

MACROECONOMIC ADJUSTMENT:

Policy Instruments
and Issues

IMF Institute



International Monetary Fund
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Macroeconomic Adjustment: Policy Instruments and Issues

Edited by Jeffrey M. Davis



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I. Introduction

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Countries undertaking adjustment programs usually suffer from a broad range of economic problems. These may include:

- external imbalances that are reflected in current account deficits, capital flight, and high levels of external indebtedness;
- accelerating inflation often accompanied by falling private investment and stagnant (or even negative) growth; and
- growing reliance on rationing and controls (for credit, imports, prices, etc.) with consequent reductions in capacity utilization and increases in structural maladjustments and underlying imbalances.

In this context Fund-supported adjustment programs seek to restore economic growth, while bringing about a balance of payments position that is sustainable in the medium term. Achievement of these objectives requires coordinated use of a variety of policy measures. These include:

- demand management policies, particularly monetary and fiscal measures;
- exchange rate policies;
- external debt management policies; and
- structural policies affecting capacity utilization and productive potential.

This volume, which has been used in selected IMF Institute courses, provides an introductory review of some of the policy issues in each of these areas. In particular, successive chapters review issues relating to monetary, fiscal, exchange rate, trade, external debt, and supply-oriented policies.

Emphasis in each chapter is on issues that may arise in adjustment programs. Importance has been attached to making the papers accessible to the non-technical reader. To this end the papers emphasize intuitive, rather than rigorous, arguments and make substantial use of country examples.

The papers were prepared, in the latter part of 1990, by an IMF Institute team headed by Jeffrey M. Davis. Individual authorship is recorded for each of the chapters; papers, however, draw extensively from other Fund and Institute documents. In some cases papers have been updated by staff members other than the original authors. Jeanine Moeis was responsible for editing, design, and production. The opinions expressed in the papers, as well as any errors, are the responsibility of the authors and do not necessarily represent the views of the Fund.

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II. Monetary Policy and Financial Reform

by Jeffrey M. Davis

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1. Introduction

Excessive growth in the money supply leads to high rates of spending on domestic or foreign goods. Given that domestic supply is essentially inflexible in the short run, the former is likely to result in substantial inflationary pressures in the economy. To the extent that spending pressures are directed towards foreign goods (or assets) balance of payments pressures will ensue.

Countries implementing adjustment programs usually suffer from high inflation, sluggish growth and external disequilibrium. To a substantial extent these problems are likely to reflect inappropriate developments in monetary aggregates. The task of monetary policy is to ensure that the expansion in domestic liquidity is consistent with the authorities' objectives for growth, inflation and the balance of payments. In this context policies to control monetary aggregates play a central role in adjustment programs.

From the viewpoint of stabilization policy, the primary role of monetary policy is to prevent excessive spending. However, in a broader sense financial policy plays a key role in affecting the efficiency of resource use in the economy by influencing the mobilization and employment of financial resources. The role of financial intermediation in influencing savings and investment is discussed in Chapter VII. Importance should be attached to ensuring that the mechanisms of monetary control are consistent with efficient financial intermediation.

Section 2 of this chapter develops a framework for considering monetary policy that emphasizes the determination of the appropriate monetary stock and the money supply process. In Section 3 the effectiveness of different instruments of monetary policy are reviewed.

2. A framework for monetary control

a. Instruments and objectives

Monetary policy requires establishment of a relationship between the monetary instruments that the authorities control and objectives for growth, inflation and the balance of payments. Rather than establishing a direct relationship between instruments and objectives, an intermediate target such as money or credit is often considered. Introduction of an intermediate target allows a two-stage process that focuses on the appropriate level of the money supply and the use of policy instruments to limit monetary aggregates to that amount.

- **Demand for money.** The appropriate level of the money supply depends on the amount of money the public (i.e., households and enterprises) wish to hold. This requires analysis of the public's demand for money balances.

- **Supply of money.** Control of monetary aggregates depends on the use of monetary instruments and the impact of other factors affecting the money supply. This requires consideration of the money supply process.

Money may be defined as the sum of currency outside banks and demand deposits held with the monetary institutions by the rest of the economy other than the central government. However, the choice of intermediate target should reflect the stability of its relationship with ultimate policy objectives. This may lead to consideration of a more broadly defined monetary aggregate that includes deposits (quasi-money) that are close substitutes for money more narrowly defined. The need to achieve balance of payments targets in the context of fixed exchange rate regimes may lead to an emphasis on credit variables as intermediate targets (see Section 2.d).

b. Determination of the appropriate money stock

The alternative to holding money balances is to spend them. Consideration of the appropriate money stock requires determination of desired holdings of money balances given objectives for inflation and growth. The demand for money results from the need to have money balances available to carry out routine purchases (transactions demand), and its use as a store of value. For both of these purposes it is the real purchasing power of money that is important.

- **Transactions demand.** Holdings of money balances for transactions depends on the level of economic activity, which may be approximated by the GDP.
- **Store of value.** The demand for money for this purpose depends on how well money keeps its purchasing power. For example, if the interest rate paid on deposits exceeds the inflation rate, there is an incentive for the public to hold money balances with the banking system. More generally, expectations of high inflation will reduce the likely purchasing power of money and its attractiveness as a store of value.

Empirical estimation of the demand for money may be based on statistical relationships with GDP, inflation, interest rates and other variables, using historical data. Particularly where there is substantial structural change in the economy, including reform of the financial system, past relationships may prove of limited value in predicting future developments.

A more judgmental approach would be to assess the demand for money on the basis of the likely movement of the ratio of money to nominal GDP. Alternatively, attention may focus on the velocity of money, which is the inverse of this ratio.

c. The supply of money

Consideration of the use of policy instruments to affect monetary aggregates requires analysis of the money supply process. Such analysis is facilitated by reference to the summary accounts for the monetary sector that are presented in Box II.1.

(1) The accounting framework

Analysis of the money supply process requires review of three sets of accounts.

- **The monetary survey.** The liabilities of the monetary survey show the movement of money and quasi-money. In an accounting sense these liabilities may be related to the domestic and external assets of the banking system. Consideration of the money supply process, however, requires a more disaggregated approach.
- **Monetary authorities.** This account focuses on the activities of the agency responsible for monetary policy. The liabilities of the monetary authorities include currency held outside the banks and bank reserves (holdings of currency and deposits with the monetary authorities), which together are referred to as reserve money. Currency held outside the banks represents a direct component of the money supply, while the availability of bank reserves affects the ability of deposit money banks to create deposits. Analysis of the asset side of the balance sheet indicates external and domestic factors affecting the growth of reserve money.
- **Deposit money banks (DMB).** The DMB's accounts summarize the activities of the institutions whose liabilities represent the deposit component of the money supply. Assets of the DMBs include their reserves and their extensions of domestic credit.

(2) The money multiplier

From the above the money supply process can be defined in terms of two factors.

- The initial creation of reserve money, which is achieved by increasing the liabilities of the central bank to the public and the banking system.
- A secondary expansion of the money supply by the DMBs. This is achieved through the "multiplication" of the resources deposited with these banks, whereby part of the credit provided with these resources, when spent by the borrower, returns to the DMBs as new deposits which can be lent out again.

An understanding of this process can be facilitated by consideration of some simple identities based on the previously discussed accounts.

An Accounting Framework for Monetary Analysis

Monetary analysis and policy is greatly facilitated by an appropriate accounting framework. The following accounts are particularly important in considering the factors determining the money supply.

- **Monetary authorities.** The monetary subsector responsible for currency issue, credit control, managing the country's international reserves and maintaining general supervision of the monetary system. These duties are usually largely carried out by the central bank or a similar body.
- **Deposit money banks.** Those financial institutions, other than the monetary authorities, which have significant liabilities in the form of deposits payable on demand and transferable by check or otherwise usable in making payments. Usually largely composed of commercial banks.
- **Monetary survey.** A consolidation of the accounts of the monetary authorities and deposit money banks that shows the financial relationship between the monetary institutions subsector — whose liabilities include the economy's money supply — and other sectors of the economy.

Schematic versions of each of these accounts as shown below are referred to extensively in the text to illustrate the factors affecting the growth of monetary aggregates.

Monetary Authorities		Deposit Money Banks	
<i>Assets</i>	<i>Liabilities</i>	<i>Assets</i>	<i>Liabilities</i>
Foreign Assets	Reserve Money	Reserves	Demand Deposits
Claims on Central Government	Currency	Foreign Assets	Time, Savings, and Foreign Currency Deposits
Claims on Deposit Money Banks	Outside Banks	Claims on Central Government	Foreign Liabilities
	Banks'	Claims on Official Entities	Central Government Deposits
	Reserves	Claims on Private Sector	Credit from Central Bank
	Foreign Liabilities	Claims on Non-monetary Fin. Institutions	Other Items (Net)
	Central Govt.		
	Deposits		
	Other Items (Net)		

Monetary Survey	
<i>Assets</i>	<i>Liabilities</i>
Foreign Assets (Net)	Money
Domestic Credit	Quasi-Money
Claims on Central Government (Net)	Other Items (Net)
Claims on Official Entities	
Claims on Private Sector	
Claims on Non-monetary Financial Institutions	

Box II.1

$$MO = CY + D \quad (II.1)$$

$$RM = CY + R \quad (II.2)$$

The first equation defines money (MO) as the sum of currency outside the banking system (CY) and deposits (D). Equation (II.2) defines reserve money (RM) as the sum of CY and bank reserves (R). Defining the money multiplier (*m*) as the ratio of money to reserve money,

$$MO = m RM \quad (II.3)$$

The money multiplier can equally be defined in terms of the ratios of currency and reserves to deposits. Dividing the right hand side of equations (II.1) and (II.2) by deposits and substituting in equation (II.3),

$$m = (1 + c)/(c + r) \quad (II.4)$$

where *c* represents the ratio of currency to deposits and *r* indicates the ratio of reserves to deposits.

From the asset side of the monetary authorities' accounts,

$$RM = NFA + NDCG + CCB \quad (II.5)$$

where reserve money is indicated as the sum of net foreign assets (NFA), domestic credit to the government net of government deposits (NDCG) and claims on deposit money banks (CCB).

(3) Implications

The following implications may be drawn from this analysis:

- the money supply depends on the factors affecting the money multiplier and reserve money;
- monetary policy instruments work through their impact on either the money multiplier or reserve money;
- the money multiplier depends on the behavior of the banks (reserve ratio) and the nonbank public (currency ratio);
- movements in reserve money depend not only on the policies of the monetary authorities, but also on developments in the external (NFA) and fiscal (NDCG) sectors; and
- NFA and NDCG reflect movements in the balance of payments and government budget, respectively; therefore, a fundamental requirement for effective monetary policy is that it be coordinated with the use of fiscal and external policies.

d. Financial programming

The Monetary Survey indicates that changes in the money stock reflect movements in net foreign assets or domestic credit. Countries undertaking adjustment programs may be expected to have a target for the balance of payments and are not indifferent to the combination of external and domestic factors affecting the money stock. Further, in an open economy operating under a fixed exchange rate, the money supply is an endogenous variable influenced by surpluses and deficits in the balance of payments.

For these reasons Fund-supported adjustment programs usually adopt domestic credit as an intermediate target rather than the money supply. Linkage of monetary instruments with balance of payments, growth and inflation targets might then involve the following steps:

- prediction of the demand for money that is consistent with growth and inflation targets;
- establishment of a target for net foreign assets that is consistent with the balance of payments forecast;
- determination of a ceiling for domestic credit that is consistent with the predicted demand for money and the balance of payments (NFA) objectives;
- consideration of the appropriate allocation of credit to the government given the total credit ceiling and the requirements of the private sector; and
- setting values for monetary instruments that are consistent with the desired level of domestic credit and the money stock.

This framework remains predicated on the ability to establish reasonably stable links between money balances and spending (demand for money) and the money stock and policy instruments (supply of money). Limitations on credit and the money stock also remain dependent on coordination of monetary, fiscal and balance of payments policies.

3. Instruments of monetary policy

a. Types of instruments

A broad distinction may be made between direct and indirect instruments of monetary control.

- **Direct instruments** seek to attain the authorities' objectives through regulations that directly set the monetary targets at desired levels.
- **Indirect instruments** operate by taking advantage of the relationship between money and reserve money and of the special role of the monetary authorities in the creation of reserve money. In contrast to direct controls, indirect instruments seek to align market behavior with monetary policy objectives.

b. Direct controls

Monetary policy in developing countries has typically relied on direct instruments of control. Most important from a macroeconomic viewpoint have been credit ceilings on individual banks, and direct controls on interest rates. Controls have also encompassed sub-ceilings relating to the amount or cost of credit to be provided to individual sectors. Use of other monetary instruments has often been geared to sectoral and fiscal priorities rather than the needs of monetary control.

Direct controls may in the short run be reasonably effective in preventing excessive credit expansion. However, a trade-off needs to be recognized inasmuch as there are substantial resource allocation costs attached to such measures. Direct instruments may also have significant limitations over time from the immediate viewpoint of monetary control.

(1) Resource allocation costs

- Reduces competition among the commercial banks and penalizes the most efficient institutions.
- Distorts portfolios of banks with, for example, lending focused on established borrowers rather than potentially profitable new enterprises.
- Encourages financial disintermediation (i.e., a reduction in the share of savings channeled through the financial system) and contributes to the growth of the informal sector and alternative monetary instruments.

(2) Monetary control problems

- Disintermediation limits the effectiveness of controls inasmuch as they focus on the formal financial system whose market share is falling.
- Excess reserves emerge if reserve money growth is not constrained. This increases incentives for disintermediation and complicates the future removal of credit ceilings.
- Administrative allocations of credit may encourage demand-determined access to credit by government or public enterprises.

c. Indirect instruments of control

Reflecting these problems there has been a recent trend, in both industrial and developing countries, towards substituting indirect instruments for credit ceilings. This is illustrated in Box II.2 by reference to the case of Indonesia.

Reform of the Financial System: Indonesia

A key element of Indonesia's comprehensive adjustment effort in 1983, following a sharp decline in oil revenues and a weakening of the economy's finances, was a reform of the financial system. Before the reform, the major instruments for conducting monetary policy available to the central bank, Bank Indonesia (BI), were credit ceilings for individual banks, interest rate controls for state banks, and a selective rediscount mechanism (liquidity credits) designed to reallocate credit at subsidized interest rates.

Prior to financial reform, the expansion of liquidity credits and net foreign assets had led to a rapid growth of reserve money, which left the banking system with a large volume of surplus funds. This excess liquidity together with interest rate controls produced distortions in the pattern of domestic financial intermediation. Moreover, since an increasing proportion of deposits was being placed in nonbank financial intermediaries which were not subject to either interest rate controls or credit ceilings, during this period, the effectiveness of monetary controls was weakened.

The financial reform included replacing the system of restrictions on financial institutions with a more indirect system of monetary control. Interest rate controls were eliminated, a wide range of loan categories were made ineligible for liquidity credits, credit ceilings on individual banks were eliminated, and a new mechanism of monetary control that relied principally on open market operations was introduced.

Since there were no domestic public debt instruments available for open market operations, BI began issuing its own debt instruments which could be readily marketed under the prevailing circumstances of excess liquidity. The sale and repurchase of these instruments allowed the central bank to absorb or inject bank reserves at its own initiative and to influence domestic money market conditions.

The most conspicuous success of the reform was the rapid growth of domestic currency deposits after June 1983 and the marked slowdown in the accumulation of foreign currency deposits, reflecting the increased confidence in the domestic banking system and its greater competitiveness. Moreover, the move to open market operations as the principal instrument of monetary control greatly improved the authorities' technical ability to manage monetary and reserve aggregates. Indonesia was able to successfully put in place an indirect system of monetary and interest rate management despite the lack of a sophisticated money market at the outset of the liberalization process.

Box II.2

Market-oriented instruments of monetary control seek to influence the demand for and supply of reserve money to achieve values consistent with intermediate targets

for monetary aggregates. Use of such instruments leaves financial institutions free to determine the allocation of credit in accordance with market forces. Despite the advantages of indirect instruments, there should be caution in eliminating aggregate credit ceilings until alternative methods of monetary control are seen to be operating effectively.

Effective utilization of indirect instruments is closely linked to the development of money markets. Indirect instruments of monetary control may both be facilitated by, and help foster, money market development. Strong interrelations also exist between government debt management policy and indirect instruments of monetary control.

Indirect instruments are based on some variant of open market operations, supported by suitable policies on reserve requirements and central bank lending.

(1) Open market operations

Open market operations involve the sale or purchase of securities by the central bank to withdraw or inject liquidity into the system. Reliance on open market operations has several advantages:

- flexibility exists both in terms of the amount and the timing of intervention;
- the central bank has the initiative, whereas in the case of discount policy, for example, it is the financial institutions that decide whether and how much to borrow; and
- transactions are voluntary at market-determined yields.

The central bank may undertake open market operations in either secondary or primary markets.

- **Secondary market** operations are based on purchase and sale of existing securities, or self-reversing transactions, such as repurchase agreements. In countries with well-developed secondary markets, central banks generally prefer to operate in these markets.
- **Primary market** operations involve new issues and redemptions. Although not quite as flexible as those in secondary markets, such operations have the same effects and are the primary form of intervention in countries with less-developed financial markets.

Several practical problems are involved in setting up open market operations. Particularly, important issues relate to the type and maturity of securities and the choice of selling mechanism. Approaches to these issues may vary according to the particular institutional features of each country. A willingness to accept market-determined interest rates and to pay such rates on government debt is, however, central to the success of open market operations.

(2) Reserve requirements

Reserve requirements (cash in vault and deposits with the central bank) help to achieve control of money and credit by affecting the demand for reserve money and thereby the money multiplier. Changes in reserve requirements are better suited to effecting secular rather than short-term changes in the money supply.

- Frequent variations in reserve requirements complicate financial management and lead to large holdings of excess reserves that frustrate monetary control.
- Insofar as reserve requirements carry zero, or below-market, interest rates, they involve a taxation element that adversely affects financial development and encourages disintermediation.

More broadly defined liquidity requirements are usually designed to place government securities rather than contribute to monetary control. From the viewpoint of monetary control, liquid asset ratios are of little relevance and may be determined solely by prudential requirements.

The effectiveness of open market operations does not depend on the level of reserve requirements. However, certain technical changes in the requirements can make them more compatible with indirect mechanisms of monetary control. For example, reliance on average reserve requirements can reduce excessive interest rate pressures to meet end-of-period positions.

(3) Central bank lending facilities

The cost and availability of central bank refinancing should ensure that borrowing from the refinancing window is consistent with the desired track for reserve money.

- Importance should be attached to ensuring that the availability of central bank finance is constrained so as to avoid offsetting the impact of open market operations.
- The discount rate should be sufficiently penal to discourage borrowing, with the rate kept under review to ensure it remains significantly above market yields.
- Central bank refinancing should, however, be sufficiently available to maintain its short-term safety role, and provide some insurance against excessive fluctuations in interest rates.

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III. Fiscal Policy and Reform

by Jeffrey M. Davis

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1. Introduction

The effectiveness of fiscal policy is a major factor determining macroeconomic performance. In part this follows from the size of the public sector, with Central Government spending alone averaging almost 25 percent of GDP in developing countries in the mid-1980s. Further, governments have sought to use taxing, spending and borrowing powers both to maintain the desired level of economic activity and to manipulate the allocation of resources to achieve growth and equity objectives.

Despite impressive objectives, the results of fiscal policy intervention in developing countries have often been far from favorable. Indeed, substantial evidence exists that in many cases poor fiscal management has been a major factor underlying problems of internal and external balance and low growth rates. Consequently, there is a need to focus on fiscal policy both as a possible source of disequilibrium and as a major tool for achieving growth-oriented adjustment.

For countries that now face unsustainable fiscal deficits, macroeconomic stabilization represents a top priority. However, achievement of growth-oriented adjustment requires that comparable emphasis be given to the structure of taxation and the establishment of priorities for government spending. This chapter initially reviews stabilization aspects of fiscal policy. Subsequent sections review tax and expenditure policy issues, respectively.

2. Contribution to macroeconomic stability

a. The importance of budget deficits

Consideration of the appropriateness of the fiscal policy stance often focuses on the size of budget deficits. Such deficits provide a measure of the excess of the government's spending over its revenue and, as such, an indication of budgetary addition to domestic demand. There are, however, important problems in measuring and interpreting budget deficits which must be considered in policy analysis. The following problems may be noted:

- the impact of a given deficit on domestic demand, external balance and aggregate supply depends crucially on the structure of revenues and expenditures;
- extrabudgetary funds and quasi-fiscal operations of public sector financial and nonfinancial institutions may require a more comprehensive measure than provided by conventional deficits; and
- the conventional deficit may tend to overstate the expansionary thrust originating from fiscal operations in situations of high inflation. In these

circumstances, a significant share of the government's nominal interest payments may effectively compensate bondholders for the erosion in the real value of their principal rather than representing a transfer of purchasing power.

Nevertheless, an understanding of the possible relationships between budget deficits and their financing, and macroeconomic targets is crucial to developing an effective fiscal policy. As, however, illustrated in Box III.1 it may be necessary to complement the conventionally measured deficit with alternative indicators of fiscal impact.

Alternative Concepts of Fiscal Deficit

The appropriate measure of the fiscal deficit may need to be adapted to the particular circumstances of each country. This may be illustrated with respect to the fiscal deficit concepts used in monitoring the 1986–87 Fund-supported program with Mexico. The high inflation rate that prevailed during this period and the large stock of domestic debt complicated the evaluation and monitoring of fiscal policy solely on the bases of conventional concepts of the fiscal deficit. The public sector borrowing requirement (PSBR) measures the difference between total expenditures and revenues of the nonfinancial public sector. In the context of high inflation, the concept of the PSBR contains a large element of debt amortization in its interest component. Thus, the concept of the operational balance, which corrects for this component, was adopted along with the usual calculation of the PSBR. The operational balance was derived by subtracting from the overall economic balance the inflationary component of the interest payments on the internal public debt denominated in Mexican currency. Also, to assess the fiscal effort resulting from the measures being implemented, the concept of the primary balance was employed. The primary balance is defined as the economic balance, excluding all interest payments.

Box III.1

In the context of adjustment programs, particular importance attaches to the relationships between budget deficits and the external current account balance, and those between the methods of financing deficits and other stabilization objectives.

b. The budget and external balance

A simple accounting relationship can be established between budgetary and external current account balances. Gross national product (GNP) can be defined in terms of expenditure components or income uses:

$$GNP = C_p + I_p + G + X - M = C_p + S_p + T + R \quad (III.1)$$

where,

C_p = private consumption;

I_p = private investment;

G = government spending;

X = exports of goods and services;
 M = imports of goods and services;
 S_p = private savings;
 T = government revenue; and
 R = net current transfers to abroad.

Rearranging,

$$(I_p - S_p) + (G - T) = (M - X + R) \quad (III.2)$$

Equation (III.2) shows the external current account balance as the counterpart of the domestic private sector's investment-savings balance and the overall budget deficit. Thus, an overall budget deficit must be matched by a domestic private sector that saves more than it invests and/or by an external current account deficit.

Considerable caution is required in moving from the accounting identity to the assumption that a simple causal relationship exists between budget and external deficits. Establishment of such relationship requires consideration of the impact of fiscal policy on private sector savings and investment; budget deficits also respond to, as well as influence, external balances.

While such caveats are important they do not lessen the likelihood that large and prolonged fiscal deficits will be reflected in a deteriorating external current account balance. Correspondingly, a recent World Bank study suggested that budget deficits were a principal cause of the international debt crisis, with the aggregate current account deficit of the seventeen highly indebted countries widening in step with their aggregate fiscal deficit.

c. Financing the deficit

Budget deficits may be financed by borrowing from domestic bank and nonbank sources, and from the rest of the world. Excessive reliance on any of these methods of finance has its dangers and potentially adverse effects on macroeconomic targets.

- **Monetization of deficits.** Government borrowing from the central bank directly affects the monetary base and the money supply. Reliance on commercial bank finance may be expected to have similar effects if banks are not forced to constrain credit to other borrowers. In many developing countries, the government sector is the primary influence on the money supply. Excessive growth in the money supply leads to high inflation rates and balance of payments problems.
- **Reliance on nonbank financing.** Substantial borrowing from the nonbank sector may adversely effect the structure of demand and growth potential. In particular, this borrowing may limit the availability of resources to finance private investment. Such "crowding out" of private investment may occur through the impact of government borrowing on domestic interest rates.

- **Borrowing from abroad.** Reliance on external finance leads to the accumulation of debt, which needs to be serviced and eventually repaid. The dangers of excessive, or inappropriate, borrowing are well evidenced by the recent situation of heavily-indebted countries.
- **Accumulation of arrears.** Delays in payments on debt service, or on goods purchases, are considered a particularly unfortunate means of budgetary finance. Such arrears have similar macroeconomic consequences to other forms of public borrowing, as well as jeopardizing future financing and the integrity of the budgetary system.

d. Consideration of a prudent fiscal deficit

The appropriateness of deficits needs to be assessed in the context of the way resources are utilized and the overall macroeconomic environment and objectives.

- If the use of public resources is sufficiently productive, future income can be generated to cover the servicing costs of any debts incurred.
- Deficits can be more easily absorbed by countries with high rates of domestic private savings and well-developed capital markets.
- More generally, a prudent fiscal policy can be defined as maintaining the public deficit at a level consistent with other macroeconomic objectives: controlling inflation, promoting private investment, and maintaining external creditworthiness.

e. Fiscal policy and adjustment strategy

Fiscal measures in Fund-supported adjustment programs seek to reduce pressures arising from excess demand and to enhance the contribution of the public sector to growth.

- **Limitation of excess demand.** Reduction of fiscal deficits usually represents an important target of adjustment programs. Emphasis is also given to the financing of deficits, with limitations on government borrowing from the banking system and ceilings on commercial external borrowing by the government (or public) sectors.
- **Structural measures.** Adjustment programs have, in recent years, given increasing attention to the supply-side effects of fiscal measures. This requires more detailed emphasis on the structure of taxation and expenditure priorities.

3. Tax policy issues

Countries undertaking adjustment programs usually need to increase revenue quickly to address urgent stabilization problems. Emphasis also needs to be given to raising tax elasticity; this involves enhancing the ability of the tax system to generate increases in revenue in response to growth in the economy, without continued resort to new tax measures or rate increases. Over time, achievement of growth-oriented adjustment may require a fundamental reform of the tax structure.

a. Tax structures

Tax policy issues need to be seen in the context of the actual and potential tax structure in particular countries. The tax structure tends to vary substantially according to the level of development, reflecting the availability of tax bases and administrative capacity. Tax structures in low-income countries often reflect the features described below.

- A heavy reliance on domestic commodity and international trade taxes; together these accounted for 70 percent of tax revenue in low-income countries, in 1985, with import duties alone representing over 40 percent of this amount.
- Domestic income taxes tend to be of more limited importance (25 percent of 1985 tax revenue), with greater reliance on company than personal taxes. This reflects the convenience of large (often foreign) companies as sources of revenue and the administrative difficulties of applying an effective personal income tax.

By contrast, international trade taxes are insignificant in industrial countries, while personal and social security taxes are major sources of revenue.

b. Problems in tax systems

Concerns have been expressed as to the possible adverse effects of the tax structure, and the design of particular taxes, on growth in many developing countries. Essentially, such concerns reflect the impact of taxes on relative prices and the possible adverse effects on incentives of inappropriate price signals. These problems may be exacerbated by weak tax administration. Tax issues that arise in developing countries include:

- import duties with high and variable rates that give unintended effective protection and encourage inefficient import substitution (see Chapter V for a review of these concepts);

- export taxes and implicit taxation through surpluses of marketing boards and overvalued exchange rates that serve as disincentives to production and export;
- high nominal rates and ad hoc exemptions from direct taxes that may adversely affect the level and pattern of investment, saving, work effort, and capital flows; and
- reliance on turnover taxes that are not neutral with respect to the number of stages of production and distribution.

c. Tax system design

Recent studies have reviewed some of the desired features of the tax system that should emerge as countries develop. These suggestions have reflected theoretical and empirical work that has questioned the equity of existing tax systems and emphasized the resource allocation costs associated with high marginal tax rates and wide exemptions. Importance has also been attached to designing tax systems that ensure revenue increases in line with growth in the economy.

- **Concentration of revenue sources.** A system that raises revenue from a limited number of taxes and rates may substantially reduce administration and compliance costs. Avoidance of numerous taxes, and rate schedules that yield limited revenue, may also facilitate the assessment of the effects of policy changes and avoid an impression of excessive taxation.
- **Broad and objectively defined tax bases.** A broad tax base with limited exemptions enables revenue to be raised with relatively low rates. Substantial erosion of the tax base through exemptions requires much higher rates to achieve a given amount of revenue. The likelihood of adverse incentive and resource allocation costs, and of tax evasion, is consequently increased. Tax bases should be defined so as to ensure that producers and consumers can clearly estimate their tax liability given their planned activities.
- **Minimization of collection lags.** In an inflationary environment the real value of tax receipts may decline substantially when there are long lags in payments. High penalties are necessary to ensure that legal delays are not compounded by delinquency lags. Payment delays are more likely to occur for capital than wage income, leading to equity problems.
- **Tax neutrality.** The tax system should finance government operations with the least cost and disturbance to the patterns of production, and the generation and use of income. Hence, neutrality of the tax system is considered desirable, in the sense that distortions in incentives should be limited unless there are compelling reasons to discourage the production, consumption, or trade of a particular commodity. Insofar as possible the activity most profitable before tax should remain most attractive after tax.

d. Tax instruments

Particular tax instruments may be viewed in relation to the above criteria, and their comparative efficiency in generating revenue, discouraging consumption of particular products, providing protection to specific industries and in the short run influencing the balance of payments.

- **A general sales tax** should serve as a major instrument of revenue generation. To fulfill this role, while adhering to the criteria for efficient tax design, the tax should be levied at a uniform rate on as broad a base as possible. Problems of cascading, that is cumulative taxation as goods move through successive stages of production, can be avoided by utilizing a value-added tax (VAT) or single-stage sales tax.
- **Excises** (selective commodity taxes) can discourage consumption of particular items, or link tax payments to special costs. Taxes on alcohol and tobacco provide examples of the former function, and those on products to offset the cost of roads, the latter. Discouragement of luxury consumption should be achieved through excises on both domestic and imported products; this avoids an unintended stimulation of local production of the latter. Particularly in an inflationary environment, ad valorem are preferable to specific excise duties.
- **Import duties.** Assignment of the major revenue-raising role to a general sales tax leaves import duties to provide protection or effect short-term balance of payments objectives. These objectives could be achieved through a low general ad valorem tax on imports, with high rates reflecting explicit decisions to allow particular industries or sectors special protection.
- **Export taxes** may serve to obtain revenue from the hard-to-tax agricultural sector, to tax windfall gains from devaluation or exceptional movements in world prices, and to divert production to the domestic market. Reliance on export taxes should, however, be limited by their possible serious adverse effects on production and exports.
- **Income taxes.** Personal income taxes may serve revenue generation and equity objectives. Exemptions should be geared to administrative capacity and a proliferation of high rates with limited yields should be avoided. Separate taxation of enterprises may be justified by equity and revenue objectives. Integration of the personal and corporate taxes would be administratively very complicated, particularly for the treatment of nonresident shareholders.
- **Investment incentives.** Governments often use special investment incentives such as exemptions, tax allowances, tax credits, or special reliefs designed to assist particular groups or activities in specified industries or locations. Recent thinking has questioned the effectiveness of such tax

incentives, with preference for low tax rates. Consideration, however, needs to be given to tax incentive legislation in neighboring countries.

e. Tax reform

The serious structural problems in many developing countries has led to the introduction of major tax reforms in developing and industrial countries. Central to several reforms have been measures to broaden the tax base, reduce exemptions, and achieve a simplified and more easily administered tax system. These objectives are illustrated in Box III.2 by reference to aspects of tax reform in Jamaica and Indonesia.

Tax Reform – Developing Countries

In 1985, the government of *Jamaica* embarked on a comprehensive tax reform. This reform included changes in the personal income tax, the company tax, and indirect taxes. The reforms of the personal income tax were particularly profound. A complicated, narrowly-based individual income tax levied under a progressive statutory rate was replaced by a broadly-based single-rate tax in 1986. Before the reform, the highest marginal tax rate of 60 percent (including payroll taxes) was reached at the relatively low annual income level of less than three times per capita GDP. The provisions of the tax code were complicated, with no standard deduction and sixteen separate credits. In addition, employers could grant nontaxable allowances to employees. The resulting tax system was difficult and costly to administer and contained important disincentives; evasion and avoidance all but negated the progressivity of the statutory rate structure.

Under the reformed system, the complex rate structure was replaced with a single rate of 33 1/3 percent; the 16 tax credits were replaced with a standard deduction equal to two times per capita GDP; most non-taxable allowances were incorporated into the tax base; and interest income was included in the tax base. Initial results suggest that the combination of a higher standard deduction, a broadened base, and a lower flat rate has improved administration, increased the progressivity of the tax system, and raised tax yields.

The government of *Indonesia* adopted a major tax reform in late 1983. An important aspect of this reform was the wholesale elimination of tax incentives for investment. Before 1983, a massive array of incentives in the investment code was designed to favor specific industries, promote exports, develop remote regions, promote technology transfers, strengthen the stock exchange, and even encourage firms to be audited by public accountants. The numerous, and often contradictory, tax incentives created an excessively complicated system unable to fulfill its revenue function or to serve the special purposes originally intended. Further, such incentives created effective tax rates that varied both between and within sectors and thus misallocated the capital stock. Tax reform eliminated nearly all special tax incentives, allowing the company tax rate to be reduced. The simplified incentive system was intended to minimize tax-induced inter-sectoral preferences, while the lowered company tax rate would provide more uniform benefit to all investors.

Box III.2

4. Expenditure policy issues

a. Expenditure cutbacks

Adjustment programs, often mandated by fiscal crises, have forced cutbacks in government spending in many developing countries. Real central government spending in fifteen (mainly highly-indebted) countries, fell on average by over 18 percent in the early 1980s. Capital spending suffered more than a 35 percent decline, while current spending fell by less than 8 percent.

The magnitude of the resource constraints facing developing countries has emphasized the need to carefully consider the areas where public sector involvement is necessary as opposed to reliance on markets. Consideration also needs to be given to the most effective utilization of scarce government sector resources in areas where public sector involvement is judged necessary.

b. Expenditure reform

Experience with structurally-oriented adjustment programs has suggested several areas where expenditure reform can help to promote higher productivity and greater utilization of existing productive capacity.

- **Encouragement of productive government investment.** Importance should be attached to ensuring that the investment program is of a high quality and that projects pass a number of economic tests, because the cost of poorly designed or inefficiently implemented projects can be high. Such assessment is liable to be most effective in the context of more general policies to correct distortions in relative factor and commodity prices. Emphasis should be given to government investment that complements, rather than competes with, market-determined activities.
- **Funding operations and maintenance.** Part of current spending on goods and services goes for the operation and maintenance of capital investment and is critical for the success of such investment. Inadequate spending on operations (whether supplies or personnel costs) can lead to low levels of effectiveness in areas such as education and health. Similarly, inadequate spending on maintenance can lead to rapid deterioration of physical capital. A corollary of the concern for operations and maintenance is the need to avoid across-the-board cuts in materials, supplies, and services.
- **Addressing sources of low productivity in government.** Low pay and inadequate salary differentials for skilled managerial and technical staff may discourage work effort and contribute to low productivity in the public sector. At the same time, the common practice of the public sector acting as the employer of last resort may substantially increase wage costs.

Recent reforms in several countries have emphasized the difficult tasks of reducing the wage bill and increasing the salary differentials in favor of senior staff.

- **Cost-effective expenditure policies.** Lack of resources has emphasized the need to use more cost-effective expenditure policies to attain given political goals, such as income redistribution, external or internal security, or self-sufficiency. As an example, general food price subsidies may not be the most cost-effective means of improving the nutritional status of the poor and could be replaced by target schemes.
- **Limiting government consumption.** Reduction of the less productive forms of government consumption increases the contribution of the public sector to national savings as well as limits the need for raising taxes further. Gradual diminution of such spending may represent the most appropriate means of financing growth-oriented adjustment.

c. Budget planning and control

Improving the efficiency and effectiveness of public spending requires reform of fiscal planning, budgeting, implementation, and monitoring.

- **Fiscal planning** ideally involves formulating a phased investment program, projecting current spending needs, and assessing revenue availability and borrowing requirements for three to five years.
- **The annual budget** would then be a comprehensive one-year slice of the medium-term plan. For plans and budgets to promote effective decision making, the trade-offs among agencies, programs and projects must be explicit, and the budget constraints firm.
- **Budget and expenditure control systems** should be strengthened, with an increase in the transparency and timeliness of fiscal reporting particularly critical for effective fiscal management and for monitoring both the government and public enterprises.

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IV. Exchange Rate Policy

by Richard Barth

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1. Introduction

Exchange rate policy involves choosing an exchange rate system and determining the particular rate at which foreign exchange transactions will take place. A country's exchange rate policy affects its relative price structure in domestic currency terms between goods which are traded internationally (tradables) and goods which are produced for the domestic market (non-tradables or home goods). Moreover, exchange rate policy will affect the overall level of domestic prices. For these reasons, the particular exchange rate system and exchange rate level selected will have a widespread impact, in terms of price incentives, on the entire economy.

A country's economic structure and its institutional characteristics are important considerations in determining exchange rate policy. In this context a number of characteristics that are common to many developing countries may be noted:

- reliance on primary commodity production and exports (minerals and agricultural crops);
- limited substitutability of domestically produced goods for imports;
- dependence on the external sector for essential imports, particularly intermediate goods and capital equipment;
- importance of capital flows, including direct investment and official and private lending; and
- underdeveloped financial markets, with a limited number of foreign exchange dealers.

These characteristics have implications for the choice of an exchange rate system and suggest possible limitations on the use of exchange rate policy to effect resource shifts, particularly in the short run, in response to balance of payments disequilibria.

Section 2 of this chapter covers alternative exchange arrangements for developing countries. Section 3 discusses issues related to the particular level chosen for the exchange rate. A brief review of experience with exchange rate policy is provided in Section 4. Box IV.1 provides a summary review of exchange rate concepts.

2. Options for exchange rate policy

a. Peg to a single currency

Pegging the value of a currency to that of a single currency has a number of advantages.

- Trade may be facilitated between the pegging country and the country whose currency is used as the peg. Typically, the currency to which a developing country pegs is that of its main trading partner. By pegging, the uncertainties associated with changes in exchange rates are reduced. Capital flows related to investment in the developing country may be positively affected by the stability of the exchange rate.
- Confidence in the developing country's currency may be enhanced if the country whose currency is being used for the peg is regarded as following economic policies conducive to stable prices. In this case, in order for the pegging country to maintain the level of the peg, it must also follow policies which will maintain stable prices. Thus, an exchange rate peg may serve as a basis for following macroeconomic policies consistent with domestic stability.

The main drawback to an exchange rate peg to a single currency is that movements in the rate vis-à-vis the currencies of other countries may interfere with domestic policy objectives. To a certain extent, the effects of fluctuations in the exchange rates of other currencies cannot be avoided, but they may be amplified by a single currency peg. If, for example, the intervention currency appreciates vis-à-vis other currencies, then prices of internationally traded goods will fall, stimulating import demand and raising the incentive to shift resources into production intended only for the domestic market (nontraded goods). These effects may be contrary to the intended objectives of macroeconomic policy.

b. Peg to a basket of currencies

An alternative approach to exchange rate policy determination is to maintain a peg to a weighted average of several currency values, commonly referred to as a basket peg. There are two main advantages to this form of exchange arrangement.

- By pegging to a basket, a country is normally able to avoid large swings in its exchange rate with respect to several trading partners' currencies, and is thus able to stabilize its nominal effective rate.
- Price instability resulting from exchange rate changes is reduced. In general, changes in the exchange rates of industrial countries vis-à-vis a developing country as well as the geographical pattern of the source of imports will affect import prices denominated in domestic currency. By weighting the changes in exchange rates of supplier countries by their shares in the imports of the developing country, the effect on the import price index (in domestic currency) of any bilateral rate movements will be dampened. Thus, a peg to a basket the currency composition of which is determined by import shares will enable a developing country to avoid some import price fluctuations.

Exchange Rate Definitions

Exchange rate

The exchange rate may be defined as the price of a unit of domestic currency in terms of foreign currency. Demand and supply in the foreign exchange markets lead to the establishment of a nominal exchange rate at a point in time. As demand and supply in the foreign exchange market shift, and depending on a country's exchange system, the exchange rate may change. An increase in the rate (or price) is referred to as an appreciation with respect to the foreign currency, while a decrease is termed a depreciation. Since the exchange rate is frequently defined as the number of units of domestic currency per unit of foreign currency, in this case an appreciation of the domestic currency should be identified with a decrease in the rate and depreciation with an increase.

Effective exchange rate

The domestic exchange rate defined in terms of a single foreign currency is termed a bilateral rate. Increased exchange rate flexibility since the mid-1970s, however, has led to the construction of exchange rate indices that are designed to measure the average change of a country's exchange rate against a number of other currencies during a particular period. This concept of the average relationship between a currency and a set of other currencies is referred to as the effective exchange rate. The effective exchange rate index is thus an average of bilateral exchange rates. Correspondingly, movements in the effective exchange rate index indicate either an appreciation or depreciation of the domestic currency vis-à-vis the set, or basket, of other currencies. Movements in the index are referred to as effective appreciations or depreciations.

Real effective exchange rate

The effective exchange rate index is a nominal index since it is calculated as an average of nominal bilateral exchange rates. In order for an effective exchange rate index to be useful in terms of measuring a country's external competitiveness, however, the nominal index must be adjusted for movements in prices or costs at home relative to those abroad. The nominal index adjusted for relative price movements is referred to as a real effective index. Alternatively, the real effective index may be considered an index of relative prices — domestic prices relative to an average of the prices of a group of countries — adjusted for nominal exchange rate movements. This latter definition is equivalent to an index of relative prices, expressed in a common currency. Therefore, assuming that exchange rates are stated as the price of a unit of domestic currency in terms of foreign currency, an increase in a country's real effective exchange rate index, or in its effective price index adjusted for nominal exchange rate movements, is an indication that external competitiveness has deteriorated. Conversely, a decrease in a country's real effective exchange rate — a real depreciation of the currency — or a decrease in its effective price index is an indication that competitiveness has improved. Currencies which have shown real effective appreciations over levels in base periods when the external position was considered adequate are said to have become overvalued, and vice versa.

Box IV.1

There are several disadvantages, however, to a basket peg.

- Technical difficulties of implementing a peg which would in general change on a daily basis vis-à-vis all of the industrial countries.
- Varying cross rates between developing countries using different baskets; under a single-currency peg, currencies pegged to the same major currency would remain stable vis-à-vis each other.
- Diminished attractiveness to foreign investors of a country pegging to a basket since there might be more uncertainty about the future value of the country's currency, reflecting the possibility that a basket peg as compared with a single currency peg was more open to manipulation, particularly if details of the composition of the basket were not publicized.

c. Independent floating

While pegging the exchange rate to a basket may dampen the variability of a country's effective exchange rate, it does not ensure equilibrium in the foreign exchange market. Independent floating potentially provides a mechanism for determining the equilibrium exchange rate and may also serve to insulate the domestic monetary system from external shocks.

- **Exchange rate determination.** Independent floating, in principle, allows a more continuous adjustment of the exchange rate to shifts in the demand for and supply of foreign exchange. This avoids the difficulty of determining the appropriate level of the rate under either a fixed or basket peg.
- **Domestic monetary policy.** Under a fixed rate system shifts in the demand for and supply of foreign exchange will affect the overall external balance and the level of official reserves, thereby having an impact on the monetary base. A floating exchange rate, on the other hand, equilibrates the demand for and supply of foreign exchange by changing the exchange rate rather than the level of reserves. Since the monetary base is not affected by foreign exchange flows under a floating rate system, a country has the freedom to pursue its own monetary policy without having to be concerned about balance of payments effects. Thus, external imbalances would be reflected in exchange rate movements under a floating rate system instead of reserve movements, with monetary implications, under a fixed rate system.

An evaluation of the attractiveness of a floating rate system should allow for the factors mentioned below.

- **Potential for an efficient foreign exchange market.** Even if an adequate market were to develop, initially there may be high variability in the exchange rate due to the thinness of the market.

- **Response of trade and capital flows to exchange rate fluctuations.** Greater movements in exchange rates will be necessary to adjust to external shocks if the price elasticities of trade are low. Increased variability in rates may have adverse consequences for capital inflows, particularly if foreign investors also are concerned that exchange rate flexibility may reduce a country's willingness to follow restrained domestic monetary policies.

d. Experience with alternative exchange rate systems

While most industrial countries and some developing countries have adopted floating or flexible exchange rate systems, the financial systems and other institutional features of a number of other developing countries do not readily lend themselves to an exchange regime of this type. Table IV.1 shows the evolution of exchange rate arrangements of Fund member developing countries over the period 1977-90. The trends described below may be noted.

- A shift toward greater flexibility, with the proportion of developing countries pegging to a single currency falling from 61 percent as of end-1977 to 36 percent as of mid-1990; over the same period the percentage of developing countries choosing a flexible arrangement rose from 13 to 36 percent.
- Within the group of countries pegging to a single currency, the proportion pegging to the U.S. dollar declined steadily over the period and as of mid-1990 the pound sterling was no longer used as a peg. Fourteen countries were pegged to the French franc in 1977 and in 1990.
- The share of countries pegging to a basket of currencies rose sharply between 1977 and 1985 and this was maintained through mid-1990. In contrast, pegging to the SDR as a convenient basket has diminished in importance.

The sharp rise between 1977 and 1990 in the proportion of countries relying on flexible exchange arrangements reflects mainly the increased number of independently floating currencies, although the number of currencies adjusted by means of a managed float, in which the rate is effectively set by the authorities and adjusted frequently, has also grown. The increased use of flexible arrangements has been in large part a response to accelerating domestic inflation rates, which made necessary continuing currency depreciation in order to avoid a deterioration in external competitiveness, and the uncertainties associated with the fluctuations in the exchange rates of the major currencies.

As previously indicated, while basket pegs have been adopted to reduce the impact of major currency fluctuations, there has also been some reluctance to tie exchange rates to a preannounced formula. Rather, countries have found it expedient for both economic and political reasons to adopt a more flexible arrangement.

Developing Countries: Exchange Rate Arrangements, 1977-90

(In percent of total number of countries)

	Dec. 31 1977	Dec. 31 1980	June 30 1985	June 30 1990
Classification				
Pegged to a single currency	61.11	49.57	40.00	35.94
U.S. dollar	40.74	33.91	25.60	21.09
French franc	12.96	12.17	11.20	10.94
Other currency, of which:	7.41	3.48	3.20	3.91
Pound sterling	3.70	2.61	0.80	0.00
Pegged to composite	25.93	28.70	32.00	28.13
SDR	14.81	13.04	9.60	5.47
Other (currency basket)	11.11	15.65	22.40	22.66
Flexible arrangements	12.96	21.74	28.00	35.94
Adjusting to indicators	4.63	2.61	4.00	2.34
Other ^{1/}	8.33	19.13	24.00	33.59
Total	100.00	100.00	100.00	100.00

Source: International Monetary Fund, *Annual Report* (various issues).

^{1/} Includes the following categories: "flexibility limited vis-à-vis single currency," "managed floating," and "independently floating."

Table IV.1

3. Adjusting the exchange rate

a. Indicators of adjustment need

The need for an exchange rate adjustment should be considered in the context of an assessment of the overall external position, taking into account prospects for the medium term. This assessment is usually complemented by a consideration of the indicators listed below.

- **Real effective exchange rate index.** This is the indicator most commonly used in assessing the need for an adjustment of the exchange rate. An increase in a country's real effective exchange rate index (real appreciation of the domestic currency) over its level in a period when the external position was considered adequate is an indication that external competitiveness has deteriorated. Real effective exchange rate indices are usually constructed using bilateral trade flows, although to gauge export competitiveness it would be preferable to take into account the importance of export competitors in third-country markets. While a unit labor cost index would be the best indicator of cost developments, the consumer price index is commonly used in real exchange index calculations because of the unavailability of data on unit labor costs in most developing countries. If the consumer price index basket includes a significant proportion of traded goods, a rising value for the real exchange rate index rather than reflecting a loss of competitiveness could simply be associated with successful adjustment of an overvalued currency and not indicate the need for further adjustment. Thus, it is important to examine carefully the reasons underlying a change in the real exchange rate index.
- **Rate in the parallel market.** The rate in the parallel market, if one exists, is another indicator that may be useful in judging the appropriateness of the level of the exchange rate. A parallel market rate in which transactions take place at a more depreciated rate than the official rate, for example, might indicate that the domestic currency is overvalued in terms of the official rate. Consideration of the parallel market rate should, however, allow for the size of this market and the possibility of the rate including a substantial risk premium if the market is not officially sanctioned.

b. Devaluation effects

Exchange rate action in the form of a change in the external value of the domestic currency can be an effective means of improving a country's balance of payments. It is most often appropriate when a country is running an unsustainable balance of payments current account deficit but may also be used in the case of current account surpluses. The basic idea of exchange rate action, raising or lowering the external value of the domestic currency, is to alter the relative domestic profitability of tradable goods. Tradable goods consist of exportables, which include actual exports as well as goods produced and consumed domestically that are close substitutes for exports, and importables, which consist of imports as well as goods produced and consumed domestically that are close substitutes for imports. The domestic prices of tradable goods are determined by the world market and the exchange rate, subject of course to international transport costs, tariffs, and export subsidies, if any. The prices of nontradables, which consist for the most part of services, are determined by domestic supply and demand.

A deterioration in a country's current account position may have a variety of causes and frequently reflects the impact of a combination of factors. Some of the main factors are the following:

- domestic supply disruptions;
- higher debt servicing costs due to an increase in international interest rates;
- worsening of the terms of trade — prices of imports rising relative to export prices; and
- expansionary monetary and fiscal policies.

An external imbalance can persist as long as it can be financed by capital inflows or by drawing down official external reserves, but there are limits to these sources of current account finance. A large and persistent current account deficit, therefore, is normally not sustainable and policy actions must be undertaken to deal with the imbalance in order for adjustment to take place. A number of possible policy responses are open to the authorities, including exchange rate action, which is normally undertaken in combination with complementary measures. The latter may include a tightening of fiscal and monetary policy, debt rescheduling, price liberalization, and a variety of structural measures depending on the immediate cause of the problem. The case for exchange rate action is particularly strong when the underlying cause of the current account deterioration has been overly expansionary financial policies, but a worsening of the terms of trade may also call for an exchange rate change.

If the terms of trade deteriorate from a decline in export prices caused, for example, by a recession in the industrial countries, developing countries could await the cyclical upturn and the improvement in prices rather than make a change in the exchange rate. However, if the decline in export prices is a reflection of a more permanent shift in demand away from certain exports, perhaps due to technological change, then diversifying the export base would be called for and an exchange rate action would be appropriate. In practice, developing countries may have neither the reserves nor the borrowing capacity to await the cyclical upturn of industrial countries. They may also lack the ability to diversify the export base in the short or medium term. In either of these situations a devaluation may be required to restore profitability to the export sector.

When the exchange rate remains unchanged while export prices in foreign currency terms fall, the profitability of exports is reduced. A devaluation raises the domestic currency price of exports, thereby increasing their profitability, assuming that the domestic price of all intermediate goods used in their production and labor costs do not rise by an equivalent amount. The higher domestic price of foreign currency following a devaluation will also provide an incentive to develop nontraditional export activities, thus encouraging a diversification of the export base.

Overly expansionary macroeconomic policies frequently have their origin in unrealistically high government expenditures when compared to the financial resources available to the government from tax and nontax revenues and voluntary lending from the nonbank private sector. The ensuing fiscal deficit is then financed by borrowing from the banking system which, when added to bank lending to the

private sector, creates an excess supply of liquidity in the economy. The expansionary monetary policy raises incomes, thereby allowing domestic expenditures to increase, which puts pressure on the prices of nontraded goods and on wages. Under a fixed exchange rate, this sequence of events will cause the prices of nontraded goods to rise relative to the prices of traded goods, whose prices are set in world markets. Domestic expenditures on traded goods will thus tend to rise for two reasons: because nominal incomes are higher and because the prices of traded goods are relatively lower. While domestic expenditures are thereby shifted away from nontradables toward tradables, production of tradables is discouraged, as domestic factor costs rise and profits in the traded goods sector are squeezed. Therefore, as a consequence of the expansionary fiscal and monetary policies, the external current account will tend to deteriorate as a larger proportion of tradables is consumed domestically and the supply of tradables is reduced.

If administrative restrictions on imports are to be avoided, the profitability of exports must be restored and expenditures must be cut to a level consistent with the country's income. In principle, a devaluation can be used to achieve both of these results.

- A devaluation increases the domestic price of tradables, thereby raising the price and profitability of tradables relative to nontradables. The external current account will improve to the extent that domestic expenditures are shifted away from tradables and the production of tradables is expanded.
- A devaluation will also tend to bring about a reduced level of expenditures. Since a devaluation raises the domestic price of traded goods while leaving unchanged the price of nontraded goods, the average domestic price level will rise and incomes and expenditures in real terms will fall.

It is important to highlight the fact that for the current account to improve, there must be a reduction in expenditure in real terms which may represent a cut in living standards. A relative price change by itself will not eliminate the external imbalance.

c. Supporting monetary and fiscal policy

For a devaluation to be effective, the value of the domestic currency must depreciate in real terms. That is, the increase in the relative price and profitability of tradables to nontradables, brought about by the devaluation, must not be eroded by a subsequent rise in the price of nontradables. Since devaluation inevitably increases the aggregate domestic price level there will be pressure to raise wages to compensate for a reduced standard of living of wage earners. Moreover, a devaluation will cause government expenditures on goods and services to rise in proportion to their import content and the size of the devaluation, while the domestic currency equivalent of the cost of debt service payments will also increase. To a certain extent these higher fiscal costs will be offset by a rise in receipts from international trade taxes, but on balance there is likely to be pressure on the budget.

These pressures may force monetary policy to a more accommodating stance, since monetary policy is frequently subordinated to domestic employment and fiscal considerations. Both theory and recent experience suggest that to avoid an erosion of the gains from relative price changes brought about by a devaluation, wage and fiscal restraint are of critical importance.

4. Experience with exchange rate policy

Exchange rate policy actions have been important elements of many countries' macroeconomic programs, whether or not the programs have been supported by the Fund. Box IV.2 reviews experience with exchange rate policy in Singapore.

Policy actions have related to both the exchange rate system and the exchange rate level. Moving to a flexible exchange rate system has frequently been a key element of structural adjustment programs. In some of these countries, a floating exchange rate was considered feasible and put in place. Subsequently, several of these countries had to abandon their floating rates, often under pressure from expansionary demand policies. Moreover, while a sizable adjustment was made in the level of the exchange rate in a number of countries, the adjustment was not always sufficient to correct the initial distortions in exchange rates. Despite the mixed record of policy implementation, however, in most cases there was some depreciation of the domestic currency in real effective terms. On the other hand, there were also large fluctuations in the exchange rate and in many cases, the initial real effective depreciation was eroded in part or entirely.

Several conclusions can be drawn from the experience of countries undertaking exchange rate actions.

- There appears to be evidence of a significant response of exports to exchange rate changes. Export diversification, on the other hand, is only evident after a longer time period and seems to take place only if the exchange rate action is supported by other policies, such as trade liberalization and adequate external financial support.
- Import substitution has been limited in the short run, particularly for imported raw materials and investment goods, but substitution has been more promising for food and energy products. In part, reflecting an often large share of imports tied to aid, the effectiveness of exchange rate action on import demand has been limited.
- Exchange rate changes affect the domestic price level in the short term through increases in prices of imported goods. The concern for the potential inflationary impact of exchange rate changes has been a major reason behind the reluctance of countries to adjust the exchange rate. A key factor behind the inflationary impact of an exchange rate change has been the strength of monetary management. In cases where monetary expansion was kept under effective control after a depreciation, inflation decelerated and vice versa.

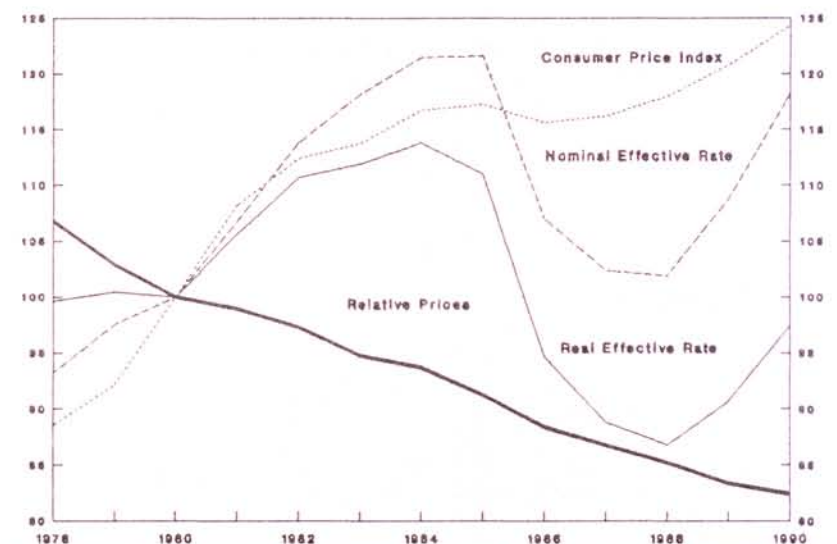
Exchange Rate Policy in Singapore

The evolution of Singapore's nominal and real effective exchange rates and the rate of inflation in Singapore relative to its trading partners is shown in the Chart below. From 1978 to 1985 the Singapore dollar, the value of which is determined by a managed float, appreciated vis-à-vis the currencies of Singapore's trading partners. During this period, exchange rate movements of the Singapore dollar closely followed movements of the U.S. dollar, which was appreciating. Since the inflation rate in Singapore over this period, as measured by the consumer price index (CPI), was lower than its trading partners, the Singapore currency appreciated in real terms by 11.5 percent as compared to a nominal appreciation of 30 percent. If unit labor costs are used to calculate the real effective exchange rate index, however, the real effective appreciation amounted to about 40 percent, as a high wage policy was followed during this period and unit labor costs rose by almost 50 percent. One effect of the real appreciation of the currency was a loss of external competitiveness which contributed to a decline in exports and a recession in 1985.

The policy response to those developments was to implement a severe wage restraint and, owing to the close link between the Singapore dollar and the U.S. dollar, a 16 percent nominal depreciation between 1985 and 1988. As a result, the value of the Singapore dollar in real effective terms depreciated sharply during 1986 and 1987 and to a lesser extent in 1988. Export growth resumed in 1986 and accelerated in 1987-88. In 1989, exchange rate policy was directed toward an appreciation of the currency, mainly in order to forestall inflation pressures. As the currency appreciated by 17 percent in nominal effective terms from mid-1988 to mid-1990, this more than offset the decline of 4 percent in the rate of inflation in Singapore relative to its trading partners, resulting in a real effective appreciation of 13 percent.

Singapore: Exchange Rates, 1978-90

(Index, 1980 = 100)



Note: Exchange rate indices are calculated using the price of Singapore dollars in terms of foreign currency. Relative prices indicate Singapore's CPI divided by the average CPI in trading partners.

Box IV.2

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V. Trade Policy and Reform

by Robert Franco

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1. Introduction

Trade policy has received increased attention in recent years in Fund-supported adjustment programs. This attention reflects the growing concern with structural policies and the importance attached to developing programs aimed at stimulating aggregate supply, as well as re-establishing financial equilibria. Over 90 percent of Fund-supported adjustment programs in operation on June 30, 1990, called for the adoption of measures that would fall in the general category of trade policies. Furthermore, all of the Extended Fund Facility, Structural Adjustment Facility and Enhanced Structural Adjustment Facility arrangements included some form of trade policies, as did 10 of 14 stand-by arrangements.

This chapter assesses arguments for protectionism, reviews some alternative trade strategies and discusses the types of trade policy measures included in recent Fund-supported adjustment programs.

2. Protectionism versus open trade

Open trade promotes competition in domestic markets, increases pressure on enterprises to innovate, provides consumers with wider selection of goods, and allows firms to fully exploit comparative advantage and economies of scale. Thus, open trade raises the standard of living of nations. Furthermore, it unleashes dynamic forces tending to raise the growth rate of the economy in the long run by encouraging adaptation and innovation, while protectionism inhibits those forces increasingly as time passes.

Despite these advantages protectionism has many advocates, particularly among producers left behind in the process of development and structural change. Such protectionist pressures have a long history. For example in the 19th century, following the birth of the industrial revolution, Great Britain began securing new markets abroad, while France was drawing into a protectionist shell, as witnessed by the following plea by French wine growers in 1816 for a tax on tea:

This drink 'tea' destroys national character for it develops in those who use it frequently the cold nature of northerners, while wine expands the soul with a gaiety and hilarity which helps to give Frenchmen that friendly and witty character that distinguishes them from the citizens of all other nations.

Advocates of protectionism have put forward a number of economic arguments; many of these are fallacious, amounting to little more than weak rationalization for protectionism. Others have some substance, but require careful qualification.

a. Common fallacies

(1) Purchase of domestic goods keeps money at home

This argument is sometimes explained as follows:

A Frenchman buys a radio from Korea, the Frenchman gets the radio and Korea gets the French Francs (FF), but if the Frenchman buys a French-made radio, he has the radio and France retains the FF.

The fallacy is that Koreans do not work hard to produce radios for export to permanently hold FF. Rather, they earn FF to acquire commodities and other resources from France, or from third countries which will eventually use them for this purpose. Thus, while the French buy radios with money in the first instance, ultimately they are purchased with other domestic goods, services or assets. More generally, purchase of goods abroad may allow domestic productive capacity to be used for alternative, and potentially more valuable purposes.

(2) Labor productivity differentials limit competition

Although labor may be more productive in industrial countries (for example, Germany) than in developing countries, wages are also higher. When both influences are taken into account, it does not necessarily follow that costs are lower in Germany, and that developing countries cannot compete in certain areas. Developing countries may not be able to compete with Germany in areas in which it has a comparative advantage; there are, however, activities where lower productivity is more than offset by wage differentials. A variant of this argument is that *industrialized countries cannot compete with cheaper labor from developing countries*. However, the reasons wages are higher in Germany than in developing countries is that its labor is more productive. When both influences are taken into account, it does not necessarily follow that the German costs are higher.

(3) Tariffs should be tailored to equalize costs

This recommendation may sound plausible, but it misses the whole point of international trade; i.e., gains from trade are based on cost differences between countries. It is to the advantage of, say, Sweden to import bananas, oil or radios precisely because they can be produced more cheaply abroad. Thus, success in the difficult task of tailoring tariffs to make costs precisely equal domestically and abroad would eliminate incentives for trade, and the potential gains from trade would be lost. All that tailored tariffs accomplish is to strangle trade and raise the domestic resource cost of producing commodities (see Box V.1).

Key Concepts

Nominal protection

The concept of nominal protection relates to the effects of protective measures on the price received for a product by domestic producers. When a tariff is levied on an imported commodity, the domestic price can rise by the full amount of the tariff if the world supply is perfectly elastic, or by less than the full amount if the elasticity is less than infinite. This assumes that the tariff is not so prohibitive that it precludes imports altogether. The tariff rate is often used as an acceptable indication of the nominal rate of protection. If the imports are subject to quantitative restrictions, the nominal rate of protection can in principle be estimated as the percentage difference between the domestic producer price and the c.i.f. import price of equivalent products, using shadow exchange rates. Thus, the nominal rate of protection may be defined as $(P_d - P_w)/P_w$, where P_d is the domestic protected price, and P_w the world or free trade price.

Effective protection

Since the possibility exists that inputs as well as outputs may be protected, economists have developed the concept of effective protection, which measures the combined impact of output and input protection. The effective rate of protection for a product is defined as the percentage difference between the value added in domestic prices V_d , obtainable as a result of the application of protective measures, and the value added in world market or free trade prices V_w . The former is derived by taking the output and its inputs in domestic prices and the latter by valuing outputs and inputs in world market prices, expressed in domestic currency at shadow exchange rates. Thus, the effective rate of protection may be defined as $(V_d - V_w)/V_w$.

Domestic resource cost

A closely related measure to effective protection is that of the domestic resource cost, DRC, which measures the opportunity cost of earning or saving a unit of foreign exchange. The DRC of saving a unit of foreign exchange by import substitution is the total value of the domestic factors of production used in increasing domestic output of a good that was previously imported, divided by the net value of foreign exchange saved. Similarly, the DRC of earning a unit of foreign exchange through exports is the value of domestic factors of production utilized, divided by the net earnings of foreign exchange. In all cases, shadow exchange rates are used to convert foreign prices into domestic prices.

Trade regime biases

The notion of trade regime bias concerns the direction and the degree to which, on average, domestic incentives diverge from those that would prevail under free trade. Under this system, resources would be allocated among the production of tradable commodities, in such a way that at the margin resources devoted to saving a unit of foreign exchange should be the same as to earn a unit of foreign exchange, i.e., all DRCs would be equalized. If this is not the case, the extent of the bias can be defined as the degree to which domestic prices of importables to exportables diverge from their international price ratio. In a two commodity world, the trade regime bias B is defined as $B = (DM/WM)/(DX/WX)$, where the D s represent domestic prices, and the W s free trade or international prices, while M and X denote the import-competing and exportable goods, respectively. Shadow exchange rates are used to convert world prices into domestic prices. If the world and domestic prices of exportables coincide and the domestic price of import-competing goods is above the world price, then $B > 1$, and the trade regime is biased toward import substitution. Conversely, if $B < 1$ the bias is toward exports. The greater is the divergence of B from unity in either direction, the more biased is the regime.

Box V.1

b. Arguments with some substance

(1) Domestic purchases preserve employment

This argument is sometimes explained as follows:

If Americans buy cars from Detroit, employment will rise in Detroit rather than in Japan.

This statement may contain elements of truth, particularly if there is mass unemployment in Detroit and significant rigidities in the labor market. However, the employment advantage is based on the questionable assumption that if the United States restricts imports, Japan will not reduce its imports from the United States. This is often called a *beggar-my-neighbor* policy, because the United States would be trying to solve its unemployment problem by shifting it onto the Japanese. In this case, the United States cannot prevent the Japanese from retaliating by restricting imports of United States' goods, and thus, shifting the unemployment problem back to the United States. In periods of world-wide recession, all countries are tempted to initiate a *beggar-my-neighbor* policy with increased protection. However, if all countries attempt to solve unemployment this way, the results would be a general disruption of trade, possibly leading to an increase rather than a decrease in unemployment. If there is large-scale unemployment, the cure should be sought in domestic monetary and fiscal policies, and measures to improve the efficiency of labor markets, but not in mutually destructive trade restrictions.

(2) Restricting trade will diversify a nation's economy

Just as trade encourages specialization, restrictions lead to diversification. However, countries can gain from specialization and trade even though there are risks involved. As discussed below, countries may be advised to take a cautious approach to encouraging diversification, and should avoid policies that adversely affect areas of existing comparative advantage. For advanced industrialized countries, policies to diversify the economy are unnecessary. No matter how freely they may trade and specialize, their activities are likely to remain highly diversified.

(3) Countries need to protect their infant industries

This argument can be illustrated as follows:

Kenya may not be able to compete with an industry with economies of scale until it is well established and operates at high volume and low cost. This can be a real problem if the industry is one in which Kenya has a comparative advantage, and where it would eventually be able to produce very cheaply. Thus, Kenya should use a tariff to protect such an industry from being wiped out by tough foreign competition during the delicate period of its infancy.

Although this line of reasoning is logically valid, it raises the important practical question of when the subsidy ceases to be needed. Experience of developing countries is replete with industries that are chronically dependent on tariffs. Such industries can become a real problem in terms of ongoing budgetary subsidies.

(4) Restricting imports may reduce prices

A single country, or cartel, may seek to use market power to reduce the price paid for imports, or increase that received for exports. For example, if France imposes a tariff or quota to restrict imports of Senegalese groundnuts, it may be able to lower the price it pays for that good. This is sometimes referred to as improving its terms of trade, that is reducing the number of units of exports it must give up in order to acquire a unit of imports. Similarly, the same type of argument can be made in terms of use of monopoly or oligopoly powers, such as for example OPEC, with oil in the mid-seventies and early eighties. The possibility of using market power to improve terms of trade is probably very limited in most cases. This is particularly so over time as alternative sources of supply and markets can be developed. Furthermore, attempts to develop and use such market power may lead to retaliatory measures and reduced trade volume.

3. Trade policies for adjustment and growth

The history of international commerce reveals a range of experience concerning the effects of trade policy on structural adjustment and growth. For many countries, trade appears to be an engine of growth, with gains from trade playing a crucial role in expanding their real incomes. Others, which have long been active exporters of primary products, have yet to see the gap between their real incomes and those of industrial countries narrow. Key trade policy issues include the emphasis that should be given to export diversification and the relative advantages of export promotion and import substitution strategies.

a. Export diversification for primary producers

Many developing countries earn almost all their foreign exchange from one or two exports, examples being Senegal (groundnuts), Côte d'Ivoire (cocoa and coffee), Sri Lanka (tea), and Iran (petroleum). Small reductions in the world price of an export may, depending on the commodity and country, limit their foreign exchange earnings substantially. This has given rise to two major concerns.

- The tendency of demand for primary products to grow at a slower rate than real income, together with productivity advances in agriculture and the development of low-cost synthetic substitutes, can lead to over-supply and downward pressure on prices in the medium and long run.

- Primary products are sold on commodity markets and their prices fluctuate from day to day, while many industrial goods are sold at administered prices. Moreover, because agricultural output is subject to crop failures due to changing climatic conditions and diseases, export earnings from rice, sugar, coffee, and the like are vulnerable to sudden and often drastic changes. The economic reasons for the price instability are the low price elasticities of demand and supply for primary products on world markets.

These concerns do not, however, necessarily indicate that countries should curtail their primary exports in favor of export diversification. While terms of trade of developing countries fluctuate, there is no clear evidence of secular decline. Furthermore, if countries have a proven comparative advantage in their export lines, and these must be curtailed for other kinds of production to be started, the opportunity cost of new enterprises may be too high. To the extent idle resources can be employed so that traditional exports can be continued and others added, there is much to be said for this type of development. As, however, discussed below, there are dangers in encouraging diversification through inefficient and internationally uncompetitive import substitution.

Diversification, when it requires the contraction of activities that can earn foreign exchange, may lose average real income over the years. The economic cost of diversification is, therefore, a sort of premium paid as insurance against price fluctuations. However, there may be less expensive ways to stabilize the incomes of export producers. Thus, government marketing boards can stabilize prices through purchase and sale of major commodities. A problem with stabilization schemes is that, by definition, they eliminate the regulatory effects of price changes; they also require a government wise enough to estimate developments in commodity markets, and strong enough to withstand producers' influence on the marketing board and resist the temptation to turn the Boards into taxing agencies.

For many countries, export diversification may best be served by eliminating existing distortions that adversely affect incentives for new and efficient industries. Establishment of a realistic exchange rate and liberalization of the import regime may be particularly important in this context.

b. Import substitution versus export promotion

For a variety of reasons, including the increased ability of the authorities to affect decisions by producers when the economy is less open, measures to promote import substitution tend to consist of a mixture of pricing actions and of direct quantitative controls over various aspects of economic activity. Although, in principle, import-competing goods could be encouraged with subsidies, this is often ruled out by budgetary considerations. Consequently, domestic production is usually encouraged by either imposing tariffs or quantitative restrictions (in the extreme case prohibitions) on the import of the commodity. Thus, the hallmarks of an import substitution regime generally include:

- high levels of protection to a number of industries with a very wide range of effective protection, i.e., protection against the value of added component of imports;
- fairly detailed and complex quantitative controls and bureaucratic regulations; and
- an overvalued exchange rate.

An important and unwanted result of protecting domestic industry may be the discouragement of exports. This may occur for the following reasons:

- exporters using the often more expensive protected commodity in their production process are placed at a disadvantage;
- resources employed in the import-competing sectors are drawn away from other, including export, industries;
- establishment of a new domestic industry often requires imported capital goods, which tends to put pressure on foreign exchange resources; and
- overvalued exchange rates discourage exports.

An export promotion strategy requires a production or an export subsidy, or a realistic exchange rate. Subsidies, however, are costly to government budgets and since they are clearly visible, tend to be politically unpalatable. Consequently, this strategy usually involves maintenance of a realistic exchange rate, which not only encourages exports, but also reduces the balance of payments motives for tariff protection. Export promotion requires that industries be permitted to purchase their needed intermediate goods and raw materials at world prices if they are to be competitive. This puts pressure on the authorities to reduce barriers to imports, which in turn may encourage other producers to enter the export market. Thus, a genuine export promotion policy must be accompanied by a fairly open trade regime with limited biases. Cross-country evidence strongly indicates that this more liberal, market-oriented regime has been substantially more successful than import substitution strategies.

4. Trade policy measures in adjustment programs

Experience with liberalization suggests that the attainment of completely free trade is not a practical option. More realistic goals should include the elimination of anti-trade biases from the policies in place, and the maintenance of low, non-discriminating, and transparent protection levels. The Fund has encouraged countries in the context of Fund-supported adjustment programs to implement measures to liberalize trade policies and bring about conditions that will engender economic growth concomitant with a viable balance of payments over the medium term. In this

context, importance has been attached to coordinating trade reforms with initiatives in other areas, including tax and exchange rate policies. Below are listed some of the trade policy issues addressed in recent Fund-supported adjustment programs.

a. Encouragement of exports

(1) Reduction of impediments to exports

The following impediments to exports are often addressed in adjustment programs.

- **Quantitative restrictions on exports.** The number of prohibited, or restricted exports, should be sharply limited. Further, lists of such exports should be published by the authorities and subject to annual review.
- **Restrictions on imported inputs.** Intermediary goods needed for the production of exports should either not require licenses, or be subject only to open general licenses. Allocations of the required foreign exchange should be automatic.
- **Export taxes.** Although such taxes may be required for revenue purposes, they have the undesired effect of discouraging exports. Over time, export taxes should be reduced and replaced with alternative, less discriminatory, tax measures.

(2) Reduction of anti-export bias in the trade regime

As previously indicated, attempts to promote import substitution have often led to a substantial bias against exports. Elimination of this bias, and particularly the adoption of an appropriate exchange rate, often represents a crucial part of the adjustment program. Similarly, reductions in import restrictions will help promote exports. Reduction of these restrictions will need to be coordinated with the move to a realistic exchange rate.

Export subsidies may have been used to compensate for biases in the trade regime. Such subsidies are, however, discriminatory and inferior to measures aimed at eliminating the exchange rate and other measures underlying the bias.

b. Liberalization of imports

(1) Simplification of quantitative restrictions

Quantitative restrictions on imports should be eliminated over time. Movement towards such elimination may take place in several steps.

- In cases of absolute prohibition, positive lists of goods that can be imported may be replaced by negative lists of restricted imports.

- Negative lists could be gradually converted from absolute prohibitions to import quotas. The transfer of items from the negative to the quota list may represent a program goal.
- At a later period, general licenses should replace the quota system.

Administration of the import system by state monopolies may exacerbate inefficiencies. Early introduction of competition into the import trade may be an important step in the reform process. For example, in the context of the Fund-supported program, Guinea in 1984 started to dismantle a pervasive system of state import monopolies.

(2) Removal of quantitative restrictions on non-competitive imports

Quantitative restrictions on non-competitive imports are for balance of payments purposes and not for protection. Their removal needs to be accompanied by use of other instruments to prevent a flood of imports. An appropriate exchange rate can substitute for quantitative restrictions. Sufficiently restrictive monetary and fiscal policies complement the expenditure-reducing effect of devaluation. When no exchange rate adjustment is feasible for institutional reasons (e.g., in the CFA countries of Africa), the Fund has suggested that quantitative restrictions on non-competitive imports could be replaced by indirect taxes, tariffs, and tight monetary policies.

(3) Lowering effective protection on import substitutes

The major long-term benefits from liberalization derive from opening up the tradable goods sector to foreign competition. This is especially true for developing countries, where domestic production is usually concentrated in monopolistic or oligopolistic structures. Consequently, Fund-supported programs have given special importance to this area. The speed of implementation may depend on the economic and political influence of the affected subsectors. Agriculture, for example, has succeeded in retaining protection long after most manufacturing was opened up to foreign competition in high income and newly industrialized countries. For most developing countries, trade liberalization has most relevance for the manufacturing sector. In most cases, it would be desirable to prepare preannounced time schedules, specifying the tariff ceiling, the items on which tariffs would be lowered and the new levels. A useful system is to initially lower higher tariffs. This has been done in many Fund-supported adjustment programs.

Conclusion

The potential gains from trade for developing countries are substantial. Both economic theory and the empirical evidence show that fuller participation by developing countries in world trade should increase their efficiency and growth. This suggests that developing countries ought to gain if they reduce their trade barriers and liberalize their own economies. They would, however, find such policies much easier in an environment of more liberal and expanding world trade. This gives developing countries a keen interest in the successful completion of the Uruguay Round (see Box V.2).

The Uruguay Round

Since the end of World War II, countries have agreed on tariff reductions largely through multilateral negotiations under the aegis of the General Agreement on Tariffs and Trade (GATT). GATT has fostered large tariff cuts and helped settle serious disputes over commercial and trade policy. As a result of seven successive rounds of multilateral trade negotiations, average tariffs on manufactured products in industrialized countries declined to about 5 percent in 1988 from more than 40 percent in 1947.

Current multilateral trade negotiations are covered by the so-called Uruguay Round, initiated when 105 countries and the European Community (EC) met during September 15–20, 1986 in Punta del Este, Uruguay, and issued a common declaration. It is generally recognized that the Uruguay Round is the most ambitious of all the GATT negotiations that have taken place so far. This is evidenced by the many and greatly varied subjects that have been put on the agenda at the ministerial conference. No less than 14 different negotiating groups were created by the Group of Negotiations on Goods, which deals with such matters as tariffs, agriculture, dispute settlements, trade-related investment measures, safeguards, and the general functioning of the GATT system. In comparison, the Tokyo Round negotiations (1973–1979), which at the time were regarded as embracing all trade problems, were conducted in only six negotiating bodies. In addition, for the first time a Group of Negotiations in Services was created in the current Round.

The Uruguay Round was scheduled to be completed by the end of 1990 in Brussels. However, major issues remained unresolved, and the negotiations continued into 1992. The areas in which it proved most difficult to reach agreement included agriculture, trade-related aspects of intellectual property rights, safeguards (that is, Article XIX of the GATT, which allows temporary restrictions on imports when domestic producers are seriously affected), and textiles and clothing.

A group favoring fundamental reform—which is made up of agricultural exporters, including the United States—has pressed to remove the agricultural exceptions to GATT rules. It would phase out all voluntary export restraint agreements and other gray-area measures and would eventually prohibit domestic subsidies that distort trade. The Multifiber Agreement would be terminated under these proposals, and textiles would be covered by GATT rules.

A second group—including the European Community, Japan, the Nordic countries, and Switzerland—has argued for restraint. These countries contend that national policies protecting agriculture should be continued although limited. Disagreement between the EC and the United States regarding possible reductions in farm support programs accounted, in large part, for the extensions of the deadline for completing the negotiations.

Box V.2

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VI. External Debt Policy

by Nadim Munla

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1. Introduction

Determination of policies towards borrowing from abroad and external indebtedness represent a crucial part of the adjustment strategy for many developing countries. Emergence of serious external debt servicing problems in several countries in the early 1980s has heightened concerns with this area of economic policy.

This chapter initially reviews debt management issues for individual countries, focusing on policies to avoid external debt crises. Subsequently, successive sections consider the magnitude of the external debt problem, the evolution of the debt strategy, and the role of the Fund in this strategy.

2. Debt management

Two general requirements of effective debt management strategy should be emphasized.

- **The appropriateness of borrowing depends on the use of the resources.** External borrowing supplements domestic savings and provides the debtor country with scarce foreign exchange which enables it to finance a greater volume of investment. For developing countries there is a strong presumption that foreign savings can and should be utilized to augment the stock of domestic capital over and above what could be provided by domestic savings. In addition, short- and medium-term borrowing (such as the use of Fund resources) may be used to compensate for external disturbances. External debt crises may occur when external borrowing is used to finance unproductive activities, and/or unexpected factors with significant adverse effects on the balance of payments emerge.
- **The effectiveness of debt management depends on the appropriateness of other policies.** Trade, exchange rate and pricing policies, as well as domestic monetary and fiscal policies, directly affect the return on investment and therefore the appropriate level of foreign borrowing. Further, the level and terms of external indebtedness have important implications for policy options in these areas. Therefore, debt managers should have a clear understanding of expected macroeconomic developments, while policymakers must have a good grasp of expected new borrowing requirements and debt service payments.

a. Objectives of debt management

Effective debt management should consider both growth and stabilization objectives.

(1) Growth

Over time, external borrowing should be used to promote high and stable rates of economic growth, that are consistent with the achievement of a sustainable balance of payments position over the medium and long term. This requires that the use of borrowed funds — with appropriate support from other policies — generates an adequate future stream of external real resources so as to permit the timely servicing of the foreign liabilities incurred. Thus, a principal objective of external debt management is to ensure that the growth of external obligations is kept within the country's capacity to service debt.

(2) Stabilization

In the short run, the level of external borrowing should be determined in such a way that the financial flows, both domestic and foreign, are consistent with the level of aggregate demand that is compatible with internal and external balance. Thus, external debt management should complement policies influencing domestic credit expansion, thereby ensuring that aggregate demand is maintained within appropriate limits. This is particularly important when internal and external imbalances arise as a result of deficits in the operations of the public sector; in such cases, control of public sector external borrowing directly complements limitations on its domestic financing.

b. Principles of debt management

The principles of debt management relate to the determination of borrowing capacity and to the conditions that need to be satisfied to ensure the servicing of the debt by the debtor country.

(1) Capacity to borrow

In order to increase the growth rate of national income, the marginal product of capital should exceed the interest rate charged on foreign borrowing. Following the law of diminishing marginal productivity, this principle implies that a country cannot always achieve higher growth targets solely by stepping up the reliance on foreign borrowing, even if foreign credits are used entirely for investment purposes. It also implies that policies aimed at improving efficiency of resource allocation and raising capital productivity will increase debt capacity and the chance of achieving higher growth through borrowing abroad.

(2) Ability to service the debt

To the extent that an increment to external debt adds more to investment income payments than to the capacity to make such payments, the "error" implicit in obtaining these resources must be reversed through net exports of goods and services. Failure to do so will lead to additional debt being incurred to make payments, and debt growing faster than debt service capacity. A shorthand way of stating this concern is that the interest rate paid on additional debt should not

persistently exceed the growth rate of exports. Similarly, growth of external debt that persistently exceeds that of income can give rise to concerns as to future debt servicing capacity. Some commonly used debt indicators are reviewed in Box VI.1.

Debt Indicators

Debt ratios offer various measures of the cost of, or capacity for, servicing debt in terms of the foreign exchange or output forgone. Exports of goods and services and gross national product may be used as scaling factors. Both stock and flow indicators are used in assessing a country's external debt situation. The former emphasize the extent of past dependence on contractual capital inflows. Flow indicators are often used as indices of short-run rigidity in a country's balance of payments; the higher the ratio, the greater the external adjustment required to compensate for adverse balance of payments developments. The following are frequently referred to measures:

- debt outstanding and disbursed to exports of goods and services;
- debt outstanding and disbursed to gross national product;
- total debt service to exports of goods and services (the debt-service ratio); and
- total debt service to gross national product.

Although these ratios may be helpful in signaling possible debt problems, two countries facing similar ratios may face considerably different economic circumstances. A full assessment of a country's debt position requires consideration of the overall macroeconomic situation and balance of payments prospects.

Box VI.1

c. Debt management in practice

The practical task of external debt management is complicated by uncertainties relating to many of the main determinants of debt capacity. For example:

- the growth of exports for most developing countries is subject not only to the caprices of weather conditions (for agricultural products) but also to the changes in the level of economic activity in industrial countries (for mineral and manufacturing products);
- the terms of new debt are generally determined by forces in international capital markets which reflect overall supply and demand conditions; and

- interest rates may change on existing debt that is contracted at floating rates.

A satisfactory system for registering, approving and monitoring external debt is an essential starting point for decisions on the level and composition of external debt.

(1) Managing the level of external debt

Several rules of thumb have been suggested for managing the level of external indebtedness, such as limiting the total debt service ratio to a specific number, say 20 percent. However, ability to sustain any particular debt service ratio depends on a number of factors including the outlook for exports, import requirements, the reserve level, future terms of trade and interest rate developments, and the flexibility to adjust policies and economic structure.

A formal ceiling on borrowing may be useful inasmuch as it encourages discipline and helps focus official attention on macroeconomic management. Official borrowing rules can be especially helpful if they cover projects that are not always easy to control for political reasons. However, the overall debt structure can be biased by partial controls. Limitations on the public sector's foreign borrowing may help control a potential source of excess indebtedness. This advantage may be lost if the public sector then borrows heavily from the domestic market, forcing the private sector to borrow abroad, often at higher interest rates and shorter maturities than the government could have obtained.

The extent to which the central government controls external borrowing varies across countries. A few countries have statutory rules limiting the amount of external borrowing by the public sector and by the country as a whole. Some have no clear borrowing guidelines, allowing each investment to be judged on its own merits and on the availability of foreign funds. Most countries announce overall guidelines either in the form of the absolute value of new commitments in a particular year or in terms of some debt or debt service ratio. Usually target levels of public debt are approved by the government or by parliament at the beginning of a fiscal year.

(2) Managing the composition of external debt

Determination of the appropriate composition of external debt requires decisions on the following issues:

- the terms of foreign borrowing, including interest, maturity, and cash flow profiles;
- the balance between fixed rate and floating rate instruments;
- ways of sharing risk between lenders and borrowers, including the balance between debt and equity;
- the currencies in which foreign liabilities are denominated; and

- the level and composition of international reserves.

The following guidelines may prove helpful in making these decisions:

- a country should maximize its use of any highly concessional funds before resorting to commercial markets;
- loan maturities should, to the extent possible, be matched with the payoff period of the investments that are financed;
- if floating rate loans are obtained, it is essential to project future debt service payments based on various assumptions about interest rates;
- it may be advantageous to increase the share of foreign equity in total capital inflows, particularly in a situation of high real interest rates;
- the currency composition of debt should help insulate the economy from exchange rate volatility; and
- higher reserves should be maintained the more variable are export earnings, the higher is debt exposure, the less flexible are economic structure and policies, and the more uncertain is access to a steady flow of foreign capital.

3. Evolution of the debt problem

a. Origins of the debt problem

The debt crisis had its origins in the substantial rise in the external liabilities of the developing countries during the second half of the 1970s and early 1980s, in an environment of large-scale recycling of the oil exporters' surpluses, rising world inflation, and negative real interest rates. At the time many viewed this recycling of funds as a positive development: creditors were able to identify new investment outlets and debtors could acquire funds needed for development purposes.

The development of this situation into an external debt crisis was due to:

- a drastic deterioration in external economic environment in the form of higher interest rates, lower commodity prices, and severe recession in the industrialized economies;
- economic mismanagement and policy errors in debtor countries; and
- excessive lending by commercial banks to some countries, with little regard to country risk limits.

The emergence of external debt problems may be clearly related to the earlier discussion of debt management. In particular, difficulties of many countries stemmed, in part, from the failure of external borrowing to be put to uses that yielded adequate return. There is by now substantial evidence that many of the funds borrowed in the 1970s were used to sustain declines in the saving ratio, and to finance capital flight or projects that were not viable at prevailing market prices. Furthermore, even in some cases where funds were invested wisely *ex ante*, unforeseen adverse movements in interest rates and the terms of trade made the *ex post* rate of return inadequate. In these circumstances, many of the heavily indebted countries accumulated large external debts, but did not generate sufficient capacity to service them.

b. The size of the debt problem

Approximately 60 percent of the total external debt of developing countries is owed by countries with recent debt-servicing difficulties. Most problem debtors are either middle-income countries, largely from Latin America, or low-income countries from Africa. While both groups of debtor countries face major challenges, the nature and magnitude of their problems differ substantially. Table VI.1 provides debt indicators for fifteen heavily indebted middle-income countries (HICs) and for Sub-Saharan Africa (SSA). The following points may be noted.

- Levels of external indebtedness for both groups of countries were substantially higher in the 1980s than in the previous decade.
- Debt for the middle-income countries had risen by the early 1980s to levels that gave rise to concerns as to its impact on the international financial system. Although debt ratios have declined somewhat in recent years, they remain high in comparison to earlier periods.
- For most Sub-Saharan countries official debt accounts for more than 80 percent of total external debt. By contrast, the largest part of the debt of the middle-income countries is owed to commercial banks.
- Although debt levels are substantially lower in Sub-Saharan Africa than in the middle-income indebted countries, debt ratios tend to be higher and have risen since 1982. For both groups of countries the scheduled debt-service ratio is significantly higher than actual payments given the extent of debt relief and arrears.

4. Evolution of the debt strategy

a. Principles of the debt strategy

The strategy for dealing with the debt situation since 1982 has been based on three fundamental principles:

Principal Debt Indicators: Fifteen Heavily Indebted Countries (HICs) and Sub-Saharan Africa (SSA) — Selected Years

(In percent: unless otherwise indicated)

	1975	1982	1985	1990
Total Debt				
HICs	...	380.3	419.2	508.2
SSA	...	54.0	65.5	130.1
Debt/Exports				
HICs	133.9	267.5	284.3	247.7
SSA	65.2	213.6	257.0	390.9
Debt/GDP				
HICs	18.5	41.0	45.5	38.8
SSA	17.1	51.3	61.9	83.7
Debt Service/Exports				
HICs	27.7	51.1	40.9	27.9
SSA	8.2	21.5	22.4	22.5

Source: International Monetary Fund, *World Economic Outlook* (various issues).

Note: The group of 15 heavily indebted countries comprises those countries associated with the "Program for Sustained Growth" proposed by the Governor for the United States at the 1985 Fund/Bank Annual Meetings in Seoul. These countries are: Argentina, Bolivia, Brazil, Chile, Colombia, Côte d'Ivoire, Ecuador, Mexico, Morocco, Nigeria, Peru, Philippines, Uruguay, Venezuela, and Yugoslavia. Sub-Saharan Africa comprises all African countries (as defined in International Financial Statistics) except Algeria, Morocco, Nigeria, South Africa, and Tunisia. Excludes debt, owed and debt service paid, to the Fund. Total debt is shown in billions of U.S. dollars, exports includes goods and services, and data for 1975 and 1990 are estimates.

Table VI.1

- debtor countries need to pursue strong adjustment programs, supported by determined structural reforms, aimed at increasing domestic resource mobilization, attracting non-debt creating flows, and reducing impediments to growth;
- creditors and donors need to ensure the provision of adequate external financing in support of such programs on a case-by-case basis; and
- the international economic environment must be conducive to the success of these efforts.

b. Strategy for commercial bank debt, 1982–88

Although the principles of the debt strategy remain valid there have been considerable adaptations in its implementation.

(1) Initial approach

The debt crisis that surfaced in 1982 was initially viewed as a problem of liquidity rather than solvency. Thus, it was believed that debtor countries, or at least the middle-income countries of Latin America, would be able to regain the confidence of financial markets in time.

Immediate concerns stressed the avoidance of widespread defaults that might endanger the international payments mechanisms and the financial stability of heavily exposed creditor banks. The Fund played a major role both in directly providing resources and in putting together concerted financing packages involving commercial banks and others.

Between 1982 and 1985, the indebted developing countries, faced by severe financing constraints, had no choice but to focus on the immediate need to reduce current account deficits. These efforts, supported by the more favorable external environment during 1983–1984, led to a rapid reduction in their external deficits. This reduction was, however, achieved primarily through severe cuts in imports and investment, with adverse consequences for future growth and payments capacity. Thus, it became increasingly apparent that rapid turnaround in the performance of many developing countries would be more difficult to achieve than had initially been envisaged. Moreover, despite progress with adjustment, the needed financing flows from private creditors did not appear to be forthcoming.

(2) The “Baker Initiative”

Against this background the *Program for Sustained Growth* launched by then U.S. Treasury Secretary James Baker III in October 1985, was directed toward the fifteen heavily indebted countries (HICs) and emphasized the need for a longer-term commitment by both creditors and debtors. In particular, the “Initiative” called for new lending in support of growth-oriented macroeconomic and structural reforms, setting specific goals for increased financing efforts from both commercial banks and the multilateral development agencies.

In spite of the resumption of growth in real GDP and in export volume in the HICs, the response to this initiative was in several respects disappointing. Specifically:

- commercial bank financing turned negative from 1985, contributing to a large resource transfer from the indebted countries;
- policy adjustments in many of the indebted countries did not adequately address the underlying need to raise domestic savings and improve the efficiency of investment; and

- relatively high real interest rates and weak commodity prices complicated the adjustment problems of the indebted countries.

Such problems were reflected in continuing high external debt ratios and a sharp rise in secondary market discounts for the debt of heavily-indebted middle-income countries.

c. Proposals for commercial bank debt reduction

Proposals for debt reduction reflect concerns that the large stocks of external debt accumulated by many developing countries, and the resource transfers required to service them, may act as a deterrent to growth and adjustment. Thus, in situations in which a debtor country is not fully performing on its external obligations, debt payments (or the conditions obtained in a rescheduling agreement) are likely to reflect the economic performance of the country. If, for example, the value of its exports increases, a part of the additional resources may have to be used to service the debt. This may weaken incentives to invest from the point of view of the debtor country, because the effective return to investment is reduced.

In 1988 and 1989 various proposals were made by France, Japan and the United States to strengthen the debt strategy by focusing on a reduction of debt and debt-service. An underlying assumption of the debt strategy up to this stage had been that the debtor countries could ultimately service their debts in full. The Brady Initiative, as articulated by U.S. Treasury Secretary Nicholas F. Brady in March 1989, arose out of a consensus that debt and debt service reduction operations may indeed be necessary in certain instances. More concretely, severely indebted countries with sound adjustment programs would get access to debt and debt service reduction facilities, supported by financing from international organizations and official creditors. A three-pronged approach thus emerged:

- adoption of sound economic policies, with stronger emphasis on measures to increase foreign and domestic investment and the repatriation of flight capital;
- timely support from the IMF and World Bank for countries' reform programs, in part through financing for debt and debt-service reduction transactions; and
- active participation by commercial banks in providing financial support through the negotiation of debt and debt-service reduction and new lending, where needed.

Debt reduction operations have broadened the menu of financial options to address the diverse needs of both debtors and creditors. The following techniques have been widely used: debt for equity swaps; debt buy-backs; debt exchanges; exit bonds; securitized new money claims; and fees to encourage early participation by banks in restructuring agreements. Some commonly used debt reduction mechanisms are reviewed in Box VI.2.

Debt Reduction Mechanisms

Buy-backs

Debt buy-backs permit countries to repurchase their debt at a discount for cash. When negotiated directly with the debtor country, buy-backs normally require waivers from creditor banks of certain provisions in loan or restructuring agreements. Either the country's international reserves or foreign exchange donated or borrowed from official or private sources may be used for such operations.

Swaps

Debt-equity schemes allow foreign banks to swap their loan claims for an equity investment, while foreign nonbanks may purchase loan claims at a discount in the secondary market to finance direct investment or purchases of domestic financial assets. In some cases, resident nationals of the country may also purchase bank loan claims, employing their own external assets (including flight capital) in order to convert them into domestic assets (such as privatized public entities). A few countries have applied two additional conversion schemes: debt-for-export swaps and debt-for-nature swaps.

Exchanges

Debt exchanges involve the exchange of existing debt instruments for new debt instruments denominated in domestic or foreign currency. The terms of the two claims will normally differ substantially. For example, the face value of the new claim may reflect a discount from the face value of the old claim; or the face value may remain unchanged while the contractual interest rate on the new claim is lower than the old claim. The value of the new claim may be enhanced, for example, through collateralization of principal or interest.

Box VI.2

d. Policy response of official creditors

A major development over the past three years has been the progressive adaptation of policies by official creditors (Paris Club) to the chronic and deep-rooted problems of the heavily indebted countries with high levels of official debt. For low-income countries, most significant has been the adoption of the "Toronto terms" in June 1988 followed by the more generous "Trinidad menu" in December 1991. These initiatives provided for the first time a menu of options, including the partial cancellation of debt service, extensions of maturities, and interest rate concessions. Moreover, the Trinidad menu included a "good will" clause under which the Paris Club agreed to consider further debt relief after the expiration of the consolidation period, and a commitment to meet at the end of three to four years to consider the matter of the stock of debt. Initiatives for middle income countries have been largely limited to the extension of maturities. In the middle of 1991, notable exceptions were made for Poland and Egypt for which the stock of debt was reduced by about one half, in present value terms, over the next several years.

5. The Fund and external debt

The Fund has played an important role throughout the debt crisis by providing both policy advice and financial assistance. Such assistance, in turn, mobilizes funds from other sources, because it assures the international financial community that appropriate policies are being implemented.

a. Policy advice

The Fund may contribute advice and input on external debt policies in the context of consultations with member countries and debt restructuring operations.

- Article IV and use of Fund resources discussions emphasize sound debt management policies that are consistent with the achievement and maintenance of sustainable external payments positions. Medium-term scenarios, which assess balance of payments and debt prospects under different assumptions, provide a focal point for such discussions. Further, in cases where Fund resources are made available in support of an adjustment program, the stand-by or extended arrangement usually includes provisions regarding new borrowing (mainly limitations placed on new nonconcessional foreign loans with maturities of over one year) during the period covered in the arrangement.
- In the framework of Paris Club restructuring of official debt, the Fund may provide technical assistance to the debtor and, in the context of the creditors' meeting, furnish an objective assessment of recent economic performance, the main elements of a current adjustment program with the Fund, and the debtor's balance of payments prospects and external debt outlook. The role played by the Fund in negotiations between debtors and commercial bank creditors is less straightforward, reflecting the Fund's attitude of avoiding any direct role in negotiations, as well as the importance of maintaining the confidentiality of a member's relations with the Fund.

b. Financial assistance

Since the outbreak of the external debt crisis the Fund has provided substantial support to the indebted countries through its various facilities. Creation of the Structural Adjustment Facility (SAF) and Enhanced Structural Adjustment Facility (ESAF) and modifications of the Extended Fund Facility (EFF) have enhanced the ability of the Fund to support programs with the indebted countries. In addition, the Fund has developed and adapted policies on financing assurances (see Box VI.3).

In 1989, the IMF adopted guidelines governing its support for debt and debt-service reduction operations. Eligibility of members for this support are governed by the following criteria:

Financing Assurances

The key objectives of the Fund's policy on financing assurances are to ensure that adjustment programs are adequately financed, that financing is consistent with a return to a viable balance of payments position and with the member's ability to repay the Fund, and that the program, if appropriately implemented and supported, would contribute to the maintenance or re-establishment of orderly relations between the member and its creditors.

In May 1989, the Fund modified its policy on financing assurances in light of changes in the financial environment and the possibility that debtors may need more time to agree on financing packages with their creditors. The modifications were as follows.

- 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 would be closely monitored.
- In promoting orderly financial relations, every effort will be made to avoid arrears. Nevertheless, an accumulation of arrears to banks — though not to official creditors — may have to be tolerated where negotiations continue and the country's financing situation makes such arrears unavoidable.

Box VI.3

- the member is pursuing an economic adjustment program with strong elements of structural reform, in the context of a stand-by or extended arrangement;
- voluntary, market-based, debt and debt-service reduction will help the country regain access to credit markets and achieve external payments viability with economic growth; and
- financial support for debt and debt-service reduction represents an efficient use of scarce resources.

According to the guidelines, under an extended or stand-by arrangement the proportion of IMF resources committed that could be set aside to finance operations involving a reduction in the stock of debt would generally be about 25 percent. Further, the Fund would be prepared to approve additional access to its resources, in certain cases, provided that such support is decisive in promoting further cost-effective operations and in catalyzing other financial resources. Such additional access — up to 40 percent of the member's quota — can be used as collateral for debt instruments paying below-market interest rates in connection with debt- or debt-service reduction operations.

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VII. Supply-Oriented Adjustment Policies

by Amr F. Moustapha

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1. Introduction

A persistent imbalance between aggregate domestic demand (absorption) and aggregate supply will be reflected in a worsening of the external payments position, an acceleration of domestic inflation, and a slower rate of growth. To address these problems, and in particular to regain a viable balance of payments position, measures will have to be taken (with or without Fund assistance) to bring about an orderly adjustment between absorption and aggregate supply. Either the level of absorption must be reduced or domestic output increased, or both.

Supply-side policies may be defined as measures that increase the incentive or ability of the domestic productive sector to supply real goods and services at a given level of aggregate nominal domestic demand. Such policies can be divided broadly into two categories.

- Policies designed to increase current output by improving the efficiency with which factors of production (capital, labor, and land) are utilized and allocated among competing uses. Included in this category are all measures that reduce the distortions that drive a wedge between prices and marginal costs. Such distortions can arise, for example, from price controls, imperfect competition, taxes and subsidies, and trade restrictions.
- Other measures designed to raise the long-run rate of growth of capacity output, for example, by providing incentives to stimulate domestic saving and investment and educational and technological innovation. Also important are policies that increase the inflow of foreign savings, whether in the form of private lending, foreign direct investment, or increased development assistance.

These two categories of supply-side policies are interrelated, since policies that increase current output may, themselves, lead to a larger flow of saving and a higher rate of growth of capacity output.

Following this distinction, Sections 2 and 3 of this chapter review issues related to sectoral resource allocation and measures to increase capacity output, respectively. Section 4 considers the use of supply-side measures in the design of Fund-supported adjustment programs. This chapter emphasizes the use of supply-oriented measures in developing countries. As illustrated in Box VII.1, however, structural measures have also been stressed in industrial countries in recent years.

The Role of Supply-oriented Policies in Industrial Countries

The importance of supply-side policies as part of a strategy for long-term growth has been broadly recognized by industrial countries since the early 1980s. This recognition was motivated by a desire to shift from the existing environment of low growth, high and rising unemployment, high inflation, and large fiscal deficits to conditions of stronger and sustained non-inflationary growth. The reorientation of policies was also based on the recognition that, beyond the short run, macroeconomic performance was strongly influenced by the supply side of the economy.

Over the past decade, a number of industrial countries have taken important steps toward improving efficiency and removing distortions. Those have included financial market reforms, measures to deregulate domestic goods markets and stimulate competition through privatization, major tax reforms and steps to enhance the flexibility of labor markets. Efforts are also underway to consolidate the progress made so far in these areas and to extend structural reforms to other sectors where progress needs to be achieved.

Among the important measures that still need to be considered are to cut industrial and farm subsidies and to reduce the restrictions that distort agricultural production and trade; to reform land regulations and those aspects of the distribution system that add to domestic costs and restrict market access; to further reduce distortions and rigidities in labor markets; and to modify certain aspects of existing tax systems, including some tax preferences that affect the level and distort the allocation of private saving. Strong actions in these areas would contribute to raising productive capacity, lowering unemployment, and reducing price pressures. It would also enhance the ability of markets to react to changes in relative prices (including real exchange rates) and thereby facilitate the process of external adjustment.

Box VII.1

2. Policies to improve resource allocation

Supply-oriented policies to improve the allocation of given productive resources consist of a wide range of actions to remove rigidities, including prices and distortions that hinder the mobility of resources. In this section, the focus is on broad aspects of structural reform in four key areas: the financial system, public sector enterprises, producer pricing and agricultural marketing, and labor markets. Box VII.2 provides illustrations of supply-oriented measures implemented by Turkey during 1980–85 in three of these key structural areas. Other areas, including the exchange and trade systems and taxes and public expenditures, are dealt with in other chapters.

Turkey: Supply-Oriented Measures, 1980–85

The government of Turkey, supported by large-scale external assistance, adopted an economic program beginning in 1980 aimed at achieving an export-oriented economy relying strongly on market forces. In light of this, structural reforms were implemented with a view to liberalizing prices and reducing the role of the government in the economy. Measures were also taken to manage domestic demand in a manner consistent with elimination of the external and internal imbalances.

The Turkish authorities implemented over the period 1980–85 a wide range of reforms in key structural areas including: the financial system; public sector enterprises; producer pricing and agricultural marketing; exchange rate and trade policies; and taxation. The following discussion focuses on measures taken in the first three areas of reform.

- **Financial system.** Interest rates, which had been controlled at levels well below the inflation rate, were freed in 1980. Deposits rates became positive in real terms in 1981. The financial system underwent a number of reforms designed to end financial repression, free capital markets and enhance monetary control. Initially, this decontrol was not accompanied by appropriate safeguards against unsound financial practices, which contributed to a financial crisis in 1982. This strained the liquidity position of the entire banking system. Subsequent changes in monetary control and in banking and capital market regulations allowed the process of liberalization of the financial and capital markets to be continued.
- **Producer pricing and agricultural marketing.** The prices of goods produced by the private sector were decontrolled in 1980. Prices of basic commodities produced by state economic enterprises (SEEs) were increased sharply, with future price changes to be made on the basis of cost developments. Pricing of agricultural products and inputs was also changed to reduce subsidization.
- **Public enterprises.** Changes in the pricing policies of SEEs have been complemented by more fundamental reforms. Over time SEEs are increasingly expected to base their operations on principles of commercial viability, with greater managerial autonomy and accountability, and more exposure to competition.

Box VII.2

a. Financial system

The financial system plays a central role in mobilizing saving and channeling it to the most efficient investment. Consequently, reform in this area is, in many cases, a primary element in the achievement of growth-oriented adjustment. A number of serious distortions in the financial sector, which have important macroeconomic consequences, can be identified. These include:

- controls on deposit and lending interest rates;
- the use of credit limits for individual banks to control monetary aggregates and the lack of alternative instruments for monetary control;
- selective credit controls and subsidization of credit to favored sectors;
- control over the direction of credit through the operation of publicly-owned financial institutions;
- high reserve requirements and taxes on financial transactions and institutions;
- restrictions on entry; and
- underdeveloped supervision and regulation systems.

Interest rate controls can result in high negative real rates of interest (defined as the nominal interest rate on domestic financial assets adjusted for expected inflation) for prolonged periods. These rates tend to depress financial saving and discourage development of the financial system. In some cases, particularly in Latin America, the real interest rate was lower than -20 percent a year during the 1970s; it has been estimated that during this period financial saving in several countries was being eroded at an average rate of over 10 percent a year in real terms. Thus, while lower interest rates may increase the demand for investment, they tend to reduce actual investment, since at low interest rates insufficient financial savings will be generated to finance these investments.

Low or negative real interest rates imply credit rationing and control. This is likely to contribute to increased costs of intermediation, the growth of unofficial credit markets, and resource allocation problems. Subsidization of credit may also place a burden on the government budget and contribute further to an inefficient allocation of financial resources.

Reforms to reduce or eliminate distortions in the financial sector require achievement of positive real interest rates, as well as policies to improve the structure of rates. These may go beyond ad hoc adjustments to individual rates, and require systematic adjustment of interest rates at regular intervals in line with particular indicators. Rapid interest rate liberalization may, however, pose problems when there is limited competition in the financial sector and inadequate prudential and supervisory mechanisms. Any interest rate reform should be coordinated with exchange rate movements to avoid destabilizing capital flows.

Development of a more efficient financial system may involve a wide range of reforms in addition to measures directly affecting interest rates. These may include lowering reserve requirements that discriminate against the banking sector; strengthening of bank regulation and supervision systems; reduction in the scope of the authorities' control over the direction of credit; and even liquidation, privatization, or rehabilitation of publicly controlled financial institutions.

Elimination of credit rationing will also require development of alternative, market-based instruments of monetary control. Experience has suggested that successful financial reform requires reasonable macroeconomic stability, and the elimination of excessive fiscal deficits.

b. Public sector enterprises

In many developing countries public sector enterprises have played a leading role in providing basic infrastructure, promoting industrial development, and in pursuing social objectives. Unfortunately, in many cases, public enterprises have proved highly inefficient and, particularly in recent years, experienced serious financial difficulties.

This poor performance can be attributed to a variety of reasons. For example:

- a lack of managerial accountability and an implicit survival guarantee for the enterprise through government financial backing;
- bureaucratic disincentives for efficient and innovative management;
- rigid labor laws and practices;
- a lack of clearly defined objectives for each enterprise, and the sector as a whole, often resulting in the overextension of the public sector into activities it does not have the resources to manage efficiently; and
- the absence of competition in many areas of public enterprise operation.

Problems have often appeared in the form of wide-ranging subsidization. This has occurred because of inadequate pricing policies, overstaffing, poor investment decisions and arrears accumulation from other public agencies or the private sector. Implicit subsidies may arise from the preferential treatment of public entities in the allocation of credit or foreign exchange, and noncompetitive procurement and marketing policies. Moreover, inadequate accounting and financial reporting have rendered it difficult to assess the performance of these enterprises.

The financial performance of public enterprises has direct implications for government finance, credit and monetary aggregates, and the balance of payments. In many countries, large and growing deficits of public enterprises have contributed to a deterioration in the balance of payments, rising inflationary pressure, and a crowding out of the private sector. Further, when the public enterprise sector accounts for a significant proportion of the economy, efficient resource use by individual enterprises may have a direct bearing on economic growth.

Underpricing of inputs produced by public enterprises for the domestic private sector may artificially raise the profitability of certain sectors. This, in turn, will give false signals as to the areas of the economy that should receive emphasis in the overall development strategy. Inadequate pricing, especially of infrastructural services, also has a major impact on efficient resource use.

Recent adjustment programs have stressed measures relating to public enterprises. In some cases, the focus was on measures that could be taken quickly, such as price adjustments and hiring freezes. In other instances, more fundamental restructuring was undertaken. Progress, however, has generally been slower than anticipated, particularly when privatization was involved. This reflected the considerable logistical and operational problems that are connected with the task of privatization.

In sum, there are three broad approaches to the reform of the public sector enterprises: rehabilitation, privatization, and liquidation.

- **Rehabilitation** involves measures at the level of individual enterprises, redefinition of the relations between public enterprises and the government, and policies that affect the competitive environment within which the public enterprises operate. Also considered are steps aimed at the restructuring of management and improvement in accounting procedures.
- **Privatization** aims at taking advantage of productivity gains that might stem from the increased incentives for managerial performance imposed by responsibility to private shareholders. It also seeks the discipline of financial markets and limitations in political interference in decision making.
- **Liquidation** might be considered when all options are exhausted.

c. Producer pricing and agricultural marketing

Intervention in agricultural pricing and marketing is a common practice in industrial and developing countries that takes various forms, including state control of domestic and international marketing, regulation of producer and consumer prices, and taxation of exports and imports. It is usually targeted at achieving a wide range of social and economic objectives, such as: stabilizing producer prices or income; influencing the distribution of income between the urban and rural populations; raising tax revenue; assuring food security; and exploiting monopoly power in world markets.

Intervention usually results in severe distortions in the level and structure of domestic producer and consumer prices with negative impacts on output and productive efficiency. In many countries marketing boards set prices for domestic producers well below world prices for their output, and food prices are directly subsidized. Uncompetitive prices often reduce the incentives for domestic agricultural production. Further, subsidization, especially of food, may both contribute to external imbalance and impose a direct drain on the fiscal budget. State-controlled marketing has also contributed, in some cases, to severe macroeconomic imbalance as a consequence of excessive credit expansion to the marketing agencies. Empirical research on food subsidy schemes has raised questions as to the effectiveness of many of these schemes in targeting those most needy. Subsidies on food can lead to overconsumption and waste, as well as the use of certain subsidized items in unintended ways, e.g., the use of subsidized bread as animal feed.

There are several approaches to reform of producer pricing and agricultural marketing. Producer prices may be adjusted on an ad hoc basis in line with international prices; in some cases, this may involve the reduction or elimination of export taxes. Alternatively, an adjustment formula can be adopted for producer prices, which would include international prices and strict margins for marketing agencies and limited government involvement. Pricing and marketing can also be liberalized by allowing prices to be determined by market forces and domestic marketing and exporting to be undertaken by the private sector. This system is likely to be more successful in maintaining appropriate price incentives.

d. Labor markets

The structure of the labor market and the price obtained in that market, the real wage, are important in determining the allocation of domestic factors of production and in maintaining international competitiveness. Distortion in this area arises from various factors.

- Certain kinds of wage-setting arrangements, such as indexation, have the potential for reducing real wage flexibility.
- Segmented labor markets and an environment where wage-setting is not subject to financial discipline (e.g., the existence of strong labor unions under accommodating credit policies, and wage-setting in the public sector motivated by political criteria) may cause widespread distortions and rigidity in the labor market.
- A public sector that is acting as residual employer may push the wage bill too high while other expenditure categories are relatively underfunded. This is likely to cause an overemployment of labor compared to non-labor inputs, with adverse implications for public finance. High employment levels in the public sector may also coexist with low or declining real wages, particularly for skilled positions.

In many developing countries, real wages increased far beyond the rate of increase in productivity. Studies have suggested that capital/labor ratios are sensitive to relative costs of labor and capital. Distortion in labor markets have tended to hurt both growth and labor intensity, to impede growth of employment and, in particular, to contribute to urban unemployment.

Measures to improve the functioning of labor markets may be essential to ensure the successful implementation of macroeconomic policies. Examples of these measures are:

- excluding the price effects of terms of trade shocks, or more generally, supply shocks, from indexation arrangements;
- strengthening incomes policy by developing government wage guidelines and outright legal limits on normal increase in wages negotiated in collective bargaining agreements;

- removing artificial barriers to labor mobility (including training, especially in cases involving a mismatch between demand and supply of given labor skills); and
- controlling the size of employment, and reviewing wage differentials, in the public sector.

3. Policies to increase capacity output

The rate at which an economy's capacity can be expanded depends among other things on the split between consumption and investment, as well as the nature and quality of the capital stock being added. Higher capacity growth rates therefore require policies that favor investment and saving. In particular, interest rate policy is prominent in influencing not only short-run changes in spending, inflation, and external finance but also in affecting longer-term accumulation of financial assets and the level and composition of investment.

a. Investment

A considerable increase in output can be achieved in the short run through more efficient and fuller utilization of existing resources. However, economic growth over the longer run requires an increase in productive capacity. This can be achieved through increasing the rate of investment and improving its quality.

(1) Increasing the rate of investment

Investment in developing countries is frequently constrained by the availability of saving, thereby giving policies that favor public and private saving special importance in adjustment programs.

For the public sector, this involves steps to improve the fiscal position. The focus for the private sector, is on interest rate policies and the elimination of distortions in the market for financial saving. Such measures are likely to yield gains in terms of increased rate of domestic private capital formation, and therefore higher rate of capacity output. Sound financial policies are also needed to create an atmosphere of confidence in the future of the economy and its management. Without such confidence, private capital will be transferred abroad and investors may postpone, or cancel, their domestic investment projects.

(2) Improving the quality of investment

The quality of investment is as important for growth as the quantity. Empirical studies generally find that less than half the growth in output is attributed to increases in labor and capital, with higher productivity, explaining the rest. Recent studies have shown that investment productivity as measured by the ratio of the

change in GDP to investment (the inverse of the incremental capital to output ratio — ICOR), is significantly higher in faster growing countries.

Several measures may help improve the quality of investment.

- Positive real rates of interest that adequately reflect real rates of return will help ensure that more productive private sector investments are selected; in turn, the average productivity of investment will be increased. The productivity of investment will also increase, with greater reliance on the price system for the allocation of capital, and less use of non-price rationing mechanisms. Moreover, maintaining a set of relative costs and prices that represent real underlying scarcities, including an exchange rate that reflects the true cost of foreign exchange, will encourage more efficient investment decisions.
- Recent experience in developing countries has shown that public sector investment programs have sometimes not yielded returns commensurate with the cost of borrowing (especially from abroad). A more effective system of project evaluation is, therefore, an important part of the strategy to enhance the overall quality of investment.
- Studies have also emphasized that public investment in human capital (e.g., health and education) may have a strong impact on growth in developing countries. Further, there is increasing evidence that investment in public infrastructure can complement the expansion of the most efficient sectors, especially those producing internationally traded goods. Examples of such investments are the development of irrigation facilities in agriculture, and improvements in transport infrastructure.

b. Saving

The objective of raising private saving and improving its allocation can be pursued through a variety of measures aimed at removing distortions in financial markets, eliminating tax disincentives, and fostering a climate of confidence and stability. In the latter respect, monetary and fiscal policies aimed at keeping inflation under control can play a key role in maintaining a stable environment. As previously discussed, interest rate and financial reforms are the principal policy measure for stimulating the mobilization of private domestic savings in developing countries. Although the effect of interest rates on the overall level of savings remains a debated issue, there is some recent evidence of a positive impact. There is more general agreement that positive real interest rates are likely to lead to financial deepening as savers switch some of their saving from real to financial, and from foreign to domestic, assets.

Recent discussion has argued that a switch from income to consumption taxes may encourage saving. The applicability of a general consumption tax in developing countries remains subject to debate, with concerns also expressed as to the equity implications of such a switch. Selective tax measures to promote saving may have more impact on the allocation than total amount of private saving.

4. Supply-side measures in adjustment programs

a. Role in Fund-supported programs

In recent years severe balance of payments problems in many developing countries have been accompanied by low, or even negative, growth rates. This has led to increasing importance being attached to designing programs that both address adjustment problems and contribute to an increase in sustainable growth over the medium term. In this context, considerable emphasis has been given to supply-side measures, such as those reviewed earlier, as these can enable a country to reduce its external imbalance with a smaller decline in absorption.

There are, however, important difficulties or constraints on the extent of reliance on supply-side measures. For example:

- many types of supply-side measures increase output only after a significant delay (e.g., increases in producer prices for agricultural products, or infrastructure investment);
- supply-side measures may affect the political and social objectives of the government, or be perceived as having important impacts on equity as well as efficiency (e.g., changes in food subsidy schemes, or public sector employment policy); and
- elimination of excess demand remains an essential condition for the successful implementation of supply-side measures.

In general, stabilization programs have to use both demand and supply-side policies and the degree of emphasis on growth-oriented measures will vary according to the cause of external imbalance, the availability of financing to allow time for structural measures to have impact, and the constraints facing the government in pursuing policies that have important political and social implications.

b. Adjustment programs and growth

A distinction may be drawn between short- and long-term issues relating to the effects of Fund-supported programs on growth. In the short run, reduction in excess domestic demand will generally be accompanied by some fall in the growth of output, particularly if inflation has become ingrained in the system. The decline in the growth rate is a necessary part of adjustment to eliminate underlying imbalances in the economy. However, balance of payments recovery should not conflict with economic growth when the time horizon for both objectives is properly specified to be the medium term. This view is based on the following considerations:

- to the extent that supply-side policies are successful in enhancing the production potential of the economy, they minimize any inescapable impact upon growth of measures that focus on reducing absorption;

- by raising the capacity of the country to service debt in the future, supply-side policies permit a higher level of sustainable capital inflows and thus a higher rate of economic growth in the long run; and
- financial stability resulting from a successful stabilization program can boost confidence in the economy.

Recent empirical analysis for 69 developing countries, during 1973–88, suggests that in the short run Fund-supported programs have led to an improvement in the current account of the balance of payments, a lowering of inflation, and a decline in growth. As the evaluation period is lengthened, the positive effects of programs on the external balance and inflation are strengthened and the adverse growth effects reduced. Evidence also supports a positive link between macroeconomic stability and economic growth. There is, however, no general agreement either about the methodologies employed in evaluating the macroeconomic effects of Fund-supported programs, or about the impact past programs have actually had on principal macroeconomic objectives. Further, existing studies do not take into account the degree of implementation of the policies agreed between the Fund and the country.

c. Bank-Fund collaboration

Adjustment with growth can best be promoted in an environment where demand-management and structural policies are mutually supportive. A comprehensive package of reform that enables an appropriate integration of macroeconomic and structural policies is facilitated by close Bank-Fund collaboration. In several areas, structural measures embodied in recent Fund-supported adjustment programs have been formulated with the assistance of the World Bank. These areas cover a wide range of structural policies, including trade reform, public sector investment programs, public enterprise reform, agriculture and industrial policies. Similarly, the World Bank has relied on the Fund's expertise in other areas, including reform of the exchange system, and certain elements of fiscal and financial sector reform.

For Structural Adjustment Facility (SAF) and Enhanced Structural Adjustment Facility (ESAF) eligible countries, Bank-Fund collaboration has been formalized in Policy Framework Papers (PFPs). These papers are prepared by the authorities (with the assistance of Bank-Fund staff) of recipient countries for arrangements under the SAF, ESAF and for the Bank's Special Program of Assistance (SPA) in sub-Saharan Africa. A PFP document sets out macroeconomic and structural policies for a three-year period and reviews the country's public investment program and financing requirements. The PFP also outlines the likely social impacts of policy changes, along with the steps that can be taken to cushion the poorest segments of the population.

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