Helping the Poor: the IMF's New Facilities for Structural Adjustment

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Introduction

The international community has responded to the crisis in the poorer developing countries by equipping the International Monetary Fund with two special new facilities—the structural adjustment facility (SAF) in March 1986 and the enhanced structural adjustment facility (ESAF) in December 1987. Under these facilities, up to SDR 8.7 (about US$12) billion of concessional resources is expected to be made available to help low-income countries with protracted payments problems take measures to improve their balance of payments and foster growth over the medium term.

The concept embodied in the two facilities is innovative. They establish a procedure to build consensus on an adjustment program within the borrowing country and among the international lending and donor communities and they provide a rallying point for the mobilization of additional funds. Policy framework papers, the basic documents that describe in broad terms the measures the country proposes to take during the program period, are prepared by the national authorities with the joint assistance of the staffs of the Fund and the World Bank. These papers identify the sources of a country's problems as well as the remedies and external financing that are needed, providing a framework for other donors planning additional assistance to the country in question.

The need for special facilities to support adjustment in the low-income countries arose out of their unprecedented problems. These countries have very low per capita incomes. Many have faced falling prices for their exports and deteriorating external positions. At the same time, the external sources of finance for most have been declining just when their debt burden represented an increasing claim on future earnings.

This combination of circumstances seriously undermined the capacity of these countries to grow out of their poverty without exceptional assistance.

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Sustainable growth requires a steady rise in the level of investment as well as improvements in its efficiency. But after a decade of poor growth, the domestic resources available for investment in these countries were too low to compensate for the slowing inflow of foreign funds. If growth was to recover, fundamental reforms were called for to strengthen and expand productive capacity. More resources had to be released for new investment. To increase the efficiency of existing investment, institutions had to be reformed and new ones created; above all, people had to be persuaded to follow new approaches. These reforms frequently meant basic shifts in the structure of economic activities.

Traditional sources of concessional lending were insufficient to support countries' efforts to meet these challenges. This conclusion was behind the decision of the international community to support the creation in the Fund of the SAF and, less than two years later, the ESAF. The idea behind these facilities was that adjustment and growth must be mutually reinforcing. If structural impediments delay and undermine countries' adjustment efforts, these must be directly addressed. The broad objectives of the SAF and the ESAF are to help countries restore and maintain payments viability, while changing the structure of economic activity to achieve high and sustainable rates of economic growth. The terms of the facilities recognize that low-income countries implementing strong adjustment programs are apt to be less successful if they have access to financing only on market terms. Concessional resources allow borrowing countries to pursue the bolder and longer-term reforms that are needed, and the resources available under both of the Fund's new facilities are highly concessional.

The SAF and the ESAF are part of a broader effort to cope with the unprecedented problems of the poorest countries. When the size of the ESAF was being determined, SDR 6 billion of additional resources was estimated to be essential for the medium-term financing needs of low-income countries, even when other exceptional sources of concessional finance were taken into account. These included prospective reschedulings of official debt by official and private creditors, growing bilateral flows for nonproject assistance, the World Bank's Special Program of Assistance for low-income, debt-distressed sub-Saharan African countries as well as its strengthened program for cofinancing in the poorer countries, and the rapid implementation of IDA VIII and IX, which were replenished in late 1987 and in 1990. The African Development Bank and the African Development Fund also received strong financial support from donors in the same years.

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The SAF was created with about SDR 2.7 billion of resources to support adjustment in low-income countries with protracted balance of payments problems. The funds available under the SAF come mainly from repayments on loans from the Trust Fund, which continued to be received through April 1991. However, it was evident from the outset that these resources were inadequate to enable the poorest countries to overcome their increasingly severe payments difficulties and to assist them in embarking upon the fundamental structural reforms that were required. The idea of a new facility backed by far larger funds emerged, and the Fund was able in a relatively short period of time to obtain, from a wide range of sources, a significant amount of loans as well as grant contributions to subsidize the interest payments on these loans. Accordingly, in mid-December 1987 the Fund established the ESAF with some SDR 6 billion of additional loanable resources.

Sixty-one of the Fund's poorest members are eligible to use the SAF, but two of the largest, China and India, indicated at the outset that, as they did not anticipate acute or persistent balance of payments needs, they did not intend to make use of the resources. The Fund now commits up to 70 percent of a member's quota under the three-year arrangements supported by the SAF. Resources are made available for SAF-supported programs on highly concessional terms—½ of 1 percent interest, with the principal repayable over 5½ to 10 years with a 5-year grace period. Disbursements under the SAF are made annually and are linked to the approval of annual arrangements, with members receiving the equivalent of 20 percent of quota under the first annual arrangement, 30 percent under the second, and 20 percent under the third.

The same 61 countries that were originally eligible to use the SAF are also eligible for the ESAF and in April 1992 11 additional low-income countries became eligible. As for the SAF, in 1987 China and India indicated that, under the prevailing circumstances, they did not intend to use the facility. They remain, however, fully eligible to do so.

Eligible members can receive a great deal more assistance under the ESAF than under the SAF; up to 250 percent of quota over a three-year program period, with provision for up to 350 percent in exceptional circumstances. The broad objectives of programs supported by the ESAF are similar to those of SAF-supported programs, and these programs are also designed on the basis of a policy framework paper formulated by the national authorities with the assistance of the staffs of the Fund and the World Bank. Disbursements under the ESAF, however, are semiannual instead of annual; with more resources available to countries, it was felt that more frequent review of the member's

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performance under the program was both reasonable and appropriate. ESAF resources are available to members on the same highly concessional repayment and interest rate terms as SAF resources.

By the end of February 1992, 35 countries had obtained support from the SAF, and 19 countries had obtained support from the ESAF, for their adjustment programs. (See table.)

The Basic Policy Document

An essential component of a program under the SAF and ESAF is the country strategy paper mentioned earlier, the policy framework paper (PFP), which is prepared by the national authorities with the joint support of the staffs of the World Bank and the Fund. The PFP establishes the country's macroeconomic and structural policy objectives for the next three years, identifies the strategy that will be followed, and estimates the financing that will be needed. It also sets out the sources of the country's growth and identifies the main macroeconomic and structural constraints on higher growth and better payments performance. The PFP is updated at the outset of each program year, and provides a framework for consistent policy implementation and analysis that is useful both for the authorities and for the international lending community in supporting the country's adjustment. As experience with the facility has accumulated, the process has also evolved; policy framework papers have become more detailed, and more specific information is now included on policy measures planned under the adjustment program and on their timing.

Commitment is an important element of the potential effectiveness of the strategies contained in the PFPs. While it is relatively easy to identify that a country has a payments problem, the questions of why the problem has arisen and what should be done about it are not always easy to answer. In addition, while orderly and rational adjustment is less burdensome to a country than the emergency adjustment that would otherwise take place, this is not always obvious to those faced with having to make the decisions, particularly when it may be necessary to incur some short-term costs at the outset of the adjustment program in order to provide the basis for longer-term gains later on. Adjustment programs require, first, full conviction on the part of the authorities that the strategy chosen is appropriate, and, second, courage on their part to implement it over the period that is judged necessary.

The PFP is not a blueprint, but it is sufficiently detailed to link the country's adjustment strategy with the sources of its problems and to show how

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structural change and payments viability will be achieved and the method that will be used to monitor progress. Since almost all policy measures have some effect on the distribution of income among different social groups, the PFP contains analysis of the social impact of the strategy proposed and describes how the authorities plan to cushion any adverse short-term impact of adjustment on vulnerable groups within the society. A frequent objective of programs under the facilities, for example, is to restore competitiveness to agriculture as the source of future growth for the country, and a typical result of the social impact of measures to achieve such objectives in a program is to redistribute incomes from the urban to the rural sectors.

An important element of the PFP is that it provides fairly detailed estimates of the financing requirements of the adjustment program, including those of the public investment program, and identifies the external resources that are expected to be available. Since the PFP is circulated among potential donors, this specification of the assistance that is going to be needed shows donors where their contributions could be most useful, on the basis of the analysis in the policy document. In addition, the PFP can be, and often is, used by the national authorities as a background document to support their own bilateral requests for financial assistance.

The more formal coordination between the Bank and the Fund in assisting the country in developing the strategies incorporated in a PFP is a novel contribution to developing consistent and comprehensive country analysis. The Bank lends for structural adjustment or sectoral programs in most of the low-income countries. It is clearly important that the analysis and policy recommendations underlying these lending programs be consistent with and complementary to the funds disbursed under the SAF and the ESAF. The PFP provides a framework for ensuring this consistency. In general, the staff of the Fund focuses mainly on the macroeconomic framework and objectives and on measures to eliminate financial imbalances, while the staff of the Bank tends to focus mainly on longer-term issues and on the analysis of sector policies and the public investment program and its priorities.

PFPs are reviewed by the Executive Boards of both the Bank and the Fund before disbursements are made. As noted earlier, disbursements are made under three-year and annual arrangements that spell out in more detail the specific conditions for the loans. The Fund's Board reviews the PFP after the Bank has done so, and can therefore take into account the views of the Bank Board in its deliberations.

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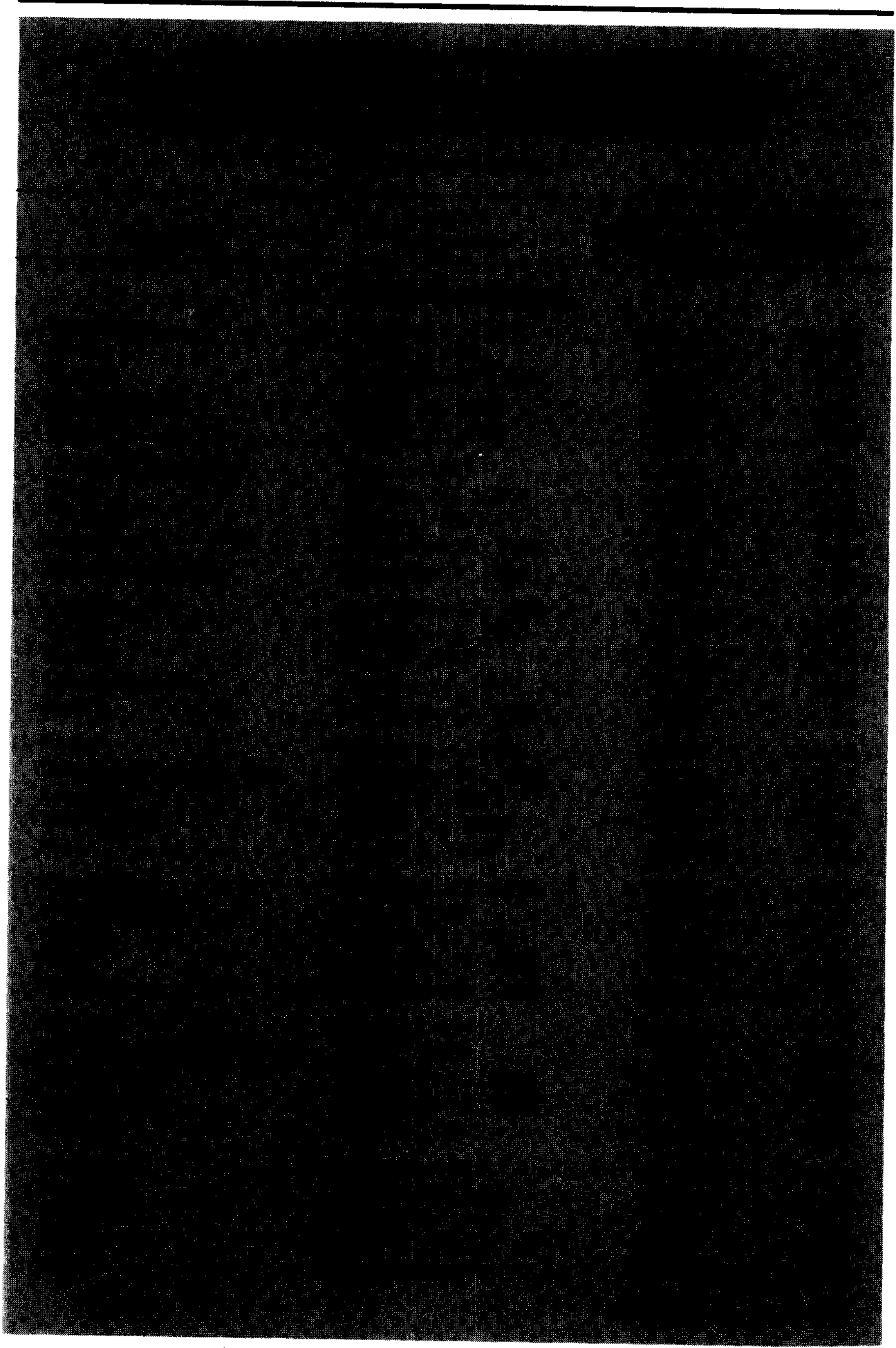

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Some Examples

All programs supported by SAF and ESAF resources aim to restore payments viability to a country in a sustainable way by establishing the conditions under which it can achieve higher rates of durable growth. This does not mean countries concentrate on increasing exports or the domestic production of imported goods only to reduce the trade imbalance. The objective is much broader; by increasing the capacity for growth based on the country's ability to compete in world markets, the country expands its long-term potential for raising living standards.

The programs supported by the facilities are, as noted above, developed by the member country, with the assistance of the staffs of the Bank and the Fund, and are tailored to meet the circumstances of individual countries. Although typical problems, such as excessive payments deficits, fiscal deficits, or payments arrears, do mean that programs contain measures to con-

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strain the country to live within its means, the tremendous diversity in the situations of the countries implementing the programs makes for a corresponding diversity in their strategies. Although it is too early to be able to identify clear results from the strategies put in place, some examples will illustrate their diverse objectives and approaches.

Case 1

This first case of a country that initiated a policy program supported by a SAF arrangement from the Fund was an economy that had once been wealthy. Not only was it richly endowed with natural resources, fertile land, and well-timbered areas as well as large deposits of minerals, but it had also once had a thriving manufacturing and commercial sector. In addition, with a long tradition of education, the country had one of the scarcest resources of all—a population with a high level of academic and business skills.

A combination of political instability, bad domestic policies, and unfortunate developments outside the country's control, such as the fall in world commodity prices and two severe droughts, thoroughly eroded the productive capacity of the country. Real per capita incomes actually fell by about 30 percent between 1970 and 1982; savings and investment declined; and, unable to pay its debts, the country began to accumulate arrears. Between 1981 and 1985, earnings from its largest export fell, and industrial production and manufacturing also declined. Total export values dropped, not only because of lower world prices, but also because export volumes were lower, and this decline extended from agricultural commodities across the whole range of mineral exports.

When it approached the Fund with a proposal for support from the SAF, this country had already begun to address its major problems, but it needed the assurance of financing over a longer period than that covered by a normal Fund stand-by arrangement. It needed time to fully liberalize its exchange and trade system—its currency had appreciated well beyond its competitive level, discriminating heavily against exports and in favor of imports, particularly energy. The country also needed time to implement policies to stimulate output in the agricultural sector, where extensive replanting and rehabilitation was badly needed and urgent action was called for to put an end to large-scale smuggling to neighboring countries. Finally, time was needed to restore the basis for diversified economic activity, to streamline and reorient public investment to support higher and more varied production, and to improve infrastructure, particularly road maintenance, which had been a bottleneck on distribution and marketing for some time.

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This was a country with good potential for growth. The challenge was to undo the harm that previous policies had done to productive capacity, to restore output in agriculture, mining, and commerce, and to raise the efficiency of transport and the use of energy. At the same time, the large public sector had to become more efficient and the fiscal deficit less of a burden on the economy.

The SAF-supported program focused on four essential areas: raising price incentives for agricultural producers; increasing domestic savings; easing bottlenecks on supply; and improving fiscal management. Further liberalization of the exchange and trade system was expected to stimulate the production of exports in general, in an effort to reduce the economy's vulnerability to external shocks from overconcentration on a few products.

Sensible fiscal and monetary policies had to ensure that financial imbalances were addressed while these structural reforms were being implemented. Good policies were needed so that inflation could be controlled, domestic savings encouraged, and resources released for productive investment. Given the country's already high level of debt, the SAF-supported program had to be implemented within strict budget constraints and limited prospects for external assistance. To ease these constraints, domestic savings were to be encouraged by a reform of the financial sector. Domestic interest rates were liberalized to offer savers better returns on their deposits, while an active domestic money market was to be stimulated by establishing a discount house and introducing an auction market for treasury bills. A reform of the tax system was to complement these efforts.

The SAF-supported program envisaged an average annual growth rate of real gross domestic product (GDP) of about 5 percent over the period of the program, which would maintain the level achieved over the previous two years. It was planned to bring inflation down substantially over the same period, and to generate large export surpluses to meet the expanded import needs of new investments. Barring the unforeseen, it was hoped that by the end of the program's period, the country would have a viable external payments position and the basis for more diversified and sounder growth in the future.

Case 2

As a striking contrast to the first case, this second example of a country that implemented a SAF-supported program was a small economy that was heav-

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ily dependent on two agricultural products as its main source of income and exports. This economy did not have the broad potential for growth of the first case. Because the country was small and mountainous, moreover, its production costs for even its limited exports were high compared with those of its competitors. It had previously had access to preferential markets; these were now closed. This country needed a basic reorientation in its objectives and policies—first, to ensure that its scarce resources were used as efficiently as possible and that the demands on these resources were not excessive, and second, without being overly ambitious about what could be achieved, to lay the basis for new sources of income.

Before the country approached the Fund with a request for SAF support, bad weather had battered the agricultural sector, slowing exports, and actually reducing the production of one basic export. Although these had begun to recover, the vulnerability of the economy to outside forces was clear. Meanwhile, unemployment was high and investment prospects limited; the government had difficulty in generating public sector savings, and public investment was financed mainly with foreign money. Although most of this was still on concessional terms, the outlook for continued concessional finance was limited and the country simply could not afford market terms. Adjustment had to be achieved by skillful fiscal management; as the main source of domestic investment, the public sector had to reallocate resources to potentially productive activities while reducing nonpriority expenditures.

The SAF-supported program identified agriculture as the key source of future growth in this country. To improve productivity in the sector as a whole, measures were envisaged to improve the quality of the supporting infrastructure by rehabilitating feeder roads and improving extension services. Producers were to be given better incentives through reduced export taxes. Meanwhile, efforts were made to diversify agricultural activity and to seek new markets. Diversification was also sought outside the agricultural sector, as the country's location and climate made it potentially attractive to tourism. Finally, private investment in manufacturing was planned—a strategy which included measures to reduce company taxes, simplify procedures for investment applications, and construct factory space on industrial estates to entice foreign investors.

Providing the infrastructure to support this strategy involved heavy investment by the public sector, much of it in the form of imported equipment. Because the country did not have the means to generate additional savings, either from the public or the private sector, the program provided for larger budget and balance of payments deficits in the first years. Part of the fiscal

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deficit was to be offset by reducing the public sector wage bill through the removal of a provision for automatic merit increases for civil servants.

The program specifically envisaged that real GDP growth would pick up in the first year of the program, under the impetus of a recovery in agriculture and tourism, and that it would be maintained during the program period. While both the budget deficit and the current account deficit were projected to widen in terms of GDP during the first year of the program, they were expected to be more than covered by new concessional money. It was hoped that by the end of the period, growth in nontraditional activities would be established, providing a stepping-stone to sounder economic performance in the future.

Case 3

This third example of a country requesting SAF resources to implement an adjustment program fell between the two extremes represented by the previous cases. It neither had rich potential, nor were its prospects very limited. It neither had the opportunity to use all the tools of macroeconomic management, but nor did it face the constraints of Case 2. This was a country with limited natural endowments and, because of its location, extreme vulnerability to drought. The great majority of the population was employed in the subsistence agricultural sector and lived off domestically produced or imported cereals. The modern sector was small, with some manufacturing and tourism. Exports were highly concentrated and vulnerable to changes in the terms of trade and to the vagaries of the weather; in the year the country began the SAF-supported program, three agricultural exports and one mineral accounted for about 60 percent of total export earnings. Food and petroleum products made up 40 percent of import payments.

When droughts were severe, as they had been over recent years, exports plummeted and food imports rose massively. Weak international prices for the agricultural exports were also a problem. While the small industrial sector was reasonably diversified, its costs were high, and it operated in an environment of excessive regulations and distortions. Controls and tariffs on competing imports, export subsidies, and a variety of special agreements protected costly domestic operations in many different ways. The public sector was large and inefficient, with enterprises active in almost every sector of the economy. Both the budget deficit and the external deficit were unsustainably high and the country was in arrears. External debt was high and unsustainable. Although the authorities had already been implementing an adjustment program for three years, longer-term funds were needed so the country could reorient its

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activities to reduce its external vulnerability and establish new and sustainable activities.

The SAF-supported program contained a three-pronged strategy: to strengthen agricultural production and exports; to reform the industrial sector; and to achieve fiscal adjustment. It was hoped that good growth rates could be maintained throughout the program, that inflation could be reduced to less than half the rate that existed at the outset, and that fiscal and payments surpluses could be achieved by the end of the program. Arrears were also to be paid off, the current account deficit was to be financed mainly by official grants, and debt rescheduling was also envisaged.

To stimulate agricultural production, producers had to be given incentives to produce more of the traditional crops and to diversify into new ones. A large part of the answer was the reduction of government intervention in the sector, which had ranged from the setting of producer prices at levels that benefited urban consumers (and had the opposite effect on producers), to the distribution of inputs and the marketing of the crops. Another part of the answer was seen to be to make farming profitable.

This process of reform had begun two years before the country approached the Fund, but needed new impetus. Cereal production was to be stimulated to reduce food imports by offering farmers competitive producer prices and by liberalizing marketing arrangements. A comprehensive reform of the industrial sector called for streamlining the array of tariffs, quantitative controls, and special privileges that individual producers faced. To encourage industrial exports, local producers had to become more competitive and cost conscious. The only way to achieve this, it was decided, was to stop giving them preferential treatment at the expense of the budget; only if producers faced world market prices for their goods would the country begin to export those goods in which it had a comparative advantage.

Structural reforms of the productive sectors have to be supported by sensible fiscal management. With an excessive budget deficit, resources could not be released so that private sector activities could grow. Moreover, when debt is high, as it was in this country, any foreign exchange earnings are quickly utilized—in debt service payments or capital flight—and make little direct and immediate contribution to sustaining domestic growth. The SAF-supported program, therefore, involved both dealing with the problem of the immediate overhang of current debt and the need to prevent the economy from continuing to consume more than it earned, while simultaneously providing for growth in priority sectors.

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In this country, the need to deal with a debt overhang while sustaining growth meant providing for debt reschedulings in the early years of the program so that debt payments could be made later and in an orderly way. It also meant paying off existing arrears. The funds to do this had to come from the budget. The assurance that the country would, in the future, live on the foreign exchange it could earn also had to come from budget management. The program called for curbing nonpriority expenditure as well as reallocating money in line with development priorities to the agricultural and industrial sectors. Meanwhile, an expansion of the revenue base was provided for by tax and customs reforms—provisions were made to tax the informal sector, for example. A comprehensive reform of the parapublic sector was envisaged to prevent it from draining the budget and to make individual enterprises financially responsible.

In Conclusion ...

The first arrangement supported by the SAF was approved by the Fund's Executive Board in August 1986. With almost six years of experience with the facilities behind us, it is possible to say that the PFP approach is working. Although it is too early to evaluate the full impact of the additional support provided by the facilities on the long-term adjustment of the low-income countries, preliminary indications are encouraging. In very difficult circumstances countries are beginning to implement strong adjustment programs and are raising additional finance to assist their implementation. The formulation of the three-year programs to improve growth prospects and external positions has focused attention on those measures that will be most effective in improving welfare among the populations of the poorest countries. All programs foresee a substantial increase in investment and most provide for a healthier external position. From this sound basis, countries should be able to restore the momentum of growth.

By the end of February 1992, 35 countries had already used resources under SAF arrangements and 19 under ESAF arrangements. For several of these, donors have used the PFP as a basis for deciding their own loan commitments. It is hoped that this, the Fund's part in the international effort to deal with the crisis in the poorest countries, will make an effective contribution to improving their well-being in a sustainable way.

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