How Successful Are IMF-Supported Adjustment Programs?

SUSAN SCHADLER

How successful have countries been during adjustment programs? While most have seen a quick turnaround in their external accounts, a sharper focus on medium-term sustainability, firm nominal anchors, and better coordination of fiscal and monetary policy would help to raise growth and stamp out inflation.

THE 1980s were marked by severe strains in the international economy. External financing slowed to a trickle for many countries, while primary commodity prices dropped sharply. As a result, IMF lending rose to unprecedented levels during the late 1980s and early 1990s. Moreover, conditions in the countries borrowing from the IMF were, by historical standards, unusually weak: fiscal and external imbalances were large; output was often falling; frequently, inflation was high. In most countries, these weaknesses were not simply cyclical but resulted from deep-seated structural distortions.

These circumstances posed considerable challenges for the design of "conditionality"—the policies that a country agrees to follow as a condition for borrowing from the IMF. Conditionality had to be pushed beyond the traditional reliance on demand restraint. For countries that were addressing large debt overhangs or entrenched structural distortions rather than cyclical weaknesses in the balance of payments, reliance on demand restraint alone for the needed adjustment would have required an unacceptably deep depression of domestic demand. Thus, supply-side policies aimed at bolstering growth—such as reducing the role of the government and opening the economy to external competition—became an important part of conditionality. Also, conditionality began to focus more on the sustainability of policies over the medium term.

These issues were examined in a 1995 IMF study (see references) of the conditionality attached to 45 IMF lending arrangements approved between mid-1988 and mid-1991 for 36 middle-income countries. The study concluded that the conceptual approach to designing adjustment programs was sound, that most countries adhered reasonably well to their policy programs, and that most aspects of macroeconomic performance improved. The most striking gains were on the external accounts; developments in the key domestic targets—inflation, investment, and growth—were less impressive. These patterns prompted an examination of ways to strengthen the design of programs.

The setting and the strategy

Economic conditions at the outset of the arrangements were, almost without exception, dire. Most countries had debilitating underlying problems—severe institutional weaknesses, fiscal indiscipline, and weak external competitiveness. In these circumstances, many had been pushed to a crisis by a sudden outside disturbance, such as a deterioration in the terms of trade. Others had seen a gradual deterioration in the external accounts, erosion of external reserves, slow growth, inadequate savings and investment, and rising inflation (see chart). Typically, a country's first response was to borrow abroad, without addressing underlying problems. Countries usually sought IMF support as a last resort.

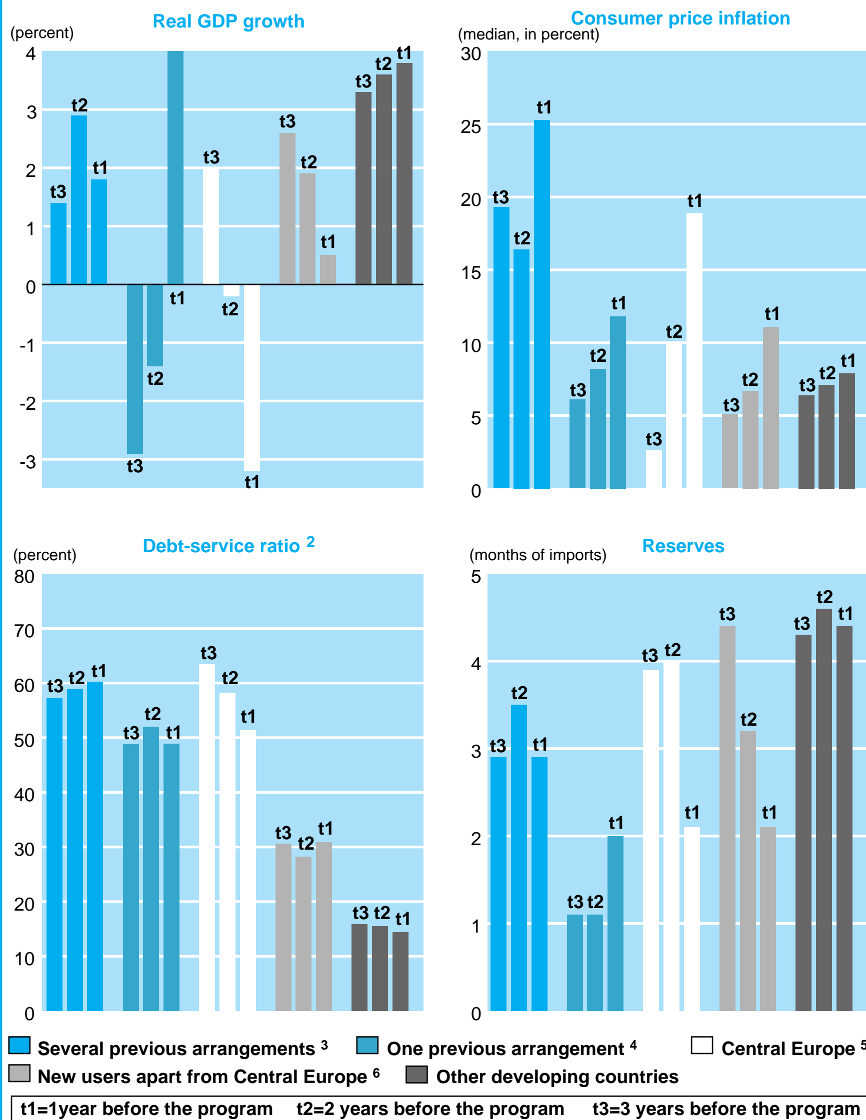
Although the countries shared severe external financing constraints, initial conditions did vary. Almost half of the countries had had at least two recent borrowing arrangements with the IMF; for these countries, trade imbalances had been narrowed in preceding arrangements, and remaining external problems largely reflected debt overhangs. In countries that were just beginning the adjustment process, external difficulties more frequently reflected an acute imbalance between what they absorbed and what they produced. In many Latin American and Eastern European countries, excess demand showed up in high inflation, but in many African, Asian, and Middle Eastern countries, inflation was low. The Central European countries brought a new dimension to the traditional diversity of initial conditions: in general, their need for, and commitment to, structural reform surpassed that in other countries. At the same time, the collapse of their principal export markets and a deterioration in their terms of trade made their adjustment unusually daunting.

The strategy for addressing macroeconomic imbalances had three prongs: (1) reining in domestic demand through fiscal and credit restraint; (2) implementing

Susan Schadler,
a US national, is Senior Advisor in the IMF's Policy Development and Review Department.

Initial conditions varied

Countries with IMF arrangements and other developing countries [1]



Sources: IMF Executive Board documents; and *World Economic Outlook*, various issues.

[1] Figures for other developing countries are a weighted average of calendar year data with weights corresponding to the share of each calendar year in t-1, t-2, t-3 of countries with arrangements, excluding Central Europe.

[2] Ratio to exports of goods and services before debt rescheduling.

[3] Argentina, Brazil, Costa Rica, Côte d'Ivoire, Ecuador, Haiti, Jamaica, Madagascar, Mali, Mexico, Morocco, the Philippines, Uruguay, Yugoslavia, and Zaïre.

[4] Algeria, the Congo, Egypt, Gabon, Nigeria, and Tunisia.

[5] Bulgaria, the former Czechoslovakia, Hungary, Poland, and Romania.

[6] Cameroon, El Salvador, Guatemala, Honduras, Jordan, Pakistan, Papua New Guinea, Trinidad and Tobago, and Venezuela.

structural reforms to promote a supply response and improve the efficiency of resource use; and (3) securing external financing to support the program (and often to clear external arrears). While this broad approach was suitable for virtually all countries confronting unsustainable external positions, the diversity of specific circumstances meant that the degree of reliance on each prong needed to be attuned to each country's circumstances.

Program developments

In most countries, macroeconomic performance improved during the arrangement and, in many, continued to do so afterward. Improvements were large in the external sector. In countries that started their arrangements in the midst of acute balance of payments crises (mostly the countries that had not had recent arrangements with the IMF), a marked improvement occurred quickly. In countries with less acute difficulties, underlying problems were addressed. Official reserves rose to more comfortable levels; about half of the countries that had had external arrears cleared them; some countries (particularly those that had had recent arrangements) benefited from large increases in capital inflows; and current accounts converged toward positions that could be financed by normal capital inflows.

There were disappointments, however, even in external developments—particularly in sub-Saharan Africa and Central Europe, capital inflows failed to materialize as projected; several countries did not fully resolve their debt overhangs and arrears; and, in most countries, strong export growth early in the program faded toward the end of the period reviewed.

Developments in the domestic economy were less impressive. A few countries (the former Czechoslovakia, Mexico, and Poland) sustained dramatic reductions of inflation from very high initial rates, but many continued to experience the moderately high inflation rates they started with; a few (Algeria, Hungary, Jamaica, and Romania) even saw inflation accelerate. For most countries outside Central Europe, there was some strengthening of growth and, on average, an increase in savings ratios. Still, no country shifted to a distinctly more rapid pace of growth backed by higher savings. Most worrisome was that few countries saw an increase in total investment as a share of GDP. On the brighter side, however, private investment rates rose, on average, as public investment rates fell, and the productivity of investment—as measured by the incremental capital-output ratio—rose.

Policy focus

In light of these developments, the review focused on the characteristics of policies supported by the arrangements and how they could be improved. The review examined whether policies were tailored to the particular needs of each economy, whether there was too much emphasis on reaching external objectives or a subordination of domestic objectives, and whether there was adequate focus on the sustainability of policies over the medium term.

Government budgets. Fiscal adjustment strategies were tailored, in several

crucial respects, to the specific nature of initial imbalances. Fiscal adjustment, on average, was targeted to come about equally from revenue increases and expenditure restraint. Planned expenditure cuts, however, were largest in the countries where the ratio of expenditure to GDP was the highest, while the opposite was true for revenue. Targeted changes in overall deficits were greatest in the countries with the largest initial imbalances.

In fact, fiscal adjustment was, on average, close to that targeted. With available data, however, and the short period considered, it is impossible to account precisely for the separate roles of discretionary policy change, exogenous influences, and cyclical factors. On average, spending restraint was somewhat greater than planned, and revenue increases were slightly short of target. Proportionately, restraint of capital spending was greater than that of current spending.

These observations suggest that fiscal adjustment strategies were sensitive to countries' initial conditions and policies were largely implemented as planned. However, programs were often not presented in the context of an explicit medium-term analysis of the potential for revenue mobilization, expenditure needs, and financing. It was, therefore, not possible to answer one critical question: how much of the gap between actual and sustainable fiscal deficits was closed over the program period?

One recommendation of the study is that programs should be based more explicitly on medium-term fiscal frameworks that consider the medium-term targets for money creation and inflation, the intertemporal dynamics of the government debt ratio, and the impact of fiscal adjustment on the savings-investment balance of the economy. Also, where data permit, programs should take fuller account of the effect of current decisions on future fiscal trends or prospects for investment and growth—for example, where protecting capital spending is important, where social expenditures have borne a large share of cuts, or where the efficiency of revenue measures is questionable.

Financial programs. The study found that targets for money supply growth were exceeded in two-thirds of the program years. About as often, inflation targets were missed by sizable margins. Most missed money targets did not reflect higher-than-targeted credit growth, but rather higher-than-targeted inflows of foreign exchange.

This echoes the earlier observation that programs more consistently achieved external objectives than inflation targets. The typical structure of financial programs—ceilings on the net domestic assets of the monetary authority or banking system and floors on the net international reserves of the monetary authority—is highly effective in achieving reserve targets but inherently less so in restraining money creation and reducing inflation. When inflation expectations are entrenched and nominal exchange rate appreciation is resisted, capital inflows can accommodate higher-than-targeted inflation. To help redress this limitation, programs should specify benchmarks for an appropriate monetary aggregate. Deviations from such benchmarks would signal dangers for inflation targets and the need for prompt policy responses, guided by the causes of the deviations and by the short-term trade-offs between building reserves, controlling inflation, and preserving competitiveness.

Financial market reform. Financial market liberalization, particularly the decontrol of interest rates and the introduction of auctions for government paper, progressed quite remarkably. As a result, real interest rates often rose from negative to positive levels—sometimes even to levels that could be considered excessive. In general, high real rates fell back to moderately low levels within one or two years.

The study considered ways to avoid high real interest rates even for short periods. Essentially, these involve ensuring that, as financial market liberalization and shifts in fiscal financing from bank to market borrowing create a market-clearing role for interest rates, the persistence of other distortions does not put excessive pressure on interest rates. Two issues are particularly important. First, programs need to focus on improving prudential controls, bank supervision, and the competitive structure of financial markets to minimize oligopolistic behavior and reduce pressure on interest rates from adverse selection by banks.

Second, programs must ensure adequate fiscal adjustment to avoid excessive reliance on tight credit for achieving inflation targets. Judging the appropriate mix of financial policies—even ex post—is difficult. Typical indicators of insufficient fiscal adjustment and excessive reliance on credit restraint—persistently high real interest rates, large capital inflows, or weak private investment—can occur for reasons unrelated to excessive credit restraint. Few of the countries reviewed showed clear evidence of excessive reliance on credit restraint. Nevertheless, further work on the development of indicators is needed.

Exchange rate as an anchor. Almost half of the countries reviewed used the exchange rate as a nominal anchor—that is, a fixed or pre-announced path for the nominal exchange rate. These were usually countries with inflation rates that were initially either very low or very high. By contrast, most countries with moderately high initial inflation (annual rates of 20–50 percent) chose to manage their exchange rates more flexibly. These differences reflected the choice between two possible short-term roles for the exchange rate—on the one hand, anchoring inflation expectations and disciplining policies, and, on the other, maintaining or improving competitiveness. In general, the countries that had an exchange rate anchor reduced inflation or maintained it at low levels. The cost was typically a loss of price competitiveness as inflation fell or stayed low, but was still above that in trading partners. In two countries—Argentina (1989) and Yugoslavia (1988)—an exchange rate peg was not adequately supported by other policies and proved unsustainable. Countries that chose a more flexible policy tended to see little decline or even increases in inflation, but, on average, saw some improvement in competitiveness.

The experience confirms the results of other studies that exchange rate anchors are effective in reducing high, or sustaining low, inflation when supported by macroeconomic discipline and when initial exchange rates are not misaligned. In a first-best world, where financial policies are sufficiently restrictive, there would be clear rewards to using the exchange rate as an anchor for a period of at least a few months to a year. In fact, policies are often not strong enough and a short-term trade-off between inflation and competitiveness arises; often the choice is dictated by the external constraint. The trade-off needs to be kept under review, especially in the face of adverse movements in the terms of trade or protracted loss of competitiveness.

When the exchange rate is used more flexibly, limits to the effectiveness of nominal depreciation to achieve real depreciations must be recognized. Real exchange rate rules—targets for the real exchange rate to guide nominal exchange rate policy—should be avoided. Decisions on whether to adjust nominal rates should take into account the prospects for needed support from fiscal policy and wages.

Structural reforms. All countries pursued structural reforms—typically

fastest and first in exchange, trade, and financial systems, and, in Central Europe, price liberalization. Reform of taxes, public spending, and, particularly, public enterprises and labor markets was slower. There was no evident pattern in the sequencing of reforms, which appears to have been a function more of political opportunities and administrative capabilities than optimal sequencing considerations. In some cases this may have led to problems, but they were not especially serious. In general, the analytical basis for comparing different sequences for removing distortions is weak, and insisting on specific patterns of sequencing may often have slowed or even obstructed structural reform owing to delays in taking politically difficult actions.

The experience suggests that, except when there are clear risks in a specific pattern of reform, it is best to move as rapidly as possible with reforms when they are technically and politically feasible and to channel any resulting tensions into a consensus for further change. Nevertheless, the costs of sequences of reforms that may prove particularly risky—such as financial market liberalization before adequate prudential controls and bank supervision are in place—need to be recognized and avoided.

Labor markets. Although widespread, labor market rigidities were addressed only to a limited degree. In many countries, real wages in the organized sector were not very responsive to labor market conditions. Backward-looking indexation (de facto or explicit) existed in many countries, especially those with high and intermediate levels of inflation. Modifying this practice was essential to lowering inflation, reducing real wages to market-clearing levels, and girding economies against disruptions from nonfinancial shocks. In most countries, the problem was recognized, but a political consensus for change could not be secured. Poor data and political sensitivities hampered an evaluation of the degree to which labor market and wage-setting practices constrained job creation, investment, and growth. Greater efforts are needed to collect wage and employment data, and, where possible, to apply analytical techniques common in industrial countries for judging whether real wages are excessive.

Saving, investment, growth

The study looked at possible causes of the rather weak development of savings during programs. The econometric evidence bears out the conclusions of other studies that the channels for policies to influence saving rates directly were limited. Changes in government savings had a direct effect on aggregate savings, although, on average, about half of any such change was offset by an opposite movement in private savings. Other systematic determinants of private savings—actual and expected growth rates and the terms of trade—were beyond the direct control of policies. The influences that were controlled most directly by policies—changes in real interest rates and exchange rates, financial reform, and pension reform—proved to have weak effects. Indeed the success of programs in attracting capital inflows and raising expectations about future growth may, in the short run, even depress private saving ratios.

There are several possible reasons for the sluggishness of investment and growth—slow growth of final demand, deficient savings (domestic or foreign) to finance investment, restraint on government investment, and the need to establish a track record to gain investors' confidence. A first perusal of the evidence suggests that the last of these—a wait-and-see tendency among investors—is likely to have been the strongest explanatory factor. Final demand generally picked up during the programs; countries that experienced large increases in the availability of foreign savings did not systematically see better outcomes for investment than other countries; and many of the countries that squeezed government investment the most saw the largest rebounds in private investment. The exploration of these issues clearly needed to be more exhaustive than was possible in the study, and follow-up studies were undertaken on the responses of investment and growth to adjustment policies.

Were strategies right?

In broad terms, the study concluded that the basic three-pronged approach was appropriate. The approach did place a strong emphasis on achieving balance of payments objectives, but this was inevitable in light of limited access to external resources and the generally dire balance of payments problems that brought countries to the IMF for support. Most programs appear to have pursued these objectives with sensitivity for the ultimate goals of economic policy—to improve living standards through higher growth. Fostering sustainable growth is invariably a protracted process requiring steadfast adherence to sensible policies over a long period. Thus, most programs aimed to secure immediate improvements in external finances as part of the process of establishing conditions for greater efficiency, saving, investment, and growth over the longer term.

Still, the study did identify several areas where program design could be strengthened. In general, programs would benefit, data permitting, from comprehensive medium-term scenarios that spell out consistent medium-term prospects for savings, investment, intertemporal debt dynamics, and the current account. This would help determine the adequacy of fiscal adjustment, realistic investment and growth goals, and the need for structural reform to cultivate an environment attractive to investment. With respect to financial policies, episodes of very high real interest rates underscore the importance of bank reform and adequate fiscal adjustment so as to avoid excessive reliance on credit restraint to rein in demand and contain inflation. The increasing number of countries for which disinflation is an important objective means that more attention needs to be given to establishing a nominal anchor in each program. In many circumstances, the exchange rate is best suited for this role, although firm money targets are useful when uncertainties about the equilibrium real exchange rate exist. Finally, programs need to extend the good record of structural change in exchange, trade, and financial systems to labor markets, tax policy, and public enterprise finances. F&D

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