

ESSAYS IN INTERNATIONAL FINANCE

No. 166, December 1986

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IMF CONDITIONALITY:  
INEFFECTUAL, INEFFICIENT, MISTARGETED

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JOHN SPRAOS



INTERNATIONAL FINANCE SECTION

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PRINCETON UNIVERSITY  
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## ESSAYS IN INTERNATIONAL FINANCE

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Library of Congress Cataloging-in-Publication Data

Spraos, John.  
IMF conditionality.

(Essays in international finance, ISSN 0071-142X; no. 166 (Dec. 1986))

Bibliography: p.

1. International Monetary Fund.      2. Loans, Foreign.      I. Title.      II. Series:  
Essays in international finance ; no. 166.  
HG136.P7 no. 166      332'.042 s      86-33805      [HG3881.5.I58]      [332.1'52]  
ISBN 0-88165-073-0

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Printed in the United States of America by Princeton University Press at Princeton,  
New Jersey.

International Standard Serial Number: 0071-142X  
International Standard Book Number: 0-88165-073-0  
Library of Congress Catalog Card Number: 86-33805

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IMF CONDITIONALITY:  
INEFFECTUAL, INEFFICIENT, MISTARGETED

The International Monetary Fund is currently held in high esteem. Its role in the management of the international debt crisis has been much applauded in the creditor countries. But applause for short-run successes should not satisfy the IMF. At the next crisis or the one after, the Fund may receive plaudits yet again, but in the long run the worth of an institution and the value of its contribution must be judged on less transient considerations.

This essay will focus critically on a feature of IMF operations that has become permanent—conditionality. For more than three decades, members seeking access to the General Account of the Fund have had to commit themselves to explicit conditions regarding the conduct of their national policies. The principle of conditionality will not be questioned here, although it is worth recalling that there was a great debate inside the Fund in its early years on whether conditionality or automaticity was more in keeping with its Articles of Agreement. Conditionality became explicitly enshrined in the Articles only in 1969, twenty-four years after the Fund's inauguration, although it had been applied for many years before.

The questioning will be directed instead at the current *practice* of conditionality. It is the central theme of this essay that conditionality, as practiced, is conceptually flawed at its core: by targeting policy instruments, such as the volume of credit and the public-sector deficit, instead of genuine policy targets, conditionality reverses the natural priorities and leads to inefficiencies. It is proposed here that a switch be made to targeting the balance of payments, which is a genuine policy target and can therefore be logically cast in that role.

Section 3 is devoted to the central theme just described, and section 4 examines some practical problems and implications. Sections 1 and 2 build up to the central theme. Section 1 outlines the record of Fund programs. It is derived from secondary sources but plays an important part in the argument: by laying bare the fact that the record is unimpressive, it reinforces the logical argument for a change in the practice of conditionality. Section 2 considers the responsibilities of the IMF to the international economic system in the processes of balance-of-payments adjustment. It argues that they cannot be properly discharged because countries are massively inhibited from seeking early recourse to the Fund by the intrusiveness of conditionality as currently

practiced. Thus the present regime fails to promote the efficiency of the system—yet another debit item.<sup>1</sup>

## 1 The Record of Conditionality

There is obviously a multiplicity of worthy targets of economic policy, including high employment, rapid growth, low inflation, more equitable income distribution, and balanced international payments. For three reasons, however, the balance of payments has a unique and preeminent position in the context of Fund programs. First, a member must demonstrate a balance-of-payments need in order to gain access to the resources of the Fund. Second, an improvement in the member's balance of payments is the only specific target prescribed in the IMF Articles. Third, a balance-of-payments improvement is needed if the Fund is to be paid back, and the Fund's own interest in repayment provides the major legitimization of conditionality in a world of sovereign states.<sup>2</sup>

The other target variables are not irrelevant, but their relevance is indirect, in that they are liable to affect or be affected by the pursuit of the balance-of-payments target. To put it another way, the other target variables define the tradeoffs that measure the cost of attaining the primary target. It is not meaningful, therefore, to put other target variables on an equal footing with the balance of payments and say, as some evaluations of Fund programs do in substance, that in  $x$  percent of programs the balance of payments improved, in  $y$  percent growth accelerated, and in  $z$  percent inflation slowed down. This is record keeping in the abstract. How would we judge Fund programs if the  $y$  percent of programs that were associated with accelerated growth comprised the same cases as the 100 percent minus  $x$  percent of programs in which the balance of payments had not improved?

It is, of course, hard in practice to apply the proper methodology, which would evaluate programs in terms of the cost incurred by each economy to achieve a given balance-of-payments improvement. But when the balance-of-payments record is weak, a negative assessment is appropriate on that basis alone. Failure in the primary dimension is dominant. Because the balance-of-payments record has in fact been weak, attention will be concentrated on this

<sup>1</sup> Sections 2 and 3 expand and develop ideas briefly adumbrated in Spraos (1984).

<sup>2</sup> Kenen (1986) neatly shows that the provisions for repayment of drawings on the IMF are neither necessary nor sufficient to ensure the revolving character of Fund credit. They are not necessary when there are no countries with persistent payments imbalances, and they are not sufficient when there are some persistent surplus countries. Pursuing Kenen's reasoning, it would seem that, to make credit revolve, the repayment provisions are necessary when there are persistent deficit countries and they are also sufficient if they succeed in securing repayment (thereby purging the system of persistent deficits).



one criterion, without regard to the tradeoffs. They would be relevant only to measuring the cost of success.

A number of studies have examined the balance-of-payments record of Fund-assisted countries before, during, and after the operation of IMF programs. One of the most recent, under the auspices of the Overseas Development Institute, is by Killick (1984) and his team, who also surveyed all the earlier studies. For the current account, the conclusion is that "there appears to be some tendency for the current account of programme countries to move in the desired direction but it is a tendency that has low established claims to statistical significance" (p. 233). For the "basic" and overall balances, "(a) there is a general tendency for Fund programmes to be associated with a reduced basic or overall BoP deficit," but "(b) the known statistical significance of the tendency towards improved balance is slight" (p. 235).

To add a quantitative flavor to these conclusions, Table 1 gives data extracted from an IMF staff study by Donovan (1982) for the decade 1971-80. The results of before-and-after comparisons are reported for the current ac-

TABLE 1  
COMPARISONS SHOWING ABSOLUTE AND RELATIVE EXTERNAL-SECTOR IMPROVEMENT  
ASSOCIATED WITH UPPER-CREDIT-TRANCHE STANDBY ARRANGEMENTS, 1971-1980

	No.	Percent
Year before vs. year after program's inception (N = 64): <sup>a</sup>		
Absolute improvement:		
In ratio of current account to GNP	35	55
In ratio of overall balance to exports	39	61
In both ratios	28	44
Relative improvement: <sup>b</sup>		
In ratio of current account to GNP	44	69
In ratio of overall balance to exports	36	56
In both ratios	29	45
3 years before vs. 3 years after program's inception (N = 54): <sup>a</sup>		
Absolute improvement:		
In ratio of current account to GNP	32	59
In ratio of overall balance to exports	39	72
In both ratios	24	44
Relative improvement: <sup>b</sup>		
In ratio of current account to GNP	37	68
In ratio of overall balance to exports	36	67
In both ratios	25	46

<sup>a</sup> Because program and calendar years do not coincide, Donovan (1982) adopts a special convention for coping when data are available only annually.

<sup>b</sup> The benchmark is the performance of all nonoil developing countries combined.

SOURCE: Donovan (1982, Table 3).

count and the overall balance, in absolute terms and relative to all nonoil developing countries. Both annual and triennial comparisons are made.

Take absolute improvement first. With one exception, the proportion of cases showing an absolute improvement was no better than 3 out of 5. The respectable exception was with respect to triennial comparisons relating to the overall balance. (Though Donovan does not report statistical significance, this last case is the only one relating to absolute improvement that can boast of robust significance at the 5 percent level.)

A before-and-after comparison is of course imperfect (Williamson, 1983a). It does not require that all else remain the same (apart from IMF programs), but it does require that other factors do not bias the chosen measures of success either across countries or over time, and this condition is not easily satisfied. To eliminate bias, Donovan introduced a relative-improvement test. The underlying assumption is that all nonoil developing countries, including the program countries (which are, however, heavily outnumbered by the rest) were subject to the same systematic influences and can thus serve as a "control" group. A comparison between all nonoil developing countries and the program countries might then be expected to isolate more effectively the role of Fund programs.

It can be seen from Table 1 that the relative test favors the Fund more than the absolute test with respect to the current account, but it favors it less with respect to the overall balance, and the percentage of programs recording improvements in both current account and overall balance changes little between absolute and relative comparisons.

From the bare figures it might be argued that, on balance, the relative test makes the record of Fund programs a little more respectable. But, as Goldstein and Montiel (1986) point out, the relative test would be unbiased only if the nonprogram countries in the control group were drawn from the same population as the program countries. And this they are not in at least one particular that is crucial for the point at issue. As one would expect, the balances of payments of nonprogram, nonoil developing countries were in much better shape with respect to both the current account and the overall balance in pre-program years.<sup>3</sup> They were thus under less pressure (if any) to engineer an improvement or resist a deterioration, so that their use as a control flatters the Fund greatly.

With some allowance for this bias, the relative improvement shown in Table 1 becomes less than impressive. And it does not look as if this unimpressive record can be explained away by reference to countries that failed to comply with the provisions of Fund programs. When Connors (1979) sepa-

<sup>3</sup> Killick (1984) also alluded to this difficulty (p. 268, note 7) and Donovan (1982) was clearly aware of it.

rated “compliers” and “noncompliers,” he did not find a statistically significant difference in current-account performance—in itself a result that is not helpful to the reputation of Fund programs.<sup>4</sup>

If the Fund could plausibly claim high marks for the effectiveness of its programs on the balance of payments, there would be reason to ask at what sacrifice this was achieved. Since such a claim is apparently not sustainable on the available evidence, we need not ask about tradeoffs. The ineffectiveness of Fund programs on the external front stands on its own.

## **2 Timing of Fund Assistance and System Efficiency**

The IMF was created in the aftermath of World War II to help in the management of a stable exchange-rate system and to be a source of revolving international liquidity. (SDRs, which provide permanent liquidity, came much later.) The first function disappeared with the collapse of the Bretton Woods exchange-rate regime. The second, which concerns us here, has been distorted by the Fund’s conditionality practices.

It has been frequently pointed out that countries with a balance-of-payments problem have a choice between a hurried and painful response and the use of international borrowing to finance the deficit while more measured and less disruptive adjustment is undertaken. The choice between the two will be influenced in a major way by the terms on which borrowing is available.

The international community’s legitimate interest in this choice has two parts: one relates to redistribution, the other to efficiency. Redistributive considerations arise when the countries facing payments deficits are poor. But these considerations are not very germane to the work of the IMF unless it is viewed as an aid agency. Efficiency considerations are relevant whether the potential borrower is rich or poor. The efficiency issue arises because of the externalities associated with adjustment actions by countries facing deficits: smoother, less disruptive adjustment avoids unnecessary multiplier effects on other countries and wasteful counteradjustment by them.

Because these externalities do not figure in the profit calculation of the commercial banks, there is a need for an institution to make temporary liquidity available on terms more attractive than those offered by commercial banks in order to give countries an extra incentive to take the borrow-early-and-adjust-more-smoothly option.

The IMF was intended to be just that institution. Instead, it is now feared and resented by the developing countries. Its assistance is sought only as a

<sup>4</sup> The latest study that attempts to test for noncompliance relates to the effect of Fund programs on inflation (Kirkpatrick and Onis, 1985). Compliers and noncompliers are distinguished by a dummy variable in a regression equation, but the coefficient is not significant even at the 10 percent level.

last resort. It is not possible to devise an objective standard for measuring the appropriateness of resort to the IMF so that deviations from it could measure the reluctance of countries to turn to Fund assistance (but see Bird and Orme, 1981). However, the mood and perception of policymakers and their advisers in developing countries, as well as of articulate public opinion, is unmistakably anti-IMF. (A similar tendency is evident in developed countries, where it has become a common coin in the small change of party politics to accuse opponents of advocating economic policies that will lead the country to the IMF—the ogre that will devour naughty children.) In the late 1970s, Fund assistance was sought mainly by the poorest countries because their low commercial-credit ratings debarred them completely from alternative sources of funds. Middle-income developing countries like Mexico and Brazil did not return to the IMF until 1982, when the eruption of the international debt crisis put them in the same boat. The IMF itself expressed concern about these developments and sought to widen its appeal (Diaz-Alejandro, 1983), which may partially explain the short-lived easing of Fund terms from October 1979 to May 1981, documented by Williamson (1983b).

Arguably, some of these phenomena resulted in part from the increased availability of credit from private financial institutions, not just from Fund conditionality practices. But the question remains: why was the Fund, which had been designed to be at the front of the queue of lenders, pushed right to the back? The interest rate charged by the IMF does not exceed and is frequently well below that of commercial lenders. The terms of conditionality and their perceived high social costs must therefore be deemed responsible for developing-country hostility toward the Fund, carried so far that countries are reluctant to avail themselves of even the low-conditionality first credit tranche.

This relegation of the Fund to the end of the queue, to be approached only in desperation, marks a crucial failure by the IMF. It is a failure not by the standards of unreconstructed Keynesians, starry-eyed expansionists, or people who have failed to appreciate that, for a time, there was an increased supply of commercial lending for balance-of-payments purposes, but by the standards that the Fund itself enunciated as recently as 1979, when it adopted Guidelines to govern its conditionality practices. The very first paragraph stated:

Members should be encouraged to adopt corrective measures, which could be supported by the 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.

Note that this guideline goes beyond early-stage assistance; it extends to the precautionary stage. Current practice could not be further removed from this precept.

If "encouraged" could be interpreted to mean "exhorted," the Fund could go on using its favorite argument that its clients themselves are to blame for onerous conditionality, because they delayed their approach to the Fund until painful surgery was necessary. But exhortation is cheap, and the Fund should not wash its hands in this manner. The guideline must be deemed to contemplate action by the Fund—action that would elicit the requisite response by members. Furthermore, encouragement, if it is not to be drained of meaning, must be strong enough to yield results and thus lessen the reluctance of member countries to resort to the Fund.

In terms of this criterion the Fund has failed. It has not performed the efficiency-enhancing role that it should be performing. And its failure has been getting perceptibly worse.

Damage limitation, though crowned with success in the international debt crisis, is neither the equivalent of nor a satisfactory substitute for the efficiency-enhancing role. Indeed, it is a distortion of the role for which the Fund was designed. Damage limitation is a last-ditch defense against collapse, whereas the Fund should be in the business of early-stage assistance. This is not to deny the usefulness of damage limitation, but to deny that the last ditch is the Fund's proper habitat. It is also to assert that praise for the Fund's contribution to damage limitation must be muted to the extent that the Fund's own practices regarding conditionality delayed earlier resort to the IMF by the debtor countries and thus exacerbated the debt problem itself.

Finally, the theme developed here must be linked with the ineffectiveness of Fund programs that was discussed in the previous section. The connection is a negative one. Considerations of efficiency emphasized here imply that the proper response to the Fund's ineffectiveness is not to make its programs tougher, as suggested in some quarters. More onerous programs will only drive the Fund further into the last ditch. The discussion of conditionality in the next section should help in the quest for a more appropriate response.

### **3 Confusion between Targets and Instruments**

In order to establish an early-stage role for the Fund and thus promote its efficiency-enhancing function, the terms of conditionality must be made less unattractive. If this required a massive increase of transfers from developed to developing countries, one could not realistically expect the subject to be inscribed on the international agenda, given the current attitude of developed countries toward such transfers. Furthermore, it would be unfair to criticize the Fund for its practices and the associated retreat to the last ditch if that retreat could be halted only by mobilizing a large increase in transfers.

Fortunately, it is possible to separate, substantially if not entirely, the improvement in the terms of conditionality from the need for additional resources and more transfers. If, as will be contended, conditionality as now

practiced is mistargeted, the mere change to more appropriate targeting will constitute a major amelioration.

*The Present Practices of the IMF*

When providing assistance from its General Account, the Fund is restricted by its Articles to instances in which members need it "to correct maladjustments in their balance of payments." Unsurprisingly, therefore, an improvement in the balance of payments is articulated explicitly as a program goal in virtually all Fund programs and is usually quantified as well.

But the conditions that bite, the terms that constitute the core of the conditionality package, are not attached directly to the balance of payments. Standby arrangements stipulate that access to successive installments of drawings depends on preconditions (so called because they must be satisfied before the formal beginning of a Fund program) and on performance criteria, and all of these relate to instruments of policy, not to the target of the balance of payments. It is these targets for instruments that are being enforced and policed by the IMF, not targets for genuine target variables.

The instruments favored overwhelmingly are ceilings on credit, restrictions on the public-sector deficit, and devaluation. The evidence is summarized in Table 2, which Killick (1984) has derived from a special survey conducted by the IMF in 1981. Because devaluation is often set as a precondition, it does not figure prominently in the table, but it is reported in Killick (1984, p. 194) that in 61 percent of standby and Extended Facility credits in the period 1973-80, a devaluation occurred within six months of either side of the credit arrangement. It is also reported in Killick (p. 191) that an unpublished Fund review of standby's in 1978-79 acknowledges that exchange-rate action (not necessarily devaluation) was set as a precondition in 9 cases out of 13.

TABLE 2  
SELECTED PERFORMANCE CRITERIA IN UPPER-TRANCHE STANDBY ARRANGEMENTS

Criterion	Number of Observations <sup>a</sup>		
	1964-69	1970-73	1974-79
Credit ceilings:			
Total domestic credit	3	10	9
Credit to government/public sector	7	5	7
Credit to private sector	5		1
Devaluations	3		
Reduction in current payments arrears		1	2
Minimum levels for foreign-exchange reserves	1	1	4
Restrictions on new external debt	3	7	5

<sup>a</sup> The maximum number of observations for each entry is 10.

SOURCE: Killick (1984, p. 192).

Fund programs involve much more than preconditions and performance criteria. Policy understandings, incorporated in "Letters of Intent," may span a very wide range of measures, for example, measures affecting the functioning of public administration, the subsidization of consumer goods, and the control of wages. Increasingly, the Fund has stressed that measures relating to the supply side are being given prominence (Guitian, 1981; Crockett, 1982). Note that supply-oriented measures can mean very different things; radical development planners and conservative supply siders are both concerned with supply management, but in very disparate senses. But let us not be detained by this. For the main thrust of Fund programs is to restrict aggregate demand, and the policy instruments selected as performance criteria—the core of conditionality—confirm this thrust.

### *First Criticism: Neglect of Sources of Imbalance*

Since policy instruments are numerous and are not ranked uniquely for efficacy and appropriateness, even among those who agree on the ultimate targets, the Fund's predilection for a particular set of instruments has generated much opposition. The criticism that has made the greatest mark was most clearly articulated by Dell and Lawrence (1980, p. 129):

It is a fundamental conclusion of the present study that, in determining the appropriate volume of balance of payments support and the conditions required for the provision of that support . . . it is important to distinguish between those elements of the balance of payments deficit for which a developing country is itself responsible and those elements that are due to factors beyond its control.

Dell and Lawrence note that this principle was accepted by the Fund in the limited contexts of the Compensatory Financing Facility and the short-lived Oil Facility, but they argue that it should be applied more generally. Ceilings on credits and budget deficits are not necessarily the optimal remedies when a balance-of-payments problem is due to external events such as a rise in interest rates, a world recession, chronic surpluses in some countries, or a secular decline in the demand for a country's exports. Even if home-grown, the problem may be structural, requiring treatment different from that prescribed by the IMF.

The Fund's defense against this criticism is to deny the importance of the distinction concerning the source of the problem; what matters is whether the payments imbalance is long-term or transitory. If transitory, it should be financed, but if long-term, the economy must be made to adjust (Nowzad, 1981, p. 16; Khan and Knight, 1983).

Yet the need for adjustment, which is not disputed in the case of a long-term imbalance, does not itself indicate the appropriate form of adjustment and the best means of bringing it about. And this is what Dell and Lawrence were driving at. They may have narrowed the issue unduly by focusing on the

distinction between imbalances for which a country is responsible and those generated by factors beyond its control. But theirs is merely a special case, albeit an important one, of the robust proposition that in the selection of instruments the source of the imbalance matters.

A Fund official has indeed acknowledged that differential conditionality, depending on the source of the balance-of-payments difficulty, may be right in some individual applications, but he then asserted without explanation that this cannot be raised to the status of general principle (Nowzad, 1981, p. 16). Why not? Why should the status of principle be denied to what is only a particular expression of an even more general principle—so general that it is difficult not to phrase it tautologically—that the best policy is the one tailored most suitably to the circumstances to which it is applied? If the Fund cannot commit itself to this principle on operational grounds, that is reason enough for seeking to recast its conditionality practices.

### *Second Criticism: Not Enough Structural Orientation*

The strand of criticism of IMF conditionality that stresses the structural origins of the balance-of-payments problems of developing countries has been around for a long time, but it has received its most systematic exposition and development in the Overseas Development Institute (ODI) study by Killick (1984) and his collaborators. They do not deny that the demand-restricting monetary instruments favored by the IMF have a role to play in certain circumstances, but they wish to shift the focus to policies that engineer structural adjustment by the real economy. More specifically, they favor policies that switch resources from nontradables to tradables, thus promoting export expansion and import substitution and generating a long-run improvement in the trade balance at a high level of resource utilization and with minimally retarded growth.

The devaluations that figure in many conventional IMF programs have the same objective (when not offset by import-liberalization provisions), but Killick and associates have in mind a large package of detailed measures, operating at sectoral, subsectoral, and even micro levels of the economy, constituting in its entirety an elaborate blueprint for reform designed to enhance the efficiency and competitiveness of the tradables-producing sector. In such a program, conditionality would hinge not on the attainment of quantitative targets but on the implementation of specified policy measures at preassigned times.

The ODI authors acknowledge that their thinking has been influenced by the World Bank's Structural Adjustment Loans, but they do not deal with the problems that will arise from the blurring of the demarcation line between the IMF and the World Bank. Structural Adjustment Loans were initiated in 1980 and constituted until recently a small fraction of the Bank's lending (not



exceeding 10 percent), but a big expansion, which has had its advocates for some time (Please, 1984), is currently underway, spurred by the Baker plan.

Other things equal, Killick and associates would presumably not care whether an IMF or a World Bank label was attached to a program. But if the Bank's label is attached, the lending will be financed by diverting funds from the Bank's project loans. Therefore, the ODI authors address their proposals to the IMF, hoping to achieve an expansion of the Fund's resources and thus an expansion of total flows to the developing countries. The opportunity-cost implications for the developing countries are seen to be different in the two cases.

### *A More Fundamental Criticism*

The critiques of the Fund's practices that have just been outlined are radical in some respects. But in one fundamental respect they do not challenge the rules that the IMF has evolved: the critics, particularly the ODI team, accept the major premise that conditions should be attached to policy instruments. This, it will be contended, is a flawed premise in principle and a major source of distortion of the Fund's role in practice.

The Fund sets quantitative targets for instruments such as credit expansion; these serve as performance criteria and thus govern access to successive installments of drawings on the Fund's General Account. The Fund thus raises instruments to the status of targets, while genuine targets of policy are not directly targeted.

There is seemingly a parallel here with the fashion that grew in the 1970s for national economic policymaking to give prominence to so-called "intermediate targets," in particular the growth of the money stock. Though this fashion drew some inspiration from the "rules vs. discretion" debate in which Friedman (1968) was a protagonist, with hindsight we can see that it did not truly constitute an application of the "rules" position. Discretion about changing the targets was retained by policymakers, and changes in mid-stream came to be made with increasing frequency. The dominant motivation for setting money-stock and other intermediate targets has been to influence expectations, so that intermediate targeting became in effect another instrument of discretionary policy (albeit one not to be frequently retargeted). Its prominence waned after a time as it came to be realized that expectations do not lend themselves to molding by simple formula.

Thus the parallelism between the Fund's practice and intermediate targeting by national policymakers is rather superficial. The contrasts are more instructive. Two are crucial. First, intermediate targeting at the national level tended to turn targets into instruments, while the Fund practice has raised instruments to the status of targets. Second, intermediate targeting at the national level is discretionary, whereas the Fund's targeting is mandatory. (The

Fund, at its discretion, condones transgressions *ex post*, with or without renegotiation, but this is another matter and will be discussed later.) The absence of discretion has a serious consequence: policy becomes committed to instruments whether or not they work as anticipated.

*Is the Distinction between Targeting Instruments and Targeting Targets Redundant?*

Under certain conditions, the distinction between targeting an instrument and targeting a genuine target becomes unimportant. When this is so, any argument that rests on such a distinction becomes pointless. But the requisite conditions are stringent. A partial enumeration of those conditions, with commentary, may help.

First, the instrument must have a stable and well-defined relationship to the genuine target. The Fund pioneered the monetary approach to the balance of payments, which posits such a relationship between domestic credit expansion (DCE) and the balance of payments, and was no doubt gratified to see it gain influence. The Fund is entitled to defend its intellectual capital at the academic level. But its pioneering gives it no license to make DCE the linchpin of the programs it imposes on borrowing countries, which it continues to do despite the breakdown of demand-for-money functions since the 1970s and the poor balance-of-payments record of Fund programs so far. The Fund ought, at least, to heed the lessons of its own experience. It can, of course, find explanations to excuse its unimpressive record. Since policy measures are not implemented as part of a controlled experiment, unforeseen and unpredictable events can swamp the influence of the chosen instruments. But recall that Fund programs did not shine even when tested relative to the performance of nonprogram countries. In any case, divergences between instruments and genuine targets, for whatever reason, warn against making a policy commitment to a particular set and mix of instruments.

Second, there must be some version of the instrument which, if not unique, stands out preeminently as worthy of being selected to be a target, or, alternatively, all of its versions must be in the habit of keeping in step, making the choice immaterial. But with the breakdown of demand-for-money functions, the choice among  $M_0$ ,  $M_1$ , or  $M_3$ , to name but a few of the possible candidates, has become a matter of controversy, and adherence to any particular version has turned fickle even among dedicated money-stock targeters. (The Fund typically targets DCE, not  $M$ . But  $M_3$  and DCE are related via the balance-of-payments surplus or deficit, and a stable demand function for  $M_3$  is part of the rationale for DCE targeting.) Furthermore, it turns out that the choice of a particular money stock cannot be made optimally *ex ante* even when the model underlying the economy is perfectly known; the optimal choice depends on the shocks to be experienced (Argy, 1983).

Third, the version chosen must not be exposed to easy substitution between what is included in it and what is excluded. If, for example, the chosen money-stock measure includes bank deposits but excludes deposits at mortgage-finance institutions, this condition would not be satisfied if the security, yield, and liquidity of the latter differed little from those of the former. This third condition is implicit in the first two, but it acquires an independent status when the target is imposed by an outsider, such as the IMF. The government or central bank can take action to induce substitution in the direction required in order to comply with the letter of the target imposed by the outsider while violating its spirit. In these circumstances, instrument targeting either becomes a ritual or it faces three unsatisfactory options: it must focus on a very narrow measure, which is inappropriate; it must focus on an all-embracing measure, which is meaningless; or it must be enforced by heavy policing, which would increase the intrusiveness of the IMF.

It is by now well understood that in countries with an advanced financial sector, simple regulatory devices can induce substitution between liquid assets in ways that have a significant effect on various measures of the money stock.<sup>5</sup> In developing countries, the financial system is usually less flexible but more directly under the control of the central bank. Even if, in consequence, the IMF's instrument targeting is more effective in developing countries, the Fund cannot rest its case on considerations that give it a vested interest in financial underdevelopment and involve *de facto* discrimination between developed and developing countries.

Fourth, the targeted instrument must be the only one that can influence the genuine target in the desired direction, or, if it is not the only one, it must have no side effects, or, if it has side effects, it must dominate all other instruments in a strict sense: with respect to every side effect, the chosen instrument must involve a lower burden (or larger benefit) than all other instruments. (Without such Pareto-superiority there may be some reasonable weighting of side effects that will give a low ranking to the Fund's chosen instruments.) Issues under this heading are responsible for the bitterness generated by IMF practices. Even when the genuine targets are agreed upon, the choice of instruments is not value-free (because different value weights can be attached to side effects), so that an imposed targeting of instruments creates discord and division.

The *déformation professionnelle* of technocrats is to believe that competent professionals may differ about ends but will agree about the best way to attain any ends that may be chosen. Those who do not agree are incompetent, and

<sup>5</sup> The best-known case is that of the "corset" in the United Kingdom. It consisted of a penalty on banks if their interest-bearing deposits exceeded a certain target growth rate; the larger the excess, the bigger the penalty. Its imposition rendered bank deposits uncompetitive, and deposits in other financial institutions flourished instead (see Argy, 1985).

it would be in everybody's best interests if the competent ones exercised leverage to enforce their views. Although this can sometimes be true, it does not excuse behaving as though it were always true, which is what happens when technocrats arrogate to themselves the right to choose and target instruments, as distinct from advising about them.

This danger is recognized at a certain level of discourse. A former senior official of the IMF's twin, the World Bank, observed, "The swings of professional judgement and fashion . . . must give all professional economists . . . cause for reflection and concern" (Please, 1984, pp. 90-91). But he viewed this as a marginal qualification to the right and duty of technocrats to exercise leverage in enforcing "desirable" policies. The Fund likewise appears to acknowledge the problem at a certain operating level. While insisting on a reduction of the fiscal deficit, it declares itself ready to leave to the country concerned the choice between reducing expenditure and increasing revenue (Heller, 1985). Even at this second tier of choice, however, the discretion of the borrowing country can be only theoretical, because of the Fund's judgment that "in practice it is sometimes very difficult or undesirable to raise revenues. . . . As a practical matter, therefore, policy measures must often be directed to checking or reducing government expenditure" (Heller, 1985). And the Fund has sometimes insisted on having the final say at even much lower tiers of choice.

#### *Absence of Professional Consensus on Instruments*

The inappropriateness of insisting on particular instruments to attain macroeconomic objectives is compounded when macroeconomic theory and the associated policy prescriptions are highly contentious and subject to "schools of thought." The imposed choice of instruments is then school-influenced as well as value-loaded. Despite impressions and claims to the contrary, a monetarist consensus was not attained in the economics profession, even among economists in the advanced industrial countries and at the peak of monetarism in the late 1970s.

Sample surveys of professional opinion in the United States and four European countries (Austria, France, West Germany, and Switzerland) have been brought together by Frey *et al.* (1984). Table 3 gives the responses to three statements that test the monetarism of respondents. The monetarist position is firmly taken by less than half of all respondents in answering all three questions and by less than a quarter in answering two out of three. Fewer than one in four even believe in the ability of the central bank to keep the money stock under steady control, let alone to achieve genuine targets by so doing. (This may be due in part to the fact that some European currencies do not float freely, so that money stocks depend on the balance of payments. This could also explain why U.S. economists differ most sharply from others in

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TABLE 3  
ECONOMISTS' RESPONSES TO SAMPLE SURVEY  
(in percent)

Statement	Generally Agree	Agree, with Provisions	Generally Disagree	No Reply
1. The money supply is a more important target than interest rates for monetary policy.				
Total sample	45.5	29.2	21.3	4.0
U.S. only	45.0	21.8	27.5	5.7
2. Inflation is primarily a monetary phenomenon.				
Total sample	22.8	22.8	45.9	2.5
U.S. only	26.1	28.9	41.2	3.8
3. The central bank has the capacity to achieve a constant rate of growth of the money supply if it so wishes.				
Total sample	23.8	45.1	27.8	3.3
U.S. only	33.2	38.9	22.7	5.2

NOTE: Economists in five countries were sampled: Austria, France, Federal German Republic, Switzerland, and the United States. The results for the United States (N = 211, response = 35.2%) were published in 1979, and the others (N = 936, response = 45.2%) followed at intervals until 1983.

SOURCE: Frey *et al.* (1984).

their answers to the third question. To the extent that this is so, it detracts from the discriminating power of the question.) A more up-to-date picture would presumably show a further erosion of the monetarist position, with Keynesianism regaining some lost ground and the macro-policy nihilism of the "new classical macroeconomics" contributing to the erosion.

It would be incorrect to brand the Fund as dogmatically monetarist. But in making credit ceilings the linchpin of conditionality, the Fund leans in the monetarist direction, so these observations about professional support for the monetarist position are germane. If the thrust of Fund programs were Keynesian or Marxian, analogous observations would be in order.

#### *Inversion of Priorities*

If failure attends any one of the conditions needed to equate the targeting of instruments with the targeting of genuine targets, the targeting of instruments becomes misplaced. If failure attends all of those conditions, the tar-

geting of instruments, backed by financial sanctions, becomes perverse. It imposes rigidity in the use of instruments when flexibility is needed in order to respond to unanticipated exogenous events, to make room for modifications in the light of current experience, and to allow for the trial-and-error component of policy management. President Roosevelt is quoted as saying about the New Deal: "We will try something. If it works we will keep it. If it doesn't, let's try something else." He had his priorities right: the instrument is discardable; the commitment is to the genuine target. The IMF policy of targeting instruments has the priorities wrong.

Those who, like the ODI team, advocate the broadening of IMF conditionality to encompass a real-economy approach may be justified in emphasizing the need to select instruments that best fit each case. They are nevertheless open to the criticism that they, too, invert the correct priorities by focusing conditionality on instruments rather than genuine targets. The fact that the quantified targeting of instruments is not retained in the ODI scheme but is replaced by a qualitative test—whether or not the instrument has been activated on schedule—does not prevent the irrational consequences of conditionality focused on instruments. Suppose, for example, that a program dictates the activation of a certain instrument during the first phase and it turns out to perform badly. It cannot be deactivated without jeopardizing the installment of IMF assistance due at the end of the first phase. True, the ODI team wants to replace automatic cutoffs with discretionary ones, Fund discretion being exercised, they hope, with sympathy and understanding toward the problems faced by the program countries. But the difficulty remains: as with the Fund's occasional readiness to condone transgressions, discretion exercised *ex post*, however benevolent, is of little help in the design of policies *ex ante*.

The ODI team's proposals also trip over another principle. It can be granted that a broadening of Fund conditionality to real-economy or supply-oriented considerations can lead to greater concordance than at present between the Fund's ideas of appropriate adjustment and those of its prospective developing-country clients. At the same time, however, the supervision that accompanies a Fund program will become much more intrusive. The instruments to which conditionality will be attached will multiply manyfold to cope with the sectoral, subsectoral, and micro-level objectives associated with a supply-oriented program. (Killick, 1984, and associates fill a page of their book with what they term a partial enumeration of the appropriate instruments.)

It is not at all clear that, on balance, potential clients will become less reluctant to approach the Fund. And if they do not, the fundamental principle of early-stage involvement by the Fund will be violated. The ODI team were not preoccupied by this question, perhaps because they drew the wrong in-

ference from the fact that most developing countries find the World Bank more congenial than the Fund. As noted before, the team acknowledged the influence of the conditions set by the Bank in its Structural Adjustment Loans. But the Bank's image in developing countries does not rest on these loans, which constituted a very small proportion of its lending until recently. It rests on the Bank's project loans, the conditionality of which, insofar as it extends beyond the immediate confines of the project being financed, is not enforced and has no bite. The conditionality of Structural Adjustment Loans is a different animal; it implies massive supervision. And if the Fund attached such supervision to its own assistance, it would probably deter countries from seeking it except in desperation.

It is significant that paragraph 9 of the Fund's Guidelines for conditionality adopted in 1979 states:

... 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.

The restriction of performance criteria to macroeconomic variables (albeit with qualifications) is not an act of self-abnegation by the Fund but a reflection of the reluctance of potential clients to accord an even more intrusive role to the IMF.

### *Correct Targeting*

The efficiency principle of early-stage IMF involvement and the principle of correct targeting constantly converge. By being intrusive and divisive, the targeting of instruments causes the IMF to be treated as all but untouchable. If the balance of payments were to be targeted instead, the Fund and its potential client would be on common ground and a large obstacle to early involvement by the Fund would be eliminated. There would still be disagreements, since the perspectives of borrower and lender are inevitably different, but they would center on issues relevant to the target (for example, the speed with which balance-of-payments improvement is to be attained), not on the functioning and side-effects of instruments that are contentious.

Targeting instruments causes distortion, and distortion can turn into perversity when, as has happened, the balance of payments improves but, say, the fiscal deficit rises. If the latter has been designated as a performance criterion and was supposed to fall, its failure to do so will automatically trigger sanctions. The absurdity of this outcome may be recognized *ex post* by the Fund, which would then waive its objections, but it is an avoidable absurdity. The fiscal deficit should not have been targeted.

The choice of instruments should be left to policymakers in the countries concerned, where by sovereign right they properly belong, subject only to considerations of good-neighborliness designed to exclude actions that damage other countries to an extent not dictated by the underlying need for adjustment. The Fund could tender advice about instruments, which would not always be accepted. But under a new, benign relationship, it might be accepted surprisingly often.

Switching to a balance-of-payments target need not imply a softening of conditions. Whether conditions are tough or mild does not depend strictly on what is being targeted. But of course the principle of early IMF involvement does bar offsetting the lesser intrusiveness associated with balance-of-payments targeting by more toughening elsewhere.

Which measure of the balance of payments should serve as a performance criterion? This is a difficult question, but one on which it is not necessary to take a firm position here. The purpose of this essay is not to lay down narrow rules but to argue the general case for balance-of-payments targeting; the particular measure to be targeted is a secondary question. The answer may depend on the nature of the maladjustment. If a country suffers predominantly from a flow maladjustment, it would be most appropriate to target the current account. This need not imply indifference about the capital account: the current-account target can be set in light of what is deemed to be the sustainable capital inflow. Moreover, capital flows of a stock-adjustment nature are often dependent on the behavior or expected behavior of the current account. The current account is the dog that wags the capital-account tail via expectations about the exchange rate. It is arguable, however, that the capital account should be given a more central position in some circumstances or that a more general-equilibrium approach, encompassing the capital and current accounts simultaneously, is both desirable and feasible. In such a case, the overall balance of payments would be the more appropriate target. To come to grips with some other issues, however, without making the argument too cumbersome, it is necessary to choose a particular measure for targeting. Let this be the current account, in the belief that flow maladjustment is usually dominant in serious cases.

As was already noted, the target need not be a zero current-account balance; it should not normally be zero for developing countries. An informed guess must be made about the sustainable capital inflow, and a current-account deficit equal to that inflow should be deemed acceptable. A phased attainment of the ultimate target must be provided for, including, where appropriate, a phase in which deterioration can take place to allow for policy packages that improve the current account in the longer run but have adverse effects in the short run. These phased targets will constitute the performance criterion. But the targets must be made contingent on relevant exogenous cir-



cumstances, such as world economic activity, domestic harvests, and terms of trade. If any of these deviate from assumed levels, target revision must be set in motion. This might be automatic (according to prearranged schedules) or the subject of new negotiations. No targets for instruments will have the status of performance criteria, although voluntary targets for instruments may be included in policy understandings and incorporated in a country's Letter of Intent.

#### **4 Problems and Implications of Targeting the Balance of Payments**

At the level of principle, the targeting of genuine targets is unambiguously superior to the targeting of instruments. Insistence on the targeting of instruments can be defended, if at all, only at the practical level.

##### *Some Practical Problems*

The Fund advocates three practical properties for variables that are to serve as performance criteria. These variables should be (a) objective, (b) controllable by the government or central bank, and (c) quickly monitorable. (The second is a modified version of what the Fund actually enunciated; see Williamson, 1983b, p. 635.)

Interpreted in a perfectionist manner, these requirements would rule out the Fund's own performance criteria, which fall well short of satisfying them completely. Therefore, the three properties should not be viewed as an inviolable standard against which current-account targeting is to be judged. They can serve, however, as a framework for discussing practical issues.

a. *Objectivity.* The current-account balance scores well under the heading of objectivity. There *are* borderline items between the current and capital accounts that none of the official conventions on balance-of-payments accounting can allocate uniquely, and they give scope to a government that is so minded to play accounting games. The recorded timing of some international payments also provides scope for accounting maneuvers. But then, an ill-willed government can play games when faced with the Fund's current-performance criteria. Think of the substitutions among different categories of liquid assets that a central bank can engineer in order to massage the items included in a credit ceiling, or of the scope for accounting maneuvers in the government's budget.

Actually, the Fund means something different by objectivity. It means that a country's success or failure in satisfying a performance criterion does not depend on discretionary judgment by the Fund's own staff. A simple current-account target would encounter no problem with objectivity in this sense. This cannot be affirmed quite so categorically for a contingent current-

account target. Full objectivity could be secured in principle. But there are substantial difficulties, and it may be taken for granted that operational perfection cannot be achieved. What "tolerances" are acceptable is a matter for debate in the light of the mixed experience under current IMF practices. But there is a deeper issue here. While bureaucratically convenient, the automaticity that stems from objectivity in the Fund's sense has very dubious value. Jumping ahead for a moment to the second property, controllability, experience has shown that targets are often missed by a substantial margin, despite the best endeavors of the powers that be. To trigger sanctions automatically regardless of the good faith with which a target was pursued is not only rough justice but a positive disincentive to an honest policy effort. The Fund recognizes this and departs from automaticity and thus objectivity by using its discretion in condoning breaches of targets *ex post*. The boundary between objectivity and discretion is thus blurred, and it is not clear that objectivity in the Fund's sense retains much significance.

b. *Controllability*. Controllability is obviously highly desirable. As Cooper (1983) has observed, there is no point in setting a target for something entirely outside a government's control, still less in attaching penalties to missing such a target. Yet full controllability is unattainable. There can only be varying degrees. The current account is clearly subject to unpredictable exogenous influences that can throw the best-laid plans off course. The problem, however, is greatly reduced if a current-account target is made contingent on assumptions about certain exogenous factors that can be expected to exert a major influence. Failure to meet the target would not constitute a failure to satisfy the performance criterion if it was due to deviations of those exogenous variables from their assumed levels or ranges.

Even with contingent targeting, there will be a residual element of uncontrollability, the dimensions of which will remain uncertain. This can lead to targets being missed after due allowance for foreseen contingencies, despite the best efforts of countries to attain them. There is no simple way of coping with this problem, which is not specific to balance-of-payments targeting. It may be added in passing that contingent targeting will embed an anticyclical element in IMF practices, which was fervently intended by the founding fathers but has been sadly neglected. Financing would not be withdrawn from client countries the moment they failed to meet the target if that failure was associated with a cyclical decline in the world economy.

Williamson (1983b) has asserted that a balance-of-payments target is inferior to a credit ceiling from the standpoint of controllability. His argument rests on the susceptibility of payments outcomes to exogenous influences. He grants that credit creation is also prone to these influences but, in his view, less so. With contingent targeting, however, the principal exogenous influences are frozen out. Even if this were not conclusive, the controllability ar-

gument need not point away from targeting the balance of payments. For it should be borne in mind that unless we make a fetish of controllability, the controllability of an instrument must be discounted by the uncertainty of the link between the instrument and the genuine target or targets it is expected to influence.

c. *Quick monitoring.* Quick monitoring has two aspects. The first concerns the lag between the occurrence of the events to be monitored and the statistical recording of those events. The second concerns the lag between the application of a policy and its effects on the target variable. The first lag is not too serious for the current account; even developing countries with weak statistical administrations could, if given some technical assistance, turn out monthly data with a lag no longer than, say, four to six weeks. (Credit data emerge faster, but a few weeks are not critical.) The second lag is more of a problem. For many components of the current account, it would be optimistic to think of a lag between policy and response shorter than six months. As the typical Fund standby arrangement is of twelve months' duration, with critical phases that are inevitably even shorter, a six-month gestation period would create severe monitoring problems for current-account targeting.

But how much does the Fund stand to lose from weaker monitoring? "Not much" seems to be the answer. As a member of the ODI team, Bird (1983) studied IMF conditionality for three years and estimated that over recent years performance criteria had actually been fulfilled in perhaps as few as 20 percent of cases. With an 80 percent failure rate, monitoring may not provide a more selective foundation for doling out Fund credit than an arbitrary rule of thumb. If monitoring is intended to encourage or enforce compliance, it is clearly failing at present. Indeed, if we hypothesize, legitimately, that non-compliance is positively related to the unwelcome character of present Fund conditionality, then balance-of-payments conditionality, being less intrusive, could improve compliance despite weaker monitoring.

The happiest solution to the problem would come about as a byproduct of another reform of IMF practice—the lengthening of IMF programs—which has much to commend it on its own merits. The revolving character of IMF financing obviously implies limits on the length of programs. But a period of twelve months, the typical length of a standby arrangement at present, is too short to expect a lasting turnaround in the circumstances that drove a country to the Fund; such an expectation would display a belief in quick fixes that neither common sense nor experience validates. The Extended Fund Facility, with a typical three-year length, represents the Fund's partial recognition of the problem, as does the practice of consecutive annual standbys. (The latter, however, is very inferior to a single program of longer duration.) But the one-time twelve-month standby is still preponderant.

There is a symbiotic relationship between focusing on quickly monitorable

policy instruments as performance criteria and running very short Fund programs. The latter could not exist without the former, and the former acquires a fetishlike quality as a result of the latter. Lengthening the typical program to, say, two years, which the Fund can do without constitutional ceremony, would provide a time frame in which current-account targeting would not be seriously handicapped by delayed monitoring. As was noted earlier, the Fund's programs showed evidence of lengthening at the start of the 1980s. The demise of this liberalization, though welcomed by the hard school, was lamented by many.

#### *A Digression on Larger Resources for the Fund*

The discussion so far leads from a number of directions to the view that the Fund should be able to commit a larger stock of resources to the financing of member countries. Lengthening the program period points in that direction: if the same stock of resources had to make do for longer programs, either fewer countries could gain access to the Fund or financing would have to be spread more thinly per unit of time. Making current-account targets contingent on world economic activity points in that direction: when recessions interfered with the attainment of targets, commitment-reducing sanctions would not be triggered. Finally, decreasing the intrusiveness of current-account conditionality points in that direction: less intrusiveness would have the intended effect of increasing the attractiveness of the IMF as a source of assistance, and the Fund would need to satisfy at least some of the increased demand in order to play the role for which it was designed.

A wider point with a bearing on Fund resources is also worth making. The financial resources made available by a Fund program are supplemented by the readiness of commercial banks to lend to countries that have entered into a Fund agreement. This link, the existence of which is doubted by some, is benign if it goes one way only—from the Fund program to bank lending. But if it goes in reverse also, so that the terms of Fund programs are set with an eye on the commercial banks' notions of creditworthiness, the link could be malignant. The interests of the international economic system and the interests of banks need not coincide. Suffice it to say here that if the resources of the Fund are increased, it will be under less pressure to accommodate the banks' interests, since it will be able to cover a higher proportion of a client country's borrowing requirements. If the link exists and is benign, one would not want to lose it. But a switch to balance-of-payments targeting should not break the link, because commercial banks are concerned with external solvency, not the means by which it is achieved. Contingent targeting may be more of a problem, but banks are used to the idea of giving more time to creditworthy clients that run into short-run liquidity problems beyond their control.

For all these reasons, implementation of the ideas in this essay cannot be completely divorced from the implications for the resources of the Fund. But those implications are modest. First, they involve only a one-time stock adjustment because of the revolving character of drawings on the Fund. Second, the transfer from creditors to debtors would approach zero as the interest rate charged on Fund drawings approached the market rate applicable to the IMF's credit rating. (The case for continuing to subsidize IMF credits is not addressed here, because the emphasis is on reducing the intrusiveness of conditionality as the most promising way to make recourse to the Fund more attractive.)

From the point of view of potential creditors, the modest resource and transfer implications must be assessed in the light of the gains from earlier recourse to the Fund and from the built-in anticyclical element embodied in contingent conditionality. Note in this context that the Fund is enjoined by its Articles "to contribute . . . to the promotion and maintenance of high levels of employment."

#### *The Risk of Internationally Injurious National Measures*

The Fund is also enjoined by its Articles to assist members ". . . under adequate safeguards, thus providing them with opportunity to correct maladjustments in their balance of payments without resorting to measures destructive of national or international prosperity."

By focusing conditionality on instruments, the Fund can control a member's choice of policy after the member has approached the Fund and agreed on terms. It may appear that this enables the Fund to discharge its responsibility for international prosperity better than under a conditionality system that would focus on the balance of payments and leave the choice of instruments to the discretion of the member country. But, although these are speculative matters, there are a number of reasons for thinking that appearances are misleading in the present context.

First, and perhaps foremost, the Fund's current practices repel potential client countries, forcing them to cope with their problems for as long as possible in ways that give priority to avoiding the Fund's embrace over avoiding injury to international prosperity.

Second, when the Fund is approached and thus acquires a *locus standi*, one thing it insists on, in keeping with its responsibility to the international economic system, is a ban on any increase in administrative and quantitative restrictions on trade. But, given the last-resort nature of recourse to the Fund at present, a country is apt to impose such restrictions *before* going to the Fund. The restrictions may reach a peak at the inception of a Fund agreement—a level that is then perpetuated. (This would not be the case, however, if trade-liberalizing measures were set as preconditions or as policy un-

derstandings that were implemented despite the absence of explicit penalties for nonimplementation.)

Third, while the Fund may invoke its responsibilities to the international economic system in defense of its instrument-focused conditionality, it has a selective approach to those responsibilities. It has not seriously attempted to act anticyclically, nor has it taken visible cognizance of the global effects of parallel actions by a number of countries. (But see Goldstein, 1986, for a defense of the IMF on this score.) In contrast, under the proposed contingency targeting of the current account, there is, as we have seen, at least a small anticyclical element built into the Fund's operations.

Nevertheless, some leverage on instruments is clearly needed to guard against the use of those that are liable to be excessively injurious to other countries. The Fund should pursue this objective if a consensus can be reached about the injurious instruments and if the leverage it exerts is not so intrusive as to inhibit early recourse to the IMF. These are big ifs, and they are not unrelated.

The negative power to ban the extension of trade restrictions, which the Fund has used routinely, can perhaps satisfy these requirements if it is administered with some flexibility and exercised with modesty. The flexibility is needed to take account, *inter alia*, of the view that the interests of the international economic system are not always well served by the ban on the extension of trade restrictions. The ban would not serve the interests of the system if, to compensate for it, the country was obliged to adopt a macroeconomic policy package so contractionary that the overall policy stance became more antitrade with than without the ban. Countries should be able to plead this view. The modesty, now being increasingly recommended (see Cooper, 1983, and Helleiner, 1983), is needed so that client countries will feel that this and other pleas will be assessed fairly and not be bounced off a wall of arrogant preconceptions. Otherwise, the ban will backfire by being too intrusive.

### *The Risk of Palliatives Instead of Cures*

With current-account targeting, there is the risk that countries will employ nonsustainable policies to meet their time-phased targets, particularly if the length of programs is not extended. Whether countries will be prone to try this approach is an important question, and it cannot be answered in the abstract. Whatever the answer, however, it must not be compared with an idealized system in which the chosen performance criteria are invested with some miraculous property that rules out unsustainable palliatives, but with the current reality.

A few illustrations will establish the point. A performance criterion that calls for cuts in the fiscal deficit may be satisfied by a reduction in infrastruc-

tural expenditure that is not sustainable without deleterious consequences for other sectors, or by a one-time sale of government-owned property. A criterion that calls for cuts in domestic credit expansion may be satisfied by inducing a one-time substitution between liquid assets that are included in the target total and those that are not. Effective policing by the Fund against such ruses would require greater intrusiveness than even its severest critics charge it with now. Only greater good will on the part of client countries can alleviate this problem. A switch to balance-of-payments targeting should help on that score.

### *A Legitimate Area for Instrument-Focused Assistance*

The objections to instrument-focused conditionality should not be misinterpreted as extending to what might be called "instrument supportiveness." Consider an example.

A country prohibits all capital exports, but some evasion is known to take place. The country wants to move to a two-tier exchange rate, with free capital convertibility at the premium rate for capital transactions. It has reason to believe that when things settle down the net capital outflow will be no larger than the illegal outflow under prohibition. But it fears that there may be a pent-up demand for foreign assets, and it feels unable to face that risk without having a line of credit to draw on.

If there is merit in the proposed reform, the IMF should be ready to provide the necessary assistance. This is instrument-focused assistance, but the instrument is also the target in this instance, so that it is a first-best form of assistance.

### *Sanctionless Surveillance*

As has often been pointed out, there is a striking contrast between the intrusive conditionality imposed on countries that draw on the Fund and the nominal IMF surveillance exercised over countries that do not need Fund assistance, even though the actions of the latter may be incompatible with the well-being of the international economic system. If the intrusiveness of conditionality were reduced along the lines proposed here while its valid core was preserved, the asymmetry would become less offensive and the resentment it generates less pronounced.

There has been much talk in recent years among the industrially advanced countries of the Group of 10 about strengthening the surveillance role of the IMF. The Statement by the Ministers and Governors of the Group of 10 issued at the conclusion of their Tokyo meeting in June 1985 devoted one of its longest paragraphs to this matter. If anything substantial were to come of it, the asymmetry would be narrowed from that end. But bearing in mind the background—the sharp disagreements among the Americans, Europeans,

and Japanese over the others' policies—it would be unrealistic to expect much more than a slight sharpening of the annual consultation process between the Fund and each individual member.

Yet the IMF consultation process should not be undervalued. Its value for the developed countries is not easy to establish, if only because they also consult in many other forums—OECD Working Party 3, the Bank for International Settlements, the “Summit” of the big seven, not to mention the elaborate machinery of consultation among the twelve European Economic Community members. For many developing countries, by contrast, the annual IMF consultation is the most substantial occasion for a general stocktaking of the economy. Workers in the economic and statistical services of the government and central bank have their minds concentrated more than at any other time, and policymakers have the opportunity to stand back from their immediate preoccupations and think strategically. The ground is fertile and policy seeds are planted. Those planted by the IMF missions may not be the ones to germinate, but the ones that do germinate are better thought out and more consistent thanks to the consultation.

“Enhanced surveillance,” which joined the IMF menagerie in 1985, is a different animal. It was instituted as part of the multi-year rescheduling schemes for heavily indebted countries and is designed to oversee their policies in order to sustain the confidence of creditor banks. In contrast to ordinary surveillance, it is coercive, with the collapse of rescheduling the sanction behind it. It is too soon to comment extensively on enhanced surveillance. But there is a risk that it will come close to the malignant reverse link mentioned earlier, the commercial banks' requirements heavily influencing the policy package that the Fund then deems acceptable. A big debtor like Mexico may have “debtor power” to exert as a countervailing force, which the Fund itself may not be averse to exploiting vis-à-vis the commercial banks. But in the case of smaller debtors, at least, enhanced surveillance will need to be watched.

### *Creditors' Management*

It could be argued that countries that succumb persistently to payments problems of their own making, as distinct from problems created by shocks in the international economy, cannot expect to receive international assistance beyond a certain point unless they agree to a form of receivership—to the installation of creditors' management to restore solvency. Since this cannot be done directly in a world of sovereign states, the argument would continue, it is a proper role for the IMF to play indirectly, by dictating and targeting instruments.

Let it be granted that such a role is legitimate as a last resort for dealing with truly persistent offenders. Yet one institution is severely strained if ex-



pected to serve as the creditors' overlord and, at the same time, to facilitate balance-of-payments adjustment, the role for which the IMF was created. There is tension between the two roles, and the reputation acquired while performing one has adverse externalities for the other. But the institutional structure cannot be radically redesigned, and so the two roles should be separated as clearly as possible inside the IMF.

A step in this direction would be to establish a three-band conditionality system. At the top would be a band of instrument-focused conditionality of the current type. At the bottom would be the low-conditionality first credit tranche, as at present. Between them would be a band for nonintrusive conditionality targeted on the balance of payments. The width of the middle band would obviously be critical, and much thought will have to be given to it. For the present, it may be enough to say that the band must be sufficiently wide to keep countries from having to cross its upper boundary and suffer the penalty unless they are prone to persistent balance-of-payments delinquency. (Since access to prior or parallel bank credit differs widely among countries, a Fund credit tranche expressed as the same percentage of quota for all countries is *de facto* discriminatory. This problem is not pursued here because it is not specific to the main issues under discussion.)

In a sense the three-band system would implement, on a more transparent and conceptually firmer basis, the original idea of graded conditionality that has been carelessly, or perhaps just absent-mindedly, allowed to erode. Not a very big leap after all.

## 5 Summing Up

The Fund's practices regarding conditionality confuse instruments and targets. By giving the status of performance criteria to targets for credit expansion and the fiscal deficit, the Fund turns instruments into fetishes. This is grossly inefficient *per se* and because its intrusiveness causes potential client countries to distance themselves from the IMF and thus prevent it from effectively discharging its responsibilities to the international economic system.

The practical difficulties of operating a conditionality system that is focused on the genuine target—the balance of payments—are not to be lightly dismissed. Nevertheless, when compared with the current practices of the Fund and the weak record of its programs, they turn out on examination to be less serious than might be feared.

It is therefore the contention here that the core of conditionality—the performance criteria—should be switched to where they properly belong: the balance of payments. Such a switch need not be associated with any softening of conditionality, although softening may be desirable on other grounds.

Instrument-focused conditionality of the current type could be retained for a strictly limited punitive purpose.

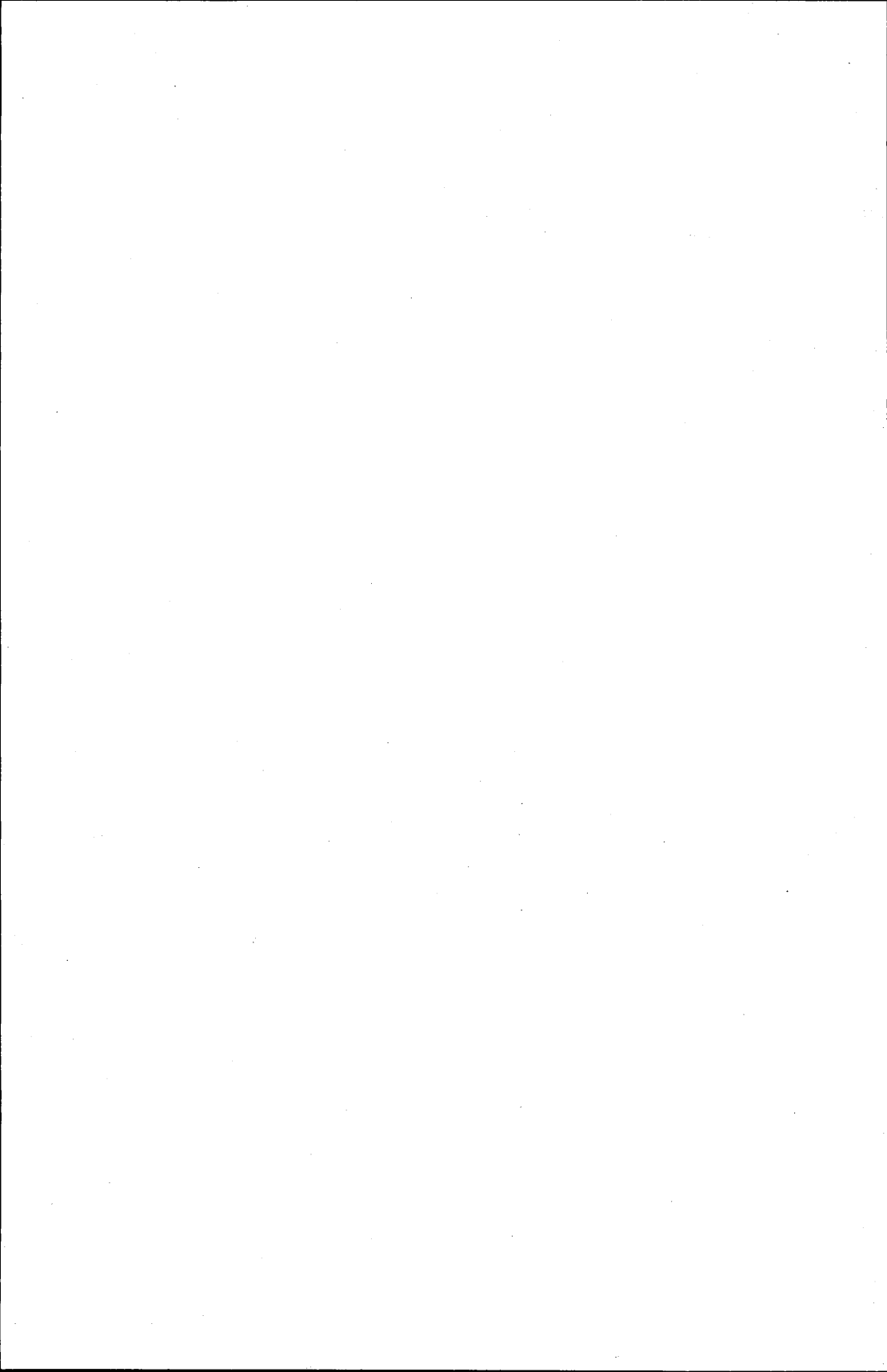
A one-time expansion of Fund resources would be required, but the size of the transfer need not be large. It depends on the interest rate at which the Fund and, via the Fund, its clients will be given access to the increased resources.

The IMF currently presents to most of the world a harsh and ugly image that is not in keeping with the vision of the founders. Some of the practices which create that image are anti-efficient. Their perpetuation is therefore doubly damaging. They should be changed.

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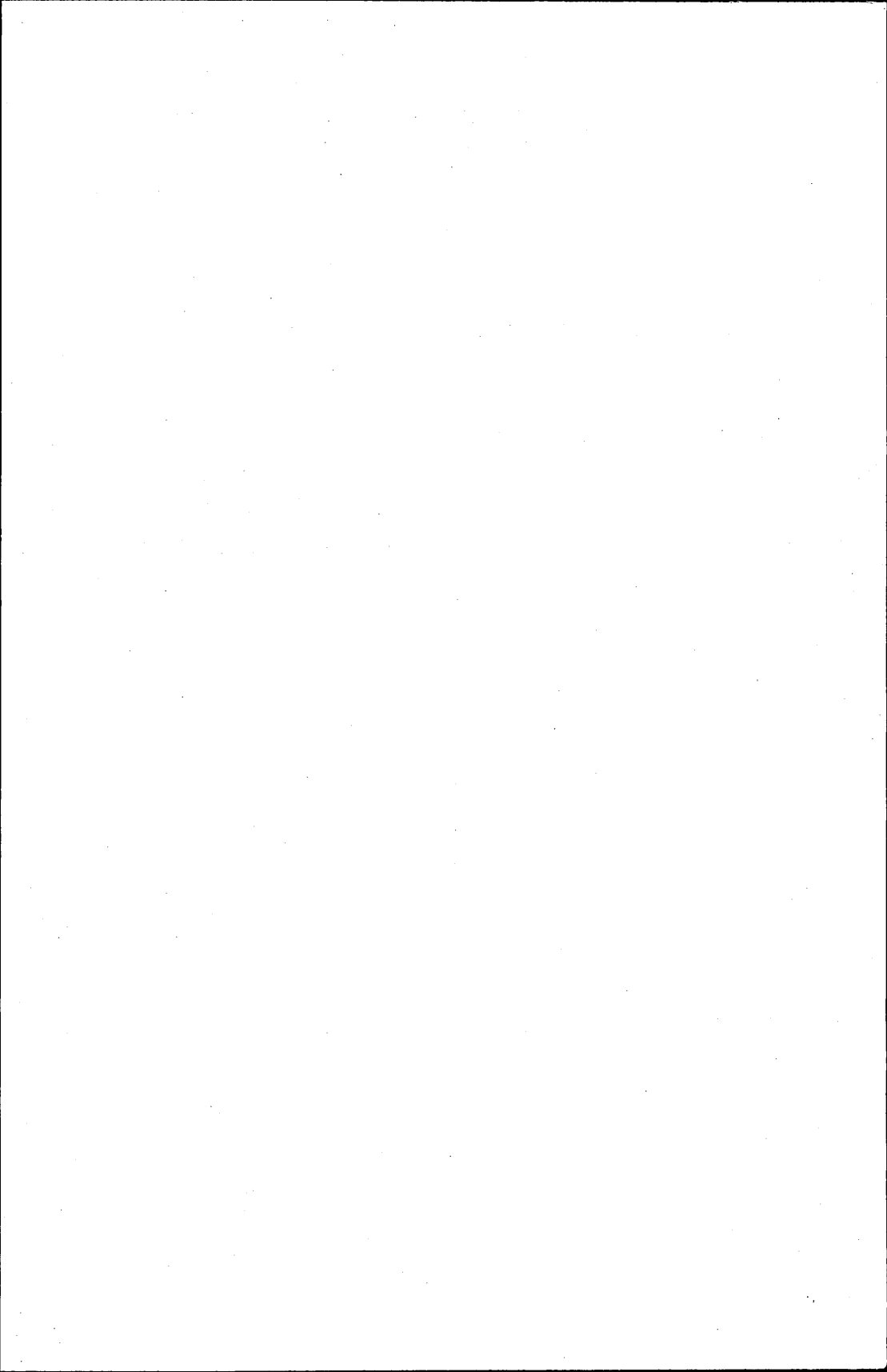
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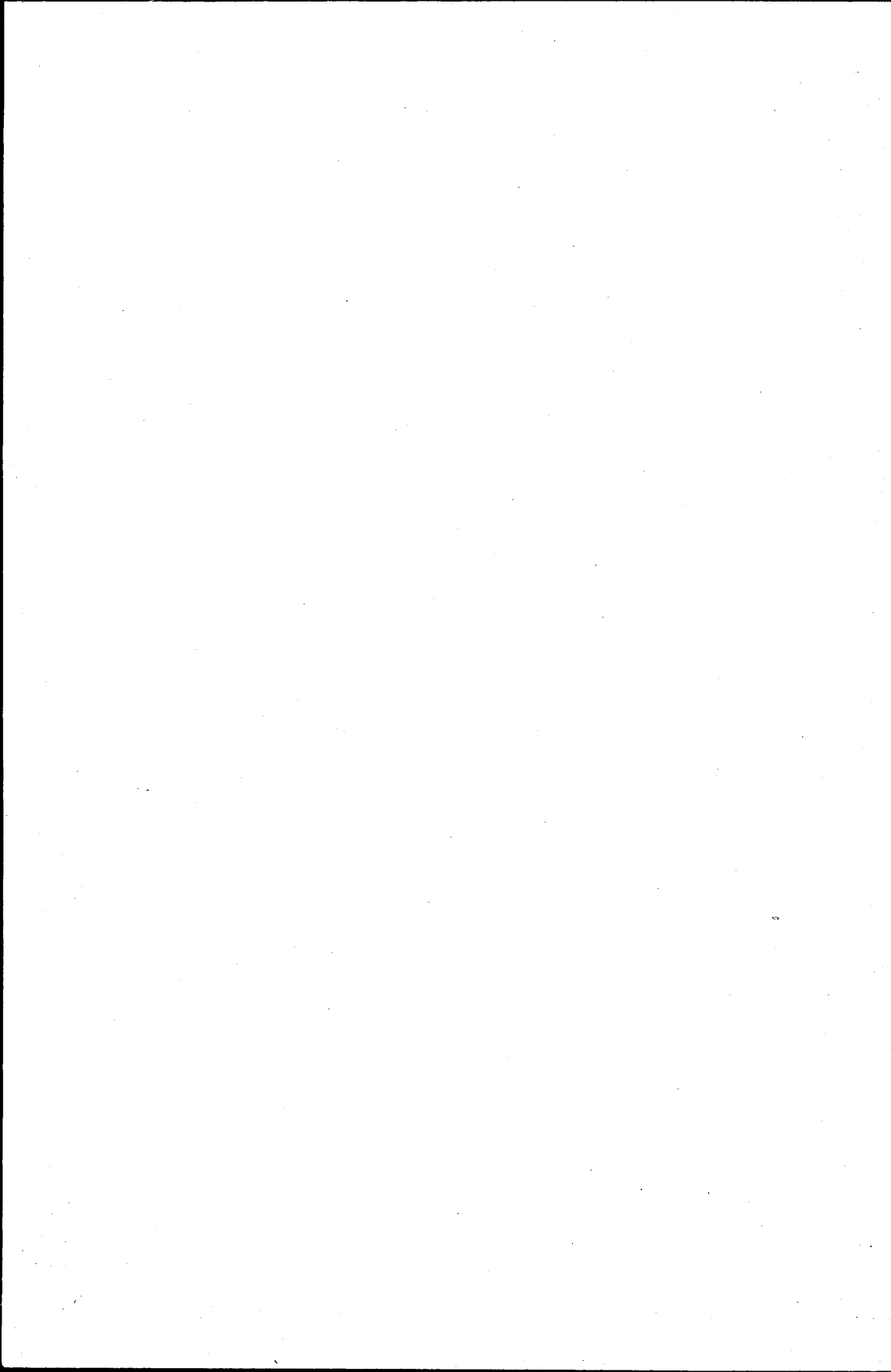
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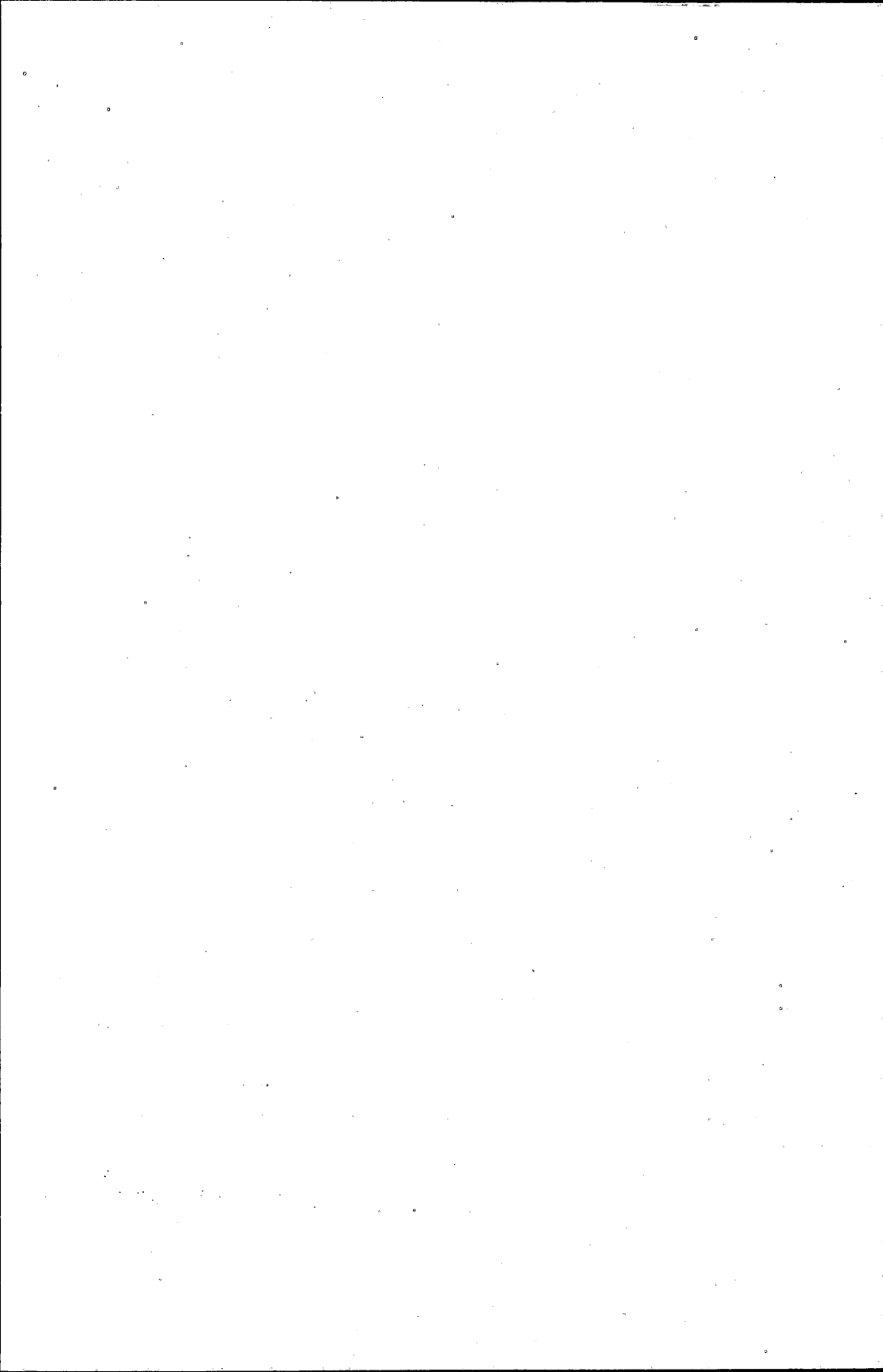
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ISBN 0-88165-073-0