implementation of the automatic adjustment, for verifying that adequate financing is available, and for examining the appropriateness of the policy measures.

Looking beyond the staff approach, I could envisage the use of such automatic adjustments even in cases in which it is not certain that the perturbation will only be temporary; taking the example of export shortfalls, the mere fact that the external receipts are lower than expected can jeopardize the achievement of the program. In conjunction with this, a shortfall need not be temporary or reversible in itself in order to be taken into account. Actually, what is relevant is that the effects of the shortfall on the program targets, particularly on performance criteria, should be reversible either spontaneously or, if necessary, through remedial action within the time period of the program. I was thus especially interested in the design of the oil contingency in the Mexican program: when oil prices are between the upper and lower limits, targets are adapted in full only in the initial quarter and the burden of supplementary adjustments is progressively phased in by policy adjustment. I would be grateful if the staff would comment on this kind of phasing, since it gives breathing space for the authorities to react to adverse developments without bringing the Fund's program automatically off track and having to embark on the always delicate negotiation of a waiver request. Finally, an important feature of this mechanism is its symmetry. This symmetry is critical. It emphasizes the commitment of each partner to the adjustment process.

An extended use of scenarios based on the sensitivity analysis of the key exogenous factors for a country could help countries in devising their policies.

b. Contingency clauses

I would like to make a few comments on the use of contingency clauses, taking as an example the two clauses included in our recent agreement with Mexico.

(1) Both of these clauses encompass automatic adjustment of performance criteria. I tend to favor these instruments if the trigger is placed on developments out of reach of the authorities, on the assumptions and not on the results of the policies. With this caveat I can favor such clauses linked to international commodity prices, since such prices are generally exogenous developments, and since the program is based on hypotheses considered possible if not sure by both the staff and the authorities.

As far as the so-called growth contingency is concerned, I have more mixed feelings for the reasons I expressed when we discussed the theoretical aspect of the design of Fund programs, and which can be summarized as follows:

- For the same reasons that lead to building performance criteria on policy instruments, and not on objectives, I have misgivings about the principle of having as a trigger one of the objectives of the program.

- Furthermore, growth performance generally is not due only to external causes, but also to domestic developments and particularly to policy implementation. That is why I would tend to consider that, if unexpected developments arise, a review is required before modifying the agreement between the country and the Fund.

I will sum up these comments by saying that we favor the greatest built-in flexibility where exogeneous assumptions are concerned, but that reviews should remain a prerequisite each time the implementation of the agreed upon policy is, or could be, a possible cause for the nonobservance of performance criteria.

(2) These two clauses have very different financial implications. I would like to address here only the "oil contingency," since the financing associated with the growth contingency does not depend on the Fund.

I read with great interest the comparison drawn by the staff between this financing and our traditional compensatory financing facility. I confess that I found more differences than resemblances, especially in the last paragraph on page 12 of Supplement 2: the definition of export shortfall; the symmetry of the mechanism; the analysis of the export prospects and of the durability of the development; the rapidity of disbursement; and not least important, the protection given to the Fund.

All of the characteristics of the oil contingency lead me to consider that it is hard to compare it to the compensatory financing facility. What really is at stake is "the augmentation of a stand-by arrangement contingent on an exogenous deterioration of a country's external account." It is an interesting way for the Fund to provide assistance to member countries and, as expressed by the staff, "this does not in itself raise issues of principle with respect to use of Fund resources," provided, of course, that it complies with access policy. My only concern is that its availability might prevent a country from undertaking further adjustment efforts and might leave them unprepared for a lasting unfavorable exogenous development.

There are two principles that run throughout my statement. First, our approach to all the questions raised by the staff takes into account and supports the basic principle of Fund programs, which is to provide assurance to a member that it will be able to draw on Fund resources if it meets the performance criteria, and to provide assurance to the Fund that the debtor country will implement the reforms that guarantee repurchases on the due date. Second, performance criteria and monitoring techniques should never be mistaken for the adjustment program itself. Therefore, in order not to be disputed, they must be kept simple and easy to understand.

Mr. Ortiz made the following statement:

Performance criteria are the operational expression of conditionality, a topic that has remained deeply controversial over the years. Although today's discussion is more narrowly focused on the problems that are posed by the setting of performance criteria in the design of Fund-supported programs, I will touch on some of the broader issues pertaining to the general concept of conditionality.

I am greatly concerned about the proliferation of performance criteria in the 1980s. The staff attributes this trend to the especially difficult circumstances that member countries have faced over the previous few years. However, it is doubtful whether adding to the number of performance criteria has helped the achievement of program objectives. As Mr. Kafka noted, no reasons are given as to why, in the face of adverse circumstances, it became necessary to increase the number of performance criteria. In fact, it could be argued that the proliferation of performance criteria may have been counterproductive.

As is stated in the main paper, the purpose of setting performance criteria is to provide the member country with assurance about the circumstances in which it will have access to financial support from the Fund and to provide a safeguard to the Fund regarding the proper utilization of its resources. From the member's viewpoint, proliferation increases the uncertainty of access, as the possibility of noncompliance--even though the main objectives of the program are being achieved--is greatly increased when multiple and overlapping performance criteria must be met. Of course, this uncertainty would be greater in the absence of automatic adjustments, since waiver requests often have to be bargained for and reviews may amount to a full-fledged new program negotiation. From the Fund's perspective, it certainly does not appear to be true that the proliferation of performance criteria has helped to safeguard its resources; on the contrary, I suspect that in the recent past there has been a positive correlation between the number of performance criteria included in Fund programs and the amounts of overdue obligations. An explanation for this seemingly spurious result could be that performance criteria may be increasingly substituting for in-depth analysis of, and for adequate adaptations to changing circumstances in, program design. Enhanced conditionality--as implied by the proliferation of performance criteria--therefore appears more like a mechanism for rationing scarce financial resources and less like a means of ensuring their proper utilization.

The Fund's obligation to safeguard the revolving character of its resources is one of the Fund's most revered concepts, since it provides the basis for conditionality. As the paper states, the key test that must be passed to ensure the proper utilization of Fund resources is balance of payments viability in the medium term, which requires a sustained capital inflow sufficient to finance current account deficits and debt repayments, including those to the Fund. In turn, the sustainability of capital inflows requires an adequate balance between aggregate supply and aggregate demand, and it is therefore the basis for including in Fund-supported programs measures that are geared to restraining demand and measures that, at least in theory, provide some supply-side stimulus. However, as I mentioned during the recent discussion on the theoretical aspects of program design, since absorption-reducing measures have a more immediate and predictable effect than those directed to increasing output, at least in the short run, Fund-supported programs usually emphasize the former.

Programs should not always be designed on the basis of the assumption that balance of payments disequilibria are always the result of excess demand caused by excessive credit creation. It could be argued that the appropriate response to imbalances caused by supply-side shocks should place less emphasis on demand restraint and pay more attention to policies that are geared to increasing productive efficiency and to re-orienting domestic production if the shock is judged to be of a more or less permanent nature. This may of course imply longer adjustment periods and increased financial assistance, thereby posing a potential conflict between the design of an adjustment strategy that is more in line with the requirements of a member country on the one hand, and a rigid interpretation of the revolving nature of Fund resources and the issue of prolonged use on the other hand.

The problems raised by the systemic nature of disequilibria and the magnitude of the imbalances determined by the debt overhang of many developing countries pose a special challenge for program design in the context of what has been labeled the "enhanced debt strategy." For example, as Mr. Kafka notes, the Fund has paid insufficient attention to the manner in which external resources are channeled to program countries. While insisting on concessional assistance to the poorer countries, the Fund has generally cautioned others to avoid incurring additional excess debt but has not openly considered the question of interest relief for highly indebted countries. This has resulted in the conception of a medium-term strategy for debtor countries--often incorporated in country-specific balance of payments projections--based on continued import compression and forecasts of overly optimistic export performance and, in general, resulting in slow economic growth. By widening the coverage of performance criteria to include the elimination of arrears to creditors, the Fund has left itself open to widespread outside criticism--which is unjustified in some cases--that one of its main roles in the debt strategy has been that of a debt collector for private and official creditors.

These comments bring me to the role of structural policies in the context of Fund-supported programs and the monitoring that the Fund should exercise in this area. While recognizing that the recent emphasis on structural policies is certainly well placed for a number of reasons that have been extensively discussed in the Executive Board, the Fund should proceed carefully in its involvement in both the design and monitoring of structural policies. As the staff paper notes, a large number of structural policies clearly fall within the domain of the World Bank, and the Fund staff should not be expected to provide guidance in areas where it has not traditionally had expertise. In the areas that fall within its responsibility, such as fiscal policy, the Fund has traditionally provided competent assistance at the request of member countries. A senior staff member recently suggested that there might be scope for a trade-off between the intensity and quality of fiscal adjustment. That staff member noted that present arrangements often entail abrupt cuts in public expenditures or the imposition of distorting revenue measures; the aim is to reach a fiscal target, but the result is often inefficient adjustment. This suggestion is worth exploring further. In any event, it seems clear that the renewed emphasis on structural policies should not lead to a further proliferation of performance criteria. On the basis of the argument that monitoring of such policies would seem to be essential for ensuring balance of payments viability, the number of performance criteria could be extended indefinitely, since, in a general equilibrium system, everything is interconnected.

The persistent issue of defining performance criteria in terms of objectives or instruments is worth reviewing. Emphasizing goals, even if it requires less frequent monitoring, might result in stricter programs but might also involve less interference in domestic decisions on how to attain the agreed goals. On the contrary, emphasizing instruments reduces the scope of the authorities in the area of policy design but, save for Mr. Kafka's exception, gives them greater assurance about drawing on the Fund's resources. As Mrs. Ploix noted, focusing on instruments rather than on program objectives in the design of performance criteria is conceptually sound, since instruments are not under the authorities' control. However, in addition to Mr. Kafka's comment on this issue, it can be noted that some of the instruments that are chosen in practice are not fully under the control of the authorities--for example, ceilings on public sector borrowing requirements, which are often greatly affected by inflation and the effects of other recommended policies, as was underscored during the recent discussion on the measurement of fiscal deficits.

I have fairly little to add to the views of Mr. Kafka and Mrs. Ploix on the selection and mix of monitoring techniques and the use of contingency mechanisms. A key question in discussing these issues is whether the setting of performance criteria will help or hinder a government's ability to adapt its policies to changing circumstances, thereby enabling the country, as Mr. Kafka put it, to govern effectively. If program design is adequate, the choice of monitoring techniques becomes a much easier task. I do not wish to discuss at this point the staff's assertion that "the principles of program design are well established and remain appropriate to the attainment of their objectives." In any event, performance criteria should be designed to accommodate flexibly the necessary changes resulting from both faulty design and modifications to the initial assumptions.

Prior actions should be used only in a limited sense and should be restricted to measures that cannot otherwise be monitored. I agree with Mrs. Ploix's comments on this area.

Reviews have the obvious disadvantage that they increase the uncertainty about access by member countries and can involve extensive and time-consuming negotiations. Clear understandings on the behavior of the relevant instruments that constitute performance criteria should be reached at the outset. Reviews should be used as supplementary mechanisms to evaluate overall developments and should not substitute for automatic adjustments.

As this chair explained on previous occasions, the incorporation of contingency mechanisms into the Mexican program was essential from both an economic and political viewpoint. A key consideration was the need to temporarily isolate the program from external shocks to enhance the viability and credibility of its implementation and of its orientation toward fostering economic growth. The staff's assertion that the desirability of these mechanisms should be judged in the light of whether they enhance balance of payments viability is of course correct. However, this judgment must be made within the perspective of an appropriate time horizon.

Mr. Wijnholds made the following statement:

After our discussions earlier this year on the implementation of conditionality, the theoretical foundation of program design, and program design in centrally planned economies, today's discussion completes a thorough treatment of various elements of Fund programs, which are clearly one of the central instruments through which the Fund discharges its duties. I have found the exercise useful not only in providing an opportunity to express our views on these matters but also as an educational experience. The staff papers for today's discussion also play this dual role.

The main paper, while concentrating on performance criteria, also deals with other monitoring techniques, including prior actions, reviews, and consultations. This broader approach is entirely appropriate, since performance criteria tell only part of the story--and perhaps a diminishing part, given the increasing importance of reviews and the possibility of prior actions. The staff provides a wealth of information on performance criteria as well as midyear reviews that is usefully categorized according to the policy areas monitored. It would have been illuminating to have similar information on prior actions, although for obvious reasons such information should not cover individual countries. Having a greater insight into the frequency and nature of prior actions would enable us to have a more comprehensive view of the Fund's monitoring practices. The staff could usefully provide such information.

In view of the substitutability between performance criteria, prior actions, and reviews, as well as of the need to adjust our practices as economic conditions change, I do not consider the number of performance criteria to be a significant matter. While I agree that the number of such criteria should be kept as limited as possible, it has been appropriate to have had more of them for stand-by arrangements in recent years given the difficult global economic problems and the large and sometimes protracted imbalances facing individual countries. However, as I have stated on previous occasions, the Fund should adhere as much as possible to the principle in Guideline 9 on conditionality that performance criteria--and I would add prior actions and reviews--should normally be confined to macroeconomic variables.

In discussing the relation of performance criteria to program objectives the staff emphasizes the need for Fund support of a program to be such as to ensure the revolving character of the Fund's resources. This is of course correct. But I would stress a point that the staff did not specifically refer to on page 11, namely, the need for close monitoring of country programs to help improve the functioning of the international adjustment process. Article I, Section 6, enjoins the Fund to "shorten the duration and lessen the degree of disequilibrium in the international balances of payments of members."

In discussing the characteristics of performance criteria the staff draws attention to the matter of weighing the probability of achieving a program's objectives against the degree of Fund involvement in the details of a member's policies. This is a difficult process for which general rules are hard to formulate, and the staff understandably does not attempt to do so. However, it would have been useful to add a reminder to the effect that a judgment of the Fund's involvement in a country should take into account the World Bank's involvement in that country. A sensible demarcation between involvement by the Fund and the World Bank should be sought in order to avoid cross-conditionality.

On the technique of setting performance criteria, I fully agree that broadly defined aggregates should be used as much as possible and that exclusions from definitions should be few. In this connection, I welcome the increased use of the overall fiscal deficit as a performance criterion in lieu of or in addition to the application of limits only on bank credit financing of the budget. The paper makes no mention of the recent innovation of using the operational budget deficit as a performance criterion. I assume that its application on a widespread basis is not foreseen. Indeed, we need to gain more experience with the concept of the operational deficit before contemplating its use in other than exceptional cases.

Limits on short-term borrowing have been increasingly included as performance criteria; they were included in only 1 percent of arrangements in 1979-82 but were included in 81 percent of arrangements in the period 1985-June 1986. This is a fully justifiable evolution reflecting the changed circumstances during these years. However, this practice may raise questions about conformity with the guidelines that state that such short-term loans will "normally" be excluded, although they could be included for nontrade-related loans in "exceptional circumstances." This is one of a few instances--another one having to do with Guideline 9, on microeconomic performance criteria, including midyear reviews--in which the guidelines on conditionality do not appear to reflect fully presentday practices. We may well be able to live with this for a while, but we should consider at what point an update of the guidelines would be called for to reflect the evolution of practices over recent years.

The staff recognizes that the use of reviews has become much greater than was envisaged when Guideline 10 was formulated. While such reviews should provide a flexible tool for close monitoring, we should be careful not to overdo things. Annual reviews in a multiyear program are of course a necessity. However, two or even three reviews in a year involving discussions by the Executive Board should be confined to especially difficult cases. I fully agree with the staff that "an adjustment effort would not be well served by reviews that substitute for comprehensive and precise policy formulation for the basic program period." In addition, I would underscore the staff's observation on page 29 that the review process should not become the equivalent of the negotiation of a program for increasingly shorter periods. I am not certain whether the Executive Board should in all cases discuss a review. It would seem worth considering whether it would not be sufficient to have a short briefing paper for the Executive Board in cases in which midterm reviews do not involve setting new performance criteria. This would be similar to having a brief report after a year for countries that are on a two-year consultation cycle.

I will now comment briefly on the delicate matter of how to deal with clear deviations from policy understandings between the Fund and a member; at present, such deviations are likely to show up as nonobservance of performance criteria but have not yet done so. It would be unwise to ignore for the time being a blatant departure from clear policy understandings, and I disagree with Mr. Kafka that a reaction by the Fund in such cases would be "extremely curious." The Fund should of course not overreact. I would therefore favor an interruption of drawings in such cases and a special consultation to attempt to reach agreement on corrective measures rather than a cancellation of the agreement. In all cases in which purchases are interrupted, it would seem desirable to inform the Executive Board without delay. The notification to the Executive Board could be in the form of a simple, short memorandum stating that, due to nonobservance of performance criteria, the country concerned was unable to make the scheduled purchase.

Another difficult question is how to proceed in a case in which there is a lack of reliable data with which to monitor a Fund-supported program. The staff suggests that reviews can be very helpful in such cases and mentions the possibility of substituting quarterly reviews for performance criteria. I have some misgivings about such an approach, which is comparable to navigating aboard a ship without a compass by relying on the stars under sometimes cloudy skies. Developing a better data base should be a prior action in cases in which it is not possible to formulate meaningful performance criteria. Fund technical assistance should be provided to solve such problems as soon as possible. Meanwhile, the countries concerned could qualify for assistance under the structural adjustment facility, which does not require the degree of quantification that is needed for a regular stand-by arrangement. In addition, the use of shadow programs in combination with action to improve the data base can be helpful in this respect.

The staff's reference to the contingency financing feature in Mexico's stand-by arrangement as an experiment is apt. The oil price contingency can be considered to be based ultimately on the principle of compensatory financing, although only one--but at the same time dominant--export commodity is involved under the contingency. The ad hoc introduction of this contingency has raised a number of questions, and the staff paper on the matter mentions the various remaining issues concerning this mechanism. Since this is a matter that will be fully analyzed and discussed on the occasion of the review of the compensatory financing facility, I will not give any definite views today on contingency mechanisms based on movements in commodity prices.

The main staff paper correctly stresses that performance criteria should apply to policy instruments rather than to policy objectives. The intention of the growth contingency clause does not seem to be fully consistent with this principle. Although no Fund resources would be involved if this contingency were to become effective, it is questionable whether the Fund should require as a condition for approval of the arrangement commitments from other creditors that do not conform to the Fund's own guidelines for such lending. Doubt can also be expressed about the claim by the staff that the growth contingency might have positive effects on the adjustment effort.

The automatic adjustment of performance criteria linked to movements in commodity prices and to difficulties in achieving program objectives is warranted only in highly exceptional circumstances. While it is not unreasonable to provide for some leeway in the event of adverse developments in order to gain acceptance of a stringent adjustment program, such leeway should be confined in principle to a review on the basis of which adjustments in the performance criteria could take place.

Mr. Ismael made the following statement:

I wish to make five general points on program design and performance criteria. First, the guidelines on performance criteria and conditionality remain appropriate. These guidelines provide adequate guidance and flexibility to the staff in designing programs as well as in monitoring the implementation of these programs.

Second, there is no doubt that a sound statistical base is crucial for program design, implementation, and monitoring. Therefore, in all cases in which the statistical base is inadequate, the Fund should provide technical assistance to improve the statistics that are crucial for program design, implementation, and monitoring. In addition, while a sound statistical base is crucial to program design, it is equally true that the design of programs in the form of the setting of performance criteria must take into account the availability of statistical data. For example, even though the concept of the public sector borrowing requirement is more comprehensive than the concept of net credit to government, there is not much point in setting a ceiling on the public sector borrowing requirement if data on public sector finances are not readily available. The design of programs must be tailored in a way in which the data requirement for monitoring is not onerous.

Third, Fund programs must be relatively simple and easy to understand. The civil servants in charge of implementation and monitoring must fully understand the rationale behind the performance criteria and must have a clear and full understanding of the instruments of control. As far as possible, performance criteria should be as limited in number as possible, and every effort should be made to ensure that the implementing and monitoring agencies fully understand both the rationale for and the mechanics of a program. This means that Fund missions have an added responsibility to ensure that government officials understand a program.

Fourth, while programs should be simple and easily understood by all parties, the matter of program design is somewhat more complicated. Until recently, the main objective of Fund programs was to improve the balance of payments; under the present growth-oriented adjustment strategy, growth has become an important objective. Hence, the Fund has to consider more carefully how the traditional macroeconomic instruments can be used to achieve the twin objectives of growth and balance of payments adjustment simultaneously. The emphasis on growth has also brought to the forefront the need for structural adjustment, which has an important role to play in Fund-supported programs. The Fund has limited experience with structural adjustment and therefore should concentrate on the limited areas within the scope of its technical competence, leaving other structural problems to the World Bank.

The fifth general point is fundamental but not always appreciated. The primary objective of all financial and structural policies is to increase production of goods and services. In other words, growth is the primary objective. Balance of payments adjustment is only a means toward that objective. The objective of growth must always be tempered by considerations of equity and income distribution. In the past, Fund-supported programs have typically involved the compression of domestic demand and the diversion of resources to the export sector. The compression of domestic demand has occasionally had an adverse effect on income distribution. To the extent possible, future Fund-supported programs must ensure that compression of demand does not adversely affect the lowest income groups. It has also been found that domestic food production in countries has suffered as a result of policies that have shifted resources from production of items for domestic consumption to production of items for exports. Such policies have led to food shortages, malnutrition, poor health, and higher food prices. This raises the question how far Fund-supported programs should go in diverting resources to the export sector simply to improve the balance of payments position of a country. Future Fund-supported programs should pay greater attention to the effects of programs on domestic food production and social welfare.

The first specific issue dealt with in the main staff paper is the desirability of more comprehensive definitions of performance criteria. The staff has suggested that in the monetary area the concept of net domestic assets should be preferred to the concept of domestic credit, and that in the fiscal area the concept of the public sector borrowing requirement should be preferred to the concept of net credit to government. While I agree that these more comprehensive concepts would be preferable because of their wider coverage, I would caution against the use of such concepts in every case. In setting performance criteria full account must be taken of the availability of data and of the need to keep the program as simple as possible, so that the authorities can easily understand it. In many countries, public sector data are not readily available. In others, these data are available only with a considerable lag, thus making it impractical to use the concept of the public sector borrowing requirement in every case.

As to the desirability of a clear specification of the path for key intermediate variables, I would once again caution that such specification might introduce unnecessary inflexibility and, in a sense, could increase the number of quantitative ceilings. Hence, I do not favor having very detailed specification of Fund-supported programs.

Program reviews have a useful role to play, especially at present, when programs have to be implemented in a highly uncertain external environment. Reviews provide a useful opportunity to adjust quantitative ceilings and other targets that may have become unrealistic in light of external developments. While I agree with the staff that program reviews should not become a vehicle for embarking on a new financial programming exercise, reviews should provide an opportunity in which to make a new assessment of the country's circumstances and to make adjustments to the ceilings as well as the targets. In this connection, I do not share Mrs. Ploix's preference for automatic adjustment of performance criteria. I would prefer to use program reviews.

We should adopt a flexible approach for dealing with delays in completing reviews, since there can be a variety of situations in which delays become inevitable. I agree with the staff that it would be preferable to use reviews, rather than automatic adjustment, in determining the need to modify performance criteria.

As to monitoring of structural adjustment, specific information on the implementation and qualitative assessment of the impact of such adjustment should be provided in the review papers. In the past, Fund-supported programs placed too much emphasis on reducing the budget deficit without making a careful assessment of the impact of the means used to achieve the reduction. In particular, the impact of tax increases on incentives should be carefully assessed. In addition, in countries where incomes are indexed the staff should be careful in recommending indirect tax increases on items that have a large weight in consumer price indices. The Fund should also be cautious in placing undue pressure on countries with programs to dismantle their restrictive trade and exchange system at a time when major industrial countries have increased their protectionist barriers against imports. We should avoid making the global trade liberalization process inequitable.

I can associate myself with much of what Mr. Kafka said in his opening statement. In particular, I share his concern about the proliferation of performance criteria, the use of prior actions as a monitoring technique, and the staff's insistence on using public sector borrowing ceilings. In addition, I strongly endorse Mr. Kafka's comments on negotiating techniques.

Mr. Finaish made the following statement:

I will begin by making two general comments. First, while proper monitoring is essential to ensuring an effective implementation of Fund programs, and performance criteria and other monitoring instruments play a useful role in that regard, we should avoid the fallacy that the tighter and stricter the monitoring, the better. Monitoring should be so devised and executed as to allow adequate flexibility for policy adaptation in the presence of uncertainties and to avoid excessive interference in members' decision-making and implementation processes. These considerations argue for avoiding a proliferation of performance criteria by limiting them to those that are necessary for effective monitoring, and for avoiding rigidity in the application of these and other monitoring devices. Some of the suggestions made by the staff in the present paper raise concerns in relation to these basic considerations.

Second, the results that are sought from effective monitoring can, at best, be only as good as those that can be expected from the implementation of the program that is being monitored. Therefore, of primary importance is the quality of program design and the appropriate matching of prescribed adjustment policies to the problems at hand. At our recent seminar, a number of issues were raised about program design. In the discussion on page 26 of EBS/86/211 the staff appears to underemphasize such issues and possible deficiencies in program design, noting that the key issue instead is to ensure program implementation. Minimizing the scope for improvement in program design and focusing instead on making monitoring more rigorous may not be the proper order of emphasis.

The staff's preference for a comprehensive definition of quantitative performance criteria is understandable, given the greater coverage of criteria so defined and because a comprehensive definition may also be the simplest and clearest. However, the most appropriate definition of a performance criterion cannot always be decided in general terms, as the question may need to be examined in light of the particular situation being addressed and the broad design of the program in which the performance criterion is to be employed. The institutional setting and the availability of requisite data are also relevant in this respect.

The staff's statement that a broad definition of the public sector borrowing requirement would normally be preferable to a definition that is limited to net bank credit to the government appears to be questionable, as it is not clear why such a definition of the fiscal performance criterion should "normally" be preferable. For example, whether the fiscal performance criterion should cover domestic nonbank financing would depend inter alia upon whether such borrowing was judged to have been excessive in terms of its implications for the growth of public expenditure, the burden on the budget of servicing domestic public debt, and the possible crowding-out effect on the private sector. Also relevant in this regard would be the different monetary and aggregate demand consequences of public expenditures that are financed from domestic bank and nonbank credit. Moreover, some types of domestic nonbank borrowing by the Government--for example, savings schemes such as post office savings deposits and government savings certificates--can serve the purpose of mobilizing domestic savings and directing them toward productive investments, broadening the available portfolio savings instruments, and developing the domestic capital market, especially in countries with relatively underdeveloped financial structures. There should therefore be no general presumption in favor of defining the fiscal performance criterion in terms of the total public sector deficit or borrowing requirement rather than the sector's net borrowing from the banking system. A move toward adopting the overall deficit or borrowing requirement of the Government or the public sector as the "normal" definition of the fiscal performance criterion would represent a significant departure from current practice, as such a definition, despite some increase in its usage in recent years, was employed in only about one fifth of all arrangements during these years.

Program reviews are especially useful as a means by which program policies can be flexibly adapted in the light of developments that cannot be adequately foreseen at the outset of the program and as a monitoring device for policies that do not readily lend themselves to being formulated as performance criteria. The staff has expressed the concern that the marked increase in the use of midyear reviews in recent years carries the risk of allowing the process of policy formulation and implementation to become weakened by being split up into a set of short-term responses to the latest developments and pressures. To the extent that the increase in the incidence of reviews reflects a tendency toward postponing the formulation of program policies even in situations in which a comprehensive formulation of policies at the outset of the program was both feasible and desirable, there would indeed be a case for limiting the use of reviews. The staff is correct in suggesting that basic program policies should be set out as clearly and as fully as possible at the outset of the program, and that where midyear reviews are considered necessary, their scope should be clearly defined. Some economy in the use of reviews can also be achieved by adopting the rule that there should be no more than one midyear review per program year. Exceptions to this rule would require special justification, such as uncertainties about the availability of external financing of an exceptional nature. In this connection, it is pertinent to note that Table 15 in EBS/86/211, Supplement 1, indicates that in more than half of the arrangements since 1984, the number of midyear reviews exceeded one per program year.

However, some other suggestions made by the staff to limit the role of reviews appear to be less appropriate. This includes the suggestion to require most structural adjustment measures of a discrete nature to be taken as prior actions. The other staff suggestion that is of questionable merit is to require that, as a normal rule, performance criteria should be set for the entire program year at the inception of the program. To the extent that the particular case under consideration permitted such an approach, one would have no quarrel with it. However, in many situations uncertainties about prospective economic developments make it difficult to establish firm performance criteria for the entire program year. In such situations, the existing guidelines requiring that, as a normal rule, performance criteria should cover a period of at least six months, with indicative targets set for the remainder of the program year, appear to be more appropriate. The flexibility in the face of uncertainties allowed under the existing guidelines seems preferable to the present staff proposal, which seeks to alleviate the rigidity that is implied by the setting of performance criteria for the entire program year by suggesting that waivers and modifications can instead be used where necessary. A reduction in the incidence of midyear reviews would be of dubious advantage if it were achieved at the expense of an increase in the incidence of waivers and modifications.

It also bears pointing out that while in one section of EBS/86/211 the staff suggests the use of the procedure of waivers and modifications to provide the necessary flexibility for program adaptation as the incidence and scope of midyear reviews are reduced, in another section a somewhat contradictory and more restrictive approach to waivers and modifications is recommended on the basis of what is termed the "integral nature" of performance criteria and other monitoring instruments.

In suggesting a more restrictive policy on waivers and modifications of performance criteria the staff also cautions against "the fallacy of composition." In that connection, it is noted that assessment of performance under a program cannot be made solely on the basis of a separate examination of the program's individual components; a look at the overall picture is also required. Although valid, this consideration does not necessarily argue for a stricter approach to waivers and modifications; instead, only deviations from performance criteria should be assessed, taking into account their implications for the program as a whole.

A clear definition of the scope of reviews at the outset of a program, in terms of policies and issues that are to be covered, would help to reduce the incidence of delays in the completion of reviews. However, delays may still occur in some cases. In view of the variety of circumstances that can cause delays, the staff is correct in supporting the continuation of a flexible and pragmatic approach to responding to delays--one that allows the response to be determined in light of the member's particular situation. Thus, the establishment of some precise rules, such as a maximum period in which to complete a review, might not be advisable.

However, there are certain aspects of the present policy with respect to delays in review completion that need to be set out more clearly. In particular, the present policy is not sufficiently clear about the circumstances in which a rephasing and reduction of the amount of access would be warranted. In some instances in which access has been reduced the matter has proved to be quite contentious. In EBS/86/211, this issue has not been adequately discussed. The only consideration mentioned by the staff--on page 30--bearing on whether access should be reduced and rephased is the length of the delay in the completion of a review. Clearly this cannot be the only relevant consideration. Other key considerations would be the cause of the delay and the extent to which overall policy implementation remained on track despite the delay or is brought back on track upon the resumption of the program following the interruption caused by the delay. When these considerations are taken into account, one can envisage cases in which a reduction in access may not be warranted despite a relatively long delay in review completion, especially when the period of the arrangement is extended upon the eventual completion of the review.

Automatic adjustments are a useful mechanism for a quick, ex ante adaptation of performance criteria to possible divergence between actual developments and program assumptions in respect of specified variables. The suggestion by the staff on page 32 of EBS/86/211 to limit the use of automatic adjustments, permitting them only for purely technical or statistical reasons and in response to deviations from the programmed availability of external financing from well-defined, official sources would be unduly restrictive; it would suppress the utilization of this mechanism to well below its potential usefulness. A key consideration in determining whether the adaptation of performance criteria to anticipated deviations from certain program assumptions should be handled through automatic adjustments or reviews should be the extent to which it is possible at the outset of the program to determine satisfactorily the nature of the anticipated deviation including its probable magnitude and duration--and the kind of adaptations in the program's package of adjustment and financing that should be made in response. The greater the scope for making this determination ex ante, the smaller the need for additional consultations or reviews ex post--which could be time consuming--and, therefore, the stronger the case for the use of automatic adjustments. One can visualize automatic adjustments being usefully employed in a variety of cases of anticipated deviations from program projections, and it would not be advisable to establish a general policy short-listing the instances in which such adjustments could be used. Moreover, as the staff notes in EBS/86/211, Supplement 2, automatic adjustments and reviews may not be seen as mutually exclusive instruments for adapting programs to deviations from program assumptions, since they can be used in combination in certain situations--for example, when it appears to be desirable, in view of the uncertainties involved, to provide for a review to assess the continued appropriateness of a contingency mechanism agreed at the outset of the program.

The contingency mechanisms in the new stand-by arrangement for Mexico constitute a useful and innovative extension of the automatic adjustment procedure, with a potential for application to other suitable cases. It would pay the Fund to maintain the degree of openness and flexibility in its approach that permitted such an innovation to be attempted. With respect to the contingent financing mechanism in particular, I will make two comments. First, securing an ex ante commitment of contingent additional financing from outside--non-Fund--sources may be particularly useful in cases in which such financing was considered to be critical to the effectiveness of the program and was of a nature that was difficult and time consuming to arrange, such as concerted financing. Contingent financing mechanisms could be seen as an extension of the established practice of requiring an assurance of the availability of the projected external financing requirements before an arrangement is approved by the Fund. Second, as the staff notes, the contingent augmentation of resources committed by the Fund itself in response to export price developments raises issues of the relationship of such a mechanism to the compensatory financing facility. The coming review of that facility would be the appropriate occasion on which to examine such issues in detail. At present, I would only say that the compensatory financing facility should remain the normal channel for providing Fund assistance in cases involving temporary export shortfalls, and for that reason both the adequacy of access under the facility and its quick-disbursing nature must be maintained. At the same time, a contingency financing mechanism within a stand-by arrangement could be a useful additional instrument at the disposal of the Fund that could be selectively employed on a case-by-case basis.

With the increased emphasis being given to structural, supply-side policies as a part of a more growth-oriented adjustment strategy, effective monitoring of such policies in Fund programs has acquired greater importance. In view of the nature of structural adjustment policies, not the least important element being the difficulty in formulating many of them as quantitative performance criteria, reviews provide the most suitable technique for monitoring their implementation. To keep the scope of reviews well defined, structural policies that are to be monitored through them should be identified as clearly as possible at the outset of the program. Some structural policies that are of the nature of specific and discrete measures may at times be required to be taken at the outset of the program as prior actions. Such policies would include those whose early implementation was considered crucial to the effectiveness of the program or was considered essential to establishing the credibility of the authorities' adjustment intentions. However, it will be inappropriate to require that all or most structural measures that can be defined in terms of discrete actions should be taken at the outset of the program, as the staff seems to suggest. Such an approach often would not be feasible. Nor would it always represent the most appropriate phasing or sequencing of adjustment policies, even apart from considerations of political feasibility. While the amenability of structural adjustment policies being defined and implemented as discrete measures is a necessary condition for their being made a prior action, it is not a sufficient condition.

For growth-oriented adjustments, the maintenance of investment at adequate levels is of course important. I see merit in suggestions to try to protect investment expenditure from bearing the brunt of expenditure restraint in Fund-supported programs by stipulating quantitative investment targets that could subsequently be monitored. Such targets could be treated as either supplementary monetary criteria or benchmarks that were to be monitored through reviews.

With respect to the staff's suggestion that the cancellation or interruption of an arrangement, and even the requirement of immediate repurchase, could be considered for dealing with major deviations from policy understandings that are not subject to performance clauses, I believe that a move in that direction would be ill advised. First, such a procedure would seriously erode the objective way in which at present drawings are related to performance clauses under which a member has the assurance of automaticity of drawings upon the observance of those clauses. Second, it could mean, in effect, an undesirable proliferation of performance clauses. Third, the existing monitoring techniques of performance criteria and reviews can sufficiently cover understandings in essential policy areas, thereby obviating the need to create any new wedges between these performance clauses and drawings.

Mr. Templeman made the following statement:

To follow up on Mr. Dallara's general comments on the theory of program design in October, today I would like to make some more precise comments on our general approach to program design and program monitoring, the structural and macroeconomic content of Fund programs, monitoring techniques, and the implications of the innovative aspects of the recently approved program for Mexico.

Where there are major adjustment problems and a member chooses to seek Fund assistance, we would normally expect the formulation and implementation of a comprehensive and integrated program consisting of both macroeconomic and structural elements. However, we believe that there is some room in Fund programs for somewhat more flexibility, imagination, and innovation in utilizing the potentially large array of policy instruments available. The case-by-case approach is fundamental, with programs to be tailored to the specific circumstances of the member country. We see nothing in this approach that would conflict with the Fund's "uniformity of treatment" principle. In our view, uniformity does not mean that policy commitments and financial packages should be identical. Some experimentation may be required as we proceed. Let me be clear that the introduction of more flexibilty does not mean that programs would be, or should be seen to be, weaker. Rather, we envisage some shift in emphasis concerning program design, implementation, and monitoring.

Key macroeconomic and structural problems must be clearly identified at the beginning, and specific policy commitments, especially those which are formal performance criteria, concentrated in these areas. We also need to integrate our technical assistance work, especially that of the Fiscal Affairs and Central Banking Departments, into Fund-supported programs. Growth orientation needs to be built into the overall program from the outset. A correct perception by other creditors and by donors of what the Fund is attempting to do in making its program design somewhat more flexible and growth oriented in the future will be very important to the Fund's success in its catalytic role.

As we said during the seminar on program design, we believe that the full integration of growth-oriented structural measures into Fund programs would contribute significantly to their success, and that specific performance criteria should be set in many cases. Some progress has been made; the Philippine case, for example, comes to mind. However, there has not yet been a concerted effort to approach all Fund programs with the possible need in mind for structural measures as important and integral elements of the program. Also, we still have to sharpen our procedural tools in order to include structural features in our program design and monitoring arrangements. This approach would need to start with a careful analysis of the member country's main problems and policy priorities. Staff papers presented to the Executive Board could sometimes be clearer on this basic question.

A concentration in Fund programs on fostering a realistic array of relative prices would come close to providing a comprehensive approach to the growth and adjustment problems of many countries, although demand-management and other structural measures will of course also need attention. The Fund does have considerable experience in urging countries to allow relative prices, in the broad sense, to allocate scarce resources. This is particularly true with regard to exchange rates and interest rates but is somewhat less so concerning the prices of publicly provided goods and services and with regard to wage rates. At the outset of the formulation of each program we would expect the staff to evaluate this array of relative prices. For goods and services this would include producer prices as incentives, consumer prices and related subsidy issues, and price controls over the prices of privately produced goods and services, with regard to their effects on consumption, profits, and investment prospects.

A realistic price of capital and capital mobility will often be crucial elements of programs, indicating the need to achieve real positive interest rates. Often these policies can usefully be linked to reforms, modernization, and expansion of financial markets, institutions, and policy tools. The relationship between interest rates and exchange rate policy is particularly important, including the combined effects of these tools on the mobilization of domestic savings and on capital flight.

The exchange rate needs to be seen in a dynamic and medium-term context, as a key instrument for allocating resources, in general, and especially for export growth and diversification. The exchange rate, trade liberalization, and customs tariff policies should be seen as part of the overall approach to opening up the economy to competition and export opportunities. Close coordination of these policies within Fund programs and between the Fund and the World Bank is especially needed.

It is in the realm of structural improvements in markets and institutions in the fiscal, financial, trade, and labor areas that we have some way to go in fully integrating these policies into Fund programs. In particular, we need to develop our procedures for analyzing structural problems, for involving our technical assistance departments in program design, and for formulating specific performance criteria, benchmarks, targets, or reviews in a manner which will be most appropriate and effective.

In the case of tax reforms, a case-by-case approach is particularly needed but some standard aims can be identified, such as the desirability of a broad tax base, an assessment of the marginal tax rates on personal and corporate income taxes, ease of collection, some diversification of revenue sources, and tax equity--both for fairness and tax compliance purposes. Concerning marginal tax rates, we would want to look especially at whether the level of rates is helpful or deleterious to economic growth and efficiency. Improved expenditure control can also be a crucial element of some programs. Public investment expenditure is an area where the World Bank should normally take the lead.

We have learned from the debt crisis the grave consequences of overdependence on borrowed foreign savings. Therefore, mobilization of domestic savings is a fundamental element of the debt strategy. Intermediation through a modern and financially sound banking system is likely to be important, as is the development of effective financial instruments and financial markets. The Central Banking Department of the Fund can be helpful in this area. The burden on the balance of payments of interest payments may be somewhat alleviated by debt/equity swaps, and in many countries, the Fund or the World Bank could take a much more active role in helping their countries to liberalize a foreign direct investment regime.

We believe that the Fund should also take a more active role in opening up economies to freer trade and payments. In recent years, trade liberalization commitments have sometimes been included in Fund programs, but I do not have the impression that the question has always been fully analyzed or given a particularly high priority. Success in trade liberalization cannot be expected without close attention to the exchange rate and customs tariff regimes. Business sectors need to be persuaded that the government is serious about liberalization, and they deserve some time to anticipate and adjust to increased competition.

The Fund has been relatively little involved in labor market reforms. However, we have seen the importance of these matters in industrial countries, state planned economies, and some highly indexed economies. We may need to proceed with caution. There could be some room for Fund attention to this matter, but the World Bank may be better placed to help.

If we are to embody a larger content of structural policy commitments in future Fund programs, then we may be able to be somewhat more flexible in our approach to the specific macroeconomic components of programs in individual cases. Let me hasten to say that the Fund clearly has a major comparative advantage in the macroeconomic area, and that all programs must be formulated and monitored with close attention to macroeconomic policies. However, it is our belief that the Fund's traditional emphasis on the monetary approach to adjustment may be somewhat narrowly focused. Of course, the test for internal financial consistency by means of financial programming needs to be preserved. However, we would like to avoid such a concentration on credit limitations as to detract from the need to focus also on structural problems and on specific ways to address them in programs. Obviously, countries with clear domestic credit problems would have performance criteria in this area. Even countries with a track record of prudent control over credit growth would have performance criteria established. But, in the latter case, the main focus of program negotiations in the financial area might more appropriately be on efforts to improve financial markets, institutions, and tools. Similarly, limitations on foreign debt may sometimes be lower priority as performance criteria where international capital markets are already acting effectively to allocate credit.

Given the prevalence of large fiscal imbalances, we would expect to see limits on credit to public sectors or parts of the public sector in most programs. But, at the outset of analyzing a country's policies and formulating program design, it will be very important that the adequacy of the tax system and of expenditure controls be evaluated and described in staff papers to determine what, if anything, needs to be done of a structural nature. Often measures in these areas will be as important as, or even more important than, the size of the fiscal imbalances. My reference to the adequacy of the tax system is meant to encompass both its effects on revenue and on economic incentives to work, save, and invest. The Fiscal Affairs Department can help here. The ability to control spending and the composition of spending also need closer attention. Specifically, we believe that in a few cases there may be a need for more use of performance criteria, or at least benchmarks or reviews, with regard to spending levels.

I will keep my comments concerning the formulation and monitoring of Fund programs brief, since I generally agree with the staff report. But like Mr. Ismael, I would stress that the aims and policies advocated by the Fund be as transparent and clearly understood by the authorities and by the public as possible.

No doubt there has been some proliferation of performance criteria and reviews and, perhaps, somewhat more frequent monitoring in recent years than earlier. While we would prefer as limited a number of formal performance criteria as is consistent with effective monitoring, the reality of the Fund's having to cope with a wide variety of problems in an increased number of member countries largely explains this development. Also, the need to focus on the medium-term framework of adjustment and on assuring that the Fund is repaid may have added somewhat to the coverage of our monitoring procedures. In any case, if the number of policy commitments is to be limited, we must learn to focus more sharply on the truly critical problems.

Our first preference is to establish performance criteria for an entire program year. However, where formal quantitative performance criteria cannot very easily be set for an entire year, we have some preference for performance criteria in the early period, supplemented by indicative targets for the remainder of the year. The indicative targets would be subject to reviews. This approach would be in lieu of attempting to set performance criteria for the entire year and then having to seek formal modifications and waivers. This view reflects, in part, the danger of misunderstandings by other creditors concerning waivers in cases where the Fund's financing role is principally catalytic.

At the risk of repeating myself, I would again stress the importance of the case-by-case approach in assessing the implications of the innovations in the recent Mexican program. As Mr. Dallara said at the September 9 Executive Board discussion of that program, we supported the innovative contingency features incorporated in that program. The key question which we asked was whether, in the context of the highly particular circumstances and implications of that case, the two contingency mechanisms were constructive and whether they served the interests of Mexico, the Fund, and the international financial community. The Fund had cooperated with the Mexican authorities in developing these innovations in a desire to contribute to the growth orientation of the program and as an exercise of its catalytic role in helping a member country to obtain financial support for the program. However, in the light of the reaction of other creditors, especially the commercial banks, to the economic program, and in view of the very considerable difficulty in achieving the critical mass of commercial bank financing, very careful consideration will have to be given to approaches of this kind.

I will not comment at length about the relationship between the oil and investment facilities and the compensatory financing facility until our review next year. Clearly there are important differences between the two approaches as to: amounts of financing, tranching, degree of conditionality, coverage of exports, and symmetry, which will need to be examined.

Mr. Foot made the following statement:

This is a broad and important subject. I would like to comment on a few issues now and perhaps return to others later.

My starting point is that this chair is broadly satisfied with the design of the typical Fund programs and with the number and type of performance criteria used.

The role of performance criteria is to provide a quantified statement of the policy understandings reached between the staff and the member. This has the important function of giving reasonable assurance that policies are being implemented that will achieve balance of payments viability over the medium run and thus safeguard the revolving nature of the Fund's resources. In addition, performance criteria should give the authorities a clear understanding of the conditions that will ensure them continued access to the Fund's resources. In some cases, the setting of explicit policy commitments may also help the authorities to focus on the magnitude of the problems that they face and ensure that a broader domestic consensus is reached on the need to achieve these aims, something that happened, for example, in the case of Sierra Leone earlier this year.

Given the variety of the economies of members that use Fund resources, it is inevitable that the number and nature of specific performance criteria will vary from case to case. I wish to make several general observations in this area. First, the number of performance criteria and related understandings should be kept to a minimum, but the size of that minimum will depend upon the nature of the economy in question and the difficulties it faces. Thus, I would expect a member of a currency zone with few restrictions on its trade and with a relatively small role for the public sector to typically have fewer criteria and understandings than a member with a dominant public sector, numerous direct controls in the economy, and many trade distortions. I would also expect a member that is unused to the Fund's ways and where the staff is relatively unfamiliar with the economy to need more mutually reinforcing criteria than a member that has had three or four successful stand-by arrangements and is well known to the staff. Certainly a large number of performance criteria will not necessarily imply that the authorities are implementing a particularly ambitious adjustment program; it is much more likely to be a hallmark of a highly regulated, fairly centralized economy.

Second, the staff correctly argues that, in general, widely defined performance criteria, such as the overall fiscal deficit, are preferable to narrow definitions, such as ceilings on bank and foreign credit to the government. I sympathize with Mr. Ismael, who mentioned that some countries with very limited administrative resources and data bases argue against this in particular cases. In some cases, subceilings may have an important role to play. Depending upon the institutional framework of a country, it may be important to ensure that a reasonable proportion of the available credit goes to the private sector. I do not agree that performance criteria have to focus on instruments that are solely within the control of the authorities. Such a focus would provide inadequate assurance to the Fund about the viability of a program, although it is difficult to be very specific without discussing individual cases.

My third general comment is that, wherever possible, the staff should set performance criteria for at least the first year of a program. In this connection, I very much agree with Mr. Templeman's remarks. In some cases, uncertainties, such as the likely availability of external financing, may mean that these criteria can only be of an indicative nature. I would not go along with the staff's view on page 28 that indicative targets are generally inferior to targets that are set at the outset for the whole of the first year. This depends partly on the timing of the budgetary process relative to the stand-by arrangement. What is clear is that either full or indicative targets are preferable to the complete absence of anything beyond a few months, which has been a feature of a number of recent programs. In addition, wherever possible, the staff should place policies in a quantified medium-term framework.

Fourth, prior actions can play an important role in demonstrating the authorities' intentions to both domestic economic agents and the international financial community. They are necessary in some cases to show the Fund that its chances of repayment are sufficiently high. They are often necessary to persuade banks to provide bridging financing and donors to mobilize financing, as in the case of The Gambia in 1986.

My final general point is that a cause for regret in the design of programs is the frequent lack of attention that is given to a timetable for dismantling trade restrictions. Mr. Templeman has addressed this point, and I will not comment on it further.

As I have said on a number of previous occasions, the key issue in the treatment of breaches of performance criteria is whether the authorities are committed to continuing to follow policies that should lead to the fulfillment of the program's objectives. In general, it is usually possible to tell whether or not this commitment exists. Where there is doubt, the Executive Board leans over backward to be accommodating while sending as clear a message as possible about the ways in which this doubt can be most quickly eliminated. Members that negotiate stand-by arrangements should bear the Executive Board's record of flexibility in mind before concluding that there are too many criteria and/or that modest breaches of one or two are likely to end Fund disbursements.

A more substantive issue is the argument that the present design of programs leaves undue uncertainty in the mind of the borrowing member as to what will or will not be available, because of the excessive use of reviews. Reviews have a number of purposes, which are described in staff papers. They can be backward looking, particularly in cases in which an economy's data base is poor and performance criteria are therefore less well suited to their task. They are also useful in bringing to the Executive Board's attention progress in critical structural areas--such as the breaking of monopolies or the reform of parastatals or the banking system--where success is important to the overall program but detailed performance criteria are difficult to construct.

Reviews also often have to be forward looking. This is most evident in cases in which programs have been negotiated in a hurry--an unfortunate necessity in many cases--and when the time of year of the negotiations is not well suited to specifying quantified targets for the coming year, especially in the fiscal area. Reviews also have a clear role to play in cases in which the imbalances in the economy are massive and urgently need correction. Fund staff members are not magicians. There can be legitimate room for argument in some cases--for example, ex ante about whether an exchange rate needs to fall by a quarter, a third, or by half. Especially in cases in which there is a dispute and the authorities are reluctant to go as far as the staff suggest, it is clearly better to make the smaller change and to have an early review than to have the change alone.

These are some of the reasons that explain the apparent increasing use of reviews. It is not, in my view, an unhealthy sign, although the work pressure it sometimes puts on the staff has to be borne fully in mind. As to the pressure on the Executive Board, Mr. Wijnholds's suggestions on the treatment of some reviews warrant further examination. But I do agree with several previous speakers that there is a need to specify as precisely as possible what is to be reviewed and, where appropriate, the yardsticks by which the evaluation will proceed.

I would not favor establishing a deadline for cases involving a delay in completing a review. The current process by which the Managing Director keeps us informed seems to be entirely adequate, especially when it is possible for the staff to supply some factual background.

In general, my authorities see only a very limited role for adjustments of the kind that are featured in the recent program for Mexico. There is little case for growth triggers involving additional financing. Adjustment and structural reforms are prerequisites for growth, but they cannot guarantee it in any particular timeframe. Nor is it possible to analyze the failure of growth to materialize as forecast; the reasons are likely to be many, including a combination of external and internal factors. Furthermore, if growth is insufficient, it is not possible to turn on a tap to produce it. Particularly when it is intended that the tap should take the form of additional public spending of extra foreign lending, it is only in the simplest of static models that one could be confident that additional growth would result. Many stand-by arrangements seek to shrink a bloated public sector. The last thing these economies may need is additional public spending, even on identified and by themselves desirable projects. I would also note the impracticality of setting a mutually agreeable minimum growth rate for different members. It is clear that some governments have a much higher minimum growth expectation than others.

I am also doubtful of the usefulness of automatic additional financing in response to adverse movements, whether in the price of single commodities or in the terms of trade as a whole, or whether in response to movement in other often key variables, such as the level of foreign interest rates or the growth of world trade. The intellectual case for such a mechanism is, however, sounder than in the case of the growth trigger, provided that the financing covers no more than the time that is needed to introduce additional adjustment measures and that there is no other way in which the same effect could be achieved. Realistically, however, we much recognize how difficult it would be to succeed in having the banking community finance such a mechanism, even for countries of major systemic importance. This is likely to leave the Fund facing alone the financing needs involved, which will often be larger than the Fund could begin to contemplate, especially in cases in which the member has already heavily utilized Fund resources. To the extent that Fund financing is possible, it could often be provided under the existing compensatory financing facility. As the staff notes, the review of that facility is therefore a highly relevant issue for the present discussion, and my authorities wish to give further thought to the linkages in this area. Of course, whatever is done, we must avoid an unsustainable medium-term debt position for the members concerned.

I see slightly more appealing aspects in the idea of automatic adjustments that do not involve additional financing but that lead to preagreed changes in performance criteria. These should still be exceptional, because, in most cases, an automatic review--as in the forthcoming review of the stand-by arrangement for Nigeria--if key parameters move outside assumed ranges would be the better approach. This is because by committing themselves in advance both the borrower and the Fund are effectively disregarding the information that becomes available between the negotiation of the program and the triggering of the adjustment period. A review would permit adjustments to the program that could take into account all the factors that were available at the time and clearly carries with it a presumption that the Executive Board would be flexible in its response.

Nevertheless, I accept that there will be occasions on which automatic adjustment to criteria would appear to be desirable. In my view, such cases should be restricted to programs with two clear features. First, any program containing triggers for performance criteria and a fortiori in the even more exceptional cases involving additional financing, would need to demonstrate unambiguous robustness in tackling the problems of the member. Triggers should not be capable of use unless basic elements of the program are on track or are being put back on track through very quick action. Second, such programs should involve symmetry, so that there is a response to favorable as well as unfavorable shocks.

In sum, any Fund program containing triggers for performance criteria or extra financing should be exceptional and should be justified, as in the case of Mexico, by generally wider, systemic considerations. The triggers will need to reflect unambiguous robustness of purpose in the adjustment as well as symmetry. They must not delay adjustment to changes in circumstances that may not be temporary, and they must not give rise to an unsustainable debt burden in the medium term. Nor must they be based on unrealistic economic assumptions about the financing that the Fund can provide or that will be provided by banks. It is not possible or desirable to underwrite a commitment to growth.

Mr. Schneider made the following statement:

The interesting staff papers are concerned with what is probably the most sensitive aspect of the Fund's relationship with members. Mr. Kafka's critical assessment of the papers shows that the Fund's use of performance criteria in the framework of its conditional lending activities is still the subject of considerable controversy. Therefore, much remains to be done in order to clarify the general views among members on the appropriate format of Fund monitoring of members' economic policies.

In this context, a major source of controversy is the number of performance clauses and the frequency of performance tests, which many users of Fund resources consider to be both cumbersome and excessive. I do not agree with this conclusion. I support the view that extensive monitoring of policy implementation and of progress under an adjustment program is the corollary of the complex and protracted nature of the balance of payments problems facing many countries. Of course, in order to be politically acceptable and ultimately productive, the recent extension of the Fund's involvement in countries' economic policies needs to be matched by a sufficient degree of flexibility; due regard should be paid to the impact of external developments on policy performance and to the member's commitment to a broad range of policy goals, including the achievement of balance of payments viability.

In this connection, the staff papers reflect an unfortunate inertia in several respects. Close monitoring of adjustment programs is recommended as a tool to ensure continued commitment of a member rather than as an opportunity to adjust policies flexibly to changing external conditions. The strengthening of policy implementation is reported to be a more important issue than the incorporation of growth considerations in the formulation of performance criteria. Moreover, the staff seems to believe that monitoring of structural policies should be resisted because these policies are considered to fall within the domain of the World Bank or because monitoring by the Fund of these policies is considered to be an undesirable intrusion upon the member's authority over domestic resource allocation. Therefore, the policies that are subject to monitoring through performance criteria continue to be narrowly defined by the need to protect the revolving character of the Fund's resources. The widening discrepancy between the ever increasing comprehensiveness at which Fund-supported adjustment programs are aiming, and the limited scope of the performance criteria that are designed to monitor these programs is discussed only indirectly in the staff papers, although it is perhaps a major reason for the failure of a number of programs in recent years. As a growing number of policy instruments necessarily become involved in the process of balance of payments adjustments, the risk that the same policies would have to serve potentially conflicting goals increases correspondingly. In order to safeguard under these circumstances the desirable adjustment path and the member's commitment to the program, it seems essential that all relevant policy actions should be reflected appropriately in the program's performance criteria, and that the Fund should monitor their implementation in a balanced way by paying due regard to the member's pursuit of growth and adjustment.

A number of aspects of the Fund's general use of performance criteria could be strengthened. At the heart of Fund-supported adjustment programs is typically the control over aggregate spending through the establishment of ceilings on the expansion of domestic credit, with the limitation on net credit to the public sector as an important subceiling. To the extent that excessive government spending is among the root causes of a country's balance of payments problems, direct and comprehensive action affecting the public sector borrowing requirement is certainly warranted. However, the situation becomes less clear when economic growth considerations are taken into account and the public sector deficit is monitored in order to achieve a relative shift in favor of private sector activity. I agree with Mr. Kafka that when this angle is taken into account the problem of ceilings becomes more complicated. However, rather than relax the public sector ceiling, I favor the provision of additional safeguards to protect public sector investment in order to maximize growth incentives within the overall control of domestic liquidity expansion.

Even more important for achieving a better reflection of the desirable adjustment path in the program's performance criteria are the actions that are mandated with respect to exchange and trade policies and other structural policies. Given their important impact on the allocation of resources and a country's foreign trade sector and their important supportive effect on exchange rate actions, I would advocate a much more explicit formulation of performance criteria with respect to exchange and trade policies than the standard performance clauses that are usually established. I also favor a more systematic use of performance criteria with respect to domestic structural reforms in cases in which the successful implementation of these reforms is judged to be essential for the achievement of a viable balance of payments position over the medium term. There is a growing body of experience that suggests that comprehensive reforms of the domestic financial system and of the price and subsidy systems may be essential to achieve over time an economic environment in which sustained growth can coexist with a viable external position. In addition, like Mr. Kafka, I see no reason why such policies should preferably be addressed in the form of prior actions. Given their comprehensive and wide-ranging character, they might indeed well be designed as the dominant path toward adjustment, while other, more demand management-oriented policies would be designed to monitor the progress with structural reform and adjustment.

If this tendency toward encompassing the whole range of domestic policies in a country's adjustment process--which is already a reality in the design of several programs--were also to be reflected more faithfully in the formulation of performance criteria, the need for greater flexibility in monitoring progress under the program would arise as a natural corollary. Of special interest in this connection is the possibility of a flexible adaptation of a program to changing external conditions in order to safeguard progress with the simultaneous achievement of various policy goals, including sustained growth and external adjustment. Further development of the contingency-type mechanisms that are used in the Mexican program seems to be of critical importance in this context. The justification for establishing these mechanisms clearly goes beyond the particular context of an isolated case, since appropriate safeguards of a member's commitment to adjustment should be provided in all cases in which the whole policy-making process, including the reform of major structural areas, is involved in the pursuit of a sound external position.

Mr. Grosche made the following statement:

As a point of departure, it is worth stressing the principles that guided the Fund in the evolution of the techniques used to monitor arrangements with member countries. The two most important ones are clearly explained in the staff paper: first, members need reasonable assurance as to when and under which conditions they can make use of Fund resources; and second, the Fund needs to ensure the appropriate use of its resources and to safeguard their revolving character. It is fair to say that on balance the system of monitoring Fund-supported programs through performance criteria, reviews, and prior actions has served these two purposes well. There have admittedly been problems, but in trying to make improvements, we need to keep these basic principles in mind. The guidelines generally remain appropriate, although I noted Mr. Wijnholds's comments on them.

Comprehensive coverage of all relevant developments in a particular policy area should generally permit better and more effective monitoring of a program, thereby increasing the probability of positive results. Comprehensive coverage would also tend to contribute to keeping the number of performance criteria as small as possible. However, any effort to limit the number of performance criteria should not result in giving up the monitoring of important subcategories of the aggregates concerned. Depending upon the individual case concerned, it may often be necessary to monitor developments through detailed quantified performance criteria for the individual components of the larger aggregates--for example, by setting separate limits for short-term, medium-term, and long-term external borrowing.

I agree with the staff that one should aim at a clear specification of the path envisaged for key intermediate variables. Any deviation from this path would be an "early warning signal." The earlier a potential noncompliance with a performance criterion is detected, the better and faster the authorities can adapt their policies and implement the necessary corrective measures.

Regular reviews in the course of a program have become an addition to our monitoring procedures. However, I would caution against using reviews as an "easy way out" of reaching necessary agreements on appropriate quantified intermediate targets or important prior actions. Reviews cannot be a substitute for precisely defined adjustment policies and objectives. Therefore, I agree with the staff that normally all performance criteria should be established for a program's full policy planning period before an arrangement is approved. Waivers and modifications would then provide the necessary flexibility in response to unforeseen developments. Reviews would serve the purpose mainly of monitoring progress in those areas where the use of quantitative performance criteria is either undesirable or unfeasible. This would be the case particularly in the field of structural adjustment. However, this does not imply that the timing and implementation of structural reforms should be left open. In fact, in many cases, structural measures are so crucial to the overall success of a program that they should be taken as prior actions. In cases in which their implementation needs to phased, at least a clear timetable should be established at the outset.

It is important to keep the scope of reviews narrow to avoid having to renegotiate the adjustment measures and performance criteria several times during the program period. While a review can provide the necessary flexibility in the event of unforeseen developments that may warrant an adaptation of performance criteria and targets, it should as a rule serve the purpose mainly of assessing progress by comparing program targets with actual results.

As the staff has noted, limiting the scope of reviews would avoid undue delays in some cases. Delay may nevertheless occur, and in those cases the Executive Board should be promptly informed by management of the reasons for the delays and of the status of discussions with the authorities. However, I see no need to establish rigid rules on such reporting. The reporting could be handled in a flexible manner, depending upon the special circumstances of the individual country.

The same flexibility is warranted in the setting of time limits for the completion of a review. It must be recognized, however, that program slippages and unduly long delays in completing a review can have serious implications for the entire program. Therefore, I agree with the staff that waivers and modifications should be used cautiously and should be granted only if there is reasonable assurance that the program can still be successfully completed.

Deviations from policy understandings that do not result in a violation of performance criteria and program targets until some time has elapsed pose particular problems in the overall context of monitoring Fund arrangements. For the sake of protecting the Fund's resources and credibility--which, of course, depends upon the maintenance of appropriate standards of conditionality--it would be essential for the Executive Board to be informed as early as possible of such deviations. The Fund's response in cases of clear violations of policy understandings should generally be an interruption of the arrangement and new negotiations with the member with a view to reaching new understandings. As to further options, such as a requirement of immediate repurchase, I would like to reserve my comments until the Executive Board considers the legal papers on the subject that are being prepared.

My remarks on the staff paper on automatic adjustments are not intended as a reassessment of the Mexican program. They are general in nature and deal with the potential problems of incorporating contingency clauses into future Fund-supported programs. The Mexican program is a clear example of the flexibility that the Fund can and should display in responding to the particular economic, social, and political circumstances of individual countries. The Fund should continue to do so without of course endangering its role and the financial integrity of its resources. Those automatic adjustment and contingency clauses, however, create considerable problems, and I am reluctant to see them become a regular feature of Fund-supported programs.

The a priori commitment of additional financial support in the event of a decline in commodity prices represents a shift in emphasis from adjustment to financing and involves the risk of adding to an already heavy debt burden without increasing the country's ability to service its debt. Valuable time may be lost until the ultimately unavoidable adjustment takes place, especially when the shortfall is not temporary in nature. A set of contingency measures that could be used when shortfalls of a longer-term nature occur would be more helpful in solving underlying problems. Moreover, special contingency financing triggered by only one factor--for example, a shortfall in oil receipts--does not take into account the potential for other effects to work in the opposite direction--for example, increasing export volumes or falling international interest rates.

I am particularly skeptical about growth contingency clauses. In addition to the restoration of balance of payments viability Fund-supported programs must foster sound economic growth. In many cases, the orderly solution to debt problems seems difficult to achieve without sound economic growth. Moreover, there is no doubt that additional investments might be needed to achieve sufficient growth rates. If the investment projects are economical and profitable, thereby justifying additional external financing, it would seem reasonable and more appropriate to incorporate such financing into the program at the outset. Implementing such projects in the context of a growth contingency runs the risk of counterproductive economic fine tuning; such fine tuning should be avoided.

In sum, I agree with the staff that a comprehensive review of a program would clearly be preferable to predetermined automatic adjustment once it becomes evident that important program targets would be missed.

As to the issue of the relationship between access to resources in the credit tranches and to the resources under the compensatory financing facility, I am not convinced by the staff's argument in favor of automatic increases in the amounts provided under a stand-by arrangement. The advantages of compensating temporary export shortfalls through the compensatory financing facility outweigh the potential merits of contingency mechanisms. For example, when there is a request for compensatory financing, the Executive Board examines the overall export situation of the country concerned, not merely developments in one commodity. In addition, an assessment is made of the temporary nature of the shortfall and of the export prospects. Of course, there is still the question of the different conditionality between stand-by arrangements and compensatory financing, but this problem would seem less important when compensatory financing goes hand in hand with a regular Fund-supported program. In any event, I look forward to further in-depth discussion of the subject during the coming review of the compensatory financing facility.

Mr. Nimatallah made the following statement:

There was a time when lending was the main tool used by the Fund to help its members. Economic adjustment and reform were only required to guarantee the revolving character of the Fund's resources. However, today it seems that the primary purpose is to address the need of members to adjust and reform their economies. The Fund's primary means of helping members is to provide its expertise in designing and monitoring such adjustment and reform. In the process, financing is needed and becomes a kind of supplementary means of assistance to members when the Fund agrees to stand by and be ready to finance and catalyze more financing in support of members' adjustment efforts. Therefore, it is in the best interest of members to work in full coordination with the Fund on the design and techniques of monitoring their adjustment programs for the purpose of successful implementation of such programs. It follows that the essential elements for the success of adjustment programs are good design and monitoring techniques, together with the existence of mutual trust between the Fund and members.

The title of the staff's main paper does not convey the true scope of today's discussion. I would have liked the title to read "Design, Monitoring, and Implementation of Fund-Supported Programs." The paper discusses performance criteria, reviews, automatic adjustments, understandings, and prior actions, but it omits discussion of benchmarks. In addition, while prior actions and understandings can constitute parts of the implementation process, they can give the Fund reason to monitor and question the appropriateness or lack of it when conditions are not fully or partly implemented. I therefore agree with Mr. Kafka that prior actions cannot be characterized as monitoring techniques. Whatever they may be, however, I do not recommend their excessive use. But I can agree with those who contend that, in certain circumstances, especially when the authorities wish to inspire confidence at home and abroad, prior actions may be unavoidable.

Since the disbursement of Fund resources is contigent upon the observances of performance criteria, these criteria are especially important, and special care should be taken in their design. *It should be noted that what is important is for the performance* criteria to capture accurately the underlying trends in an economy. They should be able to send signals, in a timely fashion, warning when an economy needs further corrective action. I agree that it is desirable to have, when feasible, a comprehensive definition of quantitative performance criteria. Of course, the more comprehensive these criteria are, the smaller their number is likely to be. In this sense, the issue is the quality of the criteria, not their number. It is important for the staff to avoid where possible unnecessary proliferation of performance criteria.

As I have stressed on previous occasions, reviews are instrumental in introducing flexibility in Fund-supported programs. However, it is important that reviews should not assume too large a role. I have no difficulty in having some reviews on a lapse of time basis, as Mr. Wijnholds suggested. In this connection, a clear specification of the path envisaged for the key intermediate variables that stand behind quantitative performance criteria should be established at the outset. I agree with Mrs. Ploix that a review is designed to inter alia update--and, I would add, to follow up on--developments rather than to establish performance criteria. Automatic adjustment can be a useful financial technique for the Fund. However, in certain circumstances, as is the case with contingencies, automatic adjustments might be more useful if combined with reviews.

The essence of the commodity contingency is to ensure that a country's adjustment efforts are not disrupted by adverse external developments. I am still at a loss as to how the commodity contingency is to be calculated, as it is expressed only in terms of changes in prices. It is not clear to me how an exact compensation amount could be arrived at to fulfill the purpose of avoiding a disruption of a country's adjustment efforts. I assume, of course, that if, for example, there are favorable developments in other export revenues, they would be taken into consideration in the calculation of the compensation. The staff should elaborate further on this matter.

Generally, however, a commodity price contingency can be useful as an additional mechanism alongside the compensatory financing facility. It has the advantages of speed and symmetry and of being integrated in a program. Furthermore, a price contingency can make a useful financial technique for all parties ivolved in Fund-supported programs; therefore, it merits serious consideration by the Fund.

It is still not clear to me how the growth contingency would work in practice. My understanding is that members that suffer from economic and financial imbalances may have to adjust and grow at the same time. I have been saying in the Executive Board that the Fund should help such members to design and implement growth-oriented adjustment programs. In correcting imbalances between aggregate demand and aggregate supply, members used to emphasize adjusting aggregate demand; insufficient attention was paid to increasing aggregate supply. The intention now, I suppose, is to adjust both simultaneously in order to achieve a higher equilibrium level that is consistent with medium-term balance of payments viability. This implies of course a rather longer program period. However, it does not mean that a specific rate of growth can be guaranteed by either the member or the Fund, with or without contingent financial support. The reason is that the growth process is complex. It can be influenced by many factors, either on the sectoral or the aggregate level, and either on the supply or the demand side, or both, or all of those. In other words, due to the lag in realization and the uncertain timing involved, it is extremely difficult to guarantee a specific growth rate and therefore to agree on a specific contingency compensation to guarantee such a rate, especially if the sluggishness in growth was triggered by a general structural decline in real incomes owing to, for example, a sharp drop in export revenues from a major export commodity, as has been the case in Mexico, Saudi Arabia, and other countries. Less promising even is that if the Fund decides not to give the appearance of guaranteeing a particular pace of economic growth during an adjustment program, then the growth contingency is disqualified as a very useful financial technique for the Fund.

The Fund should be involved in and press for structural changes to the extent of seeking determination of the details of structural adjustment policies. To that extent, the Fund should resort only to understandings on monitoring such policies in cooperation with the World Bank, which, I assume, will have further monitoring tools.

More importance should be given to understandings, not only for structural adjustment and monitoring, but also as preventive measures--for example, in cases in which there is a danger of the emergence of external arrears, in general, and of overdue payments to the Fund, in particular. Incidentally, I have noticed from programs that have been considered by the Executive Board in the recent past that the treatment of non-Fund external arrears has not been uniform. I hope that this will be corrected.

Mr. Massé made the following statement:

A number of aspects of the staff paper are quite useful. The brief historical review helps to place the subject in context, and it was particularly useful to emphasize that the development of quantitative performance criteria was intended to give certainty to both the Fund and to the member of the conditions under which Fund resources could be drawn. This fact should not be forgotten. The discussion of why certain performance criteria have traditionally been chosen over others was very clear, and I agree with the staff on the desirability of comprehensive, easily understood quantitative performance criteria.

At the same time, the paper raises a wide range of issues that were perhaps not explored in sufficient depth. An example of this is the role of structural adjustment policies under Fund-supported programs. As the Fund ventures into a world of growth-oriented adjustment based on structural reforms, it becomes all the more important for it to have a clear view of what it wishes to accomplish through structural reforms and how we will monitor these reforms. Therefore, it is somewhat disappointing that the staff paper did not go beyond the traditional approach of relying upon the World Bank to monitor much of the growth-oriented structural approach or falling back upon prior actions and policy reviews as a means of monitoring specific actions. The development of more objective and explicit monitoring of structural developments is perhaps the one area where the Fund staff could usefully focus its energies in the further development of performance criteria and program design.

I agree with the staff that where possible the most comprehensive definition of a particular performance criterion should be used. For example, the use of the public sector borrowing requirement to monitor fiscal performance or of net domestic assets to set the credit ceilings has proven effective, and I see no compelling reason to depart from this practice. At the same time, however, the Fund should not be shy of using subsector ceilings where warranted. Much of the supposed proliferation of performance criteria in recent years has in fact been due to necessary subceilings for such items as short-term borrowing and domestic or external payments arrears.

The proliferation of reviews in recent programs is perhaps even more striking than the increase in the number of performance criteria and is likely to be a greater cause of concern because of the subjective nature of the review process. In general, reviews should not be a substitute for comprehensive and precise policy formulation within a basic program. By their nature, reviews increase uncertainty, since their outcome is unknown a priori. Additional reviews also increase the work load of the staff, the authorities, and the Executive Board. To deal with these concerns, the Fund should continue to emphasize prior actions in programs, where possible, and qualitative performance criteria in areas where they can be clearly formulated. Performance criteria that are quantifiable provide a clear indication to the member of the circumstances in which resources may be obtained from the Fund; they also provide the easiest means of ensuring equality of treatment among members.

Of course, circumstances will arise in which quantifiable performance criteria cannot be specified for an entire year of an adjustment program, or in which all requisite changes cannot be covered as prior actions. In these cases, the staff might consider combining midyear reviews with some sort of notion or benchmarks or an indicative policy pattern. For example, if fiscal or monetary policy cannot be tightly specified because of the presence of high rates of inflation or structural changes in taxation, the Fund could set notional benchmarks that could help to guide the policy adjustment over time and could then use the review process to determine the final desired goal. In any event, in cases in which reviews are still felt to be desirable, the reviews should cover policy areas that are defined as precisely as possible. This would prevent the reviews from being open ended. The expectations of performance could be clearly laid out, including indicative benchmarks.

Questions have been raised about delays in completing reviews, since delays appear to be contributing to throwing programs off track. Clearly no one has an interest in extended review periods that lead to a stalemate between the staff and a member. While I agree that reviews by their nature must be flexible, it also makes good sense to narrow the range of items that might be subject to a review and to keep the Executive Board informed of the reasons for any delay.

The increased emphasis that has been placed on structural policies is partly responsible for the increased use of reviews in Fund programs. It is for this reason that I feel that the staff should explore performance criteria for monitoring structural reform. In some cases, the failure to implement structural reforms will be reflected relatively quickly in the failure to observe certain performance criteria, but this is a circuitous means of monitoring such reforms. One possibility might be to make greater use of indicative paths or indicative targets for structural reform. I would certainly appreciate any views that the staff might have on how structural changes might be monitored more closely and objectively. The staff papers have raised an important issue concerning automatic adjustments to quantitative performance criteria when actual performance deviates from the program assumptions. I certainly appreciate the difficulty in forecasting, with any degree of precision, the path of key exogenous variables, as well as the difficulty involved for members with a limited statistical base. Automatic adjustments in programs can be useful if they are confined to cases of purely technical or data-related deviations, or cases involving delays in well-identified capital inflows. In addition, the Fund should not be reluctant to grant waivers or consider modifications in cases in which deviations are due to technical factors or to delays in financing.

The issue becomes more complicated when we consider adjustment mechanisms like those recently included in the program for Mexico. These features represent, in many respects, new ground for the Fund, and it is difficult at this stage to make any conclusive judgment about the mechanisms and the possibility of their wider use. I can see both positive and negative elements in the mechanisms. To the extent that these contingency mechanisms can contribute to the continuation of the adjustment effort by building up political support or by providing a breathing space for the implementation of further measures, these mechanisms should not be discounted. However, it is not clear to what extent they can actually contribute to progress toward balance of payments viability.

It is useful to make a distinction between the commodity price mechanism and the growth mechanism. The commodity price mechanism is activated largely by exogenous developments, while the growth mechanism is not. During the discussion of the Mexican program, I noted that an automatic expansion of public sector outlays following lower than anticipated growth would not necessarily provide additional assurance of a stengthening of Mexico's medium-term prospects for growth. Furthermore, a growth contingency is particularly problematic because it does not establish the underlying reasons for weaker than expected growth performance, which might be linked to inadequate policy implementation or program design. Without knowledge of the specific causes of slower growth, there is a much greater probability that the automatic adjustment would be inappropriate. For these broad reasons, I would be very reluctant to see the growth contingency mechanism generalized or replicated elsewhere.

The commodity contingency mechanism is in some respects similar to the compensatory financing facility, as it provides financing in the event of adverse external developments. In some special circumstances, such as those of Mexico, the commodity contingency mechanism may actually provide financing more quickly and perhaps in greater amounts--because of the additional commercial financing--than might be possible under the compensatory financing facility. Unlike the compensatory financing facility, the oil contingency mechanism has the important advantage of being symmetrical. Furthermore, in the case of Mexico, there has been a staging of the financing and a close link between financing and the phasing-in of adjustment measures in order to meet program objectives.

At the same time, the commodity contingency mechanism does not permit an evaluation of the causes of the export shortfall, or an evaluation to determine whether the shortfall is temporary or permanent or even whether it is beyond the authorities' control. Furthermore, the mechanism does not evaluate total export earnings; instead, it concentrates on only one commodity. These factors are critical in determining the correct policy response as well as the pace of that response. In a more general setting, if the export shortfall were permanent, the delay in policy response would likely make the needed adjustment much more painful, even if a stronger political will to act had been developed.

It is fair to conclude that a combination of additional financing and automatic adjustments has many implications that we do not fully understand. The Mexican case involves special circumstances, particularly the degree of commercial financing, which may not be duplicated elsewhere. It would therefore be wrong to leap to a more generalized practice without further examining the broad issue of compensatory financing, specifically within the context of the coming review of the compensatory financing facility, when we will need to examine in greater depth the critical distinction between temporary and structural changes in export prospects in particular.

Mr. Lim made the following statement:

The review of the role of performance criteria and other monitoring techniques should be a useful operational adjunct to our earlier discussion of the theoretical aspects of the design of Fund-supported programs. Performance criteria provide important protection for both the Fund and the member. They safeguard the revolving nature of the Fund's resources by ensuring that purchases are made only when the member's program is on track. They also provide the member with assurances about the circumstances under which it may obtain the Fund's assistance. Flexibility is another important characteristic of performance criteria. It is essential that members are able, and do, react flexibly to changed economic circumstances. There are advantages to using broadly defined performance criteria, as they provide the authorities with greater freedom to choose among the different means available to meet an agreed target. While the defined criteria also permit the use of fewer performance criteria to monitor a program and are less likely to exclude components that could distort the relationship between the instrument monitored and the program's objectives, the broader and more comprehensive the criteria or instruments used to monitor the program, the more they take on the character of intermediate variables and are influenced by exogenous factors. Hence, there is something of a trade-off between the number of criteria used, their breadth of coverage, their susceptibility to exogenous changes, and the degree of policy flexibility that is required by the member. Acceptance of the staff's judgment that unnecessary proliferation of performance criteria should be avoided implies the need for flexible responses to changes in the economic circumstances of the member.

The staff notes that there has been a broader range and more varied mix of performance criteria across arrangements in recent years. This reflects greater diversity in the circumstances facing member countries and in the content of policy instruments underlying adjustment programs. However, the importance of avoiding unnecessary proliferation of performance criteria should always not be neglected. In general, the staff has shown flexibility and common sense in tailoring the numbers and mix of specific performance criteria to the circumstances of the member and the design of the program and supporting financing arrangements.

I will now comment on the selection and mix of monitoring techniques in Fund programs and arrangements. The staff notes that the difficult economic environment in the 1980s has led to a more prolonged and difficult adjustment effort by many members. This has proved disappointing in many cases, owing to the scale of adjustment required, inadequate program design, and inadequate program implementation. The staff suggests that 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.

With this fundamental point in mind, I now turn to the role of reviews in the monitoring of programs and how they relate to prior actions and performance criteria. I accept the staff's argument that 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 one-year time frame used in most member counries and by the Fund seems to be inappropriate.

Performance criteria, prior actions, and program reviews have generally proved to be acceptable techniques for monitoring within the one-year program cycle. Since the early 1980s, there has been increasing use of midyear reviews to establish criteria at a later portion of the program, to assess the adequacy of external financing, or to assess developments in certain important variables.

Overall, this has been seen to be a useful development that has added to program flexibility, and I generally support the use of reviews--although there seem to be indications that reviews have occasionally been too frequent. One means of reducing the need for reviews would be to set all performance criteria for the full 12-month period at the outset of a program. If this is not feasible for particular criteria, I would favor setting indicative targets; they could be set at the beginning of the program and reviewed at a later date. To deal more effectively with protracted imbalances, prior actions would increase the likelihood of the attainment of policy objectives.

It is argued, with some justification, that reviews that are used as "substitutes for comprehensive and precise policy formulation" at the outset of the basic one-year program are likely to postpone policy implementation and run the risk of reopening program negotiations for increasingly shorter periods. Confining reviews to specific issues that warrant close attention during a program period or to particular developments that might arise during that period will maintain flexibility in monitoring program design while avoiding many of the problems that are associated with reviews that the staff have identified.

I agree with the staff that the use of automatic adjustments of quantitative performance criteria in Fund programs may be appropriate for dealing with minor deviations that are clearly reversible over a relatively short period and that can be anticipated with a reasonable degree of certainty and, as important, involve cases in which no adoption of policy is required. Where uncertainties regarding the magnitude and the duration of the deviation exist, if the deviation is expected to be large, or if there is little room for policy slippages, the use of automatic adjustments runs the risk of deferring necessary adjustment.

In this context, it is worth underscoring the staff's comment on page 32 of the main paper that "expanding the scope of automatic adjustments to cover exogenous variables would render less meaningful the exercise of designing a program to meet overall objectives given normal uncertainties in external developments." Clearly, in these cases it would be more appropriate to monitor the program by means of the reviews or waivers and modifications.

These comments apply equally to all forms of automatic adjustment, including commodity price and growth contingencies. As the staff notes, growth is a major objective of adjustment programs and is best viewed in the context of an overall program period. Moreover, a country's rate of growth generally cannot be predicted with precision, nor can a specific rate of growth be guaranteed under a particular program. These factors suggest that a review of the program, rather than an automatic adjustment mechanism, would be appropriate if there is any significant lag in the expected rate of growth.

The Executive Directors agreed to continue their discussion in the afternoon.

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/86/189 (12/1/86) and EBM/86/190 (12/3/86).

3. EXECUTIVE BOARD COMMITTEES

The Executive Board approves the reconstitution of the membership of the four Executive Board standing committees as proposed by the Managing Director in EBD/86/310 (11/25/86) and Correction 1 (11/26/86).

Adopted December 2, 1986

4. PENSION COMMITTEE - NOMINATIONS

The Executive Board approves the election of the four Executive Directors nominated to serve as members of the Pension Committee for the term ending October 31, 1988, as set forth in EBAP/86/294, Supplement 1 (11/26/86).

Adopted December 1, 1986

5. EXECUTIVE BOARD TRAVEL

Travel by an Executive Director as set forth in EBAP/86/298 (12/1/86) is approved.

APPROVED: July 10, 1987

LEO VAN HOUTVEN
Secretary