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CONDITIONALITY AS BARGAINING PROCESS: STRUCTURAL-ADJUSTMENT LENDING, 1980-86

PAUL MOSLEY



INTERNATIONAL FINANCE SECTION

DEPARTMENT OF ECONOMICS PRINCETON UNIVERSITY PRINCETON, NEW JERSEY

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CONDITIONALITY AS BARGAINING PROCESS: STRUCTURAL-ADJUSTMENT LENDING, 1980-86

1 Introduction

International financial institutions dealing with third-world countries have devoted enormous attention recently to increasing the effectiveness, or productivity, of the capital resources they supply. One of the main policy instruments used for this purpose is the practice variously known as "conditionality," "leverage," or "policy dialogue": negotiation with the recipient government of a set of changes in economic policy that the recipient must implement in return for a loan or grant.

Conditionality is nothing new in itself. It is a standard feature of loans by banks to individuals or domestic companies. This first type of conditionality normally consists of a legally binding undertaking by the borrower to hand over a negotiable capital asset to the lender if he cannot otherwise pay back the loan.

When financial institutions lend to overseas governments, the conditions often become more complex, because the borrower is a sovereign body on whose assets the lender has no legal claim. The International Monetary Fund, for example, normally asks the governments to which it lends to adhere to specified targets for the growth of bank credit and government expenditure, and it may require changes in other variables such as the exchange rate (see Killick and associates, 1984, especially Chap. 6). This second type of conditionality is still an instrument intended to maximize the probability that the loan will be repaid, as in the case of an ordinary commercial loan, but for two reasons its application becomes more controversial: the link between the instrument and the ultimate target is less certain, and the application of the instrument may hurt influential interest groups and thus be politically destabilizing.¹

A third type of conditionality has now evolved. Whereas the IMF provides

¹ Both of these points can be illustrated by reference to devaluation, a common IMF condition (or precondition). An influential literature argues that in developing economies the elasticity of supply of exports and elasticity of demand for imports are too low to satisfy the Marshall-Lerner condition, in which event devaluation may worsen rather than improve the balance of payments (see, e.g., Taylor, 1983). Moreover, devaluation is notoriously unpopular politically, witness the finding of Cooper (1971) that devaluation trebled the risk that the finance minister responsible would lose his job within the year and doubled the risk that the entire government would fall within that time. short-term finance that is generally keyed to policy measures designed to reduce demand, the World Bank and certain bilateral development agencies have, since the late 1970s, made money available for long-term development that is keyed to policy measures designed to augment supply, such as raising food and energy prices and lowering protective trade barriers. It is the contention of this essay that this development raises new analytical issues. The link between instrument and target may be as loose as in the IMF case and the application of the instrument may arouse equal political opposition, but there are important differences.

First, the objective of conditionality is no longer simply to maximize the probability of repayment. Much bilateral development aid is given on grant or near-grant terms, the World Bank's credits from the International Development Association (IDA) are virtually interest-free,² and even "hard" development aid lent on market terms is expected to fulfill purposes other than the mere generation of a healthy cash flow, such as the development of export potential, the growth of gross domestic product (GDP), and the reduction of poverty.

Second, it often takes a long time for the donor of supply-augmenting finance to see whether the recipient government is acting in accordance with the spirit of the policy conditions to which it agreed.³ Because of the time required to commission, complete, and implement the necessary studies, it takes longer for the World Bank to find out, say, whether a recipient is genuinely rationalizing the structure of protection than for the IMF to find out whether a recipient has kept domestic credit expansion within agreed limits.⁴ This delay offers the recipient an opportunity to exploit a donor when the recipient needs short-term help but is reluctant to offend the domestic interest groups that would be hurt by the application of conditionality. I shall argue that these two characteristics weaken the bargaining power of the donor of aid conditioned on the supply side, compared with the bargaining power of a commercial banker or even the IMF. A summary of the differ-

² Most bilateral aid by the countries of the Organization for Economic Cooperation and Development (OECD) consists of grants. For example, U.S. aid in 1983 had a grant element of 94 percent, and U.K. aid a grant element of 98 percent (OECD, 1984, Table VI-4). The World Bank's IDA credits are free of interest, carry a service charge of three-fourths of 1 percent, and are repaid over very long periods. They therefore contain a very significant element of concessionality in relation to loans at the standard market rate.

³ For convenience I shall use the term "donor" for the provider of conditional finance, even though much of that finance is in fact provided on nonconcessional terms.

⁴ Some World Bank conditions relating to the alteration of policy instruments can be quite quickly monitored; it generally takes longer to monitor compliance with conditions related to policy *instruments* (such as fertilizer subsidies) than with conditions related to intermediate policy *targets* (such as the budget deficit). For further discussion see section 3 below and the essay by Nelson in Feinberg (1986), pp. 71-73.

ences among the three types of conditional financial transfer is provided in Table 1.

The essay is organized as follows. In section 2, I briefly outline the history of supply-side conditionality, with particular reference to the major example to date, the World Bank's Structural Adjustment Loans. In section 3, I represent the application of conditionality by a development agency as a twoperson, non-zero-sum game and generate certain hypotheses concerning the circumstances in which it is likely to be successful. These hypotheses are tested in section 4, which considers the effectiveness of conditionality in inducing policy change and achieving the ultimate targets at which this policy change is aimed. The essay concludes with section 5, in which the implications for donor policies are explored.

	,	Type of Loan	
	1. By Bank to Individual	2. By IMF to Sovereign Government	3. By World Bank or Bilateral-Aid Donor to Sovereign Government
Instrument (condition)	Collateral must be transferred to bank in event of loan default	Various, usually including ceilings on central-bank credit and public spending	Various, usually including increases in agricultural and energy prices and reductions in protection
Target (purpose of condition)	Maximize probability of repayment	Maximize probability of repayment; reduce aggregate demand	Increase aggregate supply by improving economic efficiency
Link between instrument and target	Very tight	Fairly tight	Rather loose
Can compliance with condition be monitored?	Instantly	Yes, after short delays involved in publication of statistics (usually 1-3 months)	Often not for a number of years
Is condition legally enforceable?	Yes	No	No

TABLE 1

THREE TYPES OF CONDITIONALITY IN FINANCIAL TRANSFERS

2 Conditional Development Aid: Outline History

The main development agencies that have shown interest in conditionality as a means of enhancing the effectiveness of aid are, among bilateral agencies, the Canadian International Development Agency (CIDA), the U.K. Overseas Development Administration (ODA), and the U.S. Agency for International Development (AID), and, among multilateral agencies, preeminently the World Bank. After a period of early and transient enthusiasm in the 1960s (Hirschman and Bird, 1968), each of these agencies again increased its ratio of program to project aid disbursement during the late 1970s (OECD, 1984, p. 221). In part, this behavior was reactive—a response to the sudden deterioration in recipient countries' balance-of-payments situations caused by the oil shocks of 1974 and 1979 and to perceived limits on their absorptive capacity for projects. But, in addition, it reflected a growing perception that the failure of individual projects is frequently due to an unfavorable policy environment. An agricultural project that is well planned and executed may nonetheless fail because the price paid to producers for the crop is too low to give them an incentive to market it (see World Bank, 1978, 1981). Program aid has therefore been made conditional on improvements to the policy environment.

There is considerable consensus among the four agencies mentioned on the kinds of improvements that are necessary. Prices paid to agricultural producers, especially exporters, must be raised to give them an incentive to produce for the market; the financial performance of public enterprises must be improved by redirecting resources from the creation of new capacity to the maintenance of existing capital or by outright privatization; and trade policy must become more outward looking by the removal of trade and exchange controls that have been used to defend overvalued currencies and by the reduction of effective protection against imports (World Bank, 1981, pp. 3) and 24; AID, 1982). The common thread running through this package is that the degree of state control over the economy must be reduced. The theoretical and empirical rationale for the package will not be considered here. I will take it as given that these are the reforms desired by aid donors who wish to achieve policy change through conditionality and go on to examine the ways in which the donors have tried to persuade third-world governments to adopt them.

I shall concentrate on the most important exercise to date in this kind of persuasion, the World Bank's Structural Adjustment Loans (henceforth SALs). These were first introduced in the early 1980s, and 38 of them had been made to 21 countries by the end of 1986. Their objective has been defined by a World Bank official:

To provide quick disbursing finance to support measures designed to strengthen

recipient countries' balance of payments within five to ten years without severely constraining demand in a manner that unnecessarily sets back economic and social development. (Landell-Mills, 1981, p. 17)

Disbursement of SALs is always conditional on "the elaboration of an appropriate set of specific actions that the government will take either to increase or save foreign exchange earnings" (*ibid*.).

Table 2 provides a broad indication of the areas in which recipient countries have promised such actions. Like the IMF, the World Bank is at pains to stress that there is no question of imposing a standard package of policy reforms on all recipients (Landell-Mills, 1981); each country's path toward structural adjustment must be tailored to its specific circumstances. Nonetheless, reforms in the system of export incentives, in the financial perform-

TABLE 2

TYPES OF	POLICY MEASURE REQUESTED IN RETURN FO	R
	SAL FINANCE, 1980–OCTOBER 1986	

Measure	Percentage of SALs Subject to Conditions in This Area
Trade policy:	
Remove import quotas	57
Cut tariffs	24
Improve export incentives and institutional support	76
Resource mobilization:	
Reform budget or taxes	70
Reform interest-rate policy	49
Strengthen management of external borrowing	49
Improve financial performance by public enterprise	73
Efficient use of resources:	
Revise priorities of public investment program	59
Revise agricultural prices	73
Dissolve or reduce powers of state marketing boards	14
Reduce or eliminate some agricultural input subsidies	27
Revise energy prices	49
Introduce energy-conservation measures	35
Develop indigenous energy sources	24
Revise industry incentive system	68
Institutional reforms:	
Strengthen capacity to formulate and implement public investi	nent
program	86
Increase efficiency of public enterprises	57
Improve support for agriculture (marketing, etc.)	57
Improve support for industry and subsectors (including price c	ontrols) 49

ance and investment priorities of public enterprises, and in agricultural pricing policy had been requested in over 70 percent of cases by the end of 1986. Furthermore, Table 3 makes clear that this form of finance was confined to faster-growing and more outward-looking developing countries. The average rate of growth of GDP during the 1970s was 5.5 percent among countries awarded SALs, compared with 4.6 percent for all low- and middle-income countries, and Yugoslavia is the only socialist country to have received a SAL. In principle, "any country facing a serious medium-term foreign exchange constraint and proposing a viable adjustment programme is eligible" (Landell-Mills, 1981, p. 17), but those third-world countries with the most deep-rooted economic difficulties appear to have been excluded from the scheme. Some very poor countries have initiated negotiations with the World Bank for SAL finance, but these have been broken off because agreement on the required package of policy reforms could not be reached; I return to this point later.

Let us examine the logic behind the reform packages listed in Table 2. In nearly all cases, their implementation involves the removal from some interest group of a shield against market forces that the government had granted to win the group's political support. Food and energy subsidies provide a shield for urban consumers; tariffs and import quotas provide one for industrialists supplying the home market; extravagant projects in rural areas assist those who benefit from the services they provide. The additional real incomes that these beneficiaries obtain are, as Krueger (1974) argues, rents to the suppliers of particular factors of production that have been made artificially scarce by government policy. Countries that receive SALs have been told explicitly by the World Bank that production and exports will increase, sometimes dramatically, if the burden of these rents is lifted; some of its forecasts are shown in Table 4. This prospect of faster economic growth, along with the SAL finance itself, is the economic benefit that the Bank offers to potential recipients of SALs in order to embolden them to incur the political cost of taking away rents from those who receive them. It is a bribe to thirdworld governments to buy out some of the restrictive practices by which they currently hold the state together.

On the limited evidence available, the bribes usually succeed in eliciting the policy changes requested, but not always. Table 5 shows the degree of compliance with World Bank conditions on the part of eleven recipients of SALs and the number of SALs that those countries had received by the end of 1986. Jamaica, Pakistan, South Korea, and Turkey had met nearly all the conditions; Turkey was into its fifth SAL, while Jamaica was into its third. Bolivia, Guyana, and Kenya were particularly remiss in complying with the conditions; Bolivia and Guyana had received only one SAL, while Kenya had received two. An intermediate group, comprising the Ivory Coast, Malawi, the Philippines, and Thailand, had met most but not all of the conditions,

SAL or Crod		Date	Value (millions of \$)	Tightness Score ^b
SAL OI CIEd	it -		(minons or \$)	
Bolivia		May 1980	50	6
Burundi		May 1986	15	12
Chile		Oct. 1985	250	5
Costa Rica		April 1985	80	8
Guinea		Feb. 1986	25	14
Guyana°		March 1981	22	13
Ivory Coast	I	Nov. 1981	150	9
	II	July 1983	250	11 } 10
	III	June 1986	250	10
Jamaica	Ι	March 1982	76	11
•	II	June 1983	60	11 } 10
	III	Nov. 1984	55	7)
Kenya	Ι	March 1980	55	10
2	II	July 1983	70	14 ∫ 12
Malawi	Ι	June 1981	45	12
	Π	Dec. 1983	55	11 } 11
	III	Dec. 1985	30	9)
Mauritius	Ι	June 1981	15	6
	II	Dec. 1983	40	12 j s
Niger		Feb. 1986	60	4
Pakistan		June 1982	140	12
Panama		Nov. 1983	60	8
Philippines	I	Sept. 1980	200	5) ₆
	II	April 1983	302	7 ∫ ⁰
Senegal ^d		Feb. 1986	131 °	11
South Korea	I	Dec. 1981	250	12
	п	Nov. 1983	300	10 📔 🚺
Thailand	I	Mar. 1982	150	10
	II	Mar. 1983	175	13 / 11
Τοσο	T	May 1983	40	8
	П	May 1985	28	9
Turkey	ī	Mar. 1980	275	11)
zune)	П	May 1981	300	15
	ш	May 1982	304	14 } 13
	īV	Iune 1983	300	14
	v	June 1984	376	9)
Yugoslavia		June 1983	275	11

 TABLE 3

 TIGHTNESS OF CONDITIONS ON INDIVIDUAL SALS, 1980-86

SOURCE: Stern (1983), supplemented by data from World Bank Country Policy Department.

* IDA credits in italics.

^b Number of policy conditions listed in Table 2 that were imposed on that loan.

^c Blend of IBRD "hard" loan and IDA credit.

^d Senegal has had two structural-adjustment transactions with the World Bank, the first of which, in 1980, was terminated shortly after the beginning of disbursement.

^e Sum of the two structural-adjustment transactions.

TABLE 4

	At Time of	First SAL ^a	At Time of S	Second SAL ^b
Recipient Country	With Structural Adjustment	Without Structural Adjustment	With Structural Adjustment	Without Structural Adjustment
Ivory Coast:				
Total output	6.8	4.9	6.5	4.5
Agriculture only	4.2	1.9	6.0	4.2
Exports only	7.6	5.5	5.1	2.5
Jamaica:				
Total output			4.0	-0.2
Exports only			6.8	5.5
Kenya:				
Total output			4.3	3.8
Agriculture only			3.9	2.7
Exports only			4.7	4.0
Malawi:				
Total output			3.4	2.5
Agriculture only			3.4	2.4
Exports only			5.5	4.0
Philippines:				
Total output	6.4	5.5	6.5	4.0
Agriculture only	5.0	4.7		
Exports only	10.7	9.3	8.5	6.5
Thailand:				
Total output	7.3	7.0	5.4	4.8
Agriculture only	4.2	3.1	4.0	3.1
Exports only	10.0	8.1	6.8	4.5

OUTPUT CHANGES PREDICTED BY WORLD BANK IF CONDITIONS WERE MET

SOURCE: World Bank.

^a Growth for 1980-5.

^h Growth for the following periods: Ivory Coast—1985-90; Jamaica, Kenya—1981-86; Malawi—1983-87; Philippines—1986-89; Thailand—1982-90.

and the process of dialogue continued; the Ivory Coast and Malawi were into their third SALs.

Table 5 forces us to ask two questions: If the World Bank's arguments for policy reform have been equally cogent across countries, why have they been unevenly successful in persuading governments and overcoming the vested interests arrayed against reform? And why hasn't the Bank applied the principle of equal treatment of equals, instead of awarding two SALs to Kenya,

TABLE 5

Recipient Government	World Bank Has Granted 2 or More SALs	World Bank Has Granted Only 1 SAL
Has complied with all or nearly all Bank's conditions (compliance index of 90% or more)	Jamaica South Korea Turkey	Pakistan
Has complied with some but not all Bank's conditions (compliance index of 60-90%)	Ivory Coast Malawi Philippines Thailand	
Has complied with few of Bank's conditions (compliance index of 0-60%)	Kenya	Bolivia Guyana

STATUS OF WORLD BANK STRUCTURAL-ADJUSTMENT OPERATIONS FOR ELEVEN DEVELOPING COUNTRIES, DECEMBER 1986

NOTE: Compliance index is a measure of the percentage of conditions, expressed as a tightness score in Table 3, that had been complied with by December 1986.

SOURCE: Mosley (1985), Table 4 updated.

with a compliance index of 38 percent, but only one to Pakistan, with a compliance index of 90 percent?

We can begin our search for answers by referring back to two specific features of conditional development aid featured in Table 1. First, the conditions are likely to cause serious economic hurt to certain interest groups. Second, failure to comply with them may not be picked up by the donor for several years, because policy changes of the structural-adjustment type have a long gestation period. These two features may tempt a government to promise to comply with the conditions proposed by a donor and then to renege on its promise if it does not expect to need program finance beyond the point at which its failure to comply becomes known to the donor. In other words, it may treat aid negotiations as a game whose object is to obtain specific sums of money without complying with the associated conditions. In this sort of situation, the donor needs threat strategies to discourage such behavior without embittering relationships to the point where it loses all influence over the recipient.

3 Policy Dialogue as a Non-Zero-Sum Game

This section attempts to model the relations between the donor and recipient of conditional development aid as a two-person game. A formal solution to the game, which would require the assumption of perfect foresight on the part of both parties, is not attempted. Instead, the model is used to generate hypotheses concerning the tightness of conditions set by the donor, the recipient's compliance with those conditions, and the donor's behavior in granting follow-on finance.

A Simple Two-Person, One-Stage Game

In the simplest model of negotiations between a donor and recipient, both parties have all-or-nothing options, threats are binding, and compliance with conditions can be monitored instantly. The donor has two possible strategies, to give a loan or not to give it; the recipient also has two possible strategies, to comply with the conditions proposed by the donor or to renege on the commitment to comply; before disbursing the loan, the donor can ascertain whether the recipient has complied or reneged; and the donor is committed to disburse the loan if the recipient has complied and to carry out its threat not to disburse if the donor has reneged. This game between donor and recipient is portrayed in Table 6.

The table describes more or less precisely the first case of conditionality mentioned in section 1: the one-tranche loan by a bank to an individual, which is conditional on the transfer of collateral (or a legal claim to it) by the borrower to the lender. The off-diagonal outcomes in parentheses would involve exploitation of one party by the other, but they are excluded by the rules of the game. Outcome (2), in which the recipient gets its money but reneges on the commitment to comply with the conditions, is excluded by the donor's binding threat to refuse to disburse if the conditions are not met. Outcome (4) is excluded by the donor's binding promise to disburse if the recipient complies with the conditions. The only thing that is indeterminate is the recipient's subjective comparison of the expected short-term cost of complying and the expected long-term economic benefit from receiving the loan. If the cost is perceived to exceed the benefit, negotiations collapse, and we have outcome 3; if the benefit is perceived to exceed the cost, the deal is done, and we have outcome 1.

	Recipient's Strategies			
Donor's Strategies	Fulfill Commitment to Comply with Donor's Conditions	Renege on Commitment to Comply with Donor's Conditions		
Disburse loan	1	(2)		
Do not disburse loan	(4)	3		

TABLE 6

SIMPLEST CASE OF CONDITIONAL LENDING

When the World Bank or a bilateral donor offers conditional program aid, the situation is different in a number of ways. First, it is open for both donor and recipient to follow mixed strategies. The recipient can comply with some but not all of the conditions set by the donor, and the donor can disburse some but not all of a planned loan, for example by giving it out in several tranches, each of which is contingent on satisfactory performance during the previous period.

Second, the donor cannot ascertain whether the recipient has complied with the conditions before disbursing the loan. All that can be negotiated before disbursement is a promise by the recipient to comply with the conditions.⁵ Actual compliance will not be ascertainable for some time. In section 1. I argued that the complexity of the requisite policy changes may make the lag quite long for loans such as World Bank SALs, which are intended to boost the supply side of the economy, compared with the lags involved in monitoring loans such as IMF standbys, which are intended to stabilize the demand side. The lag is often as long as three or four years. Some conditions, such as "Remove quantitative import restrictions on 64 commodities within the next year" (Jamaica: SAL I), can be fairly quickly monitored, but others, such as "Raise the tax/GNP ratio to 22 percent over the next five years" (South Korea: SAL I), cannot, by definition. Still others, such as "Develop a concrete program to implement government policy to make state economic enterprises financially independent" (Thailand: SAL II), enable the recipient to buy much time by promising to study a problem in the abstract, which is painless politically, rather than confront the opposition of vested interests that is likely to follow from actually altering policy instruments.

The long delay between the donor's request for policy actions and the point at which the recipient's compliance can be effectively monitored allows a recipient to "exploit" a donor if the recipient needs finance only for a short period and discounts the long-term consequences of a deterioration in the relationship with the donor. Such a recipient can promise to comply with particular performance criteria, receive its money, and then fail to comply. This behavior corresponds to the off-diagonal outcome (2) in Table 6, which becomes attainable as soon as we relax the assumption that compliance with conditions can be instantly monitored. The donor can try to defend itself against exploitation by making a series of loans, rather than one large loan, and dividing each loan into tranches; this is what happens with World Bank SALs.

A third circumstance, however, may complicate the donor's problem. The donor may not wish to be bound by its initial threat to cut off program aid if it finds at the end of a loan (or tranche) that its conditions have not yet been met. It may prefer to give the recipient the benefit of the doubt and thus

⁵ The donor can also ask for what World Bank staff members call a "down payment," the execution of certain policy reforms before SAL money is handed over.

allow a slower transition toward fulfillment of the conditions than was originally agreed. External circumstances may have deteriorated in the interim, the donor may still trust the recipient to comply eventually with the conditions, or the donor may have some other reason for wanting to sustain a relationship with the recipient. Furthermore, this situation is asymmetric: the donor may have good reasons for not implementing its threat to cut off aid when conditions are not met but no good reason for not providing aid when those conditions are met.

The game becomes a one-sided prisoner's dilemma (Rapoport and Chammah, 1965). Both parties prefer disbursement of the loan plus fulfillment of the conditions (the socially optimal solution) to the collapse of negotiations. But disbursement of the loan without fulfillment of the conditions may appear still more tempting to the recipient if it can be managed, because it permits the recipient to avoid political conflict with the domestic interest groups that would lose protection against market forces if the conditions were fulfilled.

Let us try to build these complications into the model.

A Two-Person, Multistage Game with Nonbinding Threats

In the light of the previous discussion, realism requires us to divide the game between donor and recipient into three consecutive acts:

- 1. An initial negotiating process in which donor and recipient try to agree on the conditions that are to be attached to a development loan. If successful, this process culminates in a set of promises by the recipient to take certain policy actions.
- 2. A period that may last as long as four years during which the recipient decides how far to honor promises made in Act 1.6
- 3. A response by the donor in the following period consisting of a decision to grant or refuse further finance to the recipient in the light of the recipient's performance during Act 2.

We shall assume that Act 1 unfolds in the following manner. The donor begins by asking the recipient to propose a set of policy reforms. The recipient, which is suffering from a serious balance-of-payments problem, offers a package of reforms, T_j , that is its best initial offer. (*T* is mnemonic for tightness, the subscript *j* denotes the recipient, and *i* denotes the donor.) We can think of this offer as a point of tangency between an economically feasible set of policy changes and a welfare function that trades off the long-term economic benefit from harsh policy measures against the short-term political cost of those measures, as in Figure 1.⁷

⁶ Act 2 may be split into a number of subsidiary "scenes" if the donor decides to split its loan into separate tranches, each of them conditional on the performance of specific policy actions.

⁷ Only in an exceptional case will the recipient's indifference curves be vertical; the recipient,

FIGURE 1

CONDITIONAL AID: BARGAINING POSITIONS AT OUTSET, WITH ASSOCIATED UTILITIES



however tenacious his opposition to outside interference with his economic policy, will normally be forced to implement some policy measures because of fear of default on external debt. Even President Nyerere of Tanzania, one of the most unbending third-world political leaders in negotiations with the World Bank and IMF, offered a considerable devaluation and reduction of public expenditure in negotiations with the Fund in 1978 when faced with a serious balance-ofpayments crisis. Indeed, it will normally be in the recipient's interest to offer up initially some of the policy measures he would have implemented anyhow and to represent them as concessions to the donor, saving other concessions for later stages of the negotiating process. If this happens, the impact of conditionality will be less tight than it might appear to the donor. In other words, conditions—as well as financial flows—are fungible. Just as a donor's financial aid may lose leverage if it pays for projects the recipient would have implemented anyhow using domestic resources, so a donor's conditionality may lose leverage if it consists of policy reforms the recipient would have implemented even without external aid. The donor makes a counterproposal, T_i , consisting of the package of reforms it would like to see the recipient implement. The counterproposal normally goes farther, involving more and tighter reforms than the recipient's initial offer. If it did not $(T_i = T_i)$, the game would collapse into an immediate agreement. (The donor would then become a policy adviser to the recipient, working out detailed modalities by which the recipient could implement policies agreed to, and it would become inappropriate to speak of the donor as having exerted leverage on the recipient's policies.)

In the last scene of Act 1, the donor and recipient deploy bargaining strategies. These consist partly of threats (i.e., forecasts of how they will behave if negotiations break down) and partly of persuasive statements designed to alter the other party's perception of the cost of settling on its opponent's terms. The main threat available to the donor is, of course, to provide no money if the conditions are not accepted, and its main persuasive strategy is to remind the recipient of the economic benefits that will flow if the recipient incurs the political cost of defying vested interests. Forecasts of high growth such as those in Table 4 may be used for this purpose, accompanied by economic analysis.⁸ A recipient government cannot easily make threats against a multilateral donor such as the World Bank, but it has more options when dealing with a bilateral donor that has geopolitical interests in its country. It can threaten, for example, to withdraw military facilities from that donor or to discriminate against the donor in placing government contracts for imports.⁹ Its persuasive statements may attempt to induce the donor to adopt the recipient's own view of the ultimate goals of economic policy; it can stress the need to give an incentive to producers of food crops, against a donor's argument that it should give priority to cash crops. It can also raise questions about administrative and political feasibility; it can suggest that the donor's proposed timetable for import liberalization is not realistic and should be stretched out. The bargaining process proceeds until negotiations collapse or an agreed set of policy reforms is reached with tightness T^*_{ii} , which will lie between the recipient's opening bid T_i and the donor's opening bid T_i .

We now move on to Act 2, in which the recipient decides to what extent it will implement the policy reforms to which it committed itself at the end of Act 1. In other words, it has to decide how much slippage there will be on the commitments it has made to the donor. This decision, it must be stressed, involves a series of decisions (Nelson, 1984) that may be widely dis-

⁸ For an example of economic analysis arguing a correlation between absence of price distortions and economic growth and justifying the removal of those distortions as a pre-condition for aid, see World Bank (1983, Part II).

⁹ The first strategy could be used by Kenya against the United States, which is trying to persuade Kenya to liberalize its economy by means of conditional aid but also maintains naval facilities at Mombasa on which the United States is heavily dependent; see Mosley (1986).

tributed over the diverse executive agencies of government responsible for implementing parts of the reform package.¹⁰ It may also be widely distributed over time. As we have seen, the elapsed time between disbursement of conditional finance and the first moment when the donor can make a genuine assessment of the level of slippage can be as long as four years.

The recipient's decision about slippage will affect and be affected by its decision about seeking another conditional program loan. If it decides to seek another loan, the donor must in turn decide whether to enter into negotiations. If the donor decides to go ahead, we enter Act 3: the negotiation of follow-up finance. The donor asks the recipient for a draft program, as in Act 1; the recipient makes a reply, which will be related to the degree to which it fulfilled its promises in Act 2; and a negotiation gets under way. This process is exactly as in Act 1, except that each party will be influenced by the other's behavior in Acts 1 and 2.

At this point, we encounter a difficulty. If the bargaining partners had been endowed with perfect foresight at the beginning of Act 1, they would have incorporated into the Act 1 negotiations their accurate forecasts about one another's behavior in Acts 2 and 3. The donor would have anticipated the degree of slippage in Act 2, which in turn would have been influenced by the recipient's expectation about the donor's behavior in Act 3. Given the high slippage rates revealed by Table 5, these expectations would probably have discouraged the donor from coming to any agreement at all with a number of countries. Alternatively, they might have led the donor to ask the recipient for a set of policy reforms in Act 1 that allowed for an accurate forecast of slippage and included an implicit agreement that Act 3 would proceed only if this rate of slippage was not exceeded.

The argument can be taken farther. If Act 3 is the last round of negotiations that the recipient can foresee, it has no reason to comply with any externally imposed policy conditions at that stage. Having a rational expectation of this behavior, the donor will not lend. Moving back to Act 2, the recipient will have no incentive to abide by the conditions set in Act 1, and that in turn will eliminate the donor's incentive to lend in Act 1. Under perfect foresight, therefore, the market for policy-based lending agreements fails completely! The fact that bargaining does not fail in this way is part of the argument for rejecting the assumption of perfect foresight in modeling negotiations of this kind.

There is no doubt that expectations of future behavior do sometimes affect Act 1 negotiations. In 1986, for example, the World Bank took particularly

¹⁰ Many World Bank loan officers have stressed in conversation that their major contribution to the process of policy dialogue between donor and recipient lies in the pressure they put not so much on a unified recipient government as on different agencies within the government in order to coordinate their policy actions.

tough negotiating positions with both Bolivia and Tanzania because of forecasts of weak implementation of policy reform based on those countries' poor records from 1980 to 1985. In many other cases, however, such expectations will have little bearing on Act 1 negotiations because of the difficulty of making accurate predictions.

First, it is difficult, if not impossible, to predict the degree of domestic political opposition that will be aroused by a measure such as the withdrawal of import quotas or fertilizer subsidies. It seems clear, for example, that the delays in implementing the import-liberalization provisions of the Philippine SALs were largely due to incorrect forecasts of the amount of opposition that would be put up by the industry lobby.

Second, even the negotiators for the recipient may be surprised by the subsequent slippage on a commitment they have made. For example, as part of a SAL agreement in January 1983, the staffs of the Kenya Ministry of Finance and the World Bank agreed that Kenya would privatize much of its trade in maize. Both staffs were surprised a year later to find this policy commitment rescinded by the President of Kenya.

Third, the donor's operations staff, which monitors compliance during Act 2, may interpret the conditions far more indulgently than the donor's head-office staff intended when it was negotiating Act 1, particularly if the operations staff feels that failure to comply with policy conditions is due to extraneous factors. SAL conditionality is often attached to intermediate targets that can be thrown off course by exogenous shocks rather than to instruments that are strictly under the government's thumb like."raise the tax/GNP ratio to 22 percent over the next five years." This permits a range of opinions on where to place the blame for failure to comply with a particular condition.

Finally, by the time Act 3 comes around, the donor may have changed its attitude toward slippage and not want to exercise its previously announced threat. Perhaps a political change in the recipient country suggests to the donor that future compliance will improve, making it rational to forgive the Prodigal Son. The case of Ghana provides an excellent example. In the early 1980s, Ghana defaulted on many IMF and World Bank policy conditions, but from the summer of 1985 onward it professed willingness to embark on fundamental economic reforms. The World Bank immediately made a large amount of program finance available to the government, thereby excusing past slippage on the basis of the hope—no more—of smaller slippages in the future.

For all these reasons, I must reject the assumption that perfect foresight governs the behavior of the parties in the game. Sometimes the donor will try to build a forecast into the bargaining and the deal in Act 1, but usually its forecast will be wrong, for the reasons set out above. Often the donor and recipient will not even try to make forecasts because they know how easily predictions can be upset. Thus the outcome of negotiations in Acts 1 and 3 and the slippage in Act 2 will probably be determined less by each party's forecasts of the other's behavior than by each party's bargaining strength.

In Figure 2, the account given so far is portrayed in a game tree that traces the alternative moves that each party can make at each stage in the condi-

FIGURE 2

THE "TREE" OF THE CONDITIONALITY "GAME"



tional-aid game. We must now specify the game in a form that will enable us to test it against the data, and consider more precisely the optimal strategy for each player at each point in the game.

Behavior of Donor and Recipient: Hypotheses to Be Tested

When it initiates the bargaining for a conditional development loan, the donor has three potential negotiating instruments: the size of the loan, the terms of the loan (interest rate, grace period, and so on), and the conditions attached to the loan. In what follows, we assume that the first two are not used as actual negotiating instruments—that improvement in the size or terms of the loan is not traded for tighter conditionality or vice versa.¹¹ The only thing at stake is the tightness of the conditions attaching to the loan; if the negotiating parties can agree on this, the other features of the loan follow according to mechanical formulae.

We also assume that the tightness of the conditions attaching to a particular loan, T_{ij} , can be measured along a continuous arithmetic scale, as in Figure 1, and that the level of tightness will depend on the relative negotiating strength of donor and recipient or, more formally, on the *risk limits* of donor and recipient (Harsanyi, 1977), where the risk limit of one party is the utility to that party of settling on its opponent's terms rather than reaching no agreement at all. We hypothesize that the recipient's risk limit will depend on the gravity of its economic position (e.g., its balance of payments and its debtservice ratio) and the possibility of getting development finance from other sources. Formally,

$$T_i = f(B_i, D_i, F_i) ,$$

where T_i = set of conditions corresponding to recipient's risk limit

- B_j = balance of payments of recipient country
- D_j = debt-service ratio of recipient country (debt-service payments divided by exports)

(1)

 F_j = concessional-aid flows from donor institution divided by aid flows from all other donors.

The variables on the right-hand side relate to the year before Act 1 begins. For simplicity we assume that for a multilateral institution with no strategic interests to advance, the donor's risk limit, T_i , is the same in all Act 1 negotiations. The donor takes a consistent and similar negotiating position toward all recipient countries. The agreed list of conditions at the end of Act 1, T^*_{ij} , will then be determined by factors bearing on the recipient's political and economic position, and we can write:

¹¹ The data suggest that for World Bank SALs, loan sizes are fairly rigidly keyed to the size of the recipient's balance-of-payments deficit and loan terms in a given year are the same for every country.

$$T^*_{ij} = g(B_j, D_j, F_j) .$$
 (1')

We now move forward into Act 2, the implementation phase. The recipient implements a proportion p(0 of the set T* of conditions thatwas agreed at the conclusion of Act 1. Thus (1 - p) can be interpreted as the degree of slippage on the conditions. What will determine the size of p? An extreme assumption is that "leopards never change their spots," so that the recipient will fail to implement any of the conditions that were coercively imposed on it at the end of Act 1, that is, the entire set falling in T^*_{ij} but not in T_{i} . Such an assumption, however, precludes both the possibility of "learning" by the recipient during the policy dialogue and the possibility of forward-looking behavior by the recipient toward Act 3, when it may want another loan from the donor.¹² The first possibility is hard to model or quantify except as a random disturbance. But the second is well captured by the recipient's balance-of-payments position and dependence on the donor for concessional money at the start of Act 3, which will affect the recipient's need for another program loan from that donor. An appropriate behavioral equation for Act 2 might be

$$p = \gamma (T^*_{ij} - T_j, B_j', D_j', F_j') .$$
⁽²⁾

The first term on the right side represents the coercion that the recipient wanted to shed at the end of Act 1, and the other terms represent its need for further finance from that donor at the end of Act 2 and hence its need to subject itself to further coercion during Act 3.

Finally, at the start of Act 3 the recipient must decide whether it will need another loan, and if it decides to seek one, the donor must decide whether to negotiate. If the donor does decide to negotiate, we can hypothesize that the set of conditions it proposes will be directly related to the amount of slippage during Act 2. Thus

$$T_i = \delta p \tag{3}$$

if the amount of slippage during Act 2 exceeded the donor's expectation. This completes our set of working hypotheses. We shall now see how well they measure up against the data.

4 Interim Tests of Hypotheses

Any operation can be judged in two ways, by the technical correctness with which it was carried out and by its ultimate success. Here both modes of

¹² "Learning" can occur during Act 2 either because recipient policymakers become more convinced of the correctness of the economic analysis underlying the donor's proposed condition or because the opposition of vested interests to the implementation of the condition weakens, for example because a protective umbrella no longer gives them effective shelter. Learning can be interpreted as a flattening of the indifference curves in Figure 1 during Act 2. evaluation are applied to the most important case of type 3 conditionality, World Bank SALs. We look first at the determinants of conditionality and compliance with it, measured by changes in policy instruments. We move on to consider whether, by the end of 1986, compliance had had any visible effect on the things it was meant to influence, namely exports, the balance of payments, and GDP. In both cases, we use simple tabular methods rather than econometric methods, since the number of observations (countries to which SALs have been disbursed) is too small to allow meaningful inference from regression methods.

Tightness and Compliance with Conditions

I have argued that the tightness of the conditions actually attached to a loan depends on the relative costs to donor and recipient of settling on the other party's terms rather than on failing to reach agreement, as set out in equation (1'). Table 7 provides a measure of the tightness of the conditions negotiated by the World Bank for a sample of the SALs listed in Table 3, together with measures of the other variables in equation (1'). The measure of tightness is simply the number of conditions imposed on each country and, as such, does not capture tightness perfectly. Intensity of conditions is as important as number in determining tightness. Most would agree, for example, that for a recipient government eliminating subsidies is "tougher" than reducing subsidies, eliminating quotas is tougher than reducing tariffs, and privatizing agricultural marketing is tougher than altering agricultural prices. However, a reading of the record suggests that the countries on which the largest number of separate conditions were imposed were also those for which the individual conditions were politically and administratively most demanding.13

Table 7 shows that tight conditions were generally negotiated with the poorest countries in the sample, those with the worst balance-of-payments problems, and those most dependent on SAL finance for official capital flows from abroad.¹⁴ These results are consistent with the hypothesis set out in equation (1'). Gaps in the data in Table 7 make it impossible to test whether the promise of a large increase in national income is a sufficient inducement for a country to accept proportionately harsher conditions. According to verbal testimony of World Bank staff who were involved in SAL negotiations,

¹³ The only countries to have been subjected to the tough conditions mentioned are: elimination of subsidies—Malawi, Pakistan; elimination of import quotas—Ivory Coast, Jamaica, Kenya, Philippines, Turkey; privatization of agricultural marketing—Ivory Coast, Kenya. Of these seven countries, all except Ivory Coast, Jamaica, and the Philippines are in the group for which the absolute number of conditions was highest, as shown in Tables 3 and 7.

¹⁴ The value of SALs rather than the total flow of funds from the World Bank group is used as the numerator in the final column of Table 7, because the Bank's normal practice is to continue to supply project finance to a country even if SAL negotiations break down (examples: Guyana in 1982; Kenya in 1984).

			Possible Determinants of Tightness				
Country	Year First SAL Disbursed	Tightness Score *	Per Capita GDP 1980 ^b	Current- Account Balance ^c (Average 1978-80: % of GNP)	Debt- Service Ratio (Average 1978-80: %) ^d	Increase in GDP Growth- Rate Forecast if Con- ditions Accepted (%)*	Dollar Value of SAL ^f as % of Borrower's Gross Public External Capital Flow ^g in Year of Issue (Average of all SALs)
Five tightest							
Guyana	1981	13	660	- 15.8	20.5	n.a.	22.9
Kenva	1980	12	350	-11.4	8.2	13.1	20.3
Malawi	1981	11	190	-20.1	3.2	36.0	38.4
Pakistan	1982	12	310	- 4.3	19.7	n.a.	20.8
Turkey	1980	13	1,130	- 3.8	13.1	n.a.	14.6
Average (x ₁)			528	11.1	13.0	(24.5)	23.4
Six loosest							
countries:							
Bolivia	1980	6	580	- 5.9	36.3	n.a.	11.3
Ivory Coast	1981	10	1,050	- 14.5	18.0	38.7	12.8
Jamaica	1982	10	1,140	- 5.5	12.9	23.6	16.6
Philippines	1980	6	700	- 5.2	21.1	16.3	17.0
South Korea	1981	11	1,400	- 6.2	12.0	n.a.	4.5
Thailand	1982	11	660	- 6.3	15.5	4.2	11.1
Average (\tilde{z}_2)			920	7.2	19.3	(26.2)	12.2
t-statistic ^h			3.15**	1.86**	2.17*	0.46	3.75**

TABLE 7		
TIGHTNESS OF SAL CONDITIONS AND	Possible	DETERMINANTS

* Difference between sample means significant at 10% level ($t_{0.05}$ with 10 d.f. = 1.81).

** Difference between sample means significant at 5% level ($t_{0.025}$ with 10 d.f. = 2.22).

• SAL tightness score (out of 20) is a simple arithmetic sum, transcribed from Table 3, of the number of areas in which conditions were imposed in successive loans. Note that it is a measure of average tightness on all SALs granted to end 1986.
• From World Bank (1981), Appendix Table 1.

• From IMF (1984).

^a Ratio of Debt Outstanding and Disbursed to Exports of Goods and Services as given in World Bank (1985).

Derived from Table 4.

^f From Table 3.

* From OECD Development Assistance Committee (1981) and subsequent issues.

^h t-statistic = $(\tilde{x}_1 - \tilde{x}_2)/(\sigma_{\tilde{x}_1} - \bar{x}_2)$ in all tables.

the "with and without" figures of Table 4 were seldom an important element in conditionality negotiations. Finally, I must stress that, according to the figures in Table 7, the burden of debt service had an effect *opposite* to that predicted by the theory: in general, the gentlest terms appear to have been negotiated with the countries that had the worst debt-service problems, and the gentlest of all were negotiated with Bolivia, which had an average debtservice ratio of 36 percent between 1978 and 1980, well over twice the sample average, and was forced to default on part of its overseas debts in 1983. Why fear of default failed to affect the tightness of conditions is not obvious. The World Bank's internal assessment of the Bolivia SAL certainly suggests that more pressure for policy reform would have been desirable, both in negotiating the initial conditions and in conducting a review of policies before the release of the second tranche of the loan.

First impressions therefore suggest that the relative bargaining strength of donor and recipient, rather more than considerations of strict economic appropriateness, may have exerted an influence on the World Bank's conditional aid packages. There is also little evidence that the tightness of conditions imposed on borrowers was correlated with the Bank's "price-distortion index." This indicator of the harmfulness of government intervention in the economy, published in the 1983 *World Development Report*, summarizes the effects of government intervention across a number of markets. The Bank reports a marked negative correlation between the distortion index and the growth rate of GDP across a sample of developing countries. As Table 8 shows, tight conditionality was imposed on Malawi, which scored the very

	Distortion Index ^a	Tightness Index ^b
Low-distortion countries:		· · · · · · · · · · · · · · · · · · ·
Kenya	1.71	12
Malawi	1.14	11
Philippines	1.57	6
South Korea	1.57	11
Thailand	1.43	11
Average (\bar{x}_1)	1.48	10.2
High-distortion countries:		
Bolivia	2.29	6
Ivory Coast	2.14	10
Jamaica	2.29	10
Pakistan	2.29	12
Turkey	2.14	13
Average (\bar{x}_2)	2.23	10.3
t-statistic	2.88**	0.05

TABLE 8

THE WORLD BANK'S PRICE-DISTORTION INDEX AND THE TIGHTNESS INDEX

** Difference between sample means significant at 5% level ($t_{0.025}$ with 10 d.f. = 2.23).

^a From World Bank (1983, pp. 60-61).

^b From Table 3.

best on the distortion index, and loose conditionality was imposed on Bolivia, which scored among the worst. If we take the ten countries together, there is no statistically significant difference between the tightness of the terms imposed on the low-distortion group, which on the World Bank's assessment had relatively enlightened policies, and the terms imposed on the highdistortion group, whose policies were judged far less favorable to growth.

We now consider the performance of borrowers in Act 2, when they "decide" what proportion of a conditionality package to implement. The quotation marks reflect the fact that borrower governments often do not have absolute power to implement the changes they have agreed to make. For example, a borrower that has undertaken to "reduce the public-sector financial deficit from 9 percent to 6 percent over three years" (Kenya: SAL I) may not be able to do so if its forecasts of the tax base are wrecked by the weather or some other uncontrollable variable. I have argued, however, that the controllable part of its actions can be explained by the hypothesis embodied in equation (2): the less the borrower's dependence on the donor at the end of the loan period and the greater the perceived coercion, the less likely is the borrower to implement agreed policy conditions imposed by a donor. (The borrower's dependence on the donor is measured by its balance-of-payments deficit and the donor's share in the total concessional-aid flow; perceived coercion is the gap between the reform package the borrower would have liked to implement in the first loan period and the package it actually agreed to implement.)

The first two of these variables are easily quantified, but "perceived coercion" is not. To devise a suitable proxy variable, we proceed as follows. Other things being equal, it seems reasonable to assume that perceived coercion will be greater the greater the tightness of the agreed reform package. The main factor that may render other things unequal is whether the reform was reluctantly accepted by an old government in a break with its previous policies or was enthusiastically offered by a new government as part of the policy package to which it was committed when it took office. In the former case, the implementation of reform involves a reversal of declared policies, which will humiliate the government; in the latter, the new government can present the sacrifices imposed by the reforms as part of a consistent strategy rather than a last desperate expedient. The degree of tightness on the original loan and the presence or absence of a new government at the time that loan was negotiated therefore appear to be the most obvious *a priori* determinants of perceived coercion.

A preliminary test of these hypotheses is carried out in Table 9. The results are inconclusive and not statistically significant. As predicted, slippage was greater among countries whose balance-of-payments problems were relatively minor and whose need of special assistance had become smallest: the average balance-of-payments deficit among countries with high

				Possible Determinants of Slippage		
Country	Year First SAL Disbursed	Slippage to End 1984 (%)*	Tightness Score ^b	Current- Account Balance (% of GNP in 1983; trend 1980-86)°	Dollar Value of SAL ⁴ as % of Borrower's Gross Public External Capital Flow ^e in Year of Issue (Average of All SALs)	New Govern- ment in Year before SAL Package Agreed?
Five highest-slippage						
countries: Bolivia	1080	80	6	- 20 P	11.9	N-
Guyana	1960	49	13	- 3.0 K	11.3	INO No
Kenva	1980	61	13	-2.0 F -31 F	22.9	No
Malawi	1981	37	11	-23 F	38.4	No
Philippines	1980	19	6	-8.1 R	17.0	No
Average (\bar{x}_1)		47.8	9.4	– 3.8 F		
Six lowest-slippage countries:						
Ivory Coast	1981	18	10	-12.3 F	12.8	No
Jamaica	1982	5	10	-11.8 R	16.6	Yes
Pakistan	1982	10	12	0.04 F	20.8	No
South Korea	1981	5	11	– 2.1 F	4.5	No
Thailand	1982	18	11	– 7.3 R	11.1	No
Turkey	1980	4	13	– 3.7 F	14.6	Yes
Average (\tilde{x}_2)		9.9	11.3	- 6.2 F	13.4	
t-statistic		1.41	0.49	0.3	1.31	

TABLE 9

SLIPPAGE ON SAL CONDITIONS AND POSSIBLE DETERMINANTS

^a From Table 5.

^b From Table 7.

^c 1980 and 1983 from IMF (1984), supplemented where necessary by IMF (1987). F = falling; R = rising.

^d From Table 3.

e From OECD Development Assistance Committee (1981) and subsequent issues.

slippage was under 4 percent of GDP in 1983 and falling, whereas the average deficit among countries with low slippage was over 6 percent and rising. Yet tightness has no significant correlation with slippage, and, contrary to our hypothesis, the high-slippage countries were more heavily dependent on SALs for external finance than the low-slippage countries.

Perhaps the most significant datum in Table 9, however, is that two of the three countries whose reform packages were most faithfully implemented,

Jamaica and Turkey, had both undergone changes of government in the year before their SAL agreements were concluded. In the Jamaican case the new government was civilian, and in the Turkish case it was military, but the important point is that neither government was heavily obligated to groups who could be expected to lose from a liberalization of domestic and foreign trade, nor could either be accused of inconsistency or betrayal of those groups if it went ahead with an economic stabilization program. Indeed, the SAL agreements signed by those governments did little more than codify the programs they had promised to implement in any case.¹⁵ In Jamaica and Turkey, alone among SAL countries, the leopards had formally committed themselves to change their *dirigiste* spots before the question of conditional aid even arose. By that same token, however, the range of policy reforms achieved in both countries after 1980 cannot be treated as achievements of conditional development assistance.

Finally, we consider Act 3, when the lender decides whether to grant a further loan to the borrower. Our model states that the tightness of the new loan will be directly related to the level of slippage in the previous period (and will not be granted if slippage is too high). Table 10 shows that only a part of this hypothesis is confirmed by experience. The worst performers in terms of slippage on the first SAL—Bolivia and Guyana—were penalized by

			Second SAL		
Country	Slippage on First SAL ^a (%)	Second SAL Granted?	Tightness Score ^ь	Slippage to End 1984 ° (%)	No. of Subsequent SALs Granted
Bolivia	80	No			0
Guyana	42	No			0
Ivory Coast	20	Yes	11	16	1
Jamaica	16	Yes	11	2	1
Kenya	40	Yes	14	78	0
Malawi	30	Yes	11	44	1
Pakistan	10	No			0
Philippines	10	Yes	7	30	0
South Korea	0	Yes	10	5	0
Thailand	30	Yes	13	12	0
Turkey	0	Yes	15	4	3

TABLE 10

TIGHTNESS OF SAL CONDITIONS IN RELATION TO SLIPPAGE IN PREVIOUS PERIODS

^a From Table 5.

^b From Table 3.

¹⁵ This is conceded in the World Bank's evaluation of the Turkish structural-adjustment program. For the Jamaica case, see *Sunday Times* (London), July 4, 1980. being refused a second SAL, whereas two of the best performers—Jamaica and Turkey—had been favored by the offer of three and five SALs, respectively, by the end of 1986. But Pakistan, which had only 10 percent slippage on the first SAL, was refused a second SAL, although it was offered a set of sector loans in compensation, and Turkey, whose fulfillment of the conditions of the first SAL was exemplary, nonetheless had tight conditionality attached to its second and indeed its third. There is no discernible relationship between slippage on the first loan and tightness of conditions attached to the second, although this may reflect the limitations of our tightness measure rather than the way the World Bank saw the matter.

Effect of SALs on Ultimate Targets

As a number of commentators have stressed, the seventh year of what was designed as a medium-term program to build up the supply side of developing countries is too soon to make a final evaluation. Nevertheless, an interim assessment of the SAL program may have some value for deducing whether the variables I have called "tightness" and "slippage," which are *inputs* into the reform process, have any apparent connection with the longterm improvements in exports, the balance of payments, and GDP that are supposed to be the *outputs*. To this end, we compare the performance of exports, the balance of payments, and growth in non-oil-producing developing countries that received SALs and in those that did not, and, within the set that received SALs, the performance of these variables in high-slippage and low-slippage countries.

Killick and associates (1984, pp. 227-228) note that it is possible in principle to evaluate the effect of a stabilization program in relation to what happened before the package was implemented, what the program was expected to achieve, and what would have happened in the absence of the program. The first of these procedures, however, may give extremely untrustworthy results if the "environment," that is, the set of variables *apart* from the stabilization package that influence growth or the balance of payments, changes between the first and second period. Such is the case here: 1976-79 was a period of worldwide growth, 1980-85 a period of almost universal recession. Hence the fact, apparent from Table 11, that SAL programs were not able to stop deterioration in the rate of growth of exports, the balance of payments, and the growth of GDP does not necessarily reflect adversely on those programs. We need a yardstick to measure what might have been achieved in their absence.¹⁶

Here we consider two approaches to constructing such a yardstick, or control group. The first is to compare what happened in other non-oil-producing developing countries. The second is to compare, *within* the SAL group, what

¹⁶ On appropriate methodology for the evaluation of economic policy packages, see Goldstein (1986).

TABLE 11

	1976-79 4-Year Average	1980-85 6-Year Average
Rate of change of export volume (% per annum): ^a		
Other non-oil developing countries	9.1	6.3
Sample of 11 SAL countries	12.1	9.7
5 with highest slippage	10.8	0.6
6 with lowest slippage	12.4	12.1
t-statistic = 1.83*		
Balance of payments on current account (% of GDP): b		
Other non–oil developing countries	-1.9	-3.6
Sample of 11 SAL countries	-4.1	-4.8
5 with highest slippage	-4.9	-5.9
6 with lowest slippage	-3.9	-4.6
t-statistic = 0.10		
Growth of GDP at constant prices (% per annum):*		
Other non-oil developing countries	4.9	2.6
Sample of 11 SAL countries	7.1	4.5
5 with highest slippage	5.7	2.1
6 with lowest slippage	7.5	5.1
t-statistic = 1.11		

ECONOMIC PERFORMANCE OF SAL COUNTRIES COMPARED WITH OTHER NON-OIL-PRODUCING COUNTRIES, 1976-85

NOTE: See Table 9 for the 11 SAL countries classified by highest and lowest slippage. Data for Guyana are not included in the computation of the 1976 average owing to a change in method of calculating the national accounts implemented that year.

* Difference between sample means significant at 10% level ($t_{-0.05}$ with 11 d.f. = 1.79).

^a From IMF (1987).

^b From IMF (1986).

happened in the countries where reforms were implemented largely as planned (the low-slippage countries) with what happened in the high-slippage countries. Neither procedure, however, is perfect for the purpose. As previously noted, the SAL countries appear to have stronger economies than other non-oil-producing developing countries (their GDP growth rate was 2 percentage points higher in 1976-79); by the same token, the low-slippage countries within the SAL group appear to have stronger economies than the high-slippage ones. A further difficulty is that SALs have never been given unless an IMF standby agreement was concluded previously, and it may be hard to separate the effects of Fund and Bank packages. This said, the following comparisons emerge from Table 11. In spite of the disbursement of the loans, the balance-of-payments problem of the SAL countries at the end of 1985 remained worse than average; current-account deficits stood at 4.8 percent of GDP against 3.6 percent in the other non-oil-producing developing countries. (Note, however, that the disbursement of a SAL is almost certain to aggravate the current-account balance in the short term, since a large part of it will be used to finance imports for which credit could not otherwise have been obtained.) The growth rate of real GDP and exports was between 2 and 3 percentage points higher in the SAL countries than in the control group, more or less as predicted by Table 4, but since this difference persisted throughout the period 1976-85, it is hard to tell how much to ascribe to the influence of the SALs and how much to the inherent dynamism of the SAL economies. It seems likely that the influence of SALs, as of other stabilization measures, varied sharply among recipient countries (Taylor, forthcoming).

Similar differences emerge when we compare the high-slippage and lowslippage groups within the SAL sample. The comparison is wholly to the advantage of the group that complied with the agreed conditions: the growth rate of export volume was a remarkable 11 percentage points higher in the low-slippage than in the high-slippage group, the current-account deficit as a proportion of GDP 1 percentage point lower, and growth of real GDP 3 percentage points higher. Such simple comparisons, however, say nothing about the direction of causation. According to one stereotype, which some apologists for the World Bank have appeared to espouse (see, e.g., World Bank, 1983, pp. 41-128), superior performance should be interpreted as the yield to the low-slippage governments on their investment in the political courage needed to confront vested interests and deprive them of the rents they earn from restrictive practices. According to the opposite stereotype, superior performance derives from the fact that the low-slippage countries have relatively advanced economies with a diversified range of exports that stood to gain from the upturn in world trade in 1983 and 1984. On this story, growth, far from being caused by economic reform, made reform politically possible: it is always easier to redistribute from growth than from decline.

Clearly, there is some plausibility to both these views. It is apparent from examination of data for individual years, however, that the big performance gap between SAL and non-SAL developing countries, and indeed between high- and low-slippage countries within the SAL group, opened up in 1982 and 1983, after SALs began to be disbursed; broadly, the low-slippage economies had a brief recession, with at most one year of declining export volume and GDP, whereas the high-slippage economies had a protracted recession. This is evidence in favor of the view that it was slippage itself, rather than the inherent weakness of the high-slippage economies, that made the export performance of those countries so poor in the recession, but more data are needed before this judgment can be made firm.

5 Policy Implications

Although conditionality is a device to increase the effectiveness of financial transfers, our analysis has shown that this improvement is neither automatic nor straightforward. Three tests must be passed before conditionality can be said to have enhanced the effectiveness of a financial transfer: the conditions must be technically appropriate to the specific economic objectives for which they are prescribed; they must be implemented; and they must be additional to what the recipient would have done anyhow.

Technical Appropriateness

The data in Table 11 suggest that by the end of 1985 countries that had adhered to SAL conditions had done better than those that had not, and that not all of the difference was due to underlying disparities in the capabilities of their economies. But this encouraging short-term result cannot be used to make a definitive assessment of a medium-term reform program; some of the success of the low-slippage countries may have been due to luck rather than judgment. Certainly, there is little correlation between the tightness of conditions imposed on countries and the severity of price distortions in those countries, and the World Bank's forecast of the consequences of complying with its conditions (Table 4) are based on faith and guesswork, not on formal reasoning. If recipient countries do not share the donor's faith, they have little reason to accept its economic logic, apart from their financial dependence on the donor.

My first recommendation is therefore that, in future, a donor should base its predictions of the effects of its conditions on a formal model that links the policy instruments it wants the recipient to change and the targets at which the instruments are aimed. This forecast, which should be shared with the recipient (Toye, forthcoming), will necessarily depend on a number of factors the recipient cannot control, such as weather, crop disease, and world demand for the country's exports. It should therefore typically take the form not of a simple point estimate, as in Table 4, but rather of a frequency distribution of outcomes. It should consist of statements like "If this package is implemented, there is a 50 percent chance that it will raise export volume by between 1 and 2 percent, a 20 percent chance that it will raise export volume by between 0 and 1 percent," and so on. The recipient government could conduct simulations of the effects of alternative policy packages, with the help of outside consultants if necessary.

These simulations would be a better basis for genuine policy dialogue than

the present system under which the recipient negotiates a fixed set of reforms drawn from the menu proposed by the donor on the presumption that the recipient's economic policies are mistaken and the remedy is obvious. Policy mistakes on the part of the recipient government have been referred to by the World Bank (1981, Chap. 1; 1984, Chaps. 2 and 4) and by many economic reports. This excerpt from the Bank's appraisal of the second SAL in the Ivory Coast is not uncharacteristic:

Agriculture, the force behind Ivorian growth, had lost much of its dynamism. *Unsound* price and subsidy policies produced distorted supply and demand responses. Meanwhile, *poor* planning, programming and research led to a weak public investment program in agriculture. Many public agricultural agencies were *poorly* managed and inadequately funded due to *weak* financial control systems. Excessive and *misdirected* protection arising from the widespread introduction of quantitative restrictions and distortions in the tariff system were eroding industrial productivity and exports. (Emphasis added.)

Often, however, the remedy is not at all obvious. The donor and recipient may disagree about the objectives of development policy (see Bird, 1981, p. 368; Daniel, 1983, pp. 15-16); even if they agree about objectives, there may be a technical disagreement about the policies appropriate to achieve the objectives; even if they agree about objectives and policies, they may disagree about the order in which the policies should be carried out. An example of the first type of disagreement is the argument between the World Bank and Malawi about crop prices in 1981-82, when the Bank favored an emphasis on export crops but the Malawi government raised maize prices by more than the price of export crops. An example of the second type of disagreement is the argument between the Bank and the Kenva government in 1983 about the best way to provide an incentive to maize producers, when government politicians favored a simple increase in the price paid by the statutory buying authority and the Bank insisted that this authority withdraw to the role of buyer of last resort. An example of the third type of disagreement is the debate between the Bank and the Philippine government, when the Bank favored simultaneous implementation of trade-liberalization measures and reduction of the budget deficit and government staff wanted deficit reduction to follow trade liberalization (Yagci et al., 1985, pp. 79-95).

In these circumstances, it is for donor and recipient to grope their way together toward a solution rather than for the donor to masquerade as a doctor prescribing for a disease. A recipient government will carry out lasting changes in policy and institutions only if persuaded that it is at fault, rather than threatened by financial loss. If both parties recognized this, the recipient might have a more powerful incentive to continue the policy dialogue with the donor than the threat of losing the loan if it cannot meet the donor's terms. As Berg and Batchelder (1984, pp. 47-48) write: SALs stress too little the importance of real dialogue, of changing minds, as a basic engine of policy reform. The SAL concentrates on high-level discussion, political dramatization, cross-sectoral and comprehensive conditionality. This approach leaves too little room for sustained policy dialogue and for interaction between Bank staff and local politicians at the working level, the level at which people remain to be convinced that the reformers' ideas are right.

Implementation

Implementation of conditions on SALs has been far from complete, as demonstrated in Table 5. We have seen that, on theoretical grounds, this is not at all surprising: the recipient that does not believe compliance with the conditions will be to its advantage may be tempted to play the conditionality game as a prisoner's dilemma, keeping the money and wriggling out of distasteful conditions.¹⁷ The recipient gets away with this because of the delay before the donor can discover that the conditions have not been met. This high-slippage behavior seems to be likelier the more the recipient's balance of payments improves and the more its government is subject to the accusation of changing course and betraying its supporters by complying with the agreed conditions (see Table 9).

The obvious response is to reduce the political cost to the government of compliance with the conditions by finding some way to compensate the actual losers in the recipient country. Suppose that the recipient government, before entering into a conditional aid agreement, sees the payoffs from the different outcomes in Table 5 as they are set out in Table 12. Now suppose that the various groups who suffer from the imposition of conditionality are compensated by some mechanism that preserves the allocative advantages of the proposed policy reform: farmers who lose a fertilizer subsidy can be compensated by selective programs of public investment in rural road building; local manufacturers who lose quota restrictions against imports can be compensated by reductions in payroll taxes; holders of licences to import or move grain can be offered lump-sum payments at the point of transition to a free market.

While such compensation agreements are a commonplace of negotiations between multinational companies and third-world governments (see Faber, Green, and Harvey, 1983, pp. 23-42), they have never, to my knowledge, been formally proposed by a donor of conditional aid (see Berg and Batch-

¹⁷ There is an analogy between the effects of conditionality on a country and the effects of trade sanctions. In the short run, there are few substitutes for conditional money, just as there are few substitutes for the imports subject to restriction. In the longer run, the country subject to conditionality can often find sources of finance that will not exact the same policy conditions, just as a country subject to trade sanctions can develop substitutes for the restricted imports from internal or external sources. For a theoretical analysis of the effects of trade sanctions, see Frey (1984, Chap. 6).

	Donor				
Recipient	Disburses All of Agreed Loan	Disburses Part of Agreed Loan	Disburses None of Agreed Loan		
Complies with all agreed conditions	2,2				
Complies with some agreed conditions	1,3	1,1			
Complies with none of agreed conditions	0,4	0,2	0,0		

TABLE 12 Conditional Aid as a One-Sided Prisoner's Dilemma

NOTE: First figure in each cell is payoff to donor. Second figure is payoff to recipient.

elder, 1984, p. 28). Recipients of such aid, once they have decided to bite the bullet of policy reform, do frequently compensate losers as a matter of political instinct, but in an economically damaging way: increases in nominal agricultural prices are "compensated" by equivalent increases in inflation; abolition of the import-licensing system is "compensated" by bringing in new exchange controls. It would be far better for the World Bank to devote a part of the SAL to finance explicit measures to help buy off losers in a way that is not economically damaging than to offer it to governments in the hope that they will be emboldened to confront the losers. If such compensation is sensibly planned, the political costs of stabilization programs will diminish to the point where the recipient government no longer has an interest in evading the conditions. The center and bottom cells in the left-hand column of Table 12 become (1,2) and (0,2), and the only reasons for slippage will be fear of the unknown and administrative inadequacy.

Additionality

Do the policy reforms that have been carried out under conditional aid agreements such as SALs differ in any way from those that would have been carried out under the stress of recession and balance-of-payments crisis? The numbers in Table 11, showing a sharp gap in growth and export performance between countries that have accepted SAL agreements and those that have not, suggest that they do, but a doubt persists about whether these differences in performance reflect payoffs to a change in policy or differences in the resilience of the economies. It is also unclear how much of the improvement in the economic performance of SAL countries is due to the SALs themselves and how much to standby agreements previously concluded with the IMF. What is very clear is that the most effective SAL programs—at least as judged by low levels of slippage-have been those of Jamaica and Turkey, which consisted in large part of reforms conceived by elements of the political opposition to obviously ineffective governments before the question of program aid from the World Bank ever arose. Radical as they are, these programs can scarcely be claimed as successes for conditionality, inasmuch as both governments have insisted that they would have implemented them even without pressure from the World Bank and the Fund. Donors cannot claim much credit for getting recipients to do what they had pledged to do beforehand. A reading of the record suggests, therefore, that the World Bank should not expect too much from conditionality in its pure sense-the use of a donor's financial power to convert a recipient government that is united in its opposition to the donor's policy recommendations. The outlook is more hopeful, however, for conditionality of a less pure type, such as the use of concessional funds as an instrument to increase the bargaining power of reformist groups within the recipient government, and the offer of specialist advice to implement intentions expressed merely as policy objectives by the recipient government.

There seems little doubt that the importance of policy-based lending by the World Bank will increase in the short and medium term. It has been stressed repeatedly (see, e.g., Feinberg, 1986, pp. 10 and 67) that any longterm solution to the third-world debt crisis must rest on policies that bring about accelerated growth in the debtor regions. Yet IMF-sponsored lending to developing countries, on its own account and by commercial banks, has diminished in recent years. In 1983, commercial banks committed them-

Fiscal	SA	SALs		Sector-Adjustment Loans	
Year	Number	Value	Number	Value	
1979-80	3	\$ 305	2	\$ 92	
1980-81	7	700	3	128	
1981-82	6	1,070	0	0	
1982-83	8	1,533	11	1,545	
1983-84	5	831	5	412	
1984-85	3	111	12	1,474	
1985-86	4	437	9	1,389	
1986-87	11	1.028	24	4,141	

TABLE 1	3
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Number and Value of SALs and Sector-Adjustment Credits Awarded by the World Bank, 1979-87 (dollar faurge in millione)

selves to lend nearly \$14 billion of medium-term money as part of IMFsupervised agreements; in 1984, the figure increased to \$16 billion; but in 1985, it dropped to \$2 billion (*The Economist*, Sept. 27, 1986, p. 34).

This essay has made suggestions for improvements in the efficiency of policy-based operations, including formal modeling of the impact of policy instruments and compensation payments to the losers from reform packages. But perhaps the most important suggestion that can be made for protecting the integrity of conditionality is that it be confined to policy instruments that are genuinely under the recipient government's control and are demonstrably linked to the policy targets at which they are aimed. The World Bank would therefore be well advised to eschew conditions such as "reduce budget deficit from 9 percent of GNP to 6 percent between 1980 and 1982" (Kenya: SAL I) or "raise tax/GNP ratio to 22 percent over the next five years" (South Korea: SAL I), the fulfillment of which is not directly under the recipient government's thumb. It might also be well advised to concentrate its conditionality, and indeed its future program lending, at the sectoral rather than the macroeconomic level, where the connection between instruments and targets is easier to demonstrate. It is easier to show that raising the price of rice will increase the rate of return on rice projects than to show that widespread privatization of the economy will increase the growth of exports. In fact, the World Bank is already moving in this direction, disbursing a progressively larger proportion of its policy-based lending in the form of "sectoradjustment loans," "export-development funds," or "industrial-reconstruction credits," and a progressively smaller proportion as full SALs (see Table 13). This development—a compromise between the project-based approach of the 1960s and 1970s and the full-blown macroeconomic approach of the early 1980s-promises greater precision of impact and is for that reason to be warmly welcomed.

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