Fund conditionality and the international adjustment process

a look into the 1980s

As the 1980s unfolded, the international economy was entering a difficult stage: inflation in most countries was high and showed no signs of abating; growth rates were slowing down; and external imbalances had increased and shifted among groups of countries. In this article, the author examines the recent steps taken at the Fund to support members' adjustment efforts to improve their economic performance.

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As the decade of the 1970s came to a close, the international economy was subject to severe pressures, associated with a new round of sharp increases in world energy prices. Many member countries were still experiencing difficulties from an incomplete adjustment to and recovery from the troubles of the early and mid-1970s. As a consequence, the opening of the new decade was characterized by a number of seriously disturbing features in the world economic situation. In many countries, inflation continued at historically high rates and showed no signs of slackening. Rates of growth in economic activity were slowing down, particularly in the industrial countries, a trend that threatened to jeopardize a needed expansion in world trade and to steer the world economy toward another global recession. At the same time, the current account surpluses and deficits of major groups of countries increased and underwent sudden shifts; these developments placed greater strains on world payments and gave rise to widespread concerns about how the unprecedented deficits could be financed, especially by countries in the oil importing developing world.

Meanwhile, the Fund was winding up the second comprehensive review of its practices on conditionality. (The first had taken place in 1968.) On March 2, 1979 the Executive Board adopted a new set of guidelines for the use of Fund resources. The guidelines incorporated a number of the principles that had guided the adaptations made to the conditionality practices in the 1970s. These principles included the need to take into account not only the causes of the balance of payments (BOP) difficulties of members requesting Fund resources, but also their social and political objectives as well as their economic priorities. The guidelines made allowance for longer periods of adjustment, a principle first recognized with the introduction of the extended Fund facility (established in 1974) and later incorporated in the decision

The first two articles by Manuel Guitián—published in the December 1980 and March 1981 issues of Finance & Development*—examined the rationale of the principle of conditionality and described the implementation of the conditionality practices that have been developed over the past three decades. This is the last in a series of three articles on Fund conditionality.*

on the supplementary financing facility (adopted in 1977). Acknowledging the need for the Fund's conditionality practices to evolve, the guidelines also provided for periodic assessments of the experience with adjustment programs supported by Fund resources and for the periodic adaptation of the terms of conditionality, if such adaptation proved warranted.

Two years have elapsed since the adoption of the guidelines on conditionality—sufficient time to test their resilience in guiding Fund policies to help members cope with an unfavorable international economic environment. The purpose of this article is to examine how the particular features of recent economic developments have led the Fund to initiate further adaptations to its conditionality practices. One of the initiatives is a new emphasis on policies to increase productivity and to improve resource allocation in the programs supported by Fund resources. Another is to strengthen its collaboration with the World Bank. The article also reviews how the principles of the 1979 guidelines for the policies on the use of the Fund's resources have worked so far and discusses the most recent changes in the framework of the Fund's operations.

Structural changes needed

The payments problems experienced by many member countries in the last two years led the Fund to the conclusion early in the period that the establishment of special facilities to provide resources subject to no or limited conditionality (along the lines of the oil facilities of the mid-1970s) would not be appropriate. A more comprehensive approach was necessary, for two main reasons. First, for many countries, payments difficulties had not only worsened but were superimposed on long-standing imbalances; the situation required more decisive policy action than had been taken until then. Second, although the causes of the increasing deficits were for the most part external in origin, they were not likely to be transitory. A realistic assessment of the medium-term perspective called for timely and resolute adjustment efforts to cope with the adverse external environment.

From the beginning there was a consensus that the Fund should be able to respond to the needs of members in particularly difficult circumstances. The supplementary financing facility had been conceived to provide resources to countries with large needs in relation to quotas, but the bulk of its resources had remained uncommitted during the first half of 1979; it was decided to use these funds (under the "special circumstances" clause) to make larger than normal commitments, bearing in mind that the use of these resources—which were made available under stand-by and extended arrangements—was of course subject to observance of performance criteria.

Thus, as an interim step—in cases of special need—commitments were made of supplementary resources up to the equivalent of 300 per cent of quota. This proportion was well above the amounts that under normal circumstances had been envisaged in the original decision on the supplementary financing facility, which had been 102.5 per cent of quota for stand-by arrangements and 140 per cent of quota for extended arrangements. An important aspect of this interim step was that requests by members for Fund resources would be accommodated when the policy measures that were introduced gave substantial assurance that the necessary adjustment efforts would be carried out—and, therefore, that BOP viability would be restored. In the meantime, an examination of the wide range of issues pertaining to the Fund's role in financing payments imbalances and in promoting adjustment policies was initiated.

There was general agreement that the imbalances that currently existed in the international economy were structural and therefore not amenable to correction over a short period of time. Adjustments to such disequilibria were likely to require extensive changes in members' economies, in particular those of the oil importing countries, if restoring BOP viability was not to jeopardize medium-term development and growth prospects.

The prevailing economic environment rendered the necessary adjustments more difficult. Inflation and inflationary expectations had become entrenched in many countries; yet the danger existed that sustained anti-inflationary policies—which on all counts were essential—might further dampen growth rates at a time when, as noted at the outset, they were generally below historical levels. These developments, in turn, could slow down or even reduce the volume of world trade and thereby complicate the task of adjustment even further. These considerations formed the basis for moving to a relatively long time frame for the adjustment effort; the aim was to allow for structural changes in patterns of production and demand—changes that can only be made gradually.

The ultimate aim of Fund financial assistance is to restore viability to the BOP in a context of price stability and sustained economic growth, without resort to measures that impair the freedom of trade and payments. These basic purposes of the Fund have not been altered by the recent disturbances that have beset the international economy; only their attainment has become more challenging, not to say more arduous. Consequently, the design of the stance and the mix of the policies normally supported by the Fund has become subject to constraints that make it more complex.

Thus, the broad demand management policies usually included in the Fund's programs, particularly in the fiscal and credit areas, continue to be needed, perhaps even more than before, to hold aggregate domestic demand down to a level that is sustainable and consistent with the global availability of resources. The Fund has traditionally concentrated on these broad macroeconomic policies, which were examined at length in the first article in the series (published in the December 1980 issue of **Finance & Development**). Demand management provides the appropriate financial framework for development and growth, because financial stability encourages the mobilization of domestic savings and the efficiency of resource investment. But recent events have called for attention to complementary measures directly aimed at bringing about an efficient utilization of resources to strengthen an economy's productive base. This concern has led the Fund to advocate policies affecting incentives for production.

Supply management

Strictly speaking, interest in supply is not a new development in the Fund. It can be argued that demand management measures and financial stability may have been *proximate* instruments and objectives of Fund policies, but the full attainment of supply potential has always been the *ultimate* aim. The novelty is in the emphasis that is now openly found in the Fund and elsewhere on the effects of adjustment policies on resource utilization and therefore on production. It is, of course, as difficult to distinguish between demand and supply measures as it is to determine which of the two blades of a scissors does the cutting, to borrow Alfred Marshall's classic analogy. Policy measures have an impact on both demand and supply; therefore, they need to be catalogued according to where their greatest effect lies for the distinction between them to be useful.

The longer adjustment period allowed under the new guidelines partly explains the current explicit accent on supply. On the one hand, measures that stimulate supply through productivity increases and high investment rates show results only over the medium to long term. On the other hand, more time for adjustment requires the mobilization of resources in

amounts larger than otherwise would be the case, thus allowing the process to take place more gradually; it then becomes imperative to ensure that those resources are productively used to attain supply potential.

The relationship between demand and supply management is illustrated by several factors that normally constitute a part of the design of a domestic stabilization program. In many instances, programs incorporate foreign borrowing strategies that directly enlarge the amount of resources available to the member. As a result, higher levels of expenditure can be achieved, as well as higher growth rates over the medium term. It is also common to have a number of important policy understandings in the formulation of an adjustment program, which provide the basis on which the feasibility of the domestic financial policies is predicated. These understandings are rarely made performance criteria in programs supported by the Fund, but they can be critical for the attainment of financial balance and sustainable growth rates. They normally include: public sector policies on prices, taxes, and subsidies, which can contribute to eliminate financial imbalances and to promote efficiency in public sector activities; interest rate policies, which foster the generation of domestic savings and improve resource allocation; exchange rate policy, which helps to control absorption and the external accounts but is also a powerful tool for development; and incomes policies, which keep claims on resources from outstepping their availability.

Actions in these policy areas are of direct interest to the Fund because they foster savings and investment—the basis for expanding supply and for the sound development of an economy. Measures of this type elicit supply responses on two different levels: by ensuring appropriate pricing in the broadest sense, the flow of output out of a given stock of resources is maximized, and by fostering the mobilization of savings and the efficiency of investment, the medium-term to long-term growth rate of output is enhanced.

Collaboration

Both the World Bank and the Fund share a concern over the economic and financial policies followed by member countries. Within this broad common interest, there is substantial scope to distinguish areas of primary responsibility for each institution. In general terms, it has long been agreed that the Fund is primarily responsible for BOP adjustment, and the Bank, for development programs and project evaluation. Over time, the two institutions have collaborated effectively in providing consistent policy advice to members while maintaining their distinct character and separate functions.

The complementary roles of the Fund and the Bank have acquired increased importance in the current world environment with the sharp increase in energy costs, the emphasis on appropriate supply responses, and the need for productive investment flows. At a time when the Fund has extended the time frame of its arrangements and the scale of its assistance, the Bank has undertaken a program of lending for structural adjustment to provide support to countries with BOP difficulties that require structural changes; this kind of lending will be an important complement to Fund assistance.

These recent Fund-Bank initiatives have called for an important additional measure of coordination. The range of subjects where coordination is required includes: the structure and functioning of money and capital markets; the generation of domestic savings; the financial implications of development programs; and external debt management. In providing policy advice, the Fund continues to focus on the macroeconomic and BOP adjustment policies, while the Bank concentrates on the quality and effectiveness of development plans and investment priorities. This division of responsibilities remains essential; nonetheless, an increasingly close consultation between the two institutions is being developed as more members enter into adjustment programs supported by financial resources from both agencies.

Scale of Fund assistance

Both the larger current-account imbalances and their structural nature on the one hand and the emphasis on inducing adjustment as well as promoting supply responses on the other, provided a basis for a decision by the Fund in 1980 to continue lending resources in substantially larger amounts and for longer periods than heretofore. The guideline of 300 per cent of quota for supplementary resources agreed by the Board in 1979 already appeared insufficient in the months following its introduction. For a long time, limits on the resources of the Fund had been based on a concept of total, cumulative use, but attention has since shifted to a concept of annual use, albeit within a maximum global limit. A consensus has emerged in current circumstances that broad norms for the maximum use of Fund resources should be adopted in terms of annual amounts, to support members' adjustment efforts which, in many instances, would in all likelihood take more than one year to be completed.

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Two issues arise in the context of the scale and duration of Fund lending: first, the length of the period of commitment of Fund resources, and second, the proportion of the amounts of assistance relative to quota that can be provided to members. On the basis of the quotas prevailing in mid-1980 (those under the Sixth General Quota Review) an annual limit of 200 per cent of quota, or a limit of 600 per cent of quota over a three-year period, was broadly accepted. The operation of these limits involved resources both owned and borrowed by the Fund and excluded any financing available under the compensatory financing and buffer stock facilities. The Interim Committee of the Board of Governors of the Fund endorsed these guidelines during last year's Annual Meeting.

Soon after this endorsement, work on the Seventh General Review of Quotas approached completion. This review would result in a substantial—50 per cent—increase in members' quotas. The interim limits adopted earlier had to be reassessed in the context of the forthcoming quotas. In December 1980, the Seventh Quota Review came into effect. During that month new guidelines on commitments of Fund resources (excluding, as indicated above, those under the compensatory financing and buffer stock facilities) were discussed and subsequently adopted by the Fund's Executive Board. These guidelines provide, in general terms, for commitments of Fund resources of up to an average of 150 per cent of quota a year within a maximum of 450 per cent of quota over a three-year period. The new guidelines thus provided for larger absolute amounts of assistance than those prevailing earlier. In terms of the new quotas, the 200/600 per cent limits, in effect until the Seventh Quota Review, were equivalent to 133.3/400 per cent; accordingly, the new 150/450 per cent guide-

lines represented an increase of one eighth over the amounts previously available.

These new guidelines, which will, of course, be subject to periodic reviews, were supplemented by a maximum limit on total cumulative access to Fund resources, net of scheduled repurchases or repayments, of 600 per cent of quota. Such a maximum absolute limit was necessary to take into account past use of Fund resources so that members would be treated uniformly, regardless of whether or not they had used Fund resources before the adoption of the new guidelines. The question of uniformity of treatment also arose in the context of the financial arrangements that came into effect prior to the guidelines and remained operative. Requests under those arrangements for an augmentation of the amount of resources will be considered by the Fund on a case-by-case basis in the light of developments within the program. This will normally be at the end of the first year of an arrangement, but some flexibility on the timing is allowed for.

Flexibility was built into the guidelines to accommodate the circumstances of a particular member without impairing the principle of uniformity of treatment. Amounts in excess of the guidelines could be allowed in clearly exceptional cases—for example, when there is general recognition that a member's quota is unusually low in relation to the size of its economy, or when an exceptionally strong and wide-ranging adjustment program is undertaken involving, inter alia, dismantling of controls and other restrictions that would require, at least in the initial stages, large financial support.

Actual implementation of the new guidelines will require the Fund to enter into new borrowing arrangements with members or to tap other sources of financing in amounts of SDR 6 to 7 billion a year over the next few years, a process in which the Fund is currently engaged. The guidelines will accordingly be reviewed in light of the experience not only with members' adjustment programs but also with the pace and modalities of Fund borrowing. Both of these factors will affect the liquidity of the Fund, a key element in its ability to provide timely assistance to members.

The Fund as catalyst

This article, the last in a series of three on the subject of Fund conditionality, has examined the steps undertaken at the Fund to help members cope with the rising energy costs, high inflation rates, and sluggish growth rates prevailing in the international economy as the 1980s opened. These steps aimed at achieving a balance between adjustment efforts and financing needs over a period of time that would allow results to emerge on the one hand and also be compatible with the revolving character of Fund resources on the other. Guidelines on enlarged access to Fund resources were agreed upon to support a rapid and decisive implementation of adjustment measures, the impact of which would show over the medium term.

Thus, in the brief period since the beginning of the 1980s, the Fund has striven to adapt the adjustment policies it supports and the financial assistance it extends to the needs of its membership. In its collaboration with members in the design of adjustment programs, the effectiveness of the Fund as an institution goes far beyond its provision of resources. One of the most important aspects of the Fund's financial assistance to members in BOP difficulties, if not the most important one, has been the close relationship between the provision of the assistance and the adoption of comprehensive programs of economic policy action. As a critical side-effect, the mix of adjustment and financing built into the programs supported by Fund resources has helped members obtain flows of capital from sources other than the Fund. In the past few years, the major source of financing for an important number of countries has been the international capital markets, and, in particular, foreign commercial banks in their important role as intermediaries.

This has contributed to the efficiency and sustainability of resource transfers among members. Generally speaking, an arrangement with the Fund has been useful for members seeking to tap the capital markets because it tends to reduce uncertainty by providing a clear indication of the domestic policies to be followed and the objectives sought. The complementarity of the resources from the Fund and those from the private international markets is likely to become more important in the period to come, as countries face increasingly serious constraints and difficult policy choices.

A number of members have a relatively substantial and continuing dependence on flows of aid and concessional loans to finance their development efforts. Here again, technical and financial assistance from the Fund and other multilateral agencies has encouraged donor countries to provide funds for members with a limited resource base and at a low level of development.

At present, the problems of adjustment faced by member countries are particularly complex. Large imbalances in current account deficits are likely to continue to prevail for some time. Appropriate adjustment policies will therefore continue to be needed to justify and make sustainable flows of capital on both concessional and commercial terms. In this context, the importance of the role of the Fund as a catalyst for other sources of financing cannot be overstressed.

The practices on the conditionality attached to the use of Fund resources are dynamic. They evolve over time as economic circumstances change and as the understanding of economic processes and the transmission mechanism between policy instruments and objectives is augmented with experience. The new decade of the 1980s is likely to see further important initiatives as the Fund responds to the needs of its members in a rapidly shifting international economic environment. The developments analyzed in this article can be viewed as an indication of the capability of the Fund to create a workable consensus in order to respond rapidly and resolutely to help members adapt to these changing circumstances. F&D

Related reading

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