

ESSAYS IN INTERNATIONAL FINANCE

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THE CHANGING NATURE OF
IMF CONDITIONALITY

JACQUES J. POLAK



INTERNATIONAL FINANCE SECTION

DEPARTMENT OF ECONOMICS
PRINCETON UNIVERSITY
PRINCETON, NEW JERSEY

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THE CHANGING NATURE OF IMF CONDITIONALITY

1 Introduction

In the terminology of the International Monetary Fund, “conditionality” refers to the policies the Fund expects a member to follow in order to avail itself of credit from the Fund (Gold, 1979). Over the years, major developments in the landscape surrounding the Fund and in the situation of its members have brought about important changes in the content of conditionality. These developments have been most pronounced in the 1980s, and they have led gradually but cumulatively to a fundamental change in the Fund’s relations with its borrowing members, with further adjustments likely in the 1990s.

The Impact of Changing Economic Conditions

One major change affecting the Fund’s conditionality has been the narrowing down of the Fund’s *clientele* to its developing-country members. The Fund was conceived as an institution to which any member could be expected to turn for temporary financing when faced with balance-of-payments difficulties. In its first two decades, the main industrial countries accounted for over half the use of Fund resources. As early as the 1960s, even the United States was seen as a potential user, and the General Arrangements to Borrow concluded in 1962 were to a large extent inspired by the realization that the resources available from quotas would not suffice to give large-scale assistance to the United States. As recently as 1977, the United Kingdom and Italy concluded major stand-by arrangements with the Fund, and, in November 1978, the United States announced a drawing on the Fund (admittedly in its reserve tranche, to which it had automatic access) as part of a stabilization exercise (Polak, 1989b, p. 49). More recently, however, with the ample availability of credit from the world’s capital markets, as well as credits from Brussels to the members of the European Community, the industrial countries have no longer felt the need for Fund credit. By contrast, and especially since the onset of the debt crisis in 1982, many developing countries have seen the Fund as their main source of balance-of-payments credit. The resulting division of the Fund’s membership into borrowers and nonborrowers has exacerbated the problem of conditionality by giving one group of members an

overwhelming interest in making access easier, and the other group an equal interest in making it more limited (Kafka, 1991).

A number of other developments have played a role in shifting the content and emphasis in the Fund's conditionality. The introduction of the Extended Fund Facility (EFF) in 1974 gave formal recognition to a medium-term outlook in Fund programs, as well as greater attention to structural and supply aspects of adjustment. The adoption of Structural Adjustment Lending (SAL) by the World Bank at the end of the 1970s brought the Bank very close to (and perhaps sometimes across) the demarcation line between the operations of the two organizations. The debt crisis brought about a major expansion in the list of the Fund's clients in the first half of the 1980s, and their problems soon proved to be unresponsive to simple prescriptions for traditional adjustment. It also became clear that there would be no solution to the debt crisis unless the highly indebted countries could resume a growth trend. During that same decade, the retrogression of many African economies became increasingly evident, and the conviction spread in the international community, as well as in many of the countries themselves, that only radical changes of policy could reverse the negative trend. Finally, in 1989-90, the search for ways of making the transition from state planning to market economies in Eastern Europe presented the Fund (and the Bank) with a new array of economic problems.

The cumulative effect of these changes in its members' problems has brought about a fundamental shift in the Fund itself. In its first quarter century, the Fund's financial relations with its members were essentially episodic in character. Misfortune or mismanagement would cause a member country to turn to the Fund for temporary help, but the underlying problems were quickly overcome in most cases, thanks in part to the rapid expansion of the world economy. Even then, some countries in perpetual difficulties needed and received Fund credit under successive arrangements. These were the exceptions, however, and the notion of the Fund as a "credit union" (Kenen, 1986) where members (industrial and developing) took turns as borrowers and lenders continued as a broadly valid characterization of the institution.

By now, however, that notion has been wholly overtaken. Not only has the number of countries with Fund arrangements increased—to about one-third the total membership in recent years—but the problems that they face are far more complex and persistent than in the past; the adjective "intractable" has even slipped into the Fund's vocabulary, and the Fund has become reconciled to the proposition that many members

will require its assistance over an extended period. This assistance is not limited to finance; the Fund is being called upon to mobilize and provide a wide range of services in the areas of policy advice, technical assistance, training, and sometimes staffing to help countries improve the management of their economies.

Considerable emphasis is put on “working with” countries (to use a currently popular expression). In some instances, for example, the Fund has agreed to a less than fully satisfactory program in the hope of helping country authorities to develop a better program next time around; the initial arrangement has sometimes comprised an elaborate technical-assistance package designed to improve fiscal management and thereby lead the country to a fiscally sound successor arrangement. Inevitably, approaches of this kind tend to prolong the financial association between the country and the Fund—and thus to increase the likelihood of prolonged use of Fund resources.

The changes described in the relationship between the Fund and members using its resources have made the Fund’s conditionality more complex than in earlier years. In addition, the massive increase in the Fund’s case load during the 1980s and its more intensive involvement with structural policies in close association with the World Bank have yielded new findings about policies that do and do not work. This experience has also had an impact on the content of conditionality.

Changing Conditionality: An Overview

The Fund’s conditionality was never a simple concept, but it has become much more ambitious and complex as the Fund has responded to shifts in the world economy and learned from its own experience. The resulting changes within the Fund relate to many of its institutional features, its policy objectives and instruments, and to Fund/member relations. It would be nice if these could be presented here in a simple, orderly way. Unfortunately, they are too interwoven to make this feasible. Even in Section 2, which aims mainly at giving the reader the necessary institutional knowledge, policy issues arise that need to be addressed immediately. For example, the historic distinction between conditional and unconditional (or low-conditional) Fund credit can hardly be described without noting it has ceased to exist for all practical purposes. What might appear to be minor differences between the Structural Adjustment Facility (SAF) and the Enhanced Structural Adjustment Facility (ESAF) prove to harbor significant policy implications. The following road map may help the reader through what is thus somewhat confusing terrain.

Section 2 serves to familiarize the reader with various institutional and technical aspects of conditionality and to explain them in historical context. It begins by describing and interpreting the arrangements under which members now receive credit from the Fund (four, as against only one prior to 1974). In addition to lending under arrangements, however, the Fund has taken decisions to make resources available from a number of special facilities; these include the 1963 decision on the compensatory financing of export fluctuations and, to some extent, the 1974 decision on an oil facility. These were not expected to involve conditionality in a major way, because the policies of the eligible members were assumed to be broadly in harmony with Fund purposes. By 1981, however, the Fund's most authoritative publication on conditionality noted without qualification that "Fund members have agreed that the Fund's financial assistance should be conditional on the adoption of adjustment policies" (Guitian, 1981, p. 2). With minor exceptions, the Fund now operates on the assumption that the balance-of-payments difficulties of any country seeking to use the Fund's resources require changes in that country's policies, so as to ensure the temporary character of the use of those resources. It is therefore necessary to discuss certain features of the Fund's special facilities and the gradual abandonment of the concept of low conditionality. Section 2 concludes by describing certain technical aspects of conditionality. Some are familiar and need only brief mention, such as letters of intent and performance criteria; others, in particular, "financial assurances," are novel and have not been discussed before in the literature on conditionality.

Section 3 begins by describing the content of the Fund's conditionality as it was understood until ten or fifteen years ago. At that time, balance-of-payments adjustment was central to it, but recent developments have for all practical purposes added growth as an equally important, perhaps even more important, Fund objective. The implications are examined, along with ups and downs in the Fund's concern about price stability.

Section 4 discusses the Fund's emerging concern with a number of secondary objectives. The Fund acknowledges some of them explicitly, including the relief of poverty and the protection of the environment, although it does not treat them as targets at which to aim its conditionality. Others, such as the containment of military expenditures, are kept out of the limelight but nevertheless play some role in countries' abilities to benefit from Fund credit. The section concludes by examining the touchy question of political influence. To what extent has it overridden

the Fund's technical judgment—either in refusing credit when a country might technically qualify for it or in granting credit when it might fail to qualify?

Section 5 deals with the policy instruments on which the Fund focuses its conditionality. It begins with a brief description of “the monetary approach to the balance of payments” and explains why the Fund has selected a monetary balance sheet as the framework for developing a general model of an economy with which it is dealing—or for so much of such a model as is practicable in particular instances. It then discusses in more detail two policy issues that have played a major role in Fund conditionality during recent years: exchange-rate policy and fiscal policy. Current Fund views about these matters differ significantly from those of only a few years ago, and this has led to important changes in conditionality, especially in the fiscal field.

Section 6 ventures onto treacherous ground—the problem of measuring the degree of success of Fund-supported adjustment programs. Most of the evidence, such as it is, is found to be inconclusive. This then raises what is perhaps the most important issue about Fund programs. Does stabilization under a Fund program lead in the end to sustained growth? The available evidence of the 1980s is not as conclusive as one would like. A major reason is that few of the problem countries with which the Fund has been dealing took early adjustment action and then stuck to it consistently. In many countries, policymakers took the better part of the decade to adopt the full range of financial and structural policies that had to be implemented. In other countries, the process of adjustment has barely begun even now. Nevertheless, there is by now enough evidence—from Latin America, Africa, and Asia—to justify some optimism with respect to the ultimate payoff of adjustment policies.

Section 7 looks ahead toward the further changes in conditionality that are likely to occur or might be desirable. Fund arrangements, policy objectives, and policy instruments all appear to be subject to change in the light of recent and prospective changes in economic conditions and in Fund/member relations. A number of proposals for changes in policy monitoring are discussed; some are endorsed as improvements, and others are shown to raise major difficulties.

Finally, Section 8 draws on the considerable range of impressions garnered in the course of this paper to take a somewhat broader view of the relationship between the Fund and the members that seek to use its credit. It concludes that in some of the best—though by no

means all—cases, this relationship has grown from adversarial to collaborative, from “conditionality” to joint “program design.”

2 Institutional Features of Conditionality

The Range of Fund Credit Arrangements

The Fund extends credit¹ to a member either to meet a general balance-of-payments need under one of a number of “arrangements” or to meet a specific balance-of-payments need under one of a number of “special facilities.” The Fund now has four types of arrangements, two of which date from the last five years:

Stand-By Arrangements (since 1952)

Extended Fund Facility (EFF) (since 1974)

Structural Adjustment Facility (SAF) (since 1986)

Enhanced Structural Adjustment Facility (ESAF) (since 1988)

Only low-income developing countries can receive SAF and ESAF loans. These loans carry a nominal interest rate of 0.05 percent per annum, whereas credit under the first two arrangements is extended at what are essentially market interest rates. The EFF, SAF, and ESAF arrangements have repayment terms ranging from five and a half to ten years; stand-by arrangements require repayment in from three to five years

The four types of arrangements have much in common but also differ significantly as far as conditionality is concerned. All arrangements involve policy understandings for a period ahead, laid down in a letter of intent that may, at the Fund’s discretion, be reinforced by prior action on the part of the member. Stand-by arrangements now typically last for twelve to eighteen months (there were a few three-year stand-by arrangements in the early 1980s, which were hardly distinguishable from EFF arrangements). The three other types of arrangements always cover a three-year planning period (which for EFF and ESAF arrangements may be extended for a fourth year); all, however, require annual letters of intent making specific policy commitments for the next twelve months.

The conditions pertaining to EFF, SAF, and ESAF arrangements give considerable emphasis to structural elements. These are not absent from

¹ The Fund now uses the term “credit” (a term its Articles studiously avoid) to indicate money made available under the first two of the four arrangements; for some unfathomable reason, it labels SAF and ESAF credits as “loans.” The Fund’s nomenclature is the reverse of that of the World Bank Group; the Bank makes “loans” and the International Development Association (IDA) grants “credits.”

stand-by arrangements—in particular with respect to exchange-rate and pricing policies—but are typically less elaborate. Often, a country receives a stand-by arrangement, rather than an EFF arrangement, not because its problems are seen as solvable in a short period but because there has not been enough time to assemble all the elements of a comprehensive structural package. The long lead time required to work out a thorough fiscal program is frequently the main reason.

Apart from the interest-rate provisions already mentioned, there remain only minor differences in conditionality between EFF and ESAF arrangements. One such difference is that drawings are normally made quarterly under EFF (as under stand-by) arrangements, provided the quarterly performance criteria have been met, but drawings are made semiannually under ESAF arrangements and are thus based on semiannual performance criteria and reviews. (The relevant data are collected on a quarterly basis as “benchmarks,” however, and can thus serve to warn of the need for action before the next ESAF drawing is due to be made.)

One major difference in conditionality exists between SAF and ESAF loans. SAF loans are disbursed in one installment per year, so the Fund has no leverage until the next year’s letter of intent is negotiated, when it may insist on prior action if the previous year’s performance was unsatisfactory. Accordingly, there is frequently a gap of many months between the annual segments of a three-year SAF arrangement, indicative of difficulties in the negotiation between the Fund and the member.

Apart from this difference in enforcement power, the Fund applies a weaker conditionality under SAF than under ESAF; the structural content of a SAF arrangement tends to be less well specified and less action oriented, with greater acceptance of “studies.” By and large, only countries that the Fund expects to deliver a solid performance are given access to ESAF; weaker countries are allowed to use the smaller amounts of credit available under the more lenient provisions of SAF, but they can graduate to ESAF once they demonstrate their ability to perform. Not surprisingly, the results under SAF arrangements are worse than those under ESAF arrangements (examples are cited in Section 6).

Why would the Fund apply two different standards of conditionality to the same group of members? When ESAF was conceived in early 1987, there was no indication that its aims would be any different from those of SAF. It was to provide more money for the same purpose. But when ESAF was established in December 1987, the conclusion had already been reached that ESAF programs should be “more ambitious” in terms of both the magnitude and timing of adjustment measures.

Part of the explanation lies in the fact that the Fund traditionally feels comfortable with a two-track access to its resources. The soft track permits the Fund to give a modest amount of help to countries that demonstrate some, even though inadequate, efforts toward adjustment. It gives the Fund an opportunity “to work with” these countries in the hope of preparing them for access to the hard track, with more substantial access at a later date. The soft conditionality of the first credit tranche, introduced as early as 1955, was the first example of this approach. And though the Compensatory Financing Facility (CFF) was not designed with this idea in mind, some of its earliest applications (Brazil, Egypt) were seen as serving this warm-up purpose. That the CFF is no longer used as this sort of “bridging facility” is still to some a cause for regret (Kafka, 1991).²

The creation of ESAF gave the Fund a new opportunity to apply two-track conditionality, this time as the answer to a practical problem. The problem arose from the difference in entitlements to SAF and ESAF funds. SAF funds were seen as available in perpetuity to the low-income developing countries.³ ESAF funds were derived from repayable loans made by development agencies and central banks, mainly in the industrial countries. The Fund’s decision on the establishment of the ESAF trust and the chairman’s summing up that accompanied it demonstrated that the lenders wanted every possible assurance that they would receive “full and expeditious repayment.” This attitude, however, was not compatible with the soft conditionality that had

² An explicit proposal for two-track conditionality in the Fund was recently made by David Finch (1989, p. 35), the director of the IMF department responsible for conditionality from 1980 to 1987. He proposed the creation of a new low-conditionality facility to ensure that countries with serious debt problems and less than satisfactory adjustment policies do not fall into arrears to the Fund and other international agencies. Access under this new facility would be kept smaller than the repayments due to the Fund “in order to maintain openly the principle of IMF priority.”

³ SAF’s resources go back to gold sales by the Fund from 1976 to 1980; some of the profits (market price minus book value) were destined for the poorest countries. The original plan had been to distribute those profits as grants proportional to quotas, but this approach was replaced by the idea of putting the profits in a trust fund to make loans to the same countries in the same proportions. The loans had low conditionality, bore an interest rate of 0.5 percent per annum, and were repayable over a ten-year period. In 1986, reflows of these loans began, and SAF was started to recycle these funds to the same category of countries. On the plausible assumption that these funds will continue to circulate among the low-income countries, perhaps in successive ten-year cycles, the other members of the Fund have no proprietary interest in them.

become the practice for SAF loans, and the two-track approach became the natural answer.

Compensatory and Contingency Financing

Since 1963, the Fund has allowed countries to draw under a special facility,⁴ outside the limits set under the credit tranches, to compensate for shortfalls of export proceeds below trend (later expanded to include shortfalls in major invisibles and excesses over trend in the cost of cereal imports). The CFF had no phasing and its conditionality was limited to an obligatory statement by the member that it would “cooperate with the Fund in an effort to find, where required, appropriate solutions for its balance of payments difficulties.” The Fund would not explore in advance whether the member’s payments difficulties required “appropriate solutions” or attempt at that stage to reach agreement with the member concerning the nature of those solutions (Horsefield, 1969, p. 482). The assumption underlying the facility was that the occurrence of an export shortfall did not by itself create a presumption that adjustment was necessary. On the contrary, the measurement of the shortfall as a deviation from a five-year trend, centered on the shortfall year, was seen as providing evidence that the export difficulties were temporary. The Fund had also to be satisfied that the shortfall was “largely attributable to circumstances beyond the control of the member.” The broad aim of this provision—which has sometimes raised difficult problems of attribution—was to prevent use of the facility when the export shortfall was due mainly to factors such as currency overvaluation, domestic stockpiling, or unrealistic price setting for export crops.

Over the years, however, the Fund has increasingly come to the realization that even though a country’s export shortfall was both “temporary” and largely beyond its control, the country might still have balance-of-payments difficulties attributable to inappropriate policies and that large amounts of unconditional credit might cause the country to delay adopting needed policy adjustments (Goreux, 1980, p. 41).

⁴ In addition to the two special facilities discussed in this section, two others deserve brief mention. In response to the first oil shock, the Fund established an oil facility in 1974 that was broadly patterned after the compensatory financing decision of 1963. The facility was allowed to expire in 1976 and was not brought back when the second oil shock hit in 1979; a similar facility was, however, introduced in late 1990. The Fund has had a “buffer shock facility” since 1969; it never became important and has wholly atrophied in the last few years.

Therefore, the Fund has tightened access to the CFF by redefining the required degree of “cooperation” with the Fund. A member must now either have a conditional arrangement with the Fund or be following a set of policies that would qualify for such an arrangement. As a result, far fewer countries have received CFF drawings in recent years, and the overwhelming majority of them qualified by having a conditional arrangement (Table 1).

It is only a slight exaggeration, therefore, to say that the CFF has ceased to exist as a special facility in the Fund. All that is left of it is a special rule on the amount of access to the Fund’s resources potentially available to countries judged to have a qualifying export shortfall.

The same principle was observed when, in November 1990, an “oil-import element” was added temporarily to compensatory financing. The Fund noted that experience suggested it should provide added financing primarily in the context of a comprehensive adjustment program. For drawings under the oil element, there is an additional requirement that the member follow appropriate energy policies. In general, the additional compensation for high oil-import costs has gone to countries that had upper credit tranche or comparable arrangements with the Fund or were in the final stages of getting them.

The Fund continues to measure export shortfalls by the elaborate five-year averaging technique (which involves a major commodity-market forecasting exercise), and it uses a comparable procedure on the import side for the “cereal-cost element” of the facility and the “oil element.” Nevertheless, it has ceased to put confidence in the built-in finding of “temporariness” for which such calculations were originally designed, and the extra helping of Fund credit that a member may receive is by now only remotely related to the size of the export shortfall or import excess. From the start of the facility in 1963, CFF

TABLE 1
NUMBER OF DRAWINGS UNDER THE COMPENSATORY
FINANCING FACILITY
(by four-year periods)

Fiscal Years	Total	Without Conditional Arrangement
1979-82	79	28
1983-86	59	13
1987-90	23	1

SOURCE: International Monetary Fund, *Annual Reports*.

drawings were subject to a quota limit, which since 1983 had been 83 percent of quota. That upper limit is preserved theoretically for a member whose balance-of-payments position is satisfactory apart from the effects of the shortfall, but the limit may be set by the Fund at 65 percent, 40 percent, or 20 percent of quota—or of course at zero—depending on the Fund’s opinion of the member’s policies and its recent policy record. Nor can it be assumed that any compensatory amount for which the country qualifies is wholly additional to its access under a stand-by or EFF arrangement concluded at about the same time. That access depends on many factors, and the Fund would no doubt take account of the CFF drawing in determining its size.

A comparable offset would be less likely if the country’s conditional program were under SAF or ESAF, but countries that are eligible for low-cost, five-to-ten-year SAF or ESAF credits are understandably hesitant to apply for CFF credit, which is repayable in three to five years and carries a market-related interest rate. Part of the decline in the number of CFF cases in recent years (Table 1) reflects the emerging view, in the Fund as well as in SAF-eligible countries themselves, that these countries should in general no longer be considered for Fund credit at the standard interest rate. In fact, only three of the twenty-two conditional CFF drawings in the last four years went to countries with SAF or ESAF arrangements.

In a 1988 decision, the Fund merged its compensatory facility into a joint Compensatory and Contingency Financing Facility (CCFF). Nevertheless, the old CFF and the new contingency facility operate as separate, and in part overlapping, facilities (although members have some leeway in choosing between the two facilities when drawing part of their total potential CCFF access).

The contingency facility is, in principle, a valuable complement to the Fund’s conditionality. A member that concludes a stand-by or EFF arrangement is assured of additional access if certain exogenous variables, such as its export prices or world interest rates, affect its balance of payments less favorably than had been assumed when the arrangement was concluded. The rationale for a contingency facility is clear: the contingent access should enable the member to stick to its program in the face of unexpected difficulties. Unfortunately, the design of the facility, even as revised in 1989, limits severely its attractiveness to members entering into credit arrangements with the Fund. Two features in particular limit its appeal. First, contingency disbursements are not available automatically when there is a net balance-of-payments shortfall attributable to the agreed upon key variables; they require new under-

standings with the Fund concerning strengthened adjustment. Second, the facility is symmetrical, in that favorable exogenous developments require the country to achieve a higher reserve target than originally agreed upon or to reduce its drawings under the stand-by or EFF arrangement. Because a country knows it can always renegotiate its arrangement in case of unfavorable developments, some of which may also provide the basis for a compensatory drawing or may strengthen the country's claim to additional foreign aid, there is little interest in a promise of contingent access under new and unspecified policy conditions, particularly when matched by a contingent promise of smaller use or less freedom in the use of reserves in the event of favorable deviations. Only two countries signed up for the contingency facility in the two years after it became available in August 1988.

Technical Features of Conditionality

The purpose of the Fund's conditionality is to make as sure as possible that a country drawing on the Fund's resources pursues a set of policies that are, in the Fund's view, appropriate to its economic situation in general and its payments situation in particular. The major policies that serve these purposes are discussed in Section 5. The focus here is on the technical provisions by which the Fund tries to pin down the desired policies.

The Fund's main instrument for this purpose is the *letter of intent*. This letter (or its attached memorandum on economic policies) reflects the outcome of policy discussions between the Fund and the member. It spells out the policy actions that the member has taken and intends to take during the period of the arrangement. Ideally, it does so with sufficient precision for the Fund to monitor the member's subsequent performance against its stated policy intentions.

In connection with SAF and ESAF arrangements, the letter of intent is accompanied by another document submitted by the government, the *policy framework paper* (PFP), in which the authorities announce to the Fund and the World Bank the broad outlines of their demand management and structural programs for the coming three-year period, with additional detail for the program year immediately ahead. The PFP is the outcome of a tripartite drafting process, in which the borrowing country collaborates with the staff of the Fund and the Bank. This process forces the borrowing country to focus on the whole range of policy actions envisaged under the arrangement. It also forces the staffs of the two institutions to pay attention to each other's concerns and to move in the direction of reconciling their views on major

policy issues, such as the exchange rate or the amount of government investment allowed by the budget. The PFP approach has been applied since 1986 to countries receiving subsidized credit from the Fund and the Bank. Similar documents have been developed in connection with recent EFFs for Hungary and Poland. It has also been suggested that the Fund and the Bank use PFPs to coordinate their assistance to countries seriously affected by the war in the Middle East. It would indeed be a rational extension of this approach to apply it to all countries that receive credit from both institutions. So far, however, movement in that direction has been successfully resisted by certain major borrowers that do not want to narrow their ability to play off one institution against the other or to widen the scope of conditionality.

The strongest indications of a member's intentions are, of course, the *prior actions* it takes before receiving credit from the Fund. As late as 1979, however, the Fund was hesitant to ask for prior actions; according to the guidelines on conditionality, it could only insist on them if they were "necessary to enable the member to adopt and carry out a program consistent with the Fund's provisions and policies." These fluffy words have meaning only if read together with the immediately preceding sentence, which tells the managing director to recommend requests for drawings only if "it is his judgment that the program . . . will be carried out." Prior actions can be very helpful in enhancing the probability that a program will be implemented, particularly when the member's past record in the Fund may be less than outstanding (Gold, 1979, p. 29). In recent years, reliance on prior action has become more common, and it can be used to a member's advantage, to minimize the policy commitments it must make in its letter of intent and thus to present itself as opting for adjustment on its own rather than under pressure from the Fund. India's 1982 stand-by arrangement was an example of such "preemptive reform" (Stiles, 1990, p. 968); the Indian authorities devised and implemented an adjustment program in advance of seeking Fund credit.⁵ The Fund has come to welcome such prior action. As the managing director, Michel Camdessus, has made clear on a number of occasions, the Fund does not want to be cast as a bogey man making unreasonable demands that countries cannot withstand because they need its money.

The Fund uses *performance criteria* to monitor whether a member's adjustment program is on track and to encourage the member to take

⁵ Stiles' observation that the Indian government "was able to effectively nullify much of the Fund's leverage" thus badly misses the point. The Fund could wish no more than to exercise its leverage with all prospective borrowers in the way it did in the Indian case.

corrective action when the program may be moving off track. In addition, performance criteria have the positive function of ensuring a member's access to the Fund's resources when the conditions are met and the negative function of interrupting access when the country has failed to meet them. The *benchmarks* used in SAF and ESAF arrangements serve only the primary purpose mentioned, but ESAF arrangements use semi-annual performance criteria in addition to quarterly benchmarks. The tendency in the 1980s was to increase the number of performance criteria as adjustment programs had to be executed in an increasingly difficult policy environment. From an average of below six per arrangement in the years 1968 to 1977, the number rose to about seven from 1974 to 1984, and to more than nine and a half from 1984 to 1987.

When a performance criterion is not met but the Fund finds the noncompliance inconsequential, it can grant a *waiver*, but the member is not in a position to draw until that action is taken.

Performance criteria serve their purposes well only insofar as they are correct indicators of the program's targets. This raises no problem where the performance criteria themselves represent the target variables. Examples include the standard provision that the member will not intensify trade or payments restrictions and the special provision that some percentage of imports will be liberalized by a given date. The case is less clear cut, however, when ceilings are attached to intermediate variables. Suppose that the growth of domestic credit is constrained by a ceiling, x , under a string of assumptions and calculations that suggest that faster credit growth would lead to a payments deficit larger than y . If all goes according to plan, credit creation will be smaller than x and the deficit smaller than y . If policies are unsatisfactory but the linkage between x and y holds, the country will be barred from further disbursement for the good reason that it has jeopardized its adjustment program. In addition to these two correct outcomes, however, there can be two wrong ones: (1) The country sticks to its credit ceiling, but for various reasons (external or internal), the deficit exceeds y . The country is allowed to continue drawing even though its payments position has become unmanageable. (2) The country exceeds its credit ceiling, but the deficit does not exceed y . Disbursements are stopped even though, at least apparently, the balance of payments remains within an acceptable range.

These problems of false positive and false negative outcomes are inherent in the use of performance criteria, and there is no evidence that such problems have become more or less severe in recent years. Up to a point, they are the price that must be paid if drawings are to

be phased to prolong the Fund's policy leverage and members are to have at least some assurance that the implementation of agreed upon policies will promptly release quarterly disbursements. The risks to the Fund and the member can be reduced by improved specification of the underlying analytical relationships, but there are limits to this process, and external factors can affect the outcome. The problem can be addressed in part by automatic adjusters to performance criteria and reviews. A number of further suggestions to mitigate the difficulties are discussed in Section 7.

In the 1970s, *reviews* were unusual except for programs extending beyond one year. Since then, mid-year reviews have become standard for all programs except those under SAF. Their purpose is not to renegotiate the conditions agreed at the start of a program (Gold, 1979) but to fill in performance criteria that cannot be specified at the beginning of the program and to reset targets in the light of new evidence, so as to mitigate the risks of false positive or false negative readings of the performance criteria. Reviews also play a role in the reexamination of financing assurances when these are not settled at the outset.

Traditionally, a key component of any Fund arrangement was that the resources provided by the Fund, together with those from the World Bank, aid donors, commercial banks, and other sources, would cover the country's projected balance-of-payments gap. In the absence of an integral financing package, the Fund could not be confident that the degree of adjustment negotiated with the country would be sufficient. To this end, the Fund sought *financing assurances* from the other suppliers of financial assistance. In the second half of the 1980s, however, commercial banks began to exploit this approach. No longer afraid of becoming the victims of a generalized debt crisis, the banks began to realize that they could insist on favorable terms for themselves by blocking a country's access to Fund credit (and to other credit linked to a Fund arrangement). The Fund was thus pushed increasingly into being used by the commercial banks in the collection of their debts. In response to this situation, the Fund began to reconsider its attitude toward financing assurances, and the same issue was raised pointedly in the context of the 1989 Brady Plan, which aimed at depriving the commercial banks of the leverage gained by delaying Fund and Bank lending until debtor countries had come to terms with the banks.

There is, unfortunately, no satisfactory answer to the question posed by financing assurances, and the Fund has found it difficult to strike an appropriate balance. Its original position clearly tilted too far in favor

of the banks. But concern for financing assurances could not simply be dismissed without raising issues of moral hazard, jeopardizing orderly relations between a member and its banks, and putting the repayment of Fund credit at risk. The Fund reached an uneasy compromise in May 1989 in guidelines that it issued on financing assurances:

The Fund may, on a case-by-case basis, approve an arrangement outright before agreement on a financing package is concluded between a member and commercial-bank creditors, (1) if it is thought that prompt Fund support is essential for the implementation of the adjustment program and (2) provided that negotiations between a country and its creditors have begun and that it can be expected that a financing package consistent with external viability will be agreed within a reasonable period. Progress in the negotiations with bank creditors will be closely monitored.

In promoting orderly financial relations, every effort will be made to avoid arrears, which could not be condoned or anticipated by the Fund in the design of programs. Nevertheless, an accumulation of arrears to banks may have to be tolerated where negotiations continue and the country's financing situation does not allow them to be avoided. The Fund's policy of nontolerance of arrears to official creditors remains unchanged (*Annual Report, 1989*, p. 26).

The Fund reaffirmed these guidelines one year later but seemed to back some distance away from them (*Annual Report, 1990*, pp. 30-31). In any event, it reverted to something close to its original position in the case of Brazil, which had run up large arrears to the banks. Brazil had adopted a program which, according to the managing director, deserved support by the Fund. Nevertheless, he called the accumulation of arrears "the willful destruction of a country's credit-worthiness" and indicated that he would not submit the program to the executive board until "negotiations with the banking community are firmly launched with a good prospect of a satisfactory solution" (Camdessus, 1990c).

3 Primary Objectives of Fund Conditionality

The Fund's lending activities, like its other activities, are guided by its purposes. It will not lend money to a member country merely because the country wants to borrow, even when the Fund feels confident that it will receive interest and repayment when they are due. The Fund must also be convinced that extending credit promotes its purposes.

In broad terms, the objective of the Fund's conditionality has been described as helping members "to attain, over the medium term, a viable payments position in a context of reasonable price and exchange-

rate stability, a sustainable level and growth rate of economic activity, and a liberal system of multilateral payments” (Guitian, 1981, p. 3). But this combination of desirable outcomes is not always achievable, and the Fund has laid primary emphasis on one or another at various times in its history.

Balance-of-Payments Adjustment

Historically, the Fund’s primary concern in extending credit related to the balance of payments of the borrowing country. When dealing with developing countries in particular, it was concerned with a borrower’s ability to achieve a viable payments position, defined as a current-account deficit not larger than that which could be financed by net capital inflows on a sustainable basis, on terms compatible with the development and growth prospects of the country. In accordance with its purposes, moreover, the Fund wanted the member to attain this viable position with a minimum of reliance on trade or payments restrictions, although it was more willing to tolerate such measures, on a temporary basis, in the 1960s and 1970s than it was in the 1980s. The Fund’s concern with growth, to the extent that it existed at all, was less pronounced.

The primary emphasis given to external objectives and the Fund’s restraint regarding domestic policies has been justified by invoking a principle of “political neutrality,” which led the Fund to seek an acceptable balance between the protection of the interests of an individual member and the interests of the membership as a whole (Guitian, 1987). This approach did not limit the Fund’s conditionality to demand management. The exchange rate and producer prices of major export commodities were seen to be very important, but important mainly for the purpose of switching resources into the production of tradeable goods and thus improving the balance of payments, rather than promoting growth (Mohammed, 1991).

Economic Growth

It may come as a surprise to many that the Fund’s Articles of Agreement do not include growth among the Fund’s purposes.⁶ That omission was

⁶ As a result of the French-American compromise in the autumn of 1975, the term “economic growth,” qualified in one instance by the modifier “sound” and in another by “orderly,” made its entry into Article IV, Section 1 under the second amendment. These expressions formed part of the avalanche of words designed to sugarcoat the transition from the purpose of “exchange stability” in Article I(iii) to that of “a stable system of

not accidental; India and Australia fought hard for its inclusion at the Bretton Woods Conference (Gold, 1971), but most delegations did not want to introduce any ambiguity concerning the respective functions of the Fund and the World Bank. Thus, growth appears in Article I(ii), not as a purpose, but as the expected result of the pursuit of the purpose of trade expansion. Gold's (1971) paper shows, however, that the Fund was fully aware that many members had a strong interest in promoting growth as one of *their* major objectives and that it was willing to support it.

The distinction between growth as a purpose of the Fund and growth as a purpose of a member might be little more than a thin legalism if it could be shown that all members applying for stand-by arrangements did indeed consider growth to be a primary policy objective. But this was certainly not the case in the 1950s and 1960s, and it is not universally true at present.

During the 1960s, countries in Central America and elsewhere pursued balance-of-payments adjustment by relying exclusively on severe demand restraint rather than combining a more moderate degree of restraint with exchange-rate adjustment, even when the Fund would not have objected to devaluation. At the time, the Fund was reluctant to insist on devaluation as part of its conditionality when a member wanted to attempt adjustment entirely from the demand side and the Fund considered that the attempt had a reasonable likelihood of success.

In recent years, however, the Fund has moved in the direction of elevating growth to one of its explicit purposes, particularly in its relations with low-income countries. This was not yet the case in 1976, when it established a trust fund for the benefit of those countries, using profits made on the sale of some of its gold. The purpose of that trust fund was simply to support members that "carry out programs of balance of payments adjustment." Ten years later, however, when repayments from trust-fund loans became available for a new round of lending under the SAF, qualifying members were asked to submit "a three-year adjustment program . . . to correct macroeconomic and structural problems that have impeded balance of payments adjustment

exchange rates" (no definition provided) in the new Article IV. To promote such a system, each member undertook the spongy commitment to "endeavor to direct its economic and financial policies toward the objective of fostering orderly economic growth with reasonable price stability, with due regard to its circumstances." As Gold has pointed out, "the most remarkable feature of this clause is its softness" (1988a, p. 104).

and economic growth” (emphasis added). And the larger trust established in 1987 (ESAF) had the dual purpose of supporting “programs to strengthen substantially and in a sustainable manner [the] balance of payments position[s of eligible members’] and to foster growth.”

In practice, the staff now appears to see the adjustment and growth priorities in reverse order. As one recent report puts it: “The objectives of all programs supported by both the SAF and ESAF were to foster growth and to make *substantial progress* (emphasis added) toward a viable balance of payments position during the three-year arrangement period.” Median targeted growth rates were 3.6 percent per annum for SAF programs and 4.5 percent for ESAF programs, but even at the end of the three-year program period, half the countries under SAF programs and one-third of those under ESAF programs were expected still to need additional exceptional financing.

There would thus seem to be every evidence that growth has become a Fund purpose.⁷ Indeed, in a recent speech, the managing director painted growth as the Fund’s quintessential objective: “Our prime objective is growth. In my view, there is no longer any ambiguity about this. It is toward growth that our programs and their conditionality are aimed. It is with a view toward growth that we carry out our special responsibility of helping to correct balance of payments disequilibria.” He then went on to explain that what he had in mind was “high quality growth” rather than “flash-in-the-pan growth” fueled by inflation and excessive borrowing, or growth at the expense of the poor or the environment, or growth run by the state. In other words, the growth objective is redefined to incorporate adjustment, income distribution, the environment and, in Eastern Europe, the transition to a market economy (Camdessus, 1990b).

⁷ By now, the original distinction between growth as a purpose and growth as an effect seems to have been lost sight of even when the Articles of Agreement are invoked. A recent survey paper begins: “The Articles of Agreement of the International Monetary Fund . . . state that the promotion of trade, increasing the levels of employment and real income, and the development of productive resources are to be the primary objectives of economic policy (Article I). Although the Fund’s major area of concern may *in practice* be balance-of-payments disequilibrium, the policies it recommends to reduce the degree and duration of external and internal imbalances must be set within the context of achieving and maintaining satisfactory rates of economic growth. In general, therefore, the Fund aims at assisting its member countries establish conditions that would yield balance-of-payments viability, price stability, and a growth rate that would support a steady improvement in living standards. In analyzing Fund policies designed to achieve these *multiple objectives*. . . .” (Frenkel and Khan, 1990, emphasis added).

A Conflict between Growth and Adjustment?

The new emphasis on growth brought to the fore the possibility of conflict between growth and adjustment. Much of the criticism directed at the Fund's conditionality is that it sacrifices growth to adjustment by compressing economic activity below its full employment or capacity level. While not denying the possibility of conflict, economists in the Fund, and many others, would point to three important qualifications.

First, they would observe that balance-of-payments difficulties frequently have their origin in fiscal or monetary policies that attempt to run the economy at above-capacity levels, leading to large spillovers of domestic demand into the balance of payments. In these circumstances, the application of policies to limit aggregate demand can bring about a major improvement in the balance of payments without much effect on employment or growth. A policy of disinflation can thus be beneficial all around; only a further dose of contraction, turning disinflation into deflation, would pose a clear choice between growth and adjustment. In countries with severe and prolonged economic distortions and growing balance-of-payments disequilibria, some outright deflation may be necessary for adjustment, though it may not have to last long even in those cases (Khan and Knight, 1985). A prolonged balance-of-payments "need" for deflation is *prime facie* evidence of an overvalued currency, which should be corrected by depreciation.

Second, the apparent conflict between growth and adjustment tends to vanish as the problem is considered in a longer perspective (Guitian, 1981). Growth can be stoked over a short period by burning up all of a country's reserves and its access to voluntary and involuntary credit (arrears). Peru did this in 1986 and 1987, when it produced annual growth rates of about 9 percent. After that, the game was up; 1988 and 1989 saw negative growth rates of 9 and 12 percent respectively. To an important extent, then, the choice before a country is not growth vs. adjustment, but growth today vs. growth tomorrow (Guitian, 1987).

Finally, to the extent that adjustment is brought about by improvements on the supply side rather than by compressing demand, adjustment obviously contributes to growth.

Adjustment and Growth in Conditionality

Although the Fund now supports growth and adjustment with equal fervor and sometimes seems to proclaim the primacy of the former over the latter, it does not insist with equal firmness on policies needed for growth and on policies needed for adjustment. When adjustment

requires disinflation, the Fund will make every effort to ensure that enough disinflation occurs. The monetary approach, described in Section 5, is designed to ensure that a country's program cures the excess-demand aspect of its balance-of-payments problem. If a reasonable agreement on this issue cannot be reached, there will be no Fund program.

The situation is different with respect to structural policies. The Fund for its part is fully aware of the fact that countries suffering from major structural weaknesses will not achieve sustainable growth, even though they may achieve balance-of-payments adjustment, unless they implement at an early stage carefully targeted structural measures as a complement to demand-management policies. Member countries, however, do not always see the problem in that way. Typically, the pain inflicted by restraining aggregate demand is widely distributed, whereas structural measures hurt particular groups. Import liberalization eats into the profits of privileged importers; financial liberalization, accompanied by higher interest rates, hurts privileged borrowers; and the abolition of general food subsidies may be felt in particular by urban consumers. Facing pressures from the groups that are hurt by such measures, governments are not always able to marshal sufficiently strong support from the broad segments of the population that can be expected to benefit from structural adjustment measures and from the avoidance of excessive reliance on demand-management policies. It is therefore far too common for the Fund to find that would-be borrowers prefer to use traditional macroeconomic policies to more intrusive structural measures. Thus a borrowing member may not be prepared to accept adequate structural components in its stand-by arrangement or, if it agrees to them, may find ways to delay their implementation. In such cases, the Fund will go along reluctantly with what it calls "second-best adjustment paths,"⁸ provided it feels reasonably confident that the member will stick to the macroeconomic measures and that the targeted payments effect will be attained. It will settle for what it regards as insufficiently strong structural policies and broad promises about them, rather than precise performance criteria.

An arrangement that fails to address a country's structural problems adequately may produce disappointing results in terms of both growth and adjustment if adjustment fatigue weakens a country's resolve to implement the macroeconomic part of its program. But this need not

⁸ The Fund also uses the predicate "second best" to characterize some programs that have turned out to be inadequate and should have been recognized as such *ex ante*.

necessarily be the outcome, at least in the short run. In a study of a sample of SAF arrangements in which the implementation of structural measures was weak, the Fund found that growth was, nevertheless, better than projected. There were a number of reasons, beyond the fact that higher producer prices tended to stimulate output, and that better weather had produced larger crops. In some cases, the Fund's seal of approval (even if it was only the modest SAF seal) unlocked financing from national and international donors and thus loosened, at least temporarily, the foreign-exchange constraint on the growth of output. In other cases, poor implementation of a fiscal program (say, the delay of a new value-added tax) prevented a reduction in aggregate demand and, although it hurt payments performance, may have provided some initial stimulus to output.

Price Stability

Is the control of inflation one of the elements of Fund conditionality? The answer has moved back and forth between yes and no in the course of the Fund's history.

Price stability, as distinguished from exchange-rate stability, did not find an explicit place in the Fund's original Articles of Agreement. It could well be argued, however, that member countries expected to be helped in their struggle for domestic price stability by their commitment to maintain a stable exchange rate with respect to the U.S. dollar, the domestic stability of which seemed assured by U.S. policy (Cooper, 1984). It was not until the first amendment (1969) that the avoidance of deflation and inflation appeared as Fund objectives, tucked away in Article XVIII, Section 1, among the considerations that should guide the allocation of Special Drawing Rights (SDRs), not added to the list of "Purposes" in Article I. In the second amendment (1978), moreover, "reasonable price stability" appeared in the context of members' obligations with respect to their exchange arrangements.

Whatever the Articles said about price stability, the Fund has never left any doubt that it "stood" for stable prices and against inflation. But the extent to which it has made this conviction part of its conditionality has varied over the years, and five phases can be distinguished.

(1) In its early years, the Fund carried its commitment against inflation to the point of refusing to enter into arrangements that did not have the clear aim of achieving price stability. In those days, roughly the 1950s and 1960s, the Fund rejected "gradualism" in the fight against inflation; if a country was not prepared to take the radical

steps against inflation required to give a devalued exchange rate a good chance of being sustainable, it could not count on Fund support.

(2) The Fund's experience with a number of countries in Latin America soon made it retreat from this dogmatic position. The Fund became aware of the difficulties many countries had in controlling inflation and, giving clear priority to balance-of-payments adjustment, began to accept (and soon to insist on) downward floating exchange rates to offset persistent inflation. Thus, price stability for those countries receded as a Fund objective. Countries could aim for it gradually, as long as they made sure that their currencies did not become overvalued, and "gradually" often came to mean "at some unknown time in the future." Most letters of intent contained targets for inflation, but these were never made performance criteria.

(3) In spite of this relatively relaxed attitude toward inflation, a number of the Fund's credit arrangements were interrupted in the first half of the 1980s as inflation rates exceeded anticipations and led countries to miss performance criteria for their budget deficit. In situations of inflation, the interest rate paid on domestic-currency debt represents the sum of the real interest rate and a "monetary correction" equal to the percentage of the principal required to maintain its real value. When inflation exceeds expectations, the budget deficit will grow as a percentage of GNP, in line with the increase in the monetary correction (Polak, 1989a, p. 105). Thus, whenever the budget deficit (or any other nominal variable) was treated as a performance criterion, the inflation rate became a performance criterion in effect if not in name.

(4) The problem can be overcome by redefining the budget deficit used as a performance criterion—specifically, by using for this purpose the "operational deficit" (which is affected only by the real interest rate) rather than the "overall deficit" (which is affected by the monetary correction as well). The Fund has adopted this practice in recent years when dealing with high inflation countries.⁹ Nevertheless, inflation can still affect indirectly a country's ability to keep within the terms of its arrangement. If higher-than-expected inflation leads to lower-than-expected real tax revenues (the Olivera-Tanzi effect), a country can still miss a performance criterion defined in terms of the operational deficit.

⁹ In practice, the Fund has tended to use the operational deficit as well as the overall deficit. This can provide a country with an opportunity to ask for a waiver of its nonperformance with regard to the overall deficit on the ground that it was due only to inflation.

(5) Finally, the Fund has tended in the last few years to lay greater stress on price stability, not by making it part of its conditionality, but by being prepared to soften conditionality in other directions. In late 1989, it agreed to support heterodox stabilization programs for Yugoslavia and Poland anchored on a fixed exchange rate. The Fund hoped to bring inflation down sharply while accepting some risks that the currency might become overvalued and the current-account position might be undermined (I return to this question in Section 5 when discussing the exchange-rate instrument).

4 Secondary Objectives of Fund Conditionality

The Fund is an international organization that wields considerable influence, primarily vis-à-vis members seeking its credit, but also through its surveillance of its membership in general. It has tended to use this influence more and more broadly over the years to express an interest well beyond a narrow definition of its purposes. Thus, Article IV consultations have for many years covered the size and nature of countries' contributions to foreign aid, and, for a period after the creation of the Buffer Stock Facility in 1969, the Fund also looked at countries' policies with respect to primary commodities.

The Fund has likewise widened its agenda in the framework of its credit operations, not necessarily as part of conditionality, but to indicate an interest on the part of the organization. We have already noticed how economic growth has gained influence among the objectives that the Fund wants to promote, whether the member shares that view or not.

Poverty Alleviation

There are many strands to the Fund's concern with poverty, and they cannot readily be woven together into a fully coherent picture. The Fund's historic reticence on spending and taxing decisions (see Section 5) brought with it the position that, on poverty as well as other social matters, the Fund respected "the domestic social and political policies of members" (Article IV, Section 3[b]). If pressed on the issue of poverty, the Fund would insist that its central mandate was to help member countries pursue sound macroeconomic and structural policies to maintain or restore sustainable economic growth, which in turn would have important beneficial implications for many of the poor (see, e.g., IMF, 1991b, p. 29). Nevertheless, Fund missions have frequently had to help governments in the difficult task of reconciling two critical objectives: fiscal adjustment and protection of the poor. Thus, by the

1970s, Fund staff was often engaged in the design of policies having an important income-distributional dimension.

It was not until the late 1970s, however, that the Fund began to pay systematic attention to the distributional aspects of stabilization programs. A first paper, which included four case studies, was published in 1980 (Johnson and Salop, 1980). And it was not until 1986 that the then managing director offered a specific Fund contribution to poverty issues: “When requested to do so by a member country,” he stated, a Fund mission would be authorized to consider with that country’s authorities the income distributional implications of alternative adjustment policies. He hastened to add to this modest offer an emphatic warning that decisions on adjustment strategies and spending priorities must rest with the countries themselves (de Larosière, 1986).

The invitation did not produce requests by member countries. Yet the Fund’s officially “neutral” position on poverty issues came increasingly under attack in light of evidence that, in some countries, adjustment programs financed with Fund resources had critically worsened the situation of the poorest groups of the population. One critic pointed out that programs that immiserize the poorest parts of the population fail to achieve the Fund’s purpose of promoting national prosperity (Sachs, 1989a) and that extreme income inequalities may well have contributed to the failure of some Fund programs and thus indirectly to the destructive populist “solutions” adopted in a number of Latin American countries.

In the face of such criticism, the “trickle-down” argument based on the Fund’s central mandate cited above obviously did not suffice, and the Fund has moved in recent years toward an active interest in poverty issues. It has defined this interest in somewhat restrictive terms, namely, “the impact on poverty and income distribution of policy changes supported by Fund financial assistance” (*Annual Report, 1990*, p. 42). In practice, however, the staff does not appear to be restricted to these particular aspects of poverty and has pursued pro-poor objectives in providing fiscal technical assistance. The Fund’s active interest in the establishment of social safety nets in Eastern Europe also transcends specific concern with the way that Fund programs affect the poor.

Even though some adjustment measures, such as higher prices for crops produced by poor farmers, may benefit the poor, other measures such as the abolition of food subsidies or personnel cuts in the government are likely to harm lower-income groups, including the poorest. To alleviate such situations, the Fund has explored two approaches in its discussions with member governments aimed at protecting the poor

during the adjustment process (Mohammed, 1991). First, it has suggested gradualism in the application of measures that have a negative impact on the real incomes of the poor, with the temporary cost covered by increases in taxation (a solution, incidentally, that does not jibe with the Fund's general approach to efficient pricing and does not help the poor in the longer run). Second, the Fund has suggested improvements in the targeting of government expenditures to aim them more directly to the poor. These expenditures include subsidies for vulnerable consumer groups and income-maintenance and retraining schemes for dismissed government workers.

To the extent that the Fund concentrates its attention on the "new poverty" resulting from adjustment programs, it may sidestep the preexisting problems of the ultra-poor. But it may also provide indirect political support for the adjustment program if the "losers" represent an important constituency.

The Fund recognizes that poverty concerns have to be balanced against other claims on fiscal resources, possible production disincentives, and administrative feasibility. Hence the importance of what might be considered a third approach: strong support by the Fund for additional aid from donor governments, nongovernmental organizations, and other international institutions—aid channeled toward the poorest groups of the population that have been hurt by adjustment measures. The most notable example of such action was Ghana's 1988 Program of Actions to Mitigate the Social Costs of Adjustment (PAMSCAD), financed by \$85 million from bilateral and multilateral donors. The lead was taken by UNICEF and the World Bank; the Fund's main function was to certify the government's adjustment effort. Comparable arrangements were made in a number of other cases, including the Bolivian program of 1986-87, which incorporated social-safety-net features funded by the World Bank.

In the same general vein, the managing director, after acknowledging that some developing countries do not share the Fund's concern about income distribution, suggested that countries that take their social responsibilities seriously are more likely to attract international help than those "that waste money on unproductive prestige projects or excessive military display" (Camdessus, 1990a).

This is not the place to enter into the political dimensions of pro-poor measures—both the difficulties of marshalling support for such measures and the need for a government to bring some of the poor (and the not so poor) into coalitions that are broad enough to provide sustained support for adjustment policies (Nelson, 1989). But it is

necessary to clarify the relationship between the Fund's recent antipov-erty concern and its conditionality.

In its efforts to have the staff explore and, if possible, find ways to mitigate the effects of adjustment programs on the poor, the Fund has had to recognize the possible presence of two major roadblocks. First, member governments are often reluctant to accept external pressure on the politically sensitive subject of income distribution. Second, some staff members may be understandably hesitant to move too far away from the Fund's traditional neutrality in fiscal matters by recommending specific expenditures for specific groups. These roadblocks sometimes vanish when the government is badly in need of technical assistance to find within its budget ways of inducing the poor to support an adjust-ment coalition. But other governments' priorities may lie elsewhere.

Faced with a wide variety of member responses, the Fund has approached its activities with respect to poverty as an area of concern, discussion, and (if the member is interested) technical assistance, but it has taken the formal position that "questions of income distribution should not be part of Fund conditionality" (*Annual Report, 1990*, p. 41). This declaration, however, needs to be read in the light of other Fund pronouncements on the poverty issue, such as the statement in the same section of the *Annual Report* that "the need to identify more closely the poor, assess the impact on them of policy reforms, *and improve the policy mix in programs* remains urgent. The Fund . . . is improving *its* design of policies to minimize the adverse effects on the poor" (p. 43, emphasis added). Members negotiating with the Fund will no doubt find it in their interest to make an effort to accommodate the Fund on an issue to which it is so strongly committed. Some recent letters of intent have in fact dealt specifically with poverty issues.

The Environment

In recent years, interest in the quality of the environment has led to an awareness of its linkages with economic activities and to calls for greater attention to environmental issues in the design of public policies. As a consequence, the Fund is being called upon by governments and nongovernmental organizations to recognize possible environmental implications of its policy advice and to encourage member countries to pursue environmentally sound policies. The U.S. Congress has passed legislation calling on the U.S. executive director in the Fund to per- suade the Fund to carry out a systematic review of the impact of its policies on the environment and the sustainable management of natural

resources and to encourage the Fund to eliminate or reduce potentially adverse impacts of Fund programs on the environment.

Pressures of this nature have induced the Fund to explore possible effects of adjustment programs and of members' economic policies in general on the environment. These can, of course, be found, just as one can trace various links between economic policies and public health. Devaluation promotes exports, including in some countries exports of logs whose cutting may cause environmental degradation; it can make imports more expensive and thus curtail the environmentally harmful effects of the excessive use of petroleum products and fertilizers. The Fund's general stance against subsidies on energy, irrigation water, fertilizers, and pesticides will help generally to conserve natural resources. But the Fund's concern about budgetary balance may lead it to recommend cuts in expenditures, which may hit expenditures on environmental protection as well as on other deserving policy objectives. The introduction of pollution taxes may improve the fiscal situation, but environmental subsidies may have the opposite effect.

These examples suggest that environmental questions can be more effectively addressed directly, by experts from the World Bank or the United Nations Environmental Program, than as the side effects of Fund programs. Increased awareness by the Fund staff will enable it to pay attention to environmental issues in Article IV consultations and in policy dialogues leading to the use of the Fund's resources and perhaps to suggest in some instances complementary policies that would lead to better environmental outcomes. But does this mean more than that the Fund should design its hiring practices and its in-house education with the aim of sending on its missions the most generally competent individuals possible? How should knowledge of environmental questions be compared with knowledge of a country's history, culture, and politics, or of development economics, education, and the latest trends in world agriculture?

The objectives of the U.S. legislation mentioned above and of a number of nongovernmental organizations would go beyond this benevolent but modest concern with environmental matters. To meet their specific objectives, the Fund would have to incorporate environmental aims into its conditionality. The Fund's official line on this issue echoes its position on the problem of poverty. It denies that the development of modest modalities for dealing with environmental issues (the hiring of a few economists specializing in those issues) would amount to the adoption of environmental conditionality. This is no doubt the case in a formal sense. But the answer may not be so clear-cut in

practice. Take one of the examples noted above. A country seeks an increase in exports of timber to correct a large trade deficit and proposes a sharp devaluation to achieve it. The Fund staff is alerted to possible environmental effects of greatly increased logging activity. The Fund cannot object to the devaluation unless it sees reason to question it under the Articles (perhaps because the new exchange rate gives the country an “unfair competitive advantage”). If it feels strongly about the environmental aspect, however, it might show itself less than forthcoming with a credit arrangement unless the member undertakes to adopt adequate environmental safeguards.

Containment of Military Expenditures

The Fund and the Bank are not on record as stipulating moderation in military expenditures as a condition for access to their resources. In the last few years, however, speeches by the top officials of the two institutions indicate increasing concern about this issue. They have begun to address the diversion of resources from development to military purposes *by developing countries* in contrast to earlier rhetoric castigating *world* arms spending, which pointed the finger mainly at the superpowers.

The concern of both institutions with the issue of military expenditures is evident also from the increasing attention that the issue is receiving from their staffs. In December 1990, the joint Fund-Bank journal *Finance & Development* carried an (unsigned) article “Are LDCs Spending too Much on Defense?,” containing alarming statistics. In contrast to the situation in 1960, military expenditures as a percentage of GDP are now almost as high in developing as in developed countries, having risen in the developing countries and fallen in the developed countries; Arms imports (in volume) exhibit a clear lagged correlation to economic aid received.

The Fund staff has been examining data on military expenditures since at least the summer of 1987, and a first result of these studies appeared in 1989 (De Masi and Lorie, 1989). It focuses on the elasticity of military expenditures (somewhat confusingly called “resilience” in the paper) to a country’s fiscal stance. Because of the long lead time of such expenditures, their ratio to total government expenditure tends to rise in situations of fiscal tightening associated with Fund programs and to fall when fiscal policy is more expansionary.

It seems likely that both institutions will overcome their historic hesitancy to broach the subject of military expenditures in the context of negotiations on the use of their resources. In at least one recent negotiation, the Fund has sought and received assurances about a

member's intentions with respect to military expenditures. In a few other cases, it has exercised pressure to reduce military expenditures as part of a program of fiscal adjustment. Action of this nature by Fund missions does not show up in letters of intent and thus does not form part of the Fund's formal conditionality. But the Fund and the Bank can be expected to use their financial clout to steer government finance in client countries from military toward development outlays.

Political Considerations

The Fund is, to a high degree, a technocratic organization. In the great majority of cases, approval of a credit arrangement depends on a judgment by staff and management that a member's adjustment program measures up to the requirements dictated by its current difficulties and its prospects in the world economy.

This characterization of the Fund's decisionmaking process does not imply that the process is wholly objective or rational. Judgments by the staff reflect interactions among many—not necessarily infallible—economists, in different departments and with different backgrounds. Their views about the current position, intentions, and outlook for a particular country are influenced to a considerable extent by discussions with the country's representatives. Staff members are subject to persuasion and engage in give and take, also called "negotiation," on aspects of a program. With respect to the amount of an arrangement, there are established limits related to members' quotas ("which may be exceeded in exceptional cases"), as well as a variety of indicators (magnitude of need, quality of program, past performance, capacity to repay the Fund) that give guidance on how closely to approach those limits in a particular case. The vagueness of the guidelines on access also leaves room for rewarding "good behavior" in economic policy by the country with which the staff is seeking to reach agreement.¹⁰

Clear cases of political decisionmaking occur when decisions on access or potential access are not supported by a staff judgment on the adequacy of a country's program. The deviation may be in either direction. Some countries may be barred from access for political

¹⁰ It would follow from this characterization of the Fund's decisionmaking process that I cannot follow Stiles (1990) in his attempt to distinguish separate modes of "functionalism" and "neofunctionalism." The former would be based on objective rationality; the latter would recognize that decisions are the outcome of the interaction of human beings. I do recognize the importance of Stiles's third mode, in which decisions are dominated by political considerations.

reasons even if they have technically adequate programs. Some other countries may be granted access for political reasons, despite a staff judgment that their programs do not meet minimum standards.

The list of countries denied access on political grounds is very short, and each case would be difficult to document. It seems to me beyond question, however, that, from the mid-1980s, South Africa was unable to use the Fund as long as it maintained apartheid and that China would have been unable to draw during the first year after Tiananmen Square. An arrangement with Vietnam that would have been technically possible has likewise been blocked by political considerations (even though it would have provided a link in the process of removing Vietnam from the list of countries with arrears to the Fund). But disregard for human rights has not in general constituted a bar to access to the Fund, as is evident from the Fund's active financial relations with repressive regimes in countries such as Chile, Zaire, Uganda, Liberia, or Romania.

The question of human rights has been raised most explicitly in connection with the Fund's relations with South Africa. Ever since 1965 the UN General Assembly has each year adopted a resolution requesting the specialized agencies "to withhold from the apartheid regime of South Africa any form of collaboration or assistance in the financial, economic and technical fields." And, when the Fund was considering a transaction with South Africa in 1982, the secretary general of the United Nations called on the managing director in an attempt to prevent it. On that and other occasions, however, the Fund rebuffed pressures from the United Nations, maintaining that South Africa, as a Fund member, was entitled to draw from the Fund if it met the Fund's criteria. The Fund concluded the arrangement with South Africa in 1982, but the situation changed with the widespread adoption of sanctions against South Africa, which, in fact, barred the country from access to the Fund's resources. A major element in this development was legislation adopted in the United States instructing the U.S. executive director in the Fund "to actively oppose any facility involving use of Fund credit by any country which practices apartheid." The ostensible reason was economic, that is, "that the practice of apartheid results in severe constraints on labor and capital mobility and other highly inefficient labor and capital supply rigidities which contribute to balance of payments deficits in direct contradiction of the goals of the International Monetary Fund" (the 1983 "Gramm Amendment" to the Bretton Woods Agreement Act, Section 43(b)). But if apartheid caused persistent balance-of-payments deficits, the Fund's standard

conditionality would have sufficed to bar South Africa from access. Therefore, the aim of the U.S. legislation must be seen as adding a political component to conditionality.¹¹

The proprieties of the Fund contain an unwritten rule that political arguments should be dressed up in economic garb whenever possible. The wording of the U.S. legislation conforms to this rule, which avoids at least the appearance of violating the Fund's Articles. But the practice is sometimes carried to extremes. In 1983, an executive director from an Arab constituency not previously known for its keen interest in Central American economies surprised the executive board by questioning the routine approval of a minor waiver requested by Costa Rica. After much sleuthing, the cause of the director's sudden interest was discovered. Costa Rica had had the temerity to move its embassy in Israel from Tel Aviv to Jerusalem.

The Fund's method of handling a country's request for credit tends to discourage political pressure to grant such credit. The request is considered in detail by a mission to the country. If the mission is not satisfied that the program meets the Fund's standards, it leaves without an agreement. The country may try to reopen the negotiations at IMF headquarters and put its case directly to the Fund management. But this approach will rarely succeed unless the country has brought its program into the range of what is technically acceptable. Once the managing director accepts a program, he puts it before the executive board, and the board will then approve it in all but the most unusual case. It will do so even if it considers the program to be inadequate, but it will then advise management not to propose a comparable program again. A member cannot bypass both staff and management and put its program to the executive board, directly or through its executive director. Argentina tried in 1984 and was promptly rebuffed.

These procedures are not foolproof. Important members can urge staff and management to bend their judgments and accept a program as being "just good enough," perhaps after long negotiations in which the country has moved a considerable distance in the right direction. There have been several cases during the last decade in which, at one stage or another, the Fund gave in to political pressure by major members against the staff's better judgment: Sudan, Zaire, Egypt,

¹¹ The same U.S. legislation uses similar language to bar U.S. support for drawings by "Communist dictatorships," but there is no evidence that this provision has had any operational effect. Yugoslavia, for example, received new stand-by arrangements in 1984, 1985, and 1987.

Argentina (Stiles, 1990; Finch, 1988). But political decisionmaking is the exception, not the rule. After studying a sample of seven countries, all politically sensitive, Stiles is surprised to find “the degree to which military/strategic concerns are of secondary importance to many industrialized nations when dealing with strategic allies that are economically unstable” (p. 972).

The case of the stand-by arrangement for Egypt in 1987 has perhaps received the most attention (Finch, 1988). It deserves closer inspection because it brings out, surprisingly, the strength of Fund procedures to withstand political pressure. Egypt had received an EFF arrangement of SDR 600 million in 1978. It drew SDR 75 million at once, but, because of policy failures, it did not draw the balance before the arrangement expired in 1981. Many discussions about a new arrangement followed while Egypt gradually repaid the Fund. It took until 1987, by which time Egypt’s debt to the Fund had been reduced to SDR 19 million, before the Fund agreed to a one-year arrangement, this time for SDR 250 million.¹² Egypt drew SDR 116 million at once, after which it failed again to meet the agreed upon policy conditions, and the balance was never drawn. New rounds of discussion with Egypt started, and they were concluded in May 1991 with an eighteen-month stand-by arrangement for SDR 278 million, based on a wide range of satisfactory policy understandings. Thus, in the thirteen years from 1978 until this third agreement was reached, and despite strong political support from all the major powers, Egypt was able to draw less than SDR 200 million gross and less than SDR 75 million net—a little over 10 percent of Egypt’s quota.

5 Policy Instruments

The Monetary Approach to the Balance of Payments

The general approach that the Fund staff has traditionally used to design economic stabilization programs is known as “financial programming.” Because it is comprehensive in scope and eclectic in nature, it has not been subject to abrupt fundamental changes. Nevertheless, it has shown continuous incremental growth and adjustment. It started

¹² To underline his doubt about the propriety of the arrangement and about Egypt’s ability to regain creditworthiness unless it adopted more adequate policies, the managing director held out for and received an unprecedented guarantee of Egypt’s new debt to the Fund from the members of the Paris Club.

from the simplest monetary models in the 1950s but absorbed new data on the national accounts, new developments in economics, new country problems, new policy instruments, and new concerns about countries' economic objectives. A recent detailed description of the approach is available in IMF Occasional Paper 55 (1987); only a few highlights need to be recorded here.¹³

The approach takes as its starting point the consolidated balance sheet of the banking system. On the asset side, that balance sheet shows the net monetary balances of the three other sectors—credit to the private sector, net credit to the government, and the net increase in foreign assets. On the liability side, it shows the stock of broad money. Fanning out from this definitional equation, net domestic credit creation (one element in the supply of money) is construed as a policy variable, and the model adds behavioral equations relating to the demand for money and to the balance of payments. Depending on the degree of refinement wanted and permitted by the available data, the variables used in these behavioral equations can be explained in turn by further equations on output, price formation, the exchange rate (if this is an endogenous variable), and so on.

In most cases, there tend to be severe practical limits to this formal process. When a country undertakes a major program of structural adjustment, including sharp changes in variables that affect the supply side of the economy, such as the real exchange rate and producer prices, the analyst in the mission will not be able to call up on his computer a ready-made country model with all the relevant supply equations. He will have to fall back on a careful *ad hoc* analysis of the factors determining supply and growth and employ an iterative process that takes account of these factors and of the financial variables (Robichek, 1985).

An operationally usable model of an economy can of course be derived by starting from any of the main macroeconomic equations. The Fund has had two important reasons to develop its model from the monetary angle. First, it has found it essential to stress the monetary character of balance-of-payments problems, a point frequently ignored, at least in the past, in many member countries. Unless the monetary cause of payments problems is addressed explicitly, the problems will persist. Second, monetary data are still the most accurate and the most promptly available, and they thus play a crucial role as performance criteria to test whether countries adhere to the conditions of Fund arrangements.

¹³ For a short description of the way in which Fund missions actually apply the approach, see Goreux (1989, pp. 142-146).

The staff has found it necessary to reconsider one basic assumption traditionally used in financial programming. As Fund programs are designed for countries with balance-of-payments problems, the Fund's primary concern in setting monetary ceilings traditionally has been to protect the balance of payments from excessive money creation. This objective is served by a ceiling on domestic credit creation, not on the money supply or the monetary base (Guitian, 1973).¹⁴ The experience of some countries in recent years, however, suggests that this is not the optimal monetary policy in all circumstances. In Yugoslavia in 1985 and Mexico in 1987, the balance of payments developed far more favorably than had been expected. When this happens, adherence to the credit target leads to an excessive increase in the money supply and a higher inflation rate than had been expected. To prevent these results and yet safeguard the economy against the risk of a persistent balance-of-payments deficit, it would have been necessary to qualify the initial credit ceiling by provisions that would lower it when there was evidence of excessive money creation—a provision that was incorporated in Venezuela's EFF program in 1989. In the Philippines, a traditionally low-inflation country, the primary objective of the authorities in adopting the 1984 adjustment program was to contain or reduce inflation, even at some cost to the reserves. Accordingly, the Fund, after much soul searching, agreed to a program containing a ceiling on the monetary base, as well as a floating exchange rate. In this case, too, a strong performance of the balance of payments led to a change in policy, including an upward revision of the monetary targets, as the appreciation of the real exchange rate raised concern about the future viability of the balance of payments.

The next two subsections consider two major policy instruments, the exchange rate and fiscal policy. But, before dealing with these two instruments separately, attention should be directed to a change for the worse in their interactive impact on the stabilization process. As long as the Fund was dealing with countries that were not heavily indebted abroad, it could probably assume that currency depreciation would by

¹⁴ The author once had an opportunity to explain this elementary truth of monetary analysis during the Fund's annual consultations with a European country suffering frequent balance-of-payments difficulties. In the final session, the minister of finance observed that monetary policy could not be the origin of its payments problems; he recounted with some pride that the growth of the money supply had been kept to 10 percent per year. "Yes indeed," was the Fund staff's answer, "whenever money leaked out through the balance of payments, it was promptly replaced through new credit creation so that it could leak out again."

itself improve the fiscal imbalance in most cases (Polak, [1948] 1991); in a developing country, the proportion of taxes levied on trade (put at one-third or more in Tanzi, 1990) would, if *ad valorem*, typically increase with the domestic currency value of trade and be well in excess of the proportion of government expenditures directed toward imported commodities. But, when, by the 1990s, interest payments on foreign debt had in many countries grown to a substantial percentage of GDP, it seems likely that the relationship was reversed, so that the real depreciation necessary to improve the current account of the balance of payments would in itself enlarge the budget deficit (Reisen, 1989).

The Exchange-Rate Instrument

In the last two decades, the Fund has been putting increased emphasis on exchange-rate action as an instrument of adjustment. In part, this reflected a change in philosophy; the attachment to a fixed exchange rate dating from the par value regime was gradually giving way to belief in the perceived benefits of exchange-rate flexibility. But it also reflected a change in circumstances. In the 1950s and 1960s, most stand-by arrangements were granted in support of programs that dealt with moderate balance-of-payments problems not compounded by serious structural distortions (Johnson, 1985). The greater distortions of the 1970s and the even more serious disequilibria of the 1980s made exchange-rate action increasingly unavoidable.

The change in emphasis is borne out by the proportion of programs (for countries that did not belong to currency unions) that included exchange-rate action: 32 percent in the years 1963 to 1972; 59 percent from 1973 to 1980; 82 percent from 1981 to 1983; and nearly 100 percent in more recent years. In addition to an initial exchange-rate action, most programs in the 1980s also called for adjustments during the program period, to sustain the real depreciation achieved initially or “prevent a loss of competitiveness.” Indeed, 18 of the 25 arrangements concluded in 1983 that began with exchange-rate actions contained follow-up provisions of this general nature (Johnson, 1985).

A further Fund shift toward exchange-rate flexibility occurred in the mid-1980s. Until then, it had been taken as axiomatic that a developing country could not allow the value of its currency to be determined freely in the market (Polak, 1988, p. 139),¹⁵ and that view was still reflected to some extent in the work of a staff team headed by G. G. Johnson (1985, p. 4). In recent years, however, a substantial number of

¹⁵ For many years, Peru and Lebanon were the rare exceptions to the general rule.

developing countries have adopted truly floating rates in the context of Fund arrangements. Quirk et al. (1987) report thirteen such cases between September 1983 and the end of 1986, and, by the end of 1990, about twenty developing countries had floating exchange rates. Typically, these countries (including a number of very small ones) adopted floating rates from positions of extreme weakness, with severe payments difficulties, external-payments arrears, and black markets in foreign exchange. The adoption of a free float gave the authorities an opportunity to liberalize exchange and other restrictions and “to shed political responsibility for the adjustment of the exchange rate” (Quirk, p. 4). The experience of these countries would seem to show that free floating is a viable option in cases where exchange-rate policy has become virtually unmanageable by other means, though it seems excessive to characterize that experience as “a significant step forward in the evolution toward exchange rate flexibility” in developing countries (Quirk, p. 1).

The last few years have indeed seen a reversal of the staff’s unqualified fealty to “flexibility” and a return to the themes of the exchange-rate debate of twenty years ago, pitting discipline against flexibility. Criticism of the staff for favoring depreciation as the stock answer to any payments problem has come from both outside and inside the organization.

Jeffrey Sachs (1989b, p. 113) has criticized attempts to reduce the real exchange rate drastically in order to maximize the outward transfer of resources. He notes that these attempts are often unsuccessful and are likely to undermine the credibility of a government’s anti-inflation policy. Within the Fund, the merits of a real-exchange-rate rule were questioned even earlier by Adams and Gros (1986). Put in its simplest form, their argument runs as follows. Suppose that a government uses depreciation to raise the domestic price of tradeables for the purpose of improving the current account from an initial level compatible with domestic equilibrium. The prices of nontradeables will soon catch up as improvement in the balance of payments provides the necessary addition to the money supply, and the strategy will institutionalize inflation even in the absence of any domestic inflationary gap. (The particular case underlying the Adams-Gros model was that of Yugoslavia, where the authorities attempted for a number of years after 1983 to create a target spread between the prices of tradeables and non-tradeables. The inflationary response was particularly rapid because the exchange rate was linked to a price index of “nontradeables” which, for want of anything better, consisted to a large extent of tradeables.)

Another cause of the rising antagonism in the Fund to a real-exchange rule was the success of the exchange-rate mechanism in the European Monetary System (EMS) during the second half of the 1980s. Realignments had occurred frequently in the early years of the EMS, almost as soon as differential rates of inflation had brought about any substantial change in real exchange rates, and academic observers were sometimes tempted to view the EMS as a crawling-peg mechanism. Recent experience, however, has demonstrated the error in that view. The essence of the EMS mechanism is that an inflation rate higher than the German rate is *not* automatically compensated by realignment. Realignments are delayed to make inflation painful and are conditioned on policy adjustments in the inflating countries to produce better performance in the future. The EMS has thus functioned as a disciplinary device in much the same way that the Bretton Woods System functioned in the 1950s and 1960s.

As the anti-inflationary success of the EMS mechanism became firmly established, with no general realignment since 1983, some members of the Fund's executive board, especially those from European countries, became increasingly wary of using a "flexible exchange rate policy" as the standard remedy for all external imbalances. Still, few of the countries that need the support of the Fund have achieved the degree of price stability that permits, say, France or Belgium, to accept the discipline of a fixed rate in the EMS.

As the Fund is, in some sense, resuming the debate of twenty years ago on the relative weights to be attributed to "discipline" and "adjustment" in setting exchange-rate policy (IMF, 1970), it has been willing to tolerate a greater variety of exchange-rate regimes in arrangements with countries in Eastern Europe. The arrangements concluded with Yugoslavia and Poland in early 1990 were both based on a fixed exchange rate, intended to serve as an anchor for price stability (which neither country managed to achieve during that year). Its arrangement with Czechoslovakia in January 1991 was also based on a fixed exchange rate as an anchor for price stability. In Hungary, Bulgaria, and Romania, by contrast, where larger price adjustments are required and the actual or potential reserve cushion is less adequate, more exchange-rate flexibility has been adopted in understandings with the Fund. The Hungarian arrangement can perhaps be described as a fixed but quite likely adjustable rate; the Bulgarian, as close to a pure float; and the Romanian, as a dual exchange market.

The Fiscal Instrument

In no area of economic policy has the Fund's de facto conditionality changed as radically as it has with respect to fiscal policy.

Traditionally, the Fund had prided itself on being neutral about the specifics of fiscal policy. Its interest was said to be limited to correction of the fiscal deficit or, more narrowly, to the domestic credit extended to the government. How the government brought down the deficit, by raising taxes or cutting expenditure, and the particular taxes and categories of expenditure at issue, were and should remain the government's responsibility. This approach "kept the Fund from entering into areas that require[d] judgment of social and political priorities . . . to keep its distance from specific decisions required for policy implementation" (Guitian, 1987, p. 88). If the country wanted advice on fiscal matters, it could ask for technical assistance, but there was no link between such advice and the conditions for use of the Fund's resources. By 1987, however, the Fund had already moved a considerable distance from political neutrality. The traditional practice had proved to be ineffective and indeed counterproductive for a number of reasons (Tanzi, 1987):

(1) Cutting bank credit to the government does not automatically reduce the budget deficit. Any government keen on avoiding effective constraints can find ways around macroeconomic ceilings, as by borrowing abroad or running up domestic arrears. Additional performance clauses may be needed to plug up loopholes. Alternatively, the deficit can be financed by borrowing in the domestic capital market (perhaps forcibly, by changing the rules for institutional investors), thus crowding out private investment.

(2) Reliance on macroeconomic ceilings may induce countries to adopt fiscal remedies that are easy but not durable. Taxes may be advanced, expenditures postponed, temporary taxes introduced, or public employees' real wages slashed to unsustainable levels for the duration of the program.

(3) Most important, fiscal measures that may be equivalent in their direct financial impact on the budget deficit can have widely different effects on the growth of the economy and thus have different effects on the fiscal situation in the medium term. Given the Fund's interest in growth, both as an objective in itself and as a determinant of countries'

willingness to persevere in adjustment, the Fund has gradually moved toward more interest in the specifics of fiscal adjustment.¹⁶

The Fund has used technical assistance for this purpose, because it has learned from experience that a country's commitment to cut its deficit by a given amount is not credible unless the country specifies *how* it will do this. Durable and effective fiscal measures may well involve major structural changes, such as the introduction of a value-added tax or of a new system of computerized expenditure control. Therefore, the Fund is anxious to provide needed expertise through technical assistance, and its help can have a major impact on fiscal conditionality.

First, fiscal restructuring takes time, and the timing and character of Fund programs may thus become a function of the progress in implementing fiscal technical assistance. Hence, the Fund may agree to a modest one-year stand-by arrangement complemented by a tightly programmed technical-assistance effort in anticipation of a far more ambitious, structurally oriented EFF. The long gestation period of fiscal reforms will thus tend to produce a more lasting Fund involvement with the country.

Second, the close integration of fiscal assistance with the elaboration of Fund arrangements unobtrusively introduces microconditionality. As part of a letter of intent (or as prior action), a government may engage itself to introduce broadly specified structural changes in the fiscal field, it being understood that these are exactly the changes worked out over the past months between a technical-assistance mission and the country's officials. A confidential document supporting the letter of intent will spell out the agreed upon details with respect to changes in taxes, public expenditure, administration, and so on. In a formal sense, conditionality guideline 9, (discussed in Section 7 below), which confines conditionality to macroeconomic variables, has been observed; in fact, however, the member and the Fund have bypassed it. Although Tanzi (1987, p. 137) suggests that this guideline may have to be amended, the more likely outcome is that it will increasingly be ignored.

¹⁶ Tanzi (1987, p. 132) mentions a further advantage to the member of designing fiscal adjustment in a manner that raises productive capacity, namely, a trade-off between the quality and the quantity of fiscal adjustment. With an increase in supply, less reduction in demand is necessary to achieve balance. But it should be noted that this trade-off is subject to a major qualification: it is not one-for-one, because the moderation that becomes possible in the necessary reduction of demand is only $s/(1 - s)$ \times the increase in supply, where s is the marginal propensity to save.

The increasing depth with which the Fund has been involved in countries' fiscal positions has also expanded the scope of the Fund's fiscal activities well beyond the impact of fiscal measures on aggregate demand. Other dimensions of fiscal concern have included the quality of the country's administrative infrastructure, efficiency, and equity. The Fund's concern with poverty emerges directly as a concern about equity in the fiscal field. Its nascent concern about high military budgets can appropriately emerge as a concern about fiscal inefficiency; military spending beyond a certain level can plausibly be castigated as 100 percent waste.

6 Do Fund-Supported Programs Work?

How to Measure the Effects of Fund Programs

Most of the earlier studies on the effect of conditionality, or the effectiveness of Fund programs, use one of two techniques, neither of which is satisfactory (Goldstein, 1986; Edwards, 1989). One group of studies seeks to measure results by comparing relevant variables (the current account, growth, inflation) before and after adoption of a Fund program; the findings are biased because this approach attributes the (positive or negative) impact of extraneous factors to the program. The other group of studies compares the average change in the target variables for a group of program countries with corresponding averages for a control group of countries without Fund programs. This too yields biased results, because control countries differ systematically from program countries; their problems tend to be less severe (otherwise they would have become program countries), and they show less improvement because they are not as urgently in need of it (Goldstein and Montiel, 1986). Comparisons with control groups also miss any extra effect that a given policy instrument may have as part of a Fund program, in particular, the dimension of confidence.

More refined statistical methods can be used to overcome these biases, but their success so far in finding statistically significant results remains less than impressive. There may, indeed, be no significant differences between program countries and nonprogram countries, if only for the reason that some programs have not been effectively implemented. But there is one piece of solid evidence: the balance of payments and current account of countries with Fund programs improved. The effect of programs on inflation is uncertain, however, which is hardly surprising, given the wide range of inflation outcomes, especially in the 1980s. Furthermore, very similar and nearly contem-

poraneous Fund and Bank studies come to clear, reportedly significant but opposite, results concerning the effects on growth.

Khan (1990, p. 215) finds that, for the period 1973-88, “the growth rate is significantly reduced in program countries relative to the change in nonprogram countries.” Using the lower of the two coefficients found by Khan, the predicted reduction in the growth rate would average 0.7 percent of GDP for any year in which a country had a program with the Fund. Thus, a country that had, say, six annual programs since 1980 would by 1988 have a level of GDP that was some 4 percent lower ($6 \text{ years} \times 0.7 \text{ percent per program year}$) than if the country had done without the Fund programs. Doubts are raised about Khan’s finding, however, by the fact that it is not confirmed when the subperiods 1973-79 and 1980-88 are considered separately; the impact of the program variable is found to be much smaller and not significant for each subperiod. If there is no clear evidence of a relationship for the 1970s or for the very different 1980s, can one put much credence in a relationship, even a “significant” relationship, produced by combining the two decades?

Corbo (1990, p. 18) compares growth rates in 1985-88 with those in 1981-84 for countries with World Bank structural adjustment programs. After controlling for external shocks, initial conditions, levels of external financing, and policies followed in the preprogram period, he finds that “adjustment programs are estimated to have boosted the rate of GDP growth by close to 2 percentage points.” Thus, he finds that the 1988 GNP level of a country with a World Bank structural adjustment program was on average 8 percent higher ($4 \text{ years} \times 2 \text{ percent per program year}$) than if it had adjusted without the Bank program.

The bewildering impression created by these two findings (neither of which strikes me as particularly convincing) is not diminished by two further observations: (1) The macroeconomic content of World Bank structural adjustment programs does not differ significantly from that of Fund programs, (2) Eighteen of the twenty-five countries in the Bank sample also had Fund programs (ten of them in six or more years).¹⁷

Future research may be more successful in isolating the effects of Fund and Bank programs, as distinguished from the particular policies

¹⁷ One possible element in a reconciliation of the two studies might be the following: the Bank study compares two groups of countries (25 with programs and 53 without), but the Fund study compares *country years* (315 with programs and 85 without), and the sample includes only those 79 countries that had at least one program during the sixteen-year period covered.

that constitute these programs. Or it might be better to leave the general question unanswered and to concentrate instead on analyzing the effects of Fund-type *policies*, perhaps combined with an in-depth analysis of the effects on groups of countries (an example of the latter type of analysis, on the growth of countries with SAF programs, was mentioned in Section 3).

There is only a limited amount of information available for comparing the execution of recent Fund programs with those in the past. Table 2 seems to suggest that countries with upper credit tranche programs in the mid-1980s and countries with SAF/ESAF programs toward the end of the decade performed less well in adhering to Fund programs than was the case in the preceding decade. This finding would not be a reason for surprise in light of the much more difficult external circumstances prevailing in the recent period and, in particular, the greater frequency of unexpected negative shocks.

Beyond seeing how well countries implemented their undertakings with respect to policy instruments, one can also examine the extent to which they achieved their objectives in terms of various target variables.

TABLE 2
IMPLEMENTATION OF FINANCIAL CONDITIONS
OF FUND ARRANGEMENTS, 1969-1989
(percentage of countries observing ceilings)

Period	(i) 1969-78	(ii) 1983	(iii) 1988-89
Sample	105 Stand-By Arrangements	34 Stand-By and EFF Arrangements	22 Arrangements 17 SAF 5 ESAF
Credit Ceiling	55	44	40 (60)
Fiscal Performance	62	36	40 (60)

SOURCES: for column (i), Beveridge and Kelly (1980, table 2, last column [54 out of 99], and table 3, line c); for columns (ii) and (iii), International Monetary Fund.

NOTE: This table expands on a comparison suggested in Edwards (1989). For the arrangements under (i), data on the observance of credit ceilings have been added, and the figure on fiscal performance has been corrected (Edwards gives 48 percent, which, in the source, is the performance on expenditure limits instead of the performance on the overall deficit). The figures in column (ii) have been recalculated from the material apparently used by Edwards in his table 4; they refer to the total number of annual below-ceiling performances for the three years 1983 through 1985 combined. Entries in column (iii) refer to "monetary and fiscal benchmarks/performance criteria"; the entry for ESAF arrangements is put in parentheses because of the small number of observations.

The two measurements of performance are not closely correlated; in a sample of 149 programs covering 1983 to 1987, only 63 countries observed the performance criteria, and only 60 percent of those met their external targets; yet 40 percent of the countries that missed the performance criteria nevertheless met their external targets.

Table 3 presents data on preprogram performance, program targets, and program results for 44 annual stand-by and EFF programs from 1985 to 1988, the most recent period for which such data are available. The average annual growth rate under the programs was 2.5 percent, about equal to the average program target, but considerably lower than the average growth rate for the 22 low-income countries that had SAF and/or ESAF programs in the latter part of the 1980s. Those countries averaged about 4 percent growth, compared with about 2 percent in the three-year periods preceding the programs. All these data should be interpreted with caution. Performance that is better during a program than before it cannot simply be attributed to the program; too many other factors may have played a role. Alert to the pitfalls of such comparisons, the staff focuses much of its attention on comparisons between results and targets. Some of these are also shown in Table 3. The main finding is that slightly over half the countries met or exceeded their targets and that the average "excess" performance was small for the current account and for growth, presumably well within the margin of error for averages of this sort. For inflation, the average performance was 12 percentage points worse than target; not surprisingly, the 21 deviations on the upside were larger on average than the 23 deviations on the downside.

TABLE 3
PROGRAM OBJECTIVES AND RESULTS,
FORTY-FOUR ANNUAL PROGRAM YEARS, 1985-1988

	Economic Growth	Inflation	Current Account
	(Percentage of GDP)		
Preprogram year	1.2	43	-5.8
Program target	2.3	27	-4.6
Outturn	2.5	39	-4.4
Outturn vs. target	(Number of Programs)		
Equal or better	24	23	25
Worse	20	21	19

SOURCE: International Monetary Fund.

What is the significance of these comparisons? It is important to understand that “targets” represent not so much an expression of countries’ desires, as informed staff guesses about what is likely to happen. In fact, the staff uses the three terms “targets,” “forecasts,” and “projections” mostly without distinction. Accordingly, comparisons between targets and outcomes cannot be used to gauge the quality of the program; they gauge the quality of the forecasting exercise done at the time the program was agreed upon. Read in this way, outcomes of approximately 50 percent above and below target deserve commendation—for unbiased forecasting.

Compared to a similar exercise done a few years ago for the period 1983-85 (reported in Edwards, 1989, pp. 30-32), recent staff forecasting appears to have been more accurate with respect to growth and inflation. This may mean that it has improved, or that exogenous factors have behaved less erratically, or that the staff is less prone to an earlier tendency signalled by Guitian (1981, p. 38), to announce optimistic targets in the hope of influencing the results.

It is important to note in this connection that overly optimistic assumptions about inflation may have a contractionary impact on the outcome of a program, because credit targets may be set too low. The fact that inflation “targets” underestimated outcomes in about 60 percent of the cases in the 1983-85 sample caused Bacha (1987) to conclude that Fund programs engaged in “overkill of domestic demand.” Yet the same programs overestimated the growth in the demand for money with about equal frequency. Even when the inflation rate and the growth rate are both forecast without bias, as in the 1985-88 programs, there may be individual cases in which higher-than-projected inflation would lead to undue tightness in the money supply if the credit ceilings were observed. But that may have been a rare occurrence; of the 21 countries in Table 3 that overshot their inflation targets, 11 also missed their credit targets, and of the 17 countries that met both their fiscal and credit targets, 13 also met their growth targets.

In any event, a judgment about the success of Fund programs can hardly be based on comparisons between outcomes and projections that may be faulty. The actual outcomes by themselves may be more relevant. In this context, the greatest interest attaches to the growth rate; balance-of-payments adjustment *had* to occur as reserves ran out, and inflation performance differed enormously among countries, being generally much better in Africa and Asia than in Latin America. Given the difficulty—perhaps the impossibility—of finding a statistical con-

nection between programs and growth, some more qualitative thoughts on the subject may be in order.

From Stabilization to Growth?

Adjustment measures are agreed upon between a country's government and the Fund. Even when they are implemented by the government, however, their ultimate effects are brought about by the responses of the private sector. What is the link between government action and private-sector response?

With or without the help of a stabilization program supported by the Fund, a country may take all the right measures: cut the budget deficit, constrain credit, adopt a realistic exchange rate, liberalize imports, deregulate domestic financial markets. Sustained adherence to a comprehensive set of measures is likely to ensure success in terms of stabilization. Inflation will come down to a low level, and the exchange rate will be reasonably stable even if it is not pegged. Interest rates will decline, though not necessarily quickly or all the way to levels prevailing in international capital markets.

But will there also be a payoff in the real sphere? Will stabilization be accompanied by—or at least soon followed by—a healthy resumption of growth? From a broad policy point of view, this is the most important test of the effects of the Fund's conditionality.¹⁸

The Fund has been aware for decades that stabilization was not a sufficient condition for the resumption of growth (Jacobsson, 1961, pp. 30-31). But when stabilization is explicitly "growth-oriented" (the Fund's and the Bank's currently favored adjective), will it indeed be growth producing? Growth orientation includes such ingredients as an exchange rate, producer prices, and trade liberalization aimed at stimulating the production of tradeables; tax rates that encourage risk-taking; and expenditure pruning not only to give confidence to entrepreneurs that the government's finances are being brought under control but also to safeguard urgently needed outlays for the maintenance and expansion of the country's infrastructure, for worker training and basic education, and for salaries high enough to maintain a motivated civil service. But are these and other measures in the same spirit sufficient to set the private sector on the road toward economic expansion?

¹⁸ Of less importance is some episodic evidence of instances in which countries did all, or almost all, the wrong things, but the private economy remained on a healthy growth path. Brazil in the 1980s could perhaps be cited as a case in point, although one should note one helpful factor; most of the time, the Brazilian government kept its commitment to avoid overvaluation of the country's currency.

In a recent paper, Dornbusch (1990) has presented a theoretical construct to support the proposition that, “even with major adjustment efforts in place, countries do not fall back on their feet running; they fall into a hole.” He argues that countries that land in a low-investment, low-output situation tend to remain stuck there, unable to move to another equilibrium situation with higher investment and growth. Once stuck, they require an external push of resources and confidence—mostly the latter, he implies—to shock them into a more satisfactory, higher orbit.

More specifically, Dornbusch’s proposition is that, “in the aftermath of [a] major macroeconomic shock, there may simply be no equilibrium that is politically safe and economically rewarding on a scale that induces the return of growth as the response of competitive markets” (Dornbusch, 1990, p. 24). Whether or not this is the case is ultimately an empirical question on which Dornbusch presents some material, but not enough to convince me that his construct represents the typical case.¹⁹ The data that Dornbusch presents for a number of Central European countries in the early 1920s show that those countries snapped back rather quickly from their stabilization crisis. They did receive large inflows of foreign capital later in the decade, but the only foreign financial support that they received initially came from League of Nations stabilization loans (the League’s role in the affairs of those countries was much the same as that of the Fund now—complete with conditionality, resident representatives, and finance ministers who put the blame for necessary adjustment measures on the demands of the institution.)

The evidence that can be drawn from Latin America in the 1980s is not extensive, because some Latin American countries (such as Argentina, Brazil, and Peru) have not taken more than transitory stabilization measures and others (such as Venezuela) have had only a short run of convincing adjustment measures. Chile, which stabilized earlier, is generally agreed to be doing rather well. More recently, Mexico and Trinidad and Tobago provide two encouraging examples.

Dornbusch bases his argument almost entirely on the case of Bolivia. That country, he says, implemented all the essential reforms “and now waits for recovery and growth” (Dornbusch, 1990, p. 3). That is one way of looking at the Bolivian experience. At the other extreme, one finds Sachs (1989b), not generally an admirer of Fund programs: “The IMF’s recent record in the debtor countries is one of failure,” he writes

¹⁹ I would nevertheless agree with Dornbusch that the model by Khan and Knight (1985) does not suffice to demonstrate the opposite proposition, that stabilization does *not* have lasting effects on economic performance.

(p. 103), but the Bolivian program has been “among the most successful in the world, with continued low inflation and rising growth, based on a strategy of liberalization and budget austerity. Bolivian politics have become far more stable and supportive of stabilization . . . and the role of the IMF is widely accepted” (p. 109).²⁰ In any event, even Bolivia does not conform to Dornbusch’s theory of immiseration through adjustment. Hit by a catastrophic decline in its exports just after taking its stabilization action, Bolivia still managed to return to positive growth one year later and then achieved an annual growth rate of about 2.5 percent for four years in a row—far from satisfactory for a country with a population growing at 3 percent per year, but not indicative of an inescapable misery trap, given the circumstances, including the political uncertainties caused by the 1989 election (*The Economist*, October 20, 1990, p. 48).

One can, in fact, point to a lengthening list of countries that are emerging from the adjustment process with substantially strengthened economies. The Bank lists five top performers in the 1980s: Korea, Mauritius, Chile, Thailand, and Ghana (Corbo, 1990, p. 20). All five had the benefit of Fund programs. Other countries deserve to be mentioned in the same context, including The Gambia, Malawi, and Morocco.

Finally, let us look somewhat more closely at the cases of Mexico and Venezuela, in part to shed some light on the time it took them to move from debt crisis to the resumption of growth.

Viewed from the outside, the Fund’s roles in these two countries seem almost entirely dissimilar. Mexico entered into an EFF arrangement in January 1983, which became inoperative in mid-1985 as Mexico’s policies slipped. It then took until November 1986 before an eighteen-month stand-by arrangement could be approved. This arrangement expired, fully drawn, in April 1988. After another year-long lapse, a new three-year EFF arrangement was concluded in May 1989, and the bulk of the money available under this arrangement has been drawn down on a regular basis. Venezuela, by contrast, did not make its first Fund drawing until December 1988 and then used only its reserve tranche. It had its first Fund program, for the amount of its first credit tranche, in April 1989. It did not receive large-scale Fund assistance until June 1989.

On closer consideration, however, collaboration between the Fund and these two countries shows pronounced similarities. In 1982-83, when both countries were struck by the debt crisis, each one held extensive discussions with the Fund about a financial arrangement.

²⁰ For a more detailed analysis of the aftermath of Bolivia’s adjustment measures, see Cariaga (1990).

Mexico had no choice; only the highly visible application of Fund conditionality would make it possible to obtain the refinancing of commercial-bank credit necessary to stave off insolvency. The Fund resorted to an EFF arrangement (with which it had become somewhat disenchanted and which it had used for only one country in 1982) in order to announce the availability of very large assistance (425 percent of quota) over a three-year period. The Fund negotiated satisfactory demand-management conditions, but, with regard to structural policies, Mexico was not prepared to go beyond rather broad promises, which led to little action in the short run.

Venezuela still had large reserves and was in a stronger position than Mexico. It managed to stick to its tradition of avoiding Fund support by taking sharp fiscal action on its own, and this was sufficient to satisfy the banks. Public opinion in Venezuela, unlike that in Mexico, was unfamiliar with the Fund, and it would have been politically difficult for Venezuela even to announce structural remedies (with respect to exchange-rate unification or import liberalization) that the Fund would have required. Venezuela was able to stick to this course for the next few years. By the mid-1980s, however, the banks wanted Fund involvement as a precondition for a multiyear restructuring accord. The Fund obliged by accepting Venezuela's request for "enhanced surveillance" (a procedure it had recently adopted to facilitate such reschedulings). In essence, enhanced surveillance involved half-yearly consultations, rather than the usual yearly consultations, combined with an undertaking to send the staff reports to the country's creditor banks. As the Fund did not commit resources on the basis of these reports, the implied conditionality of its "candid assessments" was not demanding,²¹ but it served to establish closer working relations between Venezuela's technicians and the Fund staff, which formed the basis for the 1989 program.

It was not until late in the decade that Mexico and Venezuela became sufficiently convinced of the need for comprehensive financial and structural adjustment programs. Mexico designed its own independent program in 1988-89 and then persuaded the Fund to support it. The program had important heterodox elements but also a strong orthodox basis in fiscal and monetary policy. The Fund accepted the program essentially as presented, albeit with some hesitation, because it contained

²¹ Conditionality was only implied, because no program was negotiated under enhanced surveillance. But the Fund's role was nevertheless designed to be activist, to influence the adoption and maintenance of "appropriate policies through a close process of consultation and of helping the review and decision process of creditors through the provision of candid assessments" (*Annual Report, 1988*, p. 45).

a wide array of favorable components: a major fiscal reform, trade liberalization, a much improved climate for direct investment, financial liberalization and the eventual denationalization of the commercial banks, a monetary policy run by open-market methods instead of credit controls, and a positive attitude toward privatization of government enterprises. Venezuela was also anxious to show that its program was its own, not imposed by the Fund; it knew the structural actions that the Fund would require, and it took them before entering into negotiations with the Fund.

By 1989, both countries had adopted a set of policies that gave them a good structural basis for sustained growth. The Fund's conditionality played a role, but it was not simple or direct. In Mexico, adjustment has taken hold, with perhaps the strongest evidence provided by the recovery of private investment. It was as low as 11 percent of GNP in 1983 and 1984 but rose to about 14.5 percent in 1988 and 1989, a little above the peak achieved just before the debt crisis (Pfeffermann and Madarassy, 1991).²² In Venezuela, many of the major adjustment measures were delayed until early 1989, causing a severe adjustment shock when they were introduced, with an 85 percent rise in prices, a decline of more than 10 percent in real non-oil GDP, a very sharp fall in investment, and a large improvement in the current-account balance (IMF, 1991a). Recovery began in 1990, when real GDP rose by 4.4 percent, and the policies now in place with respect to domestic prices, import liberalization, tariffs, and foreign investment are impressive. But further evidence will be required with respect to policies, particularly tax reform, and the responses of the private sector to the new policy setting, before one can be fully confident that Venezuela has achieved the transition from stabilization to growth.

7 Looking Ahead: Further Changes in Fund Conditionality?

Facilities, Objectives, and Instruments

The process of change in Fund conditionality described in the preceding sections is unlikely to have run its course. Many of the adaptations of conditionality that unfolded in the course of the 1980s still have some way to go. And times will continue to change, impelling the Fund to change with them.

²² An even sharper recovery of private investment occurred in Chile, from a low of 10 percent of GDP in 1983 to over 20 percent in 1989.

The need for further adaptation runs through all aspects of conditionality discussed in this essay. There is, for example, widespread recognition in the organization that the multiplicity of Fund financial arrangements has led to excessive complexity and may inhibit understanding of the Fund's role. As mentioned in Section 2, the differences between EFF and ESAF arrangements (apart from the interest rate charged) have become minor and now seem to reflect mostly accidents of history. As both stand-by and EFF arrangements increasingly contain structural elements, one may ask whether these two arrangements deserve to be maintained as separate facilities.

Credit under SAF will in any event have to cease as its resources run out, at least until a new cycle can begin in 1996 as repayments start flowing in.²³ The continuation of ESAF credit on concessional terms will require an act of "replenishment" within a few years, and it will raise serious problems.

Further developments can also be expected in the objectives that the Fund pursues by means of its conditionality and in its appraisal of the effectiveness of the various policy instruments used by members to achieve those objectives. A few examples will elucidate the range of issues the Fund will have to consider.

The Fund will have to come to a clearer position as to how strongly it wants to insist on structural measures necessary for long-run growth when dealing with members willing to adjust their payments positions but hesitant to make radical changes in their economies.

The trend toward an increasing role for Fund advice on fiscal policy, largely through fiscal technical assistance, is likely to persist. The dual role of the exchange rate, as an instrument for achieving and maintaining international competitiveness and as an anchor for domestic prices (Aghevli, Khan, and Montiel, 1991, p. 1), will no doubt continue to be debated for many years to come.

There are also indications that the Fund will pay increasing attention to some of the secondary objectives discussed in Section 4. The charter of the European Bank for Reconstruction and Development (EBRD) commits that organization to "the fundamental principles of multi-party democracy, the rule of law, [and] respect for human rights," and Richard Feinberg (1991) expects these elements of political conditionality to spill over to other multilateral lending institutions. Citing both the *World Development Report 1990* and the managing director of the

²³ This problem relates to burden sharing and thus falls outside the scope of this paper. For some discussion, see Polak, 1989b, p. 51.

Fund, he foresees that the Bank and the Fund will be under pressure in the 1990s to incorporate into their conditionality considerations of social equity, as well as political variables such as the quality of economic governance, the avoidance of corruption, and the observance of human rights. He notes the dangers of developments in this direction, but he urges the organizations “to seize the initiative and become positive forces in promoting these worthy objectives.” In its April 1991 communiqué, the Development Committee (IMF, 1991b) addressed for the first time the question of military expenditures, emphasizing “the need to re-examine the possible reallocation of public expenditures, including excessive military expenditures, to increase their impact on poverty reduction.”

It may be noteworthy that the Fund has turned its attention to the measurement of military expenditures, assembling data for 125 countries from 1972 to 1988, to the impact of such expenditures on economic development, and to the trade-off against social and development expenditures (Hewitt, 1991a and b). One of its working papers concludes that “military expenditures are quite reactive to financial constraints. Therefore, without controls or pressure, foreign financial assistance both enables and encourages a nation to spend more on the military” (Hewitt, 1991a). In much the same vein, Robert McNamara (1991) has urged that conditionality be applied to financial flows to developing countries to cut down on the waste represented by excessive military spending.

Monitoring Performance

The aspect of Fund conditionality that tends to provoke the widest attention is its system of monitoring performance. In the best of cases, when the member and the Fund agree about objectives and instruments, the policy discussions that precede an arrangement may raise few issues between the two parties, and conditionality may dissolve painlessly into a common effort to design the most effective program. But these cases are rare. Typically, some—and sometimes many—of the requirements embodied in the Fund’s proposals for conditionality are difficult for the member to accept, raise tensions and cause delays in the negotiation of an arrangement, and may even lead to a prolonged breakdown of relations. The problems, moreover, are not limited to the initial negotiations. If performance clauses are not met, further drawings on the Fund automatically cease, and this interruption may extend to other credits (e.g., from commercial banks) that have been tied to the Fund’s performance criteria. The member may be faced with new cash-flow problems, new embarrassments, and new rounds of disagreeable negotiations.

The difficulties mentioned are unavoidable up to a point. It is worth asking, however, whether the Fund could adjust its practices so as to mitigate some of the difficulties while continuing to ensure the proper use of its resources.

Guidelines for Conditionality

In the 1960s and 1970s, members of the executive board, and those from developing countries in particular, were ever vigilant to constrain the Fund's management and staff as to the scope of the conditionality they could pursue in negotiations with prospective borrowers. Rules on this touchy subject were finally codified in a set of *Guidelines on Conditionality* adopted in 1979. At that time, the relevance of some of the guidelines was already being undermined by developments in Fund practices, but the guidelines were considered valuable as a collection of unexceptionable principles. Periodic reviews of the guidelines have, on each occasion, led the board to conclude that they "remain appropriate in the present circumstances."

A number of guidelines reflect the principle that conditionality should interfere as little as possible with the preferences of the borrower. Guidelines 4, 7, and 9 are particularly explicit on this point.

In helping members to devise adjustment programs [i.e., in letting members know what programs it will or will not accept], the Fund will pay due regard to the domestic social and political objectives, the economic priorities, and the circumstances of members. (no. 4)

A member may be expected to adopt some corrective measures before a stand-by arrangement is approved by the Fund, but only if necessary to enable the member to adopt and carry out a program consistent with the Fund's provisions and policies. (no. 7)

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. (no. 9)

It is clear from these citations that the guidelines do not attempt to change the structure of conditionality; their aim is limited to making that structure less intrusive by limiting the number of performance criteria, insisting on their macroeconomic character, circumscribing the reasons for reviews, and keeping preconditions to a minimum. Yet, these restraining provisions have not prevented the intensification of conditionality in every direction that the guidelines attempted to block.

A more promising way to reduce the controversial aspects of conditionality may therefore be to focus directly on its content, rather than merely on its instrumentation. A number of suggestions to this end are discussed in the rest of this section.²⁴ I start with one that, coming from the side of public-choice economics, does not readily fit into the literature on the Fund.

Ex ante vs. ex post conditionality. Roland Vaubel (1988) argues that the Fund's *ex post* conditionality is "an inefficient way of giving policy advice." He asks why the Fund does not favor *ex ante* conditionality. "Why does it not, for example, exclude all applicants who have exceeded some limit for monetary expansion in excess of trend real economic growth, or for the budget deficit relative to GDP, or who have imposed unacceptable exchange restrictions, trade barriers, minimum wages, price controls or interest ceilings, or who have expropriated investors without adequate compensation?" Vaubel's own answer to this question, in true public-choice style, is that the Fund's staff would be against *ex ante* conditions because they would cut the amount of Fund lending, which justifies the staff's employment.

A more plausible answer to Vaubel's question would perhaps marshal two arguments. First, public-choice theory may well help to explain why governments sometimes adopt economic policies that are clearly detrimental to the welfare of the population and thus to resolve the "paradox" posed by Paul Streeten, who finds it odd that an international agency imposes conditionality.²⁵ But *ex ante* conditionality would be unlikely to work. It seems too much to hope that a government interested primarily in its own survival would be held back from unwise policies by the mere knowledge that the IMF would not stand ready to mitigate the severity of the eventual adjustment crisis. Second, the international community of governments has an interest in coaxing countries back from irresponsible policies and, acting through the Fund, is willing to pay for that purpose by providing the modest subsidy inherent in charging prime interest rates to less-than-prime

²⁴ One suggestion can be quickly disposed of, namely, that criteria should not be set in terms of a single number but as a range. As Kafka (1991, para. 30) points out, the upper limit would be the operative one under this approach and the change would thus be meaningless.

²⁵ Streeten (1988, p. 107) poses the paradox in the form of a question: "If the policy prescriptions which form the conditions are truly in the interest of the receiving country, why are they not already pursued by the policy-makers?" He suggests ten possible answers but not the obvious public-choice answer that policymakers may be pursuing some objective other than the interest of the receiving country.

borrowers. The case for doing so is particularly strong when a new government can be induced to reverse the policies of its predecessor, but it is also strong when a government remaining in office credibly admits to its previous sins.

External performance criteria only. Although the Fund and its members have as one of their objectives the attainment of a viable balance of external payments, Fund conditionality is mostly directed toward internal instruments, such as credit creation and the budget deficit. As the links between instruments and targets are, at best, subject to uncertainty, it has been suggested that the Fund limit itself to targeting external variables, such as the current-account balance and the change in reserves.²⁶

The proposal to target external variables has one fundamental weakness that makes it inconsistent with the very principle of conditionality. An agreement on external targets without an understanding on the domestic policies to achieve them would amount to the Fund accepting on faith the member's unstated adjustment policies. Because the country that turns to the Fund for credit typically has a recent record of inadequate policies, a promise to deliver better external results without allowing the Fund to verify the plausibility of the outcome would have a hollow ring. If the Fund were to agree to this, moreover, it would have to disregard the requirement of Article I(v) that there be "adequate safeguards" for the use of its resources. The member would make its first drawing and probably fail (except by luck) to reach the next external target, and it would then have to engage in the painful negotiations that it wanted to avoid in the first place. There is ample evidence for this forecast in the history of Fund arrangements, especially in 1980-81, when an important policy ingredient, the exchange rate, was left to be negotiated before the *second* drawing.

Reduced frequency of performance tests. Performance criteria serve the double function of monitoring a country's adherence to its program and ensuring or interrupting the right to draw according to whether the targets are satisfied or not. The second function is automatic and absolute (although it can be amended by waivers); the first is no more than prescriptive and is open to analysis.

What can be said about the comparative merits of quarterly and semiannual performance criteria? Recent experience with ESAF arrange-

²⁶ G-24 (1987), following Díaz-Alejandro (1984), and Spraos (1984), who present their suggestions as improvements in the technique of conditionality. The G-24 report, by contrast, appears to emphasize softening conditionality.

ments is relevant. Their quarterly benchmarks ensure that there is no diminution in the intensity of monitoring. Yet the monitors act as potential interrupters at half-yearly intervals only, so the probability of chance interruptions is cut in half and so is the tension generated at each test date. After more than two years of experience with this new mechanism, it would seem advisable for the Fund to shift to semiannual performance criteria and, correspondingly, to semiannual drawings, in its stand-by and EFF arrangements. The Fund decided in June 1988 that this could be done, but only in EFF arrangements, and the shift was made in only one case during the next three years.

Reviews vs. performance criteria. The initial purpose of a review was to delay the setting of certain performance criteria to a later date, when more information would be available. But the recent practice of incorporating midterm reviews in all programs has extended their scope to the reconsideration and possible revision of performance criteria set earlier. Reviews have thus taken on a new character. They involve a discretionary judgment by the Fund concerning a member's performance. The effect has been to qualify the guarantee of access under precisely stated conditions, which members have always regarded as the redeeming feature of performance criteria.

The actual or potential lack of clarity about a member's position and the double risk of interruptions to drawings resulting from the superimposition of reviews on initial performance criteria has led some observers to argue for an either/or solution. Killick (1984, p. 288) suggests that continuing access be determined, not by performance criteria, but by "an overall judgement by the Fund about the extent of programme execution" (unless a government prefers the certainty of conventional performance criteria), and Kafka (1991, para. 29) would also give members the choice between reviews and performance criteria.

Would borrowing countries or the Fund be better off by relying entirely on wholly judgmental reviews? The experience of the World Bank is instructive. It initially based its conditionality for Structural Adjustment Lending (SAL) on reviews appraising a large number of targets, frequently nonquantitative (Polak, 1989a, pp. 167-168). That approach proved less than satisfactory to the borrowing country and to the Bank. The borrower was left in uncertainty about the degree to which it might deviate from the multiple targets and yet be able to count on drawing the second and third tranche of a loan. The Bank saw the approach as failing to treat different countries consistently. In a number of recent SALs, therefore, the Bank has moved toward the incorporation of specific numerical indicators to guide it in judging

whether the borrowing country is proceeding along a satisfactory macroeconomic path.

Against this background, it seems unlikely that Fund members would benefit from sole reliance on reviews without the protection of objective criteria. A careful definition of the scope of reviews would seem more satisfactory. To the maximum extent possible, performance criteria should be set at the start of an arrangement; and, when this is not possible (e.g., with respect to improvements in expenditure control), the clearest possible understanding should be reached at the outset on the nature of the progress that has to be made.

“Reciprocal conditionality” or “development contracts.” Although Fund programs have increasingly incorporated structural elements and the promotion of growth, the main focus of conditionality remains on the balance of payments. A number of suggestions have been made, however, to strike a more even balance between adjustment and growth. The Group of Twenty-Four (1987, paras. 35-45), following Bacha (1987),²⁷ suggests that Fund programs should contain not only “financial exercises” of the traditional type but “growth exercises” as well. These would derive estimates of the foreign credit needed to achieve an acceptable growth target, and creditor countries would accept the concept of “symmetry in adjustment” by committing themselves to provide the credit required under “reciprocal performance criteria.” Under the somewhat more ambitious version proposed by Bacha (1987, p. 1465), the country would be entitled to an automatic increase in Fund or Bank credit if the creditor countries failed to honor their obligations.

A comparable idea, described as “a system of development contracts,” was put forward by Thorvald Stoltenberg (1989, pp. 241-242), then Norwegian minister for foreign affairs. He notes that the developing countries carry the full burden of responsibility for the success of their adjustment programs, “even though that success depends fundamentally on the trade and economic policies adopted in other countries.” Therefore, he suggests replacing adjustment programs by comprehensive “development contracts” for the financing of medium- and long-term development plans, which “would bind both the recipient government and the other parties (donors, banks, and international organizations) to follow the agreed upon policy framework.” He describes (p. 242) the *modus operandi* he envisages:

²⁷ Although published in 1987, Bacha’s paper was written as a background paper for the G-24 report.

One possibility is to prepare a financing package composed of IMF loans for balance of payment support, Development Bank loans for sectoral adjustment support, bilateral grant elements for basic needs components, co-financing from a bilateral donor and export credits for the imports of special foreign products and capital goods and services required. Some of the financing should be quick disbursing, whereas other should require conventional project cycle reviews. Burden-sharing should be arranged on the basis of explicit assumptions about the roles to be played by the participating parties.

The institutional machinery could be an improvement of the present consultative groups and round tables. Arrangements would have to ensure a balanced and fair partnership and a central role for the developing countries in question. The overall coordination of the political and economic aspects of the system of the "Development Contract" should be carried out within the UN system.

In attempting to appraise these suggestions, it may be helpful to separate their broad objective from the particulars proposed for their implementation.

There can be no doubt that one of the conditions for successful growth-oriented adjustment (but only one, as explained below) is an adequate and assured supply of foreign capital. That is why the Fund has actively involved itself in efforts to bring together total financing packages that would permit both growth and adjustment.

The first broad effort providing such packages occurred on behalf of Jamaica in 1978. The country was prepared to undertake a major adjustment program involving devaluation and a massive fiscal improvement, but the program was not viable without new government aid and the refinancing of commercial-bank credit. Working against considerable odds, the Fund staff managed to line up both sources of external capital (Finch, 1989, p. 4). Subsequently, in the negotiations that began in the summer of 1982 under the shadow of the debt crisis, the Fund performed a similar function on a much wider scale.

The drafting of policy framework papers (PFPs) in preparation for SAF and ESAF credits has given a more formal aspect to the Fund's involvement with the supply of credit from other institutions. The requisite collaboration with the World Bank frequently serves to firm up understandings on planned Bank or International Development Association (IDA) credits, and the working out of PFPs also requires a knowledge of the aid plans of donor countries, although uncertainties about these plans often force the incorporation of "assumptions" about aid in lieu of firm predictions (Fund programs have sometimes broken down because aid deliveries were smaller or later than had been anticipated by the country and the Fund when the program was drawn up).

The difficulty of pinning down future flows of capital is one of the major handicaps facing a country that is trying to combine growth with payments balance. It is an important function of the Development Assistance Committee to minimize these uncertainties, as well as to maximize the flow of aid, and there is much room for improving the practices of donor countries. It is by no means clear, however, that improvements in these practices could be promoted by introducing reciprocal conditionality or development contracts.

First, there is no point in constructing symmetrical arrangements when the basic positions of the partners are not symmetrical. The Fund's performance criteria have a precise meaning; unless they are met on the specified date, the next disbursement does not take place. There can be no comparable sanction imposed on a donor government that does not live up to its stated intention to lend, give aid, or ensure export credits; on a commercial bank that fails to restructure a loan; or on a development institution that fails to engage in the wide variety of financial support measures that were cited in the Stoltenberg plan.

Second, there is a real danger that this perfectionist approach will slow down the convoy to the speed of the slowest (or the least daring) ship. The Fund, in particular, often deals with situations in which policy remedies are urgent. It may sometimes be wise tactically for a country to delay an agreement with the Fund until all other credit arrangements have been lined up. But this can hardly be a general prescription. Indeed (as was discussed in Section 2), the Fund has found it advisable in some recent instances to proceed with an arrangement with a country before receiving financial assurances from commercial banks.

Third, it would be counterproductive to aim at a symmetrical contract between a developing country on the one hand and all of its potential creditors and donors on the other. Growth does not depend exclusively on the supply of financial resources; it also depends on the way they are used and thus on a country's structural policies (Polak, 1989a). When I observed in Section 3 that the Fund has often found it impossible to insist on growth conditionality, the conditions for growth at issue were those under the country's control, not its ability to obtain finance from abroad. Providers of capital from abroad would no doubt want satisfaction with respect to a country's structural policies before accepting their own reciprocal "performance criteria." Unless the Fund were to extend its conditionality to the whole range of structural policies affecting growth, the simple two-part deal envisaged in the G-24 report—adjustment policies against capital commitments—could not be completed.

Contingency provisions in conditionality. Even the best compact linking policies with money would not guarantee a happy outcome in terms of growth and the balance of payments. Stoltenberg (1989, p. 240) refers to the impact on developing countries of inappropriate trade and economic policies by the industrial countries but then ignores this problem in the design of his contract. Or perhaps he assumes that “a global system of monitoring and examination of economic policies by the OECD, the IMF, and others” would provide the answer by producing “more concrete and coherent solutions to the economic, developmental and environmental problems of the 1990s.” Instead of waiting for these mechanisms to be perfected, however, a partial solution to the problem of global instability should be sought by introducing contingency elements into the Fund’s conditionality.

Since 1988, the Fund has agreed to provisions under which it can authorize additional access during the course of a stand-by or EFF arrangement, if certain specified components of the borrowing country’s balance of payments develop less favorably than was assumed in a baseline scenario (see Section 2 above). Contingency finance, however, is not the whole answer to the problems of a country hit by unexpected external developments. Disappointing payments developments of external origin not only affect the country’s supply of foreign exchange, and hence its ability to maintain the flow of imports and keep the economy on a growth path, they directly affect the country’s ability to meet the Fund’s performance criteria and may thus lead to a secondary reduction in the supply of foreign exchange by interrupting Fund disbursements. A fall in the price of a major export commodity, such as oil in Mexico or Venezuela, or copper in Chile, may cause a major reduction in government revenue. A rise in world interest rates may cause an unavoidable increase in government expenditure. Large changes of this nature may make it virtually impossible for a country to meet a budget performance criterion under a Fund arrangement. A borrowing country thus needs two-part protection against unfavorable external contingencies: enough elasticity in performance criteria to keep its arrangement operative and thus continue its previously agreed access, and provision for additional access. The second without the first may be useless.

A movement toward contingency-adjusted performance criteria has been underway since 1986. Like so many new ideas in the Fund (Gold, 1988b), it originated in the Fund’s relations with Mexico. During the negotiations for a new stand-by arrangement in 1986, immediately after the sharp fall in the price of oil, Mexico sought to protect the new

arrangement against the consequences of a decline in the oil price below \$9 per barrel. In that event, Mexico wanted to be able to draw a larger amount on a formula basis and to receive a corresponding automatic adjustment in the performance criteria. Mexico was prepared to make all of these changes symmetrical; drawings would be reduced and performance criteria tightened if the oil price exceeded \$14 per barrel.

Agreement between the Fund and Mexico on these contingency provisions led to two more developments. At the 1987 annual meetings, the U.S. Treasury secretary, James A. Baker III, proposed an external contingency facility in the Fund. The end product of this suggestion, the CCFE, did not provide for automatic changes in access, and the board decision on the CCFE made no more than passing reference to the possibility of adjusting performance criteria.²⁸ But the idea of adjusting performance criteria in response to major balance-of-payments shocks has begun to spread through the Fund. The extensive discussion of the modalities of the CCFE made members and the staff more aware of the risk that Fund arrangements might be interrupted by events beyond the member's control, and formula-adjustable performance criteria have been introduced in a number of arrangements that do not contain provision for contingency financing. Recent arrangements with a number of oil-exporting countries contain built-in adjustments for fluctuations in the export price of oil; similarly, with Chile, for fluctuations in the price of copper. In a number of other arrangements, including some under ESAF, countries have been given protection against possible shortfalls of aid flows from baseline assumptions. Although adjustable performance criteria are still somewhat experimental, they are likely to become more widely accepted over time. This tendency could be speeded up if the Fund could find the courage to streamline the CCFE decision by making supplementary contingency access automatic.²⁹

²⁸ Paragraph 25(a) of the decision stipulates that contingency purchases "shall be subject to the observance of any applicable performance criteria, adjusted by the Fund as may be necessary."

²⁹ The ideas offered in this section have also found support from the G-24 in their 1987 report (para. 68):

Contingency mechanisms to protect a country's program from any threat resulting from exogenous events should be related to the financial exercise. The amounts that the country is entitled to draw, as well as the performance criteria and the design of the program, should be made dependent, in a predetermined manner, on a set of critical exogenous variables, such as the price of primary commodity exports, the rate of market growth for nontraditional exports, receipt from nonfac-

8 The Relationship Between the Fund and Its Members: From Conditionality to Program Design

Although the subject of this essay is conventionally known as the Fund's "conditionality," exploration of the subject makes one increasingly aware of the fact that the term is too narrow to put into proper focus the relationship between the Fund and a member in the context of a stand-by or similar arrangement.

The term "conditionality" conveys the impression of a country having acute payments difficulties but failing to realize that there is anything wrong with its policies—or at least manifesting little willingness to make major policy changes. In swoops an all-knowing Fund mission, armed with a set of precise macroeconomic conditions for financial assistance: "Devalue your currency by x percent, cut credit expansion to y percent of the money supply, cut the budget deficit by z percent of GDP, liberalize at least q percent of imports in the first year." After two weeks of talks, the country, strapped for money, negotiates a few percentage points from some of the Fund's initial numbers—which allowed for this contingency in the first place—and the finance minister signs a letter of intent (drafted by the mission). Alternatively, the country refuses to accept the main thrust of the Fund's conditions, no agreement is reached, the mission leaves, and the country's situation worsens in the absence of adequate policy changes, especially if donor governments follow the Fund's lead and cut down on aid. Desultory talks with the Fund resume and may stretch over years; in the end, agreement is reached with the Fund, broadly on its terms, and the newly adopted policies, together with resources from the Fund and from donor countries ("catalyzed" by the Fund arrangement) put the country on the road to recovery.

One can probably point to some instances that fit this caricature of Fund/member relationships, but it does not describe the overwhelming majority of Fund arrangements. Developments in member countries and in the Fund have brought about relationships of mutual respect and common purpose between member countries' technicians and their opposite numbers on the Fund staff.

tor services such as workers' remittances, the prices of key imports, and the interest rate on foreign debt. The choice of the specific set of exogenous variables would depend upon the characteristics of the country adopting the program. It may, however, be advisable to begin with only a few such variables that are considered most critical.

Technicians in member countries have, in fact, increasingly become the equals of the Fund staff members with whom they deal. They hold degrees from the same universities, they have served on the Fund staff or Fund board or have taken elementary and advanced courses in the IMF Institute. In brief, they know the Fund, and its negotiating tactics, inside out. As was observed by a senior member of Ghana's team negotiating with the Fund, countries have learned to enter discussions with the Fund with "a strong and technically competent team . . . able to articulate the concerns of the authorities . . . [and] to take advantage of the experiences of other countries that have undertaken adjustment programs" (Abbey, 1989, p. 15).

Furthermore, there has been a significant change in policy attitudes on the part of economists and policymakers in developing countries. The change sprang from many sources. In Europe and the United States, the disappointing stagflation experience of the 1970s produced the policy consensus required to attack inflation decisively and to give greater freedom to markets. The impressive economic performance of Asian economies, from Japan to Hong Kong and Taiwan, in contrast to the poor performance of most other developing regions, helped to overturn confidence in traditional development models dating back to the 1940s and 1950s. This movement was supported by the research activities of the World Bank. By the early 1980s, some countries in Latin America began turning their backs on the failed strategies of "structuralism" and import substitution. In Africa, too, countries began to recognize the cost of excessive government intervention and of distorted price systems. These changes spread across Latin America and Africa in the course of the 1980s. And the surge toward capitalism in Eastern Europe can be seen as further confirmation of the same trend.

Many observers in the industrial countries were slow to recognize this sea change in attitudes in the developing countries, and the labels under which it has been welcomed have been less than inspiring. The managing director of the Fund has characterized it as a "silent revolution" in attitudes, which he found most notably in Latin America but also in Africa and in some of the centrally planned economies of Eastern Europe (Camdessus, 1989). He cited acceptance of the need for sound fiscal and monetary policies and of structural measures to raise productivity, for greater scope for market forces, and for reform in the machinery of state and the role of government. Williamson (1990) described the same development as a convergence of policy views toward the "Washington consensus" on effective policies for adjustment

and growth, meaning the views generally held in the Washington establishment, including the international institutions.

With this convergence of ideas, the issues to be resolved between members and the Fund have tended to move from hard-to-reconcile matters of principle to such practical problems as the specification of policies, the pace of implementation, the need for governments to persevere in their adjustment policies, and the marshalling of sufficient external financial support. Moreover, as political leaders became convinced of the need for a broad range of adjustment policies, in part by the failed experience of nonadjustment, technicians became free to follow their convictions in discussions with their opposite numbers in Fund teams.

On the Fund side, one might perhaps have feared that four decades of experience with stand-by and similar arrangements would have led to the cementing of increasingly orthodox positions on the correctness of Fund policy advice. Yet available evidence would appear to point in the opposite direction. The frequent failures of Fund arrangements in the 1980s appear to have had a sobering influence. In the search for explanations, the Fund's analysis focuses attention not only on countries' failures to implement agreed upon programs and on unfavorable external factors (terms of trade, weather, world interest rates and, especially in Africa, the underperformance of aid donors), but also on weak program design. In a number of instances, especially in the early 1980s, the Fund underestimated the seriousness of countries' problems and thus failed to insist on programs of sufficient scope and severity. In other cases, the Fund knowingly accepted an inadequate program in the hope of making at least partial progress toward adjustment. In some such instances, too great a burden was put on fiscal policy that was not supported by an appropriate exchange-rate policy. But the opposite imbalance occurred more frequently: a flexible-exchange-rate policy was insufficiently backed by fiscal and monetary restraint, which lead to accelerating inflation.

Why has the Fund agreed to arrangements that it recognizes *ex post* (and sometimes recognized *ex ante*) as being weakly designed? Apart from political considerations, discussed in Section 4, there are at least two groups of reasons.

The first group relates, perhaps surprisingly, to uncertainties within the staff about the suitability of particular policy measures to achieve desired ends.

On the question of exchange-rate policy, recent years have seen the Fund advising different countries (or the same country at different times) to target a low real exchange rate, to use the exchange rate as an

anchor, and to adopt market-determined fluctuating rates or crawling pegs. It has also accepted fixed rates in its dealings with countries of the French franc zone and an insufficiently depreciated rate as a transitional device. It is by no means clear that the exchange-rate policies applied in Fund arrangements have always reflected the different requirements of the various cases or the different preferences of the national authorities.

On monetary policy, the staff has generally followed its long-standing concentration on credit creation, rather than the money supply. This approach protects the balance of payments against unfavorable shocks but, unless targets are adjusted downward, risks inflation in the event of unexpected favorable balance-of-payments shocks. In other cases, however, the staff has regarded inflation as the most serious risk and has thus endorsed a money-supply (or base-money) target rather than a credit target.

With respect to the speed and comprehensiveness of moves toward market economies in Eastern European countries, the Fund has tended to accept the size of the “bang” each country’s authorities have preferred. As a result, the Fund has supported a radical program in Poland and a much more gradualist program in Hungary.

The differences of view prevalent within the staff with respect to major policy issues greatly reduce the risk that the Fund will impose standard recipes across countries and enhance the possibility of an outcome that reflects the requirements of the particular case.

The second group of reasons relates to more pragmatic considerations. The Fund has sometimes agreed to arrangements that it knew to be below standard because the alternative—breaking off negotiations—seemed to be even worse. In some instances, failure to reach agreement with the Fund, and the consequent drying up of other sources of capital, might cause a government to engage in even less satisfactory policies than those it was ready to implement under a Fund arrangement. In other instances, the Fund feared that a breakdown in negotiations could bring into office an economic team even less tractable than the one in place. Finally, the Fund has sometimes been swayed by the desire to maintain the confidence of the international community in a country and to avoid the accumulation of external arrears, including arrears to the Fund. When a country has had large Fund credits outstanding, management has sometimes found itself weighing the risk of arrears against the risk of opening up some additional exposure through a less-than-satisfactory new arrangement—an unthinkable choice a decade ago (but the arrears to the Fund of some members may also

have had a restraining effect on transactions with other members, leading the Fund to an “even stronger emphasis on the quality of programs and increased concerns with the capacity of countries to meet their obligations to the IMF” [Mohammed, 1991]).

In brief, changes in member countries and in the Fund have put their stamp on the character of the Fund’s conditionality, but their impact has been far from uniform. When some of the negative factors have dominated, discussions between the Fund and the member have become increasingly tense, and the arrangements produced have often been unsatisfactory. When the member and the Fund have had similar objectives and concerns, working out an arrangement, including an agreement on performance criteria, has become a common exercise in program design, and the concept of conditionality has lost much of its adversary content. Indeed, in this more satisfactory situation, the distinction between “conditionality” (the minimum program on which the Fund must insist) and “program design” (the program most suitable for the member) tends to vanish. One should note that the two terms are used virtually without distinction by Azizali Mohammed, until recently the director of the Fund’s external relations department (Mohammed, 1991).

The cooperative approach is frequently sustained by a commonality of incentives. The country’s team, typically composed of senior treasury and central bank officials, will often seek alliances with the Fund staff in order to strengthen its own policy prescriptions. Not infrequently, letters of intent contain commitments put there only because the country wanted them. For its part, moreover, the Fund staff wants a positive outcome that only the country team can provide. The two sides cannot but be aware of their mutual dependency in producing recommendations that will be acceptable to higher decisionmakers in the country and the Fund.

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