III

Revolutions in Structural Adjustment

13

Lending for Adjustment and Growth

The goal of conditionality on IMF credit arrangements is to promote a combination of internal and external economic balance in borrowing countries. In its lending practices, the Fund seeks "to help members to attain, over the medium term, a viable payments position in a context of reasonable price and exchange rate stability, a sustainable level and growth rate of economic activity, and a liberal system of multilateral payments" (Guitián, 1981, p. 3). This description is essentially similar to the accepted definition of overall macroeconomic equilibrium. John Williamson, for example, has defined an exchange rate as being in "fundamental equilibrium" when it "is expected to generate a current account surplus or deficit equal to the underlying capital flow over the cycle, given that the country is pursuing 'internal balance' as best it can and not restricting trade for balance of payments reasons" (Williamson, 1985, p. 14). Of all the complex relationships embodied in these descriptions, the most difficult to model and analyze is also the most important: the linkage between adjustment and economic growth.

The Fund did not always make its credits conditional on the conduct of economic policy.[1] The Fund's first credits, starting with a drawing by France in March 1947, were disbursed immediately and without further conditions, subject only to an agreed schedule of repayments. When the Fund began entering into stand-by arrangements in 1952, the typical arrangement was only for six months and included no policy conditions. The first example of a conditional arrangement came in February 1954, when the Executive Board approved a stand-by arrangement for Peru in which the authorities agreed not to draw if certain conditions were not met, notably if they changed their policy regarding intervention in the foreign exchange market. Two years later, an arrangement was approved in which Chile's right to draw was "phased"; that is, the country could draw up to specified amounts every 30 days for

[1]In addition to this summary and the earlier IMF Histories, sources on the evolution of Fund conditionality include Guitián (1981, 1995), Mohammed (1991), Polak (1991), and references therein. The general practice of Fund conditionality in the 1980s is analyzed in detail in IMF Assessment Project (1992). For an introduction, see Rajcoomar and others (1996), especially Chapter 3. For an external critique of conditionality, see Dell (1981). Also see Robichek (1984), which notes that it "is no secret that the argument [in favor of making IMF credits conditional] was settled under pressure from the U.S. Government, against the solid opposition of the rest of the Fund's membership" (p. 68).

the life of the arrangement. Most lending arrangements in that period, however, were still unconditional (Horsefield, 1969, Vol. 1, pp. 373–75 and 430–31).

In July 1957, a stand-by arrangement for Paraguay introduced the "performance clause," under which failure to satisfy certain "performance criteria" would result automatically in suspension of drawing rights. In this seminal case, three ceilings were specified: on domestic assets of the central bank and on both current and capital spending by the government.[2] By 1964, the practice of imposing performance criteria became virtually universal for arrangements that would extend a country's indebtedness beyond the first credit tranche.[3] To make the government's more general policy intentions as explicit and as comprehensive as possible, the authorities were required to submit a Letter of Intent to the Fund, which was appended to the text of the stand-by arrangement. That practice began with an arrangement for Peru in February 1958. Also in 1958 (starting with an arrangement for Brazil in June), the Fund began requiring the completion of periodic reviews before the later drawings could be made.

These various practices that evolved during the first two decades were formalized following a comprehensive review of Fund lending policies in 1968. That review established that performance clauses and phasing of drawings should be standard practice in all upper-tranche arrangements. It also reacted to the large number of performance criteria (as many as 15) that had crept into some programs by establishing the (slightly hedged) principle that the Fund should not attempt to micromanage a country's economic policies:

> Performance clauses will cover those performance criteria necessary to evaluate implementation of the program with a view to ensuring the achievement of its objectives, but no others. No general rule as to the number and content of performance criteria can be adopted in view of the diversity of problems and institutional arrangements of members. (Decision No. 2620-(68/141), November 1, 1968; reproduced in de Vries (1976), Vol. 2, pp. 197–98)

While the Executive Board was developing broad policies on Fund lending in the 1950s and 1960s, the staff was developing the theoretical and empirical underpinning for conditionality. As noted above, the seminal Paraguay program included constraints on both monetary policy (domestic credit expansion) and fiscal policy (current and capital spending). This shotgun approach, which was aimed at reducing domestic expenditure to a level commensurate with the value

[2]Paraguay succeeded in staying within the ceilings. The dubious honor of being the first country to be (temporarily) denied a scheduled drawing because it had failed to carry out the agreed policies goes to Bolivia, in September 1958 (Horsefield, 1969, Vol. 1, p. 433).

[3]From 1964 on, the only upper-tranche stand-by arrangement without a performance clause was for the United Kingdom in November 1967. Stand-by arrangements for 1964–67 are summarized in "Fund Policy with Respect to Use of Its Resources and Stand-by Arrangement," SM/68/128 (July 23, 1968). The last time that the Fund permitted an upper-tranche drawing without a stand-by arrangement and not linked to a specialized facility or emergency assistance was for Egypt in March 1968 (de Vries, 1976, Vol. 1, p. 319). Readers unfamiliar with the "tranche" policies of the Fund will find a brief introduction in the Preface to this History.

of national income, reflected two major theoretical developments to which the Fund staff made key contributions in the 1950s. The first contribution was the "absorption approach" expounded in early *Staff Papers* articles, notably Tsiang (1950) and Alexander (1952).[4] An implication of that approach was that excess domestic spending ("absorption"), whether fed directly by the government or indirectly by monetary expansion, would worsen the external current account balance. The second contribution was the monetary approach to the balance of payments, to which Jacques J. Polak (who succeeded Edward M. Bernstein as Director of Research in 1956) made a pivotal contribution by setting out a dynamic general equilibrium model in which the primary cause of a weak external balance is domestic credit expansion (Polak, 1957).[5] Empirical verification of the importance and reliability of the monetary approach required several years of research, but the Polak model quickly took root as the foundation of all financial programming in the Fund.

Although both the principles and the practice of Fund conditionality came under heavy criticism in the 1970s, the Fund essentially reconfirmed the 1968 guidelines after an extended review in 1978–79. Criticisms from actual or potential borrowers quite naturally focused on both the harshness and the extensiveness of the conditions, but the standardized application of the monetary approach also came under fire from those who favored flexibility or who wanted the Fund to pay greater attention to social concerns. Nonetheless, when the Executive Board approved new guidelines in March 1979, the main effect was to enshrine the concept that countries should not wait until their economic prospects became desperate before seeking assistance. In other words, the Fund should be a lender of *first*, not last resort. (See de Vries, 1985, Chapters 25 and 26.) The 1979 guidelines, which were confirmed again in the comprehensive review of 1988, are reproduced in the Appendix to this chapter.

The first section of this chapter examines the controversy that flared up in the early 1980s about whether the Fund was inappropriately weakening its conditionality. The second section covers several specific issues that were raised about con-

[4]For a review of the contributions of Fund staff to the theoretical development of balance of payments theory, see Blejer, Khan, and Masson (1995).

[5]The stock of money is endogenous in this model and reflects the effects of the balance of payments on the foreign assets of the banking system. For the development of the modern monetary approach outside and within the Fund, see Frenkel and Johnson (1976) and IMF (1977). Polak (1991), pp. 33–36, summarizes the application of the approach in Fund programs, and Polak (1998) reviews the evolution of the model over 40 years. The origins of the monetary approach date back at least two centuries, to an essay by David Hume:

> . . . suppose that all the money of Great Britain were multiplied fivefold in a night . . . ? Must not [the prices of] all labour and commodities rise to such an exorbitant height, that no neighbouring nations could afford to buy from us; while their commodities, on the other hand, became comparatively so cheap, that, in spite of all the laws which could be formed, they would be run in upon us, and our money flow out; till we fall to a level with foreigners, and lose that great superiority of riches, which had laid us under such disadvantages? (Hume [1752], p. 63)

ditionality and the design of Fund-supported adjustment programs and then reviews the evidence on the success of programs. The final section takes up the overarching issue, the relationship between Fund conditionality and economic growth.

How Much Conditionality?

Although the Fund began conditional lending to developing countries in the late 1950s, this was hardly its principal financial activity. Conditionality moved to center stage only in 1979, and the following years witnessed a prolonged and sometimes bitter debate about how extensive the Fund's conditions should be.

Most of the Fund's lending in the five years between the first and second oil shocks was either to industrial countries or on terms that required little or no policy adjustment. For fiscal years 1975 through 1979, low-conditionality credits through the first credit tranche, the oil facilities, the Compensatory Financing Facility (CFF), and the Buffer Stock Financing Facility totaled SDR 11.7 billion ($14 billion). Another SDR 5.1 billion ($6 billion) in funds were provided through unconditional reserve-tranche purchases, and SDR 1.3 billion ($1½ billion) through the Trust Fund (either as loans or as distributed profits from the sale of part of the Fund's stock of gold) and as grants to subsidize interest payments. These amounts far exceeded the SDR 6.1 billion ($7¼ billion) in credits extended via regular and extended upper-tranche stand-by arrangements, SDR 4 billion of which went to two large industrial countries (Italy and the United Kingdom). Overall, only 25 percent of the Fund's disbursements in those years was subject to high conditionality (Table 13.1).

Not only was lending low in conditionality in that era; it also slowed in volume after the initial burst of activity in response to the first big increase in oil prices. In calendar years 1974–76, gross disbursements from the General Resources Account averaged SDR 4.3 billion a year; in 1977–79, just 2.1 billion. By the end of the decade, reflecting the normal cycle of flows from the Fund's short-term lending, repayments of earlier credits exceeded new lending. Consequently, at a time when Fund quotas were being raised sharply, total Fund credit outstanding fell from a peak of SDR 13.2 billion at the end of 1977 to 9.3 billion two years later (Figure 13.1).

When the second oil shock hit in 1979, the Fund came under pressure from both borrowers and creditors to play a more active role in helping the oil-importing developing countries cope. That pressure came to a head at the Annual Meetings of Fund and Bank governors in Belgrade, Yugoslavia, that October, where the Fund was heavily criticized for standing on the sidelines while an increasing number of developing countries urgently needed external financing. Criticism from creditors was as widespread as it was unexpected. The French finance minister, René Monory, representing Giscard's center-right government, put the case bluntly:

> . . . the possibilities of access to the Fund for countries in difficulty have been expanded: conditionality has been eased so as to take better account of the adjust-

Table 13.1. Conditionality of IMF Disbursements, 1975–89
(Fiscal years; in SDR millions)

	1975–79	1980–84	1985–89
I. General Department	22,867	38,231	21,644
A. Low (or no) conditionality	16,753	13,936	6,373
Reserve tranche drawings	5,082	4,264	1,353
First credit tranche drawings[a]	1,290	990	799
Oil facilities	6,902	0	0
Other special facilities[b]	3,479	8,682	4,221
B. Higher conditionality	6,114	24,295	15,271
Upper-tranche stand-by arrangements	5,565	13,400	11,157
EFF arrangements	549	10,895	3,240
SAF loans	0	0	874
II. Administered accounts	1,055	2,259	1,860
A. Trust Fund	970	2,022	0
B. Grants[c]	85	237	1,596
C. ESAF loans[d]	0	0	264
Total (General Department plus administered accounts)	23,922	40,490	23,504
Percent of total with high conditionality			
Total disbursements [(I.B + II.C)/total)	26	60	66
General Department credits only[e]	34	72	75

[a]Includes emergency assistance for natural disaster relief.
[b]Compensatory, contingency, and buffer stock financing.
[c]Subsidies for selected users of the oil facilities and the Supplementary Financing Facility.
[d]Includes SAF resources committed under ESAF arrangements.
[e]Excludes reserve tranche purchases.

> ment problems peculiar to developing countries. . . . [The] IMF has sufficient resources today to double or triple the annual volume of its assistance. In the present situation, it therefore has the necessary resources to play a central role in financing developing countries' balance of payments deficits (IMF, *Summary Proceedings*, 1979, p. 62).

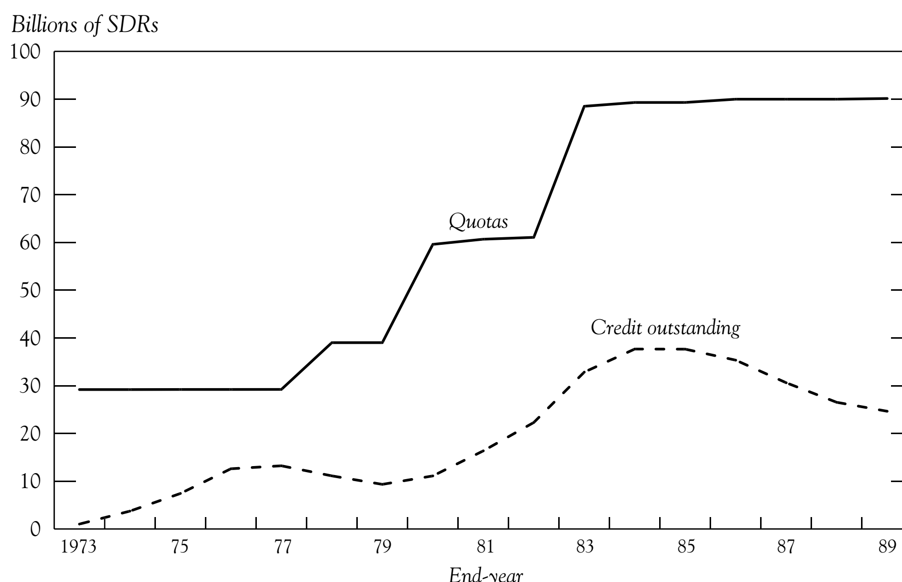
Monory's reference to conditionality having been eased appears to have been an allusion to the adoption of revised guidelines earlier in the year. Although on paper the 1979 guidelines made little substantive change, the fact that they were adopted in response to criticisms of the Fund's practices raised expectations in some quarters that conditionality would become simpler and less burdensome.

Even representatives of some quite conservative creditor governments urged the Fund to lend more without worrying too much about conditionality. Witness Geoffrey Howe, the U.K. Chancellor of the Exchequer:

> Now that the rules governing conditionality have been liberalized, I hope that developing countries will find it acceptable to work closely with the Fund and exploit to the full the resources now available to help them overcome their problems (IMF, *Summary Proceedings*, 1979, p. 100).

This general viewpoint was given official sanction in the communiqué issued by the Interim Committee a few days earlier:

Figure 13.1. Availability and Use of Fund Resources, 1973–89



> The situation of the non-oil developing countries . . . underlined the need for a larger flow of external resources. . . . The Committee noted with satisfaction that . . . a number of developments [had] enhanced the Fund's ability to provide balance of payments assistance to its members. [paragraphs 2 and 4]

The communiqué cited several contributing developments, including the new conditionality guidelines, the liberalization of the CFF, the establishment of the Supplementary Financing Facility (SFF), and the impending creation of an interest subsidization mechanism.

It was standard practice in those days for the Managing Director to gather his senior staff together in the Executive Boardroom after each Annual Meeting, for a debriefing on the implications for the work program in the coming months.[6] The post-Belgrade meeting was long remembered by many participants as especially significant because the Managing Director, Jacques de Larosière, used it as the occasion to lay out the plight of the developing world—particularly of low-income countries—and to exhort the staff to respond positively to the calls for more lending. Although he also cautioned that more lending should not imply less conditionality, and although official policy of the Fund stressed that "adjustment and financing have to go hand in hand," the demand for heightened

[6]By the late 1980s, the increased size of the institution forced a choice between squeezing out division chiefs from these meetings or moving the meetings to a larger hall. The latter option won out, and the new forum was large enough that deputy chiefs and senior economists could also be included. Consequently, the debriefings lost much of their operational significance.

activity was widely interpreted as having the higher priority. It was not at all clear to many on the staff how lending could be increased without loosening conditions.

De Larosière subsequently stressed again to the staff that what he had in mind was conditional lending. When the Economic Counsellor, Jacques Polak, submitted a proposal a few weeks later for a "temporary intermediation facility" that would provide more or less automatic credits for deficit countries to replace an expected decline in the availability of bank lending, the Managing Director quickly quashed it: "What the world needs is, in my view, (1) conditionality and (2) appropriate conditions (because of the debt service problems), and not an Oil Facility No. 2." Nonetheless, de Larosière's greater stress in that period was on the importance of increasing the volume of lending. At a staff retreat in 1981, he recalled his earlier views: "So what I tried to do at the beginning of my stay here was to ask you to put the emphasis on showing the countries in which we were operating how the Fund could help. I remember telling a large staff committee: 'You have to be sellers.' I thought that it was important to try to persuade countries that there was something we could offer them." He went on to note the importance of conditionality and admitted that the two views seemed to conflict. His point, he concluded, was that "if an organization wishes to be effective, it must not turn people down before they start listening to its advice."[7]

What is clear is that Fund lending accelerated markedly, beginning in the second half of 1979, predominantly through a rise in conditional credits enabled by a policy of expanding members' access to Fund resources. (On enlarged access, see Chapter 17.) For the five fiscal years through April 1979, upper-tranche conditional lending averaged SDR 1.1 billion ($1¼ billion) a year; for the next five years, SDR 2.7 billion ($3¼ billion), as the Fund sought to play a major role in the process of "recycling petrodollars." As a portion of total disbursements, upper-tranche arrangements rose from 26 percent in the earlier period to 59 percent in fiscal years 1980–84 and to 66 percent in the second half of the decade (see Table 13.1). Was this surge in conditional lending achieved by easing up on the conditions?

John Williamson (1983, Chapter 24) examined the increase in lending to evaluate what he characterized as "hearsay evidence" (i.e., anecdotes told to him by Fund staff) that a "major loosening" in "the toughness of IMF conditionality . . . occurred after . . . Belgrade" (p. 641). Williamson was working with one hand tied behind his back, in that he did not have access to data on performance criteria in the Fund's lending agreements. His often-cited study therefore relied on two indirect indicators, neither of which provides unambiguous information. First, he

[7]Memorandum from Polak to the Managing Director (January 15, 1980), with handwritten response in the margin (January 16); in IMF CF (S 651); and opening remarks at the Seminar on Adjustment Policies, Annapolis, Maryland (July 16, 1981), pp. 2–3; in IMF/RD Managing Director file, "Use of Fund Resources/Conditionality (Memos), 1980–1981" (Accession 84/188 A–2 (15), Box 1, Section 343).

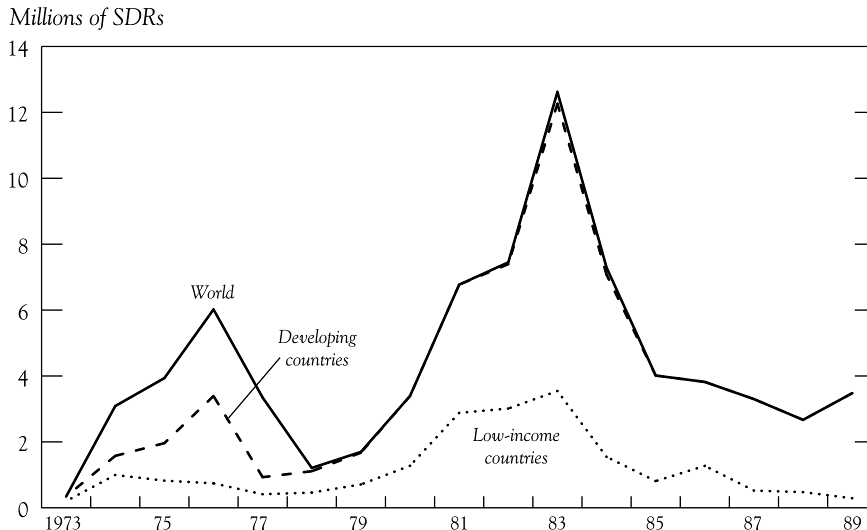
noted that an unusually large portion of the programs approved during the 18 months after the Belgrade meetings covered more than one year, which he regarded as implying a tolerance for more gradual adjustment and thus weaker conditionality. (An alternative interpretation would be that longer programs reflect more extensive adjustment, including structural reforms that take longer to carry out.)[8] Second, he calculated that this period was marked by a tendency for borrowing countries to experience exchange rate appreciation in real terms, which he interpreted as a weakening of the Fund's insistence on devaluation as a policy condition. (An alternative interpretation would be that economic conditions made it more difficult for countries to realize real gains in competitiveness.) On that basis, Williamson concluded that the "evidence seems to confirm that Fund conditionality was eased in mid-1979 (though before the Belgrade Annual Meetings) and retightened in mid-1981" (p. 646).

The case studies given below and in the next three chapters, as well as a large number of interviews with the staff who were involved, illustrate plainly that the Fund was eager to meet financing requests around 1979–81 and that conditionality was not as strong or as effective as it later became. To understand that development, one must take account of a crucial development not stressed by Williamson: the increase in lending to countries with deep-seated long-term structural problems, countries that needed to undertake major structural reforms to have any hope of graduating from dependence on continued official financing. Low-income countries, which until then had not been a major locus of Fund lending, were facing particularly desperate circumstances and were coming to the Fund for help in increasing numbers. In 1975–79, low-income countries borrowed an average of SDR 630 million a year from the Fund, 19 percent of the total. In the next five years, annual borrowings by this group quadrupled to SDR 2.5 billion, or 33 percent of the total (Figure 13.2). When the necessary reforms were not forthcoming, and when external economic conditions turned out worse than expected, a large portion of stand-by arrangements was suspended, many countries required repeated and prolonged access to Fund resources, and several went into arrears to the Fund and other external creditors. Whatever effect on the quality of the Fund's portfolio might have resulted from weak conditionality, the predominant factor was this shift in the nature of the demand for the Fund's resources. (The problem of arrears to the Fund is discussed in detail in Chapter 16.)

As Figure 13.1 illustrates, the surge in lending continued until 1984. By Williamson's indicators, however, conditionality effectively "retightened" after

[8]In setting out this issue for the Interim Committee in April 1980, de Larosière argued that "the structural problems faced by many countries may require that adjustment take place over a longer period than has been typical in the framework of our programs in the past. . . . Our putting forward increased resources for balance of payments financing would of course facilitate adjustment and stretch it over a realistic period." (For the full paragraph, see Appendix IV of Chapter 17.) The central question is whether the increase in lending served primarily to facilitate adjustment or to stretch it out.

Figure 13.2. Drawings from the IMF, 1973–89



Source: IMF, *IFS*. Includes all drawings from the General Department except reserve tranche purchases. Low-income countries include the 47 developing countries classified as low-income in the 1989 WEO, plus 18 others that were eligible for ESAF loans.

mid-1981. That assessment, which is consistent with the evidence discussed below, is striking because the views expressed at that time in the main policy discussions about conditionality were still mixed. When the Interim Committee met in May 1981 in Libreville, Gabon, a few speakers (notably Howe, and Horst Schulmann, representing Germany) cautioned that the Fund should continue applying conditionality to its lending, but no one argued for a tightening.[9] At home and in the field, however, both staff and management were beginning to realize that they might have gone too far too fast in responding to calls for help.[10]

Much has been made of the fact that the Reagan administration, which took office in the United States in January 1981, viewed Fund conditionality as insufficient and pushed for it to be tightened. Criticizing a proposed stand-by arrangement for Grenada in May of that year, Donald Syvrud (Alternate—United

[9]Minutes of the Sixteenth Meeting of the Interim Committee (May 21, 1981), Second Session, pp. 37 (Howe) and 55 (Schulmann).

[10]An early indication of the retightening is a January 1981 memorandum from the Managing Director to department heads, noting the increased number, size, complexity, and political sensitivity of upper-tranche programs; and calling for special clearing procedures by his office whenever program negotiations were expected to involve "novel or difficult issues." See "Strengthened Procedures for Dealing with Country Program Issues" (January 14, 1981); IMF/RD Managing Director file "Extended Fund Facility, 1981–1983" (Accession 86/32, Box 3, Section 379).

States)[11] complained that "while Executive Directors talked a great deal about the need for adjustment and financing to go hand in hand, in practice he saw more and more financing and less and less adjustment."[12] The United States withheld support for that small arrangement (see Chapter 15), and later in the year made a more dramatic and more public flourish by abstaining from very large requests from India and Pakistan on similar grounds (Chapters 15 and 14, respectively).

Less well known is that Directors from industrial countries, especially from Europe, expressed similar concerns about what they viewed as weak programs almost as soon as the Fund began lending more frequently to low-income countries. A particularly dramatic example came just a month after Belgrade.

Sierra Leone

On the surface, Sierra Leone's 1979 request for a one-year stand-by arrangement for SDR 17 million ($22 million, or 55 percent of quota), plus a loan of SDR 10 million ($13 million) from the Trust Fund, was routine. The country faced a severe balance of payments problem that had resulted mainly from weak control over domestic spending over an extended period. The payments deficit now was exacerbated by the need for large capital outlays in anticipation of a major conference of the Organization of African Unity, which was to be held in Freetown in July 1980. Sierra Leone had some outstanding obligations to the Fund, primarily from drawings on the oil facility and the CFF, but they were not unusually large.[13] The only question was whether the authorities were prepared to adjust economic policies by enough to restore viability to their external accounts.

The prior record was not promising. In 1977, a stand-by arrangement was approved for Sierra Leone following negotiations in which the authorities successfully resisted the pleas of the Fund staff for a devaluation. (The currency, the leone, was pegged to the pound sterling at the time.) While that arrangement was in effect, the authorities failed to control government spending as planned, and they did not make the final scheduled drawing.[14] Fiscal overruns continued into 1978 while the authorities negotiated with the Fund staff on a new, larger, stand-by arrangement. Throughout 1978, the Fund again insisted on an up-front devaluation of the currency, partly because of doubts regarding the authorities' ability to carry out the large spending cuts that otherwise would be required to balance the

[11]Syvrud was appointed in 1979 as the Alternate for Sam Y. Cross. In May 1981, he was Acting Executive Director pending the appointment of Cross's replacement by the Reagan administration.

[12]Minutes of EBM/81/79 (May 11, 1981), p. 5.

[13]At the time of the request, Sierra Leone's obligations to the Fund amounted to 73 percent of quota (slightly below the mean for all countries with outstanding obligations), of which all but 8 percent of quota was from the CFF or the oil facility.

[14]The 1977 arrangement, which covered only the "enlarged" first credit tranche (36.25 percent of quota), called for three drawings spread over 12 months. The first two were made on schedule. Following a review that concluded that policies were unsustainable, the third drawing was not made.

external accounts, and partly because of a view that the authorities had to show a willingness to set out on a new policy course. Following a meeting in Washington between the President of the Republic, Siaka Stevens, and the Acting Managing Director, William B. Dale, the authorities agreed to devalue the leone by 5 percent at the end of October 1978, to change the peg from the pound sterling to the SDR, and to devalue by a further 15 percent over the next two months. The first two actions were taken immediately, but the authorities backed away from their commitment to devalue further, "for political and social reasons," and continued to focus on making selected cuts in government spending.[15]

Negotiations continued along these lines throughout the first half of 1979. As late as June, the Managing Director supported the view that any agreement had to include a further devaluation. Finally, however, after a July mission and a meeting with Stevens in Zurich failed to budge the authorities from their position, de Larosière went along with a suggestion from the mission chief (Rattan Bhatia, Senior Advisor in the African Department) that the Fund agree to accept the authorities' program.[16] Thus, for the second time in just over two years, the Fund's management approved Sierra Leone's request for a stand-by arrangement in which policy adjustment was to be effected through promised spending cuts without an initial devaluation, even though everyone in the Fund regarded the program as a risky and decidedly inferior solution to the country's economic problems.

When the Executive Board met to consider the request at the beginning of November (just a few weeks after the Belgrade Interim Committee meeting), some industrial country Directors chose the occasion to make a stand for stronger conditionality, and Sierra Leone's case was defended by several Directors from developing countries.[17] The meeting developed into a dramatic confrontation in which, as Byanti Kharmawan (Indonesia) noted, "principles were at stake."

Knowing that the arrangement would be criticized, the authorities had taken measures before the meeting to cut spending and credit growth, and they had agreed to schedule an early review—to be held in January 1980—of progress in carrying out the program. Several Directors, however, remained unimpressed. H. Onno Ruding (Netherlands) argued that "the proposed program did not meet the

[15]See the statement by the mission chief (Bhatia) at EBM/79/168 (November 2, 1979), pp. 3–6. The "political and social" quotation is from p. 3.

[16]In IMF/CF (C/Sierra Leone/810 "Mission, Bhatia and Staff, June–July 1979"), see memorandum from J.B. Zulu (Director of the African Department) to the Managing Director (June 22, 1979), with undated handwritten reply from the Managing Director; and memorandum from Bhatia to the Managing Director (July 12), with handwritten reply the same date. In IMF/RD African Department file "Sierra Leone, 1979" (Accession 82/13, Box 2, Section 211), see file memorandum by Bhatia (June 26).

[17]Also see Polak (1997), p. 496 and note 60, where this case is presented as a rare example of the Executive Board overruling the Managing Director; and Sampson (1981), p. 305. Polak incorrectly suggests that the Sierra Leone case may have been the only time that the Executive Board overruled a financing request from the Managing Director. Two instances occurred in 1981, involving a CFF rescheduling requested by Sudan and an extended arrangement requested by Grenada (see Chapter 15). Sampson incorrectly interprets the Board meeting as a debate over the specifics of conditionality.

standards normally applied to drawings in the higher credit tranches" and thus might encourage other countries to seek lenient terms. He also worried that the record suggested that the authorities "might not be able" to carry out their expressed policy intentions. On that basis, he asked that Sierra Leone not be allowed to draw beyond the first credit tranche until after the January review. This amendment would reduce the funds immediately available to the country only by SDR 2.1 million (from SDR 9 million to 6.9), but it would send a message that the Board was not prepared to approve upper-tranche arrangements without strong justification.

Ruding felt strongly enough about setting an example with this case that he had prepared for the Board meeting by lobbying many of his colleagues for support. As the meeting progressed, all of the Directors representing the Group of Seven (G-7) industrial countries supported his amendment. Akira Nagashima (Alternate—Japan) averred that he "was beginning to feel uneasy about the gradual shift toward easier conditionality, which might undermine the basic principles and the credibility of the Fund." Similarly, Costa P. Caranicas (Alternate—Greece), after detailing what he believed to be weak elements in the program, noted that this "case was not the first in which a weak or inadequate program had been brought to the Board for approval, and his chair [i.e., the constituency headed by Italy] in the past had voiced dissatisfaction with the trend, seen particularly in Trust Fund loan approvals."[18]

Other Directors, defending the proposed arrangement, pointed out that Ruding's amendment seemed inconsistent with the Fund's tranche policies, which limited the use of performance criteria to the upper credit tranches. Jacques de Groote (Belgium), for example, observed that if Sierra Leone was permitted only to draw on its first credit tranche, it would "seem a little odd" for the Fund to require the authorities to implement an adjustment program. Joaquín Muns (Spain) added that the amendment would represent a "fundamental departure from what had been negotiated with the country." And Samuel Nana-Sinkam (Cameroon) pointed out that requiring a country to meet preconditions was unprecedented for the Board before it could draw in the upper credit tranches.[19] De Larosière, who was chairing the meeting, also defended the strength of the authorities' program. Echoing the Fund's long-standing concerns about trying to adjust only through fiscal contraction without a devaluation, he warned that the proposed cuts could lead the Sierra Leonean economy "to the verge of very great difficulties. Indeed, the one weakness of the program might well be that it would be almost impossible for the authorities to adhere to it."

[18]For the quotations in these three paragraphs, see the minutes of EBM/79/168 (November 2, 1979), pp. 3 (Kharmawan), 10–12 (Ruding), 19 (Caranicas), and 28 (Nagashima).

[19]George Nicoletopoulos, Director of the Legal Department, confirmed that the Fund had not imposed preconditions in any case in the previous ten years (i.e., since the adoption of formal conditionality guidelines in 1968). See also the discussion below on the distinct practice of requiring "prior actions" (p. 605–06).

With eight chairs holding 53 percent of the voting power lined up against the original proposal and most others strongly opposed to Ruding's amendment, de Larosière sought to forge a consensus. He suggested that the Board could lower the amount to be made available immediately, but to keep it above the first credit tranche by at least a token amount. Ruding and Syvrud initially demurred, but after further discussion the Board unanimously accepted a specific compromise by Kharmawan to set the initial drawing at SDR 7.5 million.[20] It had been a long and often bitter debate over a small financial matter, but the outcome preserved all of the principles that had been raised. The stand-by arrangement would provide immediate access to upper-tranche credit; the Board's approval of an arrangement could not be presumed, especially when the conditionality was suspect; and yet the Fund was prepared to show flexibility in responding to a country's circumstances.

Whatever general effect this debate might or might not have had on the evolution of Fund conditionality, it did mark the beginning of a more positive period in economic policymaking in Sierra Leone. The adjustment program was successfully carried out and reviewed, and the full amount of the stand-by arrangement was drawn and later repaid on schedule.

Program Design Issues

The most comprehensive review of the design of Fund-supported programs undertaken in the 1980s came in response to a series of studies finding that a large portion of programs had failed. One of the most exhaustive studies, prepared by the staff around the beginning of 1987, examined results for 34 countries that had borrowed from the Fund under conditional arrangements in 1983.[21] From then through 1986, those countries had entered into a total of 71 stand-by or extended arrangements, many of which had gone off track. More often than not, these countries were not much closer to achieving "external viability" (broadly speaking, a sustainable balance of payments, achieved at a sustainable rate of economic growth) than they had been four years earlier, and their prospects for economic growth were bleak.[22]

[20]Minutes of EBM/79/169 (November 2, 1979), pp. 5–22. For the statements quoted in the preceding paragraph, see pp. 8–11.

[21]The sample covered all countries with stand-by or extended arrangements (i.e., longer-term arrangements under the Extended Fund Facility, or EFF) approved in 1983 except for Grenada, whose extended arrangement was canceled soon after approval. The EFF and the Grenadian case are discussed in Chapter 15.

[22]Only 7 of the 34 countries were judged to be "relatively close to achieving viability"; 21 others were thought to be in a position where they could achieve viability within five years, although some of those would need "major further shifts in policies." Of the seven "successful" cases, four (Korea, Mauritius, Portugal, and Turkey) had no further need of Fund resources in the next seven years; two (Bangladesh and Togo) drew only on the concessional structural adjustment facilities; only one (Uruguay, in 1990 and 1992) had a new stand-by arrangement. Of the six with the most deep-seated problems (Haiti, Liberia, Sudan, Uganda, Zaïre, and Zambia), all either were or soon would be in arrears to the Fund and would remain in serious difficulty for several years.

What had gone wrong? Almost everything imaginable. First, most borrowers had started off in dreadful circumstances, having taken on large external debts in the 1970s only to watch their markets and their terms of trade weaken while the interest rates on their debts soared. Many of these countries had also experienced droughts, floods, storms, or other natural disasters. Second, to a large extent, the mid-1980s brought an even more hostile external environment: very high real interest rates, an expensive U.S. dollar,[23] collapsing prices for export commodities, and sluggish market growth. Third, for the poorer countries that depended on concessional lending and other forms of aid, the declining willingness of many industrial countries to provide official assistance weakened these borrowers' ability to service debts and obtain essential imports. Fourth, many countries, especially those with weak governments, had difficulty carrying out their policy commitments.[24] The question for the Fund, however, was whether a fifth problem was also important: Were the adjustment programs poorly designed, and if so, was there an alternative paradigm that could be expected to raise the rate of success?

The staff had already prepared a preliminary report on this crucial question (published later as Research Department, 1987) and had concluded that the Fund's adjustment strategy was appropriate, partly because the basic monetary model was applicable to a wide range of circumstances and partly because the model was applied flexibly to take account of the specific circumstances facing each country. Executive Directors, however, were more skeptical and suggested that programs could be made more flexible, more structural, and more growth-oriented.[25]

Developing countries, represented by the Group of Twenty-Four (G-24), were especially critical, but in retrospect their recommendations for reform seem surprisingly mild. A Working Group of the Deputies of the G-24 prepared a report (Sengupta and others, 1987) that suggested two changes in Fund conditionality procedures.[26] First, the Fund should use ranges, not single points, for performance criteria, to give borrowers more flexibility in setting macroeconomic policies. For example, instead of requiring a country to keep the net domestic assets of the banking system below a specific ceiling, the country would be allowed a margin of error. Second, the Fund should allow drawings to continue when specific performance criteria were not satisfied, as long as the overall program objectives were being met. For example, excessive domestic credit creation might not disqualify a country from borrowing unless its current account deficit was also too large.

[23]The appreciation of the dollar against other key currencies in the mid-1980s adversely affected most developing countries because their debts were larger and more heavily concentrated in dollars than their financial claims.

[24]See "External Adjustments, Financing, and Growth—Issues in Conditionality," EBS/87/40 (February 25, 1987).

[25]"Theoretical Aspects of the Design of Fund-Supported Adjustment Programs," SM/86/162 (July 2, 1986); and minutes of Executive Board Seminar 86/11 (October 20, 1986).

[26]In addition to these specific suggestions, the report also endorsed the principle that the number of performance criteria should be kept to a minimum; see below, pp. 602–05. The report also dealt with broader issues, particularly the challenge of endogenizing growth in Fund programming, on which it offered more sweeping recommendations; see below, p. 612.

The U.S. authorities offered a similarly technical suggestion for reform. Treasury Secretary James A. Baker III, in his address to the 1987 Annual Meetings (IMF, *Summary Proceedings,* 1987, p. 111), proposed that the Fund use semiannual rather than quarterly intervals for performance criteria. Reasoning that macroeconomic deviations are inherently difficult to correct within a calendar quarter and that even to try can force a government or central bank to pursue a disruptively erratic policy course, Baker sought both to give borrowers more flexibility and to promote a steadier medium-term strategy.

The Executive Board discussed these "monitoring" proposals as part of a general review of conditionality in April 1988.[27] As in all discussions of Fund conditionality, most actual and potential borrowers lined up on one side and most creditors on the other, though the lines became a little ragged at times. On the question of whether to move to ranges rather than specific values for performance criteria, several Directors from both camps—including Hélène Ploix (France) and Alexandre Kafka (Brazil)—recognized that the issue was a red herring ("more apparent than real," in Ploix's phrase). If the staff judged that a given degree of restriction was needed, it would simply aim to set the ceiling lower if it had to allow for a margin of error.[28] Similarly, the proposal to waive small violations automatically drew little support; most Directors were satisfied that the Fund was already flexible enough in waiving minor breaches. The U.S. proposal for semiannual monitoring was embraced by Directors from developing countries and supported much more reluctantly by a few Directors representing industrial countries. Summing up the discussion, the Managing Director suggested that the idea could be tried experimentally in cases involving longer-term arrangements for countries with a well-established "track record" on policy implementation. In practice, however, few such cases were ever found.

Despite the nearly universal dissatisfaction with experience in the field, the Fund thus decided in 1988 not to make any radical departures in the design or monitoring of conditional adjustment programs. Far from being a reluctance to fix a system that was not broken, the conclusion instead was that the Fund was hemmed in by the need to balance several conflicting objectives. The Fund required a borrower to develop a program to restore external viability but encouraged it to do so in a way that would promote sustainable growth. The Fund wished to promote structural reforms while respecting the social and political choices of the country. The Fund tried to design programs that were politically feasible but that could be carried out quickly and strongly. The Fund tried to take account of the special circumstances facing each country while ensuring uniformity of treatment. The Fund sought to collaborate with the World Bank in recommending structural reforms while avoiding cross-conditionality. The Fund had to monitor the implementation of programs but tried to minimize interference with the authorities'

[27]Minutes of EBM/88/58–59 (April 6, 1988). The Chairman's summing up of the discussion was presented at EBM/88/60 (April 8, 1988).

[28]The proposal for ranges was originally made by the staff, in the background paper for the 1968 review of conditionality. The idea was abandoned at that time because it was thought to be unnecessarily complex.

management of the economy. Changing the guidelines or the procedures would do little to resolve these conflicts, all of which were cited by the Managing Director in his summing up of the 1988 review.

The Fund did devote considerable effort throughout the 1980s to examining specific technical features of conditionality, with an eye toward improving implementation and performance. The cumulative effect was not just to refine conditionality but to extend its reach. As Jacques Polak phrased it (with a modicum of exaggeration) in his 1991 essay, the "restraining provisions have not prevented the intensification of conditionality in every direction that the guidelines attempted to block" (p. 54). The remainder of this section reviews several of the main issues.

Exchange Rate Policy

Although a basic tenet of the Fund's approach on macroeconomic stabilization is that countries should aim to maintain a competitive exchange rate, that premise does not imply that overvaluation should necessarily be corrected by depreciation. If the real exchange rate (the country's price level relative to prices abroad, expressed in a common currency) is overvalued, it can be reduced either by depreciation or by price reductions. The Fund's long-standing emphasis on exchange rate depreciation was based on the empirical assessment that price reductions are difficult to achieve and sustain and are less likely to lead to a broadly based strengthening of economic efficiency and international competitiveness. Moreover, although the Fund often recommended floating exchange rates in the context of its surveillance activities (see Chapter 2, p. 86), that option was seldom viable in the context of conditionality. Countries seeking to borrow from the Fund often lacked the institutional soundness and macroeconomic policy strength that are required for exchange rate stability in a floating-rate regime.

During the first half of the 1980s, the great majority of countries borrowing from the Fund undertook to depreciate their exchange rates, most often shortly before beginning a stand-by arrangement. In 1985, the Exchange and Trade Relations Department (ETR: the department that was responsible for reviewing the Fund's policy advice to countries) prepared a review of the Fund's experience in recommending currency devaluation or depreciation as a condition for borrowing from the Fund (Johnson and others, 1985). The study revealed that in 1983, almost all countries that could adjust the exchange rate had done so as part of their Fund-supported adjustment programs.[29] Although the consequences of exchange rate adjustment were not easy to separate from other determinants of economic performance, a number of Executive Directors expressed concerns when the paper was discussed that it did not appear that depreciation had generally led to better outcomes.[30]

[29]Out of 35 cases reviewed, 25 had involved devaluation or managed depreciation. Eight of the exceptions were countries that were participating in currency unions or were using the U.S. dollar as the domestic currency. In the other two cases (Guatemala and Haiti), the Fund staff had concluded that the countries could undertake adjustment in domestic policies while keeping their currencies pegged to the dollar. See Johnson and others (1985), p. 13.

[30]See the minutes of EBM/84/174–175 (December 5, 1984).

Because the initial gains from depreciation often were frittered away through subsequent wage and price inflation, the staff frequently recommended that countries adopt what became known as a "real exchange rate rule." In that framework, the use of which peaked in the first half of the 1980s, the authorities would adjust the exchange rate continually or periodically during the program so as to keep compensating for any remaining differences in inflation.[31] That is, they would peg (or try to peg) the real rather than the nominal exchange rate. In a typical case, at the outset of a Fund-supported adjustment program, the authorities would announce a big enough devaluation to restore international competitiveness after an extended period of erosion resulting from a combination of loose monetary and fiscal policies and a fixed or inflexibly managed exchange rate. Following the devaluation and the adoption of more disciplined financial policies, the rate might still be pegged to a major currency such as the U.S. dollar, or to a currency basket, but the rate would be adjusted—possibly daily, perhaps monthly—to offset any excess of domestic over international inflation.[32]

In 1986, Charles Adams and Daniel Gros (both Economists in the Research Department) published a critique of the real-rate rule (Adams and Gros, 1986) that helped persuade at least some operations staff to have second thoughts about the efficacy of the practice. Their argument was that the adoption of such a rule may negate the effectiveness of monetary discipline for stabilizing the price level; in extreme cases, the authorities could completely lose control over inflation. Although the Fund recommended real-rate rules on the understanding that monetary restraint would eventually stabilize prices, Adams and Gros argued that capital inflows could be quite difficult to sterilize and could undermine monetary control. Experience soon validated that proposition in several cases. When Yugoslavia, attempting to operate a real-rate rule at a time when it was experiencing severe internal and external shocks, saw its inflation balloon and then explode, the realism of the Adams-Gros model became all too clear.[33] By the end of the 1980s, the Fund had greatly reduced its advocacy of real-rate rules.

Adjustment of economic policies away from an unsustainable course was often extremely difficult, regardless of how the exchange rate was managed. Although the choice of exchange regime was important, it was not a substitute for making hard choices in monetary, fiscal, and structural policies. This point may be illustrated by reviewing two cases of adjustment in the 1980s: Yugoslavia, where ag-

[31]Quirk and others (1987), pp. 16–17, lists 106 Fund-supported programs approved during 1983–86, nearly two-thirds of which included "frequent adjustment to the exchange rate under managed floating arrangements with the aim of maintaining or increasing competitiveness."

[32]See Johnson and others (1985), Table 3, for descriptions of eight cases implemented in 1983; and Quirk and others (1987), Table 2, for a list of 48 cases implemented in 1983 through 1986. A 1990 internal review listed 15 cases during 1988–89; see "Analytical Issues Relating to Fund Advice on Exchange Rate Policy," SM/90/198 (October 16, 1990).

[33]Overall, according to Quirk and others (1987), p. 31, more than 60 percent of countries that adopted real-rate rules in conjunction with Fund-supported programs in 1983–86 experienced an acceleration of inflation. For analyses of the problem, see the series of articles by Montiel and Ostry (1991, 1992, and 1993).

gressive depreciation eventually led to hyperinflation, and Côte d'Ivoire, where a reluctance to consider devaluation also eventually led to economic collapse.

Yugoslavia: Targeting the Real Exchange Rate

The prototypical real-rate rule, employed as part of a Fund-supported adjustment program, occurred in Yugoslavia beginning in 1980.[34] At the time, the Yugoslav economy was suffering from a combination of macroeconomic imbalances, a large and growing external deficit, and structural rigidities, which everyone understood would take at least several years to fix. The process of adjustment had begun tentatively in 1979, supported by financing from the Fund in the amount of the first credit tranche (SDR 69.25 million, or $95 million, fully drawn in June). A key element in the government's strategy—taken on its own initiative, not imposed by the Fund—was to reverse the deterioration in the trade balance by depreciating the exchange rate aggressively. Over the next year, the dinar was depreciated by 9 percent against the U.S. dollar and by 17 percent in effective (trade-weighted) terms. Allowing for Yugoslavia's relatively high inflation rate, however, the real effective exchange rate was estimated to have depreciated by just 5 percent. The death in May 1980 of President Josip Broz Tito, who had led Yugoslavia since liberation in 1945 and who was widely acknowledged to be the only real glue holding the fragile federation together, significantly raised the uncertainty about the future of the economy. Consequently, in June, the authorities announced a large additional devaluation, by 23 percent in terms of dollars.

An upper-tranche 18-month stand-by arrangement was approved by the Fund in June 1980 in support of this adjustment program,[35] and it was soon superseded by a larger and even longer-term deal: a three-year stand-by arrangement for 1981–83, under which the authorities would borrow another SDR 1,662 million ($1.9 billion, or 400 percent of quota).[36] With that arrangement, the emphasis shifted toward a more sustained effort to remedy the formidable structural weaknesses in the economy. The current account was already improving in response to

[34]All references to Yugoslavia are to the Socialist Federation of Yugoslavia, which was dissolved as a country in 1992. See Chapter 19.

[35]The June 1980 devaluation, announced the day after the Executive Board approved the stand-by arrangement, was not part of the program agreed between the staff and the authorities and was not expected by the staff. When, as a result, inflationary pressures intensified, the monetary and credit ceilings were soon breached. The Fund nonetheless welcomed the move. In December, the Board approved a waiver for the missed criteria, permitting Yugoslavia to make the second scheduled drawing under the terms of the arrangement.

[36]Prior to 1979, Yugoslavia (an original member of the Fund) had had five stand-by arrangements: three in the 1960s and two in the early 1970s. The authorities then drew on the oil facility in 1974–76, and by mid-1979 had a small level of outstanding obligations to the Fund (equivalent to about 40 percent of quota) resulting only from those purchases. Over the next year, the authorities drew the equivalent of 100 percent of their quota under the CFF, in addition to drawing on their reserve tranche and taking out the first-tranche arrangement. Under the June 1980 arrangement, the authorities borrowed SDR 200 million out of an approved total of SDR 339.33 million, bringing their outstanding obligations to just under SDR 600 million ($760 million; 143 percent of quota) at the end of 1980.

the depreciation strategy, but inflation was already rising for the same reason. The staff—led by mission chief Geoffrey Tyler, Assistant Director of the European Department—was perfectly aware of the inflation effect but regarded it as a controllable problem. As summarized in the January 1981 staff report:

> The least satisfactory area was prices. However, it is important to note that the acceleration in inflation [from 16 percent during 1978 to 24 percent in 1979 and 37 percent in 1980] reflected to a considerable extent deliberate and desirable policy actions such as the depreciation of the dinar and structural price increases, combined with the unexpected rapid increase in world prices of oil and other raw materials. There are grounds for hoping that not all such factors will be so adverse in 1981.[37]

The goal of the depreciation strategy, and of the whole adjustment program, was not just to eliminate the current account deficit but more importantly to strengthen exports by providing incentives for firms to shift production into competitive export activities. Depreciation therefore was accompanied by direct government actions to promote and finance investment in export industries and by a restructuring of administered pricing policies to encourage agricultural exports. To combat inflation, monetary and fiscal policies were to be tightened. Moreover, growth in aggregate demand was expected to weaken and, in any event, high inflation was a fact of life in the world economy in 1980. The government even partially dismantled price controls in a further effort to encourage the growth of market activity.

The 1981 stand-by arrangement was based on a commitment initiated by the authorities to "continue to aim at maintaining external competitiveness through any necessary adjustments in the exchange rate of the Yugoslav dinar in accordance with relative price and cost movements and the evolution of the current account."[38] During 1981, the exchange rate was depreciated by 23 percent in nominal effective terms, which almost exactly offset the estimated difference between domestic and partner-country inflation.[39] Retail price inflation in Yugoslavia, rather than decelerating to 25 percent or less as forecast by both the authorities and the staff, rose slightly to 39 percent.

Aside from a few slippages, the Yugoslav government carried out the agreed program through 1981 and 1982, but it did not succeed in resolving the underlying imbalances or in convincing international creditors that it was still a good credit risk in the less-friendly environment of the 1980s. By the second half of 1982, the reexamination of risks by bankers in the aftermath of the crises in Poland and Mexico simply dried up the provision of commercial loans to Yugoslavia. When

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[37]"Yugoslavia—Request for Stand-by Arrangement," EBS/81/5 (January 16, 1981), p. 17.

[38]This language is from "Yugoslavia—Request for Stand-by Arrangement," EBS/81/5 (January 16, 1981), pp. 15 and 57. The Letter of Intent submitted by the authorities included only a more general statement: "Exchange rate policy will be implemented to ensure that the Yugoslav economy is competitive." Later staff papers omitted the vague reference to changes based on the evolution of the current account.

[39]In October 1982, the staff estimated that the real effective exchange rate had appreciated by 1 percent during 1981. See "Yugoslavia—Stand-by Arrangement—Review of Developments," EBS/82/181 (October 7, 1982), p. 17.

the Fund staff (now headed by Helen Junz, Senior Advisor in the European Department) arrived in Belgrade in November 1982 to negotiate terms for the third year of the stand-by arrangement, they knew that they would have to insist on toughening the program.

Inflation in Yugoslavia was aggravated by structural inconsistencies created by the government's attempt to decentralize decision making within a planned economy. In contrast to economies with central planning, firms had the right to set their own output prices; in contrast to market economies, those pricing decisions were not subject to hard budget constraints because firms normally could sell all of their output in the domestic market. An exogenous shock such as a depreciation would provide an excuse for workers to demand wage increases to compensate for the higher cost of imported goods. Firms would readily grant those demands and then would raise output prices commensurately, triggering a spiraling effect on wages and prices throughout the economy. The central bank would provide the credit that was needed to validate the resulting claims on national income.

To short-circuit the inflationary spiral, the Fund imposed ceilings on credit creation and encouraged the adoption of policies aimed at supporting productive investment while controlling wage increases. At the same time, the authorities were gradually liberalizing the trade and exchange system as part of an effort to position the economy for trading more and more with western markets rather than within the Soviet-centered region.[40] The process of liberalization frequently required price increases that aggravated the inflationary spiral and frustrated the effort to become more competitive. By 1982, the authorities were trying to dampen inflation by slowing the rate of currency depreciation, which of course was eroding the earlier gains in international competitiveness. For the 1983 program, the Fund imposed a very detailed rule for managing the exchange rate through a formal stabilization of the real effective exchange rate. It was not different in substance from the policy that the Yugoslavs themselves had begun in 1980, except that it took away the authorities' discretion to trade off competitiveness against price stability.[41]

A few Executive Directors expressed reservations when the program was reviewed by the Board in March 1983. Notably, Caranicas complained that it was not clear to him how a complete pass-through of depreciation into higher prices could be avoided, and Gerhard Laske (Germany) worried that excessive depreciation was simply covering up more fundamental deficiencies in the quality of the products that Yugoslavia was trying to sell in western markets. Overall, however, the Board welcomed the design of the adjustment program.[42]

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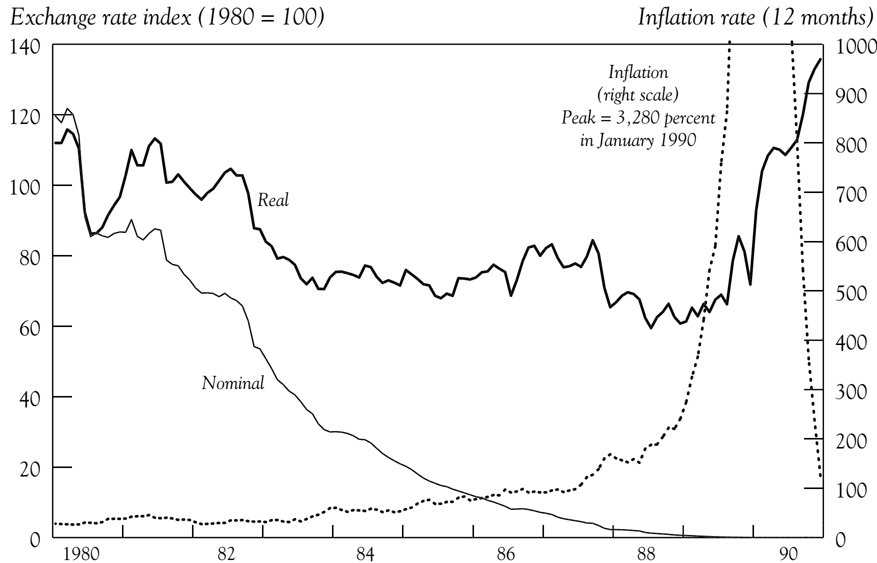
[40]Yugoslavia, which conducted much more trade with the west than did other countries in central and eastern Europe, was an associate member of the Soviet-dominated Council for Mutual Economic Assistance (CMEA). See Chapter 19.

[41]"Yugoslavia—Staff Report for the 1982 Article IV Consultation and Review Under Stand-by Arrangement," EBS/83/46 (February 24, 1983), especially pp. 8, 24, 26, 45, and 49.

[42]Minutes of EBM/83/46–47 (March 11, 1983); for the cited remarks, see pp. 21 (Caranicas) and 25 (Laske) of meeting 83/46.

Figure 13.3. Yugoslavia: Nominal and Real Effective Exchange Rates and Inflation, 1980–90



In the event, the Yugoslav authorities began anew to depreciate the dinar aggressively in 1983 and achieved a 25 percent drop in real effective terms during the year. That level then became the benchmark for subsequent programs and stand-by arrangements during the next five years.[43] On its own terms, the real exchange rate rule was spectacularly successful. Throughout the rest of the 1980s, international competitiveness as measured by the real effective exchange rate averaged about 25–30 percent better than it had been at the start of the adjustment process in 1980. The improvement eroded in 1986 and the first half of 1987, but another large devaluation in May 1987 more than offset that loss and brought a permanent strengthening (Figure 13.3). The current account deficit (excluding CMEA trade), which had been as large as 6 percent of national output in 1979, was eliminated by 1983, and a surplus equivalent to 4½ percent of output was recorded in 1988.

Throughout the 10 years that the real-rate rule was in effect, both the Yugoslav authorities and the Fund staff consistently underpredicted inflation. From an initial level of 16 percent in 1978 (well below the average for non-oil developing countries), retail price inflation in Yugoslavia rose to a plateau of 30–40 percent in the early 1980s, to 80–90 percent in the mid-1980s, and to more than 200 percent

[43]Following the 1981–83 stand-by arrangement, two 12-month arrangements were approved in 1984 and 1985. Yugoslavia then became the first country to have a formal "enhanced surveillance" relationship with the Fund, as described in Chapter 10. That relationship, in which the Fund staff continued to monitor progress in adjustment, was in effect for two years, until the Fund approved a new 12-month stand-by arrangement in June 1988.

by the time of the 1988 stand-by arrangement (Figure 13.3). Each year, inflation was forecast to fall; each year but one, it rose. When the country's already weak federal cohesion began to unravel completely in 1989, high inflation quickly exploded into hyperinflation. In the last four months of 1989, following Slovenia's announced intention to secede from the federation, prices were rising by 50 percent a *month*.

It would be too simplistic to blame Yugoslavia's inflation (especially the hyperinflation) on the application of a real exchange rate rule, but neither can the policy be absolved of blame.[44] If political cohesion had been stronger, if the government had given the central bank the authority and the means to control credit growth, if firms had been subject to hard budget constraints, if income policies had been applied more realistically and more consistently, and if financial liberalization had been coordinated with the development of an effective system of monetary control, then inflation certainly could have been better curtailed. Those conditions, however, were obviously not present, and the exchange rate policy interacted with an inefficient economic and political structure to produce hyperinflation.

Finally, in late 1989, the authorities and the Fund decided to try an entirely different strategy. Negotiations on a new economic program began in October (led by Jan van Houten, Assistant Director of the European Department, and initiated by a meeting in Washington between the Managing Director, Michel Camdessus, and the Prime Minister, Ante Marković), and on December 18, the government announced a comprehensive disinflation program. The dinar was replaced immediately by a new dinar at a ratio of 10,000:1, and the new currency was pegged to the deutsche mark. Wages and a wide range of prices were temporarily frozen, and residents were given the right to exchange dinars freely for foreign currency. Fiscal and monetary policies were both to be tightened sharply.

The Fund supported these policies in March 1990 by approving a new stand-by arrangement—Yugoslavia's last—for SDR 460 million ($600 million; 75 percent of quota) payable over 18 months. It was, however, too late for stabilization. Yugoslavia in 1990 and 1991 was paralyzed by conflicts between those (especially in Slovenia and Croatia) seeking autonomy and those seeking to retain central control. The authorities made only the initial drawing on the stand-by arrangement, and by the time it expired in 1992 the political federation had been dissolved by civil war. Even the major economic questions—how to stabilize prices and competitiveness and how to apportion responsibility for Yugoslavia's outstanding debts among five successor states—were overwhelmed by the immense human tragedies that engulfed the region.

Côte d'Ivoire: Adjusting Without the Exchange Rate

In contrast to the case of Yugoslavia, where choosing an exchange rate policy was a critical element in designing an effective adjustment program, Côte d'Ivoire

[44]Pleskovic and Sachs (1994, p. 196) infer that the exchange rate policy was imposed by the Fund and imply that it was the cause of the hyperinflation.

illustrates a situation in which exchange rate adjustment was rejected as a policy instrument until quite late in the game. This situation arose because Côte d'Ivoire participated in a currency union, the CFA franc zone, that enabled the country to enjoy the benefits of both a freely convertible currency and stable domestic prices. Only after exhausting all other adjustment options were the authorities willing to undertake the considerable risk of tampering with the exchange rate.[45]

As a member of the CFA franc zone, Côte d'Ivoire was effectively precluded from using the exchange rate as a policy instrument and had only limited ability to use monetary and fiscal tools. The CFA franc was pegged to the French franc at a fixed rate (50:1) throughout this period, and that parity could be changed only through the unanimous consent of the participating countries.[46] The rules of the system provided that France would guarantee the convertibility of the CFA franc by providing overdraft facilities with the French treasury, on condition that certain rules were observed. In particular, the stock of loans from the regional central bank (the BCEAO) to the government was not to exceed 20 percent of the government's fiscal revenues in the preceding year. Although this "20 percent rule" was designed to circumscribe the country's fiscal policy, it left open some loopholes by adopting a narrow definition of the government in which borrowing by public sector enterprises was not covered. In any case, fiscal policy was the main policy tool left for macroeconomic adjustment. Debit balances with the French treasury were subject to interest charges, and the central banks' charges on rediscounting of government obligations varied inversely with the government's deposit balance. While the overdraft and rediscounting system left some room to adjust monetary policy, it was intended only to prevent major inconsistencies between the regional exchange rate policy and each country's domestic credit conditions.

Côte d'Ivoire in the 1980s was the world's largest exporter of cocoa and the third largest exporter of coffee. Despite a diversification effort in the 1970s, the economy's fortunes remained highly dependent on the world markets for these two primary commodities. Following a coffee and cocoa boom of unprecedented scope in 1975–77, the government of Felix Houphouët-Boigny (the man who had led Côte d'Ivoire to independence in 1960 and had been its president ever since) undertook a massive program of capital investments. That strategy generated rapid growth but brought the country to a major financial crisis when commodity prices returned to normal levels in 1979 and 1980. At that point, Côte d'Ivoire—which

[45]For an analysis of the costs and benefits of participation in the CFA franc system, see Boughton (1993a, 1993b).

[46]The CFA franc zone comprises two distinct currency unions, each with its own currency and its own regional central bank: the West African Monetary Union, where the Central Bank of West African States (known by its French acronym, BCEAO) issues currency for Benin, Burkina Faso, Côte d'Ivoire, Mali, Niger, Senegal, and Togo; and a central African region where the Bank of Central African States (BEAC) issues a separate currency for Cameroon, the Central African Republic, Chad, Republic of Congo, Equatorial Guinea, and Gabon. Technically, the exchange rate of either currency could be modified independently of the other, but such action was never contemplated during the period reviewed here. For details on the history and operations of the system, see Boughton (1993a) and references therein.

had never before had a stand-by arrangement since joining the Fund in 1963—requested a three-year arrangement under the EFF.[47]

A staff team headed by Louis Goreux (Deputy Director of the African Department) quickly negotiated a program under which adjustment focused on cutbacks in several major categories of government spending, a redirection of public investment toward more efficient businesses, and a rationalization of government finances to bring parastatal enterprises under closer control. The Fund's Executive Directors agreed that the program was reasonable and ambitious, and only a few expressed reservations about the ability of the authorities to effect substantial adjustment without changing the exchange rate. The arrangement was readily approved in February 1981, giving Côte d'Ivoire a commitment totaling SDR 513 million ($625 million, or 450 percent of quota).[48]

Côte d'Ivoire adhered to the terms of the EFF arrangement remarkably well, especially considering how adverse global conditions were. Coffee and cocoa prices were still depressed but import prices were rising rapidly, so the terms of trade fell sharply in 1981 and did not recover until 1984. Export market growth was weak, owing to an unexpectedly severe recession in industrial countries. Even though the strengthening of the U.S. dollar against the franc improved Côte d'Ivoire's international competitiveness, it also substantially raised the local-currency cost of servicing the country's huge and rapidly growing external debt (which was largely denominated in dollars). A sustained increase in world interest rates further exacerbated the debt-service problem.

The authorities responded by cutting back capital investment plans even more drastically than originally planned, and they managed to keep the fiscal and monetary accounts close to the agreed limits throughout most of the three years that the program was in effect. Economic growth ground to a halt and then turned negative, and the current account deficit remained large, but both the authorities and the staff believed that the groundwork had been completed for a return to sustainable growth.[49]

Prospects for external viability were less bright. Côte d'Ivoire's current account deficit in 1983 amounted to 10 percent of GDP, largely because of the high cost of servicing the external debts contracted during the late-1970s boom years. Even under optimistic assumptions about trade, the deficit was projected to remain large for the next few years. Consequently, the authorities requested a new stand-by arrangement for 1984, which the Executive Board approved with the understand-

[47]Côte d'Ivoire (then known as the Republic of Ivory Coast) borrowed through the Oil Facility in 1974–76, through the CFF in 1976, and from the Trust Fund in 1978–81. Aside from the long-term concessional Trust Fund loans, all borrowings were completely repaid by 1979.

[48]"Côte D'Ivoire—Use of Fund Resources—Extended Fund Facility," EBS/81/34 (February 13, 1981); "Ivory Coast—Staff Report for the 1980 Article IV Consultation," SM/81/41 (February 17, 1981); and minutes of EBM/81/29 (February 27, 1981).

[49]Côte d'Ivoire made all scheduled drawings on the arrangement except for the very last one, which was disallowed owing to overruns on public sector borrowing in the second half of 1983. See "Ivory Coast—Staff Report for the 1983 Article IV Consultation and Request for Stand-by Arrangement," EBS/84/81 (April 6, 1984).

ing that the country was likely to need continual financial support from the Fund for the foreseeable future.[50] That forecast proved to be depressingly accurate. Côte d'Ivoire would have five more stand-by arrangements virtually back-to-back, lasting through 1992, at the end of which it would still need major policy adjustments and external financing before it could hope to reach equilibrium.[51]

For the next few years, occasional difficulties arose that prevented the full amount of the stand-by arrangements being drawn, but Côte d'Ivoire's overall record of adjustment continued to look strong through 1986. Indeed, when the 1986 stand-by arrangement was approved, Executive Directors from creditor countries praised Côte d'Ivoire's efforts as exemplary. The authorities were "continually designing and successfully implementing far-reaching structural policies" (Hélène Ploix—France); their "program had been very successful in 1985" (J. de Beaufort Wijnholds—Alternate, Netherlands); "performance . . . had been excellent and the authorities deserved to be particularly commended" (Bernd Goos—Alternate, Germany); and that record "had helped to restore the confidence of the international financial community" (Mary K. Bush—Alternate, United States).[52]

Throughout those first six years of adjustment, Côte d'Ivoire's exchange rate was not a significant policy issue. In effective terms, the rate was quite stable until the U.S. dollar started reversing its appreciation in March 1985 (Figure 13.4). Moreover, the tightening of monetary and fiscal policies in Côte d'Ivoire gradually reduced the domestic inflation rate to well below world levels, so that the real effective exchange rate depreciated by 28 percent from 1980 to 1985. From that point on, however, circumstances severely deteriorated. Coffee and other export prices declined again, foreign aid dried up, and the authorities ran out of ways to generate the resources to keep servicing the external debt. Consequently, Côte d'Ivoire's arrears to foreign creditors (official and private, but mostly to commercial banks) skyrocketed from just $21 million at the end of 1986 to nearly $1.8 billion at the end of 1989.[53]

When the authorities requested a new stand-by arrangement in 1987, the staff concluded that exchange rate policy was still broadly appropriate. By then, the exchange rate was appreciating in both nominal and real terms (Figure 13.4), but the

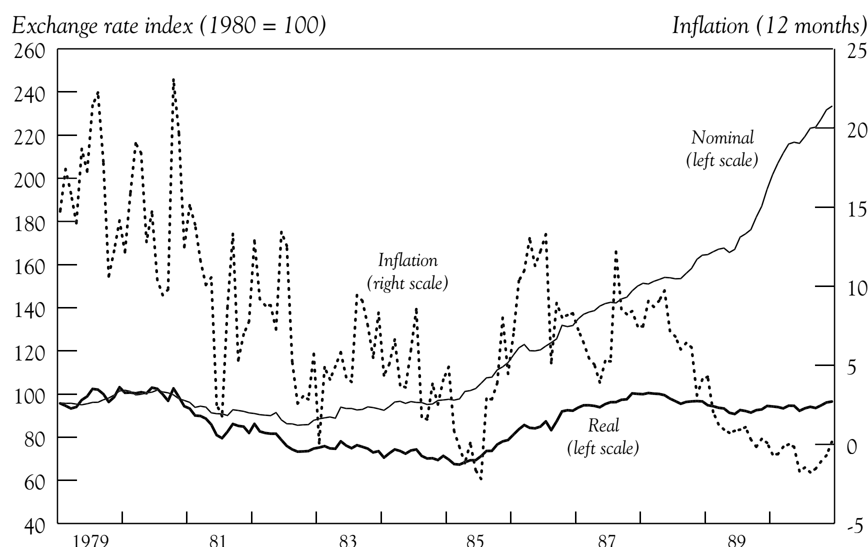
[50]During the discussion of Côte d'Ivoire's request for the 1984 arrangement, the Managing Director observed that the "prospect was for long-term balance of payments difficulties, with relatively little hope of regaining a viable balance of payments position in the short term; . . . the Fund would probably be called upon to assist Ivory Coast for a number of years to come . . . "; minutes of EBM/84/70 (May 2, 1984), pp. 37–38.

[51]The financial effect of the stand-by arrangements was to offset a portion of Côte d'Ivoire's repayments of the 1981–83 extended arrangement and thus to limit the decline in the Fund's exposure. From a peak of SDR 670 million ($675 million; 405 percent of quota) in August 1984, Côte d'Ivoire's outstanding obligations to the Fund declined gradually to approximately SDR 270 million ($335 million; 160 percent of quota) by the fall of 1989 and then remained around that level until they began to decline further in 1992.

[52]Minutes of EBM/86/101 (June 23, 1986), pp. 6 (Ploix), 9 (Wijnholds), 12 (Bush), and 14 (Goos).

[53]Converted to U.S. dollars from data in CFA francs in "Côte D'Ivoire—Review Under Stand-by Arrangement," EBS/90/209 (December 6, 1990), p. 21.

Figure 13.4. Côte d'Ivoire: Nominal and Real Effective Exchange Rates and Inflation, 1979–90



principal problem was the sharp drop in the terms of trade. Accordingly, the adjustment program incorporated "stringent domestic demand-management policies and increased efforts to improve productivity and reduce production costs." Moreover, participation in the currency union with neighboring countries and with France enabled Côte d'Ivoire to "maintain an open exchange and trade system" and to obtain "exceptional financing" (from France) to stay current on external payments obligations.[54]

In December 1987, the Fund's Executive Directors reacted skeptically to this optimistic assessment, and they directly examined Côte d'Ivoire's exchange rate policy for the first time. By then, this matter was becoming an international political issue, as some officials in the United States and other industrial countries had concluded that the tight link between the CFA and French francs was diverting trade away from their exporters and toward France.

The Board discussion was initiated by Charles Enoch (Alternate—United Kingdom), who expressed disappointment that the exchange rate had been largely ignored. Despite the difficulties, he argued, "the Board must recognize that it was being asked to approve a Fund-supported adjustment program that did not achieve balance of payments viability, while one instrument which could help in that regard—the exchange rate—had simply been set aside." Directors from the United States, Germany, Canada, and Australia also indicated their desire to see the authorities and the Fund take a fresh look at whether the level of the exchange rate

[54]"Côte d'Ivoire—Staff Report for the 1987 Article IV Consultation and Request for a Stand-by Arrangement," EBS/87/249 (November 30, 1987), pp. 17–18 and 30.

was still appropriate. C.R. Rye (Australia) went so far as to claim that there was "clear evidence that Côte d'Ivoire's exchange rate is substantially overvalued. . . . The Ivoirien authorities cannot seriously address their country's balance of payments weakness . . . without early action on the exchange rate." Although both the staff and the Directors speaking for Côte d'Ivoire (Corentino V. Santos, from Cape Verde) and France (Hélène Ploix) defended the status quo, the summing up of the discussion sent a clear signal to the authorities: "Although it was clear that difficult issues were raised by Côte d'Ivoire's membership in a currency union, several Directors thought that, given Côte d'Ivoire's prospective external environment, consideration of adjustments in currency relationships should not be precluded."[55]

The requested stand-by arrangement was approved in principle that day, and it took effect at the end of February 1988.[56] The adjustment program, however, immediately went off track, largely because the authorities—who believed that the disastrous decline in world prices for coffee and cocoa would be temporary—refused to cut the guaranteed prices paid to growers. When the decline continued, the price stabilization agency incurred enormous losses that put the country into a financial crisis.

From 1987 to the first half of 1989, Côte d'Ivoire's fiscal deficit rose from a nearly unmanageable 7 percent of GDP to a completely unfinanceable 16 percent. Nonetheless, a succession of Fund missions from December 1988 through April 1989 was told directly by President Houphouët-Boigny and other officials that the government did not see the need for further moves toward austerity. Then, on April 21, 1989, Houphouët-Boigny met tête-à-tête with Camdessus for some 2½ hours in Paris, at the end of which he agreed to put in place a major new adjustment program including substantial cuts in producer prices.[57] With that breakthrough, the authorities entered into detailed negotiations on a new adjustment program with a staff team headed by Christian A. François (Assistant Director in the African Department). Throughout these discussions, no serious consideration was given to a devaluation, and the new adjustment program was built around a 50 percent cut in prices paid to coffee and cocoa growers and a freeze on public sector wages.[58]

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[55]Minutes of EBM/87/172 (December 15, 1987), pp. 14–15 (Enoch), 25 (Rye), and 33 (summing up).

[56]Final approval of both the stand-by arrangement and a drawing under the CFF was contingent upon a satisfactory conclusion to rescheduling and financing negotiations that were taking place between Côte d'Ivoire and external private and official creditors. On February 29, 1988, the Board gave its final approval, and Côte d'Ivoire then borrowed SDR 7 million ($10 million) under the stand-by arrangement (out of a total commitment of SDR 94 million—57 percent of quota—to be made available over 12 months) and SDR 83 million ($115 million) under the CFF to cover a temporary shortfall in export earnings.

[57]Minutes of EBM/89/43 (April 24, 1989), pp. 3–4; and memorandums in IMF/RD Managing Director file "Côte d'Ivoire, January–October 1989" (Accession 90/223, Box 2, Section 473).

[58]"Côte D'Ivoire—Staff Report for the 1989 Article IV Consultation and Request for Stand-by Arrangement," EBS/89/212 (November 2, 1989), pp. 15–27.

No sooner was the 1989 program agreed upon than conditions deteriorated even more. With the collapse of the marketing agreements and quotas of the International Coffee Organization in July, the price of Côte d'Ivoire's coffee exports dropped by a further 30 percent. Both the staff and the Managing Director recognized that the government could not be expected to tighten its domestic policies any more at this stage, and it was agreed to try to seek additional external financing commitments instead.

After a delay of several months while additional loans and grants were being arranged from the World Bank and from a group of official donors, the Executive Board approved a new 18-month stand-by arrangement in November 1989. Approval did not come without qualms, however. Thomas C. Dawson II (United States) worried that "social constraints to adjustment" would be "exacerbated" by reliance on "highly visible cuts in nominal incomes" of agricultural producers, especially when the relatively high incomes in the public sector were being protected from cuts. Overall, the Board was impressed by the government's new seriousness of purpose, but Directors were split as to whether the government could carry out draconian cuts in wages as an alternative to changing the exchange rate, and as to whether the planned adjustment would suffice to restore balance and eventually regenerate growth.[59]

External conditions continued to worsen, so François and his team returned to Abidjan in January 1990 to negotiate terms for tightening the program enough to keep it on track. This time the authorities relented and agreed to cut public sector wages as well. When news of the agreement leaked to the public, however, protests broke out and continued until the government deployed troops to restore order. To restore a semblance of order, the government was forced not only to roll back the wage cuts but to begin to open up what had always been a very closed political process. Houphouët-Boigny appointed Alassane Ouattara, the governor of the BCEAO (and former Director of the Fund's African Department; see Chapter 20), to head a special Interministerial Committee with powers to redesign the adjustment strategy. Ouattara's committee decided to continue to concentrate on fiscal tightening, but through measures to raise substantial new tax and other revenues rather than through wage cuts. On that basis, a modified program was negotiated, and in June 1990 the Executive Board approved the resumption of drawings under the stand-by arrangement.

The revised program held together well enough to carry Côte d'Ivoire through the remainder of that stand-by arrangement and then through one more, but it was not sufficient to free the country from the burden of its foreign debt. Without more aggressive action to improve competitiveness, the authorities had no hope of diversifying the economy by enough to eliminate its dependence on the vagaries of the world markets for a few primary commodities. When further efforts to enforce austerity failed in 1992 and 1993, the only remaining option was to devalue the currency. After intense negotiations among the several member states, the CFA

[59]Minutes of EBM/89/150–151 (November 20, 1989). Dawson's quoted remarks were made at meeting 89/151, pp. 7–8.

franc was devalued against the French franc in January 1994: the first change in the rate since 1948.[60]

Standards for Fiscal Policy

Starting in 1983, some countries with high domestic inflation rates began asking the Fund to use inflation-adjusted measures of the government's budgetary balance as the performance criterion for fiscal policy. The Fund agreed to add such measures to the criteria in credit arrangements for Argentina and Brazil that year (see Chapters 8 and 9, respectively) and for Mexico in 1986 (Chapter 10). Those agreements, however, were exceptions to the general practice of setting ceilings only on the overall deficit or on monetary financing of the deficit.

Though the debate on how to measure fiscal restraint was technical, the central issue was quite important. Part of government interest payments reflects an inflation premium and is not expected to have the same depressant effect on private sector saving as the "real" component. In economies with high inflation, the nominal deficit can seriously overstate the pressures on the economy resulting from fiscal expansion.[61] Moreover, if the rate of inflation was assumed to be beyond the authorities' control during the coming year (or over whatever period the performance criteria covered), then the actual budget deficit was also beyond their control, because changes in inflation would alter borrowing costs, tax revenues, and many types of expenditure. Adjusting the deficit to exclude the effects of inflation on interest costs would produce a performance criterion for which the authorities could be held more accountable. If, instead, reducing the rate of inflation was viewed as a key element in the effort to stabilize the economy and therefore as an essential goal of macroeconomic policy, then the actual deficit should be targeted. Setting targets for both variables enabled the Fund to avoid resolving the underlying debate unless the authorities managed to meet the operational target while missing the unadjusted ceiling. In that case, the Executive Board would have to decide whether to grant a waiver for the missed performance criterion.

The staff of the Fiscal Affairs Department prepared a study of this issue (published later as Tanzi, Blejer, and Teijeiro, 1987), which was discussed by Executive Directors in a seminar in June 1986: just when Mexico was pressing for flexibility on the fiscal constraint.[62] The staff view was that no single measure of the fiscal deficit was adequate by itself and that the two measures provided complementary information. At the seminar, the Mexican Director, Guillermo Ortiz, offered a detailed rationale for making the operational deficit a primary performance criterion. At the other end of the spectrum, Berndt Goos (Germany) argued that only the conventional unadjusted deficit could measure the required degree of fiscal

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[60]For a Fund staff analysis of the 1994 devaluation, see Clément and others (1996).

[61]The range of possible effects of inflation on the government's accounts is more complex than this brief summary suggests. For a review, see Heller, Haas, and Mansur (1986).

[62]"Inflation and the Measurement of Fiscal Deficits," SM/86/53 (March 3, 1986).

adjustment. Reduction of inflation was critical to the success of an adjustment program, and in his view external viability could not be assured unless the overall budget deficit was reduced. Most Directors, however, agreed that the matter could not be resolved in favor of any single statistic and supported the Managing Director's conclusion that the Fund should experiment with different practices on a case-by-case basis.[63] In the field, however, the operational deficit never did take hold as a performance criterion except as a supplemental indicator in isolated high-inflation cases.

Fiscal standards were reviewed more generally in 1988. A central issue in that review was whether the conditionality guidelines should be extended (or interpreted more broadly) to make structural reforms—not just overall deficit reduction—a performance criterion or at least a benchmark for reviewing the progress of adjustment programs. The staff suggested some ways to incorporate qualitative structural benchmarks, for example by asking the authorities to specify detailed reform plans in the Letter of Intent. Donald C. Templeman (Temporary Alternate—United States) laid out the clearest argument for increasing the Fund's focus on fiscal reforms:

> Of course, it is not the Fund's business to tell a member country what role the public sector should play in its economy. However, the Fund does have a legitimate role in pointing out the different effects on the achievement of economic objectives that are likely to result from specific fiscal measures or from the failure to introduce such measures.

In rebuttal, A. Vasudevan (Temporary Alternate—India) argued that no matter how valuable fiscal reforms might be in particular circumstances, the general case was not empirically established and even analytically was "less than fully convincing." Moreover, "once an array of structural measures is allowed to creep into fiscal conditionality, there will be a tendency . . . to lengthen the program period . . . without a corresponding increase in access to Fund resources." After a full day of deliberation, the best that the Managing Director could suggest as a conclusion was that "we will have to proceed in a pragmatic way, looking at individual cases."[64] The result was a gradual increase in attention to the quality of government spending and revenue policies, though generally without explicit conditionality.[65]

External Debt Limits

An especially controversial performance criterion was the practice of limiting the overall amount of external debt that a country could undertake while operat-

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[63]Minutes of Executive Board Seminar 86/7 (June 4, 1986).

[64]Minutes of EBM/88/81 (May 20, 1988), p. 5 (Templeman) and p. 23 (Vasudevan); and EBM/88/82 (same date), p. 21 (Managing Director's summing up). Also see "Fiscal Aspects of Fund-Supported Programs," SM/88/53 (February 29, 1988).

[65]For staff views on the structural aspects of fiscal conditionality, see Tanzi (1987), IMF Fiscal Affairs Department (1995), and Mackenzie, Orsmond, and Gerson (1997). In the 1990s, the Fund paid increasing attention to the distribution and quality of government spending.

ing under a Fund-supported program. Throughout the 1970s, the Fund expressed concerns that the ready availability of inexpensive and unconditional bank credits was inducing many developing countries to overborrow and to postpone needed adjustments of economic policies. Consequently, from 1973 through 1978, two-thirds of all upper-tranche arrangements (36 out of 54) included some form of limitation on external borrowing as a performance criterion.[66] The staff, had, however, found it difficult to establish general rules governing such limitations that would ensure both efficacy and uniformity of treatment.[67] Finally, a few months after the completion of the general rewriting of the conditionality guidelines, the staff proposed an additional, specific guideline covering the use of external debt limits. After lengthy debate on technical issues, the Board accepted the addition of performance criteria on debt ceilings "when the size and rate of growth of external indebtedness is a relevant factor in the design of adjustment programs."[68] That criterion turned out to apply to almost every case from then on.

From 1979 through 1982, external debt ceilings were included in more than 90 percent of upper-tranche arrangements. The policy was reviewed in April 1983 in light of the onset of the international debt crisis. That review found that in the great majority of cases (61 out of 68 upper-tranche arrangements), countries had stayed within the agreed debt ceilings. The staff concluded that experience with these ceilings had been positive and was now more important than ever. Executive Directors concurred and suggested that the coverage should be made even more inclusive (covering both short- and longer-term debts; see footnote 67).[69] From that point on, a ceiling on external debt was used in virtually all Fund-supported programs.

This insistence on limiting foreign borrowing provides a further illustration of the uneasy relationship between the Fund and private financial markets. Restoring and maintaining access for developing countries to credits from international banks was a major goal of the Fund's approach to adjustment and reform. That approach, however, forced the question of whether bilateral negotiations between the author-

[66]"External Debt Management Policies," SM/79/125 (May 11, 1979), Table 1, p. 14.

[67]The major issue related to efficacy concerned the types of debt to include under the ceiling. As finally adopted, the Fund's guideline excluded both very long-term debts (particularly debts with initial maturities of more than 12 years), which were assumed to be beneficial to development, and short-term debts (with maturities less than one year), most of which were trade credits. This maturity-based criterion, though arbitrary in its dating, was judged to be more practical than earlier, largely abandoned, efforts to distinguish debts directly by purpose. The guideline also specifically exempted concessional loans.

[68]For the text of the decision, see the Appendix to this chapter. The Executive Board met on July 6, 1979 (EBM/79/106–107) to consider the staff paper, "External Debt Management Policies," SM/79/125 (May 11, 1979). The Managing Director then prepared a summing up that set out the proposed guideline along with several paragraphs of interpretation in light of the July 6 discussion. That draft was discussed at EBM/79/121 (July 23, 1979). A final version ("Text of Revised Summing Up," EBD/79/183, Rev. 1; August 2, 1979) was accepted on a lapse-of-time basis on August 3.

[69]"Fund Policies and External Debt Servicing Problems," SM/83/45 (March 8, 1983); minutes of EBM/83/57–58 (April 6, 1983).

ities of developing countries and commercial bank creditors could be relied upon to regulate the provision of credit and prevent overborrowing. Once a country had access to credit on market terms, foreign borrowing could substitute for domestic credit creation and could finance excessive growth in domestic demand. The judgment of the Fund staff and management, supported by the Executive Board, was that the danger of market excess was very real in these circumstances.[70]

Structural Conditionality?

Throughout the 1980s, the Fund became increasingly concerned with structural policies. Chapter 2 recounted how the coverage of Article IV consultation reports gradually became more structural, in response to a growing political and academic interest in the supply side of the economy, the Fund's increasing involvement with planned economies, its role in dealing with the international debt crisis, and the need to counteract political pressures for protectionist trade policies. Those same forces, plus the development of structural adjustment lending by the World Bank after 1979, also led to periodic calls for the Fund to devise performance criteria for certain structural policies in addition to the standard criteria on macroeconomic policies. More fundamentally, the increase in the portion of Fund lending directed to countries with deep-seated structural problems meant that requests for credit arrangements could no longer be evaluated solely in terms of macroeconomic stability. The Fund's conditionality, however, was constrained by the 1979 guidelines, which stated that performance criteria "will normally be confined to (i) macroeconomic variables, and (ii) those necessary to implement specific provisions of the Articles or policies adopted under them." (See Guideline 9, in the Appendix to this chapter.)

In 1981, just as the arrival of the Reagan administration in the United States was giving a high profile to "supply-side economics," the Research Department prepared a background paper on the scope for structural reforms that was generally sympathetic to the notion that economic liberalization could significantly strengthen aggregate supply. Policies designed to reduce market distortions, enhance incentives for saving and investment, improve education and training programs, or stimulate technological innovation were singled out as potentially beneficial. In addition, exchange rate devaluation was examined as a beneficial supply-side policy in situations where an economy was in external disequilibrium, perhaps because of a sustained terms-of-trade loss or the cumulative effects of high domestic inflation.

Ariel Buira (Mexico) opened the Board meeting on this topic by launching a blistering attack on the staff approach as it applied to developing countries. Regarding the paper's argument that the economic role of the state should be limited, which he saw as a "nineteenth century liberal concept in which the state has . . .

[70]For a clear statement of Fund policy, see "The Use of Limits on External Debt in Fund Arrangements," EBS/88/51 (March 4, 1988).

no development responsibilities," he responded that his authorities "did not expect Fund guidance on this matter." Furthermore, assigning a central role in adjustment programs to price incentives was a matter of "ideology and fashion," not economics. Many developing countries were likely to reject the Fund's advice on structural reforms, not because of "special interest groups," as alleged in the staff paper, but because of fundamental differences in economic analysis. The essence, if not the tone, of Buira's arguments was echoed to a degree by Directors from other developing countries.[71] The silent revolution was still some years away.

Throughout the first half of the 1980s, the staff often encouraged countries to implement liberalizing structural reforms, though usually without formal conditionality linked to borrowing rights under a lending arrangement. In some cases, countries were required to eliminate restrictions or other incentive-distorting policies before entering into a stand-by or extended arrangement. In other cases, progress in carrying out reforms was monitored through periodic reviews during the life of the arrangement. For example, almost all arrangements approved in the aftermath of the 1979–80 increase in world oil prices required the borrowing country to price petroleum products domestically so as to cover fully the cost of importing or producing the oil. In a few isolated cases (notably in arrangements for Argentina, Sudan, and Yugoslavia), performance clauses related specifically to structural reforms on interest rate, pricing, and subsidization policies.[72] More generally, staff recommendations on ways to cut fiscal deficits became increasingly structural, with emphasis on matters such as broadening the tax base and strengthening the administration of expenditure restraints.

The 1986 conditionality review revealed a more sympathetic view toward structural reforms than had been evident a few years earlier. Buira's successor in the Mexican chair, Guillermo Ortiz, accepted that "the recent emphasis on structural policies is certainly well placed," and he cautioned only that the Fund should defer to the World Bank with regard to many structural issues and that structural concerns should not lead to a proliferation of performance criteria. At the end of the day, the Managing Director concluded that the staff should continue to explore avenues for monitoring structural progress outside the realm of formal performance criteria.[73]

The Fund edged closer to embracing structural conditionality in a 1987 review of monitoring techniques for structural reforms. As the Managing Director summarized the review:

[71]The staff paper was "Supply-Oriented Adjustment Policies," SM/81/78 (April 6, 1981), and the Board discussion was held at EBM/81/62 (April 20) and 63 (April 21). Buira's statement is in the minutes of meeting 81/62, pp. 13–19.

[72]"Program Design and Performance Criteria," EBS/86/211, Sup. 1 (September 11, 1986), pp. 15–16. For a review of the Fund's practice with regard to petroleum pricing, see memorandum from Vito Tanzi (Director, Fiscal Affairs Department) to the Managing Director (May 6, 1983), in IMF/RD Managing Director file "Extended Fund Facility, 1981–1983" (Accession 86/32, Box 3, Section 379).

[73]Minutes of EBM/86/190 (December 3, 1986), p. 20 (Ortiz); EBM/86/191 (same date), p. 51 (summing up).

> Most Directors supported the principle that conditionality should be attached to structural reform when the latter was seen as essential for the achievement of external viability—often but by no means always the case—and hence for safeguarding the revolving character of the Fund's resources.[74]

Consensus, however, was less comprehensive than this sentence suggests. In contrast to the Fund's conventional adjustment levers—monetary, fiscal, and exchange rate policies—there was no generally accepted model or paradigm linking specific structural policies either to macroeconomic performance or to external viability. The Board in effect was authorizing the staff to experiment further in trying to develop a general approach, but structural conditions would still have to be applied case by case.

Despite this gradual slide toward an increased Fund involvement in structural reforms, the Board consciously declined to take the extra step of extending formal conditionality to cover structural policies in any general way. For the 1988 review of the conditionality guidelines, the staff asked Executive Directors to consider whether cases in which structural reforms were essential for the success of an adjustment program should still be regarded as "exceptional," as stated in Guideline 9 (but apparently contradicted by the 1987 conclusion quoted above). Broadly speaking, Directors agreed that a strict interpretation of that guideline would be too narrow, but they preferred to let staff and management continue to experiment liberally and to "place more emphasis on structural reforms" rather than to tinker with the governing principle.[75]

South Africa: Structural Impediments to Growth

An especially delicate issue of structural reform arose when South Africa applied for a stand-by arrangement in 1982: the most controversial case the Fund had ever had to consider. It was not the first time that the Fund had approved a stand-by arrangement for South Africa, but it came at a time of increasing international outcry against the apartheid policies of the regime. From 1958 through 1976, the Fund approved four stand-by arrangements and one CFF drawing, without provoking any generalized political objections. Subsequently, events such as the 1976 Soweto uprisings and the 1977 murder of imprisoned resistance leader Stephen Biko led to a more widespread awareness of the implications of apartheid, the imposition by many countries of restrictions on economic and other contacts with South Africa, and a series of condemnations of the regime by the General Assembly of the United Nations. Consensus on tactics, however, was less than universal. Notably, although the United States imposed sanctions beginning in 1977, the Reagan administration shifted to a policy of "constructive engagement" upon taking office in 1981. Hence in 1982, most countries were officially opposed to the maintenance of

[74]Minutes of EBM/87/176 (December 18, 1987), p. 8.

[75]Minutes of EBM/88/60 (April 8, 1988), p. 6 (summing up). The handling of structural conditionality became a more urgent issue after 1997, as a result of the role of inadequate banking supervision and other structural deficiencies in the financial crisis in Asia.

normal relations with South Africa, but the United States and a few other industrial countries were resisting moves to isolate the country economically.[76]

South Africa joined the Fund in 1945 as an "original member." Although since 1974 it had been one of a handful of pariah states not represented on the Executive Board,[77] it retained full rights of membership. When the UN General Assembly implored the Fund to sever relations, the Fund's response was that it was prohibited by its Articles of Agreement from considering political or other noneconomic issues in its relations with its members.[78] The central question was whether apartheid was a relevant economic issue.

South Africa's balance of payments weakened considerably in 1981 and 1982, partly as a result of the retreat in the price of gold (the country's principal export) from the heights reached in 1979–80, but also because of weaknesses in the prices of several other exports (mostly other minerals). In February 1982, the authorities informed the staff that they wanted to use the impending Article IV consultations to discuss a possible stand-by arrangement or other use of Fund resources. Staff and management readily agreed that such a request would have to be considered apolitically, on the basis of equal treatment of all members. The Managing Director took the precaution of sounding out Executive Directors from the major industrial

[76]In the UN General Assembly, the United States, the United Kingdom, and Germany consistently voted against resolutions condemning relations between the Fund and South Africa. Most other industrial countries, and a few developing countries, joined them in some instances but more often abstained.

[77]In 1946–48, South Africa was a member of the constituency headed by the Netherlands. From 1948 (when the National Party took power) through 1974, it was in the constituency headed by Australia. For the next two decades, South Africa did not participate in the election of Executive Directors. At Board meetings dealing with South Africa, the government was normally represented by a Special Resident Representative. Throughout that time, consultations with the country and the negotiation of stand-by arrangements were handled by the Fund's European Department. Following the adoption of a nonracial constitution and the election of Nelson Mandela as president, South Africa joined the group of Anglophone African countries through the election of Executive Directors in 1996, and responsibility for dealings with the authorities was transferred to the Fund's African Department.

[78]As discussed in Chapter 20, the basic agreement defining relations between the Fund and the United Nations respects the independence of the Fund in all respects. It does, however, require the Fund to give "due consideration" to requests by the United Nations that items be placed on the agenda of the Board of Governors. In November 1981, the General Assembly adopted Resolution A/Res/36/52, stating that it "deeply deplores the persistent collaboration between the International Monetary Fund and South Africa in disregard of repeated resolutions to the contrary by the General Assembly and calls on the International Monetary Fund to put an end to such collaboration." The resolution also requested that relations between the Fund and South Africa be placed on the agenda of the Annual Meetings of the Board of Governors. The following month, the General Assembly adopted Resolution 36/172 D, calling on the IMF to cease lending to South Africa and to suspend it from membership. Both resolutions were circulated to and discussed by Executive Directors, and a formal reply was made to the United Nations. De Larosière, however, declined to place the matter on the Annual Meetings agenda, and no governor moved to do so. The UN resolutions were circulated internally at the Fund as attachments to "United Nations General Assembly—Thirty-Sixth Session," SM/82/15 (January 22, 1982) and "Resolution of the United Nations Assembly on Relations with South Africa," EBD/82/107 (April 30, 1982). The latter document also included a letter of response on behalf of the Fund.

countries and was assured of their support.[79] Even so, the staff mission (led by Adalbert Knöbl, Advisor in the European Department) reached an understanding with the authorities that, to avoid a possible political confrontation during the Annual Meetings in Toronto, no formal request would be submitted until the fall.[80]

Knöbl's team returned to South Africa in August 1982 to negotiate the terms of a stand-by arrangement and also to review the authorities' informal request for a CFF drawing to compensate for a shortfall in export earnings. Two aspects of these discussions turned out to be controversial. First, although the price of gold was then above $350 an ounce and rising, the staff decided to base the economic program for 1983 on an assumed price of $315 (the average price for June 1982). The purpose was to "safeguard the adjustment," to ensure that policies would be tightened by enough to restore external balance even if gold prices weakened again. This choice, however, appeared to overstate the case for the requested credits by making the balance of payments outlook worse. Although the existence of a "balance of payments need" for borrowing from the Fund could have been made even at the higher gold price,[81] the dubiety of this assumption would be cited by several Executive Directors as a possible reason for turning down the request.

The second controversy arose from the staff's judgment that structural policies were not relevant for evaluating a request for a 12-month stand-by arrangement. The staff report discussed the need for adjustment of monetary and fiscal policies but did not deal with the economic consequences of the country's labor market policies. One element of apartheid was a panoply of restrictions on the employment, movement, training, and education of nonwhite workers. Those restrictions obviously stunted the economy's growth prospects and had contributed to the weaknesses underlying the request to use Fund resources. In the staff view, however, improvements in labor policies would not affect economic performance until after the one-year life of the proposed arrangement, and it would therefore not be appropriate to require such adjustment in this case.[82]

Once the authorities announced publicly in early October that they were requesting the credits, a storm of protest erupted. The UN General Assembly passed another resolution, specifically asking the Fund to deny the request. Letters and ca-

[79]Memorandum from William B. Dale (Deputy Managing Director) to the Managing Director (February 18, 1982), with attachments; in IMF/RD Managing Director file "South Africa, 1982" (Accession 84/21, Box 5, Section 168).

[80]Memorandum for files (July 8, 1982) by Nigel Carter (Personal Assistant to the Managing Director); in IMF/RD Managing Director file "South Africa, 1982" (Accession 84/21, Box 5, Section 168).

[81]The CFF drawing was fully justified on the basis of shortfalls in receipts on goods other than gold, and the projected current account deficit for 1983 would still have been substantial with an assumed gold price of $350. See "South Africa—Request for Stand-by Arrangement," EBS/82/173 (October 4, 1982), p. 6, and minutes of EBM/82/141 (November 3, 1982), p. 3.

[82]The staff view on this point was stated most clearly by Whittome at EBM/82/141 (November 3, 1982), pp. 6–7. Also see "South Africa—Request for Stand-by Arrangement," EBS/82/173 (October 4, 1982).

bles from religious groups, political leaders, and others around the world carried a similar message. On October 29, four days before the Executive Board was scheduled to consider the proposal, de Larosière received a delegation from the United Nations' Special Committee on Apartheid. Two days later, he met with the UN Secretary General, Javier Pérez de Cuéllar, to explain the Fund's position. Through it all, he expressed determination not to be swayed by political considerations, no matter how fundamental they might be.[83]

Executive Directors from developing countries (known then as the "G-9") caucused on November 2 and agreed to request a postponement of the Board meeting. Several among them had just arrived at the Fund, having been elected in September for a term beginning November 1, and they wished for time to reflect. They knew that they lacked the votes to defeat the request by themselves, but if a vote could be put off even for a few days while they studied the documentation, the pressure on others was likely to rise. When the Board met the next morning, the G-9 spokesman, Mohamed Finaish (Libya), opened the discussion with a motion to postpone. Positions were quickly tallied, and no one outside the caucus supported the move. The nine chairs in favor of postponement held just 31 percent of the voting power, and the eight chairs opposed—all from industrial countries in the Group of Ten (G-10)—held 55 percent. (Four chairs were silent, and one was vacant on that day.)[84]

Next, the discussion turned to the substance of South Africa's program. Most speakers accepted that both the CFF drawing (SDR 636 million, the equivalent of $680 million, or 100 percent of quota) and the stand-by arrangement (for SDR 364 million; $390 million, 57 percent of quota, and sized so as to make a total of SDR 1 billion available) were justifiable on technical grounds, despite the controversies described above. Five Directors spoke out against the program, primarily on the grounds that structural reform should have been required.

The case that apartheid incorporated debilitating labor market policies was introduced by Yusuf A. Nimatallah (Saudi Arabia), who argued that "unless the labor supply bottlenecks are eliminated, South Africa will be unable to embark on a noninflationary growth path. Removing the rigidities in the labor market should be part of the adjustment program." He was joined in this line of attack by Finaish, A. S. Jayawardena (Alternate—Sri Lanka), Ghassem Salehkhou (Iran), and Tai Qianding (Alternate—China). Neither of the Directors from sub-Saharan Africa argued against the substance of the program, and neither voted against it. Having argued that the discussion should be postponed, both stated only that they were "reserving their positions" on whether the credits should be approved. With 14

[83]Minutes of EBM/82/140 (November 3, 1982), pp. 4–5.

[84]The Executive Director for Indonesia, Byanti Kharmawan, had died a few weeks earlier, and his successor was to take office on November 4. The Group of Nine Executive Directors from developing countries was formed as an informal caucus in November 1966, as a counterweight to the Group of Ten industrial countries in the negotiations on the creation of the SDR; see de Vries (1976), Vol. 1, p. 107.

chairs in favor, 5 opposed, and 2 in effect abstaining, the Fund approved the request.[85]

South Africa made the CFF drawing and the initial drawing on the stand-by arrangement, but the authorities did not seek to draw the remaining amounts under the arrangement. Gold and other mineral prices strengthened in 1983, and the tightening of monetary and fiscal policies contributed to a further improvement in the current account. When the Executive Board met in June 1983 to review the program, the issue was not whether the performance criteria had been met (they clearly had) but whether the lack of progress in eliminating structural impediments to growth warranted canceling the arrangement. This time, the staff report devoted an entire section to "labor market policies as a constraint on growth," and a background paper included a detailed appendix on actual labor market policies and practices. Those reports left no doubt that apartheid was having severe economic effects, both on the majority of the population that was directly affected and in the aggregate.[86]

At the Board meeting, six constituencies voted against the continuation of the stand-by arrangement (the five that had opposed the initial approval in November, plus the then-unrepresented group headed by Indonesia). Others, even while not opposing the decision to continue, now spoke out more clearly for the proposition that Fund lending should be linked to structural reform. On this occasion, the case was stated most eloquently by E.I.M. Mtei (Tanzania):

> The so-called job reservation regulations, which excluded certain race groups from some categories of employment, had impeded vertical mobility of labor, discouraged the acquisition of skills by certain race groups, distorted the occupational allocation of labor, and hindered optimal use of the labor force and proper functioning of the labor market. Impediments to horizontal or geographical mobility of labor also affected morale and hindered efficiency. All those factors led to high interregional and interrace group pay differentials and added to inflationary pressures. With excess supply of labor in some areas and shortages in others, the natural consequences were economic inefficiency and higher costs of production. In that regard, it was regrettable that there was no indication of any clear prospects of improvement in the educational system or of the abolition of those irrational regulations in the present employment policies and practices of South Africa.

At the time, the South African case demonstrated the Fund's commitment to political neutrality, even in the most egregious circumstances. More fundamentally, however, it forced the Fund to begin to reconsider its aloofness with regard to economic malpractices that derived from political or social mores. Throughout

[85]Minutes of EBM/82/140–141 (November 3, 1982). The quotation from Nimatallah is from meeting 82/140, p. 15. As a further indication of how far removed this case was from the Fund's usual apolitical environment, the normal secrecy of the Board's deliberations could not be maintained. The *Wall Street Journal* ran a story the next morning that included detailed information about the positions taken by individual Executive Directors. Eventually the entire text of the draft minutes of the meeting was in wide circulation among journalists, UN delegates, and others.

[86]"South Africa—Staff Report for the 1983 Article IV Consultation and Review Under the Stand-by Arrangement," EBS/83/100 (May 20, 1983), pp. 14–16, and "South Africa—Recent Economic Developments," SM/83/111 (June 3, 1983), Appendix.

the remaining decade of minority rule in South Africa, the Fund's policy advice focused with increasing intensity on the economic consequences of apartheid. As the authorities made no further requests to borrow, the question of imposing structural conditionality never arose again in this specific context. The incident was nonetheless a pivotal step in moving the Fund's policies in that direction.

East Africa: Balancing Stabilization and Reform

Many African economies in the 1970s and 1980s were managed by dominant central governments that exercised tight controls over most aspects of economic activity. When that system produced reasonable economic performance, as in Kenya, the Fund and other international creditors and donors tended to focus on the need for macroeconomic stability and not to push very hard for structural reforms. That complacency led to a "halo" effect in Washington and a "spoiled child" effect in Kenya that delayed progress and resulted in more manifest problems in the 1990s.[87] When economic policies were less successful, as in Tanzania, the Fund placed greater emphasis on the need for structural reforms as an adjunct to macroeconomic adjustment.[88]

Kenya

Kenya joined the Fund in 1964, less than two months after gaining independence from British rule. The new government of Jomo Kenyatta set out to control the economy through a complex set of parastatal enterprises and marketing boards, but it adopted a distinctly more capital-friendly and open economic environment than most of its neighbors. It inherited and then built on a relatively modern infrastructure, including one of the more advanced transportation systems in sub-Saharan Africa. By 1973, Kenya was able to present Nairobi as a showcase of African development when it hosted the Annual Meetings of Fund and Bank governors.

The Fund's financial assistance to Kenya began with SDR 108 million ($130 million; 224 percent of quota) in mostly low-conditionality credits in 1974–77,[89] followed by SDR 47 million ($60 million) in Trust Fund loans from 1977 to 1981. Kenya enjoyed good access to international capital markets on commercial terms, and the World Bank also was an active creditor. The Bank took an unusually "protective" attitude toward what it saw as one of the best governments in the region, and it showed little interest in pushing for policy reforms (Kapur and others, 1997, pp. 289–93).

The Fund's low-conditionality credits were followed by a series of three stand-by arrangements (1979 to 1982) for the successor government of Daniel arap Moi, on which conditionality was not very strong or effective. Notably, despite a persistent upward trend in the real effective exchange rate and a recognition that Kenya was thereby becoming uncompetitive in world markets, the Fund did not

[87]On the "halo" effect, see Kapur and others (1997), p. 761. The "spoiled child" effect was cited in interviews for this study by officials in Nairobi.

[88]For the story of the Fund's assistance to the third country in the East Africa region, Uganda, see Chapter 14.

[89]The only high-conditionality lending was an EFF arrangement approved in July 1975, on which just one drawing was made. See de Vries (1985), pp. 370–73, and Killick (1984).

insist on a devaluation as a condition for financial assistance until 1981.[90] Two devaluations that year improved matters only temporarily, were soon overtaken by overly expansionary monetary and fiscal policies, and did not restore viability to the balance of payments.[91] By late 1982, Kenya found itself with substantial outstanding debt obligations to the Fund and other creditors and an undiminished need for policy adjustment.

A serious effort to get macroeconomic policy under control began around the end of 1982, not long after the government survived an attempted coup by Air Force officers. At the urging of the Fund, Kenya adopted a policy of targeting (and gradually depreciating) the real effective exchange rate. The government also took a few tentative steps toward decontrolling prices, but without alleviating the major distortions in the price structure; and they began to rationalize both the tax system and the financing of parastatal enterprises.[92] Despite some major economic shocks (including a severe drought in 1984) and lack of progress in reforming parastatal enterprises or agricultural marketing, the gradualist strategy worked reasonably well for the next three years. In 1985, in the midst of a boom in world coffee prices, Kenya was able to wean itself temporarily from dependence on Fund financing.

No sooner had Kenya begun to experience strong performance than the authorities let policies slip. Excessive monetary growth and government borrowing in 1986, followed by a deterioration in the world coffee market in 1987, brought Kenya quickly back to the Fund for more help. In February 1988, the Executive Board approved a combination stand-by and SAF arrangement, under which Kenya could draw SDR 28 million ($38 million, or 20 percent of quota) immediately and a total of SDR 175 million ($235 million; 123 percent of quota) over three years. Policy conditions for this financing stressed the standard prescriptions for macroeconomic stability, while the overall adjustment program incorporated structural reforms as well. Monitoring of those reforms—development of the private sector, strengthening of parastatal enterprises, and improvements to agricultural marketing—was left largely to the World Bank,[93] but the Bank also was focused more on stabilization than on laying the groundwork for future growth.[94]

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[90]A September 1979 staff study found that Kenya had lost between 8 and 15 percent in relative price competitiveness during the three years through the end of 1978. On the basis of that study and related staff analysis, the staff concluded that a devaluation should be a necessary condition for further use of Fund resources. Although the Managing Director supported that conclusion, the authorities successfully resisted it in the subsequent negotiations. The exchange rate study is attached to a December 19, 1979, memorandum from Zulu to the Managing Director; in IMF/CF (C/Kenya/810 "Mission, Stillson and Artus, September 1979"). The Managing Director's support is indicated in a handwritten note on the memorandum. For the program subsequently approved, see "Kenya—Request for Stand-by Arrangement," EBS/80/215 (September 30, 1980).

[91]See "Kenya—Request for Stand-by Arrangement," EBS/81/241 (December 10, 1981).

[92]"Kenya—Request for Stand-by Arrangement," EBS/83/41 (February 23, 1983).

[93]See "Staff Report for the 1987 Article IV Consultation and Request for Stand-by Arrangement and for Arrangements Under the Structural Adjustment Facility," EBS/88/2 (January 7, 1988), especially Appendix II.

[94]See the criticisms of Bank policy on Kenya advanced by Stanley Fischer (then the Bank's Chief Economist) in 1989, quoted in Kapur and others (1997), pp. 754–55.

By the time the Fund considered a request for an ESAF arrangement in 1989, Kenya still was showing little progress on structural reforms.[95] Although several Executive Directors lamented that fact, any concerns were easily outweighed by optimism on macroeconomic stability. The most detailed critique of Kenya's structural policies was offered by Mary Elizabeth Hansen (Temporary Alternate—United States), who noted that while Kenya had a "sound macroeconomic framework," the economy still lacked "efficiency and dynamism." She called attention specifically to the need for cuts in the size of the civil service, management reform in the parastatal enterprises, liberalization of import licensing requirements, and better management of the natural resources that underpinned the tourist industry. No Director, however, questioned the appropriateness of approving the requested loans.[96]

Conspicuously absent from the Fund's deliberations on Kenya in the 1980s was any mention of the official corruption that dominated discussions at times in the following decade. Four reasons may be advanced for the shift, although it is still too early to fully assess their importance. First, the effects of corruption on economic performance in Kenya did not become severe until later. Second, as Kenya's macroeconomic policies weakened, the devastating effects of weak structural elements—including corruption—became increasingly evident. Third, the international community (in both the northern and southern hemispheres) became less tolerant of corruption after the end of the Cold War, as assistance to questionable governments could no longer be justified on geopolitical grounds. Fourth, the Fund had not yet found a formula for dealing with corruption as a structural impediment without fear of compromising its political neutrality. Once these various barriers fell, the Fund would be in a position to insist on fundamental reforms in Kenya before resuming financial assistance.

Tanzania

In the background to the Fund's efforts to instigate structural economic reform in Tanzania was an impasse over conventional conditionality that erupted in

[95]Kenya's last drawings on the Fund's general resources came in the fourth quarter of 1988 under the 1988 stand-by arrangement and to compensate for export shortfalls under the terms of the CFF. By that time, the Fund was encouraging Kenya to shift its borrowing into the lower-cost and longer-term structural adjustment facilities. Staff and management tried unsuccessfully to dissuade the authorities from applying for the compensatory financing, but the authorities insisted on getting the additional money. From the end of 1987, just before the first SAF loan, to the end of 1994, Kenya's total indebtedness to the Fund did not change materially, but all of it was shifted from the General Resources Account to the SAF and ESAF. For the dispute on Kenya's October 1988 request for compensatory financing, see memorandums and cables in IMF/RD African Department file "Kenya—Correspondence, 1988" (Accession 91/31, Box 3, Section 576).

[96]Minutes of EBM/89/55 (May 15, 1989). For Hansen's remarks, see pp. 28–30.

[97]Tanzania gained its independence from the United Kingdom in 1961 and became a member of the IMF the following year. Tanzania was formed through the union of Tanganyika and Zanzibar in 1964. It made occasional low-conditionality drawings starting in 1974 and had a small stand-by arrangement in 1975 on which it did not draw. At the end of the decade, Tanzania owed SDR 85 million ($112 million; 155 percent of quota) to the Fund's General Department and SDR 30 million ($40 million) to the Trust Fund.

1979.[97] Earlier, the government of President Julius Nyerere obtained substantial external financial assistance from donor countries and from the World Bank, which it applied to a variety of large-scale infrastructure and other developmental projects (see Duncan, 1997). The collapse of the East African Community (EAC),[98] an extended drought, a successful but costly war to drive Idi Amin out of Uganda, and the 1979 increase in petroleum prices all contributed to a balance of payments crisis that induced Tanzania to seek a stand-by arrangement with the Fund.

Nyerere and much of his government in 1979 were prepared to make no more than minimal policy concessions to the Fund as conditions for getting access to the Fund's money, and they were strongly opposed to any linkage between Fund credits and structural reform. The finance minister, E.I.M. Mtei (later to serve as Executive Director at the Fund), was virtually alone in seeing the need for fundamental change, including a major devaluation of the exchange rate. When negotiations were scheduled to begin in October 1979, Mtei knew that he would have to battle to win the approval of the president, so he decided to impress him with the seriousness of the problem as soon as the Fund staff team (led by Bo Karlstroem, Assistant Director of the African Department) arrived in Dar es Salaam. Mtei, a few other officials, and Karlstroem all went to see Nyerere at his home on a Saturday afternoon, October 27. Unfortunately, the strategy backfired when the meeting went badly. After Karlstroem seemed to insist that the government would have to abandon much of its system of direct and quantitative economic controls, and he forecast a decline in foreign assistance (including bank loans) if the talks failed, Nyerere concluded that he could not negotiate under these conditions. He abruptly terminated the mission and told the staff team to leave the country. Mtei had no choice but to resign as minister, which effectively ended the prospects for a strong adjustment program for the time being.[99]

Nyerere, one of the most highly respected political leaders in Africa, soon went on the offensive against the IMF. In an address to the diplomatic community in Dar es Salaam on New Year's Day, 1980, he questioned the whole basis for the Fund's central role in the world economy:

> When did the IMF become an international Ministry of Finance? When did nations agree to surrender to it their powers of decision making? . . . It has an ideology of economic and social development which it is trying to impose on poor countries irrespective of [our] own clearly stated policies. And when we reject IMF conditions we hear the threatening whisper: "Without accepting our conditions you will not get our money, and you will get no other money."[100]

[98]The EAC was formed in 1967 by Kenya, Tanzania, and Uganda to promote trade and other economic relations within the region and to coordinate the development of infrastructure. It was doomed by a widening gulf of political and economic divergences between its members.

[99]See memorandums by Karlstroem (memorandum for files of October 27, 1979; memorandum to management of November 8; and draft note of November 20); in IMF/RD African Department file "TA16, Use of Fund Resources—EFF, October 1979 EAD" (Accession 84/53, Box 1, Section 100). Additional information here is from interviews with officials in Tanzania and with Fund staff.

[100]The speech was reproduced in *Development Dialogue*, 1980, No. 2, pp. 7–9; the quotation is from p. 8.

A few days later, he sent his ambassador in Washington to call on de Larosière, to convey his displeasure at what he saw as the "paternalistic and condescending" treatment he had received from the Fund staff. Commercial banks had cut off lending to Tanzania pending a successful conclusion of negotiations with the Fund, and Nyerere believed that the Fund had encouraged them to do so as a means of pressuring his government. Moreover, he had concluded that the Fund was part of a "western conspiracy" to force Tanzania to abandon its socialist principles in favor of capitalism, a move that he believed would lead to corruption, a widening maldistribution of income that would work to the disadvantage of ethnic Africans, and possibly even to mass starvation.[101]

De Larosière was not about to be dissuaded by this setback. Without either economic reform or Fund financing, Tanzania had no hope for recovery, and the Managing Director felt that the Fund carried a responsibility to help if it could. Moreover, the Annual Meetings in Belgrade, where the major industrial powers had pushed the Fund to increase lending to developing countries (see above, pp. 560–63), had only recently concluded. He quickly wrote to Nyerere to express his "deep concern" over the president's reaction to events, and he promised to do "everything in my power to prevent any threat to . . . good relations" between the Fund and Tanzania. Nyerere also was eager to get an agreement, and he responded positively to the Managing Director's letter and then gave his new team (led by Finance Minister Amir H. Jamal) the go-ahead to resume talks.[102] The Director of the African Department, Justin B. Zulu, then visited Dar es Salaam at the end of March to help ease the diplomatic tension.

A second staff team (led by Evangelos A. Calamitsis, Assistant Director of the African Department) went to Dar es Salaam in April 1980, with more flexible instructions to negotiate a program that would be acceptable to the authorities. Despite the presence of goodwill on both sides, however, the Fund and Tanzania were on a collision course. The government still believed that the Fund was trying to impose an entirely different economic system on the country, and the Fund's insistence on moving toward more rational pricing policies provided some justification for that fear.[103] The ensuing negotiations produced the devaluation that the Fund thought was necessary, but the supporting measures to get the government's budget deficit under control were left for later implementation.

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[101]Memorandum for files by C. Max Watson (Personal Assistant to the Managing Director), January 7, 1980; in IMF/RD African Department file "TA16, Use of Fund Resources—EFF, October 1979 EAD" (Accession 84/53, Box 1, Section 100). The "western conspiracy" phrase is from the November 20 note cited in footnote 99.

[102]Letter from de Larosière to Nyerere (January 11, 1980); in IMF/RD African Department file "TA16, Use of Fund Resources—EFF, October 1979 EAD" (Accession 84/53, Box 1, Section 183). Letter from Nyerere to de Larosière (February 22, 1980); in IMF/RD African Department file "Tanzania—Correspondence, 1980" (Accession 83/45, Box 3, Section 183).

[103]The blueprint for developing the Tanzanian economy was the "Arusha Declaration" of January 1967, in which Nyerere outlined a strategy of state ownership and control of major industries, commerce, and finance, and of development through agriculture rather than industrialization. See TANU (1967) and Nyerere (1977).

As negotiations proceeded, Nyerere again denounced the Fund's conditions, leaked selected Fund documents to the international press, and publicly called for a special United Nations conference to develop alternative solutions.[104] That the government lacked commitment was obvious, but the staff agreed both to soften conditions somewhat and to raise the amount of credit being offered in order to reach an agreement. The Executive Board shrugged off the apparent risks and approved a stand-by arrangement (plus a CFF drawing to compensate for shortfalls in export revenues) in September 1980.[105] That enabled Tanzania to draw SDR 40 million (73 percent of quota) in October, with the prospect of another SDR 140 million over the next 21 months if the conditions were met. Inevitably, the government failed to carry out the program, and only that initial drawing was allowed.

The next few years were among the most difficult in Tanzanian economic history.[106] Output in manufacturing fell sharply, overall output stagnated, prices rose rapidly, and shortages of basic and other goods pervaded economic life. While the government attributed the decline primarily to adverse external conditions, the Fund staff regarded the external environment as a secondary issue. The main problem, in the Fund's view, was a host of inappropriate macroeconomic and structural policies: controls that distorted the price structure, excessive monetary financing of fiscal deficits, heavy reliance on subsidies on consumer goods, inefficient management of parastatal enterprises, and overvaluation of the exchange rate. By 1984, the authorities—led by a new but highly experienced finance minister, C.D. Msuya[107]—were moving away from ideological confrontation, and they gradually began to make piecemeal reforms. Overall economic performance, however, remained extremely poor.[108]

The economic crisis in Tanzania worsened further around the beginning of 1985, when official donors (principally Nordic countries) began withdrawing financial support and telling the authorities that they would have to reach a new agreement with the Fund or face a more severe loss in bilateral assistance. With-

[104]The public forum for what became known as the "Arusha initiative" for a new international economic order was a conference in Arusha at the end of June 1980, sponsored by the Dag Hammarskjöld Foundation and other nongovernmental organizations. The communiqué was published in *Development Dialogue*, 1980, No. 2, pp. 10–23. Also see Sampson (1981), p. 301, and references therein; and (for an example of the effects of the leak of Fund documents) "Le F.M.I. embarrasse les autorités," by Paul Fabra, *Le Monde* (Paris), July 5.

[105]See memorandum to management (July 24, 1980) by Oumar B. Makalou (Deputy Director of the African Department) and Subimal Mookerjee (Deputy Director of ETR), in IMF/RD African Department file "Tanzania, 1980" (Accession 83/45, Box 3, Section 183; and minutes of EBM/80/142 (September 15, 1980).

[106]For retrospectives on the economic crisis in Tanzania and the break in relations with the IMF, see Biermann and Wagao (1986), Ndulu (1987), and Campbell and Stein (1992).

[107]Msuya held various cabinet positions throughout most of the 1970s and 1980s, including three years (1980–83) as prime minister.

[108]For overall reviews of these issues for the first half of the 1980s, see "Tanzania—Staff Report for the 1985 Article IV Consultation," SM/86/23 (February 7, 1986) and "Tanzania—Request for Stand-by Arrangement," EBS/86/183 (August 8, 1986).

out large aid inflows, Tanzania was no longer able to service its external debts, and the economy virtually collapsed. Basic goods disappeared from store shelves, and vehicles waited in long queues to buy scarce supplies of petrol. After nearly 25 years in power, Nyerere decided to forgo another five-year term as president. Shortly before announcing that decision, he authorized Msuya to resume negotiations with the Fund.

Negotiations dragged on throughout 1985 without much progress. Although Nyerere seems to have seriously wanted an agreement before he left office, he was unprepared to make the major concessions on liberalizing the economy that the Fund required. Once Nyerere relinquished his post, however, matters quickly improved. Although the top economic officials did not change, they were now less bound by the rigid socialist policies of the past twenty years. In response to their newfound flexibility, the Fund relaxed its own policies and gave Tanzania extra time to clear its arrears.[109]

The economic program for 1986–87, which was to be supported by a stand-by arrangement from the Fund, included a wide range of liberalizing reforms.[110] Those reforms would fundamentally alter the structure of the economy, including the financing and operations of government departments and parastatal enterprises, the setting of the exchange rate, the control of imports, and the marketing and pricing of agricultural output. On most of these issues, the World Bank took the lead in helping the authorities design appropriate policies. The Fund's main structural concern—its obsession, in the eyes of the authorities—was ensuring that the exchange rate was maintained at a level that would enable Tanzania to compete in the world economy. To that end, the authorities abandoned the politically contentious policy of periodically devaluing against a basket of currencies, and adopted a policy of frequently adjusting the rate to achieve a gradual depreciation in real effective terms. Nonetheless, while the quantitative performance criteria for the stand-by arrangement related mostly to the exchange rate and other conventional macroeconomic policies and conditions, adoption of the comprehensive program was the sine qua non for the whole arrangement.

Agreement on all of the key measures was reached by mid-year 1986, and in July Tanzania was able to obtain new funding from Sweden that enabled it to repay its arrears to the Fund. A month later, the Fund approved an 18-month stand-by arrangement, only the third such financing in Tanzania's 24 years of membership. Although the arrangement was for a modest 60 percent of quota (SDR 64 million, or $77 million), it unlocked the door for sizeable funding from other creditors and put an effective end to Tanzania's economic isolation.

Following this stand-by arrangement, the Fund provided financing to Tanzania exclusively through the less expensive and longer-term structural adjustment facilities: a structural adjustment facility (SAF) arrangement in 1987 and an enhanced

[109]In January 1986, on the same day that the Executive Board declared Liberia ineligible to use Fund resources (see Chapter 16), it declined to impose a similar sanction on Tanzania. See minutes of EBM/86/11 (January 24, 1986).

[110]"Tanzania—Request for Stand-by Arrangement," EBS/86/183 (August 8, 1986), Annex III.

structural adjustment facility (ESAF) arrangement in 1991. As conditions for those loans, the Fund became more actively involved in advising the authorities on structural reforms, including notably agricultural production incentives and marketing arrangements, banking reforms, and improvements in the operations of parastatal enterprises.[111] The most far-reaching changes, however, those that would imply unleashing the private sector, remained too controversial at that time.

Proliferation of Performance Criteria

As noted earlier, another guiding principle for conditionality is to impose no more conditions than are necessary to ensure the success of the program in restoring external viability. Nonetheless, in the years following the affirmation of that principle in 1979, the number of criteria jumped sharply (Figure 13.5). That fact generated criticism both from borrowers and academic economists, who argued that the Fund was meddling unnecessarily and inefficiently in the management of countries' economic affairs.[112] Inside the Fund, almost everyone expressed a desire to simplify the system, but the Executive Board was unable to agree on where or how to cut.

A core set of three performance criteria defines the Fund's approach to conditionality. At least since the late 1960s, most upper-tranche lending arrangements have included a monetary ceiling, on domestic credit creation by the banking system or the monetary authorities; a fiscal ceiling, on overall government borrowing or on borrowing from the banking system; and a prohibition against introducing or intensifying exchange or trade restrictions. The increase in the number of proscriptions that took place in the 1980s reflected two developments: the addition of new general criteria, and the proliferation of subceilings and other specific criteria in cases where the core standards were thought to be inappropriate or inadequate.

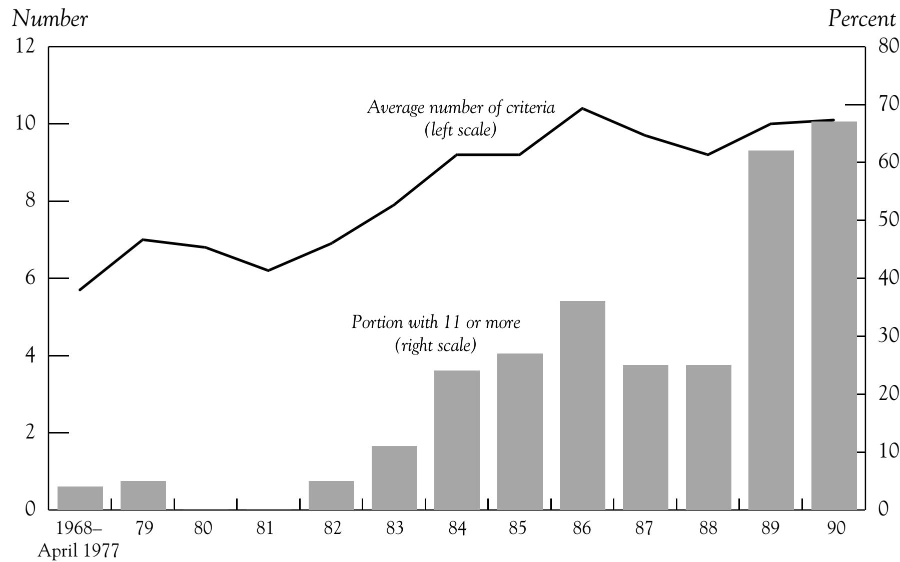
Two general additions were particularly important. One, discussed earlier, was a foreign borrowing ceiling, usually on official medium- and long-term external debt. The increased use of such ceilings in the 1980s often added two or more criteria, when the overall ceiling was supplemented by a subceiling on certain categories of debt or by a separate limit on short-term borrowing. Second, restrictions on accumulating arrears to external creditors became much more common. When a country asking to borrow from the Fund has outstanding arrears to other creditors, the arrangement usually requires a phased reduction and eventual elimination of those arrears; such cases became more common in the 1980s.[113] Moreover, the Fund began making preemptive strikes, prohibiting the introduction of arrears in cases

[111]See "Tanzania—Second Review Under the Stand-by Arrangement and Request for Arrangement Under the Structural Adjustment Facility," EBS/87/213 (October 8, 1987).

[112]See Sengupta and others (1987), paras. 57–63; and the paper by Tony Killick in Boughton and Lateef (1995), pp. 146–52.

[113]For the evolution of Fund practice regarding arrears to external creditors, see Chapter 11.

Figure 13.5 Performance Criteria, 1968–90



where no arrears existed but where a real danger was thought to be present.[114] Largely because of these two factors, all Fund arrangements beginning in 1983 included at least five performance criteria, whereas many earlier arrangements had fewer clauses.[115]

The larger and more controversial issue relates to the proliferation of subceilings and other criteria that derive from the circumstances in a particular country. A substantial minority of programs in the 1980s included "balance of payments tests," most often as a floor on the net foreign assets of the monetary authorities. That criterion was designed to prevent the authorities from running down reserves or running up short-term debts to defend an overvalued exchange rate. Alternatively, as described earlier in this chapter, many programs included "real exchange rate rules" requiring the authorities to adjust the nominal exchange rate in response to changes in the inflation rate. Since exchange rate policy was commonly an important concern in program design, criteria such as these often raised the total number of performance clauses to the high single digits without doing any violence to the injunction limiting criteria to the key macroeconomic indicators. In fact, by 1986 all upper-tranche arrangements contained at least eight performance clauses, and many contained several more than that.

[114]For several months in 1984–85, Fund arrangements also included a performance criterion prohibiting drawings while payments to the Fund were in arrears. Subsequently, that clause was replaced by a general condition governing arrangements with countries in arrears; see Executive Board Decision No. 7678-(84/62), adopted April 20, 1984; and No. 7908-(85/26), adopted February 20, 1985 (in the Appendix to Chapter 16). The Fund-arrears criterion is excluded from the 1984–85 data in Figure 13.5.

[115]See "Program Design and Performance Criteria," EBS/86/211, Sup. 1 (September 11, 1986).

If the Fund was vulnerable in the 1980s to a charge of micromanaging the economies of some borrowing countries, the issue related primarily to those cases with double-digit performance criteria. As a rule, where more than ten criteria were applied, the Fund staff had concluded that the standard macroeconomic statistics were inadequate measures of progress, usually because the country's policies included controls that distorted the signals from prices and from monetary and credit aggregates.[116] A few stand-by arrangements with as many as 15 criteria had been written as early as the 1960s. By the mid-1980s, the portion of programs in which micromanagement was judged (rightly or wrongly) to be necessary for the success of the adjustment program had ballooned. Through 1982, fewer than 5 percent of upper-tranche arrangements contained 11 or more performance clauses. That portion rose sharply throughout the 1980s until it became the rule rather than the exception (Figure 13.5).

Proliferation of very specific conditions took two forms. First, many programs for countries without a strong record of policy implementation included subsidiary as well as overall constraints, such as a ceiling on noninvestment public sector spending and a floor on fiscal revenues in addition to a ceiling on the fiscal deficit. Second, when the authorities themselves undertook to micromanage the national economy through central planning or extensive use of controls on market prices and activity, stand-by arrangements often incorporated constraints on several of the government's own policy levers.[117]

Yugoslavia provides a clear example of micromanagement in programs for a highly controlled economy. In April 1984, the IMF agreed to lend Yugoslavia up to SDR 370 million (approximately $390 million) on a stand-by basis over the next 12 months. In applying for the stand-by arrangement, the finance minister and the central bank governor submitted a 24-paragraph Letter of Intent specifying their economic policy program for the coming year. The letter was supplemented by nine detailed "technical notes" explaining exactly how the authorities intended to adjust public sector prices, control the exchange rate, ensure financial discipline in the financial sector, determine interest rates in the banking sector, limit the growth of the banks' domestic assets, control public sector revenues, limit bank lending to the public sector, limit borrowing from abroad, and strengthen the balance of payments. The stand-by arrangement approved by the Executive Board specified a list of some 15 performance criteria that would have to be met before each of the scheduled quarterly drawings could be made. For example, the Letter of Intent stated that the existing freeze on prices would be lifted by May 1, and it set out a plan for subsequently keeping certain public sector prices in line with

[116]Counting the number of performance criteria is somewhat arbitrary. If, for example, a stand-by arrangement requires the authorities to remove certain exchange restrictions and prohibits them from introducing new restrictions, the constraints could be written in one clause or two. The Fund's practices in this regard did fluctuate over time, and the late-1980s data in Figure 13.5 may not be strictly commensurate with the earlier figures, but the difficulty does not negate the fact of a sharp increase in the 1980s.

[117]See Chapter 2 for a discussion of the more general implications of the Fund's analysis of centrally planned economies.

market forces. The stand-by arrangement provided that "Yugoslavia will not make purchases . . . [d]uring any period in which . . . the intention regarding the price freeze . . . has not been carried out; or . . . the targets regarding prices of railway transportation [etc.] . . . have not been met."[118] In the event, Yugoslavia met most of the conditions, the Executive Board granted waivers for the exceptions, and the full amount of the arrangement was drawn.

The most comprehensive review of this issue took place in 1987. Directors from indebted countries generally attributed the "irritating" and "intimidating" proliferation of performance clauses to an "increasing aversion to risk" on the part of the Fund (in the phrase of Alexandre Kafka, the Director for Brazil) and on an "obsession" with quantitative precision (Ghassem Salekhou of Iran) rather than to an increasing complexity of problems the Fund was called upon to solve. Directors from creditor countries, however, were cautious about trying to reduce the complexities; some, such as Charles H. Dallara (United States), called for a broadening of the range of performance clauses to cover structural policies as well.[119] Given these divergent views, it is not surprising that no consensus was reached on changing the Fund's policies. Even so, the issue had been aired at the table, and the staff subsequently did manage to whittle down the number of performance clauses slightly.

Prior Actions

Yet another delicate balancing act arose with regard to whether the Fund should insist that borrowers take corrective actions *before* drawing on the Fund's resources. Requiring prior actions was considered punitive by some and merely prudent by others. Accordingly, the 1979 guidelines stipulated that a "member may be expected to adopt some corrective measures before a stand-by arrangement is approved by the Fund, but only if necessary to enable the member to adopt and carry out a program consistent with the Fund's provisions and policies" (Guideline 7). In practice, this guideline often meant that countries with a poor "track record" of policy implementation might be required to prove a new level of determination before management would agree to present the request to the Executive Board. It thus raised the specter of unequal treatment and was to be used as sparingly as possible.[120]

During the 1980s, the requirement of prior actions became common, especially in the form of exchange rate devaluations or other action to correct for an earlier loss of international competitiveness. Tax reforms and adjustments to administered prices also were frequent candidates for prior action. Since the management of the

[118]"Yugoslavia—Stand-by Arrangements," EBS/84/65, Sup. 1 (April 19, 1984).

[119]Minutes of EBM/87/70 (May 6, 1987), p. 6 (Kafka), p. 26 (Salekhou), and p. 41 (Dallara). The point about excessive conditionality being intimidating to potential borrowers was made by Janardana Reddy (Alternate—Fiji).

[120]Note the distinction between "prior actions" taken before Board approval and "preconditions" to be carried out after Board approval but before drawing on the arrangement. Avoidance of preconditions was one of the issues raised in the discussion of Sierra Leone described earlier in this chapter.

exchange rate usually was too sensitive an issue to be controlled through an explicit performance criterion, an initial devaluation often preceded Fund approval of an arrangement (either as a required prior action or as a preemptive move by the authorities). Commitments on subsequent actions in many cases were handled through a separate letter from the authorities seen only by the Fund's management and a few senior staff, not by the Executive Board.

The staff gradually abandoned the notion that the use of prior actions should be minimized. The background paper for the 1986 conditionality review argued that "the importance of prior actions in establishing the credibility of the member's program cannot be overstressed." Although that conclusion was challenged by several Executive Directors at the review (notably Finaish, Kafka, Julius Ismael of Indonesia, Samba Mawakani of Zaïre, and Salekhou), the Managing Director summed up the sense of the Board by saying that "most Directors stressed that prior actions were often critical to the success of programs." [121]

Allowing for Contingencies

Economies never evolve in quite the way that economists and politicians expect. Owing to misjudgments about the structure of the economy or to external shocks (or both), the Fund sometimes found that a country was failing to progress satisfactorily toward external viability even though it had met all of the specified performance criteria. Similarly, failure to meet the performance criteria in a stand-by arrangement did not necessarily mean that the economy was in poor shape.[122] In either case, the Fund had liberal recourse to waivers for and revisions in performance criteria.[123] Because of the uncertainties and potential delays associated

[121]"Program Design and Performance Criteria," EBS/86/211 (September 8, 1986), p. 7; minutes of EBM/86/190–91 (December 3, 1986); and Polak (1991), p. 13.

[122]In 1988, the staff reviewed 149 stand-by and extended arrangements approved during the preceding five years. In 25 percent of the cases, the performance criteria had been observed and the overall external objectives of the program had been met; in another 36 percent, neither category had been satisfied. Of the remainder, in 17 percent of the cases the authorities had met the performance criteria but had failed to meet their external goals, while in 21 percent the external goals had been met despite a breaching of some of the performance criteria. See "Conditionality," EBS/88/50 (March 2, 1988), Table 4, p. 28.

[123]When performance clauses were introduced in the late 1950s, the intention was that the country would have an automatic right to draw on the stand-by arrangement as long as it met the specified criteria. Post-approval program reviews were primarily to set criteria for the remaining part of the arrangement in situations where complete data were not available at the outset. As experience increasingly showed that the linkages between performance criteria (adhering to the agreed policies) and economic performance (achieving external viability in the sense described on p. 557) were not always firm, midterm reviews increasingly were used to reevaluate the proper settings for the performance criteria or to evaluate the need for waivers of the original requirements. As Polak (1991, p. 56) observes, this practice weakened the guarantee implicit in the initial agreements, but it did introduce a necessary degree of flexibility. Although no survey of the incidence of waivers was made at the time of the study mentioned in the preceding note, a 1987 review found that waivers or modifications in performance criteria were granted in about half of the programs approved during 1983–86; "Program Monitoring—Recent Experiences," EBS/87/48 (March 2, 1987), p. 14.

with having to request a waiver or modification, some borrowers began pressing for contingency provisions in the initial agreement.

The Fund was galvanized into action on this issue by the necessity of including contingency provisions in the 1986 stand-by arrangement with Mexico. As related in Chapter 10, the Managing Director broke a stalemate in the negotiations with Mexico by introducing two innovative contingency clauses: one that would allow the government to undertake additional investment spending (financed in part by loans from the World Bank) if output growth fell below a benchmark rate, and one that linked the amount of financing to the price of oil (an unexpected fall in the price of Mexico's exported oil would trigger additional credits from the Fund and the commercial banks, and a rise would trigger a reduction).[124] Even before the ink was dry, the Fund had to decide whether this type of provision should be made more generally available.

The staff prepared a paper in the fall of 1986 that set out the issues related to contingency provisions but avoided taking a position on whether their use should be generalized in the Fund. The paper particularly stressed the danger that relaxing conditionality in the event of adverse external developments could weaken the authorities' commitment to undertake adjustment at the very moment when the need for adjustment was greater than ever. Provision for automatic adjustment could, however, strengthen the initial agreement and increase the likelihood of its success (as had clearly happened with the Mexican arrangement).[125] Executive Directors, on the whole, were more impressed by the dangers than by the promises, and no action was taken: "Most Directors were not ready to consider any *generalized* use of such schemes *at this time* and emphasized the need to approach this matter *with caution and on a case-by-case basis*" (summing up; emphasis added).[126] Contingency mechanisms related to a borrower's growth rate were particularly discouraged, and most Directors felt that contingencies related to export prices should be examined again in the next scheduled review of the Compensatory Financing Facility (see Chapter 15). For the moment, the Managing Director had a limited mandate to experiment if necessary but not to push the boundaries any further.

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[124]For several years prior to 1986, many Fund arrangements provided for automatic technical adjustments in cases where the quality of the data base was inadequate, and for more substantive adjustments in response to exogenous shifts in the availability of financing. The closest precedents for the type of automatic contingency adjustments included in the 1986 Mexican program are found in arrangements for Chile and South Africa. Chile's stand-by arrangements of 1968 and 1969, and the 1985 extended arrangement, included provisions for revising certain performance criteria in case of major changes in the price of copper. The 1982 stand-by arrangement for South Africa provided for revisions if the price of gold fell below a benchmark level.

[125]"Program Design and Performance Criteria—Automatic Adjustments in Response to Developments in Commodity Prices and Economic Growth," EBS/86/211, Sup. 2 (November 11, 1986); see Appendix I and II for the pre-1986 experience summarized in the preceding footnote.

[126]The Board discussion was at EBM/86/190–91 (December 3, 1986) and 192 (December 5); for the Managing Director's summing up on the role of contingency allowances and automatic adjustments, see the minutes of meeting 86/91, pp. 51–53. The quoted passage is found on p. 52.

Growth-Oriented Adjustment?

The purposes of the International Monetary Fund are: . . .

(ii) To facilitate the expansion and balanced growth of international trade, and to contribute thereby to the promotion and maintenance of high levels of employment and real income and to the development of the productive resources of all members as primary objectives of economic policy.

Articles of Agreement, Article I

The single issue that dominated the conditionality debates more than any other was the relationship between adjustment and growth. So crucial was this linkage for economic success and political stability that partisans often resorted to demagoguery. On one side, it was argued that adjustment was synonymous with austerity and that austerity was the enemy of growth; on the other, that growth could not be sustained without effective adjustment. Both arguments, of course, were true, but neither was much help. An excessive current account deficit can be reduced either by stimulating exports (which will raise growth) or by compressing imports (which may depress growth). During an adjustment phase, import compression almost always precedes whatever stimulus may occur to exports, so that growth is likely to be weakened in the short run. Countries can sometimes sustain growth temporarily by ignoring the balance of payments constraint, but sooner or later—usually within a few years—they will have to confront the unpleasant calculus of the adjustment process.

Until the mid-1970s, the Fund's lending arrangements were always for a short enough period that conflicts between growth and adjustment did not arise. Extended arrangements, whether made through the EFF or categorized as longer-term stand-by arrangements, raised the problem of perseverance: What could the Fund do to ensure that borrowers could adhere to an adjustment program for three years or more and not be thrown off course by a severely depressed economy? The staff recognized this problem explicitly in a paper prepared for a 1978 review of conditionality:

> Purely deflationary policies . . . may . . . have a deleterious effect on investment and fail to encourage the required shift of resources to the external sector. In the absence of an improvement in . . . growth . . . political and social pressures will in the course of time cause a reversal of [adjustment] policies with the result that the task of eventual correction may become more formidable.[127]

The Executive Board discussion in February 1979 revealed a fundamental split in perception. Byanti Kharmawan argued that developing countries frequently got into economic difficulties because of factors outside their control, such as natural disasters or declines in the prices of their export commodities. Forcing countries to adopt contractionary macroeconomic policies at such times was likely to depress

[127]"Conditionality in the Upper Credit Tranches," SM/78/103 (April 19, 1978), p. 3.

their growth prospects further and to be counterproductive both for the borrowing country and for the preservation of the Fund's assets. Kharmawan concluded that the nature of conditionality should take account of and vary with the source of the country's problems. Eckard Pieske (Germany) and others threw cold water on that idea, responding that a country's obligation to bring its external accounts into balance did not depend on the origins of the problem.[128]

The staff, in any event, did not have a model for making adjustment more conducive to economic growth, and efforts to find one floundered quietly throughout the first half of the 1980s. In a debriefing after the Interim Committee meeting of February 1983, de Larosière asked the staff to use a "keen eye to single out only those elements of economic activity that really have to be restricted, in order to sustain as much real growth as possible." Because of the ongoing debt crisis, growth would be more difficult to achieve than in the past, and the Fund would have to be "more imaginative" and to get "involved in aspects of economic development that are more fundamentally political."[129] Without a specific blueprint, however, it was difficult to make much headway in that direction.

The Fund was galvanized into a more concerted effort after the 1985 Annual Meetings in Seoul, principally in response to U.S. Treasury Secretary James Baker's call for "growth-oriented adjustment."[130] As discussed in Chapter 10, the "Baker strategy" identified a set of heavily indebted countries and aimed to prod creditors into providing additional financing on terms that would enable those countries to maintain essential imports in the short run and to reorient adjustment toward export- and growth-stimulating activities. Part of the Fund's response was to undertake a thorough reexamination of whether the standard conditionality on Fund lending could be restructured to support this growth-oriented strategy. During the conditionality review held a few months later, Executive Directors stressed that "more thought and more work was called for on the . . . relationship between Fund programs and growth."[131]

For the 1986 conditionality review, the issues paper prepared by ETR argued that, despite the persistence of "public misperceptions," conventional adjustment programs were already well designed to promote sustainable growth over a medium-term period; the misperceptions were attributable to the fact that adjusting countries often experienced a temporary slowdown in growth from *un*sustainable levels. The paper concluded that although more effective structural adjust-

[128]Minutes of EBM/79/29 (February 16, 1979), pp. 3–5. This argument, however, cut in both directions. At the Board meeting on Sierra Leone several months later (see above, p. 566), Onno Ruding argued that the arrangement should be subjected to especially strong conditionality because the economy's problems were largely domestic in origin.

[129]Summary notes (prepared February 23, 1983) on the Managing Director's remarks of February 17, prepared in the Managing Director's office. In IMF/RD Managing Director file (Accession 85/33, Box 3, Section 376).

[130]Separately but simultaneously, the Fund increased its focus on growth in structural adjustment programs for low-income countries that were financed by the structural adjustment facilities (SAF and ESAF). See Chapter 14.

[131]Chairman's summing up, minutes of EBM/86/13 (January 27, 1986), p. 12.

ment measures could contribute further to the promotion of growth, the existing guidelines on conditionality—which permitted the imposition of conditions on microeconomic variables "only in exceptional cases"—provided sufficient scope for the design of growth-oriented programs.[132] "Widespread attention" had been paid to structural issues in the design of programs in the first half of the 1980s, although the staff acknowledged that "the reforms achieved were often of a stepwise, piecemeal character."[133]

After discussing the matter for two days, Executive Directors agreed on January 27 that the Fund should do more to promote the restoration of growth in the heavily indebted countries, but they also supported the staff's view that the guidelines on conditionality in Fund-supported programs should not be changed to support a more growth-oriented strategy.[134] In summing up the Board discussion, the Managing Director concluded:

> A number of Directors felt that the Fund should give higher priority to the supply-side, structural aspects of Fund programs . . . in close association with the World Bank. . . . However, several other Directors warned the Fund staff not to go too far in the formulation and follow-up of microeconomic policies. While a few Directors held the view that conditionality guideline 9 on performance criteria should be extended to cover microeconomic criteria in a more routine way, this view was not supported by the majority of the Board.[135]

This reexamination continued with a review paper prepared in the Research Department, which was discussed at an Executive Board seminar in October 1986. While again defending the Fund's macroeconomic orientation to conditionality, the Research Department paper laid out several policies that could be expected to raise a country's sustainable growth rate. Setting interest rates at realistic levels (positive in real terms) helps to prevent capital flight, strengthen the domestic financial system, and provide funds for domestic investment. Public sector investments should be aimed at those with the highest social rates of return. And relative prices, including exchange rates, should be set so as to reflect underlying market pressures. The Fund's neoclassical emphasis on liberalization and macro-

[132]"Issues in the Implementation of Conditionality: Improving Program Design and Dealing with Prolonged Use," EBS/85/265 (December 5, 1985), p. 11 (on the growth issue) and pp. 36–37 (on the guidelines for conditionality).

[133]"Aspects of Program Design—A Review of the Experience in the 1980s of Countries with Upper Credit Tranche Arrangements Approved in 1982," EBS/85/277 (December 17, 1985), p. 63.

[134]The prevailing view was that the guideline limiting the use of microeconomic variables as performance criteria to "exceptional cases" had not prevented the staff from introducing such variables where it was appropriate to do so, and that the practice should not be generalized any more than it already was. Luke Leonard (Alternate—Ireland) suggested that it would be better to amend the guideline to reflect the already fairly general practice, and J. de Beaufort Wijnholds (Alternate—Netherlands) suggested that if the Board wanted the staff to go further in this direction, then the guideline should be amended. Most other Directors spoke in favor of the status quo.

[135]Minutes of EBM/86/13 (January 27, 1986), p. 14.

economic stabilization should, the report argued, provide the economic strength needed to pursue these longer-run growth-oriented policies.[136]

The Executive Board seminar brought forth several suggestions for broadening the design of Fund-supported programs to promote economic growth more directly. E.I.M. Mtei observed that the basic monetary model describes static equilibria; to study the requirements for economic growth, one needs a dynamic model that takes account of the fact that activity-depressing effects often work much more quickly than those that stimulate longer-run growth. Finaish remarked that since the usual staff approach was to assume a growth rate and to examine its implications, the first step should be to endogenize the growth rate in the model. On more specific issues, Jacques Polak argued that more could be done to strengthen banking systems in developing countries, Guillermo Ortiz suggested that the Fund had to take account of the fact that excessive indebtedness depressed growth, and Charles Dallara noted the importance of taking account of the supply-side effects of macroeconomic instruments such as fiscal policy.[137]

The next step involved a public airing of the issues, which gave the staff an opportunity to obtain the views of leading academics and policymakers, and to try to develop a coordinated response with the World Bank. The two institutions held a joint symposium in February 1987, which generated a stimulating collection of papers (Corbo, Goldstein, and Khan, 1987) but no consensus on how the Fund might alter its adjustment strategy other than at the margins. Stanley Fischer suggested that the Fund could help alleviate the recessionary effects of adjustment by recognizing that inflation may worsen government deficits and by promoting productive public sector investment. He also cited devaluations supported by incomes policies and the "avoidance of excessively high interest rates" as potentially growth-inducing tactics (p. 172). More generally, Fischer endorsed the neoclassical strategy of economic liberalization and export promotion, as did many other speakers at the conference. Jeffrey Sachs, however, warned of the dangers of accepting a "facile orthodoxy" that equated "outward orientation with market liberalization." The latter, he argued, was a distraction that often conflicted with the primary need for macroeconomic stability (pp. 292–94). Moreover, Sachs argued that because "extremely unequal income distributions" increased the difficulty that governments faced in improving economic efficiency, adjustment programs should be designed to alleviate distributional problems (p. 323). Manuel Guitián, however, concluded that the Fund's mandate was to help countries restore external viability; if it did that job well, growth would follow as the natural complement (p. 69).[138]

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[136]In the published version of the paper, Research Department (1987), see pp. 32–35. Also see above, p. 570.

[137]Minutes of Executive Board Seminar 86/10 (October 20, 1986), pp. 15–16 (Mtei), 21 (Polak), 31–32 (Finaish), 36–37 (Ortiz), and 40 (Dallara).

[138]Fischer was Professor of Economics at MIT at the time of the symposium. He later served as Chief Economist at the World Bank and as First Deputy Managing Director of the IMF. Sachs was Professor of Economics at Harvard. Guitián was Deputy Director of ETR.

Empirical tests of these propositions are difficult to devise, but the general complementarity of stabilization and growth was demonstrated most clearly by occasional attempts to deny or ignore it. At the time of the symposium, Peru was in the early stages of an experiment in which the government unilaterally ran up arrears to foreign creditors, ran down its foreign exchange reserves, allowed inflation to rise sharply, and ignored the consequent collapse in its international credit rating. The economy achieved an output growth rate averaging 9 percent a year for 1986 and 1987 but then ran out of steam. For the next two years, output fell by 9 and 13 percent, respectively. At the end of the decade, Peru's GDP was 5 percent lower in real terms than in 1985 and inflation was raging at an annual rate of 3,400 percent, a collapse that set the stage for a return to economic orthodoxy in the 1990s.[139] Such experiences unfortunately provided little guidance for strengthening the economies of countries that took the medicine needed to stabilize but still found growth elusive.

The 1987 G-24 Report (Sengupta and others, 1987; also see above, p. 570) sought to provide help for the latter group of countries by reorienting financial programming more directly toward raising growth rates. Specifically, the report suggested that the Fund should conduct "growth exercises" as a prelude to its financial program exercises. Developing countries typically faced two gaps, the report argued: a shortage of domestic saving to finance potentially profitable capital investment, and a shortage of foreign exchange (from export receipts and inflows of foreign capital) to finance essential imports (for basic consumption needs and capital investment). From those two gaps and a model linking investment to growth, one could in principle calculate the minimum level of external financing needed to sustain a targeted rate of economic growth. Together with the Fund's conventional approach linking domestic financial policies to the balance of payments, one could solve simultaneously for the policy and external-financing requirements for external viability and sustainable growth.[140]

The staff responded to the G-24 by producing two papers, one setting out a methodology for conducting "growth exercises" and the other analyzing more broadly the determinants of growth in developing countries.[141] Essentially, these papers took the basic growth-exercise proposal as a starting point, showed how it could be integrated with financial programming based on the conventional monetary model, and discussed the many theoretical and empirical extensions that

[139]The Peruvian economy is discussed more fully in relation to the country's arrears to the Fund, in Chapter 16. The Brazilian experience with rapid but short-lived growth was similar; see the sections on Brazil in Chapters 9–11, and the summary in Chapter 12.

[140]The two-gap growth model, derived from seminal work by Hollis Chenery and others in the 1960s (see Chenery and Strout, 1966), had long been in use at the World Bank. In the mid-1980s, Bank economists undertook to combine that model with the Fund's monetary approach to produce an operational framework for adjustment with growth; for an exposition, see Khan, Montiel, and Haque (1990). That synthesis provided the theoretical framework for the suggestions from the G-24 Deputies.

[141]"Issues in the Design of Growth Exercises," SM/87/267 (November 17, 1987), and "Financial Programming and Growth Exercises," SM/87/268 (same date).

might be needed to make the approach applicable to the real world. The staff agreed that growth depended in part on the availability of external financing, but the papers stressed that this relationship was complex and must be embedded in a much broader model in which the roles of structural policies and of potential shifts between capital and labor in production were fully incorporated. In that spirit, the Executive Board approved the growth exercise idea, in principle, in December 1987.[142]

A few months later, at the 1988 review of the conditionality guidelines, the Board considered anew whether the analysis of the adjustment-growth nexus had progressed to the point where it could be incorporated into the guidelines. The staff paper for the review stated frankly that the primary goal in designing adjustment programs was achieving balance of payments viability. Restoring growth was important for preventing "adjustment fatigue," but no consensus existed on how to direct conditionality toward that objective.[143] Nikos Kyriazidis (Alternate—Greece) rejected that conclusion and asked that "the objective of promoting orderly economic growth, as spelled out in Article IV, Section 1, should be explicitly incorporated into the guidelines." Dallara agreed and proposed that Guideline 9 be amended to state that "nonmacroeconomic" performance criteria are no longer to be limited to "exceptional cases." Dallara suggested several growth-enhancing structural policies that could be stressed in the design of conditionality: elimination of nonmarket pricing systems, measures to strengthen the financial system, improvements in tax and expenditure policies, and efficiency improvements in public enterprises.

The attack on growth-oriented conditionality was led by Directors from developing countries. Ortiz and Arjun Sengupta (India), among others, questioned the view that market liberalization and reduction of institutional constraints would necessarily improve efficiency or raise growth. Sengupta also pointed out that improving efficiency was not sufficient for raising growth in low-income countries, because "savings growth cannot take place without an increase in . . . incomes." Rather than more complex conditionality, what was needed in this view was more flexibility in program implementation. In the words of Mawakani Samba (Zaïre), the Fund should eschew "shock" programs and aim for "gradual adjustment that will preserve growth." If the period for programs were lengthened, borrowers would have the time to carry out their own structural reforms. Similarly, Ahmed Abdallah (Kenya) agreed that structural reforms were needed in many countries but ar-

[142]The endorsement was tentative, as the Managing Director's summing up of the meeting made clear: "Directors emphasized that Fund-supported programs should promote sustainable economic growth in a medium-term perspective. . . . [A] number of Directors felt that quantified 'growth exercises' would be a useful complement to the financial exercises in the design of Fund-supported adjustment programs. . . . Directors expressed concern about the uncertainty necessarily involved in this approach . . . although some speakers noted that uncertainty was also characteristic of the traditional financial programming approach. . . . Directors encouraged the staff to continue its efforts to examine and strengthen the analytical foundations of growth exercises." Minutes of EBM/87/174 (December 16, 1987), pp. 23–25.

[143]"Conditionality—A Survey of Current Issues," EBS/88/50 (March 2, 1988), pp. 9–10.

gued that it was the authorities' role, not the Fund's, to design and carry out institutional change.[144]

Despite a universal agreement that growth was a "primary objective of economic policy" and that adjustment would often fail if growth was too long in coming, all efforts to link adjustment to growth foundered on this simple dilemma. Lacking a well-established and validated model of economic growth, the Fund could not require structural reforms as a condition for its credits. Not until domestic political support would emerge for those reforms in their own right—not until the silent revolution could be won—would the dichotomy between growth and stability finally fade away.[145]

Evaluating the Success of Fund Programs

The experimentation of the 1980s confirmed the difficulty of designing and carrying out effective adjustment programs, but it did not by itself resolve the underlying questions posed at the beginning of this chapter: Was the basic model appropriate, and was the basic strategy successful? Unfortunately, the extensive literature that emerged to evaluate the success of Fund programs is as difficult to evaluate as its subject. An ideal study would compare each country's performance under an adjustment program with the performance it would have had without adjustment. Since that ideal was unattainable, each study tried to approximate it as well as possible given the limitations of data and techniques.

Mohsin Khan's 1990 review of this literature distinguished four branches.[146] First, several early studies compared the economic performance of countries before and after implementing Fund-supported adjustment programs. Those studies—which mostly covered programs before the 1980s—generally reached ambiguous conclusions. Whether such studies reveal weak effects from Fund conditionality or offsetting effects from other forces is, however, impossible to judge. Second, several other studies of programs from the 1970s and early 1980s compared economic performance of adjusting countries with a "control sample" of nonadjusting countries that are thought to have faced similar conditions. The most sophisticated example of this genre—Goldstein and Montiel (1986)—found no statistically significant effects on performance from adjustment programs.[147] Third, a few published

[144]Minutes of EBM/88/58 (April 6, 1988), pp. 5 (Mawakani), 25–26 (Kyriazidis), 31–35 (Dallara), and 40 (Abdallah); and EBM/88/59 (same date), pp. 4 (Ortiz) and 7 (Sengupta).

[145]In the first half of the 1990s, the staff continued to analyze relationships between adjustment and growth, primarily through detailed case studies. For two such multicountry studies, see Goldsbrough and others (1996) and Hadjimichael and others (1996).

[146]Khan (1990) includes a comprehensive list and detailed discussion of the studies alluded to in the text of this paragraph. Also see Haque and Khan (1998), Killick (1995), Polak (1991, pp. 41–45), and the papers in Williamson (1983).

[147]Selecting a control group with similar initial conditions is not easy. Santaella (1996) studied more than 100 Fund-supported programs in the period 1973–91 and found that on average, countries faced significantly worse conditions in the period preceding adoption of an adjustment program than in nonprogram periods.

studies by Fund staff have compared outcomes for selected macroeconomic variables with the targets specified in the lending arrangements. Those studies—though they reveal little about the effects of programs on overall economic performance—found that program targets were met or exceeded in between one-half and two-thirds of the cases. Fourth, econometric studies based on simulation of estimated macroeconomic models, notably by Khan and Knight (1981, 1985), found significant positive effects from the successful implementation of adjustment programs.

Some later studies derived more positive conclusions by isolating the effects of Fund-supported programs from the more general effects of adjustment. For example, Edwards and Santaella (1993) examined 48 devaluations by developing countries between 1948 and 1971 and concluded that devaluation was more likely to have beneficial real effects when undertaken in the context of a Fund-supported adjustment program. Bagci and Perraudin (1997) found beneficial program effects in a comparison of economic performance within countries between periods with and without Fund-supported programs in effect.

The staff also conducted detailed studies for internal review almost annually during this period, as mandated by Guideline 12 (see Appendix). On five occasions, the staff reviewed in detail the experience under all of the upper-tranche arrangements approved in a particular period; on three other occasions, the analysis pertained to selected arrangements of a particular type. In all cases, the straightforward objective was to examine the extent to which countries had carried out their programs and the extent to which they had succeeded in achieving their objectives. These internal studies did not break new methodological ground, but they benefited from more extensive data than was accessible to outside researchers. Broadly speaking, the internal studies confirm the picture that emerges from the published literature: successful adjustment and sustainable growth are elusive goals, largely but not entirely because of the difficulty of carrying out stringent programs over a long enough period. The following summary relates the major findings.[148]

The first internal study, which covered the 11 arrangements approved in 1977, uncovered a widespread implementation failure. Most of the fiscal ceilings, and about half of the credit ceilings, had been breached. In only three of seven multiyear arrangements had negotiations succeeded in reaching understandings for the second year. Most countries had nonetheless experienced the expected improvements in their balance of payments and in inflation, though not necessarily in economic growth. This study was completed in 1979, shortly after the conclusion of most of the covered arrangements. The authors therefore were not particularly concerned by the apparent failure of programs to restore growth, since the benefits for growth were thought to take longer to appear.[149]

[148]In addition to the unpublished studies summarized here, Schadler (1995) and Schadler and others (1995) present a comprehensive analysis of arrangements approved in 1988–92.

[149]"Adjustment Programs Supported by Upper Credit Tranche Stand-by Assignments, 1977," EBS/79/635 (December 26, 1979).

The next review looked at the 22 stand-by arrangements approved in 1978 and 1979.[150] The staff found that performance criteria had been met in about half of these cases and that macroeconomic performance generally had improved but often had fallen short of the objectives specified at the outset. Output growth in countries with Fund arrangements had remained below the average for all non-oil developing countries, but the initial gap had been partially closed.[151] Similar conclusions emerged from a 1982 review of 17 stand-by arrangements approved in 1980 and 12 extended arrangements approved in 1978–80. The biggest factor determining success or failure of these arrangements was judged to be the country's own commitment to carrying out the program, the factor that later became known by the buzzword "ownership." The paper acknowledged that more work was needed to ensure that programs were politically viable, especially in multiyear programs where adjustment fatigue was likely to be a problem.[152]

Next, a review of 27 arrangements approved in 1981 shifted attention away from whether performance criteria were met and toward whether more fundamental objectives (balance of payments viability and restoration of growth) were achieved. The broad assessment, however, was unchanged: success was mixed. Successful countries usually were those who had acted quickly, had sustained the adjustment process throughout the period of the arrangement, and had responded flexibly to changing circumstances so as to stay on target.[153]

The 1984 review offered a longer-run and more intensive analysis of a selected sample of large borrowers (the 25 countries to which the Fund made the largest cumulative commitments relative to quota during 1977–80). This study stressed the "key role of widening budget deficits" as a cause of the initial problems that led countries to borrow from the Fund, and the correspondingly important role of fiscal adjustment in reducing external deficits. With the longer lens of this study, it became clear that countries that undertook sustained fiscal retrenchment experienced, on average, a strengthening of economic growth within four years after the initiation of adjustment.[154]

The next study examined results for the 22 countries that had undertaken adjustment programs in 1982: the year of the international debt crisis. By 1985, six of those countries had successfully carried out their programs and appeared to be

[150]Two of the nominal total of 23 stand-by arrangements were combined for the study: the 1979 arrangement with Peru was treated as an augmentation of the 1978 arrangement rather than as a new program. The seven extended arrangements were excluded from the study on the grounds that they were still active and could not yet be evaluated.

[151]"Review of Upper Credit Tranche Stand-by Arrangements Approved in 1978–79 and Some Issues Related to Conditionality," EBS/81/152 (July 14, 1981).

[152]"Review of Recent Extended and Upper Credit Tranche Stand-by Arrangements," EBS/82/97 (June 9, 1982) and "Additional Information," Sup. 1 (June 10).

[153]"Review of Upper Credit Tranche Arrangement Approved in 1981 and of Some Issues Related to Conditionality," EBS/83/215 (October 4, 1983) and "Upper Credit Tranche Stand-by and Extended Arrangements Approved in 1981," EBS/83/216 (October 4, 1983)."

[154]"Experience with Adjustment Policies," EBS/84/228 (November 13, 1984); the quotation is from p. 50.

at or near a viable external payments position; the others all still had large and unsustainable payments deficits. The reasons for failure to carry out programs to completion or for performance to rebound followed a now-familiar pattern. Most commonly, countries had been unable to implement either the large cuts in government spending or the large increases in tax revenues that so many of them needed. In addition, in several cases both the countries and the Fund had underestimated the amount of adjustment that was ultimately needed.[155] These findings were reinforced further by the 1987 review summarized at the outset of this section, which examined the experience of the record number of 34 countries that had entered into upper-tranche arrangements in 1983.

In 1989, the staff took a different approach and presented a detailed analysis of nine country studies (with a total of 40 Fund arrangements, 1976–87), representing a broad spectrum of developing countries.[156] This study identified several instances in which the specific conditionality appeared not to have been appropriate for the circumstances at hand. Explanations included initial underestimation of the country's economic problems, excessive optimism about the availability of external financing, willingness by the Fund to enter into arrangements in the face of inadequate policy commitments, laxity in the granting of waivers or modifications, and concern about the systemic implications of withholding financial support. For programs to be successful, the staff concluded, they had to center on strong adjustment of financial and exchange rate policies, backed up in many cases by major structural reforms. The problem, in short, was not with the basic model for designing adjustment programs; the problem was to be both firm and flexible in applying that model.

All of these surveys, of necessity, stopped short of answering the ultimate question of whether adjustment programs were designed as well as could be realistically expected. When countries failed to carry out policies that they had promised to implement, did they fail because they lacked will, wisdom, and courage, or because they had made unrealistic promises under duress? When the Fund failed to apply its own standards and allowed countries to borrow under poorly designed and weakly implemented programs, did it fail because it lacked will, wisdom, and courage, or because it recognized the political and social constraints on its borrowers and weighed the risks of lending against the risk of letting the country's economy sink even further? In a world of national governments and international organizations with limited vision and powers, is a success rate of between one-fourth and one-half in rescuing floundering economies alarming or simply realis-

[155]"Aspects of Program Design," EBS/85/277 (December 17, 1985).

[156]The sample included three African countries (Ghana, Morocco, and Zambia), two Asian (Bangladesh and the Philippines), two from Latin America (Chile and Mexico), and one each from Europe and the Middle East (Yugoslavia and Egypt). This selection was designed to include low-income countries eligible for concessional (SAF) loans as well as middle-income countries; borrowers from commercial as well as official sources; heavily and less indebted countries; and successful and less successful adjusters. All nine had undertaken at least three stand-by or extended arrangements with the Fund in the preceding decade.

tic?[157] Such questions underlie any empirical analysis, but they do not admit of unambiguous answers.

Prolonged Usage

One widespread consequence of the difficulty of implementing successful adjustment programs was that many countries became regular and prolonged users of Fund resources. Despite the Fund's goal of restoring external viability to borrowing countries, the number of prolonged users (as defined in the Fund) rose from 6 in 1980 to more than 30 in 1987 before dropping back (Figure 13.6). Notably, 5 countries—mostly with very low incomes—had lending arrangements in effect for at least part of each of the 11 years covered here, 1979–89. In West Africa, Senegal, Togo, and Zaïre each had 7 or more stand-by or extended arrangements in those years plus concessional loans from the Fund's structural adjustment facilities. And in the Caribbean, both Haiti and Jamaica had lending arrangements in effect throughout the period.

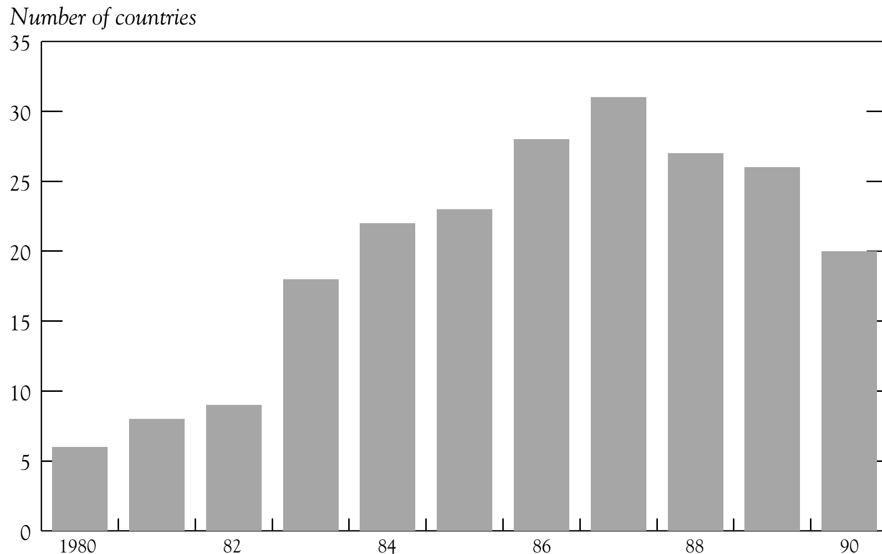
Although the reasons for countries being unable over long periods to extricate themselves from economic difficulties—and from the Fund—obviously vary from case to case, the underlying cause is nearly always a political paralysis that prevents rational economic policymaking. By the 1980s, some critics were charging that the Fund was fostering that paralysis by providing what amounted to insurance against bad economic outcomes. Roland Vaubel, a leading exponent of applying "public choice" analysis to international institutions, acknowledged that conditionality could reduce the "moral hazard" from the availability of credits to countries in trouble, but he complained that it was ineffective because it was applied only after the country was already in trouble.[158]

A close examination of actual cases suggests that the prevailing problem is usually a gap between the short-term horizons over which the authorities try to maximize their own utility and maintain power and the longer horizons over which social welfare is maximized. The empirical question is whether the authorities are forward-looking enough to take account of the expected costs of submitting to the policy constraints that accompany Fund credits. If conditionality is applied appropriately and is effective within the authorities' horizon, it should nullify the expected net short-run benefit from myopic policymaking. In many cases, that point has been reached only after long and bitter experience.

[157]The 1992 Wapenhans Report on World Bank lending found that although three-fourths of Bank-financed projects were earning satisfactory rates of return, nearly 40 percent of borrowing countries had "major problems" with at least 25 percent of their projects. The report noted that any measure of success or failure of a development institution was arbitrary, and that a very low failure rate could indicate that the Bank was "not taking risks in a high-risk business" (p. 3).

[158]See Vaubel (1991), especially pp. 230–35. Public choice theory attempts to explain the actions of public sector institutions by examining the incentives facing the principal agents (management, staff, major stakeholders). The moral hazard problem is that insurance must be coupled with adequate safeguards so that insured parties will have an incentive to prevent losses. Vaubel argued that the Fund could reduce moral hazard by refusing to lend to countries that had followed inappropriate policies, but the Fund was unlikely to do so because it would restrict lending and because the staff derives utility from lending.

Figure 13.6. Prolonged Users of Fund Resources, 1980–90



Note: A prolonged user is defined here as one with five or more annual programs in the preceding 10 years and with outstanding credit of at least 100 percent of quota in the year indicated.

As an illustration, consider the following story.

The Philippines

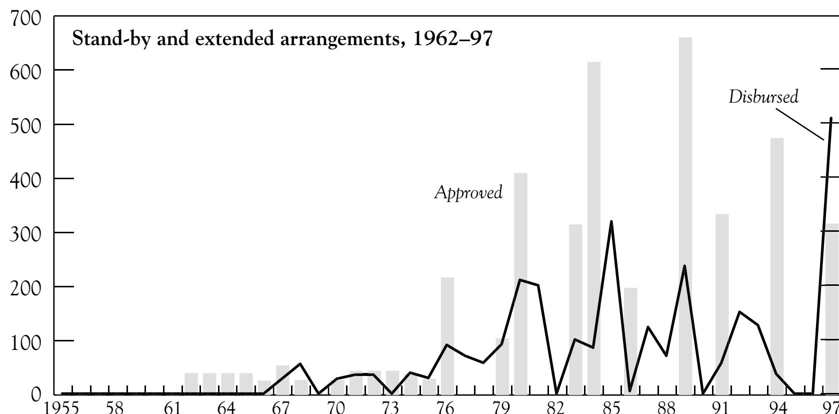
> The story of our debt restructuring is really the story of my life. A large part of my recent experience has involved the tension between the internationally oriented sectors of our economy, which directly benefit from the debt restructuring exercise, and the much larger domestically oriented sectors, which get constricted through the austerity measures and may not share the benefits to the same extent.
>
> Cesar E. A. Virata
> Prime Minister of the Philippines
> September 1985[159]

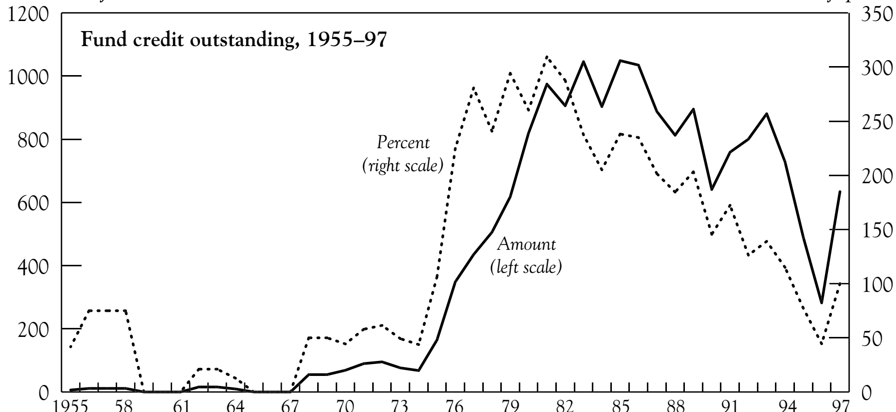
The Philippines had one of the longest outstanding debit positions in the Fund, having attempted to implement a total of 23 Fund-supported adjustment programs between 1962 and 1998 and having had outstanding obligations to the Fund continuously since 1968 (Figure 13.7).[160] The explanation for the country's seemingly perpetual need for extraordinary external financing and adjustment is complex and extends well beyond the boundaries of a history of the work of the IMF. As Prime Minister Virata's poignant statement suggests, this problem be-

[159]For the text of this speech, which was given in London, see IMF/RD Managing Director file "Philippines, Vol. VI" (Accession 87/136, Box 2, Section 168).

[160]Sudan and Pakistan have had outstanding drawings since 1965, but they have had fewer Fund-supported programs than the Philippines.

Figure 13.7. Philippines: IMF Borrowing and Outstanding Credit





came a national obsession, a barrier that had to be breached before normalcy could be restored to economic affairs in the Philippines. The central part of this story developed from a domestic investment boom that began in earnest in 1979, through to a major financial crisis that peaked in the latter part of 1983, and on until a new government replaced the regime of President Ferdinand Marcos in 1986.

As this History opened in 1979, a three-year extended arrangement had been fully utilized, raising the country's obligations to the Fund from less than SDR 40 million ($45 million, or 25 percent of quota) in mid-1975 to just over SDR 500 million ($650 million, or 240 percent of quota) at end-1978.[161] That program was

[161]For the background on the development of the Philippines' economic difficulties and the 1976–78 extended arrangement, see de Vries (1985), pp. 373–77. The end-1978 figure for obligations to the Fund also includes some outstanding balances from the oil facilities and the CFF, plus SDR 64 million ($83 million) in Trust Fund loans.

considered to have been reasonably successful, although it had been necessary to modify its targets and although the country clearly remained a long way from shore as it struggled to reach external viability. The Philippines was riding the crest of the surge in growth in the Middle East, as remittances from workers in that region limited the weakening of the current account and, in 1978, produced a fiscal surplus. The sustainability of that wave, however, was subject to doubt and was soon to be tested.

When the Executive Board met in June 1979 to consider the Philippines' request for a new six-month stand-by arrangement (for SDR 105 million, equivalent to $135 million or 50 percent of quota), the dominant issue was the effect of adverse external shocks on the country's ability to restore equilibrium to the balance of payments.[162] The prices of two of the country's principal exports—sugar and copper—had fallen precipitously on world markets at a time when the price of imported oil was rising sharply. It was thus appropriate that the resources to be made available under the stand-by arrangement would be supplemented by a CFF drawing (for SDR 44 million) to help cover the shortfall in export earnings. With this support, the authorities were thought to have the means to solidify the achievements of the previous three years.

What was not foreseen at the June 1979 meeting were the depth and persistence of the Philippine economy's structural problems. There was no dissent from the view expressed by Richard Lang (Alternate—New Zealand, speaking for the Philippines) that the economy had the capacity to sustain the real growth rate of about 6 percent a year that it had reached under the extended arrangement of 1976–78. But that growth had been achieved through investments in export-oriented industries that would eventually prove to be inefficient, import-dependent, and uncompetitive. Moreover, much of the external financing for those investments had come from commercial banks. As with so many other developing countries, the cost of servicing this debt would soon become prohibitive, and the flow of new money would suddenly dry up in the second half of 1982 in the wake of the international debt crisis. In the Philippines, the burden of the debt was known to be dangerously high even in mid-1979, but the magnitude of the danger could not be foreseen.[163]

The 1979 program, like its predecessor, was viewed as a success even though the balance of payments continued to deteriorate and external commercial debt continued to accumulate. The culprits were identified to be the low price of sugar—which was on the rebound by the end of the year—and the high price of oil. In these circumstances, another and much larger stand-by arrangement (along with

[162]Minutes of EBM/79/88–89 (June 11, 1979). The statement by Richard Lang cited in the next paragraph is on p. 27.

[163]One technical difficulty that faced the Fund staff was that while most countries reported official debt service separately from that on private debt, the Philippines did not. The debt-service ratio was relatively high for the Philippines, but part of the difference could be attributed to this reporting practice. It was natural to conclude that the country was in no worse shape than others, but in the event the argument turned out to be a lullaby.

another CFF drawing) was a clear necessity, and the Executive Board met to consider the request at the end of February 1980. Several Directors expressed concerns.[164] To take a few examples: Gerhard Laske (Germany) was worried, as he had been the previous June, about the debt buildup; Donald Syvrud (Alternate—United States) was worried about the inflationary effects of low interest rates, which were negative in real terms; Bernard Drabble (Canada) was worried about the unusually high proposed use of the Fund's supplementary (borrowed) resources; and Onno Ruding (Netherlands) was worried about the long-term continuous use of Fund resources without a solution to the balance of payments problem. In no case, however, were these concerns major enough to warrant formally objecting to or abstaining from approving the program.

External developments did not improve over the next two years, and in 1981 the domestic money market nearly collapsed in the wake of a scandal that became known as the Dewey Dee affair (after the local financier who triggered it).[165] Nonetheless, the program remained essentially on track, with the continuing and crucial exception of the nagging lack of improvement in the balance of payments.[166] By 1982, however, doubts about the ability of the authorities to effect the necessary degree of adjustment in the face of continuing domestic and external difficulties began to dominate discussions at the Fund. When the Philippines informally requested a new stand-by arrangement that February, de Larosière concluded that stronger measures—especially for budgetary control—would be needed before a program could be approved.[167] The fiscal, current account, and external debt positions had become unsustainable, and the authorities' views on what measures could feasibly be undertaken were far apart from those of the Fund's management and staff.

An important element of the difference in perspective in 1982 concerned the evaluation of the uses to which external financing had been put since the late 1970s. As noted above, a major component of the growth realized in 1976–78 had been investment in new industries. Most of those investments—for government-guaranteed private sector projects—had subsequently soured. The objectives certainly were laudable. Textile production had been modernized, copper smelting and nickel production facilities had been developed, a tree-planting program had been undertaken to promote timber exports, and so forth. In the aggregate, however, these projects required substantial inflows of foreign capital and failed to generate returns sufficient to service the resulting debt. The reasons for the lack of profitability of these investments are diverse. Ex ante, they were viewed as good prospects not only at home but also by major commercial banks who bid aggres-

[164]Minutes of EBM/80/30–31 (February 27, 1980).

[165]See Broad (1988). The longer-term costs of the resulting financial crisis are analyzed in Nascimento (1990).

[166]The 1980–82 stand-by arrangement, in the amount of SDR 410 million ($525 million; 195 percent of quota) was fully drawn.

[167]The Managing Director's disapproval of the request was noted on February 28, 1982 as a response on the February 19 back-to-office report from the Article IV consultation mission; in IMF/RD Managing Director file "Philippines, 1982" (Accession 84/21, Box 3, Section 168).

sively to help finance them. Subsequently, both the Fund and the World Bank questioned the viability and efficiency of a number of projects, and the realization emerged that many investments had been intended to benefit individuals close to the government (the original "crony capitalism") rather than the economy at large.[168] In contrast, officials in Manila emphasized the role of adverse external developments, such as the effects on fuel costs from the 1979–80 rise in oil prices, and they argued that structural reforms could not be implemented without such investments.

Hampered by these divergent views, negotiations dragged on for several months in 1982 after the initial negotiating mission in April (led by Ranji Salgado, Assistant Director of the Asian Department). The Philippine team, led by Virata, met with the staff and often with the Managing Director, on several occasions and in different locations around the world during the spring and summer. Finally, around the end of August, when the flow of bank loans was suddenly drying up in the wake of the Mexican crisis (Chapter 7), the outlines of a solution were resolved via a controversial compromise under which the degree of required fiscal adjustment for 1983 was to be relaxed.[169] In October, Tun Thin, Director of the Asian Department, met with President Marcos in Manila and emphasized the necessity of the proposed fiscal measures. Before the end of November, agreement was reached on a draft Letter of Intent for a 12-month stand-by arrangement. Final approval was granted by the Executive Board in February 1983, for a 12-month stand-by arrangement in the amount of SDR 315 million ($410 million; 100 percent of quota).

Another factor hampering these negotiations was the effect of extraordinary publicity on the political dimension. As opposition to Marcos's rule intensified, the U.S. government entered into sensitive but well-publicized negotiations to renew its expiring leases on two large military bases in the Philippines. A Fund staff report that was critical of economic policies in the Philippines was leaked to an anti-Marcos group in April 1982. The resulting flurry of news stories (see, for example, Nations, 1982) raised the danger that any effort to find a workable compromise would be interpreted as a response to political pressures and would inhibit the return of private financing that was essential for the success of the program.

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[168]See Broad (1988) and De Dios (1984) for analyses of the high-investment strategy that was initiated in 1979.

[169]This compromise was proposed to IMF management by the staff team working on the Philippines, following extensive negotiations with the authorities. Others on the staff objected, arguing that the only problem with greater adjustment was the government's unwillingness to act. The Managing Director indicated that he found the proposal "worrying," but he declined to overrule the staff recommendation. See memorandum to the Managing Director from Tun Thin, Director of the Asian Department, and Manuel Guitián, Senior Advisor in ETR (August 25, 1982), with August 27 annotation by the Managing Director; memorandum to Tun Thin from Alan A. Tait, Deputy Director of the Fiscal Affairs Department (August 26); and memorandum to Tait from Tun Thin and Guitián (August 27); in IMF/RD Managing Director file "Philippines, 1982" (Accession 84/21, Box 3, Section 168).

Money did begin to flow again from the major banks in the early months of 1983; a $300 million bank loan to the central bank was syndicated in January by Manufacturers Hanover Trust and Fuji Bank, and it was quickly oversubscribed. Unfortunately, a new set of problems soon stanched this flow. In June, Salgado took a mission to Manila to conduct the annual Article IV consultation and review the progress of the stand-by program. During the course of this mission, the staff became concerned about the accuracy of the central bank's records and of their consistency with the country's deteriorating external position.

Since about the beginning of 1983, Fund staff had been meeting occasionally with private bankers, at the request of the Philippine authorities, to share information and views on the country's prospects and financing requirements. By June, these bankers were reporting that the central bank was having difficulties meeting payments to them. Official data, meanwhile, showed that the central bank held foreign exchange reserves of about $2 billion. Confirming the likelihood of a discrepancy, the balance of payments deficit was now much larger than had been foreseen and suggested that official reserves must be falling sharply. Banks were withdrawing credit lines, and there seemed to be a serious risk of a financial crisis of major proportions.

In July 1983, Virata met with de Larosière in Washington and then flew to Paris to meet with the major official and private creditors and with Salgado. Pending the resolution of the technical issues raised by the June mission, these meetings produced agreement in principle for a successful review of the progress of the stand-by arrangement with the Fund. Then, in August, the Fund sent Anoop Singh (Division Chief in the Asian Department) to Manila, to investigate the apparent discrepancies more fully. As with the previous mission, he was confronted with numerous obstacles to measuring the extent of the problem, but he was able to determine that the central bank's reserves were substantially overstated. Against the backdrop of a rapid deterioration in the country's political stability—opposition leader Benigno S. Aquino, Jr. was assassinated upon his return from exile on August 21—a financial crisis now appeared inevitable, and continuing the program on its original terms was no longer possible.[170]

Intense negotiations over a revised program took place in Washington and in Manila from the latter part of September 1983 through early November, simultaneously with continued efforts to pinpoint the extent of the country's actual foreign exchange reserves and the source of the discrepancy.[171] Meanwhile, as the crisis began to unfold, the peso was devalued by 21 percent on October 5, and on October 14 Virata met with the commercial banks' Advisory Committee to pro-

[170]Of the original SDR 315 million available under the arrangement, the Philippines drew SDR 50 million ($54 million) in March 1983 and another SDR 50 million in May. No further drawings were allowed.

[171]In October, it was agreed that the IMF would assign a resident representative to Manila, for the first time in three years; in the interim, the office had been staffed by a consultant. From January 1984, a resident representative was stationed in the Philippines at least through 2000.

pose a "stand-still" on principal payments on bank loans. The banks, facing a Hobson's choice, readily agreed. A few days later, Virata met with U.S. Treasury Secretary Donald Regan, who reportedly indicated that the United States was prepared to provide short-term bridge financing once a new agreement was reached with the Fund.[172] On October 19, however, the Advisory Committee gleaned the full extent of the reserve discrepancy and concluded that the requirements for their participation in financing a new program would have to be even more strict than they had anticipated.

The overstatement of the central bank's reserves was eventually determined to have gone as high as $1 billion in mid-1983. For more than a year (apparently beginning in the aftermath of the Mexican crisis), as cash reserves dwindled, the central bank had made increasing use of time differences in global money markets—going from Singapore to Bahrain to London and on to New York—to cover payment obligations with very short-term borrowings. By mid-1983, this practice had been refined into one in which the source of the funds vanished altogether. For example, the central bank would wire a deposit to an overseas branch of the government-owned Philippine National Bank. The branch would redeposit the funds in the Manila home office, which would then complete the circle by depositing them at the central bank.

The details of this scandal became known through two formal investigations, first by an internal review ordered by the Monetary Board (the governing body of the central bank) and then by an outside auditing agency. The governor of the central bank, Jaime Laya, consequently resigned in January 1984 to pave the way for needed reforms, but in the meantime the country's and the IMF's efforts to assemble a credible economic program had suffered a severe setback. The Philippines ultimately would spend more than a year and a half without access to credits from either the Fund or the banks, and a full recovery from the debacle would take several years.

The appointment (on the specific advice of the Fund) of a strong new governor, Jose B. Fernandez (known universally as "Jobo"), breathed new life into the negotiations but did not produce any immediate breakthroughs. When the Executive Board met in June 1984 (in restricted session) to conclude the long-overdue Article IV consultations, Directors were more skeptical than ever of the sustainability of economic policies and of the credibility of the adjustment program. The Board concluded that four types of reform were needed: liberalization of exchange markets, tightening of monetary and fiscal policies, rehabilitation of public financial institutions, and stricter control over public sector investment decisions.[173] These conclusions would underpin a new round of program negotiations, which began less than two weeks later.

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[172]The Fund's liquidity position at this time was unusually tight, owing to delays in obtaining approval of the Eighth General Review of Quotas (Chapter 17). Secretary Regan's support was reported to the Managing Director by Virata during a meeting at the Fund later the same day. See memorandum for files by P.R. Narvekar (October 18, 1983), in IMF/RD Managing Director file "Philippines, July to October 1983—Vol. II" (Accession 86/34, Box 28, Section 209).

[173]Summing up by the Managing Director; minutes of EBM/84/102 (June 29, 1984).

After two additional missions by the Fund team, now headed by Hubert Neiss (Deputy Director of the Asian Department), and extended visits by Virata and other leading officials to Washington in the period surrounding the Annual Meetings, agreement was reached on the terms of a new program, and a Letter of Intent was signed on October 31, 1984. By this time, new policies were already being carried out, including notably a liberalization of the exchange regime introduced in mid-October: the peso was allowed to float, resulting in a 10 percent depreciation, and monetary policy was tightened to stabilize the rate near this new level.[174] Given the high priority attached to reducing inflation, the principal monetary target in this program was a ceiling on growth in reserves of the banking system, rather than the usual ceiling on domestic credit expansion.[175] The authorities also provided understandings for limiting increases in public sector wages and for the elimination of external payments arrears by the end of 1985.

Perhaps more important than these macroeconomic measures were the structural reforms that the authorities planned to carry out as part of the program. These reforms, which were to be monitored by the prime minister's office, included tax measures such as replacing distortionary taxes on international trade with taxes on domestic economic activity; establishment of a framework to monitor the performance of nonfinancial public corporations; restrictions on lending by public financial institutions, and the termination of the practice by these institutions of guaranteeing foreign loans; and some decentralization of the highly monopolized sugar and coconut sectors. In addition, the Philippines sought technical assistance from the Fund with regard to the tax system and its administration. Although these structural reforms were not formal performance criteria for the stand-by arrangement, they were to be examined by the Fund staff as part of the regular program reviews. In that way, any major delays could trigger a postponement of drawings.[176]

[174]From 1970 until October 1984, policy aimed to maintain stability of the peso against the U.S. dollar. The effect of devaluations in October 1983 and June 1984 was limited by the concurrent appreciation of the dollar against other major currencies. See Houben (1997).

[175]The concern that determined this shift was that a ceiling on domestic credit expansion might lead to large and inflationary capital inflows. Polak (1991), p. 35, observes that the Fund agreed to rely on a reserve target for this program only after "much soul searching." For the staff assessment, see "Philippines—Request for Stand-by Arrangement," EBS/84/226 (November 5, 1984), pp. 25–27.

[176]The program approved in December 1984 incorporated performance criteria for end-December and for end-March 1985. Following a review, criteria were then to be set for the following two quarters. A second review should then have led to agreement on criteria for the next two quarters, and so forth. Because not all criteria were met in the initial two quarters, the first review was delayed by two months and performance criteria were then set for May, July, and September. Although all performance criteria for July were met, those for September were not (see below). The second review therefore was delayed until November 1985, at which time the July requirements were waived and new complete criteria were set only for end-December. (Some criteria for end-March 1986 were deferred until the third review.) In both reviews, the progress of the structural reforms was examined in detail.

The new stand-by arrangement, which was intended to last through the end of 1986, was approved by the Executive Board on December 14, 1984.[177] The following week the Paris Club approved a rescheduling agreement covering the same period, provided the Fund program was in place. Almost immediately, however, the program went off track, and completion of the third leg of the financial support for the program—a planned commercial bank rescheduling agreement—was put on hold.

On January 23, 1985, barely a month after the program was approved, de Larosière informed Virata by cable that he was "greatly concerned to learn of recent monetary and exchange rate developments which are at variance with the program and, unless reserved quickly, will irretrievably undermine achievement of the program's objectives."[178] Monetary policy had been eased, and that had caused a breaching of the program's ceiling on the growth of reserve money. In addition, most of the depreciation of the peso had been reversed, and the Managing Director questioned whether there might have been "administrative or other delays that are limiting the demand for foreign exchange."

Virata replied that these developments had resulted largely from unanticipated capital inflows, that only through lower interest rates could the economy revive, that a revival of demand would lead to increased production, and that higher production was essential both to stimulate export growth and to control inflation in the longer run. He then flew to Paris to meet with Singh and on to Washington to see de Larosière, seeking agreement on a revision of the program targets, which he regarded as being "so tight you could hear everything squeak" (interview, November 1992). Meanwhile, Governor Fernandez met with the Deputy Managing Director (Erb) and with Neiss at a conference in Kuala Lumpur, Malaysia, where he made a similar request. But although the Fund was prepared to discuss modifications, there was no real choice on the necessity of responding to the immediate problem. The Philippines therefore was not allowed to make the drawing that would have been scheduled for the first quarter of 1985. Neiss took another mission to Manila in March, but when the program criteria were violated again at the end of that month, the second-quarter drawing was disallowed as well.[179]

On the surface, the Philippines now faced a classic midadjustment dilemma as the authorities tried to get the program on track. To control inflation and maintain financial stability, controlling monetary growth was important; to stimulate economic growth, maintaining and even strengthening international competitiveness was important. However, as capital began to flow back into the country, both strategies were threatened. What distinguished this case from so many others was that it was not clear whether capital was really coming back—after all, inflation

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[177]The arrangement totaled SDR 615 million ($605 million; 140 percent of quota), of which SDR 85 million was available immediately. As discussed below, the Philippines drew an additional SDR 106 million in July 1985 and SDR 212 million in December 1985. The arrangement was canceled in June 1986 with an undrawn balance of SDR 212 million.

[178]The cable is in IMF/CF (C/Philippines/1760 "Stand-by Arrangements, 1985").

[179]"Philippines—First Review Under Stand-by Arrangement," EBS/85/109 (May 1, 1985).

was still above 50 percent a year and there was still a great deal of political uncertainty and even turmoil—or whether—as suggested in the Managing Director's January cable—it was being discouraged from leaving. Structural reforms were under way, but implementation was slow and difficult to gauge.

When the Executive Board met to review the program on May 30, 1985, Directors were cognizant that the Fund's support was essential for the continued implementation and strengthening of structural reforms. The Fund (and the World Bank) had been pushing hard for months to convince the authorities to dismantle some of the most egregious monopolization and centralization of trade in export commodities, notably in the marketing of coconuts and sugar; substantive progress was finally evident. Reflecting a general commitment to reform, the authorities had agreed to a revised program in April. In mid-May the commercial banks had finally approved the rescheduling agreement. Apprehensively but without dissent, the Board approved the revised program.[180]

To underline the apprehensions that Directors had expressed about the success of the adjustment effort, the Managing Director took the unusual step of preparing a summary of the discussion to convey to the authorities.[181] This summary, as noted in de Larosière's covering letter to the prime minister, highlighted "the considerable emphasis placed by Directors on the need to persevere with tight monetary policies, to carry through with the implementation of structural reforms anticipated in the program, and to remove remaining rigidities in the foreign exchange market." He also noted the "broad consensus that these policies will create the basis for a sustained recovery over the medium term."[182]

What the program might have achieved over the medium term will never be known, because the Philippines was now heading toward presidential elections that would lead to far more substantial political and economic reforms. Meanwhile, the last eight months of the Fund's dealings with the Marcos regime were dominated by a mutual effort to keep the program patched together. The annual Article IV consultation mission, which was held in Manila in July 1985, revealed that the existing policy stance would not enable the authorities to meet the performance criteria for the remainder of the year. Although the criteria had been met for July, the second program review could not be completed in conjunction with the Executive Board's conclusion of the consultation in September. Consequently, the purchase scheduled for the third quarter was not allowed. Then another mission visited Manila in November, only to find that the fiscal deficit had overrun the ceiling in September; the fourth quarter drawing was also disallowed.[183] These circumstances set the stage for the final program under the *ancien régime*.

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[180]Minutes of EBM/85/83 (May 30, 1985).

[181]As discussed in Chapter 2, Article IV consultations are always concluded by a "summing up" by the Chairman, which is then conveyed to the authorities as well as to other member countries. Program reviews, however, do not require a summing up, and normally none is prepared.

[182]Letter of June 13, 1985; IMF/CF (C/Philippines/1760 "Stand-by Arrangements, 1985").

[183]"Philippines—Second Review Under Stand-by Arrangement," EBS/85/261 (November 25, 1985).

Between the July 1985 mission and the November mission, the Philippine authorities had decided to implement several policy changes aimed at meeting the program targets. First, the excess fiscal deficit for 1985 would be reduced, principally by restricting transfers to government-owned financial institutions. Second, the tax system would be reformed to reduce reliance on taxes on foreign trade and exchange, in favor of a broadening of the domestic tax base. Third, the sugar and coconut sectors would be restructured according to a plan worked out with the World Bank, with the aim of promoting competition. Fourth, exchange rate policy would be actively pursued to promote competitiveness; in practice, this would imply intervening in exchange markets to ensure a moderate depreciation of the peso against the U.S. dollar. These actions, together with revised agreements on the quantitative performance criteria, would form the basis for a program that would enable the Philippines to make the two previously disallowed purchases in December 1985. That strategy was approved by the Executive Board on December 20, 1985, and the Philippines drew SDR 212 million ($235 million) a few days later.[184]

With the campaign for the presidency in full swing in January 1986, fiscal policy turned very expansionary. Like its 1984 predecessor, this final program was already headed for an early grave when the election was held on February 7, 1986. Mrs. Corazon Aquino won the election over Ferdinand Marcos, but Marcos declared himself the winner and scheduled a competing inauguration. Fortunately, this constitutional crisis lasted less than two weeks as military support for Marcos crumbled. A four-day "people power" revolution culminated in Marcos fleeing the country on February 25.

The shift in regime did not, of course, immediately solve the economic problems that had built up over more than two decades. It did, however, restore a sense of optimism in the country and a sense of goodwill in the international community. Within a few weeks, a staff team (led by Neiss) was back in Manila, and a new 18-month stand-by arrangement was quickly negotiated. That arrangement (for SDR 198 million, equivalent to $235 million or 45 percent of quota) was successfully completed and fully drawn. And in May 1989, the Philippines was one of the first countries to obtain debt relief through an EFF arrangement under the terms of the Brady Plan (see Chapter 11). Even then, however, the size of the debt problem remained too large to conquer in a few years, and the Philippines' continued dependence on new injections of credit from the Fund lasted into the late 1990s.

Appendix: Conditionality Guidelines

The Executive Board approved the following guidelines on the use of the Fund's resources in March 1979 (Decision No. 6056-(79/38), March 2, 1979). These guidelines remained in force throughout the period covered in this history.

[184]Minutes of EBM/85/183–184 (December 20, 1985).

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

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

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

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

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

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

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

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

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

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

10. In programs extending beyond one year, or in circumstances where a member is unable to establish in advance one or more performance criteria for all or part of the program period, provision will be made for a review in order to reach the necessary understandings with the member for the remaining period. In addition, in those exceptional cases in which

an essential feature of a program cannot be formulated as a performance criterion at the beginning of a program year because of substantial uncertainties concerning major economic trends, provision will be made for a review by the Fund to evaluate the current macroeconomic policies of the member, and to reach new understandings if necessary. In these exceptional cases the Managing Director will inform Executive Directors in an appropriate manner of the subject matter of a review.

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

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

On August 3, 1979, the Executive Board approved the following text for a guideline on conditionality on external debt. [Decision No. 6230-(79/140)]

The Chairman's Summing Up on External Debt Management Policies

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

> When the size and the rate of growth of external indebtedness is a relevant factor in the design of an adjustment program, a performance criterion relating to official and officially guaranteed foreign borrowing will be included in upper credit tranche arrangements. The criterion will include foreign loans with maturities of over one year, with the upper limit being determined by conditions in world capital markets; in present conditions, the upper limit will include loans with maturities in the range of 10 to 12 years. The criterion will usually be formulated in terms of loans contracted or authorized. However, in appropriate cases, it may be formulated in terms of net disbursements or net changes in the stock of external official and officially guaranteed debt. Normally, the performance criterion will also include a subceiling on foreign loans with maturities of over one year and up to five years. Flexibility will be exercised to ensure that the use of the performance criterion will not discourage capital flows of a concessional nature by excluding from the coverage of performance criteria loans defined as concessional under DAC criteria, where sufficient data are available.

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

1. The above guideline will be applied with a reasonable degree of flexibility while safeguarding the principle of uniformity of treatment among members. The external debt guideline should be interpreted in the light of the general guidelines on conditionality [reproduced above], especially guideline No. 4, which states:

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

Also, guideline No. 9 includes the following:

> The number and content of performance criteria may vary because of the diversity of problems and institutional arrangements of members. Performance criteria will be limited to those that are necessary to evaluate implementation of the program with a view to ensuring the achievement of its objectives.

Furthermore, guideline No. 8 states:

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

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

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

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

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

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

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

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