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December 30, 1985

To: Members of the Executive Board

From: The Acting Secretary

Subject: The Design of Adjustment Programs in Planned Economies

The attached paper on the design of adjustment programs in planned economies is tentatively scheduled for a Seminar discussion by the Executive Directors on Monday, January 27, 1986.

Mr. Allen (ext. 8381) or Mr. G. G. Johnson (ext. 8779) is available to answer technical or factual questions relating to this paper prior to the Seminar discussion.

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INTERNATIONAL MONETARY FUND

The Design of Adjustment Programs in Planned Economies

Prepared by the Exchange and Trade Relations Department
(In consultation with other departments)

Approved by C. David Finch

December 30, 1985

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I. Introduction

During the discussion of the staff paper "The Application of Fund Policies in Planned Economies" (SM/82/82, 4/26/82) 1/ at an Executive Board seminar (Meetings No. 82/3 and 82/4, 6/25/82), Executive Directors asked that further consideration be given to the question of the appropriate design of Fund-supported adjustment programs with such countries. Since that time the Executive Board has approved or reviewed additional programs with planned economies, on which occasions the question of the appropriate configuration of performance criteria has sometimes been raised. This question has also arisen in connection with the periodic reviews of the guidelines for conditionality as well as in the context of country policy assessments on the occasion of Article IV consultations.

The present paper explores some of these issues. It builds on the earlier paper mentioned above, on further research work done by the staff, 2/ and on the practical experience gained in recent arrangements. The first section of the paper outlines the basic issues and discusses why the nature of these economies can give rise to problems in designing programs. The second section considers the objectives of adjustment programs in planned economies. The third section considers how the adjustment policies to be supported by a Fund program can best be formulated; this is followed by a discussion of the appropriate way of monitoring such a program in order to give the Fund the necessary assurance that adjustment is taking place. Conclusions are drawn in a final section.

II. The Nature of the Problem

While countries with planned economies have long been among the membership of the Fund, their number has been small, and experience of designing adjustment programs with such members has been relatively limited. The present paper is designed to explore how the Executive Board can be given a degree of assurance that Fund-supported programs with these members will achieve their objectives similar to that which

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1/ In addition, a paper, "Prices, the Exchange Rate, and Adjustment in Planned Economies" (DM/82/34, 5/19/82) was issued as background to this discussion.

2/ See for example: Toma Gudac, "Policy Responses to External Disequilibria in the Planned Economies: Factors Affecting Pricing and Exchange Rate Policies" (DM/83/47, 6/17/83); Martin J. Fetherston, "Fiscal Developments and Issues in Selected Centrally Planned Economies" (DM/83/72, 10/13/83); Toma Gudac, "The Role of Credit and Interest Rate Policies in Modified Planned Economies" (DM/84/52, 8/17/84); Thomas A. Wolf, "Economic Stabilization in Planned Economies: Towards an Analytical Framework", Staff Papers, Vol. 32, No. 1, March 1985, pp. 78-131; Thomas A. Wolf, "Exchange Rate Systems and Adjustment in Planned Economies", Staff Papers, Vol. 32, No. 2, June 1985 pp. 211-247.

can be given in the case of other members. Thus, the paper explores how to ensure evenhanded treatment of members with differing economic systems.

Countries having planned economies constitute a diverse group at different stages of development and with differing histories and traditions. Moreover, these economies differ among themselves in such areas as the form of ownership and control of the means of production, the degree of government intervention, the scope and nature of central planning, and the role of markets. Furthermore, a country's economic system may change significantly over time. Of course, the large group of countries customarily regarded as market economies also differ significantly among themselves in such areas as the degree of state ownership and government intervention and they vary widely in levels of economic and institutional development, resource endowment, openness, and economic structure. Not only is the group of planned economies a diverse one but the dividing line between planned and market economies is blurred, each set containing members which would on some criteria be placed in the other.

Within the group of planned economies, useful distinctions can be made. The group includes some economies where the economic mechanism remains relatively little changed from the traditional Soviet model of the interwar period. In others this form of organization has been significantly modified with greater decentralization of decision making, a more extensive use of markets, and in some cases an abandonment of central planning. In Yugoslavia, this process has probably gone furthest. Some other developing countries have also adopted some or all the organizational forms of central planning. This paper is intended to treat at a general level the issues connected with the design of adjustment programs that are common to this group of countries. At a minimum, it tries to cover the common features of the economic systems now prevailing in China, Hungary, Romania, Viet Nam, and Yugoslavia. It can of course be no substitute for the country-specific analysis that alone can take fully into account all the details of the economic system in a given country. Given the diversity of both planned and market economies, there can be no single approach to the design of Fund-supported adjustment programs in either group of members. Within the constraints imposed by the broad objectives of such programs, they have to be designed on a case-by-case basis, utilizing to the full the Fund's and the authorities' own experience of the behavior and response of the economy and applying well-tried principles of economic reasoning and analysis.

For simplicity, the paper will refer to "planned" economies, even though some are not planned and some would not be so described by their authorities. The common features of all these economies that justify treating them as a distinct group and that are relevant to the design of adjustment programs can be summarized under two broad headings: the subordinate role of the private sector, and the pervasiveness of administrative intervention and control in order to achieve economic and social policy goals. 1/ Other features, such as the hierarchical bargaining relationship between enterprises and planners, the conducting of much foreign trade among each other under special institutional arrangements, or the fragmentation of the financial system, are either not shared by all the economies treated here or can be regarded as consequences of the two features listed.

In most of these countries, the bulk of industrial and commercial activities are carried out by state-owned, and normally state-controlled, enterprises. In agriculture, the situation is more diverse; in some, private farming predominates, while in others cooperative, collective, or state-owned, farms are the primary organizational form. Co-existing with state-owned industrial and commercial enterprises, there may be a cooperative sector, particularly in handicrafts and services. In Yugoslavia, almost the entire economy is based on relatively small *self-management units, the "organizations of associated labor."* Private economic activities are allowed in some of these countries, but their scale is small; there are usually limitations on the number of staff a private entrepreneur may hire and the place of such activities in the nonagricultural economy is usually minor.

With private economic agents forming only a small part of the economy, the response of the particular economy to economic stimuli may differ from that occurring in market economies based on private enterprise. The response patterns of state-owned industries, or for that matter of cooperatively-owned bodies, to changed signals may differ markedly from those of private economic agents. This has two main causes: the different objective function of enterprise management and the discretionary application of market sanctions.

As is the case with public enterprises in predominantly market-oriented economies, the basic economic units in planned economies in general cannot be assumed to behave as profit maximizers and to adjust their activity automatically in response to changed price signals or to changes in demand not reflected in prices. Enterprises in these economies will tend to maximize output for a variety of reasons, including the customary demands of the authorities for high rates of output growth and the expectation that financing will normally be made available in one way or another to cover the attempts to increase production. Market sanctions do not automatically follow uneconomic or inefficient business decisions, though at times the difference from market economies in this respect may be primarily one of degree.

A second aspect of these economies is that intervention and control by government (or possibly by party or local authorities) is pervasive. This does not necessarily preclude the existence of markets. In these economies there are usually fairly well-developed markets for certain consumer goods and some forms of labor; capital goods and financial

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1/ For a discussion of the features characterizing planned economies, see SM/82/82 (pp. 1-2), and in more detail DM/82/34 (pp. 3-7).

markets, on the other hand, tend to be extremely undeveloped. Even when an enterprise does transact on a market, there is a possibility that any market decision may be administratively overridden, and in many cases the markets themselves are not allowed to clear. Extensive government intervention and control may in fact be a necessary concomitant of the predominance of state-owned or cooperatively-owned units in the economy.

The scope and nature of administrative intervention varies widely among these economies. There is normally a "plan", but this may be anything from a general indicative document containing official forecasts to an extensive and binding legal instrument assigning detailed tasks to each enterprise. The essential feature of these economies is not necessarily a formal central plan governing the period ahead but the pervasive intervention by administrative and political bodies in the everyday activities of economic units intended to ensure that the goals of the authorities are achieved. This is often facilitated by the hierarchical organization of the economy, with enterprises being the lowest rungs of administrative hierarchies headed by ministries. In this environment there is considerable scope for administrative discretion in the implementation of policies.

While enterprises are the subject of plans and instructions emanating from above, they cannot solely be considered as obedient executors. An enterprise's management can influence the tasks and resources it is assigned, and these often emerge from a process of vertical bargaining. Planning is frequently based on the enterprise's own report of what it produced the previous year and what it could produce the next if sufficient physical resources were assigned to it. There may be further room for discretion in the implementation of the plan, in deciding which tasks to complete and which can be safely ignored. Finally, no system of instructions can cover all decisions or eventualities; thus there will always be a large number of decisions to be taken independently by enterprise management.

The relationship between an enterprise and the market is thus not the same as that prevailing in a market economy. Enterprises may be prevented from engaging in some market-related activities that would be permitted elsewhere and the verdict of the market is seldom as final as in other economies and rarely so in the short term. Since administrative intervention is so widespread, enterprises have a greater self-interest in persuading the authorities to intervene in their favor, either to increase available imports or to provide favorable tax and subsidy treatment. Thus, the benefits accruing to enterprise management from working to change the administrative framework may be as large as, or larger than, those to be gained from exploiting market opportunities.

In those planned economies that are members of the CMEA, a considerable volume of trade is conducted with other CMEA member countries under bilaterally-negotiated agreements. Intra-CMEA trade takes place at special prices and is subject to particular domestic institutional arrangements. This trade and the associated arrangements constrain policy flexibility, influence the structure of production, and introduce rigidities in the structure and volume of trade with non-CMEA members.

In some planned economies, the authorities lay particular stress on the achievement of certain sociopolitical objectives, such as full employment, price stability, rapid growth, and a particular distribution of income. While most or all of these are also policy objectives in many other countries, the authorities in planned economies tend to consider that the best way to assure the achievement of these objectives is through the particular institutional arrangements described above, including state ownership of production units, detailed administrative intervention, and strict controls. In this way, for example, enterprises can be required to employ all job seekers and to strive for maximum production at fixed prices.

From the above discussion, some of the main elements can be distinguished that make difficult the design and monitoring of adjustment programs in these economies. Firstly, there is a lack of transparency in the operation of these economies. Even if there were no statistical problems associated with these countries, the extent and detail of the administrative intervention, which is immensely difficult to know in depth and to summarize, hinders the presentation of an adequate picture of economic behavior. Furthermore, policies are not primarily macroeconomic in nature, but generally consist of extensive microeconomic intervention. Secondly, these economies lack an analytically tractable market, thus rendering systematic macroeconomic analysis with general applicability hardly possible. This leads to the third element, that an understanding of how the economy works requires an analysis of how the administrative hierarchy makes decisions and responds to events. From the practical point of view, the above makes it impossible to specify in advance all necessary adjustment measures, to know if they have been fully implemented, and to ensure that they are not offset by other (sometimes hidden) measures.

III. The Objectives of Fund-supported Adjustment Programs

Fund-supported adjustment programs aim at the restoration of macroeconomic conditions conducive to economic growth and a viable balance of payments position. This can be considered a position in which the member can finance its current account deficit and service its debt by means of normal capital inflows and without reliance on trade and payments restrictions. By promoting such positions, the Fund directly contributes to the achievement of its fundamental purposes, which include shortening the duration and lessening the degree of disequilibrium in members' balances of payments, and assisting in eliminating foreign exchange restrictions which hamper the growth of world trade.

Although restrictions are to an extent a feature of planned economies, the intensification of restrictions in any economy cannot resolve underlying balance of payments difficulties. Unless the imbalance between available resources and claims on them is addressed, it will re-emerge as open payments difficulties or will be transformed into price pressures and a decline in economic activity. The Fund therefore has two reasons for supporting adjustment programs that ensure no intensification of border restrictions: only these programs offer the prospect of eliminating the underlying imbalance and only they contribute to the Fund's purpose of achieving an open and multilateral system of trade and payments. The Fund was created to offer an approach to adjustment that did not involve intensification of restrictions that hampered the efficient growth of world trade, adversely affecting the interests of all members.

The prevalence of administrative intervention in the economies treated by this paper raises two fundamental issues in framing the objectives of an adjustment program. The first is how, given the extent of controls over external transactions, adjustment can contribute to a freer system of trade and payments, or how regimes of varying degrees of restrictiveness can be measured. The second is how to adapt the administrative intervention to ensure that fundamental economic imbalances are corrected.

This question of identifying border restrictions and assessing changes in their restrictiveness in an economy characterized by administrative controls was discussed in "The Application of Fund Policies in Planned Economies" (SM/82/82, pp. 7-16). In a formal sense, the vast majority of external transactions may require official sanction, and this may be an integral part of the economic system of the country in question. The above paper concluded that in such economies measures need to focus more directly on the correction of domestic imbalances if restrictions are to be reduced.

The second issue concerns the relationship between domestic macroeconomic imbalance and external imbalance. As a result of the prevalence of administrative intervention, the link between domestic and external disequilibria is more tenuous than in most market economies. In addition, the ways in which imbalances manifest themselves may be different. Once again, however, the distinctions between planned and market economies are not as sharp in practice as in theory, and differences can be viewed as predominantly ones of degree.

Given a structure of relative prices, income levels, institutional arrangements, and plan instructions, domestic economic units have a certain level of demand. Part of this demand is satisfied either from domestic supply or through the current account of the balance of payments. The remainder of the initial demand of economic units is suppressed, mainly through queues and restrictions but possibly through inflation, and this part is referred to as the internal imbalance. The net supply originating from external sources is financed by reserve use or by borrowing, some of which may be unsustainable, in which case it corresponds to the external imbalance facing the economy. The sum of the internal and external imbalances constitutes the overall imbalance in the economy.

In market economies, the multiplicity of closely interconnected markets means that disequilibrium in one sector or subsector is reflected promptly in relative price changes, which then affect all other sectors relatively rapidly and automatically. Domestic macroeconomic imbalance is manifested in inflation, but it also has a direct effect on the balance of payments and perhaps less directly on output and employment. In the same way, external shocks are promptly transmitted to the domestic economy. While restrictions may dampen these processes, they rarely eliminate them. The main consequences of this linkage are that in general domestic and external imbalances tend to move together in a market economy and that measures to correct one imbalance serve also to correct the other.

In a planned economy, the network of controls over the functioning of markets and the resulting absence of relative price adjustments breaks much of this linkage. Excess macroeconomic domestic demand may thus coexist with external surplus, balance, or deficit. Similarly, excess macroeconomic supply in the domestic economy is not automatically related to an external surplus. In fact, even within the domestic economy, excess supply regimes for some goods may coexist with excess demand for others as discussed further below. One consequence is that actions to correct external imbalance may cause or aggravate domestic imbalance or vice versa. This will typically be the case if an external deficit is repressed by restricting imports or reduced by an administrative mobilization of domestic goods for export.

The concept of the external imbalance does not differ between planned and market economies: the process of identifying unsustainable borrowing is also essentially the same. The measurement of the internal imbalance, however, takes a different form and is more difficult. In a market economy, the primary indicator of this imbalance is the rate of inflation and, in certain circumstances, the rate of unemployment; further, because of the linkage described above, the external imbalance is also a guide to the internal imbalance. In a planned economy, price control is normally so effective that the imbalances are reflected in shortages, queues, black market transactions, and other phenomena; the external imbalance need not be directly related to the internal imbalance. Data on nonprice indicators of imbalance are often not readily available, which can make the analysis of the economic situation more difficult. In view of the central role that the correction of imbalances plays in adjustment programs, it is important that adequate and appropriate indicators be developed if programs are to be properly assessed. 1/

A Fund-supported adjustment program should aim at a substantial reduction in the total imbalance facing the country. It is not sufficient to reduce the external imbalance if this is done at the cost of exacerbating the internal imbalance, since such an approach fails to deal with the underlying problem facing the economy. A reduction in the degree of internal imbalance is needed to allow for an efficient

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1/ For a discussion of such indicators, see DM/82/34, pp. 31-32.

allocation of resources, thus putting the country in a better position to contain its external deficit within sustainable bounds, and indeed experience a higher rate of economic growth through a more efficient use of resources. In addition, the worsened internal imbalance will either be accompanied by an acceleration of inflation or, particularly in the case of planned economies, by an intensification of border restrictions. Thus, in normal circumstances, together with measures designed to reduce the external imbalance, a program also needs to work directly to reduce the degree of internal imbalance, and this will ordinarily involve measures to contain the various components of an economic unit's initial demand, and to strengthen domestic supply by shifting resources to more productive uses.

The above discussion has focused on the need for Fund-supported adjustment programs to reduce macroeconomic disequilibrium. While in an economy with integrated and fully-functioning markets, macroeconomic disequilibrium is reflected principally in a movement in the general price level as the economy tries to restore microeconomic equilibrium in the supply and demand for individual commodities, in the planned economies, the extensive system of restrictions and controls often leads to varying degrees of shortage of some goods coexisting with surpluses of others. Furthermore, measures to reduce aggregate imbalance in planned economies will not necessarily reduce microeconomic imbalances. Measures to bring about macroeconomic balance are necessary, but not sufficient.

IV. The Choice of Adjustment Measures

On the basis of the discussion in the previous section, the proximate objectives of Fund-supported programs can be summarized as:

1. reducing the overall macroeconomic imbalance of supply and demand;

2. strengthening the balance of payments

3. shifting resources to more productive uses; and

4. reducing microeconomic imbalances.

The availability to the authorities of instruments to achieve these goals, and the effect of a given instrument, will depend on the precise nature of the economic system. In this context it should be noted that any Fund-supported adjustment program with a member is based on discussions between the Fund and the authorities on the range of options open to the latter in practice, rather than on the use of a set of measures chosen a priori. Thus the design of an adjustment program draws on the understandings of the country's authorities and their practical experience of the availability and effectiveness of policy instruments. The position of the authorities is of course critically appraised by the

Fund, and an adequate statistical and informational base is necessary to do this. All these considerations are particularly relevant in the design of adjustment programs in the economies dealt with here, since in each case it requires a good understanding of the particular economic system and detailed information that only the authorities are likely to possess.

In discussing and agreeing on a program of adjustment measures, it is vital in any Fund program that understandings be reached with those who really formulate the relevant economic policies. In the economies considered in this paper, major responsibility for macroeconomic policy may be shared between the Ministry of Finance and the Central Bank, as well as several other bodies. Among these may be the Planning Commission, the economic apparatus of the Party, and local party and state bodies. Indeed, these are usually more important in the formulation of policy than the bodies with which the Fund normally deals, which may in some cases only be the executors of policies decided elsewhere. Without the support and understanding of all bodies concerned with the relevant economic policies, a program may run the risk of being undermined.

1. *Microeconomic adjustment*

The process of adjustment is intended to lead to extensive changes in the real economy. Adjustment is ultimately a matter of microeconomic changes in the behavior of the basic units constituting the economy. Thus, one of the main issues in designing adjustment programs for a planned economy is to ensure that the required microeconomic adjustments are made. In a market economy, the functioning of interconnected markets gives an assurance that the microeconomic change induced by the use of macroeconomic policy instruments will be reasonably efficient and widespread. It is thus possible, when designing an adjustment program, to concentrate mainly on the broad macroeconomic aggregates and the factors affecting the functioning of markets, including the setting of key prices at appropriate levels. In the economic systems dealt with here, markets may be fragmented and controlled; indirect macroeconomic policy instruments may be of limited effectiveness; and, while any macroeconomic change will indicate that some microeconomic changes are taking place, there may be less assurance that the microeconomic changes are in any sense optimal.

While households and private sector enterprises can be relied on to adjust their activity automatically to changed signals, this is not the case for public sector enterprises, particularly if the latter have the ability to control their prices or conditions of activity, or if they do not expect to be denied any financing they need. In any adjustment program, therefore, other means must be found to ensure that microeconomic adjustment takes place in such units. One method is to specify administratively, through the plan or other means, formally or informally, the adjustments that are required. But it is impossible for the authorities to specify all actions, nor do direct instructions guarantee efficient adjustment. What is required is that enterprise management be encouraged to work spontaneously to bring about the necessary microeconomic changes.

Enterprise management thus needs to be held responsible for the results of its activities. This implies that there be clear standards by which such results can be assessed. If means exist to set prices and incentives appropriately--that is, if the correct indirect instruments can be applied as discussed above, microeconomic adjustment will be reflected in the improved financial position of enterprises and the generation of savings. Whether by these or alternative means, in general, management should be held to account for its financial performance. It should be noted again, however, that enterprise management is not normally accountable to the Ministry of Finance or the Central Bank. If adjustment is to be achieved, then it is essential that the parts of the political and economic hierarchy which have the power over enterprises that would elsewhere be exercised by the market be fully committed to the aims of the program.

2. Adjustment of the Plan

In the more traditional centrally planned economies, a physical plan and the instructions governing its implementation constitute the principal instruments of economic policy. Consequently, in such economies the main instrument for adjustment must be the revision of the plan and its implementation. In accordance with the objectives of a Fund-supported program, this revision of the plan should entail measures to reduce or contain the level or the rate of growth of demand in the economy by influencing expenditure levels, by reallocating resources to more efficient uses and to reduce the extent of microeconomic imbalances, and by shifting resources into the balance of payments.

In some of the other economies considered in this paper, a physical plan does not play the same role in economic management. When the plan is a set of indicative targets, these would usually need to be revised to bring them into accordance with the program's objectives. However, the changes in the real economy will normally be effected by revising particular policies, such as those governing investment, wages, government and public enterprise finance, money and prices, as discussed further below. Nevertheless, the amount of administrative intervention in the economy, either in the form of instructions from the center or other forms of extraeconomic influence, usually remains substantial, so it is important that this intervention, too, be revised to bring it into accord with the objectives of the program.

The extent of this intervention and the impracticality of detailed monitoring can make it difficult for the Fund to be sure that the needed reorientation of policies has taken place. The staff can make some broad assessment of the consistency of the plan with the objectives of the program, particularly the macroeconomic objectives. It may also be able to follow sectoral adjustment measures in more detail where these are particularly important. However, it will frequently have difficulty in assessing the adequacy of measures to bring about the desired outcome. Furthermore, an assessment of the effectiveness of measures to achieve microeconomic balance or to promote the efficient use of resources may be particularly difficult. There may be useful anecdotal evidence available, but this is not always the case.

Apart, then, from the possibility of assessing the adequacy of measures by monitoring policy outcomes, and in common with other types of economies, the main assurance that administrative intervention in planned economies has been reoriented toward the goals of the program can only come from the commitment of the authorities to those aims. A program must therefore be based on a firm understanding with the key national policymakers as to the objectives of the program, and these objectives must be shared by the Fund and the authorities.

3. The management of demand

An adjustment program must bring demand and expenditure into a sustainable relationship with supply so as to release resources to strengthen the balance of payments. The management of demand thus requires the control of its various constituents: demand by households, the government, and enterprises. Demand by households and the government in planned economies differs little from that in market economies; demand emanating from enterprises is somewhat more complex.

Initial household demand is, as everywhere, a function of disposable income, wealth, the price level, and the opportunity cost of spending income. The authorities have a number of ways of influencing these variables. Disposable income can be affected by wage policy, taxation, and subsidies. In the more traditional centrally planned economies, wages in the state sector are governed by an officially established tariff schedule, and the placement of a worker on this schedule follows centrally determined rules. Nevertheless, enterprises may in practice have leeway or find ways of placing workers higher on the tariff schedule than the rules permit, particularly if labor is in short supply, as is often the case. Another means of paying higher wages is by adjusting piece-work rates or by increasing bonus payments. To control this, some countries pay particular attention to limits on the amount of cash made available to enterprises to pay wages. In any case, the root of the issue of controlling wages lies with enterprises, whose demand for labor needs to be moderated along with other forms of demand. Tax policy can work on wages to regulate disposable income and on enterprises to raise the cost of (and reduce the demand for) labor.

While resources can be released for the balance of payments by withholding them from domestic markets, this does not serve to correct the total imbalance facing the country. In some planned economies, the level of shortage is such that there is considerable suppressed purchasing power or liquidity overhang in the household sector, which should be reduced as part of an adjustment program. An increase in the retail price level, thus reducing real wages and the value of cash holdings, could have such an effect. Should this prove unacceptable, other ways need to be devised to attain a comparable result, such as an increase in the number and variety of opportunities for saving and the related returns.

From the macroeconomic point of view, the transactions of the government have a substantial impact on the level of demand in the economy. On the one hand, the raising of revenue by the government removes financial resources from the rest of the economy and, to the extent that such resources are needed for demand to be expressed, lowers the level of demand. Taxation or profit remittances tend to be particularly selective in planned economies and tax rates very varied, directly influencing the financial resources of the population, the incentives for wage and bonus payments, or the amount available for spending on investment projects. Government expenditure can also be a major source of demand pressure. As in any economy, the government has the discretion to alter its expenditure levels and patterns, and can thereby make an important contribution to the objectives of the adjustment program. In particular, government wages and transfer payments may be an important factor influencing the level of consumer demand, and government-financed investment a major element in total investment demand. Nevertheless, as anywhere, the authorities may feel constrained by social policy objectives in the pursuit of macroeconomic fiscal policy, in particular by their political commitment to guaranteed employment and the low cost provision of some goods and services.

Controlling the pressure of demand emanating from the public enterprise sector is normally a major issue in the design of adjustment programs in planned economies. The demand of enterprises for labor and their expenditure on wages, bonuses, and benefits in kind can be a source of imbalance in consumer goods markets. Their demand for materials may be excessive when incentives to use them efficiently are weak. In an environment of shortage, enterprises can contribute to its perpetuation by trying to build up precautionary stocks. Enterprises' demand for investment, dealt with more fully below, may be unconstrained by considerations of financial return. In an adjustment program, enterprises must make a contribution to the generation of savings, and this in turn requires that they show an appropriate financial performance. The two will be closely related in the context of an appropriate set of relative prices and costs, but, in its absence, the principle of enterprise accountability for economic and financial performance remains critical.

In normal circumstances, the incentive for enterprises to maximize profits may be quite weak. Enterprise management may consider it more advantageous to raise wages, lower inputs or invest than to increase profits beyond a certain level. Even though the level of profits may be one factor influencing managerial bonuses, the incentive may not be adequate in light of the other elements determining bonuses, and the benefits from the enterprise's spending its money, and higher profits this year, may just mean a higher profit target the next.

There are a number of steps that the authorities can take to raise the level of savings generated by enterprises. They can adjust the plan and channel resources to profitable and efficient enterprises, while phasing out or even proceeding to close down those making a loss. They can introduce stricter rules on permitted wage payments, on norms for inventories, on production for inventory, or investment. They may be able to adjust credit policy to control the level of activity and to eliminate those activities without a sufficient rate of return. Since prices may reflect the social priorities of the government, there may be a conflict between social policy objectives and the generation of increased savings.

Ultimately what is required, as already mentioned, is to make the objective of output maximization subject to the constraint of financial discipline. This requires holding enterprise management responsible for the financial results of the enterprise, and strictly limiting the amount of financial support provided by the government, the banks, or others. In turn, accountability will require a reduction in direct administrative intervention and in the discretionary application of rules, since these detract from the manager's responsibility for outcomes. Given the tradition of intervention and enterprises' experience as to the priorities of the authorities, it may be a long task to make enterprises sufficiently responsive to price signals and profitability considerations. Changing these entrenched behavior patterns may require considerable resolve and courage on the part of the authorities.

Overambitious investment programs are frequently a major cause of imbalance in planned economies. To some extent, the problems of the investment sector in a planned economy are shared by public and publicly financed investment programs in market economies. In both there is no automatic mechanism to ensure that adequate savings are available before an investment is launched, or that a project will have a sufficient rate of return. Nevertheless, the problem is often a more extensive one in planned economies, where periods of overinvestment and subsequent retrenchment are frequently observed.

The problem is more serious for a number of reasons. Firstly, virtually all investment is public investment in these economies. Another factor is that investors may have other motives for investing besides prospective financial profitability. One frequent motive for investment is to relieve bottlenecks at the enterprise level in order to reduce dependence on unreliable suppliers. Another is to spend the enterprise's earnings: in the absence of a capital market in which to make financial investments, the alternative to investment may be to have the surplus confiscated by the state. Management may find it rewarding financially, politically, or for reasons of self-esteem, to have a larger enterprise. A further factor is that the responsibility for investment decisions tends to be diffused, thus the investor may feel little responsibility for the distant outcome of the project, and therefore be less concerned that it be properly appraised.

Within a set of sensible investment selection criteria, the authorities may have a number of options available for controlling the volume of enterprise investment. They may cancel or postpone projects in the plan, or make inspections to see that all investment under way has been approved. They can also set the cost of investment at appropriate levels, by taxing it or by raising interest rates, and this will affect investment activity to the extent that cost is a factor in the investment decision. Another means of curtailing the amount of investment is to reduce the incentive to invest. Steps can be taken to reduce the degree of shortage or the unreliability of suppliers, thereby weakening that motive for quasi-autarkic investment, and the penalties for making unsatisfactory investment decisions can be increased, as can the rewards for the right decisions. The authorities can also take steps to reduce the amount of financing available for investment. They can cut down on allocations of investment resources by the state, reduce the amount of bank credit for these purposes, or discourage the use of the enterprise's own funds on deposit with banks.

As in other cases of measures of financial restraint in these economies, the restriction of finance for investment may not in itself be enough to reduce actual investment. It is possible, particularly if there is considerable excess liquidity, that enterprises will continue to carry out their investment and finance it illegally, by diverting other earmarked funds or by obtaining credit, whether voluntary or involuntary, from suppliers or customers. Should this occur, further measures need to be taken to ensure that the desired cutback in investment expenditures occurs. Once this has happened, and payments discipline has been restored, the reduction in investment will be reflected in the income and expenditure balance of the investing units.

4. Improvements in supply

At the center of the problem of improving supply conditions and the efficiency of resource use in the economy lies the question of prices. If an economy is based on the planning of the physical flows of goods, and enterprises' targets are similarly expressed, then a change in prices by itself is unlikely to have a marked effect on enterprises' economic activity. Even in this highly stylized economy, however, a case can be made for setting prices to correspond to relative scarcities, since this should facilitate rational planning. Without a price system that measures relative scarcities, it is difficult to see how planners can make optimal investment or allocation decisions.

In reality, prices play a fairly active role even in the more traditional planned economies, and this role can normally be expected to increase as part of an adjustment program. Some targets are expressed in value terms, and so the configuration of prices may affect how such targets are achieved. Similarly, the fulfillment of the financial plan will depend on the prices attached to various transactions. During an adjustment program, both the government and enterprises should be under pressure to increase savings and financial surpluses, at least to the point where abuses of monopolistic positions do not distort the economy. If prices reflect relative scarcities, then pressure to increase financial savings should also lead to more efficient resource use. The stricter the financial discipline, the more responsive the economy is likely to be to relative prices.

In economies where market allocation mechanisms play a more important role, price changes can be expected to have a more significant effect on economic activity. Still, to the extent that enterprises pay less attention to their financial results, the effect of price or exchange rate changes on enterprises' activities can be expected to be less than in a market economy. Since setting prices correctly in a planned economy does not guarantee that enterprises will change their behavior, efficient resource allocation may also require the establishment of mechanisms to promote such a response. This may include the creation or legalization of markets, changes in the system of administrative allocation, the establishment of appropriate forms of enterprise organization and control, and changes in incentive systems. Thus, economic reform may have an important part to play in resolving problems of economic imbalance. At the same time, it should be noted that while enterprises remain relatively unresponsive to price and profit considerations, decentralization can result in the abandonment of traditional means of macroeconomic control without their being replaced by new means of control. Thus, in the interim period, and particularly while excess demand conditions persist, the devolution of responsibility can greatly complicate macroeconomic management.

Correct prices are a necessary, although not sufficient, condition for establishing an efficient pattern of investment. Good cost-benefit analysis needs to be done, and this in turn requires that prices be set to reflect the opportunity costs, so an adequate reappraisal of investment will need the establishment of appropriate prices, exchange rates, and interest rates. However, it still may be difficult to ensure that costs and benefits are assessed adequately when the investor may have an interest in pursuing an unprofitable project. Here the authorities may have to rely on the banking system or independent auditors to control inappropriate investment.

Changing prices is clearly only one step towards reducing microeconomic imbalances and moving resources into the external sector. A depreciation of the exchange rate makes exporting more attractive and importing less so, and the increase in the price of a scarce commodity should encourage economy in its use and an increase in its production. The decision to change real economic activity in response to these signals needs to be taken partly by enterprises and partly by the planners, and correct prices can facilitate those decisions enormously. They can also help in determining which goods to import or export, as decisions based on correct prices should serve to reduce the incidence of microeconomic imbalance and the intensity of border restrictions.

It must be recognized that the authorities in planned economies often show considerable resistance to the establishment of more flexible systems of price formation. While recognizing the need to make major price changes periodically, say once every 10 or 15 years, more frequent adjustments, especially within a plan period, can create difficulties. In particular, price changes can make it more difficult to hold enterprises to account for their financial results, or even to ensure that they fulfill their physical plans. Moreover, since prices are changed administratively, the authorities may become subject to more pressure from below to make price changes to benefit particular units. The authorities, as in market economies, may also for social reasons have followed a policy of guaranteeing low prices for particular consumption goods and services or high prices to benefit certain producers. The entrenched nature of these decisions may make the required price changes politically difficult. Finally, given the usual existence of suppressed demand and shortages in these economies, the authorities may fear that any flexible price formation system will rapidly lead to open inflation.

Even where there is the will to set prices so as to reflect the relative scarcities facing the economy, this can be a complicated and difficult task. If domestic prices are market-determined, they can be brought into line with the true relative scarcities by adjusting the exchange rate to its market-determined equilibrium level and eliminating the bulk of border restrictions. However, in many planned economies most prices are determined administratively and bear only a loose relationship to the appropriate pattern. Here, the question of establishing an effective price formation system arises.

The pattern of domestic scarcities, and the need to reduce incentives for black or unofficial markets, would normally be one input into such a system. However, an adjustment program which reduced microeconomic imbalance would be expected to lead to a change in the pattern of domestic scarcities and therefore in relative prices. Since one goal of an adjustment program is to reduce reliance on border restrictions, international relative prices should be prominently reflected in the domestic system. The relative profitabilities generated by such a price system can be a guide both to domestic microeconomic adjustment and to a rational restructuring of foreign trade.

V. The Monitoring of Adjustment

1. The function of performance criteria

a. General

Performance criteria have two main functions: firstly, they help focus the decisions involved in negotiating the program, and secondly, they provide a standard against which the performance of the economy can be monitored. They constitute, for the member, objective indicators of the circumstances in which it can make a drawing on a specified date under a Fund arrangement, and they help ensure that the use of Fund resources will in fact be temporary. The observance of the performance criteria should give a sufficient assurance that the adjustment to restore viability to the balance of payments is taking place. Meeting the performance criteria thus combines the member's right to make an agreed purchase without further review, with an assurance to the Fund that the improvement in the economy is such as to provide the basis for the eventual repurchase. The failure to meet a performance criterion should be a signal that either adjustment is not proceeding as anticipated or the original adjustment path is now inappropriate. In either case, it points to the need for further discussions between the Fund and the authorities on the causes of the failure, and the reaching, if necessary, of additional understandings.

It should not be forgotten that performance criteria are only monitoring devices and do not represent the program as a whole. No set of performance criteria, however carefully designed, can be a substitute for a properly specified program. In this connection, it should be noted that preconditions or prior actions can also be essential in giving confidence that a program will be implemented and its objectives attained. Prior actions can be particularly important when a program involves major changes in regulations or controls with the purpose of improving supply conditions.

The effectiveness of performance criteria hinges on their ability to measure properly and promptly a member's progress toward attainment of the objectives of the program, or to signal deviations from it. In designing a set of performance criteria, a balance must be struck between vague understandings that give little assurance of progress in adjustment and overdetailed regulation that needlessly constrains the authorities. This is a complex task, requiring the exercise of a considerable measure of judgment. It can be impossible if the statistical base is inadequate, if the adjustment process is improperly understood, or if trust is lacking between the Fund and the member.

The importance of good faith, trust, and cooperation can hardly be overstated in any consideration of the effectiveness of performance criteria. 1/ Proliferating performance criteria, or defining them in increasingly intricate ways, can be no substitute for a joint understanding of the purposes of a program, or, more generally, for a properly specified program itself. If there is sufficient intent, ways can be found to circumvent even the most intricately defined performance criteria. To multiply performance criteria or make them more complicated could put the Fund in the role of an inquisitor or auditor, and might be incompatible with the relationship of trust which should prevail with the member. If this basis of trust is not present, then in all probability neither is the basis for an arrangement. This is not to say that there may not be circumstances where a detailed specification of performance criteria is useful. The authorities may in some cases prefer a lengthier list of performance criteria, possibly in order to assist them in ensuring that other domestic bodies follow the desired policies.

As the use of performance criteria has developed during the history of the Fund, the main considerations governing their selection have been: (1) that they should be capable of being expressed in quantitative or

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1/ See discussion on "Reporting Problems of Performance Criteria in Fund Arrangements--Legal and Policy Issues" (EBS/84/94, 4/26/84).

objective terms, (2) that actual performance can be compared to the criteria without undue delay, and (3) that the criteria should be able to serve as a basis for an appraisal of the economy as a whole. 1/ There are also other desiderata. To the extent possible, they should be variables which are under the control of the authorities. Furthermore, the guidelines on conditionality specify that they "will normally be confined to (i) macroeconomic variables, and (ii) those necessary to implement specific positions 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". 2/ Some of these aspects are discussed in more detail below.

The guidelines on conditionality do not specify that performance criteria should be uniform: on the contrary, they state that "the number and content of performance criteria may vary because of the diversity of problems and institutional arrangements of members." The uniformity of treatment to which Fund members are entitled does not relate to the configuration of performance criteria, but to the amount and speed of adjustment required of similarly situated members, and the access to the Fund's resources that they can expect. Nevertheless, to the extent that a uniform set of performance criteria can be used, the practice in the Fund has been to use them.

b. Monitoring policy instruments or monitoring policy results

In selecting economic variables as performance criteria, there is a strong presumption in favor of those that are directly under the control of the authorities. When this is the case, the authorities can be given greater assurance that, if they follow a given set of policies, an agreed amount of Fund resources will be available to them. This follows from the principle that a stand-by arrangement should be given in support of a set of policies, and not in return for a particular outcome.

Nevertheless, if its resources are to be used in accordance with the purposes of the organization and be properly husbanded, the Fund must have confidence that the policies adopted and monitored will contribute to the desired outcome, in particular an improved balance of payments and less pressure on domestic resources. Where it is difficult to find such policy variables to serve as performance criteria, the Fund must place more stress on monitoring outcomes. The implication in such cases is that the authorities must be prepared to adjust their policies as needed to achieve the goals of an adjustment program, if the latter is to be supported by the use of Fund resources.

1/ J. Horsefield, ed.; The International Monetary Fund, 1945-1965, Washington D.C., 1969, Vol II, p. 492.

2/ Decision No. 6056-(79/38), March 2, 1979, paragraph 9.

Even when this is the case, to the extent possible the specification of policies rather than outcomes would have to remain the norm, because the Fund is concerned with the efficient correction of microeconomic imbalances as well as macroeconomic ones, and it cannot be indifferent to the selection of policies. Thus, while the use of outcomes as performance criteria, and in particular balance of payments tests, can be useful and important means to monitor progress toward the objectives of a program in these economies, it does not remove the need to specify as far as possible the sorts of policies and policy instruments that underlie them.

c. The use of microeconomic performance criteria

Besides the use of prior actions mentioned earlier, one response to the difficulties discussed above might be to make more active use of microeconomic performance criteria, and there are cases where such criteria are appropriate. However, there are also many difficulties associated with intense reliance on monitoring the adoption of microeconomic measures. In the first place, while as a general matter the Fund is concerned with the attainment of microeconomic balance, it is not desirable for it to become too deeply involved at this level, as recognized in the guidelines on conditionality. Clearly the Fund staff may not have the time required for a detailed examination of all the issues involved. In addition, it may be both unnecessary and undesirable to specify microeconomic actions too closely. If microeconomic balance is maintained, particular sectoral outcomes can fluctuate considerably, provided that such changes compensate each other and thus do not affect macroeconomic balance.

A second reason for a reluctance to make extensive use of microeconomic performance criteria is that they could be very numerous. The proliferation of performance criteria can weaken their effectiveness. While the breach of any one of a set of four or five key macroeconomic performance criteria can be clear evidence that a program is no longer on track and warrant the interruption of disbursements, the breach of one of a large number of microeconomic criteria cannot carry the same weight. Thus, with an unduly large number of performance criteria, the Fund would be likely to find itself too often in need of having to make a discretionary judgment as to the severity of the failure to meet the performance criterion, and whether it could countenance a drawing if, say, 16 out of 20 targets were met. As a result, the performance criteria would lose their character as clear and unambiguous signals as to the circumstances under which drawings could be made. The difficulty of making this judgment is compounded when there are problems in determining with reasonable certainty whether some particular measure has actually been taken or, having been taken, has been effectively offset or neutralized through some other action.

As discussed further below, the use of review clauses can often be more appropriate than a proliferation of formal microeconomic performance criteria. A review can examine performance in a number of microeconomic policy areas on the basis of an agreed and quantified program. It allows a judgment to be made about the adequacy of these policies without making the continuation of the program dependent on the likely need for waivers of a few microeconomic performance criteria. Of course, as already mentioned, there may be cases where the authorities prefer to make drawings subject to a number of microeconomic performance criteria, as this can help them to specify their program and to convince others of the need to implement particular measures. In some cases, such a use of microeconomic performance criteria would correspond to the circumstances envisaged in paragraph 9 of the guidelines on conditionality, i.e., "when they are essential for the effectiveness of the member's program because of their macroeconomic impact."

2. Financial programming

a. General

Financial programming is normally an integral part of the design of adjustment programs. It consists of the quantification of the financial policies and consequent flow of funds through economic sectors, and in particular the banking system, that are associated with the desired improvement in the balance of payments and the rate of inflation. This quantification forms one of the bases for the establishment of ceilings for domestic credit extension, for credit to the government, for the contraction of external debt, and sometimes for setting the floor on net international reserves that normally act as performance criteria in Fund programs.

Financial programming is based on the assumption that there is a relatively stable relationship between financial variables (such as money and domestic credit) on the one hand, and nonfinancial variables (such as real national income and prices) on the other hand, and that the monetary authorities can control some of the financial variables so as to affect the real side of the economy. Neither of these propositions is at all self-evident in planned economies, and so the application of financial programming to them needs to be examined critically.

The policies that are quantified in the financial programming exercise, in particular domestic credit expansion and changes in the exchange rate, are among the primary instruments used by the authorities in market economies to improve the balance between the availability and use of resources in the economy. A Fund-supported adjustment program is not limited to understandings on these policies, but also entails supporting commitments in respect of other policies that are required to bring about the desired results. Even though the monetary and fiscal authorities in the strict sense carry the bulk of the responsibility for ensuring the success of an adjustment program in a market economy, specific undertakings may be required from other parts of the government for there to be an assurance that the adjustment program can be carried out as planned.

These considerations are particularly relevant in the economies considered here. Credit and exchange rate policies are usually not the principal means of reducing economic imbalances. As discussed in the previous section, such instruments as wage and investment policy and the physical plan itself, along with the more general and pervasive administrative guidance in the economy, are usually much more important than monetary policy in the strict sense. As a result, the monetary authorities proper take less responsibility for the overall outcome of economic policy.

This means, of course, that an adjustment program in a planned economy cannot rely on credit and monetary policy to the same extent as it does in a market economy. Understandings on policies need to be reached with authorities other than the central bank if there is to be confidence that adjustment will proceed as planned. This does not in itself preclude the use of the monetary magnitudes derived from financial programming as monitoring devices, whose triggering warns that all is not following the agreed schedule.

Similarly, the fact that monetary policy is not usually the primary, or even a major, determinant of real economic behavior does not rule out the use of financial performance criteria. The situation is analogous to that of fiscal policy in a market economy. There are few countries where the stance of fiscal policy is determined by the amount of bank finance available to the government. The causality usually works the other way round, with the fiscal gap determining the amount of bank financing. Nevertheless, fiscal performance criteria have a clear role to play in monitoring the development of fiscal policy. No program would normally rely on these fiscal ceilings to ensure the correct orientation of fiscal policy; instead programs specify in some detail the fiscal measures the authorities intend to take to meet these ceilings. 1/

1/ The following quotation is also relevant in this context: "Credit expansion is subject to the responsibility of the banking system. It may be difficult, perhaps in some circumstances humanly impossible, for the system to withstand demands for credit from the government or from other insistent borrowers; and in some circumstances, the desire to make public development expenditure, or to construct private factories, may be considered, from many points of view, the cause of the expansion in the economy. But for purposes of monetary analysis and monetary policy there is a clear gain in clarity if the responsibility is pinpointed on the credit expansion. The economic development could also have been financed by higher taxes or by a foreign loan. The factories might have been built by restriction of consumption or by the repatriation of capital. In all these situations, the desire to spend for a particular purpose would not have led to a payments problem. In a real sense the credit expansion is the cause of the payments problem." (J.J. Polak, "Monetary Analysis of Income Formation and Payments Problems", in IMF, The Monetary Approach to the Balance of Payments, Washington, D.C., 1977, p. 27).

Still, as discussed further below, less reliance can generally be placed on financial indicators in these economies than in market economies. This is because in both theory and practice the relationship between financial and real variables is less stable, and less predictable. Thus, a particular financial outcome may be associated with a range of outcomes in the real economy. Furthermore, the controls and regulations governing the supply and use of financial instruments may change during the monitoring period, altering the relationship of financial aggregates to outcomes.

b. Credit ceilings and subceilings

The economies discussed in this paper are frequently characterized by disequilibrium on the money market. Actual holdings of money by both the population and by enterprises are often greater than desired. This monetary disequilibrium reflects that prevailing on other markets: the widespread excess demand for goods and foreign exchange is mirrored in the excess holdings of money. Neither prices nor foreign trade are allowed to play an equilibrating role.

In normal circumstances this does not mean that the financial consequences of a given set of policies cannot be forecast. The authorities normally understand the behavioral relationships sufficiently well to be able to project the monetary accounts that will accommodate a given plan and the specific policy actions they intend to undertake. In fact, the financial plan is often used as a means to monitor the fulfillment of the physical plan. The financial accounts provide the authorities with early warning signals when policies leave the planned course. One implication of this is that credit policy, to an even greater extent than in other economies, cannot be set independently of, or without a full understanding of, the underlying policies influencing the real economy.

The problem occurs when an effort is made to conduct monetary policy in accordance with the plan at a time when the measures directly affecting the real economy have shown themselves to be inadequate. For example, if the authorities' measures to restrain investment turn out to be inadequate to achieve their target, one of the consequences in these economies would be an excess demand for credit by investors above the planned level. If the monetary authorities refuse to supply credit for the excess investment projects, under normal circumstances other sources of financing will be found. These will often include the running down of money holdings, the use of financial resources earmarked for other purposes, and the involuntary extension of credit by suppliers when the investor delays the payment of bills. With the possible exception of the first option, these approaches are normally illegal, but in practice they prove difficult to stop in times of financial stringency. Thus, if credit policy is kept on course, possibly with the purpose of meeting a performance criterion, at a time when developments in the real economy are more expansionary than planned, the velocity of circulation may increase to the extent that money holdings are run down or payments discipline may break down if the other approaches are followed.

Neither of these outcomes is unique to these economies, as is clear if it is noted that, functionally, the breakdown in payments discipline is equivalent to the accumulation of domestic payments arrears by a government unit or public enterprise in a market economy.

An increase in the velocity of circulation as excess money holdings are reduced is a normal part of the process of correcting the overall imbalance in a planned economy, and as such, would normally be welcomed as an outcome of the program. Furthermore, financial stringency may induce enterprises to reduce their expenditures or become more efficient, or both. The undesirable responses of enterprises to a tighter monetary policy, i.e., an unscheduled diversion of funds or a breakdown in payments discipline, are not so much an indication that monetary policy is too tight as a sign that the adjustment in the real economy that is needed to prevent these phenomena occurring has not taken place.

Failure to pay suppliers may be indicative of a need to close some inefficient enterprises, or restructure production in some other way. If measures to control the level of investment can be strengthened, their effect on demand will reduce the pressure on the payments system. The point is that the financial system does provide good signals of untoward developments in the real economy: however, a program needs a mechanism whereby the authorities can introduce changes in the real economy in response to these signals.

While tight credit can be expected to lead to an increase in velocity, this process has an end. If there are no means of payment other than those supplied by the monetary authorities, excess liquidity can be eliminated by sufficiently severe credit restraint. In these, like other economies, equilibrium on the money market is the counterpart of overall equilibrium on other markets combined that is an aim of a program. However, the attainment of balance on the money market will normally require substantial change in the real economy. Nor is it necessarily possible in practice to forecast what equilibrium money holdings will be, particularly if the economy has been in a state of disequilibrium for a long time.

While the behavior of monetary aggregates in a planned economy provides some indication of developments in the real economy, the observance of credit ceilings cannot provide the same assurance that adjustment is fundamentally on track that it does in a market economy. The basic balance sheet identity that equates changes in money holdings outside the banking system to the sum of changes in net foreign assets and net domestic credit applies to both market and planned economies. However, even if money holdings have been observed to have been a stable function of certain macroeconomic magnitudes in the past, the theoretical basis does not give confidence that this relationship will remain stable in the event of a tight money policy. When there are excess money balances, the velocity of money can be expected to increase if the corresponding credit aggregate is used as a control variable. If the increase in velocity could be predicted with a reasonable degree of accuracy and there was an assurance that internal payments arrears would not accumulate, this would pose no problem. From a general perspective, velocity can be difficult to predict and arrears can arise in all types of economy. The difficulty in forecasting velocity and the incurrence of internal arrears tend however to be more prevalent in planned economies during periods of tight monetary policy and therefore there is less assurance that the behavior of credit mirrors the behavior of spending. 1/

One possible approach to the problem of the uncertain behavior of money, and in particular enterprise deposits, is to define the credit ceiling on a net basis, thus netting out enterprise deposits from total credit in the same way that government deposits are usually excluded. This approach would require the banking system to reduce credit to the economy to the extent that enterprise deposits fall below the predicted level. While in certain programs, unpredictable financial aggregates have been excluded or netted out from credit ceilings, it would seem inadvisable to treat the whole enterprise sector on a net basis. Firstly, enterprise deposits are not under the direct control of the authorities in the same way that government deposits are. Secondly, the treatment of the public sector on a net basis could permit an undesirable buildup of excessive liquidity at the enterprise level during the program period. Thirdly, the more that is netted out, the greater the ability and temptation in some of the economies considered here to meet the ceiling solely through the use of restrictions. Thus a credit ceiling expressed as the sum of cash outside banks plus net foreign liabilities might be met by restricting wage payments, blocking savings accounts, imposing restrictions on imports, and mobilizing goods for exports. Such an approach would place the burden of adjustment on the household and external sectors, while leaving untackled the fundamental problem of demand generated by the enterprise sector. While such restrictions might also be used to meet more broadly defined credit ceilings, the presumption is that the latter would better monitor developments in the economy by more accurately reflecting the components of demand. In some market economies, the definition of the credit ceiling in terms of narrow money plus net foreign liabilities is based on the control that this magnitude exercises over the level of domestic demand. In planned economies, this is not necessarily the case, as both narrow money issue and net foreign liabilities can be changed without necessarily affecting the level of domestic imbalance.

Another method of tackling the problem might be to block part of enterprises' deposits. This would make measured velocity more predictable by preventing a running down of deposits, although it would not in itself resolve the problem of a breakdown in payments discipline.

1/ It is of course true that velocity does not always behave as expected in market economies. However, the underlying difference with a planned economy is that theory leads us to expect a stable or predictable velocity in the market economy, whereas the opposite is true in the planned economy with excess money balances.

However, a reduction in excess deposits is a desirable part of an adjustment program, and such a blocking would leave the problem of a monetary overhang unresolved at the end of the program period. Furthermore, it might undermine enterprises' willingness to generate financial surpluses, something which is desirable both as part of an adjustment program and over the longer run if the authorities wish to make greater use of indirect instruments of economic management.

While credit restraint cannot ensure certain changes in the real economy, it can be a step toward and a consequence of both expenditure restraint in particular and a reduction in economic imbalance in general. The various measures discussed in the previous section of the paper should have an impact on the need for credit by the economy. As enterprises, individuals, and the government restrain their expenditures and increase their savings, and as resources are used more efficiently and are moved into the balance of payments, the net demand for bank credit will decline. 1/ Thus, credit restraint will normally be an integral part of an adjustment program. The broader the credit aggregate considered, the broader the expenditure it will reflect. Nevertheless, it should be noted that there is rarely a market mechanism for allocating credit in these economies, and thus there is less assurance that tighter credit flows will be allocated to the most efficient enterprises. In fact, unless steps are taken to prevent this outcome, the credit needs of failing enterprises may pre-empt the credit expansion that would be more efficiently channeled to the more dynamic and profitable enterprises. In these circumstances, the supply response of the economy to the financial program would be weakened and the amount of demand restraint required for a given adjustment target would be increased.

Subceilings on credit to the government or the public sector are used in Fund-supported programs to ensure that the operations of the government contribute to the reduction of the imbalance. Within the overall credit ceiling, the fiscal subceiling also ensures that the public sector does not preempt all available credit. In many of the economies dealt with in this paper, the public sector constitutes the overwhelming bulk of the economy, and there may therefore be less cause for special measures to guarantee a flow of credit to the private sector.

In some cases, the operations of the government proper can be a major source of imbalance in a planned economy as in a market economy. Excessive expenditures on investment, transfer payments, or subsidies may contribute to domestic disequilibrium and need to be corrected in the context of a Fund-supported adjustment program. In some cases, these policies may lead to a budget deficit whose monetization has negative consequences, but more often the vagueness of the dividing

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1/ For a more detailed discussion, see Mark Allen "Adjustment in Planned Economies," Staff Papers, Vol. 29, No. 3 (September 1982), pp. 398-421, and Thomas A. Wolf, "Economic Stabilization in Planned Economies: Towards an Analytical Framework," Staff Papers, Vol. 32, No. 1 (March 1985), pp. 78-131.

line between the finances of the budget and those of public enterprises will make it difficult to isolate the consequences of fiscal policy for the financing of the budget proper.

This need not present a problem for the monitoring of fiscal developments if adequate data are available on government and public enterprise finances and on the transactions between them. But if such information is not available, there is the possibility that any narrow fiscal ceiling can be met by undocumented transfers between the two parts of the public sector. When this can occur in market economies, the fiscal subceiling is often placed on the public sector as a whole. A narrow fiscal subceiling is thus most likely to be useful when enterprises are relatively independent of the government, since, in these cases, there is more chance of unscheduled levies on enterprises being reported. Another situation where such a subceiling might be used would be one where the government feared that arbitrary levies on enterprises would jeopardize the decentralization they were trying to achieve.

In conclusion, credit ceilings do have a role in monitoring the progress of Fund-supported adjustment programs in planned economies. They are both instruments and indicators of expenditure restraint in the economy as a whole. Their observance, however, does not give the same assurance that adjustment is on track as it does in a market economy: if sufficient measures have not been taken to reduce expenditures, credit ceilings can still be observed if they are accompanied by the unscheduled running down of deposits, the use of credit from nonbank sources, or the breakdown in payments discipline. In that case, these phenomena will indicate that the program is not on track. It may be possible to draw up performance criteria to cover some of these other magnitudes; however, in some cases additional performance criteria may needlessly hamstring the authorities or encourage a proliferation of controls without tackling the fundamental problems. Thus, while a ceiling on withdrawals from deposits by enterprises may serve to reduce the possibility of increased velocity or excessive expenditure from that source, and as such may have a place in a program, it could also increase the amount of direct intervention in the economy, reduce confidence in the currency, and inhibit a strengthening of market mechanisms. If credit ceilings cannot by themselves give an assurance that adjustment is on track and that needed measures are being taken, and if it is not practicable to give this assurance by supplementing them with a few other criteria, then reliance must be placed on review clauses.

c. Foreign borrowing ceilings

The rationale for ceilings on foreign borrowing applies to both market and planned economies. Firstly, borrowing during the program period should not exceed the country's debt-bearing capacity or result in an unsustainable debt-servicing burden at the end of the program period. Secondly, the program's control over the level of domestic expenditure should not be subverted by excessive financing from abroad.

As far as the coverage of a debt ceiling is concerned, as in a market economy, it would normally cover public and publicly guaranteed borrowing, as well as borrowing by financial intermediaries. Similarly, the same considerations governing the contracting of medium- and long-term debt would also be expected to apply. The case may be slightly different for ceilings governing short-term debt. In market economies these used often to be excluded from ceilings on the grounds that most short-term borrowing was autonomous, commercial, and trade-related. Recent practice, however, has been to broaden the scope of the foreign borrowing ceiling to include short-term loans. This recent practice fits well in an economy where the government exercises much direct control over the activities of the banking system, in such cases, there is greater scope for the use of short-term borrowing for financing the balance of payments and therefore the practice of including short-term borrowing in a debt ceiling seems advisable.

d. Balance of payments tests

In market economies, a balance of payments test, i.e., a floor under the level of net foreign assets, can be used as a way to ensure a flexible exchange rate policy. Credit ceilings are established on the basis of assumptions about the rate of inflation, the demand for money, the supply of goods for export, and the demand for imports. In normal circumstances, observance of the credit ceilings will have a clear implication for the development of the balance of payments. However, when the exchange rate is flexible, credit ceilings are often accompanied by balance of payments tests. This is particularly important in cases with an inappropriate exchange rate, perhaps brought about by relatively rapid domestic inflation, which might lead to an undesirable balance of payments outcome, as demand is channelled toward the external sector. In these circumstances, a balance of payments test is designed to ensure that the authorities purchase foreign exchange from domestic units. To do this, they will either have to adopt additional adjustment measures to reduce the demand for foreign exchange or have to offer a sufficiently attractive price for foreign exchange in terms of domestic currency.

At first sight, the considerations governing the use of a balance of payments test in a planned economy appear to be different. As discussed in previous sections of this paper, progress in reducing domestic disequilibrium in a planned economy is not automatically translated into a direct improvement in the balance of payments or a reduced need for restrictions on external transactions in the way this occurs in a market economy. Since a Fund-supported adjustment program is always intended to strengthen the external sector, a balance of payments test provides a means of ensuring that some of the improvement in the balance of the economy is channelled into the balance of payments. It is not necessarily envisaged that this be achieved through a flexible exchange rate policy, although on occasion this may help, but that the authorities take the measures that work in their system to bring about the desired external result.

Looked at more closely, the rationales for the use of balance of payments tests in the two kinds of economy are not dissimilar. In both, the problem addressed is the possibility that the measures already adopted have failed to bring about the desired improvement in the balance of payments. To rectify this, the test encourages the use of the most effective instrument in the market economy, i.e., a change in the exchange rate. In the planned economy, the test does not favor any particular instrument, but merely obliges the authorities to take the necessary steps to bring about the desired balance of payments result.

A balance of payments test can be viewed as an example of making an outcome, rather than a policy instrument, into a performance criterion. It therefore runs the risk that the outcome may be achieved even when inappropriate policies have been adopted. The injunction in Fund programs against the imposition of external sector restrictions is designed to reduce this danger. However, since it can be difficult to monitor the imposition or tightening of restrictions in some planned economies, the use of a balance of payments test in isolation runs a danger of promoting undesirable policies.

To minimize this danger of repressing external imbalance by the resort to restrictions, it is important that balance of payments tests not be used as the sole monitor of adjustment. A balance of payments test can be a useful complement to the other measures and performance criteria in the program which are designed to bring about a reduction in the overall imbalance in the economy. If sufficient measures are taken to reduce the total imbalance, then there will be some assurance that the balance of payments test will not be met by increasing restrictions.

The precise formulation of any balance of payments test will depend on the circumstances of the country and the objectives of the program. It will also depend on the possibility of obtaining prompt and reliable data. In some, the focus has been on the overall balance of payments, while in others the objective has been some level of current account balance, sometimes approximated by the trade balance. 1/ In many cases, the capital account will be effectively constrained, either by a foreign borrowing ceiling or by the difficulty of finding lenders: in these cases, there may be little difference between tests focusing on the overall or current account balances.

In all cases of use of a balance of payments test, there may be serious problems of forecasting balance of payments developments, since both current and capital account elements may be subject to a large degree of uncertainty, partly emanating from exogenous factors. Because of this, a balance of payments test does not provide an infallible signal of the need to interrupt drawings. This problem has occurred relatively frequently in recent programs with all kinds of members, especially when

1/ On account of the particular institutional arrangements prevailing in intra-CMEA trade, the trade balance in convertible currencies only was used.

satisfactory debt rescheduling or the reduction in arrears is made a performance criterion. In these cases, as in the use of balance of payments tests in planned economies, the most satisfactory solution has been found to lie in the use of review clauses to investigate the causes of any departure, rather than the abandonment of the performance criterion.

3. Other performance criteria

a. Restrictions

It is standard practice for the performance criteria in all Fund arrangements to include a clause stating that the member will not introduce new, or intensify existing, restrictions on payments, or introduce new, or intensify existing, trade restrictions for balance of payments purposes. This clause underlines a major principle of a Fund-supported program: that fundamental adjustment in the balance of payments cannot be achieved by imposing restrictions, and indeed a program should make it possible to reduce reliance on such measures. Not only should the measures specified in the program make it possible to reach the desired balance of payments outcome without the imposition of trade or payments restrictions, but their intensification is normally a sign that the program has gone off track.

In a planned economy, measures to reduce the degree of domestic disequilibrium are the fundamental way to ensure that the system's restrictiveness is lessened. From this point of view, a reduction in restrictions is at least as important a part of a program for a planned economy as it is for a market economy. However, as discussed in SM/82/82, the identification of restrictions, let alone an assessment of changes in their restrictiveness, poses serious difficulties. In these circumstances, the standard performance criterion relating to restrictions may not be as effective in signalling the progress of adjustment as in a market economy.

Without wishing to repeat the arguments used in the above-mentioned paper, it might be noted that the problem of monitoring restrictions in planned economies stems only in part from the nature of the economic system. While it is true to some extent that the pervasiveness of administrative intervention makes it difficult to distinguish a border restriction from the intervention needed for the economy to function normally, another part of the problem stems from the opacity or lack of detailed information often supplied about intervention at the border. If as much information were supplied about the instructions and prohibitions applied to the foreign economic transactions of units as is usually available in most other member countries, the difficulty of making the restrictions clause into an effective performance criterion would be much reduced. There may therefore be scope for more effective indicators of restrictions than have been used hitherto. As it is, the restrictions clause often needs to be supplemented with review clauses if it is to be a useful monitoring tool. Even with these difficulties, there are restrictions, such as the incurrence of payments arrears, whose imposition presents no particular identification problem. In other cases, there may be evidence from partner countries, such as the imposition of countertrade requirements.

b. Other performance criteria

Fund-supported adjustment programs often include performance criteria to monitor the implementation of specific policies that are crucial to the success of the program. As mentioned, the guidelines on conditionality provide that these may be microeconomic performance criteria when appropriate. Examples of these may be schedules for the elimination of payments arrears or some other restriction, for changes in the exchange rate, or for some other policy action that lends itself to this treatment.

There may be scope for using such performance criteria in programs with planned economies to monitor particular policies that are central to the success of an adjustment program. It is possible to envisage the use of such indicators to monitor the progress of a price reform, or to ensure an effective liberalization of the restrictive system. In practice, this will depend on the availability of reliable and prompt statistics on the magnitudes in question, statistics that may not always be published in the country itself. For example, data on pending applications for foreign exchange or transactions of any equalization fund may be very useful in this regard.

The performance criteria described so far have been similar, if not identical, to those used in market economies. If used carefully, they can provide an indication that adjustment in a planned economy is on track, but they cannot normally by themselves give the same degree of assurance as they do in market economies. No set of quantitative performance criteria can give this assurance when market mechanisms are suppressed, but it is possible that some indicators which have not been used hitherto could do a better job than those described. The staff is alert to this possibility, and has considered and rejected several options during the course of designing programs with specific members.

Since credit ceilings are designed to monitor progress in reducing domestic demand to a sustainable level, it may be wondered whether or not there are indicators that would allow this progress to be monitored more directly. The main components of final domestic demand are investment and consumption expenditure, so one possibility would be to find indicators that reflect developments in these variables. Monthly indicative ceilings have been established for (real) cash incomes of the population and for investment expenditure, which together were believed to mirror the behavior of consumption and investment. There are other indicators of adjustment which might also be used in this context, for example, wage payments, stocks, or the value of unfinished construction. It might also be possible to constrain the level and composition of governnment or public sector expenditure directly.

Nevertheless, there can be problems with these indicators substituting for more traditional performance criteria. Firstly, the data may not be available on a sufficiently timely basis, or they may be subject to extensive revision. Secondly, they may be considered too intrusive into sensitive policy areas, for example, wages policy. It may be one thing for a program to contain understandings on wages policy, but to use wage payments as a performance criterion may open the Fund to the criticism of excessive interference in the political process. Further, they may be insufficiently flexible. For example, if demand were greater than programmed, this might not matter if it was associated with an even greater excess of supply. As another example, if a ceiling on consumption were missed by a small margin, the objectives of the program would not necessarily be compromised if the authorities were prepared to take compensating measures elsewhere, say by reducing the level of investment. In this case, a waiver of the performance criterion would be in order, on the grounds that a third indicator, total expenditure or total absorption, was still within the programmed limits. A better performance criterion might then be this magnitude if adequate data existed, or perhaps the sum of the consumption and investment indicators.

In principle, developments in investment and consumption should also be reflected in financial indicators, and on a more timely basis. Wage payments and investment expenditures need to be financed, and this can to some extent be monitored by looking at developments in credit and money. The authorities in many planned economies collect a large volume of other monetary statistics that might be exploited in this context. One example might be more detailed information on enterprises' finances, which could allow a monitoring of the progress in reducing the number of unprofitably operated enterprises and the volume of their losses. However, further analytical work would need to be done by the staff once such data were made available to explore whether they could be used as performance criteria.

The staff is open to the possibility of using other performance criteria in these economies when this can be done effectively. The extent and nature of administrative intervention means that a wide range of policy instruments is used in these economies to achieve a program's objectives. If the authorities prefer to have supplementary performance criteria on some of these magnitudes, the staff is quite willing to experiment with their use, providing the performance criteria meet the standards mentioned at the start of this section of the paper.

4. Review clauses

As the above discussion has shown, quantitative macroeconomic performance criteria, while useful, will not give the same assurance that adjustment is on track in a planned economy. In particular, there are circumstances in which credit ceilings can be met without satisfactory progress in reducing domestic expenditure levels having taken place, and in which a balance of payments test can be satisfied through the intensification of border restrictions. Furthermore, there may be insufficient information available at a distance to give confidence that the performance criterion governing restrictions is being observed. To ensure effective monitoring of the program, these performance criteria need to be supplemented by periodic reviews.

Reviews provide an opportunity to establish whether agreed measures have been taken, if they are having the expected effects, what factors account for any divergence, and what additional measures need to be taken. They allow a more detailed monitoring of policies, which is necessary in an economy with such extensive microeconomic intervention by the authorities. Reviews can be more effective than a proliferation of microeconomic performance criteria in determining progress at this level. Finally, they allow for a critical appraisal of the assumptions underlying the use of other performance criteria, both of the behavior of monetary variables, and of exogenous factors that might affect outcomes.

It might be asked whether the use of other performance criteria should be forgone altogether in favor of the sole use of review clauses. This would not seem desirable. It is useful to have the quantitative guidelines provided by the other criteria, both to ensure a disciplined negotiation of the program and to give pointers to the expected progress of the adjustment effort. The observance of the other quantitative and qualitative performance criteria should create a presumption in favor of drawing, if other magnitudes are behaving as expected. Otherwise, review clauses can tend to weaken the advance assurance to the member of the circumstances in which drawings will be permitted. Finally, making purchases dependent on reviews means that a considerable measure of judgment needs to be exercised at frequent intervals by the Fund as to whether the policies in place are adequate. In these economies, however, there appear no technical means of escaping such an exercise of judgment on the broad range of the authorities' policies.

VI. Collaboration with the World Bank

For those countries with planned economies that are members of both the Fund and the World Bank, and particularly those involved in a policy dialogue with the Bank or receiving Bank assistance, there is considerable scope for collaboration between the two institutions. In its discussions with planned economies on steps to improve resource allocation, however, the Bank faces many of the same problems as the Fund, and similar difficulties impede the formulation of recommendations.

The Bank's sectoral analysis can be a particularly useful complement to the Fund's macroeconomic analysis of these economies, and both institutions are concerned with the reduction in microeconomic imbalances. From its sectoral and project work, the Bank can illuminate particular problems and provide the specific information on certain microeconomic policies. However, the Bank is not involved to the same extent in all sectors of the economy.

The Bank's country economic work and the associated policy dialogue provides another perspective on resource allocation problems. As with other members in which it is active, the Bank assesses the investment programs and strategies of planned economies, and can thus help the Fund to ensure that investments are well selected and will promote development and strengthen the balance of payments. In the case of Yugoslavia, the Bank gave a structural adjustment loan in parallel to the financial assistance given by the Fund. In this case, it paid particular attention to certain economic policy problems recognized by the authorities, including banking procedures, energy and transportation policies and the reform of price legislation. In other planned economies, the Bank's involvement is less intensive and is primarily in the form of project or sectoral assistance. Nevertheless, there is scope for broader World Bank involvement in these countries when the authorities are interested in taking major steps to improve resource allocation mechanisms.

VII. Points for Discussion

In their interventions, Executive Directors may care to address some of the following issues:

-- The diversity of the planned economies indicates the need to follow a case-by-case approach to program design;

-- Programs should aim at reducing domestic imbalances as well as the external disequilibrium;

-- Programs need to reduce microeconomic imbalances in order to promote a more rational trade system and allocation of resources;

-- All those bodies essentially involved in the formulation and execution of economic policy need to understand fully and be committed to the aims of an adjustment program if it is to be successful;

-- Adequate information on policies, often including broad information on those of a microeconomic nature, must be provided if programs are to be designed properly;

-- Programs need to contain a full specification of policies; reliance cannot be placed solely on the monitoring of outcomes;

-- The fundamental thrust of programs in planned and market economies must be the same: the moderation or containment of expenditure within the limits of available resources and the promotion of efficient resource allocation;

-- While the financial programming framework has a role to play in the analysis and monitoring of imbalances in planned economies, the staff should work closely with the authorities to supplement this approach with other alternative indicators of imbalance;

-- Programs with planned economies would normally continue to use credit ceilings as performance criteria, but these should continue to be supplemented by review clauses and, where appropriate, balance of payments tests;

-- While microeconomic performance criteria have a role to play in some programs, review clauses will normally be a more suitable instrument to ensure that microeconomic policies are adequate;

-- The establishment and maintenance of price systems that reflect relative scarcities and allow a reduced reliance on border restrictions are essential parts of effective adjustment programs;

-- Price reform needs to be complemented by measures to make enterprises more responsive to relative prices and considerations of economic efficiency, in particular by holding management accountable for an enterprise's financial performance;

-- The Fund should collaborate closely with the Bank in designing adjustment programs for those planned economies in which the Bank is closely involved in policy dialogue and lending;

-- The staff will continue to approach the question of program design in planned economies with an open mind and will be prepared to try alternative solutions on a case-by-case basis.