FOR AGENDA

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CONFIDENTIAL

December 5, 1985

To: Members of the Executive Board

From: The Secretary

Subject: Issues in the Implementation of Conditionality: Improving Program Design and Dealing with Prolonged Use

Attached for consideration by the Executive Directors is the staff paper for the 1985 review of conditionality, which is scheduled for discussion on Friday, January 17, 1986. A draft decision appears on page 40.

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

Att: (1)

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INTERNATIONAL MONETARY FUND

Issues in the Implementation of Conditionality: Improving Program Design and Dealing with Prolonged Use

Prepared by the Exchange and Trade Relations Department

(In consultation with other departments)

Approved by C. David Finch

December 3, 1985

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I. Introduction

The present review of conditionality comes at a time when members of the Fund have been entering into arrangements for use of resources in the upper credit tranches at an unprecedented rate. From 1980 to 1984, 64 countries, 44 percent of the membership, adopted programs supported by such arrangements. 1/ These members averaged 2.7 annual programs each, reflecting both the large number of multiyear arrangements and the high incidence of consecutive one-year arrangements. The proportion of the membership involved far exceeds the corresponding figures for previous five year periods (see Table 1). High frequency of use has continued in 1985, with 25 annual programs approved up to the end of October; all the members involved had also had at least one program in 1980-84.

During the 1980s, the Fund's support for members' adjustment efforts has played a critical role in promoting a coordinated approach to problems of adjustment and financing, an approach that in the large has been remarkably successful in preserving the fabric of international cooperation. It is nonetheless true that a substantial number of the members entering into Fund arrangements over the last five years have not been as successful in their adjustment efforts as would have been desirable. Such countries still have some years to go before attainment of balance of payments viability can be expected, and for some viability does not appear in sight, even in the medium term. These difficulties are reflected not only in continuing domestic economic strains as the countries attempt to cope with their balance of payments problems, but also in continuing need for exceptional treatment by their external creditors. In their financial relations with the Fund, the difficulties are reflected in repeated need for recourse to Fund resources, in lengthening periods of continuously outstanding balances and, in a few instances, in failure to remain current in their financial obligations.

Such difficulties naturally give rise to questions about the effectiveness of Fund conditionality in promoting balance of payments adjustment. The Fund's guidelines on conditionality were adopted in 1979. 2/ Since then, the evolution of the practice of conditionality has been reviewed further by the Executive Board on an approximately annual basis, with background provided by staff papers reviewing issues

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1/ One country did not make any purchases in connection with its program. The figures in Table 1 exclude such precautionary arrangements.

2/ At the end of the first comprehensive review of conditionality in 1968, the Executive Board decided that certain conclusions from that review should guide the Fund's application of conditionality (Decision No. 2603-(68/132), 9/20/68). Following the second comprehensive review in 1978-79, these were revised and codified as the "Guidelines on Conditionality" (Decision No. 6056-(79/38), 3/2/79). The guidelines are reproduced in Appendix I.

Table 1. Programs Approved in Connection with Upper Credit Tranche Stand-By and Extended Arrangements 1/

(1955-1985)

	Number of Upper Credit Tranche Programs (Annual Average)	Members with Programs		
		Number	Percent of of Membership 2/	Average Number of Programs per Member
1955-59	6	18	30	1.7
1960-64	11	27	34	2.0
1965-69	19	35	32	2.7
1970-74	7	22	19	1.5
1975-79	11	32	24	1.8
1980-84	34	63	43	2.7
1985 (January-October)	25	25	17	1.0

Source: Fund documents.

1/ Excludes direct purchases. (In recent years these have been limited to emergency purchases, but in earlier years such purchases sometimes substituted for stand-by arrangements.) Excludes programs supported by arrangements under which no purchases were made.
2/ Average membership during period.

in conditionality and the experience with adjustment programs. 1/ There have also been a number of staff reports and Executive Board discussions of particular issues in the application of conditionality, largely of a technical or operational character. These have resulted in an adaptation of the application of conditionality in a variety of areas including that of monitoring developments under programs and strengthening the linkages between implementation of country policies and purchases under upper credit tranche arrangements.

Despite these adaptations, questions remain about the effectiveness of Fund conditionality. The fact that some of the Fund's members that have embarked on adjustment programs have not achieved balance of payments viability within the normal time frame for use of Fund resources is a matter of serious concern. There has also been concern that, whether or not balance of payments objectives have been achieved, adjustment programs have been accompanied by a slowing of economic growth. This latter concern, which has been noted in previous reviews of conditionality, to an extent arises from misunderstanding of the nature and effects of Fund-supported adjustment programs. 2/ However, it remains important to consider whether improvements can be made in the design of adjustment programs to bring about stronger assurances of both balance of payments adjustment and sustained growth. A major study of theoretical aspects of program design is currently in preparation in the Research Department. The present paper, together with the accompanying review of adjustment experience in the 1980s in a sample of member

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1/ See Appendix II. The most recent review took place December 5, 1984, at which time the Executive Board had before them three papers "Review of Upper Credit Tranche Arrangements and of Some Conditionality Issues," (EBS/84/227, 11/7/84); "Experience with Adjustment Policies," (EBS/84/228, 11/13/84); and "Formulation of Exchange Rate Policies in Programs Supported by the Fund," (EBS/84/23, 11/16/84).

2/ Three major papers addressing aspects of this issue were the subject of an Executive Board seminar last July: "The Effects of Fund-Supported Adjustment Programs on Economic Growth: A Survey of the Empirical Literature," (SM/85/96, 4/4/85); "Global Effects of Fund-Supported Adjustment Programs," (SM/85/97, 4/4/85); and "Fund-Supported Programs, Fiscal Policy, and the Distribution of Income," (SM/85/113, 4/25/85).

countries, 1/ is intended to draw lessons from the experience with program design in recent years.

The plan of the paper is as follows: following this introductory section, Section II examines current concerns about adjustment and conditionality. This is followed in Section III by a discussion of specific issues in program design. While specific operational aspects of Fund financial support and monitoring of programs are not the focus of this review, certain issues in those areas that are of particular significance to the problem of delays in adjustment and prolonged use are considered in Section IV. Section V considers the implications of these findings for the role of the Fund and the guidelines for conditionality, and also briefly reviews recent experience with the extended Fund facility. Section VI provides a summary and suggests some topics for discussion by the Executive Board. The paper concludes with a proposed decision for Board consideration.

II. Current Concerns about Adjustment and Conditionality

1. Difficulties in achieving balance of payments viability 2/

Half of the Fund's developing country members have adopted adjustment programs in connection with upper tranche stand-by or extended arrangements since 1980. Overall, the 123 capital-importing developing countries (of which 64 have had Fund-supported programs), have achieved a dramatic reduction in current account deficits since their peak in 1981 and 1982. For 1985 the aggregate deficit is estimated at 8 percent of exports of goods and services, only half the level that had typically prevailed in the 1970s, and sharply down from the 1981-82 levels of over 20 percent. This decline was much more dramatic than had been expected in the early 1980s, when it was thought that the large surpluses of the oil exporting countries would continue for some years and that the industrial countries would return to their customary position as capital exporters. 3/ Nonetheless, attainment of external viability has proved

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1/ The sample consists of members for which upper tranche arrangements were approved in 1982. The choice of 1982 as the sample period permits the review to provide a longer term perspective on developments during and after the program period, an approach that has been requested by Executive Directors. The present paper, however, also takes account in qualitative fashion of the experience of other members that have adopted adjustment programs since 1982.

2/ The discussion here is based on the data reported in the October 1985 World Economic Outlook. The country classifications used are defined in the introduction to that publication's statistical appendix.

3/ The 1981 World Economic Outlook (Occasional Paper No. 4, June 1981, p. 136, "Scenario A") suggested that the non-oil developing countries might have a current account deficit of 19 percent of exports of goods and services in 1985, while the actual figure is currently estimated at 6 percent.

difficult to achieve and many countries that embarked on adjustment have not yet reached a viable position. 1/

The turnaround in current accounts has been heavily concentrated in a few of the largest countries. More than half of the aggregate decline has been accounted for by the seven major market borrowers (of which five have had Fund-supported programs) which reduced their aggregate deficit from a peak of 29 percent of exports of goods and services in 1982 to only 2 percent in 1985. More generally, the 35 market borrowers (17 program countries) reduced their deficit ratio from 21 percent in 1982 to 1 percent in 1985. The official borrowers group of 59 countries (32 program countries), on the other hand, has a ratio of 48 percent currently, virtually unchanged from the peak of 49 percent recorded in 1982. 2/ The median for all developing countries, moreover, after peaking at 36 percent in 1981 and 1982, only declined to 27 percent in 1985.

Balance of payments strains have been reflected in the behavior of imports. Import volumes, which had grown rapidly throughout the 1970s, declined in 1982 and 1983. While they have begun to recover in the last two years, they remain below their 1981 levels. This slowdown has impinged particularly on capital goods, and in many cases has reflected resort to restrictions rather than a movement toward a better degree of macroeconomic balance.

A number of countries that have undertaken adjustment programs in the 1980s have reached a position where their current account deficits can be financed by spontaneous capital inflows, but there remain countries that continue to need exceptional treatment by creditors and

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1/ A viable position "typically means a current account deficit that can be financed, on a sustainable basis, by net capital inflows on terms that are compatible with the development and growth prospects of the country and, therefore, with its debt-carrying capacity," (Manuel Guitián, Fund Conditionality: Evolution of Principles and Practices, IMF Pamphlet Series, No. 38, Washington, 1981). "Viability" is not synonymous with "financeability," and it precludes policies that keep the economy below its optimal growth path, such as exchange and trade restrictions or other policies that seriously distort incentives. From both standpoints, critical factors are the scale and terms of available external resources relative to the productivity of their use. In this regard, viability can be impaired (at least temporarily) by past excessive financing as resources have to be diverted from other uses to service debt.

2/ The other 15 program countries are included in the residual category, which includes countries whose external borrowing in 1978-82 was more or less evenly divided between official and commercial creditors, as well as China and India. The aggregate deficit of this group increased considerably between 1982 and 1985.

donors. Among the countries that experienced large outflows of domestic capital in the early 1980s, moreover, few have yet experienced significant reflows.

As for other adjustment objectives, GDP growth rates have recovered somewhat in the last two years, after sinking to very low levels in 1982 and 1983. For most countries, however, there has been little or no increase in per capita GDP in the 1980s and the improvement in current accounts has thus been associated with declining per capita consumption and investment. By way of comparison, in the 1970s median GDP growth had averaged in excess of 5 percent, twice the rate recorded so far in the 1980s. 1/ Regarding price performance, inflation rates have declined in most countries, but the median rate has remained around 10 percent in the last four years, after peaking at 14 percent in 1980.

Within this overall picture there has been considerable diversity of experience, an observation that applies also to those that have undertaken Fund-supported programs. The background paper provides a detailed review of the adjustment experience of the 22 countries for which stand-by or extended arrangements went into effect in 1982. 2/ For six of these countries, 3/ the amount of adjustment remaining for achievement of balance of payments viability is judged to be relatively small. The other countries have not advanced sufficiently, although several of them gained ground during some Fund-supported programs, only to falter in subsequent programs or in periods when no program was in effect.

While the background paper's review is limited to the countries for which Fund arrangements were approved in 1982, countries entering into arrangements in other recent years have also encountered difficulties. Countries for which arrangements were approved in 1981, for example, were rather more successful in meeting their immediate program objectives, in part because their access to capital markets had not yet declined sharply. By the middle of 1983, however, when a paper

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1/ It is to be noted that the high growth rates of the 1970s to an important extent were associated with unsustainable rates of foreign borrowing in a number of countries, particularly in the Latin American region.

2/ The countries were Barbados, Costa Rica, El Salvador, The Gambia, Guinea, Haiti, Honduras, Hungary, Kenya, Liberia, Madagascar, Malawi, Mali, Morocco, Panama, Peru, Senegal, Somalia, South Africa, Sudan, Thailand, and Uganda. (A detailed listing appears in Appendix B of the background paper. An extended arrangement with Mexico was approved on December 24, 1982, but it went into effect only on January 1, 1983.)

3/ Barbados, Hungary, Kenya, Malawi, South Africa, and Thailand. This judgment is based largely on the situation at the end of 1984. Since then there has been some weakening in a few of these cases.

reviewing their experience was prepared, 1/ it was clear that in most of them the achievement of balance of payments viability would require very strong further adjustment measures. In both 1981 and 1982, there was a rather small representation of market borrowers, several of which came to the Fund for assistance only after the major cutback in lending through the international capital markets that took place around 1982. While the market borrowers have enjoyed a considerable degree of success in reducing their current account deficits since they adopted adjustment programs in 1983, in a number of instances decisive correction of the underlying imbalances in their economies has not yet taken place.

2. The severity of the external environment

A major factor in the difficulties of adjustment programs over the last five years has been the external environment. In the 1970s, rapid growth in the industrial and oil exporting countries, together with the ready availability of external capital, permitted rapid increases in exports and even more rapid increases in imports in most developing countries, despite an unfavorable trend in the terms of trade of those that were not oil exporters. In the 1980s, by contrast, growth in industrial countries has generally been sluggish, partly in the context of their efforts to bring down inflation rates, often in the face of structural rigidities. This has hampered the growth of export volumes and exacerbated the decline in developing country terms of trade, the effects of which have been compounded by mounting protectionism in industrial countries; the latter factor has been devastating in the case of exporters of some key commodities, particularly those with a heavy concentration on one commodity, such as sugar. Ex post real interest rates have been very high throughout the 1980s and interest payments of the capital-importing countries have remained at historically high levels. To some extent, this has reflected the fact that large structural fiscal deficits in some of the industrial countries have prevented the recent deceleration of inflation from being commensurately reflected in nominal interest rates. While the fiscal deficits have also created room for a rapid expansion of exports of some developing countries, a more balanced mix of macroeconomic policies could have permitted the current account improvements of such countries to take place in a more balanced and viable fashion. With such an adverse external environment, current account adjustment has been a particularly difficult process.

While the adverse external environment has made adjustment difficult, many countries have still managed to adjust. Among the 1982 arrangement countries discussed in the background paper, the six countries that made significant progress were seriously affected, like the others in the group, by the external environment. The room for maneuver in the market borrowers that entered into arrangements more

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1/ See the background paper for the 1983 conditionality review (EBS/83/216, 10/4/83).

recently was severely constrained by the high level of real interest rates, but nonetheless these countries achieved marked reductions in current account deficits, though in some cases attainment of external viability calls for further adjustment.

Over the last two years growth has resumed in the industrial countries and, for the future, the October 1985 World Economic Outlook projects further improvements in the external environment in which adjustment will proceed. While this outlook is subject to substantial uncertainties, and is in any case not so marked an improvement as to reduce greatly the need for adjustment for many developing countries, it should ease the difficulty of adjustment.

3. The magnitude of the needed adjustment

A second major aspect of the difficulties encountered in restoring balance of payments viability has been the unprecedented magnitude of the adjustment required. This reflects the fact that the ready availability of external finance permitted the incurrence of very large current account deficits throughout the 1970s. Spurred by negative real interest rates, external borrowing remained high, and the immediate response to new external shocks at the end of the decade (with increases in real interest rates added to a renewed rise in oil prices) was largely to finance rather than adjust the imbalances. For a time current account deficits continued to rise, and in a number of cases they were accompanied by outflows of domestic capital. By the early 1980s, it was clear that external debt had reached unsustainable levels for many countries, particularly in view of the sharp rise in real interest rates.

The large external indebtedness of the capital-importing countries would not have become a critical problem had foreign borrowing been used for productive purposes. With the negative real interest rates that prevailed at the time most of the debt was incurred, however, there was little incentive to see that investment yielded a positive return, and in many cases it did not. Indeed, in a number of countries the capital stock, particularly infrastructure, has decayed, further adding to the difficulties of adjustment.

Reaction to the high levels of debt led to an abrupt reduction in the availability of private capital flows in 1982, and even the remarkable reductions in current account deficits that some market borrowers have achieved have not been sufficient to bring those deficits to levels that are at present financeable by spontaneous capital flows. The cutback in the availability of external resources has been less severe for countries that depend mainly on official creditors, but they have nonetheless been affected by the actions in the industrial and oil exporting countries to limit the growth of foreign aid as part of their effort to contain fiscal expenditures.

The daunting magnitude of the adjustment required has no doubt been a factor in the shortfalls that have occurred in adjustment so far. The experience with the 1982 arrangement countries suggests that, in general, countries that had kept their imbalances from rising to very high levels (even if still large in historical terms) had relatively greater success both in achieving reductions in actual imbalances and in approaching external viability. (There is a certain circularity in this process--large initial deficits tend to arise in countries that have had difficulty implementing adjustment policies.) Many of the market borrowers, moreover, have managed to reduce their very large current account deficits rapidly, although doubts remain about the attainment of viability. This reflects the flexibility with which such relatively large and advanced economies can shift the patterns of production and consumption of tradable goods. For most countries, however, the size of the imbalances has meant that the effort of adjustment has had to be based on measures of a fundamental, structural character and has had to be maintained over a long period. The magnitude and duration of the adjustment effort required in such severe cases has greatly strained the capacity of the policymaking framework.

4. Problems of implementation

Despite the severity of the external environment, the difficult initial conditions and the magnitude of the required adjustment, the experience of the 1982 arrangement countries demonstrates the feasibility of orderly adjustment. As noted above, the six countries that have made progress with adjustment were no less affected than the others by the external environment. An aspect that distinguishes these cases from the others is the record of policy implementation. Although several of the six countries experienced problems in the implementation of policies to some degree, in general they either implemented policies adequately or were able to make subsequent policy adjustments to compensate for slippages. The adjustment efforts of these countries were also characterized by the undertaking of adjustment when the size of the imbalance was relatively small, and by the maintenance of the adjustment effort during periods when Fund programs were not in effect. As a result, although the external current account deficits experienced by these countries in 1984 were still above levels considered sustainable and adjustment efforts would need to be continued, the amount of adjustment remaining to reach viability was relatively small. Four other countries 1/ that achieved reductions in deficits, even though they are still a considerable distance from viability, had a generally positive record of implementation, though with occasional lapses. The remaining 12 countries either had erratic records of implementation, with earlier progress being undone by subsequent difficulties, or had consistently poor records.

1/ Costa Rica, Madagascar, Panama, and Senegal.

More generally, the experience with Fund-supported adjustment programs suggests that a critical factor in the effectiveness of the adjustment effort is the effectiveness of policy implementation. This is not to say that full implementation will always result in achievement of program objectives. Obviously the adjustment that is required is also influenced importantly by exogenous developments or by the magnitudes of important parameters which may prove to be different from program assumptions. With consistent and flexible implementation, however, there is more assurance of achievement of adjustment objectives.

5. The difficulty of structural adjustment 1/

The magnitude of the external imbalances and the change in the external environment have meant that most of the programs undertaken by Fund members in the 1980s have included measures of a structural character, including actions not only to contain domestic absorption but also to enhance competitiveness and to reform institutions. Structural adjustment is not new in Fund arrangements, of course, and it has always been a feature of extended arrangements. In the 1980s, however, structural adjustment has been seen to be essential in most cases. The need for major improvements in competitiveness in many cases required that changes be brought about in real exchange rates beyond those that could feasibly be achieved through action on domestic demand alone, so exchange rate adjustments have featured in most programs. More generally, the urgent need to provide incentives for resources to move to more productive use has required close and continuing attention to the mechanism of adjustment of relative prices. The supporting fiscal adjustments required, moreover, have required detailed attention to the structure and administration of revenues and expenditures as well as to the operations of public sector institutions; in this context, particular emphasis has been given to improving tax systems and fostering domestic savings. The critical shortage of resources available for investment has required close attention to the level and structure of interest rates as well as the quality of investment strategies, particularly in view of the deterioration in infrastructure that in some cases had occurred during the 1970s.

Effective structural adjustment calls for a particularly strong commitment to sustained policy implementation. On the one hand, some types of structural measures are difficult to implement quickly and economic responses to them are often less predictable and have longer lags than the responses elicited by more immediate demand-management policies. The need to coordinate adjustment in a number of different policy areas, moreover, often requires an arduous, iterative approach in the process of policy implementation. On the other hand, structural measures that can be expected to have a rapid effect, such as direct

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1/ The design of adjustment programs and, in particular, their structural aspects are discussed in more detail in Section III below as well as in the background paper.

adjustment of relative prices, tend to be more effective and transparent in their allocative impact than is demand restraint, a feature that can render them politically sensitive. The difficulties perceived with sensitive policy measures, particularly adjustments in the exchange rate and other actions affecting relative prices, often lead to the adoption of policy mixes that favor other measures that may eventually bring about adjustment, but more slowly and less efficiently.

6. The growth issue

The external resource constraints that lead countries to adopt programs of balance of payments adjustment can imply a slowing of economic growth--under certain conditions, temporarily--below the levels attained while the imbalance was developing. Fund-supported programs are aimed at helping the economy adjust to the constraints in an orderly and efficient way, so that growth can be maintained at a higher level over time than would otherwise be the case, and the availability of Fund resources and other financing contingent on Fund arrangements serves to alleviate the resource constraint, thereby also contributing to safeguarding growth. More generally, one of the objectives over the medium term is to create or restore an environment that is conducive to sustained growth. The fact that there is generally a slowing of growth from previous unsustainable rates, associated with an even greater slowing of the growth of domestic absorption as resources are shifted to the external sector, is nonetheless perceived to be one of the most challenging issues in program design. 1/

The broad experience with Fund-supported adjustment programs, such as those discussed in the background paper, suggests that in fact the greatest shortfalls in growth occur in countries that fail to implement their adjustment programs. From the broad perspective of the membership as a whole, this is confirmed by the very favorable results that have generally been achieved by countries which applied Fund-type policies at an early stage, and which thus were in a position to avoid recourse to Fund resources. In the case of many of the market borrowers that undertook Fund-supported programs in 1983 and 1984, the adoption of the program was associated with relatively rapid resumption of growth, following a slowdown that had started before discussions on a program with the Fund had begun, because the adjustment effort had been delayed to the point where the availability of external resources sharply declined. While a strengthening of export markets was a factor in the

1/ Public misperceptions on this issue are reflected in the frequent references in the media to the Fund's "austerity" (as opposed to "adjustment" or "stabilization") programs. For a brief review of the issues, see the Managing Director's leaflet, "Does the Fund Impose Austerity," (June, 1984). The growth issue is reviewed in comprehensive fashion in "The Effects of Fund-Supported Adjustment Programs on Economic Growth: A Survey of the Empirical Literature," (SM/85/96, 4/4/85).

recovery, the early resumption of growth in these cases also reflected the favorable effect on economic activity of relative price adjustments, particularly through exchange rate action. Slow growth often reflects decisions to pursue a strategy that places relatively more weight on demand restraint and less on direct action to adjust relative prices. While in principle such a strategy can achieve the needed external adjustment, it can also have adverse effects on growth that then lead to difficulties in sustaining implementation of the program, thus jeopardizing achievement of the external objectives.

Over the medium term, a critical issue for the attainment of sustained growth is the availability of resources for the maintenance of the capital stock and for new investment, as well as the efficiency with which such resources are used. In fact, gross capital formation in the capital-importing developing countries has declined in recent years, from over 27 percent of GDP in 1980 to 22 percent in 1984, and in the case of the market borrowers, the decline has been even more pronounced. The need to ensure that the impact of adjustment does not fall too heavily on investment is therefore a particularly important question for program design. 1/ Another important issue in this regard is the prompt elimination of inflation, given its distorting effects on decisions on production and investment. In a number of market borrowers the underlying imbalances in their economies have not been sufficiently addressed and as a result, high rates of inflation have continued to prevail.

7. Prolonged use

When it became clear in 1979-80 that the non-oil developing countries were facing an unprecedented need for adjustment, it was recognized that a major increase in the availability of Fund resources would be needed to assist in the process. It was also recognized that, because of the magnitude and structural character of the problems, many countries would need to enter into adjustment programs that would have to be sustained over a number of years. 2/ This would imply that they would make continuous use of Fund resources for longer periods than had been envisaged in the past.

This expectation has materialized, not only through consecutive annual arrangements but also through the fact that many countries have entered into multiyear extended and stand-by arrangements and have made use of borrowed resources, which have repurchase periods longer than the three to five years associated with stand-by arrangements involving use of ordinary resources. What had not been anticipated, however, was that the cutback in the flow of external resources from other sources and the

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1/ Section III below stresses the fact that fiscal restraint often has an adverse impact on public investment.

2/ See "Fund Policies for Adjustment under Current Conditions," (EBS/80/146, 6/30/80) and Chairman's Summing Up (Buff 80/163, 7/22/80).

increase in the cost of debt service would be so severe, and consequently that the magnitude of the required adjustment would be so large. The depth and duration of the decline in terms of trade and the recession in the industrial countries had also been underestimated. Nor had it been expected that so many countries would run into difficulty in implementing adjustment policies.

By 1984 it was clear that progress toward balance of payments viability in many countries was proceeding slowly, and that this implied Fund involvement and use of resources even more prolonged than had been anticipated. This experience led to the need for a review of the issue of prolonged use which was conducted by the Executive Board in June of last year. 1/

a. Dimensions of prolonged use

While in a statistical sense, defined in terms of normal maximum access, 2/ prolonged use has not yet reached the scale observed in the late 1960s and early 1970s, by the end of next year it will have done so (Table 2). By then eleven members are expected to have had continuously outstanding credit tranche positions in excess of 25 percent of normal maximum access for six years or more. All of the eleven countries have had at least five annual programs supported by Fund arrangements since 1976, and some as many as eight (Table 3). Many of the other countries that appear in Table 3 will show lengthening periods of continuous use in future years, particularly if they qualify for new arrangements.

While the countries that appear in the lower right hand part of Table 3 are sometimes referred to as "prolonged users," many of them need not give rise to questions about the Fund's policies on use of its resources. A number of the countries that have had annual programs covering at least five of the last ten years, and that have current positions in excess of 100 percent of quota (which will be equivalent to 25 percent of maximum normal access under the access policy for 1986), no longer have a need for Fund arrangements; as repurchases proceed, their position in the credit tranches will decline. Of those with arrangements currently in place, some, such as Korea, have made progress in adjustment through their series of programs. Their current accounts are approaching viability, and, in the absence of new external difficulties, declining use of Fund credit can be expected. For some other countries, such as Kenya and Yugoslavia, adjustment has been lengthier than foreseen in earlier programs, but they appear to be making progress with their current programs and in some cases net repurchases are

1/ "Prolonged Use of Fund Resources," (SM/84/91, 4/27/84) and "Supplementary Material for Prolonged Use of Fund Resources," (EBS/84/104, 5/4/84), discussed by the Executive Board at EBM/84/94 (6/15/84). See Chairman's Summing Up (Buff 84/98, 6/28/84).

2/ Under current access policy, the lower cumulative limit. These are 408 and 400 percent, respectively, in 1985 and 1986.

Table 2. Length of Continuous Period of Outstanding Liabilities in the Credit Tranches Exceeding 25 Percent of Normal Maximum Access 1/

(Number of Members)

Year	Continuous Period of: 1 year	2 years	3-5 years	6-8 years	9 or more years	Total
1955	2	—	—	—	—	2
1956	5	2	—	—	—	7
1957	4	4	2	—	—	10
1958	4	3	4	—	—	11
1959	2	1	4	—	—	7
1960	6	1	1	—	—	8
1961	10	6	1	—	—	17
1962	2	7	4	—	—	13
1963	5	1	8	—	—	14
1964	5	5	6	1	—	17
1965	5	4	7	3	—	19
1966	4	5	8	5	—	22
1967	4	4	12	4	—	24
1968	6	2	10	5	1	24
1969	4	6	8	3	3	24
1970	1	2	6	5	1	15
1971	2	—	4	1	1	8
1972	5	2	3	1	—	11
1973	—	2	1	1	—	4
1974	1	—	2	—	—	3
1975	2	1	2	—	—	5
1976	3	2	2	—	—	7
1977	6	3	2	—	—	11
1978	4	4	2	—	—	10
1979	—	2	3	—	—	5
1980	1	—	—	—	—	1
1981	11	1	—	—	—	12
1982	9	11	1	—	—	21
1983	14	9	12	—	—	35
1984 2/	8	13	21	—	—	42
1985 2/ 3/	2	6	32	1	—	41
1986 2/ 3/	—	1	28	10	1	40

Source: Fund documents.

1/ Based on positions at end of calendar years. The amount of normal maximum access has tended to increase over time because of general quota increases, the inception of the extended Fund facility, temporary enlargement of the credit tranches, the supplementary financing facility, and enlarged access.
2/ Relative to lower cumulative access limit.
3/ Based on arrangements in effect at end-October 1985, with all purchases and repurchases assumed to be made on schedule.

Table 3. Number of Programs Under Upper Credit Tranche Arrangements with Purchases, 1976 - October 1985 1/

(Countries with credit tranche liabilities in excess of 25 percent of quota as of September 30, 1985)

Credit Tranche Liabilities in Percent of Quota	Number of Programs 2/							
	1	2	3	4	5	6	7	8
25-50	Belize El Salvador	Grenada Solomon Islands						
50-100	Ethiopia Guatemala Niger	Portugal Zimbabwe	Argentina Bangladesh Sierra Leone Mauritania	Barbados C.A.R.				
100-150		Ecuador Gambia Honduras Mali Uruguay	Chile Dominican Republic Guyana Thailand	Romania Western Samoa	Sri Lanka Zaire	Peru Togo		Philippines
150-200		Hungary	Ghana India	Costa Rica Pakistan	Madagascar	Haiti Zambia		
200-250		Brazil		Panama	Dominica Kenya Korea Liberia Mexico Senegal Somalia	Mauritius	Malawi Morocco	
250-300			Uganda					
300-350					Ivory Coast Sudan	Turkey Yugoslavia		
350-400								Jamaica

Source: Fund documents.

1/ Underlining indicates countries that at the end of 1986 are expected to have had credit tranche positions in excess of 25 percent of maximum normal access continuously for six years or more.
2/ Multiyear arrangements will generally comprise two or three annual programs.

already taking place. Some other countries with current programs, such as Mexico, have run into difficulties that may slow the adjustment process, but there is a reasonable expectation that these problems can be overcome.

There are two other types of situation, however, that present a major issue for Fund policy. For some countries, the fragility of the policymaking apparatus places a serious limit on the ability of the authorities to carry out a meaningful adjustment program--and some of these countries are so deeply indebted that achievement of a viable position in the foreseeable future is likely to require major concessions from creditors and donors. Other cases are not so intractable, but repeated failures to implement adjustment measures cast doubts on the likelihood that adjustment can take place. These situations, including those where use of Fund resources is currently being unduly lengthened because of the incurrence of arrears on scheduled obligations, are the cases that pose critical questions concerning the appropriateness of use of Fund resources.

b. Past experience with prolonged use

In considering prolonged use, it is instructive to recall the experience of the late 1960s. In 1969 there were six countries for which outstanding use of Fund credit had exceeded 25 percent of normal maximum access (which at that time was equal to 100 percent of quota) for six years or more, and in fact for three of them the period was over eight years. These countries had had from three to nine programs over the previous ten years. Given that the external environment had been, for most of them, considerably more favorable than that encountered by most countries entering into Fund arrangements in the 1980s, those cases might be considered to be particularly clear examples of prolonged use. They represented, however, only 5 percent of Fund membership and one quarter of members with upper credit tranche positions, smaller proportions than are likely to develop in the latter years of this decade. They had not, moreover, incurred arrears to the Fund, as several of the current prolonged users have.

Over the following three years, all six fell back below 25 percent of maximum access. In part this reflected the culmination of a long process of current account adjustment, which was assisted by an exceptionally favorable external environment characterized by rapid growth in world trade and improving terms of trade. There was also a major shift in the availability of external resources in the 1970s. Concessional assistance from multilateral and bilateral donors rose sharply, and banks and other private creditors dramatically increased their international lending. With such ready availability of other sources of international finance, there was little recourse to the Fund's conditional resources. The Fund itself provided some financing through its allocations of SDRs. The Fund also carried out "recycling" through the oil facilities and subsequently made further resources available through the Trust Fund. Not until the late 1970s did a

substantial number of Fund members again feel a need to enter into Fund arrangements.

c. Prospects

The external environment in which prolonged users will be continuing their adjustment efforts is not as propitious as was that faced by prolonged users 15 years ago. Recent initiatives in the area of external debt, along the lines of the Baker proposal, aim at alleviating the external resource constraint, albeit in an environment where the availability of external resources will very likely remain well below that which characterized the early 1980s; at current debt levels and prevailing interest rates most prolonged users cannot in any case prudently take on substantial amounts of additional external debt. In the past, increases in quotas or, more recently, supplementary financing and enlarged access meant that, from time to time, further amounts of Fund resources became potentially available to members that had built up large credit tranche liabilities but still had need for further adjustment and financing. Recently, however, maximum access limits have declined, and no early increase in the amount of Fund resources available to such countries on a net basis can be expected; most have, moreover, already made extensive use of the Fund's special facilities.

There is thus a clear need for strong adjustment measures that will generate domestic savings and improve the efficiency of production. Past adjustment efforts of many prolonged users have met with, at best, only limited success, and a major issue is how to improve the prospects for adjustment in such cases. As noted above, after discounting the impact of exogenous factors, difficulties in adjustment generally reflect difficulties in policy implementation, and ways in which program design could be improved to promote speedier and more sustained implementation need to be explored. It is to be noted, however, that such improvements cannot be expected to overcome all problems of implementation, because at bottom their resolution depends on the determination of the country authorities. A second important issue, then, is how better to link the disbursement of Fund resources to effective adjustment so as to preserve the Fund's capacity to be of assistance to members even after they have encountered problems in implementation, and to preserve the revolving character of the Fund's resources.

III. Improving Program Design

The design of a Fund-supported adjustment program has as its starting point the existence of an external resource constraint, expressed in terms of the cost or availability of external finance. The basic principles of program design involve moving domestic resources into more productive use, particularly in the external sector (either by shifting them from less productive uses, or by expanding the resource base);

where the current account deficit needs to be reduced, the growth of domestic absorption will need to be held below the growth of production. They also involve relaxing the external resource constraint (either temporarily, as through use of Fund resources, or on a longer term basis, as through making effective use of direct investment and development finance).

The aim of adjustment programs is not only to achieve the external objectives, but to do so as efficiently as possible. This is not only because of the inherent desirability of maintaining economic growth at a high level with price stability both throughout the adjustment period and beyond, but also because adjustment conducted on an inefficient basis will undermine the ability of country authorities to maintain their commitment to implementation, thereby jeopardizing the achievement of even the external objectives. This section addresses a variety of issues that arise from the varying implications that alternative approaches to adjustment have for the speed of adjustment, economic growth, sectoral impacts, and the nature of socioeconomic systems, which in turn influence the likelihood of sustained implementation of adjustment programs. The emphasis is on <u>program</u> design--in particular, the nature and timing of policy adjustments. These general issues also inevitably arise in the context of the design of Fund <u>arrangements</u>--that is, the conditions under which the Fund's resources are made available--some aspects of which are discussed later in the paper.

1. The time frame for adjustment

The selection of the time frame for adjustment has two main interrelated aspects: the speed with which policies are to be implemented, and the speed with which target variables can be expected to respond. The pace at which adjustment needs to proceed, and thus at which policies have to be implemented, reflects the expected path of the external resource constraint.

The objective is to achieve balance of payments viability over the medium term. The concept of the medium term is not a rigid one. Traditionally in the Fund it has been identified with the ability to provide for repurchase within the period of 3-5 years that applies to ordinary resources under stand-by arrangements. Where structural adjustment is involved, however, longer periods for adjustment have been envisaged, as typified by the repurchase period of 4-10 years specified for extended arrangements. Repurchase periods have also been extended through the adoption of the 3½-7 year repurchase period for supplementary financing and enlarged access resources.

The expectation in the early 1980s that adjustment would take place over a number of years was formed in the context of access by most developing countries to large amounts of external resources from private creditors, official donors, and the Fund. The margin for gradual adjustment that was made possible by the availability and resort to those resources does not appear to remain substantial, given present economic and financial conditions, and a number of countries have yet to achieve balance of payments viability, consistent with the restoration of a lasting, noninflationary real growth rate. There is thus a need for acceleration of the adjustment effort, which generally implies early implementation of policy measures, rather than gradual implementation in the course of the program period. There is also a need to stress policy strategies that have relatively rapid effects--direct action to influence relative prices, such as through exchange rate adjustment, in addition to corrective demand-management policies. The background paper notes that there has been some shift in these directions in recent years, but there is clearly room for further improvement.

With the benefit of hindsight, the amount of adjustment targeted for the program period in the early 1980s appears in some cases to have been rather small, given the sharp decline in most countries' access to external resources that occurred thereafter. More generally, an important question is the amount of adjustment that should be targeted in the short run. Programs since 1982 have generally targeted a very substantial degree of adjustment in the immediate program period, but for many countries this still left much of the adjustment to be accomplished in the post-program period. While in some cases this is simply a matter of the normal lags between implementation of policies and achievement of objectives, in others it assumes that further policy measures would be required. This implies a need for sustained commitment to continuing implementation that on occasion may be unrealistic to expect.

2. Medium-term scenarios

With the general use of medium-term scenarios, 1/ adjustment programs now are more explicit regarding the time frame for adjustment. Experience is still being gained with the use of such scenarios, and their usefulness as a tool of analysis can be expected to increase further over time. Among the issues that need to be borne in mind is the need for explicitness in setting out assumptions, which can help to ensure that a proper balance is struck between what is desirable and what is feasible. The greater use of sensitivity analyses and alternative scenarios, as called for by Executive Directors in last year's review of conditionality, has been an important innovation in this respect.

Medium-term scenarios also facilitate a more explicit evaluation of the question of medium-term viability. Scenarios generally have a time horizon of 5 years, by the end of which the targeted current account

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1/ Such scenarios are now generally developed through use of microcomputers. The availability of such computers on Fund missions has greatly facilitated technical work in connection with the design of adjustment programs and permits more comprehensive exploration of the implications of alternative policy strategies.

deficit is in most cases at a level that is considered consistent with viability. Often, however, the notion of viability needs to be qualified to some degree, either in terms of uncertainties about the adjustment path or in terms of other dimensions of the external accounts at the end of the scenario period.

With respect to the uncertainties that always surround the adjustment path, the issue of the possible need for further adjustment measures in the post-program period has already been mentioned. There is also the question of unfinanced gaps during the adjustment period, about which medium-term scenarios have become more explicit. This is an important innovation that serves to indicate the presence of uncertainties about whether or not the gaps can be filled.

One qualification to external viability at the end of the scenario period that needs to be made explicit is the projected level of foreign exchange reserves, which in some cases is less than the level considered to be desirable. In some cases, moreover, unfinanced gaps persist at the end of the scenario period. Where debt reschedulings have been assumed during the scenario period, moreover, there may be a major increase in debt service requirements in the post-scenario period that would require further rescheduling or further reductions in current account deficits.

These qualifications do not necessarily mean that viability is not expected to be achieved in the medium term. It may well be the case that further improvement in the balance of payments is expected in the immediate post-scenario period. There are other cases where the lack of viability of the target level is explicitly taken into account--this applies to some countries with exceptionally severe debt service problems and limited capacity to undertake adjustment, where the Fund plays a catalytic role and where further commitment of Fund resources is small. In such cases there seems to be little alternative but to persist in efforts toward adjustment with the expectation that they will provide a basis for the exceptional financing that will be needed for the foreseeable future. In these situations medium-term scenarios can play a useful role in showing to creditors and donors the consequences of levels of debt relief or external assistance that could severely constrain countries' prospects.

In other cases where scenarios suggest that balance of payments viability is not expected in the foreseeable future, the question for Fund policy is whether stronger adjustment measures should be envisaged. The answer to this question will be influenced by the assumptions made about the state of the world economy five years ahead. Improvement in terms of trade, stronger growth of export markets or marked declines in real interest rates would improve the balance of payments prospects, in which case stronger measures at this time would be unnecessary. On the other hand, stronger adjustment now would provide a safety margin that would in any case leave countries better placed to take advantage of any improvement in the global situation.

This discussion has focused on the financeability of the current account deficit, but the concept of viability goes beyond that notion to include the issue of whether a proper foundation has also been laid for sustained growth. This question is technically difficult to deal with, particularly in medium-term scenarios, focusing as they do on the external dimensions of adjustment. 1/ One aspect of this question that does need to be addressed explicitly in scenarios, however, is the question of whether or not elimination of most restrictions on external transactions is envisaged, since this is a key element in overall viability, which includes the promotion of growth.

3. Choice of adjustment strategy--enhancing competitiveness

Last year's conditionality review paper 2/ identified some key considerations for the choice of adjustment strategies in program design, such as the need to direct policies toward elimination of the ultimate source of the economic imbalance, rather than solely toward correction of its immediate short-term manifestation, and the need to take a comprehensive approach aimed at resolving simultaneously the important problems in the various major policy areas. As noted in Section II, the magnitude of the balance of payments adjustment that most developing countries have had to face in the 1980s has required a particularly comprehensive "structural" approach. In addition to management of demand to fit absorption within the availability of resources, this approach has called for measures designed to improve economic incentives, particularly through changes in the structure of relative prices or relaxation of quantitative restrictions. It has also called for measures of an institutional character, such as changes in investment strategy, improvement in tax collection and expenditure control mechanisms, and reform of public enterprises and other institutions.

Given the size of the imbalances faced by program countries, almost all have had to take steps to enhance their competitiveness. A major issue for program design is the extent to which direct action to affect relative prices (particularly through exchange rate adjustment, but also through changes in subsidies, wage and price policies, and so forth) should be undertaken in addition to demand management. This issue has often been considered in Fund policy papers. 3/ Where a surge of demand has led to a balance of payments problem but has not yet had major

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1/ Medium-term scenarios increasingly incorporate key domestic variables; fiscal scenarios have been developed for a number of countries. It is difficult, however, to quantify the effects of, say, structural reforms on such variables as economic growth.

2/ "Review of Upper Credit Tranche Arrangements and of Some Conditionality Issues," (EBS/84/227, 11/7/84).

3/ For a comprehensive review, see "Formulation of Exchange Rate Policies in Adjustment Programs," (Occasional Paper No. 36, August 1985).

effects on relative prices, the adjustment strategy can primarily rely on demand restraint. However, where the excess demand problem has become embedded and has distorted the relative price structure, as is often the case in economies that use restrictions to prevent excess demand from being fully reflected in the external accounts, relying solely on demand management to correct relative prices is likely to be a slow and costly process, particularly where substantial downward flexibility of wages and prices is absent. In the current world environment, the low rate of global price increase means that even if a country achieves a zero rate of inflation it will only very slowly improve the competitiveness of the external sector. When costs and prices have become distorted through controls, taxes and subsidies, moreover, direct action to adjust relative prices is virtually indispensable.

Thus a large majority of programs in recent years have called for direct action on relative prices. Only 7 of the 22 countries whose experience is reviewed in the background paper, for example, did not take exchange rate action, and most of these did take some direct action on producer prices or other allocative mechanisms in the last five years. While most of the other cases involved direct action on both the exchange rate and domestic relative prices, it is clear, in retrospect, that more emphasis on such adjustments at an earlier stage would have been preferable. This would generally have produced more soundly based balance of payments adjustment and better success in achieving other objectives, particularly economic growth, and in doing so might have helped to forestall difficulties in sustaining policy implementation.

For these reasons, when a major enhancement of competitiveness is needed, the Fund consistently favors early action on exchange rates and other prices to correct the structure of relative prices combined with relaxation of restrictive allocative mechanisms. While resistance to such a strategy sometimes reflects disagreement on the need to enhance competitiveness, more often the issue is the perception that direct action on costs and prices is more likely to encounter adverse political response, partly because of its perceived consequences for demand and incomes. Where that is the case, country authorities need to work toward obtaining public acceptance of such a strategy through emphasizing not only the desirable effects it has on production over the medium term but also the beneficial effects it can have even in the short run. One should emphasize in this respect that price controls are often associated with scarcity in official markets and the presence of high prices in black markets. A relaxation of restrictive mechanisms can mean reductions in black market prices and better assurance of availability of commodities.

The emphasis here on adjustment of relative prices does not mean that programs need be less concerned with demand management, which remains a critical element in all programs. Programs that run into difficulties generally do so because problems have been allowed to arise in both areas. There are also cases where the adjustment of relative prices takes place as envisaged, but without adequate support from demand-management policies. This has occurred in some high inflation countries that have adhered to targets for the real exchange rate but have not been able to fully implement demand-management policies. 1/ (Indexation, of course, causes particular rigidities in relative prices that can impede the desired adjustment.)

4. Exchange rates and other relative prices--techniques of adjustment

Even where the design of a program incorporates direct action to bring about appropriate adjustments in relative prices, the relative price structure that actually obtains may not match the intentions. This may result from problems of implementation, where intentions of gradual adjustment during the program period are not fulfilled or where there are unexpected developments in costs or prices other than those targeted for adjustment. Some techniques of adjustment are better than others for avoiding such problems.

Techniques of price adjustment can take the form of (1) ad hoc adjustment, (2) rules for adjustment, or (3) adjustment through market forces, with or without some degree of official intervention. While the ad hoc approach permits each adjustment to be based on an assessment of the current situation, the result is likely to be delayed and inadequate adjustment. 2/ Action on an ad hoc basis can also lead to a tendency to regard an adjustment as a once-for-all measure, after which the situation is allowed to drift.

Mechanisms that provide continuous flexibility are preferable. A rule for adjustment, such as maintenance of an exchange rate in real effective terms, or fixing the rate of subsidy for a commodity, can provide a more efficient price determination mechanism and may help to ensure consistency with other aspects of policy, such as control over government expenditures. To the extent that the authorities are seen to be responsible for the price changes, however, the issue remains sensitive. From that point of view, a market-oriented process of price determination, such as floating the currency, would be preferable and would go further in promoting consistency with other objectives. Market-oriented strategies are particularly helpful in countries where

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1/ In the current case of Brazil, for example, failure to resolve the financial imbalances in the economy has meant that a basis for sustained recovery has been missing, despite the short-run correction of the current account imbalance; inflation remains high, and domestic savings are too low to finance an adequate level of productive investment. The heavy debt service burden has, of course, been a major factor in the constraint on the resources available, inter alia, for investment.

2/ Sudan provides repeated illustrations of this problem, where the time-consuming process of working out each exchange rate adjustment have involved delays in program implementation that meant the adjustments have tended to be too little and too late.

severe data problems or scarcity of administrative resources make difficult the process of analyzing the need for changes and implementing the required adjustments.

While total reliance on market mechanisms may be opposed on ideological grounds or out of concern for the effects of market imperfections, intermediate techniques can be developed. Examples of intermediate strategies are quantified limits on exchange market intervention, or limitations on the total amount of subsidy on a commodity.

All this is not to say that exchange rate stability is not an important objective, and where a country prefers to establish a fixed exchange rate at a realistic level that preference should be respected. This assumes, however, that supportive demand-management policies are pursued vigorously and that there are no adverse developments in the external environment. Where those assumptions are not fulfilled, the sedulous pursuit of stability of the exchange rate or other prices may not be a viable option.

A related consideration is the need for a comprehensive approach to price adjustment. Greater reliance on market forces can facilitate consistency in price adjustments. Where administered prices prevail, each price must be reconsidered in the light of other adjustments. This is not just a matter of ensuring correct relativities. A broad package that combines increases in wages and prices to achieve the desired relative price structure may be more conducive to general acceptability than a strategy that focuses only on sensitive key price increases. Setting out options in these areas and exploring their consequences with country authorities is an important part of the work of the Fund.

5. Institutional reform

While the Fund has long experience with the development of policies needed to enhance competitiveness, other areas of structural adjustment present continuing challenges. Institutional reform is an essential element in structural strategies. Adjustment programs supported by the Fund have typically addressed institutional questions, but have tended to focus on, for example, the financial viability of public enterprises, or the consistency of the level of public sector investment with the overall macroeconomic constraint of the financial program. Structural strategies, however, require that detailed attention be paid to the efficiency of public enterprises and to the appropriateness of investment strategies and priorities. Close coordination with the World Bank has been and continues to be particularly important in such areas. Indeed in the foreseeable circumstances, this coordination, when appropriate, may call for understandings on policy actions recommended by the World Bank in its areas of competence as important factors in the formulation of adjustment programs.

A key issue is assessment of how far the institutional reform should be taken. This applies particularly to public enterprises. At a minimum, programs need to envisage restoration of financial viability to such enterprises. This needs to go beyond focusing on the immediate cash flow to address fundamental issues of efficiency. Attention needs to be given to such areas as wage and employment policies, investment planning, accounting techniques, and, most importantly, accountability to the budget, all of which are areas where the World Bank can play a complementary role. Going further, there is an increasing recognition in many developing countries that public ownership often entails not only problems of efficiency but also contributes to politicization of economic policy decisions. Where the authorities express an interest in limiting public sector involvement in some economic areas, by means that include privatization of activities, the adjustment program needs to be designed to support such intentions. (In fact a number of Fund-supported programs, for example in Mali and Togo, have included references to closing of public enterprises consistent with World Bank recommendations.) It is to be noted that privatization is often not easy to achieve, particularly where enterprises are in serious financial difficulties, and requires all the more attention to restoration of efficiency.

A second issue is that institutional reform is often hard to define in specific terms. Programs often incorporate provisions that are limited to study of an issue. Even where action is envisaged during the program period, it may be difficult to monitor implementation. Establishing a unit to control fiscal expenditure, for example, does not necessarily mean that the unit will be effective. In such cases, if the reform is considered essential to the success of the program, there may be a need to specify effective operation as a precondition before the Fund arrangement goes into effect. Institutional reform often takes time, of course, and it may be necessary to adopt interim measures while the needed time passes. When reform of public enterprises through, for example, a difficult process of reduction in the labor force is considered to be essential to improvement of the fiscal situation, immediate, possibly temporary, price increases may be needed to ease the fiscal drain while reform proceeds.

A third issue is the nature of the Fund's collaboration with other international organizations, particularly the World Bank. As noted above, structural adjustment requires detailed attention to the recommendations of the World Bank. This is not a question of cross-conditionality, but one of seeing that the program supported by the Fund adequately addresses the key issues. Thus, where the World Bank has made recommendations on the country's investment strategy, such recommendations need to be supported in the design of a Fund-supported program. Such appraisals are not always available when Fund programs are under discussion, however; in such cases the Fund staff itself may need to play an active role in advising on investment strategy, and to this end, coordination with the World Bank is essential. The same considerations apply to other aspects of structural adjustment.

A fourth issue is the need for development of statistical and managerial techniques, a key element in which is effective use of the technical assistance available from the Fund and other agencies. In some countries the statistical base is so weak that it seriously impedes the process of designing and implementing of adjustment policies, not to mention the monitoring of developments under the program. In such cases there may be little alternative to reliance on market mechanisms for policy implementation. If the data are too weak to provide a reliable basis for administrative determination of the appropriate level of the exchange rate, for example, floating the currency may be the only viable option.

6. The timing of policy adjustments

Some policy adjustments in Fund programs take place automatically, as through some of the techniques for price adjustments discussed above. Others, such as credit restraint, are inherently continuous in their operation, though understandings need to be reached with authorities on the precise time path to be followed. Most programs, however, particularly those that are more structural in orientation, involve specific measures that are to be taken at particular points in time. A major issue in program design is the timing of such measures.

Ideally, important measures should be taken at the outset of the program. Aside from the general desirability of early implementation, such an approach would avoid the danger that implementation does not take place at all, or is unduly delayed. While the availability of financing may permit a delay in action, there is generally no economic rationale for delay, and the result of delay is a weaker program. In the particular case of countries with severe data problems, moreover, monitoring policy action is difficult, and there is often little choice but to have the measures in place when the program is approved.

More generally, the policy measures to be implemented in the course of the program need to be specified as clearly as possible. While program monitoring identifies problem areas as they develop and helps to safeguard the Fund's resources when measures are not taken, it is the adoption of measures that are crucial to successful adjustment. It is important of course to ensure that the measures are substantive and that the follow-up required to make the measures effective is monitored.

As noted above, adjustment programs often contain commitments to study an issue, such as the appropriateness of the exchange rate or the dimensions of subsidy reform. It is obviously important that major shifts in policy be well thought out, but where some immediate action is clearly indicated, its postponement until studies are completed can often mean that an already serious distortion becomes even more severe. In such cases it is preferable to agree on and implement at least the lower limit of the measures to be taken. Refinement of the initial measure can then be left to subsequent study and implementation, provided there is a clear timetable for doing so.

7. Issues in fiscal policy

While exchange rate and pricing policies and institutional reform are essential to the expansion of the resource base of the economy that in most cases is needed to achieve balance of payments viability, in virtually all programs there has also been a need for fiscal retrenchment to at least temporarily reduce domestic absorption. Often, moreover, much of the need for balance of payments adjustment has reflected past problems in keeping fiscal deficits under control. Where this has also led to compression of the availability of credit to the private sector, there is a need to alleviate this compression.

As in other policy areas, failure to put the needed measures in place at the outset of the program has often led to shortfalls in program implementation. Problems have also arisen when programs specified ceilings on credit to government or the public sector, but did not specify clearly the measures that needed to be taken for those ceilings to be observed. In fact, the measures involved in correcting the structure of relative prices often have a major impact on the fiscal situation, as the direct costs of unrealistic exchange rate and pricing policies are often borne by the government.

While reliable data and accurate forecasts are important in all aspects of the design of adjustment programs, one finding from the experience described in the background paper has particularly strong implications for the design of fiscal policies. This relates to the projections of economic growth in the program period. In a majority of the programs reviewed there were shortfalls in the growth of nominal GDP over the program period relative to program targets. These often reflected a deterioration in external conditions from what had been expected when the program was initiated, but they also resulted from problems in implementing some of the structural policies in the program; in other cases, they reflected overly ambitious estimates of the real growth that could be expected from the strategy pursued; in a few cases they reflected a better than expected performance on inflation. Whatever their origin, such shortfalls generally resulted in shortfalls in the improvement in the fiscal position. 1/ In the absence of reassessment of fiscal policies as growth turned out to be lower than expected, domestic absorption and the current account deficit remained higher than projected. The underlying assumptions are particularly important in this area; in general, it would be best to be cautious in projecting growth variables, and to update forecasts and policies as new evidence is received. This is a complex issue because growth is a particularly difficult variable to program or even to forecast; close attention needs to be paid to the continuing adequacy of policies to achieve the targets, particularly where shortfalls in real growth occur, so that policy adjustments are, if required, made promptly.

1/ Shortfalls in other variables, such as exports or consumption, also affect fiscal outcomes.

Another conclusion from the experience described in the background paper is that, whether or not program countries achieve marked success in meeting program objectives, they do generally make considerable progress in the area of fiscal retrenchment. This means that for some countries that are still involved in adjustment, there appears to be little scope for further cutbacks in expenditure, at least not in areas where that can be accomplished quickly. At the same time, the tax base may be so narrow that tax increases would have serious effects on incentives and might be largely offset by declines in private savings. Often increases in concessional external assistance are essential to filling the gap, and in such cases the Fund needs to explain to donors or creditors the constraints and policy options confronting countries undertaking adjustment. In such cases, there is a need to address such difficult issues as extrabudgetary expenditures and structural reform of government revenue, yet data are often inadequate to the task of analyzing areas for improvement and the administrative capacity needed for reforms is missing. Unless such questions are seriously addressed, the prospects for successful adjustment are poor.

While in general Fund programs focus on the macroeconomic aspects of fiscal policy, there is always consultation with the authorities on the various options available with respect to the components of revenue and expenditure. Close attention to such issues is inescapable in structural adjustment. In fact the design of most programs emphasizes reduction in current expenditures, though in general successful fiscal adjustment involves a wide range of measures on the side of both revenues and expenditures. There is also close attention to the question of incentives, and a number of programs have included cuts in income or export taxes.

One troublesome issue is that, in its implementation, fiscal adjustment often shows up disproportionately in investment expenditures, in some cases because of shortfalls in the availability of external resources for investment projects, in others because of administrative problems in the country itself. An additional factor is that the perceived cost of delaying an investment project is often smaller than that associated with more sensitive items of expenditures. There is often considerable room to rationalize investment strategy in consultation with the World Bank, and to eliminate unproductive investment projects. Attention nonetheless needs to be given to sustaining the investment effort if the balance of payments adjustment that is aimed at is to be associated with a reasonable rate of economic growth.

8. The problem of capital flight

While cutbacks in the availability of external resources to developing countries have been a major factor behind the severe need for adjustment in the 1980s, the flight of domestic capital has also been a large contributor, particularly in the more advanced developing countries. Countries undertaking Fund-supported programs have had, in general, only limited success in addressing this issue. According to the October 1985 World Economic Outlook, for example, recorded errors and omissions, which are presumed to reflect primarily unrecorded capital outflows, exceeded $20 billion in 1983 and 1984 for the market borrowers, almost double the net use of Fund credit by such countries. 1/

Capital flight largely reflects problems of confidence, which are strongly influenced by sociopolitical factors; but it is important in these circumstances to ensure that economic policies do not add to the problem. Aside from the general need for structural adjustment to create an environment conducive to productive use of savings, the critical elements of Fund-supported programs in this regard are exchange rate and interest rate policies. Where flows of domestic private capital are important, there is no latitude for delay in moving the exchange rate to the viable level and establishing positive real interest rates to encourage the retention of domestic savings and the repatriation of capital, thereby avoiding crowding out domestic investment. In such cases the argument for prompt policy action to bring back these resources is very strong, and such action must be sufficiently decisive for confidence to be restored on a sustained basis.

9. Policy on international reserves

The background paper contains a detailed discussion of the experience in the 1982 arrangement countries with respect to reserve accumulation. Programmed changes in net reserves are a direct reflection of the overall balance of payments, and in that sense are inseparable from the question of the degree of balance of payments adjustment envisaged; net reserves can, of course, play a direct role in program monitoring through the use of balance of payments tests.

A particular aspect of balance of payments and international reserve management relates to developments in gross reserves. From a medium-term perspective, programs need to take account of the level of gross reserves that is considered compatible with balance of payments viability (including the needed allowance for prospective repurchases of drawings from the Fund), and medium-term scenarios need to incorporate a buildup to that level. There are many complex issues involved in assessing the adequacy of reserves, and attention needs also to be given to such questions as the reliance on external bank credit lines as a complement to reserve holdings.

1/ Recorded errors and omissions for such countries increased very sharply in 1980, and from 1980 to 1982 they amounted to over $60 billion. Inception of arrangements with the Fund was, in general, associated with a slowing, but not necessarily a reversal, of such outflows.

From a short-term perspective, targeting of gross reserves over the immediate program period has generally received only indirect attention in adjustment programs. The recent experience with some countries having difficulties meeting their financial obligations to the Fund, however, suggests that the issue needs more careful attention. One approach would be to take account of obligations to the Fund falling due in the post-program period and to aim for a level of gross reserves at the end of the program period which, together with the expected accumulation of reserves in later years, would provide some assurance that the resources will in fact be available to meet the obligations. Such a general policy would need to be tailored carefully to the circumstances of individual countries, but where reserves are at a low level, where repurchase obligations are large, and where the the Fund's role is largely catalytic in character, more specific attention to the issue is needed.

IV. Techniques for Addressing Prolonged Use

The key to dealing with prolonged use is to ensure that countries carry out their adjustment efficiently, and improvements of program design such as those discussed in Section III can make an important contribution in that regard. But improvements in program design cannot guarantee implementation of programs, nor can they provide assurance of continuing policy implementation and progress when programs are not in effect--that is, they cannot ensure that purchases from the Fund will be associated with sustained adjustment, nor that adjustment will be completed in time to permit repurchases to be made without renewed access to Fund resources. This section follows up last year's reviews of prolonged use and of conditionality in considering the techniques that are available to the Fund to promote more assured and sustained adjustment.

In the discussion that follows, there is no suggestion of establishing general procedures for dealing with problem cases of prolonged use. Rather, the possibility of a more nuanced approach is explored on the basis of existing practices. There may be some situations where the prospects for program implementation are so limited that the Fund concludes that direct financial involvement in the member's adjustment process is not warranted. In almost all cases, however, some progress can be achieved if the Fund assists the member in designing and implementing its program, and the challenge for the Fund is to see how to fill that role without jeopardizing the revolving character of its resources. It will thus be necessary to see what adaptations may be necessary on a case-by-case basis. The purpose of this section is to indicate the range of options available to the Fund.

1. Prolonged use and issues of program design

While any improvements in program design that result in more rapid and sustained adjustment will contribute to the solution of problems of protracted imbalances, there are some aspects that have particular significance in the context of prolonged use.

One issue is the intrinsic difficulty of structural adjustment, particularly where there needs to be major development or reform of institutions. If the process goes well, structural adjustment can be fitted into the normal time frame for use of Fund resources, but often the process proves to be longer and more arduous than expected and the possibility of slippages in implementation along the way is large. In this sense it is understandable that a number of countries have become prolonged users, and that instances of prolonged use may continue to arise from time to time in the future. One implication that can be drawn from the experience gained so far is that members' efforts need to be supported much more strongly, both financially and managerially, by other institutions and donors. It could indeed be argued that the involvement by the Fund in many such cases should be mainly of a catalytic nature.

Since problem cases of prolonged use generally are those where there have been difficulties in program implementation, the Fund needs to focus particularly on helping the member design a program that is conducive to effective implementation. While most of the subjects discussed in Section III have implications in that regard, perhaps the most critical issue is the speed of adjustment. With more rapid achievement of results, there is less danger that implementation will not be sustained. When a country has experienced problems of implementation in the past, therefore, it is particularly important that the strategy chosen is one that maximizes the probability of having rapid effects, such as exchange rate action when competitiveness needs to be enhanced, and that ensures rapid adoption of measures, with as much action as possible at the outset of the program. Aside from contributing to more rapid achievement of results, this would provide stronger assurances that Fund resources are being disbursed in a context of progress in adjustment. This does not imply lesser emphasis on the more time-consuming elements of structural adjustment, such as institutional reform, but rather stresses the importance of addressing the immediate problems promptly to provide a favorable environment in which other reforms can take place.

Problems of implementation faced by prolonged users reflect not only difficulties encountered during programs but perhaps even more the difficulties in maintaining continuity of implementation in the post-program period. This adds weight to the desirability of establishing well-designed and concrete mechanisms for policy adjustment (such as market determination) that will provide continuity through a fair degree of automaticity, rather than reliance on ad hoc decisions.

2. Examination of difficulties in program implementation

When a member has encountered problems of implementation, it is important that there be a full understanding of the nature of the problems. Papers presenting requests for programs already include reviews of developments under immediately preceding programs, as required by Conditionality Guideline 11. As was suggested in the 1984 review of prolonged use, it may be helpful in some cases to provide more comprehensive reviews. Such a review of performance and developments under preceding programs, which should also reflect the authorities' own assessment of the difficulties they encountered, can help to indicate ways in which program design needs to be strengthened or modified to promote more assured adjustment in the future. It can also serve as input to the judgment, under Conditionality Guideline 7, that the program will be carried out.

3. Continuity of policy dialogue

Given the difficulties some members have had in maintaining the momentum of adjustment after arrangements expire or more generally when programs are not in effect, it would be helpful to have more continuity in the dialogue between the Fund and the member in the period immediately following the program. Article IV consultations provide a principal vehicle for such a dialogue. As was suggested in last year's review of conditionality, where the Article IV consultation is not due to take place until a considerable time after the end of the program, an interim review might be helpful.

More generally, upper tranche arrangements include a provision for consultation during the time a member has outstanding purchases in the upper tranches. 1/ Consideration might be given to use of this provision to hold consultations with members around the end of any program that is not to be followed by another program. Besides reviewing developments under the program, the discussion should be forward-looking and focus on how program policies should be continued over the following year. In line with the growing emphasis on quantification of policy intentions, to the extent possible it would be desirable that these intentions be specified (and quantified) along the same lines as programs submitted in support of requests for use of resources. The staff would appraise the program in a report to the Board, either as part of an Article IV consultation or separately. Such a continuing assessment could be helpful both in formulating and implementing current policies. It would also help to identify problem areas in implementation that need to be taken into account in designing a new program if the

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1/ The standard language is "after the period of the arrangement and while (member) has outstanding purchases in the upper credit tranches, the government will consult with the Fund from time to time, at the initiative of the government or at the request of the Managing Director, concerning (member's) balance of payments policies."

member subsequently made a request for further use of Fund resources. As time passed, if there were no further request for use of resources, the Fund's involvement would gradually revert to the normal cycle of consultation that takes place under Article IV. 1/

4. Options for the Fund when problems of policy implementation have been encountered

In most cases when a new request for use of Fund resources is made by a country with a weak record of implementation, it should be possible to design a program in such a way as to provide stronger assurance of successful implementation in the future, particularly when detailed review of past implementation has permitted identification of the nature of the problems encountered. In some cases, moreover, assurance of implementation may also be enhanced by, for example, clear signs of political acceptance of the adjustment strategy to be followed. In such situations it is reasonable to judge that the program will be carried out and normal access to Fund resources can be granted. Where the process of further adjustment is expected to be a lengthy one, of course, the guidelines on access by individual members require that the amount of access reflect the possible need for financing to continue over a number of years.

a. Shadow programs

In some cases, however, there may still be concern that the member could run into renewed difficulties of implementation. In such cases the Fund faces the dilemma that while its involvement could be helpful to the member in its adjustment efforts--even without full implementation--when implementation is less than complete, the institution's resources are at risk. One possibility in such cases would be to discuss with the authorities a shadow program for a limited period (at most a year) to provide a clear indication of their resolve to carry out the adjustment. If such a program were satisfactorily implemented, the risk involved in providing the member with access to Fund resources would be reduced both through the fact that some progress had been made in adjustment and through the member having gained experience with successful implementation. Thus, the expectation would be that successful

1/ The implications of this procedure for the workload of the Fund would need to be carefully considered, as it would entail a delay in the decline in the workload that normally takes place when a member does not seek further use of Fund resources.

implementation would result, when appropriate, in a subsequent program supported by a regular arrangement for use of Fund resources. 1/

b. Access

More generally, the amount of access in individual cases has always been determined in the light of, not only the members' balance of payments need, but also the strength of its adjustment program and the expected speed of adjustment. Among the other factors taken into account is the quality of the record in using Fund resources in the past.

Last year's review of prolonged use concluded that the adoption of strict rules on access by prolonged users would not be appropriate, and it was considered that the existing guidelines for application of access limits should continue to be applied on a case-by-case basis. 2/ Considerations to be taken into account in this context include a member's past record, the strength of the proposed adjustment, its balance of payments prospects, external financing conditions, and the medium-term framework, all of which have an important bearing on the action to be taken in individual country cases. These considerations continue to be applicable.

c. Phasing

As noted in the paper reviewing the relationship between performance criteria and phasing of purchases, 3/ the share of the amount of the arrangement available as an initial purchase has declined in recent years, and in some cases there has been deliberate backloading of purchases. A measure of flexibility in this area, including the possibility of such backloading, can contribute to more effective encouragement of policy action, particularly in cases where there have been difficulties in implementation.

d. Preconditions and performance criteria

It was suggested above that past difficulties in implementation reinforced the desirability of developing program designs that

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1/ An example of such a technique was the 1984 shadow program with Haiti. After Haiti's two-year stand-by arrangement approved in November 1983 became inoperative, a program was developed that did not provide for further use of Fund resources. The expectation was that if implementation were successful, it would result in favorable consideration of a request for a new arrangement. In the event, Haiti continued to have problems of implementation, and no new arrangement was approved.

2/ The guidelines on access were reviewed in the context of the discussion on access limits for 1986 (EBM/85/138, 9/11/85; see EBS/85/174, 7/23/85).

3/ SM/84/259, 11/20/84, p. 3.

emphasized early action. This has been reflected in the continued use of the practice, in appropriate cases, of requiring that key measures be implemented prior to the Board's approval of the arrangement. By the same token, measures that cannot feasibly be taken at the outset can be subject to performance criteria. This also contributes to clearer understandings on the precise content of the measures envisaged, which in itself lead to stronger implementation.

V. The Role of the Fund and Related Issues

1. The role of the Fund

The various issues raised in Sections III and IV suggest that the Fund needs to play an even more active role in advising members on the policy content of their adjustment programs in the years ahead. This will be a challenging task, since many of the issues involved are sensitive, but is necessary because difficulties in adjustment affect both the Fund's systemic responsibilities and its responsibility to safeguard its resources.

With respect to the design of programs, the Fund already advises countries on such issues as the timing and details of measures and what their effects will be. What is needed is a still more vigorous effort to persuade members of, for example, the advantages of early and comprehensive policy implementation, as opposed to a gradual process that delays the achievement of adjustment objectives, which in turn jeopardizes the program's political acceptability. The Fund also will need to become more involved in discussion with the authorities on the details of policy planning, often at the microeconomic level, where such details are directly relevant to the achievement of the objectives of the program. A structural adjustment strategy, for example, implies that efforts are made to expand the resource base of the economy. If too much of the cutback in fiscal expenditures falls on investment, this objective can be jeopardized. Reinforcing the World Bank's advice on investment strategy thus becomes critical to the success of programs. Another area that needs more detailed attention in this context is public sector efficiency.

Some of the suggestions in connection with prolonged use also imply more extensive interaction between the Fund and member countries. Taking careful account of past difficulties in implementation, for example, implies a more detailed exploration of how these difficulties developed and how they can be avoided by new approaches. The suggestion of greater continuity of policy consultation when Fund arrangements are not in effect, moreover, could entail additional staff missions and more frequent detailed reviews in the Executive Board.

2. Guidelines for conditionality

It is useful to consider the issues raised in this paper against the background of the Guidelines for Conditionality. 1/ None of the suggestions put forth involve departure from the guidelines; rather, the effect is to give added weight to certain of the guidelines, particularly in cases where prolonged use has resulted from problems of program implementation. For ease of reference, the current guidelines are reproduced in Appendix I.

The strongest emphasis in the paper has been on the need for timely implementation of adjustment measures, consistent with the emphasis in Guideline 1 on encouraging members "to adopt corrective measures . . . at an early stage of their balance of payments difficulties."

The paper has also emphasized the need for close attention to the details of programs of structural adjustment, which requires careful consideration with the member of how such a strategy could fit to the "domestic social and political objectives" of the members, as emphasized in Guideline 4, which also notes the need to "pay due regard to . . . the economic priorities, and the circumstances of members, including the causes of their balance of payments problems". Thus it may be necessary to help the member to reconcile conflicting objectives with respect to medium-term viability and short-run stabilization; achieving the latter through cuts in investment, for example, may, as already noted, jeopardize viability in the medium term. There is also a need for the Fund to seek for further ways of easing the burden of adjustment through an iterative process of coordination with donors and creditors. There is a particular need for a "new look" when there are large abrupt shifts in the causes of members' balance of payments problems which lengthen the adjustment beyond the periods originally foreseen, as when the price for a major export commodity declines sharply.

The suggestion in Section IV of more detailed appraisals of difficulties in program implementation is also related to Guideline 4, which calls for paying due regard to "the causes of . . . balance of payments problems," and fits with the review requirements in Guideline 11. More continuity following programs would involve an application of Guideline 5's "provision for consultation from time to time during the whole period in which the member has outstanding purchases in the upper credit tranches."

The suggestions in Section IV are also aimed at providing stronger assurance that the member's program "will be carried out," which is emphasized in Guideline 7. Extensive use of preconditions, in cases where there are concerns about implementation, is consistent with the provision that such measures be required "only if necessary to enable

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1/ The Guidelines for Conditionality were adopted by the Executive Board March 2, 1979 (Decision No. 6056-79/38).

the member to adopt and carry out a program consistent with the Fund's provisions and policies." A nuanced approach to dealing with implementation difficulties is also consistent with Guideline 8's emphasis on "nondiscriminatory treatment."

Structural adjustment requires a broad range of measures of a microeconomic character and performance criteria on such measures that are "essential for the effectiveness of the member's program because of their economic impact" are consistent with Guideline 9.

3. Review of the extended Fund facility

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

Seven extended arrangements have been approved since 1982. The background paper discusses the considerations leading to the choice of stand-by arrangements in circumstances where extended arrangements might have been considered. These included an inadequate record of implementation under previous extended arrangements and, in some cases, an unstable political situation. Another important consideration has been the difficulty of specifying in advance a well-articulated time schedule of implementation of corrective policies over an extended period, given the weak state of administrative capacity and economic statistics. Under the circumstances, stand-by arrangements were viewed to provide more flexibility to both the Fund and the member countries.

The provisions of the extended Fund facility nonetheless remain suitable for dealing with particular payments problems of a more structural nature. Given the emphasis in this paper on the design of programs involving structural adjustment, most of the findings would apply with particular force to extended arrangements. The commitment of Fund resources over an extended period must be matched by commitment of the country authorities to policy implementation, and requires existence of the administrative capacity to carry out a comprehensive adjustment process extending through the period of the arrangement. In this regard, the past record of policy implementation and cooperation with the Fund is of particular relevance.

VI. Summary and Topics for Discussion

In recent years the Fund's conditionality has played a major role in fostering a coordinated global response to the problems of adjustment and financing of the severe payments imbalances of developing countries. A number of countries entering into Fund arrangements, however, have been unable to make satisfactory progress toward balance of payments viability. The difficult external environment and the unprecedented magnitude of the adjustment required have been major factors in the problems members have encountered in implementing adjustment. The external environment is not an insuperable obstacle to adjustment, however, as demonstrated by the experience of some members that successfully adjusted under circumstances comparable to those that did not. The difficulties of some members in adjusting poses a challenge to the effectiveness of the practices of conditionality in promoting adjustment.

Executive Directors will thus wish to consider the factors underlying the difficulties some members have had in achieving their adjustment objectives. A major issue is the difficult world environment, with regard to which the policy stance of industrial countries plays an important role. In this sense, this year's review makes clear that greater effectiveness of Fund surveillance would improve the conditions under which Fund programs operate. Another important issue in this context is the willingness of official donors and private lenders to continue to provide financial and managerial assistance to developing countries that are undertaking adjustment programs.

Despite the severity of the external environment, some countries have made substantial progress with their adjustment efforts, though not without difficulty. They have done so through determined and flexible implementation of adjustment measures. Countries that have not made substantial progress, by contrast, have generally not had adequate records of implementation. A key question for consideration by Executive Directors, therefore, is why many programs have not been fully implemented. One factor is the inherent difficulty of carrying out programs of a strongly structural character, a feature of most recent programs. Another factor has often been the adoption of too gradual an approach to adjustment.

Against this background, the paper focuses on the issue of how programs can be designed to provide better assurance of sustained implementation. Among the issues that Executive Directors may wish to consider in this connection are the following that relate to program design:

(1) The need for selection of adjustment strategies that yield rapid results, and the need for more rapid policy implementation.

(2) The role of medium-term scenarios in assessing the viability of the balance of payments and the appropriate path to adjustment.

(3) The need to broaden the scope of policy formulation in programs of structural adjustment.

(4) In connection with distortions in relative prices, the desirability of developing mechanisms for adjustment of prices and exchange rates that rely less on ad hoc decisions and more on automatic processes, including market-oriented mechanisms.

(5) The extent to which programs should emphasize institutional reform, including more efficiency and accountability of public enterprises (which can often be accomplished through privatization), and the role of cooperation with the World Bank in this regard.

(6) The need to formulate precise understandings so that policy measures contained in adjustment programs are carried out on a timely basis, preferably as much as possible at the time programs go into operation.

(7) The need to address structural issues in fiscal adjustment.

(8) The need for programs to emphasize adjustment of exchange rates and interest rates as a means of correcting and reversing capital flight.

(9) The extent to which programs should emphasize management of foreign exchange reserves, particularly in light of the problems some members have recently experienced in keeping current with their financial obligations to the Fund.

Improvements in program design can play a major role in dealing with current problems of prolonged use of Fund resources and forestalling the development of new cases in future. The forthcoming staff paper discussing theoretical aspects of program design will provide a basis for further consideration of these issues. There will continue to be problems of implementation, however, and consideration needs to be given to techniques for dealing with such problems. Some possibilities in this regard that are noted in this paper emphasize the need for a nuanced, case-by-case approach. Greater continuity of policy dialogue when Fund arrangements are not in effect could be envisaged, with emphasis on quantified policy discussions in Article IV and other consultations. Executive Directors may also wish to consider ways of taking account of past difficulties of policy implementation when new programs are designed. Possible responses could include shadow programs, differentiation of access, backloading of purchases, stronger preconditions, and additional performance criteria.

Executive Directors will also wish to consider the implications of these suggestions for the role of the Fund and for the guidelines on conditionality.

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

1. Pursuant to Decision No. 7857-(84/175), adopted December 5, 1984, the Fund has reviewed the conditionality that the Fund applies for transactions in the upper credit tranches with particular reference to the Fund's experience from recent programs supported by stand-by and extended arrangements from the Fund. In the context, the Fund has also reviewed the provisions of the extended Fund facility and the guidelines on conditionality.

2. The Fund finds that the conditionality of the Fund, including provisions of the extended Fund facility and the guidelines on conditionality, remains appropriate in the present circumstances.

3. The Fund will again review the experience relating to programs supported by stand-by and extended arrangements, and the provisions of the extended Fund facility and the guidelines on conditionality, at an appropriate time pursuant to paragraph 12 of the guidelines on conditionality.

Guidelines on Conditionality

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

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

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

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

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

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

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

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

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

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

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

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

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

Executive Board Meetings and Fund Documents
Relating to General Reviews of Upper Credit Tranche
Arrangements and Conditionality, 1979-85 1/

Executive Board Meeting 2/ Number	Date	Document	Document Number	Date of Issue
1. EBM 79/84	6/1/79	Review of the Extended Fund Facility	SM/79/122	5/9/79
2. EBM 80/21	2/8/80	Adjustment Programs Supported by Upper Credit Tranche Stand-By Arrangements, 1977	EBS/79/635	12/26/79
3. EBM 81/7	1/12/81	Review of the Extended Fund Facility 3/	SM/80/278	12/29/80
4. EBM 81/121	9/9/81	Review of Upper Credit Tranche Stand-By Arrangements Approved in 1978-79 and Some Issues Related to Conditionality	EBS/81/152 and Supplement 1	7/14/81
5. EBM 82/92	7/7/82	a. Review of Recent Extended and Upper Credit Tranche Stand-By Arrangements	EBS/82/97	6/9/82
		b. Supplementary Material	Supplement 1	6/10/82
		c. Adjustment Programs - Broad Design and Key Indicators	EBS/82/98	6/9/82
6. EBM/83/156	11/16/83	a. Review of Upper Credit Tranche Arrangements Approved in 1981 and of Some Issues Related to Conditionality	EBS/83/215	10/4/85
		b. Upper Credit Tranche Stand-By Arrangements Approved in 1981	EBS/83/216	10/4/83
7. EBM 84/175	12/5/84	a. Review of Upper Credit Tranche Arrangements and of Some Conditionality Issues	EBS/84/227	11/7/84
		b. Experience with Adjustment Policies	EBS/84/228	11/13/84

Source: Fund documents.

1/ Includes all general reviews and reviews of selected topics since adoption of the current guidelines on conditionality (Appendix I).
2/ For some items, Executive Board discussion continued at subsequent meetings.
3/ Since 1982 reviews of the extended Fund facility have been combined with reviews of conditionality and stand-by arrangements.