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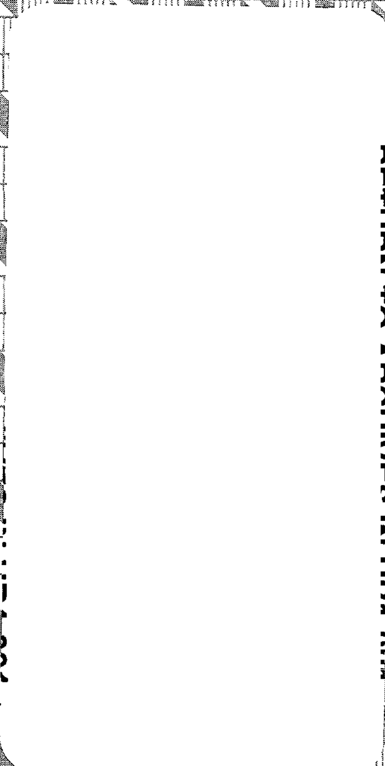

Reprinted from FINANCE & DEVELOPMENT A quarterly publication of the International Monetary Fund and the World Bank

6/87

Adjustment with Growth

The Fund, the Bank, and country experiences

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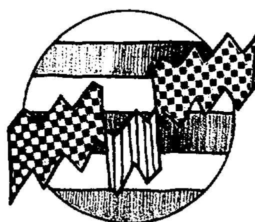


Adjustment in the 1980s: An Overview of Issues

Planning and implementing policies to restore external balance and create the conditions for sustained growth

Marcelo Selowsky

In the early 1980s most developing countries suffered three types of external shocks: prices of their major export commodities fell; world real interest rates increased; and international capital flows, particularly from commercial sources, all but dried up. The effects were threefold: lower commodity prices and higher interest rates (particularly the latter, in countries with high external debt) reduced disposable incomes in both the private and the public sector; the cost of borrowing increased; and the scarcity of foreign exchange rose in the domestic economy. Some countries were already experiencing high rates of inflation resulting from the inflationary financing of public deficits. Other countries, largely as a result of their heavy external borrowing during the late 1970s, entered the 1980s with a large external debt; they need to reach a new, sustainable, external asset equilibrium that will allow them to recover their creditworthiness.

Adjustment can be broadly defined as the adaptation of consumption patterns, the reallocation of resources, and the changes in factor accumulation necessary to recover sustained growth in the face of a more adverse external environment. This article examines the types of government policies needed to effect this adjustment.

Restoring external balance

The most immediate task of adjustment is to restore a viable current account position and level of expenditure in a way that minimizes short-term output losses and safeguards the capacity of the economy for further growth. The current account position can be improved through general expenditure reduction, which works by lowering the domestic consumption of goods that can be internationally traded, and expenditure-switching policies, which change the prices of these goods relative to nontraded goods. Both of these policies improve the trade balance by reducing imports and expanding exports. The key switching policy is the real devaluation of the exchange rate, though this needs to be accompanied by supportive fiscal and monetary policies.

Timing is crucial. If adjustment is delayed, in the extreme case until external credit is completely exhausted, the current account deficit has to be reduced very abruptly. In this case, a large part of the adjustment will have to be sought through expenditure-reduction policies, since expenditure-switching policies take longer to have effect, particularly on the supply side. Expenditure-reducing policies do not affect the output level of goods that are traded internationally, but they do affect the export and import levels of these goods and hence the trade balance. For goods that are not traded, by contrast, use of these policies can cause quite heavy losses in output in the short term. If prices and wages in the nontraded goods sector are rigid in the short term, capital and labor become unemployed, instead of being transferred to the traded sector. Thus an improvement in the balance of payments position can be associated with significant unemployment and output losses in the nontraded goods sector.

These losses will be particularly serious in economies where the traded goods sector uses very specific factors of production and where it takes considerable time to transfer labor, land, and capital from the nontraded sector. Such is the case in countries, including many in Sub-Saharan Africa, whose important export sectors are mining or tree crop production—activities in which investments take a long time to produce output. At the other extreme are countries such as Brazil, the Republic of Korea, or Thailand, where large parts of both the traded and nontraded goods sectors are within the urban economy, factor markets are relatively well integrated and more homogeneous, and it is relatively easy to retrain and transfer labor originally working in, say, construction or commerce for employment in the export or import substitution of, say, radios or garments.

Because of the costs associated with a drastic reduction in expenditures, countries have much to gain by emphasizing expenditure-switching instruments. Because these measures take more time for their resource allocation effects to be felt on the supply side, their implementation must start early and be orderly. This allows the country some minimal access to external credit during the transition. An early implementation of switching policies thus allows the country to choose a smoother

pace of adjustment with a smaller loss of output. (See article by Tanzi in this issue.)

An early and gradual introduction of switching policies, rather than a delayed but sharp introduction of expenditure-contraction policies, also has implications for long-run growth because it requires a smaller contraction of investment—one of the components of expenditure. This is an important additional reason for countries to avoid delaying adjustment.

Structural adjustment

As time passes, adjustment becomes increasingly a process of resource reallocation and then factor accumulation, influenced by the structural reforms that must be undertaken as a response to the new external conditions. First, because foreign exchange is scarcer than before (and may become even more so), countries have to expand the output of their export and import-competing sectors. But this expansion should not be pursued regardless of costs—the objective of trade policy reforms is to encourage the expansion of the most efficient export and import-substitution sectors. Second, because borrowing abroad is more expensive than before, domestic savings are now of greater value, and need to be increased, but again in ways that are cost-effective. Third, and most important, the recovery of growth depends heavily on increasing the efficiency of resource use and on the productivity of new investment throughout the economy.

The objective of structural adjustment is to create the conditions for sustained growth, including an improved flexibility to adjust to changes in the economic environment. Two broad areas of structural reform are discussed in what follows: rationalizing the scope and operations of the public sector, and improving the structure of incentives faced by the private sector.

Rationalizing the public sector

The size of the public sector is of course partly a result of political forces and the pursuit of noneconomic objectives. But in many countries there is now a wide awareness of the need to reevaluate the scope and operations of this sector using economic criteria, and to make a choice as to how cutbacks are to be shared between the private and the public sector. Noneconomic objectives that were affordable under more favorable external conditions are not affordable today. This recognition should lead the public sector to concentrate on activities with high benefits that complement instead of compete with private sector activities.

Two areas are of particular importance today. The first is the provision of public infrastructure to support the expansion of the most efficient sectors producing internationally traded goods. Examples are the introduction of better technology, extension services, and irrigation in agriculture, and improvements in transport infrastructure to increase the mobility of goods.

The second area is investments in human capital formation (i.e., in health and education). These should concentrate particularly on programs where externalities are high—so that they directly benefit other people as well as those whose health and education they improve—and on beneficiaries whose incomes are low and who cannot borrow for health services or education. Preventive health measures in rural areas, targeted nutrition programs for infants and mothers, epidemiological and vaccination campaigns, and primary education should receive most of the government subsidies and administrative resources. These investments in human capital not only have proven high rates of return; they are also vehicles for governments to protect the living standards of the poor in periods of generally declining incomes. The wider introduction of cost recovery and user charges for services that consumers are willing to pay for, such as curative health care, and secondary and higher education, will release resources to be used in these other areas (see articles by Huang and Nicholas, Akin and Birdsall, and Pfeffermann in this issue).

Public enterprises. In many countries public enterprise deficits have become the most important component of the overall public deficit. A key aspect of structural adjustment is to reassess whether the magnitude of these deficits can be justified today. When public enterprise deficits are the result of pricing policies aimed at subsidizing consumer goods, several questions should be raised. Why should these specific consumers be subsidized? Are these the poorest individuals in society? Are there more efficient ways of transferring income to the poorest groups of the population, if that is the objective? (See article by Michalopoulos in this issue.)

In other cases, public enterprise deficits are not the result of pricing policies but of inefficiency in the use of resources. Inefficiency may be caused by managers' lack of accountability and the expectation that any deficit will automatically be financed by the central government. It also commonly arises when public enterprises are charged with such noneconomic objectives as maximizing employment, irrespective of worker productivity.

The public ownership of enterprises to avoid monopoly practices may be justified in the case of public utilities. It cannot be justified in the case of traded goods, because domestic producers can always be exposed to external competition. In summary, in most developing countries, the need both to increase public savings and to raise the overall efficiency of resource use requires a reevaluation of the scope and operations of public enterprises (see article by Park in this issue).

Smoothing public expenditure levels. In many countries the current need for stabilization is a result of unsustainable bursts of government expenditure that took place in reaction to external events in the 1970s. Some governments, faced with a decline in their terms of trade, behaved as if the deterioration were only temporary, and maintained expenditure levels until it became clear that it was not. Others, in countries where the terms of trade improved, behaved as if the gains were permanent or would increase even further; public expenditure accelerated, financed by heavy external borrowing. To assume that when external conditions improve, they will continue to do so, and that when they deteriorate, they will soon improve again, makes for very risky public expenditure behavior. What we have certainly learned is that the costs of stabilization are high if optimistic predictions turn out to be wrong. Smoothing public expenditure behavior in the face of changing external conditions is an important institutional change required in most developing countries.

Incentives for the private sector

Production and investment decisions in the private sector depend not only on the *level* of incentives but on whether people can predict incentives on the basis of a rational evaluation of future economic events. Incentives need to be "transparent" and automatic: even if future economic events are uncertain, the knowledge that incentives will respond to them in predictable ways is helpful. For example, a domestic exporter of oranges knows that the world price of oranges is volatile, but he will expect an increase in that price to benefit him. It is hard for him to forecast future incentives if the government, with the purpose of protecting domestic consumers, uses export prohibitions each time the world price of oranges increases. The same government objective could be achieved through a transparent export tax, even if the tax rate varied as a function of the world price. Using the tax instead of the prohibition would make the incentives much more predictable.

Incentives become almost impossible to predict if different producers in the same activity receive different treatment, according to discretionary interpretations of the law. Moreover, if producers feel that their treatment can be influenced by lobbying or bribery, they will invest real resources and time in these activities. This is the second cost

of incentives that are not automatic and transparent.

The worst offenders against these principles of transparency and automaticity are all incentives and instruments based on quantitative restrictions and quantitative allocations. Investment licenses and prohibitions, quantitative allocations of import licenses and foreign exchange, export permits, and quantitative allocations of fertilizers and other inputs are typical examples. Because they are subject to discretionary implementation, they can be expected to vary strongly over time and across productive units in the same activity. The most important first stage in a reform of the incentive structure is to replace quantitative rules and allocations by rules based on prices, taxes, tariffs, and subsidies.

Reforms to realign the level and structure of incentives have two broad aspects: realigning the incentives for the traded goods sectors of the economy and improving the functioning of capital markets.

Trade policy reforms. In most countries, present trade policies give very different treatment to different internationally traded goods. Activities that save foreign exchange commonly receive very different incentives from those that earn foreign exchange, while activities that save foreign exchange receive different incentives according to the sector of which they are a part.

In most countries both agriculture and manufacturing produce goods that are exported and goods that substitute for imports. This defines four major sectors producing internationally traded goods. Trade policy has, however, heavily discriminated in favor of one of them—the manufacturing of import substitutes—through the use of import prohibitions and import tariffs on manufactured goods. Thus, for example, an import tariff of 50 percent on manufactured goods allows the import-competing manufacturing sector to use 50 percent more real resources per dollar saved, than all export activities are allowed to use per dollar generated, or import-competing agriculture is allowed to use per dollar saved. The objective of reforms in the trade regime is to equalize, or make more neutral, the system of incentives across all producers of traded goods. This will encourage the expansion of those activities which can save or earn foreign exchange at the lower cost—in the case of the example, export and import-substituting agriculture and manufactured exports.

The above example emphasizes that the objective of an improved trade policy should not be cast solely in terms of expanding exports. In some countries, most of the benefits of a more neutral incentive structure may come from an expansion of the most efficient import-substitution activities (agriculture, in the example) rather from than an expansion of exports.

Neutrality in trade policy has some crucial implications for the choice of expenditure-switching instruments in adjusting to an external shock. Proper switching is achieved when the external adjustment is obtained by expanding the most efficient internationally traded sectors. The best mix of exports and expansion of import substitutes is achieved when the switching is done through the use of changes in the real exchange rate (see article by Guitián in this issue). Extra tariffs or extra quantitative restrictions on imports are inefficient to the extent that they use more resources than necessary to achieve the same amount of external adjustment. If during the shock there is a case for redistributing its cost through taxation on luxury goods, the proper vehicle is a consumption tax on those goods, irrespective of whether they are imported or produced internally.

Reforms in the capital market. As a result of increases in world interest rates and the decline in the availability of foreign credit, countries must also adjust their policies in the capital market. Incentives are needed to increase domestic savings and to allocate credit more efficiently among alternative investment uses.

Ceilings on domestic interest rates inhibit the generation of domestic savings. They also distort the allocation of credit, since credit from banks tends to flow to large established enterprises with low risk and secure collateral. Smaller and less-known enterprises with high rates of return but without access to bank credit have to borrow at higher interest rates in the informal market than they would face under more unified markets. Special allocations of credit through government-sponsored programs to preferred sectors rarely have the intended effect. Because of "fungibility" they are easily diverted, and because they are provided in limited amounts (the rest of the credit has to be procured in the informal market) they do not lower the cost of credit at the margin but simply transfer income to selected recipients. When credit programs are used to compensate for discrimination against these sectors in another market (e.g., on the product market), new distortions are introduced. It is usually more efficient to correct the distortion in the original market directly.

The first reform is to let domestic real interest rates truly reflect the new scarcity of savings that results from the higher cost of borrowing abroad. Second, domestic markets should be liberalized by allowing lenders to charge different rates to different users. The net effect of this will be to help allocate credit to the activities with the highest rates of return. Reforms in the credit market should not be planned and judged solely in terms of their effects on savings, for the effects on the allocation of credit across investment uses may be equally or even more important. For example, improvements in the allocation of new investment that increase its productivity by 20 percent have the same effect on long-run growth as a 20 percent increase in the savings rate.

Highly indebted countries

Several countries entered the 1980s with a particularly large external debt. Because much of the debt had been contracted at variable interest rates, the increase in real interest rates in the 1980s hit them hard. Commercial lending stopped as these countries lost their creditworthiness. Today they not only need to improve their current account position, as do most developing countries, but they need to generate a trade surplus to the extent that their new borrowing falls significantly short of interest payments. Moreover, to recover creditworthiness, these countries will have to create trade surpluses that are large enough to allow their debt position—measured for example by the ratio of debt to GDP—to improve over the long run. What is distinctive about this group of countries is that the recovery of creditworthiness calls for a sharp adjustment of their external asset position. This cannot be achieved through regular stabilization or in a short time; it requires a substantially longer period.

Lengthening time horizons. To restore their creditworthiness, high debtor countries need to lower the ratio of their external debt to GDP. To achieve this would normally require a significant surplus of domestic savings over investment and a corresponding surplus of exports over imports. If the improvement has to be achieved quickly, the surpluses can only be generated by sharply contracting investment and imports, and thus constricting output and future growth. This has been the recent course of events.

A better alternative is to improve creditworthiness by generating these surpluses through expanding savings and exports while increasing output and consumption. This calls not only for additional time in which to reach creditworthiness but also for additional flows of external finance in the short run, to facilitate the transition. If consumption levels are to be maintained in the short run, it will take time to increase domestic savings rates significantly. Exports take time to respond to improved incentives. It also takes time for policy reforms to affect the productivity of capital and overall resource allocation, improvements in which will ultimately help to sustain growth with lower resource requirements. Although savings will be increasing during the adjustment period, in the short

run they will not be large enough simultaneously to finance interest payments on external debt *and* the investment required to sustain the critical growth of output. Additional external inflows are needed during the transition.

A successful resolution of the debt problem thus requires an effort on the part of both creditors and debtors. Creditor countries will have to resume lending and keep an open trading system, resisting protectionist pressures. Debtor countries will have to restrain their growth of consumption and undertake reforms to improve the efficiency of resource use. Many of the reforms outlined above are desirable irrespective of the debt problem. But in the high debtor countries their urgency is now much greater.

Fiscal aspects. In most debtor countries a large part of the debt is the responsibility of the public sector, but most of the foreign exchange earnings arise in the private economy. Solving the debt problem thus requires solving an important fiscal problem: how to run a significant surplus in domestic currency—equivalent to several percent of GDP—without jeopardizing other goals of the adjustment program. In many countries the public sector's servicing of its debt has relied on inflationary finance and domestic borrowing, rather than on public savings. This has accelerated the rate of inflation and increased domestic real interest rates, crowding out private investment. Higher nominal interest rates augment the difficulties of servicing the domestic debt if the private sector becomes increasingly unwilling to hold a constant real public debt.

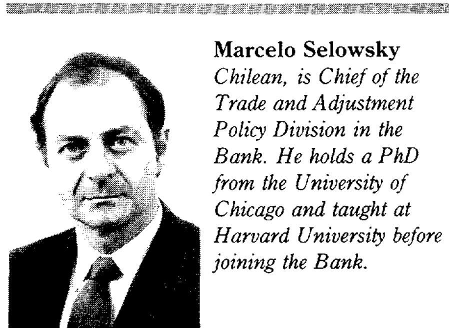
A successful internal adjustment to the debt crisis will require significant increases in public savings through a mix of government expenditure reduction and increased taxation. The proper combination will obviously depend on the specific country; however, priority should normally be given to cuts in those elements of government consumption that cannot be justified on efficiency or distributive grounds, and to the introduction of taxes that do not affect the incentive to save and invest (e.g., consumption taxes). All the adjustments in the scope and operations of the public sector discussed earlier become even more urgent for highly indebted countries.

Some implementation issues

Structural reforms that improve economic efficiency should be welcomed independently of external shocks, but the presence of shocks makes these reforms more urgent and more valuable. To implement structural reforms in the midst of an external shock, which necessarily calls for a reduction in aggregate expenditures, presents some additional problems of sequencing and policy coordination. In order to prevent an increase in the inflationary financing of public deficits, early decisions must be made about how the necessary reduction in aggregate expenditure should be distributed between the private and the public sector. The external shock may trigger an inflationary process, unless all the steps discussed earlier regarding a reasssessment of the scope and operations of the public sector are quickly undertaken. Without these steps, reforms to realign relative prices for the private sector will be swamped by the inflationary instability created by the public sector deficit.

Reforms in the incentive system for the private sector should start only if specific steps are already being taken to correct the fiscal imbalance. The first objective is to improve competition within the domestic economy by eliminating restrictions on the movement of productive factors and investment. Competition is also encouraged by replacing quantitative allocations by equivalent price signals, taxes, tariffs, and subsidies. The benefits of these reforms become even larger as lower inflation improves the information content of prices.

The process of opening the economy, to expose it to more foreign competition, should start when inflation has been lowered and a more sustainable current account deficit has been achieved; when substantial progress has been made in addressing the major structural determinants of fiscal deficits; and when a minimum level of domestic competition and transparency of incentives has been reestablished. These conditions make it easier to sustain the process of opening the economy to world markets. ■



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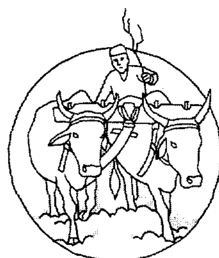

The Social Costs of Adjustment

How adjustment programs affect the poor, and how the World Bank is helping ameliorate their effects

Yukon Huang and Peter Nicholas

The economic turbulence of the late 1970s and early 1980s has taken its toll in the developing world. Most developing countries have lost a decade or more of economic progress. Many have suffered a severe deterioration in social conditions, with increased malnutrition and urban unemployment, growing numbers of absolute poor (living below minimum requirements of food and shelter), and a slowing or even a reversal of improvements in health. The suffering has been particularly evident in two groups of countries. In low-income Africa severe drought exacerbated the effects of worsening terms of trade, reduced capital inflows, and domestic policies. GDP growth almost came to a standstill by 1983. Although growth has since resumed, per capita incomes have continued to fall in the face of rising populations. In the highly indebted, middle-income countries, a decline in the flow of commercial lending and reduced access to the markets of industrialized countries have compounded the problems emerging out of past policy mistakes and the international recession. Incomes in many countries in the latter group have declined precipitously.

Reduced economic growth and weakened financial positions have adversely affected social programs for the poor. Real per capita spending on health and education is, in many cases, a quarter to one half of what it was a decade earlier. In many African countries the prices of basic foodstuffs have gone up as drought and inappropriate past policies have constrained supply even though governments have liberalized prices and reduced subsidies. In highly indebted countries, unemployment has increased as firms face material shortages, declining demand, and financial difficulties. Devaluations and wage restraints have pushed down real wages for organized labor. Meanwhile, inflation has resurged, particularly in Latin America, fed by deficit financing.

Against this background, questions have been asked about the impact of adjustment programs on the poor and about the ability of governments and international agencies to protect the poor in the process of adjustment.

The social costs

What are the social costs of adjustment? Three types of transitional costs can be identified. First, adjustment measures designed to balance aggregate demand and supply usually, though not inevitably, depress output, employment, and consumption. These costs are typical of a recession. Second, the changes in the structure of incentives stimulate the reallocation of resources and hence benefits between sectors and activities. Businessmen and employees who previously benefited from subsidies and other forms of protection from market forces are likely to suffer substantial declines in income and wealth while those in stimulated activities should benefit. Third, lags and difficulties in moving productive resources into alternative uses in response to changes in relative prices may add to costs initially.

These transitional costs are largely unavoidable but country experiences suggest that the transitional costs of an orderly adjustment are likely to be smaller and the longer run benefits larger than that of an ad hoc, disorderly process. The costs associated with well planned adjustment programs are outweighed by the long-term benefits of the more rapid and viable growth that results.

Any assessment of the social costs of adjustment programs must evaluate the effects on the welfare of the poor—the bottom 30-40 percent of the per capita income and consumption ladder in a population. This group includes poor farmers, unskilled or low paid laborers, and women and children in low-income households. It excludes traders, mid-level government employees, or relatively well-paid workers in hitherto protected industries. Such an assessment must concentrate on the immediately measurable effects on the poor of adjustment policies.

On the basis of Bank experience with such programs, a number of conclusions can be drawn about the consequences of policy measures in adjustment programs.

• ***The impact of a specific adjustment policy on the poor depends on a country's economic structure.*** Such policy changes as devaluations and reforms of the tariff regime affect low-income groups differently, depending on a country's economic and social structure, and in some circumstances, on how the government designs and implements these measures. The effects of a devaluation on

the poor, for example, depend on the labor intensity of production in the tradable and nontradable sectors, on the importance of the affected products in the consumption basket of the poor, and on the lags in relocating workers and raw materials. If small-scale farmers (for example, of jute in Bangladesh) produce most of the exports then devaluation will benefit them. But if the export goods are primarily staples that the poor consume (for example, rice in Thailand), devaluation will hurt the poor (see box).

• ***The transitional costs of adjustment may be less in low-income Africa than in the highly indebted, middle-income countries, particularly those in Latin America.*** In Africa the poor are usually concentrated in the rural areas. Those employed in government, industry, and urban services are usually in the higher income groups. In this setting, a devaluation coupled with trade liberalization and unshackling of agricultural markets should improve the average income of the poor and increase efficiency. The losers are likely to be higher income (mainly urban) groups who had previously benefited from priority access to foreign exchange and protected markets. In Latin America, such adjustment measures are likely to impose greater social costs because land ownership is more concentrated and because many of the poor are low-wage urban workers and thus more vulnerable to higher food prices.

• ***Many adjustment policies promote both efficiency and equity, particularly in the long run.*** This is often the case, for example, with reforms of social services. By shifting priorities and imposing selective user charges, governments can improve the efficiency of social programs while continuing to help the poor. Thus in the health sector, shifting priorities in favor of preventive rather than curative services and toward expansion of rural rather than urban facilities can increase social rates of return as well as promote equity (see "Financing of Health Services in LDCs" by John Akin and Nancy Birdsall in this issue). User charges for curative care can help to expand such programs and to subsidize preventive services. In education, charges can be increased for higher education and the extra resources used to expand primary education to benefit the poor. Education loans and scholarships based on income levels can maintain access to higher education for the truly needy.

• ***Some policy reforms may affect the poorest groups only marginally.*** Many of the rural poor in Africa and South Asia are largely untouched by the tax system. Their cash incomes fall below exemption levels for income taxes, and they consume mainly domestic goods that are generally not taxed. The more important consequences of tax reforms for the poor probably are efficient production and increases in employment opportunities over the long term. Liberalization of financial markets also may not directly affect the poor.

• ***An early and orderly adjustment produces fewer social costs than a delayed and haphazard response.*** The experience of the Republic of Korea provides a good example. Following the external shocks of the late 1970s, economic growth turned negative, inflation shot up, and the current account moved from surplus to a substantial deficit. Despite this, the country's prompt and well-planned adjustment—which produced growth averaging 8 percent in 1981-85—enabled the authorities to preserve and even increase their social achievements. In the health sector, for example, subsidized medical programs for low-income groups have grown since their initiation in 1980 to cover nearly 10 percent of the population, and health insurance has increased four-fold in six years to cover 40 percent of the population. In the short run, strategies which concentrate almost exclusively on helping the poor but neglect adjustment might reduce absolute poverty even more quickly. But if such strategies lead to stagnant growth as evidenced in Tanzania (before 1986) and Ghana (before 1983), poverty-oriented programs soon become vulnerable to fiscal pressures.

• ***Simply reviving growth, though necessary, is not enough to protect the poor during an adjustment.*** Both Brazil and Malawi, for

Impact of higher crop and fertilizer prices

Many governments, although committed to supporting rapid growth of agriculture, have paradoxically established a complex set of policies, notably low crop procurement prices, which have a strong anti-agricultural bias. Simultaneously, governments often subsidize food, ostensibly to help the poor. But low procurement prices end up reducing the incomes of farmers, who in many cases are much poorer than those who benefit most from the subsidies.

What happens to the poor when procurement prices are raised to stimulate agricultural production? The immediate impact on the poor is ambiguous. Various poor groups in society—farmers and laborers in the rural sector and the urban poor—are affected differently. Further, the impact of a rise in the prices of nonfood crops differs from that of an increase in food crop prices. The income gains to poor producers of higher food crop prices are counterbalanced by the losses to poor consumers who have to pay more for their food. Surplus farmers clearly benefit while deficit food producers suffer; a steep increase in food prices may even force the latter group to sell off assets, including land. Subsistence farmers are largely unaffected, because they neither buy nor sell significant amounts of food at the new prices. By contrast, nonfood cash crops are seldom purchased by the very poor, so the welfare effects of a price increase for these crops are confined to income gains to producers.

The higher purchase prices for food which normally result from raising producer prices inevitably hurt poor landless laborers and the urban poor, at least in the short run. The long-run impact, however, is less clear. For marginal laborers, employment opportunities may eventually increase as agriculture expands. This increase may be accentuated—or tempered—by such factors as the labor intensity of different crops and the choice of agricultural inputs. For the urban poor, long-run benefits would include greater food availability and (if agricultural prosperity reduces rural-urban migration) a brake on the decline in real incomes in the urban informal sector. The net effect on poverty would obviously vary according to the distribution of land, the composition of the labor force, and other structural economic factors.

Fertilizer subsidies are among the most widespread although most of the theoretical arguments support such input subsidies as a temporary measure, and even then only in special cases. What then are the effects on the poor of reducing these subsidies? Because fertilizer provides higher incremental yields on irrigated land, the generally better-off farmers with irrigated land tend to benefit most from fertilizer subsidies. The poor, on the other hand, lose from an emphasis on fertilizer-intensive crops; the demand for labor falls as fertilizers are substituted for labor, reducing incomes of the landless. Meanwhile, relatively less expensive staple crops such as coarse cereals (which are not fertilizer-intensive) are discouraged. As the availability of such crops decreases, the cereal consumption of the rural poor falls even more.

example, were unable to prevent some deterioration in social conditions for the poor even with a degree of success in restoring growth. It is difficult, however, to know whether this deterioration was due to the earlier recession or the ineffectiveness or absence of social programs to protect the poor during the subsequent adjustment. Countries which do not have a development strategy that is already oriented toward the poor may not have the institutions or processes available to protect the poor during adjustment.

• ***In designing adjustment packages, there are often trade-offs between short- and long-term economic objectives and between various social objectives.*** First, and most significantly, adjustment programs may entail some reduction in short-run growth as a price for achieving higher growth later. One major study for semi-industrialized countries suggests that the growth rate can be increased by two to three percent when the trade bias and payments regime are successfully altered. The short-term costs, according to the same study, are probably a decrease in the growth rate of one to two percent for a year or eighteen months, and are thus greatly exceeded by the later benefits. Second, various combinations of policies can, in principle, achieve a given balance of payments objective, each with a different trade-off between inflation control and short-run unemployment. Many Latin American countries, for example, have borrowed excessively so they can postpone adjustment, and have often chosen policies that minimized the immediate adverse employment consequences of postponing adjustment at the expense of inflation and future unemployment. Finally, the manner in which a policy is implemented can involve trade-offs between efficiency and welfare. Sudden and substantial price increases or exchange-rate adjustments, for example, may help producers and lend more credibility to the reform process, but may create transitional costs for poor consumers.

• ***Ameliorating social costs requires adequate external financing.*** A growth-oriented adjustment program cannot be implemented without adequate external resources. Under current conditions, this implies a reversal of recent declines in resource flows. Increased resource flows would reduce the need to slow down the economy while encouraging growth-oriented policies which typically take more time to have an impact. While a few developing countries have continued to receive high levels of external support, overall new lending has fallen sharply. During 1981-84, net public capital flows to Sub-Saharan Africa fell from $7 billion to less than $3 billion. During the same period, public and private net capital flows to the highly indebted, middle-income countries plummeted from $43 billion to $14 billion.

The Bank's role

The Bank's early support for economic adjustment focused almost exclusively on improving the efficiency of resource allocation and strengthening institutions—with a view to restoring growth and improving the balance of payments in adjusting economies. This support reflected the judgment that the quick restoration of growth was the most effective way to help the poor. More recently, with the experience of earlier adjustment efforts and as sustained growth has proved more elusive than first expected, the Bank has broadened its efforts to help adjusting countries cope directly with the social effects of adjustment. These efforts are in addition to and distinct from the Bank's continuing efforts to address the long-term problem of poverty through investments which increase the assets of the poor and the rate of return on those assets. Such poverty-oriented lending by the Bank goes for health, nutrition, population, primary education, urban development, small-scale enterprises, water and sewerage, and many agricultural projects; it comprises a substantial segment of the Bank's lending other than for adjustment programs.

The Bank is strengthening its efforts to help governments ameliorate the adverse effects of adjustment by: (1) improving the efficiency and poverty orientation of social expenditures, particularly in health and education; and (2) developing cost-effective compensatory programs in the areas of nutrition and employment in coordination with other agencies and nongovernmental organizations.

Through reviews of public expenditure and in its lending operations, the Bank is assisting governments to restructure social expenditures in favor of the poor. Public expenditure reviews for Brazil, Ghana, Nigeria, and Zambia have recommended redirecting health and education programs towards low-income groups. Where appropriate, the Bank is following up these reviews with support for reform in both the health and education sectors through its sector and adjustment lending.

The Bank is also increasing support for programs to reduce the social costs of adjustment. As discussed in a number of recent articles in *Finance & Development* (those in this issue, and, "Improving nutrition: the Bank's experience" by Alan Berg, June 1985, and "Food security and poverty" by Shlomo Reutlinger, December 1985), a growing body of experience in the Bank and in other agencies shows that properly targeted compensatory programs—to improve nutrition and reduce unemployment by facilitating the redeployment of labor—are feasible in widely different situations. Well-targeted programs of nutrition and supplementary feeding can be an important way of reducing social costs. So can food-for-work schemes and, in some cases, cash employment schemes of the kind used in Chile. In considering compensatory schemes, governments need to consider their costs, both budgetary and economic. In times of fiscal austerity, the budgetary costs may involve restructuring rather than expanding programs, to reach the poor. The economic cost includes possible efficiency losses resulting from distortions introduced by compensatory programs; for example subsidy or income supplement schemes may discourage rather than promote a shift of resources into new activities.

The Bank is strengthening its cooperation with other international agencies, such as the World Food Programme and the US Agency for International Development, on using food aid to reduce adjustment costs for the urban and rural poor, and with agencies such as the International Labour Organization on employment programs. Increased coordination with Unicef is helping some governments expand low-cost programs of mother-and-child health care. The Bank is also increasing its cooperation with nongovernmental organizations, who often have the flexibility, local knowledge, and staff commitment to administer social programs more efficiently than many official agencies. ■

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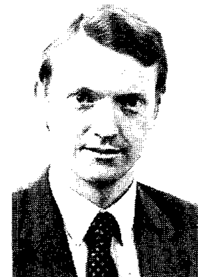

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Sequencing Economic Liberalization in Developing Countries

The order in which policy reforms are implemented represents a major challenge in the design of adjustment programs. A review of the principal issues

Sebastian Edwards

The reduction or elimination of distortions has traditionally been an important component in the World Bank's and in the IMF's policy advice. More specifically, both the Bank and the Fund have often recommended, among other things, that developing countries raise real interest rates, reduce import tariffs, eliminate import quotas, and increase the degree of integration of their economies with the international financial markets. Even though the general desirability of pursuing these reforms is agreed, the problem of recommending a specific *sequencing* for these policies continues to be a difficult one, but one which must be addressed by policy makers.

Many times, due to political or other constraints, it is not possible to pursue the liberalization of both the trade and capital accounts simultaneously; sometimes it may not even be desirable to do so from an efficiency perspective. In these cases, the question of sequencing becomes very important. Until recently, very little analytical work had dealt with issues such as: should domestic interest rates be raised before, after, or at the same time capital controls are lifted? Should the trade account be opened up before the capital account or vice versa? This article addresses some of these problems from a policy point of view and suggests a specific sequence of economic liberalization.

It has generally been recognized that opening the economy to the rest of the world is an integral part of any economic reform. However, determining the appropriate sequencing of economic liberalization is not easy; there are no theorems or recipes. Depending on the country under consideration and on the nature of the initial distortions, alternative sequencing paths can be followed. A few general principles are applicable, however, to almost every case.

A word of caution: although many of the principles discussed here are relevant to most developing countries, the analysis applies better to middle-income economies which, before the liberalization reforms, are characterized by: (1) fairly high inflation; (2) large fiscal deficits, financed by money creation; (3) very limited domestic securities markets, and controlled interest rates; (4) high trade tariffs; and (5) controls on capital movements in and out of the country. Since there has been very little empirical work done on the sequencing problems, much of the discussion is based on analytical considerations. Specific cases are cited wherever possible.

Domestic interest rates and the opening of the capital account. One of the few aspects of reform sequencing that is well established, and almost universally accepted, pertains to the liberalization of the domestic capital market and the capital account of the balance of payments. It is clear that impediments to capital movements (both inflows and outflows) should not be relaxed before the domestic financial sector is liberalized. If the capital account is liberalized when domestic interest

rates are fixed at arbitrarily low or negative levels, an outflow of capital will result. If the domestic interest rate is below the world interest rate (appropriately corrected by expected devaluation), financial capital will tend to leave the country. Capital flight has indeed resulted from acute imbalances between domestic and international real interest rates. For example, much of the capital flight that Argentina experienced in the early 1980s responded to the fact that due to high expectations of a real devaluation the (*ex ante*) real interest rate was perceived to be well below the *ex ante* real interest rate in the rest of the world.

Restrictions to capital movements, then, should not be lifted before domestic interest rates have been raised. However, in an inflationary environment, the liberalization of the domestic financial market can only be fully undertaken if the fiscal deficit is tightly under control. The existence of a large fiscal deficit, which is financed by an inflation tax, necessitates that reserve requirements on banks be kept high and interest payments on deposits be kept low. This assures that the base on which the inflation tax is collected—the stock of base money—is not eroded. The fiscal deficit, then, has to be controlled before domestic interest rates can be liberalized. If this is not done, the inflation tax base will be reduced, and the rate of this tax—the rate of inflation—will have to be increased for the government to collect the same amount of resources. This could lead to very high inflation rates, which would become increasingly difficult to reduce without a major monetary reform.

Again, Argentina in the late 1970s and early 1980s provides a good example. During this period the domestic capital market was liberalized without the fiscal deficit being reduced. As a consequence, and not surprisingly, all efforts to reduce inflation failed; in fact, given the reduced tax base, the financing of the deficit required an even higher rate of inflation. Moreover, during this period the Argentinian government resorted to foreign borrowing to finance part of its expenditure.

The first principle of reform sequencing, therefore, is that international capital controls should only be lifted after the domestic financial market has been reformed and domestic interest rates have been raised. In turn, interest rates can be raised only after the fiscal deficit is under control.

External sector reforms and the real exchange rate. What should be the sequence of liberalization of the current and capital accounts of the balance of payments? Should tariffs be reduced prior to lifting capital controls, or vice versa? Different sequencing will imply different paths for the critical macroeconomic variables and, in particular, of the real exchange rate. A number of countries have recently followed different sequencing of liberalization of these two accounts. Argentina and Uruguay in the 1970s opened the capital account first. Chile, on the other hand, reduced barriers to international trade before lifting capital controls. In the 1960s, the Republic of Korea also opened its trade account before relaxing controls on capital movements. Indonesia, in the late 1960s, significantly reduced trade barriers and simultaneously eliminated most controls on capital movements.

In general, the opening of the capital account will generate important financial flows. In most countries, if the fiscal deficit has been previously controlled and the domestic financial market liberalized, the opening of the capital account of the balance of payments will very likely result in significant inflows of foreign capital, triggered by perceived differentials between the domestic and foreign returns to capital. These inflows of foreign funds will then be monetized and, under a fixed exchange rate, will result in inflation and a *real appreciation* of the domestic currency. On the other hand, if a country chooses to adopt a floating exchange rate, the large inflow of capital will result in an appreciation of the nominal *and* the real exchange rate. In this case, the opening of the capital account will generate a real appreciation of the domestic currency and, since financial markets adjust rapidly—indeed much faster than goods markets—this real appreciation could be abrupt.

While under these conditions the opening of the capital account will generate *real appreciation*, a successful liberalization of the trade account (i.e., reduction of import tariffs and elimination of import quotas) will generally require a *real devaluation* of the domestic currency. This real devaluation will help the exportables sector expand, as the new structure of relative prices replaces the old protective structure. If, however, due to the opening of the capital account this real devaluation is precluded, the transition in the exportable and importable goods sectors from a protective to a freer environment will become more difficult. The appreciation generated by the relaxation of capital controls will squeeze profitability in the tradable goods sector precisely when it is going through a costly readjustment. Consequently, the capital and current accounts should *not* be opened at the same time. Moreover, in the transition period after trade has been liberalized, capital inflows should be tightly controlled. This policy recommendation is reinforced by the fact that, in general, the opening of the capital account will result in an overshooting of capital inflows, which will provoke a steep real appreciation in the short run. Immediately after the relaxation of controls, capital inflows are likely to be large; after some time the flow of capital will decline toward its new long-run equilibrium level.

In a number of instances the opening of the capital account resulted in excessive capital inflows and a significant real appreciation of the domestic currency. Perhaps the better known cases are Korea and Chile. In mid-1966, a large inflow of short-term financial capital flooded the Korean economy. As a result, there was an increase in inflation and substantial real appreciation, which between 1965 and 1969 amounted to 20 percent. In Chile in 1977 net capital inflows amounted to little less than $500 million. In 1980, however, these inflows increased more than six times to $3.1 billion, and in 1981 they increased to almost $5 billion. Partially as a consequence of these massive capital inflows—and partially as a result of other policies such as the simultaneous fixing of the nominal exchange rate and implementation of a backward indexation mechanism—Chile's real exchange rate appreciated 30 percent between 1978 and 1981. Throughout their experiences with major inflows of capital, Korea and Chile followed different strategies. Whereas Korea adjusted the nominal exchange rate periodically, Chile had a fixed nominal rate in effect during most of the period. In both countries, however, a real appreciation took place, with the *real* exchange rate moving against exporters.

The conflicting pressures on the real exchange rate that resulted from opening the capital and current accounts (i.e., real appreciation and depreciation respectively) capture the fact that these policies will exercise pressures for resources to move in opposite directions. To the extent that there are economic and social adjustment costs associated with resource movements between sectors, it is advisable to implement policies that would avoid unnecessary resource switches (i.e., resource movements that will be reversed after a short period of time). Once more Chile provides a good example. Starting in 1976, exporters embarked on extensive investment programs aimed at increasing their export capacity. They found, however, that in 1979–81 the real exchange rate turned drastically against them. At this point, investors moved away from the export sector and switched their resources to the nontradables sector, especially the construction sector.

Theoretically, one simple way of avoiding these unnecessary resource switches is to open the current account first and, only after the new productive structure has been established, open the capital account slowly. Although in a way this was done in Chile there still was a major real appreciation of the exchange rate. The Chilean experience

offers some important lessons for the sequencing debate. First, the destabilizing effects of massive capital movements are much greater than most observers initially expected. In hindsight it would have been advisable for Chile to allow even more time between the two reforms. More generally, the experience suggests that in countries whose initial conditions resemble Chile's in the early 1970s, the capital account should be opened rather slowly, and after "sufficient" time has elapsed since the completion of the trade reforms. Of course, it is not possible to define precisely what constitutes a "sufficient" time. Policy makers, however, should monitor real exchange rate movements and the external sector behavior when deciding how to relax capital movement controls. Also, the Chilean case clearly shows that the destabilizing effects of massive capital movements are greatly magnified by the presence of other distortions, such as legally imposed wage rigidity.

This article has assumed that once the capital account is opened, domestic agents will be able to borrow from abroad and capital will flow into the country. This is indeed what would be expected in a normal situation, where real interest rates would be substantially higher in developing countries than in developed countries. However, after the international debt crisis (1982) many countries faced a temporary situation of credit rationing imposed from abroad. Under these circumstances it is likely that the opening of the capital account will not result in additional capital inflows. Moreover, depending on the approach the country is taking to solve its debt problems, capital may even tend to flow out if capital restrictions are relaxed. This is so because in some instances the stabilization program is carried out through timid small steps, which introduce significant uncertainties regarding the future behavior of the exchange rate and the domestic interest rate. These considerations again point toward delaying the opening of the capital account. Only after the initial steps toward stabilization and external adjustment have been taken, and the trade account has been opened, should capital restrictions be slowly relaxed. *From a macroeconomic perspective and a consideration of real exchange rate responses, we obtain a second element of the sequencing policy: it is more prudent to liberalize the current account before relaxing capital controls.*

Some qualified recommendations

Trade policy, adjustment assistance, and credibility. With a reduction in trade barriers domestic relative prices will move closer to world relative prices and resources will be reallocated across sectors. In general, any process of trade liberalization will require an adjustment period in which firms retool and labor acquires new skills. In many cases, this adjustment process will take time and will be quite costly. Some experts have postulated that to increase the probability of success (i.e., nonreversal) of the trade reform, adjustment costs related to the tariff reduction should be minimized. The idea of minimizing adjustment costs is generally translated into two forms of policy recommendations: (1) a gradual liberalization of trade and (2) the provision of adjustment assistance—usually in the form of foreign funds. These arguments usually focus on the political economy of policy reform and emphasize that any major structural change will necessarily result in pressure groups lobbying to defend their interests. Of particular importance are those groups organized by firms that will be harmed by the reform.

One argument suggests that adjustment costs can be reduced through the importation of "cheap" foreign capital, which would be used to finance smoother adjustment for the import-competing industries. According to this view, the capital account should be opened first, or simultaneously with the trade account. This would increase the availability of "cheap" funds that could then be used to ease the adjustment process. However, a number of economists have strongly opposed the idea of using foreign capital flows to assist the trade reform transition period. In fact, it has been pointed out that if capital inflows are allowed, the liberalization episodes will generally be aborted. According to this view, since such capital inflows are simply not sustainable in the long run, during the liberalization process they will provide incorrect market signals.

This debate over the use of assistance during the adjustment period critically depends on the degree of *credibility* the trade reform has. The credibility of the reform will generally affect the perceived path of relative prices and incentives. If a reform announcement is credible, firms and investors will anticipate future movements in prices and relative returns to investment; they will react accordingly, mobilizing resources domestically and from foreign aid and investing in the "new exports" industries. On the other hand, if the reform is not credible, and the public believes that there is some probability that the reform will be reversed in the future, "cheap" foreign funds, obtained through the opening of the capital account, may be used by the owners of firms in the import substitution industries to maintain their firms functioning at a (temporary?) loss.

The degree of credibility—which is critical for the analysis of the sequencing of liberalization—should not be viewed as external to the reform process. On the contrary, the strategy followed during the liberalization process will tend to affect this credibility. Fundamental to establishing the reform's credibility is the internal consistency of the policies that have been, and are currently being, pursued. For example, the inconsistency between fiscal and exchange rate policies in Argentina in the late 1970s played an important role in the eventual abortion of that country's liberalization reform. There was very little credibility that these inconsistent policies could be sustained. Also, in Chile, many economic agents believed that since tariff reduction was accompanied by a significant real appreciation of the exchange rate, the trade reform was actually unsustainable. The extraordinarily large current account deficit observed in that country during 1979–81 further fueled the feeling of unsustainability of the reforms. This aspect of credibility should be a very important consideration for the Bank and the Fund when they provide adjustment assistance to countries undertaking trade policy reforms.

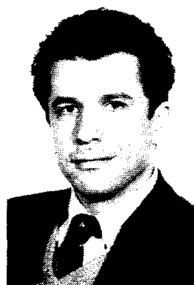
Economic reform, sequencing, and welfare effects. Welfare effects are at the center of the analytical and technical discussion on the sequencing of economic liberalization in developing countries. According to the "second-best" theory, if existing restrictions are only relaxed sequentially, it is not possible to know *a priori* if, due to the partial liberalization, some of the remaining distortions will be magnified. If this is the case, the partial reform will generate some negative welfare effects. Moreover, if the magnification of the remaining distortion is large enough, the partial reform may have a negative overall short-run effect on the economy.

Even though there have been no conclusive theoretical or empirical results on this subject, there are strong presumptions that relaxing capital controls in the presence of tariffs will amplify existing distortions. Once capital controls are lifted, a proportion of the funds obtained from abroad will be used to increase investment in the import-substitution sector. However, since tariffs have not been lowered yet, this sector is already producing "too much" and "too inefficiently" relative to what it would produce under a neutral trade regime. The existing distortion has, thus, been amplified. On the other hand, the presumption is that the reduction of tariffs in the presence of capital controls will generally not amplify existing distortions. On the contrary, it is likely that a positive indirect effect will result. This is because the reduction of tariffs will likely result in a higher demand for foreign funds to finance the acquisition of the now cheaper imports. Since, due to the existence of capital controls, the country was importing "too little" foreign funds, this effect will move this market closer to the undistorted equilib-

rium. In spite of the fact that no firm conclusions are available as yet, the presumption is that from the welfare perspective it is preferable to open the trade account before the capital account is liberalized, thus supporting the similar conclusion reached earlier.

Another important problem related to the welfare effects of economic liberalization in developing countries is whether the external sector should be fully, or only partially, liberalized. From an analytical perspective the answer to this question is clear. In the absence of other distortions, and unless the country in question can alter world prices, the first-best solution is to completely liberalize the economy, eliminating tariffs, quotas, and all restriction to financial movements. If, on the other hand, the country has a monopoly or monopsony position, and can affect world prices, there is a first-best argument for the imposition of some restrictions. Also, in a few cases, given income distribution and government revenue considerations, it may be desirable to maintain some of these restrictions.

While in practice there are a number of developing countries that have a monopoly position in the production of certain commodities, most (if not all) developing countries are small in relation to the world financial market. This, however, does not mean that these countries can borrow infinite amounts at a given interest rate. Quite the contrary, these countries face borrowing limits in the world financial markets and they are charged a premium, which corresponds to the perceived degree of country risk. The existence of this country-risk premium implies that even (very) small countries face an upward-sloping supply curve for foreign funds, where the interest rate at which they can borrow will increase with a higher level of indebtedness. There is, then, a distortion associated with the process of borrowing from abroad. In such circumstances private firms will borrow "more" than is socially optimal—since when one domestic firm borrows more, the cost of funds to all borrowers goes up. *From a policy perspective, the best way to deal with this "overborrowing" problem is to reduce the total amount of borrowing through the imposition of a tax on capital importation. In this case, there is a genuine first-best argument for retaining some controls—the optimal tax—on capital movement, even after the liberalization reforms.*



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Conclusion

While it is generally accepted that the liberalization of both the trade and capital accounts is beneficial, the simultaneous liberalization of both accounts is sometimes not feasible or even desirable, and sequencing becomes important. In such cases the domestic capital market should be reformed before the capital account is opened. If this is not done, the opening of the capital account will result in massive capital flight. Likewise, prior to liberalizing the domestic capital market, the fiscal deficit has to be controlled.

Regarding the balance of payments, both historical evidence and the theoretical considerations suggest that a more prudent strategy would be based on liberalizing the current account first. The strongest case for this ordering is based on the relationship between macroeconomic stability, capital flows, and the real exchange rate. The experience with destabilizing capital flows immediately following a capital account liberalization has generally been negative and has jeopardized other aspects of the reform package. The capital account should be opened slowly, so that the possible increase in the stock of foreign debt that will follow the liberalization will be spread through time, reducing the degree of real appreciation and negative protection provided by the exchange rate. ■

Helping Structural Adjustment in Low-Income Countries

Concessional assistance from the Fund's new structural adjustment facility and Fund-Bank cooperation help countries undertake crucial medium-term reforms

Michael W. Bell and Robert L. Sheehy

In the first 20 months of its operations, the Fund's structural adjustment facility has provided concessional financial assistance to support the balance of payments adjustment efforts of 21 low-income member countries (see Table 1). Discussions are in progress with a number of other eligible countries. The structural adjustment facility, established by the Fund's Executive Board in March 1986, is financed by about SDR 2.7 billion expected to become available during 1985–91 from Trust Fund loan repayments. The Trust Fund had provided concessional financing over 1977–81, and was itself financed largely by the sale of a portion of the Fund's gold holdings.

Most SAF arrangements have supported policy reform programs that have also received support under other Fund facilities. Indeed, all but six of the SAF arrangements that have been approved to date have also involved the use of Fund resources under other facilities. In some of these cases, SAF resources were critical in meeting balance of payments financing needs; in others, the SAF resources facilitated the implementation of additional measures, such as a further liberalization of import restrictions or an exchange reform that might not have been possible without the greater balance of payments support provided by the SAF. Thus, the resources made available under the SAF and other facilities have played mutually supportive roles, with the relatively longer-term commitment of resources under the SAF assuming special importance in enabling countries to face structural issues requiring a sustained commitment to policy reform.

This article reviews the background against which the SAF was launched and the design of adjustment programs undertaken by low-income member countries of the Fund that have qualified for assistance under the facility. It also explains, in brief, the criteria for eligibility and the nature of the collaboration between the Fund, the World Bank, and the member country in developing an agreed policy framework for medium-term balance of payments adjustment.

Conditions in the 1980s

The SAF was established in the context of very difficult economic conditions facing the low-income countries. Many had experienced a significant deterioration in their external positions and growth prospects in the late 1970s and early 1980s, brought on by diminishing net capital inflows following the onset of the debt crisis, a progressive worsening in their terms of trade, and the slowdown in growth in the industrial countries which affected their export possibilities. The deterioration was exacerbated in many countries by inadequate domestic economic policies. In responding to these difficult circumstances, a number of countries undertook adjustment measures that reduced their external current account deficits, but even so, many of these countries faced a decline in per capita income that began to be reversed only in 1984. In other countries, inadequate or inappropriate macroeconomic and structural policies resulted in a substantial worsening of their payments imbalances and made adjustment even more difficult. In some of these cases, limitations in the institutional structure of the countries reduced the effectiveness of policy instruments, hampering adjustment still further.

The fundamental concept underlying the SAF is the notion that growth and adjustment are mutually reinforcing. If a country's balance of payments position is unsustainable, it will not be able to restore and maintain satisfactory growth unless adjustment takes place; conversely, a viable balance of payments position can be sustained only in the context of adequate growth that enables production and trade to expand to meet the demands (and indeed improve the living standards) of an increasing population. The SAF was designed to facilitate this process, both by the direct support that it would provide to countries pursuing strong macroeconomic and structural adjustment programs and also through its catalytic role in encouraging the flow of financing from other sources.

Programs supported by the SAF (which are outlined in the policy framework papers—see box) are intended to promote growth by focusing investment on productive projects; by raising domestic savings and mobilizing external resources, particularly through non-debt-creating inflows; and by improving the incentives to efficient production through the establishment of appropriate prices and the removal of other structural impediments. These programs also aim at establishing a viable balance of payments position, to help meet external obligations in an orderly and timely manner, and to avoid disruptions to economic activity arising from external constraints.

SAF-supported adjustment

Although the revival of economic growth in the context of a viable external position has been and will continue to be a common objective of SAF-supported adjustment programs, the design of programs in individual countries is based on a case-by-case approach that reflects the circumstances of the member (see Table 2). There were, however, many

common features. The economic programs supported by SAF arrangements thus far generally aimed to increase growth rates; in most cases, the GDP growth target was 3–4 percent. The desired path for the external current account reflected a number of factors, including the position at the beginning of the program, the availability of medium-term external financing on appropriate terms, and the extent of liberalization of the trade system. However, in all cases, programs were designed to achieve substantial progress toward external viability during the three-year period of the SAF arrangements.

All programs approved to date included, as an important objective, the containment or reduction of inflation; in cases where inflation had significantly exceeded the global inflation rate, the programs generally aimed at a reduction to, or close to, the global rate. To this end, most programs included a reduction in the rate of growth of domestic credit aggregates. At the same time, some restructuring in the composition of domestic credit was generally expected, with private sector credit growing in real terms and domestic bank financing of the public sector declining, as less essential current expenditures were reduced to make room for higher

Table 1
Structural adjustment facility arrangements, as of October 31, 1987
(In millions of SDRs)

	Date of three-year arrangement	Amount committed	Amount disbursed
Bangladesh	Feb. 6, 1987	182.6	57.5
Bolivia	Dec. 15, 1986	57.6	18.1
Burundi	Aug. 8, 1986	27.1	8.5
Central African Republic	June 1, 1987	19.3	6.1
Chad	Oct. 30, 1987	19.4	6.1
Dominica	Nov. 26, 1986	2.5	2.0[1]
Gambia, The	Sep. 17, 1986	10.9	3.4
Guinea	July 29, 1987	36.8	11.6
Guinea-Bissau	Oct. 14, 1987	4.8	1.5
Haiti	Dec. 17, 1986	28.0	8.8
Madagascar	Aug. 31, 1987	42.2	13.3
Mauritania	Sep. 22, 1986	21.6	6.8
Mozambique	June 8, 1987	38.7	12.2
Nepal	Oct. 14, 1987	23.7	7.5
Niger	Nov. 17, 1986	21.4	6.7
Senegal	Nov. 10, 1986	54.0	42.6[1]
Sierra Leone	Nov. 14, 1986	36.8	11.6
Somalia	June 29, 1987	28.1	8.8
Tanzania	Oct. 30, 1987	67.9	21.4
Uganda	June 15, 1987	63.2	19.9
Zaïre	May 15, 1987	184.8	58.2
Total		**971.3**	**332.7**

Source: International Monetary Fund.
[1]Includes amounts disbursed under second-year arrangement.

The policy framework approach

A major innovation of the SAF is the requirement that a comprehensive three-year policy framework paper (PFP) be prepared by the national authorities, with the joint assistance of the staffs of the World Bank and the Fund. The PFP sets out the macroeconomic and structural policy objectives of the authorities for the ensuing three-year period, the policy strategy and measures that will be employed, and estimates of the financing requirements associated with the adjustment program. The paper identifies, in particular, the principal macroeconomic and structural impediments to a better growth and external payments performance. It also generally describes and assesses the public investment program and discusses financing requirements and, to the extent that information is available, the role of the major aid agencies. Finally, it analyzes the social implications of the program and describes the steps being taken by the authorities to ameliorate the possible adverse short-term impact of the adjustment measures on vulnerable groups within the society. PFPs have evolved in the 20 months of operation of the SAF and are increasingly incorporating long-term development issues.

The PFP is updated at the beginning of each program year, within the three-year policy framework. The main advantage of such a medium-term policy framework, updated regularly, is that it provides a continuity of policies and analysis that is useful for both the authorities and the international institutions and agencies that provide support for the country's adjustment efforts.

Bank-Fund cooperation. Bank and Fund staff assist the authorities in the preparation of PFPs. As a general rule, the Bank staff focus primarily on longer-term issues and on analysis of the adequacy of sector policies and of the public investment program and its sectoral priorities. The Fund staff focus mainly on the macroeconomic framework and objectives and on measures to eliminate macroeconomic imbalances. Both staffs are involved in analysis of the structural policy reforms proposed by the authorities within their respective areas of expertise. Discussions with the authorities on the PFP are undertaken jointly by the two staffs and the PFP is reviewed by the Executive Directors of both institutions. A summary of the views of the Bank's Executive Directors is made available to Fund Executive Directors for consideration prior to their own discussion.

Additional flows. A key objective of the PFP approach is to serve as a catalyst to encourage the flow of additional financial resources to eligible countries from other multilateral and bilateral sources. The resources of the SAF, even with the anticipated substantial enlargement, are relatively modest in relation to the needs of eligible countries. It is important, therefore, that additional resources be made available in association with the facility to ensure that countries undertaking the broad policy changes included in SAF programs are assured of adequate external support. The information in the policy framework papers provides bilateral and multilateral donors and creditors with a comprehensive and consistent policy framework and direction within which individual agencies could provide aid to SAF-eligible countries.

This process can help to direct resource flows to countries, and to sectors and projects within countries, that can use assistance most effectively. It can also help avoid overburdening the limited administrative capacity of many recipient governments and ensure that countries do not receive conflicting policy advice. The latter consideration assumes special importance in light of the growing emphasis on policy-based lending by many aid agencies.

public and private sector investment. To strengthen private sector savings, most programs featured an active interest rate policy, usually aimed at achieving positive real interest rates early in the program period.

The strategy for strengthening medium- and long-term growth prospects under the SAF arrangements approved so far generally involved substantial increases in domestic investment, while short-term growth was to be maximized by measures to increase the efficiency of the use of existing resources. The increase in domestic investment was in most cases to be derived primarily from an increase in private sector investment equal to about 2–3 percent of GDP. All programs also emphasized the importance of the financial viability of public investment projects. The aim was to direct public investment to those areas of the economy with the highest production potential and to projects that were efficient, cost effective, and financially sustainable. In many cases, the World Bank staff assisted the authorities in carrying out a review of the public investment program with this objective, either before or during the design of the adjustment program.

To allow for the planned increase in total public and private investment while achieving the external current account targets, programs stressed improvement in public finances and increased private savings. Overall fiscal deficits generally were expected to decline substantially over the three-year period of the arrangement. This was to be achieved in most cases by a reduction in the current expenditure/GDP ratio, while revenues were generally projected to absorb a roughly unchanged or falling share of GDP. In most programs, the strategy to induce the desired expansion in private investment and to improve its efficiency rested on: (1) increased domestic saving; (2) an improved institutional and regulatory framework; (3) a relatively liberal exchange and trade system; and (4) an appropriate structure of relative prices.

The maximization of economic growth in the shorter run, within the constraints imposed by the availability of external resources and the need to contain inflation, was to be achieved primarily by redressing the structure of incentives and relative prices, both within the economy and in comparison with those prevailing in the rest of the world. In many programs, this required modifications of the key prices in the economy, including in particular the exchange rate, interest rates, external tariffs, and prices of items that had been under rigid systems of price controls. Programs also typically attempted to remove other structural distortions, serious deficiencies in infrastructure, and supply bottlenecks where these were identified as major constraints on growth in the short run.

In most programs, structural policy reforms focused in particular on the public sector, including tax and public enterprise reform, exchange and trade system liberalization, and the pursuit of a realistic exchange rate policy. Programs have also typically included measures (frequently designed with the assistance of the Bank staff) aimed at improving the prospects for growth in the agricultural sector through better infrastructure (e.g., feeder roads, irrigation systems) and removal of bottlenecks that have impeded agricultural growth in the past; through improvements in services and regulatory practices (e.g., better availability of seeds and other inputs and the elimination of restraints and controls on marketing arrangements); and through enhanced incentives and pricing policies to encourage full exploitation of production possibilities (e.g., higher producer prices).

Industrial policy measures featured in a majority of structural reform efforts, primarily to improve the environment for industrial investment, in general, and production of tradables, in particular. Measures to eliminate institutional or regulatory barriers to

Table 2
Structural measures in three-year programs supported by the SAF in ten countries[1]

Types of measures	Number of countries
External sector	
Exchange rate system	3
Import liberalization	4
Tariff reform	7
Debt management	9
Other	2
Domestic prices	
Retail price decontrol	6
Agricultural producer prices	5
Fiscal sector	
Tax structure	10
Expenditure control	10
Public sector investment program/priorities	10
Other	8
Public enterprises	
Rationalization of price structure	7
Closure/divestiture/rehabilitation	10
Other	4
Financial sector	
Interest rate levels/structure	9
Rehabilitation of state or private banks	5
Instruments of monetary control	5
Other	4
Other sector policies	
Agricultural policy	9
Industrial policy	7
Energy	4
Transport	2
Other	4

Source: International Monetary Fund.
[1]Covers arrangements concluded by February 6, 1987.

Eligibility for SAF assistance

Access to SAF loans was limited initially to the 60 countries that were eligible for assistance from the Bank's concessional loan affiliate, the International Development Association, when the SAF was established in March 1986; subsequently, Kiribati and Tonga were added by the Fund's Executive Board following the inclusion of these members in the list of IDA-eligible countries (Table 1). China and India, the two eligible countries with the largest quotas, indicated that, because they did not anticipate acute or persistent balance of payments need, they did not intend to avail themselves of assistance from the SAF.

In order to qualify for SAF loans, eligible countries must face protracted balance of payments problems, and must develop a policy framework describing their medium-term objectives and outlining a strategy and the policies for achieving those objectives. A loan commitment under the SAF covers a three-year program of macroeconomic and structural adjustment; annual disbursements are made upon approval of annual adjustment programs within the overall three-year framework. The amount of resources available to a qualifying member country is limited to 63.5 percent of its quota in the Fund, of which 20 percent is disbursed upon approval of the first-year arrangement, 30 percent upon approval of the second-year arrangement, and the remaining 13.5 percent upon approval of the third-year arrangement. The amount of the third-year disbursement will be reconsidered during the next review of the operation of the facility.

Loans under the SAF are made on concessional terms similar to those of the original Trust Fund loans. Interest is payable semi-annually at a rate of 1/2 of 1 percent per annum and repayments are made in ten equal semi-annual installments beginning five and one half years and finishing ten years after the date of disbursement.

Table 3
Low-income countries eligible for the structural adjustment facility
(In millions of SDRs)

Member	Fund quota[1]
Afghanistan	86.7
Bangladesh	287.5
Benin	31.3
Bhutan	2.5
Bolivia	90.7
Burkina Faso	31.6
Burma	137.0
Burundi	42.7
Cape Verde	4.5
Central African Rep.	30.4
Chad	30.6
Comoros	4.5
Djibouti	8.0
Dominica	4.0
Equatorial Guinea	18.4
Ethiopia	70.6
Gambia, The	17.1
Ghana	204.5
Grenada	6.0
Guinea	57.9
Guinea-Bissau	7.5
Guyana	49.2
Haiti	44.1
Kampuchea, Dem.	25.0
Kenya	142.0
Kiribati	2.5
Lao, P.D.R.	29.3
Lesotho	15.1
Liberia	71.3
Madagascar	66.4
Malawi	37.2
Maldives	2.0
Mali	50.8
Mauritania	33.9
Mozambique	61.0
Nepal	37.3
Niger	33.7
Pakistan	546.3
Rwanda	43.8
St. Kitts & Nevis	4.5
St. Lucia	7.5
St. Vincent	4.0
São Tomé and Principé	4.0
Senegal	85.1
Sierra Leone	57.9
Solomon Islands	5.0
Somalia	44.2
Sri Lanka	223.1
Sudan	169.7
Tanzania	107.0
Togo	38.4
Tonga	3.3
Uganda	99.6
Vanuatu	9.0
Viet Nam	176.8
Western Samoa	6.0
Yemen Arab Republic	43.3
Yemen, P.D.R.	77.2
Zaïre	291.0
Zambia	270.3
Subtotal	**4,191.8**
China[2]	2,390.9
India[2]	2,207.7
Subtotal	**4,598.6**
Total	**8,790.4**

Source: International Monetary Fund.
[1]Each qualifying member country is currently eligible to receive SAF resources equivalent to 63.5 percent of its quota in the Fund.
[2]China and India have indicated that as they did not anticipate acute or persistent balance of payments need, they did not intend to make use of Special Disbursement Account resources, within which the SAF is currently administered.

growth have included, for example, the elimination of labor codes that acted as disincentives to new employment, reduction of quantitative restrictions on imported inputs, and streamlining of investment approval procedures.

The majority of countries eligible for the SAF have not experienced acute debt-servicing difficulties, and the adjustment programs in these countries envisaged that external debt would continue to be serviced on schedule throughout the three-year period. However, in some cases, there was a need for rescheduling, including through the Paris Club. Where exceptional financing was judged to be necessary, in some cases even beyond the program period, the expectation was that reliance on such financing would be eliminated, or at least substantially reduced, during the program period.

There have been some encouraging signs that the PFP/SAF process has helped stimulate the flow of additional resources to eligible countries. Paris Club creditors recently agreed to reschedule external debt service obligations of Mozambique and Uganda on the basis of SAF arrangements (see article by Thomas Klein in this issue). PFPs have also been used by several countries in discussions with bilateral aid agencies and some donors have increased assistance to the countries concerned as a result of this information. Finally, the Bank has indicated that a SAF arrangement could provide the assurances regarding the appropriate stance of macroeconomic policies that it requires for its structural and sectoral lending programs.

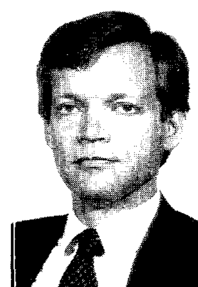
Future role of the SAF

In addition to the 21 countries for which commitments of about SDR 1.0 billion had been made under the existing SAF as of end-October 1987, a substantial number of other countries is expected to qualify for loans under the facility during the last quarter of 1987 and the early months of 1988. By May 1988, the date by which operations under the existing SAF will be reviewed, substantial additional resources of the existing SAF may have been committed.

Only a limited amount of the financing requirements of countries eligible for SAF assistance during 1988–90 could be met by the amounts remaining under the existing SAF (see Table 3 for eligible countries and their Fund quotas). Even with generous Paris Club rescheduling, a continuation of growing bilateral aid flows, a rapid eighth replenishment of the Bank's IDA, and the realization of other multilateral financing proposals, the financing needs of low-income countries would exceed current SAF resources.

Accordingly, the Fund's Managing Director has proposed that the resources available to support policy programs adopted under the SAF be increased by SDR 6 billion, which would result in approximately a tripling of the amount originally available under the facility (see "Enhancing the Fund's Structural Adjustment Facility" by Charles S. Gardner, *Finance & Development*, September 1987). The proposal is based on an estimate of the resources that would be required during 1988–90 to support strong growth-oriented adjustment programs of SAF-eligible countries. The estimate was prepared on the basis of a country-by-country examination of financing needs. The proposal was welcomed by the heads of state and government of the industrial countries meeting in Venice in June 1987 and has also been supported in a number of other international forums.

At its September 1987 meeting in Washington, DC, the Fund's Interim Committee strongly endorsed the Managing Director's proposal and noted the complementarity between this initiative and those already taken or under consideration elsewhere by the international community. The Committee welcomed the progress achieved thus far in exploring arrangements suitable to mobilize resources on the scale envisaged and asked the Managing Director and the Executive Board to proceed as quickly as possible to hold further consultations with potential contributors, with a view to concluding these discussions by the end of 1987. ■



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New Fund Facility Established

Resources to help low-income countries strengthen their balance of payments positions and promote growth were significantly boosted following the announcement on December 31, 1987, that the International Monetary Fund had established a new concessional lending facility. The enhanced structural adjustment facility (ESAF) is expected to provide SDR 6 billion from which its poorest member countries can draw when undertaking strong three-year macroeconomic and structural programs. This new entity and the remaining resources of its companion facility, the structural adjustment facility (SAF), together during 1988–90 will provide SDR 8.2 billion (about US$11.4 billion) to support such programs. The additional resources are designed to assist the adjustment efforts of low-income countries faced with high levels of indebtedness as well as those whose exports are concentrated in commodities—often one commodity—whose prices have remained weak in the world market.

The ESAF results from an initiative begun in the spring of 1987. The Fund's Managing Director, Michel Camdessus, first raised the possibility of tripling the level of resources offered under the SAF at the annual meeting of the UN Economic and Social Council in June 1987. The proposal was subsequently endorsed at the Venice Economic Summit also in June and by both the Interim and Development Committees during the 1987 Annual Meetings of the Fund and Bank.

The ESAF's objectives, basic procedures, and financial conditions are roughly similar to those of the SAF. Repayment schedules, for example, are the same under both facilities: ten equal semiannual installments, beginning five and one-half years and ending ten years from the date of disbursement. Interest rates for both facilities will be one-half of one percent, subject to the availability of the contributions of donor countries.

The two facilities draw their resources from different sources, however. The SAF was established in 1987 by reflows from the Fund's Trust Fund; the ESAF is supplied by special loans and contributions from Fund members. The SDR 6 billion made available under the ESAF will be in addition to the SDR 2.2 billion that remains to be disbursed of the SAF's original SDR 2.7 billion.

Currently 62 member countries are eligible for assistance from either facility. Access to the new facility for an individual country will be determined on the basis of balance of payments need and the strength of its adjustment effort. Maximum access to ESAF is expected to be 250 percent of quota, with provision for somewhat higher access in exceptional cases. Access under the SAF is 63.5 percent. Members borrowing from either facility will retain privileges to draw from the Fund's general resources and other special facilities.

Like SAF programs, ESAF programs will be based on a Policy Framework Paper, which outlines the authorities' medium-term economic objectives and priorities, and is developed with the joint assistance of the Bank and Fund staffs.

For further information on the PFP and other aspects of the facility, see "Enhancing the Fund's Structural Adjustment Facility," by Charles S. Gardner in the September 1987 issue, and "Helping Structural Adjustment in Low-Income Countries," by Michael W. Bell and Robert L. Sheehy in the December 1987 issue.

The Fund's Role in Adjustment

Fund-supported programs stress the fundamental complementarity between adjustment and growth

Manuel Guitián

The complementarity between adjustment and economic growth is a basic principle underlying the approach of the Fund in assisting its members. In describing the Fund's role in support of economic adjustment efforts, this article seeks to explain the opportunities that this complementarity opens as well as the limitations it imposes for economic policy formulation. After reviewing the principles the Fund must follow in its support of members' policies, the article outlines a conceptual framework for the design of adjustment and the attainment of growth. This framework is used to examine the issues, choices, and constraints posed for the Fund and member countries by the pursuit of these goals.

Scope of Fund assistance

Economic policies in general, and adjustment policies in particular, seek a broad range of generally interrelated objectives, whose pursuit is based on a combination of economic, social, and political considerations. Besides the achievement of a sound growth rate and the maintenance of an appropriate level of employment, a measure of domestic price and exchange rate stability, and a viable balance of payments position, governments often pursue equity-oriented goals, in areas such as income distribution, education, and nutrition. The scope available for full attainment of policy aims depends on the relationship between required and available resources, and therefore the setting of priorities involves choices about the mix of objectives as well as the speed of their attainment, and constitutes an integral part of the process of economic policy formulation and decision making.

The aims of the Fund's support for adjustment programs are prescribed by its Articles of Agreement. These call for the expansion and balanced growth of world trade as a means toward the promotion and maintenance of high employment and real income levels as well as toward the development of the productive resources of all members. The Fund seeks to fulfill its purposes by fostering economic and financial cooperation among member countries in a setting of exchange stability and orderly exchange arrangements, and in the context of a liberal system of multilateral payments. To this end, it stands ready to make resources available to members in support of their efforts to correct maladjustments in their balance of payments.

The basic aim is to shorten the duration and lessen the degree of the imbalance in the payments positions of members through the adoption of policy measures compatible with individual members' interests as well as with those of the membership as a whole.

The Articles call upon the Fund to support members in balance of payments need that are willing to adopt corrective policies that conform to the code of conduct embodied in its charter and that give assurances that the specific objective of balance of payments recovery will be achieved over a foreseeable period. In this manner, adequate safeguards are established to ensure that the use of resources will be temporary.

The Fund's mandate focuses mainly on external objectives, and in particular on balance of payments viability. In its financial relationships with individual members, the Fund stresses the attainment of balance of payments objectives as a domain where the interest of each member and those of the membership as a whole coincide. Out of respect for sovereignty in national policy decision making, the Fund observes a principle of political neutrality with regard to other domestic economic objectives, such as growth and price stability, and even more so as regards domestic policy objectives pursued for equity, social, or political reasons.

Observance of this broad principle has kept the Fund from entering areas that require judgement of social or political priorities. To the extent that other economic objectives (e.g., price stability, growth) contribute to balance of payments viability, however, the Fund argues forcefully for the adoption of policies to promote their achievement. Moreover, the principle of noninterference does not preclude the Fund from assessing the claims that domestic priorities put on available resources and from pointing out their economic implications and, in particular, any resulting balance of payments pressures. Moreover, while its mandate does not extend to policies and objectives that reflect mainly social or political considerations, the Articles enjoin the Fund to pay due regard to these policies and objectives in connection with its exercise of surveillance over exchange rate arrangements. The Fund has striven to abide by this prescription in its relationship with members.

An essential consideration behind the Fund's principle of political neutrality in domestic decision making has been the need to maintain an acceptable balance between protecting the interest of an individual member and safeguarding the interest of the membership as a whole. Its emphasis on the external objectives and consequences of members' economic policies helps to protect the membership's collective interest and is based on a broad consensus among members that these policies are subjects of legitimate international concern. Were the Fund to widen its focus beyond the external area, to include areas of policy with respect to which the grounds for international concern are less firm, the general acceptance of the priority the Fund accords to external objectives would be less assured, if not contested.

Conceptual framework

Major goals of adjustment efforts, as noted earlier, include balance of payments strengthening, price stability, and sound growth performance. Growth and adjustment depend on two critical factors: the *amount* of available resources and the *efficiency* with which they are used. Consequently, policy programs are aimed at mobilizing resources and enhancing their productivity.

A typical task of adjustment programs is to keep aggregate demand in an economy in line with productive capacity or, for a given level of demand in the economy, to bring productive capacity up to its potential level. Among the variety of factors behind the emergence of an economic imbalance, there is frequently an unsustainable expansion of aggregate demand and expenditure, whose elimination will entail a reduction in the level or growth rate of aggregate demand. Early on, it is not always easy to see whether such an expansion in demand indicates that an imbalance is developing that requires correction. This is particularly the case when the effects of the expansion give grounds for diverse, if not conflicting, assessments. Incipient increases in aggregate demand and expenditure can give rise to developments in, say, employment and output that are generally seen as favorable, and receive more notice than concurrent unfavorable developments in, say, prices and the balance of payments.

Why do the favorable effects of demand expansion often receive more notice than the unfavorable ones? Pressures on domestic prices and the balance of payments may not show themselves immediately, as some of the effects of the expansion of demand can be masked by borrowing abroad or by using international reserves. Even where the resulting increases in external debt and declines in foreign assets are viewed with concern, they may be considered a reasonable price to pay for the positive events elsewhere in the economy. However, the scope for increases in external debt and declines in international reserves is limited. The adverse price and balance of payments performance often becomes evident at a time when the improvements in employment and output begin to falter or have already disappeared.

Amount of resources, macroeconomic balance. A key function of economic management is to keep the level and the rate of growth of aggregate demand in a sound relationship with the level and growth prospects of the economy's productive capacity. For a given level of productive capacity and a given structure of relative prices and costs (including exchange and interest rates), this will require domestic financial policies that are consistent with macroeconomic balance in the economy. This is a first broad area of interest in the context of the relationship between the Fund and its members.

Expansions in aggregate demand are often associated with imbalances in the fiscal accounts or more broadly in public sector finances. Such imbalances are typically the outcome of the pursuit of policies and programs that require public expenditures in excess of the sector's revenues. To correct imbalances originating in the public sector requires actions to curtail fiscal spending or to raise additional fiscal revenues. Actions of this type may be labeled the *fiscal aspect of macroeconomic management.*

The implications for the private sector of the economy will depend on the particular mix of measures chosen. For example, an approach based on the reduction of public sector spending seeks to restore balance in the economy by directly lowering the participation or weight of the public sector in aggregate demand, while an approach based on raising domestic fiscal revenues would tend to be accompanied, other things being equal, by a reduction in private demand. The consequences of different fiscal policy mixes also vary in the certainty and speed with which they yield results—partly because the government's scope to control its spending generally exceeds its ability to ensure that its receipts will rise.

Fiscal policies are closely related to the broader sphere of financial policies—those affecting developments in credit, money, and borrowing flows in an economy. It is often difficult to distinguish clearly between the roles of fiscal and monetary policies in macroeconomic management; public sector spending or revenue measures—fiscal policy—strongly influence the public sector borrowing requirement and its need for domestic bank financing—monetary policy.

These considerations emphasize that to keep demand on a sustainable path requires a measure of control over the flows of domestic financing and specifically over the rates of monetary and credit expansion. These variables constitute what might be called the *monetary aspect of macroeconomic management.*

An important relationship exists between the rate of domestic credit expansion and increases in the money supply, on the one

hand, and the levels of aggregate demand and expenditure, on the other. Another important relationship exists between the demand for money balances and the level of income in the economy. Thus under most circumstances a discrepancy between the supply and demand for money (an imbalance in the money market) has as a counterpart an imbalance between expenditure and income (an imbalance in the market for goods and services).

A sound relationship between expenditure and income will also require that domestic credit expansion be kept in an appropriate balance with the prospective path of desired money holdings in the economy. Generally the behavior of these holdings is largely determined by the public. Thus policy formulation in this area focuses mainly on the rate of domestic credit expansion to ensure that sustained balance prevails or is brought to the money market, in the sense that it is not bought at the expense of the balance of payments (e.g. through international reserve losses or excessive foreign borrowing) or of price and exchange rate stability.

These general considerations provide the rationale for the importance the Fund attaches to domestic credit expansion as a policy instrument. The close relationship between this policy variable and the balance of payments is a more direct one than that between monetary expansion and the external accounts. To correct imbalances and thus protect the temporariness of the use of Fund resources, policy needs to be formulated so as to avoid—even over the limited periods in which they occur—trade-offs among economic policy objectives that endanger balance of payments prospects and weaken international reserve positions.

Consistency in macroeconomic management requires that its fiscal and monetary aspects be complemented by supportive foreign borrowing policies—the *external debt aspect of macroeconomic management.* External debt policies directly influence the expenditure-income flow, since foreign and domestic credit can substitute for each other. In general, monitoring of the global (domestic and foreign) flow of financial resources is required to keep the pattern of aggregate demand and expenditure in line with the economy's productive and absorptive capacities.

Efficiency in resource use, economic incentives. The productive potential of the economy, and its capacity to service debt, are influenced directly by macroeconomic policy actions as well as indirectly via the effects these actions have on relative prices and costs. In general, the borrowing process transfers command over resources from surplus to deficit sectors or economies. In an open economy, foreign borrowing, aside from its macroeconomic impact already discussed, adds directly to the resources available. If used efficiently, such borrowing can allow the economy both to reach higher expenditure levels and to grow at higher sustained rates than otherwise.

These considerations highlight the link that exists, via the current account of the balance of payments, between domestic macroeconomic management, external debt policies, the saving-investment process, and the long-run evolution of the economy. They also make clear that a medium-term horizon is required for the formulation and assessment of policies, and this is also the appropriate time frame for the achievement of objectives such as growth and external payments viability.

A sustained adjustment effort requires that macroeconomic balance be attained in a setting of appropriate incentives and signals to guide decisions to allocate and use resources in the economy. Relative costs and prices are critical in this regard. Imbalances can result in relative price-cost misalignments both among sectors in the economy and between the economy as a whole and the rest of the world. In these circumstances, changes may need to be made in key prices and costs if progress in the attainment of macroeconomic balance is to be durable.

This is an area of economic policy where macroeconomic management blends with structural adjustment and supply aspects. In the realm of fiscal policy, particularly expenditure management, a key issue is the efficiency and composition of spending. The durability of an effort to control demand and public sector expenditure will depend, inter alia, on the curtailment of unproductive spending and in particular on the protection of productive investment outlays.

Improvements in the structure of tax rates can also help to enhance productivity in the economy. Other important supporting actions encompass public sector enterprise pricing policy, including sectoral producer and consumer prices and the related issue of subsidies. More generally, the maintenance of an appropriate structure of relative prices is needed to promote efficiency in the allocation and use of resources among sectors in the economy.

Monetary and credit policies must lead to appropriate domestic interest rates, which are critical to efficiency in the allocation and use of financial resources in the economy and thus of primary importance for growth and balance of payments viability. On a general level, these objectives call for domestic interest rates that help to mobilize domestic savings—that is, appropriate real interest rates. They also call for interest rates to be competitive internationally so as to retain savings internally and encourage foreign capital inflows. This is yet another perspective from which the policies required for purposes of growth and the balance of payments coincide.

Exchange rates and competitiveness are of crucial importance for growth and external payments viability. With persistent imbalances in an economy, domestic prices and costs typically diverge significantly from those abroad; resource allocation is distorted; competitiveness is impaired, and so are the growth and balance of payments performance of the economy. In these circumstances, exchange rate adjustments or flexibility in exchange rate management, or both, supported by appropriate macroeconomic policies, can be essential to restore competitiveness and balance to the economy by helping to bring factor prices, including wages, and absorption, particularly consumption, to realistic levels. When competitiveness has been eroded and balance of payments pressures prevail, exchange rate action helps to shift demand from international goods to domestic goods. Exchange rate action also changes the real value of nominal assets and thus it has an influence on demand and expenditure throughout the economy. Properly conceived, exchange rate action thus helps to balance the external accounts directly by containing domestic absorption and indirectly by improving resource allocation between the internal and external sectors.

To ensure that economic incentives and pricing signals fulfill their functions, another important and desirable component of an adjustment strategy is the liberalization of exchange and trade regimes. The efficiency of pricing signals in imparting information among sectors and among economies, concerning their relative resource scarcities and demand patterns, can be seriously impaired by restrictions and controls.

Specific sectoral measures. The attainment and maintenance of an economy's growth potential often call for other types of action to eliminate inefficiencies in the economy as a whole or in specific sectors. Through its regular consultation as well as its technical assistance to member countries, the Fund actively contributes to the reform of specific sectors. Examples of this work include the development of central banking and money market institutions; the improvement of exchange market arrangements; and the establishment of adequate institutional machinery for coordinating policy decisions, as well as for monitoring economic performance, particularly in the fiscal and debt management areas. In a number of these activities, the Fund collaborates closely with the World Bank. The issues that arise in connection with such institutional reforms are not generally perceived as an integral part of aggregate economic management, but they can be critical for the efficient operation of the economy, and

therefore they are important in the context of a growth-oriented adjustment strategy.

Current issues

The policies and conditions associated with the assistance provided by the Fund have helped members to mobilize financial resources from other sources. From this standpoint, it can be said that the Fund helps to oversee the distribution of capital flows among member countries, so that it contributes to the effectiveness of adjustment and thus proves beneficial to the individual member and the membership as a whole.

In recent years, capital flows to developing countries have been severely curtailed. Procedures built around members' financial arrangements with the Fund have been developed in an attempt to ensure that external assistance in support of adjustment efforts actually flows on the required scale. Besides being the main vehicles for the provision of Fund resources, these arrangements have become a pivot for the Fund's efforts to elicit support for adjustment from major creditor countries and from the main sources of private capital, particularly the commercial banks. In this manner, the Fund has played an increasingly important role as a catalyst for capital flows to strengthen adjustment. An important factor for adjustment and growth will be its continued ability to muster external resources, as well as to elicit responsible actions on the part of creditors and capital exporting countries, so as to allow capital to flow efficiently.

The general characteristics of the main policies that are necessary to achieve growth with a viable balance of payments have already been discussed, but the scope and variety of possible policy packages give rise to a number of issues. The first issue concerns the availability of resources: the longer an imbalance has been allowed to prevail, and therefore the larger it is, the tighter is the constraint on the resources available and the more limited become the possible courses of action. Given the resource constraint, emphasis in the selection of policies must be placed on efficiency in resource use. Resource availability can pose a constraint on policy choices, but the quality of policies can also influence the availability of resources and thus ease the constraint.

The second issue applies to the relationship of growth, price, and balance of payments objectives to other aims sought on account of a combination of economic, social, and political factors. In a relatively open environment, social and political aims can rarely be pursued, on a sustained basis, at the expense of efficiency. Permanent conflicts between the criterion of economic efficiency and equity are unlikely because inefficiency and waste run counter to equity. However, these considerations do not mean that economic objectives can be pursued without regard to social and political aims. In general, the pursuit of social and political goals may help economic performance but it also places a claim on available resources. In this sense, trade-offs exist between policy objectives, but as long as efficiency in resource use is not impaired and as long as choices conform to the economy's preferences, conflicts between policy goals need not arise.

The third issue is that when imbalances develop, financing and adjustment can either substitute for or complement one another. Reliance on foreign borrowing or on use of international reserves (financing) rather than on policy action (adjustment) is a course of action that can be pursued only temporarily. Such a strategy essentially transfers and adds the imbalances from one period to the next until the cumulative need for adjustment surfaces abruptly, often when no more financing is available and there is no more scope for incurring payments arrears. At that moment, the burden of adjustment is to correct the existing flow imbalance that remains, together with the accumulated previous imbalances.

Alternatively, financing can be used in conjunction with adjustment policies to tide the economy over the period required for the policies to yield their results. Other things being equal, the stronger the policy measures are and the faster they are implemented, the smaller will be the associated need for financing. The larger the amount of financing being used during the adjustment process and the harder its terms, the higher will be the claims placed on future resources, and thus the stronger the balance of payments results that will need to be sought by policy action.

Normally the attainment of growth goes hand in hand with balance of payments viability. But it is important to stress that when the imbalances to be corrected have led to or have been associated with unsustainable growth rates in the economy, the restoration of growth to a sustained—even though lower—path represents not a problem but an element of the solution.

With a given level of resources, concentration on achieving growth may set a constraint on the range of policy mixes that are compatible with a viable balance of payments. To some extent, such constraints may also arise on account of choices made between growth and other domestic policy objectives, particularly those of a redistributional character.

When a balance of payments imbalance is to be corrected, it is often argued that a bias in favor of financing is appropriate whenever growth objectives are part of the strategy. However, the more foreign financing is resorted to, the more resources will have to be devoted in the future to its servicing. Unless the growth associated with such financing reflects its efficient use, it will not be sustained. Indeed, growth in the future may have been mortgaged with financing undertaken in excess of the economy's absorptive and productive capacities.

These relationships between policy objectives and the criteria for their selection are but aspects of the broader interdependence and interaction between the political environment and economic policy implementation. In general, a stable political environment is essential for the effective and sustained implementation of economic policies that is required in most circumstances to bring an adjustment effort to fruition.

In conclusion...

This article has stressed the essential complementarity that exists between adjustment and growth. Indeed, by removing distortions and impediments to efficiency, adjustment is necessary for the attainment of sound growth. The notion that adjustment is inimical to growth only serves to conceal the fact that without adjustment, growth today is at the expense of often significantly slower growth tomorrow.

The Fund's support of policies to restore viability to the balance of payments thus also represents support for growth on two counts: first, because those policies typically promote efficiency in resource use; and second, because the financial support from the Fund, as well as the other finance that the institution helps members to attract, adds to the resources at the disposal of countries undertaking adjustment. ■

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Fiscal Policy, Growth, and Stabilization Programs

Stabilization programs should incorporate macroeconomic and microeconomic fiscal measures; the issues and the obstacles discussed

Vito Tanzi

This article examines the following proposition: the impact of changes in fiscal deficits on economic objectives depends to a considerable extent on the quality (namely, the economic efficiency) of the specific measures employed. A change in the quality of those measures will change the relationship between the fiscal deficit and the balance of payments, especially over the medium and longer run. The required reduction in the fiscal deficit (the required austerity) needed to achieve a given effect on the basic objectives of economic policy will be more severe as less efficient measures are chosen. For this reason stabilization programs should systematically take account of microeconomic, as well as macroeconomic, issues of public finance. Programs must include needed structural changes and must integrate them with the macroeconomic framework. This paper focuses on Fund-supported programs but its arguments may also be of relevance to Bank-supported programs.

Design of programs

Stabilization programs can, in theory, emphasize either specific or general fiscal policies. For example, a country and the Fund could agree on a whole range of specific fiscal measures, such as changes in various taxes, tax rates, and specific public expenditures; subsidies; and public utility rates. These measures, however, must reduce the balance of payments disequilibrium and the rate of inflation to the desired level by reducing aggregate demand *and* increasing aggregate supply. For purpose of identification this may be called the *microeconomic approach* to stabilization programs, an approach that explicitly recognizes both the demand management and the supply management aspects of fiscal policy. It recognizes that fiscal policy changes usually affect not only aggregate demand but also aggregate supply.

Alternatively, the country and the Fund could limit their agreement on a program to general, macroeconomic variables; to the extent specific policies were discussed, it would be to assess their immediate impact on the size of the fiscal deficit and on aggregate demand. In this approach the supply-side aspects of fiscal policy (that is, the supply management aspects) would be largely ignored. This may be called the *macroeconomic approach* to stabilization policy. This approach implies that once the size of the deficit has been determined, the balance of payments consequences of that deficit have also been identified regardless of the specific measures that the country will employ to achieve the agreed reduction in the fiscal deficit. Whether the deficit is reduced by raising taxes or by cutting spending, and regardless of the specific tax and spending measures used to achieve such a reduction, the balance of payments consequences are assumed to be the same.

Complementarity

The Fund's Guidelines on Conditionality state that: "The number and content of performance criteria may vary because of the diversity of problems and institutional arrangements of members. Performance criteria will be limited to those that are necessary to evaluate implementation of the program with a view to ensuring the achievement of its objectives. Performance criteria will normally be confined to (i) macroeconomic variables, and (ii) those necessary to implement specific provisions of the Articles or policies adopted under them. Performance criteria may relate to other variables only in exceptional cases when they are essential for the effectiveness of the member's program because of their macroeconomic impact."

Over the years, in conformity with the traditional interpretation of these Guidelines, the formulation of Fund-supported stabilization programs has appeared much closer to the macroeonomic than to the microeconomic approach. Today's programs, however, pay much more attention to structural (supply-side) elements, recognizing that there is a complementarity between the macro and microeconomic approaches. The specific measures needed to reduce fiscal deficits may determine, especially over the medium and

longer run, whether a stabilization program will have durable, beneficial, effects on the balance of payments and on growth, or whether these effects will vanish as soon as the program is over. An adequate macroeconomic framework (consistent with a viable balance of payments and with price stability in the short run) is a necessary, but not sufficient, condition for growth and stability over the longer run. In addition, stability requires efficient structural adjustment policies.

Thus, before arriving at a target for the fiscal deficit, those formulating stabilization programs must consider the likely effects of the specific measures that the authorities propose to take to reduce the deficit, even if the Fund does not request that particular measures be used. The Guideline cited above does in fact allow performance criteria to be applied to microeconomic variables because of their macroeconomic impact. And though fiscal reforms are often difficult to describe in the precise terms required for monitoring through performance criteria, Fund-supported programs have often monitored such reforms through reviews.

Considered separately, the macroeconomic approach has certain advantages. First, at least in theory, this is an objective approach: whether or not the performance criteria set by the Fund for macroeconomic variables are satisfied is an issue subject, in most cases, to quantification and verification and thus beyond dispute.

A second, and perhaps more important, argument is that performance criteria based on broad ceilings imply less political interference by the Fund in the internal affairs of countries than do criteria related to specific measures. Many feel that these are political decisions that should be left to the authorities and that the Fund should at best offer only an opinion on them.

Third, discussions about fiscal ceilings, as well as the review of the outcome of these discussions at Fund headquarters, require fewer and less specialized staff resources than do discussions of specific measures. For an institution concerned about its own budget, this is an important consideration.

Fourth, closely related to the preceding point, is that, at least in the fiscal area, it is far easier to write "a letter of intent" in which a country's commitments to the Fund are couched in the form of general ceilings than to write documents that spell out formal commitments in terms of numerous specific policy changes.

Against these, however, there are arguments that caution against exclusive or excessive attention to macroeconomic performance criteria. Close attention also needs to be paid to the microeconomic aspects of fiscal policy, such as the structure of individual taxes and expenditure, the allocation of investment, the prices charged by public utilities, and public employment. The main justification for this emphasis is that provided the supply response is significant and occurs fairly rapidly, the more far-reaching is the structural reform agreed to by the country, the greater will be that supply response (in terms of output, exports, capital repatriation, and the like). Such a supply response may imply that a less stringent demand management policy is necessary.

Problems have at times been encountered with performance criteria in the form of ceilings imposed on macroeconomic variables. A program that relies exclusively on performance criteria related to macroeconomic variables may not be capable of providing the hoped-for results. First, the use of fiscal ceilings comes up against the problem at times encountered in connection with monetary rules: the longer ceilings on macroeconomic variables are in use, the less useful they may become, since countries learn ways of avoiding them. In some instances countries have engaged in operations aimed at circumventing the ceilings, in order to draw resources from the Fund, without making genuine adjustments. For example, fiscal deficits have been shifted from where they were measurable (the central government) to parts of the public sector where they were not (public enterprises, central bank, etc.).

Second, excessive reliance on fiscal ceilings, rather than on agreements about specific fiscal policies, may give the impression that the relationship between fiscal deficits and program objectives, and especially the relationship with the balance of payments, is thought to be clear-cut and unambiguous. In fact, however, a given fiscal deficit is likely to be associated with a range of balance of payments outcomes.

Third, and most important, excessive reliance on macroeconomic ceilings may divert attention away from the durability and the quality of the specific measures used by a country to comply with performance clauses in a program. The basic question regarding durability is, will the fiscal measures taken have a permanent impact on the fiscal deficit? Is, for example, a revenue increase or an expenditure cut of such a nature as to affect the deficit for years to come, or is it of a once-and-for-all type? Durability of the effect of fiscal measures is important if the program's objective is, as it should be, a permanent improvement in the economy. Here, again, there is ample evidence of cosmetic reductions in fiscal deficits that do not last beyond the end of the program.

In addition, there is the important question of the quality (or, if one wishes, the economic efficiency) of the fiscal measures. As far as short-term, demand management policy is concerned, it is inconsequential whether the country reduces the fiscal policy through the use of measures that have disincentive effects, or through measures that do not have such effects. The stabilization program will go off track if the ceiling is not observed; it will formally remain on track if it is observed through growth-retarding measures.

Stabilization and growth

As argued above, a growth-promoting stabilization policy requires reduction in the fiscal deficit through fiscal measures that are (1) durable in their effects, and (2) efficient in their impact. In other words, the policies chosen must not "self-destruct" once the program is over and must achieve their deficit-reducing objective with the least possible inhibition of economic growth.

The efficiency of fiscal instruments is important for growth, as much recent work on this issue has demonstrated. Work effort, exports, productive investment, saving, capital flight, foreign investment, and so on can be affected by the choice of specific fiscal instruments. These choices may play a large role in determining the amount of foreign resources a country will have available during and after the program period. Thus, the relationship between changes in the size of fiscal deficits and achieving the ultimate objectives of economic policy, such as growth and stability, is inevitably influenced by the choice of fiscal policy measures. It can make a substantial difference to the growth prospects of a country whether the fiscal deficit is reduced by eliminating a totally unproductive expenditure or by raising a tax that has strong disincentive effects, even though in terms of short-run fiscal deficit reduction the result would appear to be the same. The more efficient the measures used to achieve a given deficit reduction, the greater will be the rate of growth, and, assuming an unchanged monetary policy, the lower will be the rate of inflation.

The implication of the above conclusion for stabilization programs is obvious: provided a country is willing to implement considerable structural measures early enough for at least part of their positive effects to be felt during the program period, less reduction in the overall fiscal deficit (i.e., less austerity) will be needed than if the structural package is less far-reaching or if the country delays its introduction. There is thus something of a trade-off between quantity and quality of fiscal adjustment which is influenced by the timing of the introduction of the structural measures. These issues typically call for discussion between the country authorities, the Fund, and the World Bank, where the Bank is active in lending for structural adjustment.

Though this is not the place to discuss in detail the nature of the fiscal measures that can form the structural core of a stabilization program, a few examples may help convey the importance of these issues. Suppose that an agricultural commodity of wide consumption (say, wheat, corn, or rice) has been subject to an export tax in a country negotiating a Fund program. The elimination of this tax would reduce tax revenue and thus raise the fiscal deficit. This, in turn, would have monetary and, consequently, balance of payments implications, which the macroeconomic framework of Fund programs would assess. But let us consider whether there are countervailing supply-side effects. The removal of the tax would raise the domestic price of the commodity and lead to a reduction in domestic consumption, thus making some additional supply available for exports. In addition, the removal of the export tax would encourage producers to produce more of that product. When this additional production becomes available, exports will increase further. Since the availability of foreign exchange is always a key factor in a stabilization program, focusing only on the demand effect (through the increase of the fiscal deficit) that the elimination of the tax will have, and ignoring the supply effect (through the incentive to produce and export more), is likely to introduce a bias against the elimination of that tax. It may thus possibly lead to programs that require greater demand reduction and that are associated with lower growth rates than might have been necessary.

Or, suppose that some additional spending is carried out by the government to repair a road that facilitates the shipping of agricultural products out of the country. Here again the short-run negative effect on the balance of payments associated with the larger fiscal deficit is partly or fully neutralized by the positive effect associated with larger exports. These examples may be extreme but do occur in practice.

Problems of implementation

Several problems arise in connection with the greater incorporation of specific fiscal policy requirements in Fund programs. They relate to (1) existing knowledge of incentive effects, (2) timing considerations, and (3) political implications.

As to the first point, one could argue that not enough is known about the incentive effects of particular policies to place precise quantitative values on them. This is true, but irrelevant. Stabilization programs often rely on exchange rate devaluation even though the responses of exports and imports cannot be predicted precisely. They also rely on changes in real interest rates even though, again, the size of the response of financial saving to changes in real rates cannot be known with precision. The important point is to have a sense of the direction of the effects and some "feel" for their size.

With respect to the timing issue, it may be agreed that the choice of better policies would in time bring about a more efficient economy and higher rates of growth. But what about the present? Wouldn't, for example, the elimination or the reduction of an efficient tax or an increase in a highly productive government expenditure raise the deficit in the short run, thus necessitating more external or inflationary financing? A simple answer is that important structural changes often bring with them changes in expectations that can induce individuals and corporations to make further changes reinforcing their initial effects. For example, changes that create an environment more favorable to the private sector may encourage individuals to repatriate capital, encourage investment by foreign enterprises, and facilitate foreign borrowing. More finance from abroad is likely to be made available to countries pursuing structural reforms. Still, part of the answer is that, as shown in the example of the export tax, some real effects will often occur early. If structural changes are made early in a program, or even before its formal approval by the Fund, their supply-side effects would probably also occur within the program's duration so that the initial negative effect on the size of the fiscal deficit could be balanced by a positive supply-side effect in the latter phase of the program.

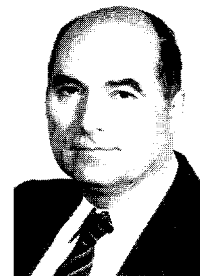
As noted earlier, in many instances Fund missions are already involved in structural aspects of economic stabilization. This is particularly the case in countries undertaking Bank-supported adjustment programs. But for the Fund formally to require, as a routine matter, understandings on specific tax or expenditure measures in the stabilization programs it supports, the conditionality guidelines might have to be amended. National authorities may object to such a change, especially if they perceive it as threatening additional conditionality without additional benefit. However, if they are persuaded, at the time of program negotiation, that there might be some trade-off between the size of the required macroeconomic adjustment on the one hand (the required austerity), and structural changes on the other, their objection may be less than one might anticipate.

Conclusions

In pursuing an approach giving greater attention to the particulars of fiscal policy, the Fund would not only identify the range of adjustment needed at the macroeconomic level but also, in cooperation with the country's experts and the Bank, would make an inventory of the changes in the levels and structures of taxes and of public expenditure that would be required to promote the country's growth objective. In doing this, the Fund would take into account the importance that the country's authorities attach to such objectives as equity and the provision of basic needs, with their implications for economic efficiency. The task would then be to determine whether the proposed changes added up to a macroeconomic adjustment package consistent with the balance of payments objective. The structural adjustment would be made up of a basic set of structural fiscal measures representing a *sine qua non* for a program. If this structural core did not add up to the macroeconomic adjustment assumed to be needed, the Fund and the local experts would look for other—and progressively less efficient—ways to add to revenues or to reduce expenditures. Should the country's economic difficulties be assumed to originate mainly from excess demand (that is, where no major structural problems are identified), the negotiations would proceed along more traditional lines.

The country's authorities would be aware that the more daring and timely they are in introducing structural changes, the more flexibility they would have in demand management. In essence, the program would be made up of three equally important elements: (1) the traditional macroeconomic framework with ceilings and targets; (2) the structural core; and (3) the investment core, which presumably would indicate, on the basis of Bank recommendations, the minimum investment, as well as the allocation of that investment, consistent with both growth and balance of payments objectives.

One should not underestimate the difficulties that a more extensive pursuit of this alternative would present; but it is an alternative that should receive further thought. Initial experimentation in well-chosen and willing countries would be indispensable to a full assessment of its general feasibility and to an outline of the procedural steps to be followed. ■



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World Bank Lending for Structural Adjustment

The nature of the Bank's support of reform efforts in member countries and a review of the experience

Constantine Michalopoulos

The World Bank has always stressed the need to use limited investable resources efficiently. In this quest it has attempted to identify investment priorities in recipient countries and lent for projects that promised a high rate of return. Over the years, the Bank has also recognized that it is virtually impossible to have a good project in a bad policy environment. It has, therefore, consistently tried, for instance, to promote appropriate pricing policies for public utilities and agriculture, two sectors for which the Bank has lent considerably. Until recently however, less emphasis was placed on lending that directly supported changes in the macroeconomic environment or in the national economic policies of developing countries.

As the turbulent economic events of the last decade unfolded, Bank programs changed to meet the challenge of adjustment in the economies of member countries. While project and sector investment activities continued to absorb the largest portion of Bank loans and credits, new instruments were introduced, such as structural adjustment and sector adjustment loans and credits. These instruments were designed to support developing countries' programs and policies of structural reform.

This article looks at structural and sector adjustment lending by the Bank up to the end of 1985. It is based in part on the findings of a major review of 15 structural adjustment loans to ten countries over 1980–82.

Types of lending

There are currently five categories of Bank lending operations: (1) specific investment loans; (2) sector operations, which include sector investment and maintenance loans, financial intermediary loans, and sector adjustment loans (SELs); (3) structural adjustment loans (SALs); (4) technical assistance loans; and (5) emergency reconstruction loans (see table). In practice, the conceptual distinctions between these categories are sometimes blurred, and individual operations can combine different categories. Before structural adjustment lending was introduced in early 1980 (and in some instances thereafter), the Bank also provided a few program loans and credits that were quite similar to the SALs.

Developing country policy issues arise in different contexts in almost all categories of loans. But the loans focus attention on different objectives in each case. In specific project and sector investment loans (and also in financial intermediary loans), for example, the focus is on specific policies that affect the viability of the project or the entity being assisted, such as input and output prices, lending rates to sub-borrowers, and so on. Similarly, technical assistance loans are primarily designed to strengthen and support institutions. Sector adjustment loans help promote the introduction and effective implementation of sectoral policies necessary for sustained economic growth. Finally, structural adjustment loans concentrate attention on macroeconomic policies and associated institutional changes at the national level—although they frequently emphasize reforms of special relevance to particular sectors in which adjustment is most urgently needed. The Bank's Operational Manual defines structural adjustment lending as "non-project lending to support programs of policy and institutional change necessary to modify the structure of an economy so that it can maintain both its growth rate and the viability of its balance of payments in the medium term." Thus there is a continuum in the aims of various forms of Bank lending, beginning with policies and institutions to ensure the viability of a narrowly defined project, and ending with the adjustment and operations of macroeconomic policies and institutions of a country.

This does not mean that macroeconomic policies cannot be affected by specific project lending. Indeed, heightened concern about the policy framework can and does substantially affect the context and focus of project

Distribution of World Bank loans and credits, by lending instrument, fiscal years 1975–86[1]

(In percent)

Type of loan	1975	1979–80	1981–82	1983	1984	1985	1986
Specific investments	**58.5**	**58.5**	**44.7**	**39.4**	**41.1**	**49.6**	**45.2**
Sector operations	**32.6**	**36.1**	**45.4**	**49.6**	**48.2**	**46.9**	**45.4**
Sector investment	15.9	22.5	26.3	24.6	26.4	27.0	19.0
Financial intermediary	16.7	13.1	18.6	20.6	13.3	9.6	12.4
Sector adjustment	0.0	0.5	0.5	4.4	8.5	10.3	14.0
Structural adjustment[2]	**8.8**	**3.3**	**8.0**	**9.6**	**8.4**	**1.1**	**5.0**
Technical assistance	**0.2**	**0.4**	**1.7**	**1.2**	**2.1**	**1.4**	**1.4**
Emergency reconstruction	**0.0**	**1.2**	**0.2**	**0.2**	**0.3**	**1.0**	**3.1**

Source: Planning and Budgeting Department, The World Bank.
Note: Details may not add to 100 due to rounding.
[1] Bank fiscal year ends June 30.
[2] Includes both program and structural adjustment loans and credits.

operations, which are likely to continue to absorb the bulk of the Bank's future lending. But structural adjustment lending enables the Bank to address basic issues of economic management more directly and more urgently than before.

The policy focus

The main purpose of Bank sector and structural adjustment loans is to facilitate the adjustment required to achieve sustainable growth and the mobilization of external financing needed to support a country's adjustment efforts. This goal is seen by the Bank as a medium-term target. Adjustment loans help delineate the annual steps to be taken in support of the policy reforms needed to promote sustainable growth in the medium term. Subsequent steps are supported by additional loans of various kinds, so that the implementation of a reform package is covered by a series of Bank lending operations over a period of several years. In all cases reform programs have required a firm commitment on the part of governments to maintain the course of the reform effort over time.

Most aspects of macroeconomic and sector policy have been covered by Bank nonproject lending. Such lending has been coordinated with the Fund to supplement the Fund-supported programs in specific countries. While the Bank has deferred to the Fund on matters of monetary and exchange rate policy, it has sometimes been involved in the institutional reform of exchange rate management (as in the case of setting up foreign exchange auction systems in Nigeria and Somalia). It has also worked closely with the Fund on matters pertaining to the reform of interest rate policies (e.g., in Jamaica).

While individual programs have dealt with different policy issues according to the priorities and objectives of individual countries, the Bank has emphasized the following broad and interrelated areas:

- *Mobilization of domestic resources* through fiscal, monetary, and credit policies. This includes support for both measures to increase revenues and measures to control or reduce expenditures; for efforts to restrict public sector or external borrowing; and to decontrol or restructure interest rates.
- *Improving the efficiency of resource allocation and use by the public sector.* This includes support for rationalizing public sector investment; strengthening the efficiency of public sector and parastatal enterprises, and rationalization of public sector programs (including divestiture of public holdings in enterprises).
- *Reform of the structure of economic incentives* in order to reduce distortions, promote more efficient resource allocation, and thus create a more productive economic structure. Within this area, two sets of policy issues are receiving the greatest attention: first, reforms of trade regimes to reduce the bias against exports, and to lower the level and rationalize the pattern of protection. Second, reforms of price systems to make prices more accurately reflect opportunity costs (e.g., in agriculture, energy, and state enterprises).
- *Institutional strengthening* to help foster adjustment with growth. A variety of reforms are being pursued in different countries depending on their needs. In some cases the aim is to strengthen institutions whose performance is critical to the success of other reforms, for example, agricultural extension in support of agricultural policy, improvements in the customs service linked to trade reform, or general tax collection related to broader tax reform. In other instances, reforms are sought in broader macroeconomic or public sector management or take the form of specific improvements in institutions providing public services. There is little distinction between the policy reforms supported by structural adjustment loans and sector adjustment loans. The main difference lies in the comprehensiveness of the policy and institutional reform involved. Relatively few countries have prepared comprehensive and implementable adjustment programs that can be supported by SALs. On the other hand, there are certain policy areas, for example fiscal reform, that are best tackled through an economy-wide approach. In several cases, SELs have been used to initiate the adjustment process which, as it becomes more comprehensive, may be supported by a SAL. In Ghana, for example, two Reconstruction Import Credits in fiscal year 1983 and fiscal year 1985 and an Export Rehabilitation Credit in fiscal year 1984 were followed by a SAL in fiscal year 1986. In some other cases, sector adjustment loans serve to deepen the adjustment process initiated by the SALs. In Turkey, for example, a series of SALs in 1980–84 was followed by an Agricultural Sector Loan in 1985, and in the Republic of Korea a Financial Sector Loan in 1985 followed the earlier SAL.

Experience with policy reforms

This review of policy issues should not be viewed as an evaluation of the impact of past Bank structural and sector adjustment lending. It is very difficult to determine what would have been the recipients' policies and performance in the absence of the programs. This is a familiar problem, which reduces most analyses to contrasting country performance after the assistance to performance before. Such an approach is dangerous because: (1) it assumes that countries would have made no policy changes to improve their situation in the absence of the Bank programs, while in fact their policies may have been unsustainable, and (2) it does not take into account changes in the international environment or other exogenous events that influence country performance. In addition, it is difficult to distinguish the effects of Bank-supported programs from those supported by the Fund, which has been actively working in almost all the countries which the Bank is assisting through SALs or SELs. Finally, this analysis does not address a number of implementation issues, such as the size of SALs, nature and size of disbursement ("tranches" of loans), the scope of conditionality and the like, all of which have a bearing on the question of program effectiveness.

Perhaps the most general conclusion that can be drawn from the Bank's experience to date is the importance of the recipient's commitment to a particular course of reform for the ultimate success of the policy package. The most successful cases of reform supported by the Bank have been in countries (e.g., the Republic of Korea and Turkey) that have adopted a series of reforms over time

and stuck by them. The least successful were those where, for a variety of reasons, policies were reversed after a time and the direction and purpose of reform was confused and uncertain (Bolivia, Guyana, and Senegal in the early 1980s). Some of the main lessons of policy reform in particular areas are discussed below.

Domestic resource mobilization. Past Bank involvement with resource mobilization has mainly focused on supporting government efforts to reduce budget deficits through revenue raising or expenditure reducing measures. Bank efforts typically supplement Fund programs in this area. In all instances, Bank programs aim to strengthen public sector performance and to reduce, directly or indirectly, public sector deficits which tend to crowd out private investment and to produce financial and balance of payments disequilibria. Reforms in this area have focused on raising public agencies' revenues or reducing their expenditures by, for example, raising prices of services or establishing user fees, or eliminating or retargeting subsidies, so as to reduce public sector expenditures. In other cases, Bank efforts have focused on administrative reforms of the tax system or the introduction of new taxation. Deficit reduction and reform of parastatals have often required cuts in public sector employment; in a period of stagnant growth, such cuts have entailed transitional costs with which governments and the Bank have had to deal.

In addition to fiscal reform, resource mobilization has been pursued through efforts to improve the functioning of the financial sector and to eliminate distortions in interest rate policy. Examples of such activities include the Industrial Finance Project in Korea and the Morocco Industrial and Trade Policy Loans. The financial systems of many developing countries have also been severely strained in the last five years in coping with the debts of financially ailing enterprises—sometimes in the public sector. This has prompted Bank sector loans designed to support rehabilitation of the financial system in a number of countries such as Chile and the Philippines.

Broadly speaking, the key issues that have arisen from the Bank's experience with financial market and banking sector reforms are the need to ensure an orderly transition for banking systems saddled with a lot of nonperforming loans (sometimes of public enterprises), and the liberalization of previously controlled lending and deposit rates.

Improving public sector performance. This effort has included three main components: (1) rationalization of public investment programs; (2) improved public sector enterprise performance; and (3) rationalization of the size of the public sector, including divestiture of public holdings.

Since 1977, the Bank has undertaken about 50 public investment reviews. A large number of these were undertaken in conjunction with Fund programs that required such reviews or depended on them. While many had common features, these reviews varied considerably in scope—ranging from relatively brief analyses to major reviews in Jamaica and Turkey.

Most reviews recommended changes in investment priorities. In addition to overall resource constraints, the key problem usually was that projects underway were not accompanied by necessary actions in other fields that would make those projects viable. In general, such reviews have been most effective when they have been based on thorough Bank sectoral analyses and have actively involved member governments.

For the future, an important dimension of the Bank's role should be to strengthen (and in some cases to help create) the institutional capacity that would permit developing countries to undertake effective investment reviews as a regular feature rather than in times of crisis. It will also be important to link such reviews to other elements of government policy such as prices and policies for reallocating resources toward export and efficient import-competing sectors. Finally, these investment reviews can greatly strengthen the process of aid coordination. All too often—especially in Africa or other countries where the internal investment review process has been weak—donors have supported activities without taking into account the budgetary implications of their maintenance and recurrent costs.

Improving the financial performance of public sector enterprises has also been an objective of many SALs (e.g., in Jamaica, Senegal and Turkey). The effort has focused both on better internal management of parastatals (e.g., in Jamaica) and on raising prices to reflect marginal production costs and to reduce the drain on the public budget. While there is evidence that objectives in this area have been achieved in some cases, the experience has been less encouraging in others. In Jamaica, for example, reductions in public sector enterprise deficits were in part offset by higher central bank losses. In Turkey, higher prices in some state enterprises that provide inputs to other entities under monopolistic conditions have harmed export competitiveness. Meanwhile, considerable progress is being made in Africa with reforms of state enterprises involved in marketing and distributing agricultural products (e.g., in Senegal).

More generally, the Bank has also been helping member countries to reassess the role of government as an owner or operator of specific public enterprises. In several cases this has led country authorities to undertake divestiture programs. Such programs have been announced by many countries (e.g., Brazil, Chile, Costa Rica, Jamaica, Malaysia, Mexico, the Philippines, and Turkey), but progress has been difficult. One of the problem areas has been the handling of financially ailing entities: closing them down has meant increasing unemployment during periods of crisis; without prior rehabilitation, they are not attractive to potential buyers; domestic capital markets are frequently underdeveloped and may not be able to finance the purchase of such enterprises, and sale to foreign investors is not always welcome—even if there was interest by foreign investors, which usually is not the case. The temptation is therefore for the government to continue to run the entity, even though it may no longer believe it to be desirable or appropriate to have the entity in the public sector.

Reform of trade regimes. Reform of the structure of incentives affecting the production of exports and import-competing goods has been a key feature of almost all SALs and many sectoral loans. On the export side, the Bank has emphasized two sets of measures: (1) the provision of financial incentives through tax rebates, subsidies on imported inputs to offset import controls, and preferential access to imports and credit (e.g., in Jamaica, the Philippines, Senegal, and Turkey); and (2) reform of administrative procedures and the establishment of better institutional support for exporters (e.g., in Jamaica, Kenya, and the Philippines).

In most instances the competitiveness of exports was expected to be enhanced by parallel liberalization and rationalization of systems of protection for import-competing activities. For example, the SALs for Jamaica, Kenya, the Philippines, Thailand, and Turkey supported the reduction of quantitative restrictions and the lowering and liberalization of tariffs. Sectoral loans to Mexico and Colombia in fiscal years 1983 and 1985 and to Argentina in fiscal year 1986 have also been designed to correct the anti-export bias of incentives by promoting export rebates, import liberalization, and so on, and by strengthening the institutional base for export development.

Finally, the trade reform components of SALs and SELs were expected to be buttressed by changes in other policies that would result in a supportive real devaluation. Most of the loans referred to the maintenance of competitive exchange rates as an essential condition for the success of the loan. Monitoring of such provisions was left to the Fund.

The results of the early lending operations have been mixed. Of all the countries assisted, perhaps Turkey, and more recently Chile and

Ecuador, have made the most progress in reforms. The financial incentives were introduced on schedule or with small delays in most cases. Progress in improving institutional support was generally slow, however, and, while most countries took some steps to rationalize the trade regime, the process was frequently halted short of the desired objectives or even reversed. In about half of the countries that had received a SAL before 1985, the real effective exchange rate appreciated within a year of the relevant SAL commitment.

On balance, this experience confirms the conclusion that implementation of trade reforms is not very successful when it is not accompanied by other measures to assure a shift in the real exchange rate—which is needed to produce the desired shifts in incentives. Experience also suggests that future reforms should ensure that export expansion programs are accompanied by significant import liberalization and action on the exchange rate. Experience does *not* suggest that import liberalization should be undertaken only after export reforms have increased the supply of foreign exchange. This kind of sequencing is likely to be self-defeating, since it is extremely difficult to reorient producers toward export markets as long as heavily sheltered domestic markets offer them sizable assured profits.

Other pricing policies. Changes in agricultural and energy pricing were also common features of many SALs and SELs. Agricultural pricing reforms almost invariably tried to raise producer prices to a level closer to international market price equivalents, and cut input and consumer subsidies (e.g., in Senegal and Pakistan). Agricultural sector loans to Morocco and reconstruction credits to Ghana had a similar approach. The same kinds of objectives were pursued in pricing energy in the SALs to Jamaica, Kenya, the Philippines, and Turkey.

Experience with these loans suggests that most of these reforms, especially those related to the energy sector, were implemented with significant benefits to the recipient. In several cases there has been evidence of increased agricultural production and improved rural incomes (e.g., Ghana and Thailand), and of increased conservation and efficient import substitution of energy resources.

An important issue in this area is how to deal with the transitional costs entailed by raising the foodstuff prices paid by politically powerful urban consumers. This issue has caused serious difficulties in at least one recent case. A key concern about Bank programs in support of adjustment and growth has been the extent to which such programs have adequately addressed the effects of adjustment on the poor. A review of the Bank's experience in this area suggests that programs which supported effective reforms to improve efficiency and increase productivity benefited the poor through the restoration of overall growth. Past experience also suggests that such programs have a positive effect in promoting a more equitable distribution of income over time. But there are frequently transition costs to the adjustment. In recognition of this, the Bank has also designed programs specifically aimed at poverty issues related to adjustment. Greater attention needs to be directed to the distributional impact of public sector consumption expenditures, however, as well as to designing employment assistance programs that would ease the burden of structural adjustment in the short term.

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Conclusion

The Bank has a variety of lending instruments to support policy reform in member countries. Over the last six years, the Bank has increased the proportion of its total commitments represented by sectoral and structural adjustment lending in support of broad economic and sectoral policy reforms. The increase has been especially pronounced for the two sets of economies currently facing the most serious problems of adjustment and growth, namely, the countries of Sub-Saharan Africa and the heavily indebted middle-income countries.

Experience with such lending suggests that consistent pursuit of the kinds of policy reforms the Bank has supported in recent years will promote adjustment and growth in member countries. Given the problems facing developing countries today, the direction of policy reforms already pursued by the Bank should be maintained. In the light of uncertainties about the appropriate pacing and sequencing of such reforms, however, it is important to be flexible in implementing adjustment programs. This means that country reform programs will need to be reviewed frequently to ensure that they are on track, and that the Bank will have to be prepared to support modifications in policy reform packages in the light of both domestic and international developments. Where policy reforms to promote generally desirable structural change give rise to transitional costs for the poor, the Bank will continue working with governments to develop programs to address such problems. ■

Structural Adjustment in Nigeria

The core of the program is being implemented. The challenge is to implement the remaining part and to maintain the momentum of reform

Nils Borje Tallroth

The sharp increases in oil revenues in 1973-74 and again in 1979-80 had a pervasive effect on the Nigerian economy. These revenues provided the basis for large increases in public expenditure designed to expand infrastructure and non-oil productive capacity, even as they served the political and social purpose of healing the wounds of the civil war (1967-70). There were also substantial increases in public spending on health, education, and other social services throughout the country.

But notwithstanding some important successes, many public investment projects were undertaken without sufficient attention either to their economic viability or to the capacity of government agencies and public enterprises to implement them. Furthermore, the rapid expansion of construction and urban services that was associated with the increase in public expenditure was accompanied by price and wage increases that severely reduced producer incentives in the non-oil tradeable sectors. Agricultural exports were particularly hard hit, since the exchange rate was allowed to appreciate substantially in order to cheapen costs of imports and to curb inflation. Within a decade, Nigeria became a major food importer, while production of export crops declined substantially, making the country dependent on a volatile international oil market for almost all of its export earnings and most of its federal and state government revenues. In industry, negative real interest rates and rapid wage increases, together with the appreciating exchange rate and the system of tariff protection and import licensing, stimulated the use of imported capital-intensive technology and rapid expansion of consumer goods and assembly-type industries based on imported inputs.

During most of the 1970s, budgetary expenditures exceeded the rapidly rising revenues from oil. Indeed, official data show only a modest surplus even in 1980, despite the spectacular rise in oil earnings that year. When the oil market weakened in the early 1980s--reducing Nigeria's oil export earnings from $23.4 billion in 1980 to $9.9 billion in 1983--the Government responded slowly. Large external and internal deficits resulted. Foreign exchange reserves were run down even as $6-7 billion of external payment arrears were amassed. Heavy external borrowing from the late 1970s increased outstanding medium- and long-term public debt from less than $1 billion in 1978 to about $12.8 billion in 1983.

In addressing the crisis, the Government resorted to economic austerity, relying heavily on administrative controls and regulations. These reinforced rather than corrected the structural distortions that had been built up earlier. Large across-the-board cuts were made in investment expenditure, leaving projects without sufficient funding for their completion. Current expenditure was also cut but, since the wage bill was protected, falling revenues left insufficient funds for materials, supplies, and maintenance. While the austerity measures brought about a rapid decrease in fiscal and external deficits, they also brought on a serious recession. The downturn was aggravated by drought-induced declines in agricultural production in 1983 and 1984. Severe supply shortages of both imported goods and foodstuffs sharply boosted prices. Together with an inflexible nominal exchange rate policy, this resulted in an appreciation of the exchange rate in real effective terms of more than 80 percent over the period 1980-84.

Policies changed when the new military government came to power in 1985, declaring its intention to move from "austerity alone to austerity with adjustment" and to seek international financial support for its program. Initial reforms, including substantial increases in domestic petroleum prices, were announced in the 1986 budget. The dramatic fall in world oil prices in early 1986 increased the urgency of reform. An ambitious structural adjustment program was adopted in June 1986. The program is supported by a debt rescheduling and external financing package to provide new funds, involving commercial banks, and the Paris Club and other creditors. The World Bank is supporting the program with a Trade Policy and Export Development Loan in the amount of $452 million. The IMF approved in January 1987 a stand-by arrangement of SDR 650 million (about $830 million) in support of the adjustment program, though the Government has declared its intention not to draw on the IMF stand by.

The adjustment program

The Nigeria program has two main components: measures aimed at changing the structure of the economy and policies to support stabilization. While there is considerable interplay between the two, the focus of structural adjustment is on exchange rate and trade reforms, while monetary and fiscal

policies are the important instruments of stabilization. The adjustment strategy is based on the assumption that external financing will permit Nigeria to run current account deficits and thereby to achieve higher import levels and growth rates than would otherwise be possible. In the spirit of the Baker Plan, the approach is to allow debt to increase, although at a slower rate than projected export growth, with the result that creditworthiness would be restored over time. Austerity is still necessary, for the oil price decline of 1986 sharply reduced export revenues. But the strategy allows Nigeria to avoid the further expenditure controls that would have otherwise been needed for a rapid restoration of creditworthiness.

Exchange rate reform. The centerpiece of the adjustment program is the shift to a market-determined foreign exchange rate for trade transactions, through the introduction of an auction system for the allocation of foreign exchange–the second-tier foreign exchange market (SFEM). At the inaugural SFEM auction on September 26, 1986, the value of the naira was discounted by 66 percent, trading vis-a-vis the US dollar at $1 = N4.6 as against the administered rate of $1 = N1.6. Initially held every week, fortnightly auctions have been the rule since April 1987. A shift has also been made to a "Dutch auction" system, whereby buyers pay their bid price, rather than the earlier system where each successful buyer paid only the marginal rate that exhausted the total amount being offered. The official, administered ("first tier") rate was kept for an interim period, with its use reserved for debt service and payments to international organizations. In accordance with the program, the two rates were unified in July 1987. Overall, the auction is working well and has become a generally accepted part of the economy. These are important achievements for a country that had long resisted outright devaluation.

In addition to the auction, SFEM encompasses transactions between authorized dealers and the private sector and an interbank market, which accommodates the recycling of foreign exchange initially purchased from private sources. The latter have become an important source of foreign exchange for the market; data for February 1987 suggest that proceeds from non-oil exports, remittances, invisibles, and capital transfers supplied to the market amounted to almost 50 percent of the auction sales for that month. This is an encouraging development, given the rather insignificant funding from such sources at the beginning of the SFEM.

Trade reform. Virtually all price controls and import licensing were abolished at the start of the SFEM, and the number of items subject to import prohibition was reduced from 74 to 16. Under the program, the Government also abolished the temporary 30 percent import surcharge introduced in January 1986 and adopted an interim import duty and excise schedule. This reduced the dispersion of rates and the trade-weighted average customs duty from 35 percent to 25 percent. Some imports of agricultural and industrial products, which compete with the products of major domestic producers, still bear high nominal rates. Nevertheless, the removal of import licensing has transformed the protection regime, with the devalued exchange rate combined with more uniform and lower tariffs now providing protection for domestic producers. By far the most powerful change in export incentives under the program is the devaluation of the naira, while regulations carried over from the previous era of bureaucratic controls, such as prohibitions and export licensing requirements, have been reduced or removed.

Monetary policy plays a dual role in the adjustment program. For demand management purposes, monetary policy is to remain tight over the program period in order to prevent inflationary pressures from creating excessive demand for foreign exchange. In 1986 the broad money supply (M2) grew by only 2 percent; inflation was only half the level that had been projected in the program, and there was considerable upward pressure on interest rates. Recently, monetary policy has become expansionary. Monetary policy also has a structural component under the program, involving movements toward a more market-oriented financial system designed to facilitate the mobilization of financial savings and to encourage more efficient allocation of financial resources. Recognizing the need to give banks greater flexibility in their credit operations, the Government replaced the earlier extensive use of sector-specific credit targets with a simpler categorization which gives guidelines for the allocation of credits between priority activities for only half of the banks' lending. This is a further step in the deregulation of the financial system. Interest rate ceilings were also raised, thereby making it more profitable for banks to intermediate savings to potential investors and ensuring resources are devoted to more profitable projects.

Fiscal policy under the program was to combine a restrictive stance with measures to improve efficiency. The program aimed at keeping the federal budget deficit below 4 percent of GDP, with the devaluation facilitating the achievement of this target by sharply increasing the value of external petroleum receipts in naira terms. But in pursuing the fiscal balance target, certain general principles designed to enhance the effectiveness of public spending were to be followed including restraint on the growth of federal wage bill; an increase in material supplies to ensure adequate maintenance of infrastructure; and a reduction in subsidies to economic and quasi-economic parastatals. In the event, fiscal policies and control over public expenditures have proved the most difficult area of the program to implement, and there has been some slippage from the fiscal deficit target. This issue needs to be addressed in order to ensure the smooth implementation of the program, in particular its monetary and price objectives.

Impact

The changes in trade policy and the real exchange rate that accompanied the introduction of SFEM are likely to have their main effects on relative prices. Thus far, the program has had its greatest impact on the price of exports. Prices of import substitutes have risen to a lesser degree, since the effects of SFEM have been partly offset by removal of import restrictions and lower tariffs. The exchange rate and trade policy changes have had less effect on the prices of nontradable goods which, with domestic demand weak, have continued to decline both relatively and absolutely. The profound distortion in the relative price structure that was built into the economy during the oil boom years has now been largely corrected.

There was some concern in Nigeria that the introduction of SFEM, together with the removal of ex-factory price controls, would cause a resumption of high inflation rates. In the event, prices of grains fell sharply in late 1986, following a bumper harvest, and prices of other food products have increased only marginally. Prices of nonfood commodities have shown a mixed pattern, with modest increases for most items, basically because their retail prices largely reflected depreciated values before the introduction of SFEM. Prices for a few highly visible goods, such as automobiles, have risen sharply. But many prices actually fell somewhat during the first three months of SFEM operation, a trend that seems to have continued during the first quarter of 1987.

In agriculture, domestic prices for the principal cash crops–oil palm, cocoa, rubber, cotton, and groundnuts–used to be set by the respective Commodity Boards, which were dismantled in 1986. This move, together with the exchange rate change, greatly improved incentives for most of Nigeria's traditional cash crops, especially those whose prices had not been artificially supported by export

subsidies or import restrictions accompanying the overvalued exchange rate. The immediate supply response has been strong for cocoa–the dominant non-oil export commodity–and rubber, with most existing trees reportedly now back in production. The longer-term supply response is still difficult to gauge; substantial new investment in additional capacity for tree crops with long gestation periods will require confidence in the sustainability of the present incentive framework.

The exchange rate adjustment and accompanying measures to liberalize trade have led to far-reaching changes in the incentive structure for industry. Previously, the Nigerian industrial sector had expanded largely in the direction of import substitution, influenced by the overvalued exchange rate which discouraged export production, and the tight limitations on actual imports. The program has reduced the previous bias against export activities. Incentives for producers of import substitutes, taken as a group, have been left broadly unchanged, although the exchange rate and trade liberalization measures have tended to affect individual producers in different ways, depending on the changes in tariffs and the share of local inputs in overall production costs. Broadly speaking, trade liberalization lowers the prices of imported final products, while depreciation of the exchange rate tends to raise them, as well as prices for imported inputs. For a given depreciation of the exchange rate and tariff reduction, the net effect on profitability of producing import substitutes will depend on the share of labor in production costs, since, in the short run at least, labor costs will not be directly affected by the exchange rate change. Hence, the larger the labor and local raw material share, the larger will be the increase in profitability.

Survey results tend to confirm these expectations. The more efficient local resource-based activities in manufacturing have felt a strong boost to their competitiveness. Import-dependent, assembly-type industries, on the other hand, have seen their costs escalate because of SFEM, while their competition from imports has increased, as a result of the freeing up of trade together with reductions in tariffs, and demand for their products fallen as a result of the recession that accompanied the drop in oil revenues. Some have closed down plants, adding to the unemployment problem. Most of the problems in manufacturing are in large, highly visible, urban-based firms which were developed behind protective tariff walls but were not, and will never be, efficient users of Nigeria's scarce resources. In fact, an inevitable outcome of a structural adjustment program designed to reorient production along the lines of comparative advantage is the restructuring or closing of such activities. The expansionary effects on industry of SFEM are likely–at least initially–to come from small companies based on local resources. These companies have limited visibility so far, particularly as the previous trade and exchange rate regime discouraged the development of a viable industrial export sector.

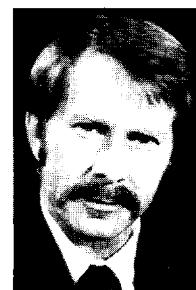
Notwithstanding serious transitional problems for some groups, the broad social impact of the adjustment program appears positive, particularly when seen in terms of the evolution of policy from "austerity alone to austerity with structural adjustment." The decline in economic activity that preceded the adjustment program increased unemployment and reduced per capita income. Without the program, the recession was projected to continue and even worsen, given developments in oil prices. By contrast, the large price boost that the adjustment program has given to exportables, and in particular the labor-intensive tree crops, has raised the demand for labor. This should help to forestall further increases in overall unemployment. As the effects of the program become more broadly felt, unemployment should begin to fall. Although the labor market adjustment process on the whole seems to be working, there is a transitional problem of mismatches between skills and job openings–the unemployed are school leavers and those with advanced training, while the jobs being created are for relatively unskilled rural workers.

Conclusions

While the response to the adjustment program in many areas has already been favorable, the domestic political situation is not an easy one, with the effects of continuing austerity and collapsing oil export revenues on imports and production partially obscuring the program's positive effects. Still, it is essential for Nigeria to persevere with present policies, for the recovery depends on availability of imports and, in turn, on export revenues and access to foreign financing. While oil revenues depend on factors that Nigeria can do little to influence, development of non-oil exports depends on the implementation of the adjustment program. The supply response to the improved incentives depends very much on entrepreneurs' confidence in a continuation of present policies. Moreover, should the Government lapse in its pursuit of reform and return to the previous policy regime of controls, external financing would be less forthcoming. The challenge ahead is to implement the remaining parts of the program and to maintain the reform momentum, thereby establishing the program's credibility in private markets.

Nigeria's prospects for growing out of the debt crisis are good. Assuming continued implementation of the program, Nigeria's debt crisis should subside over the medium term, as oil and non-oil exports grow. But until then, Nigeria will face a foreign borrowing constraint. This constraint, in turn, will limit the investment response to the structural adjustment program's changed incentive framework and constrain per capita income growth, particularly given the effects of desert encroachment and deteriorating soil fertility on agricultural prospects.

The Nigerian experience illustrates the importance of keeping public sector spending within "permanent income." This precept is difficult to implement for countries that depend, like Nigeria, on exports of a single commodity for the bulk of their foreign exchange. Indeed, if oil prices were to rise again dramatically, there would be pressures to use the proceeds for improving standards of living. However, these pressures should be accommodated only to the extent that increased revenues and spending are sustainable. With spending kept in check, painful austerity measures would not be required when prices decline again. This would also prevent the real exchange rate from appreciating unduly during periods of temporary increases in export revenues, thus avoiding costly shifts in the structure of production that would ultimately need to be reversed. This approach would also preclude foreign borrowing to finance consumption or investment in non-economic projects, which–while apparently affordable when oil prices are high–are not affordable from the perspective of permanent income. ■



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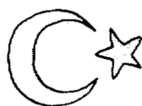

Turkey's Adjustment Experience, 1980-85

Economic growth and stabilization, achieved through outward-looking policies, implemented in a favorable sociopolitical climate and supported by external assistance on a large scale

George Kopits

Beset by a severe economic crisis, social unrest, and political instability, in 1980 Turkey launched a far-reaching stabilization and structural reform effort, which set the stage for a rapid export-led economic recovery and a significant correction of external and domestic imbalances. Although not yet completed, the Turkish adjustment—traced through 1985 in the present article—illustrates that the success of such an effort depends not only on the adequacy of economic policies but also on the sociopolitical climate and external assistance. In Turkey, on balance, these three fundamental criteria appear to have been met.

Background

In the early 1970s Turkey achieved rapid economic growth, while maintaining a moderate rate of inflation and a surplus in the external current account. In the wake of the first oil crisis, the government persevered with an ambitious inward-looking development strategy and sought to shelter the economy from the deterioration in the terms of trade. During 1973-76 the growth of real GNP averaged almost 8 percent a year, paced by an increase in real fixed investment of some 16 percent yearly. This was achieved, however, at the cost of mounting internal and external imbalances. The deterioration in public finances was particularly acute: in 1977 the public sector borrowing requirement had reached the equivalent of more than 11 percent of GNP, compared with 2 percent of GNP in 1973. Excess demand, fueled by expansionary fiscal and monetary policies, contributed to a considerable weakening in the balance of payments and to a rise in inflationary pressures. The current account moved from a surplus of $0.7 billion in 1973 to a deficit of $3.1 billion in 1977, reflecting the sharp rise in the oil import bill coupled with stagnation in exports and workers' remittances. The deficits were financed mainly with short-term borrowing. With rapidly shrinking external reserves, Turkey became less and less able to meet mounting import and debt-service payments, which resulted in the accumulation of arrears and a virtual drying up of normal sources of financing.

In 1978-79 the authorities made several attempts to arrest the deterioration of economic conditions. In spite of debt reschedulings and the provision of some external assistance, these attempts met with little success. The operating losses of state economic enterprises (SEEs) rose sharply and the public sector borrowing requirement remained high. Wage settlements likewise were excessive. Adjustments of the exchange rate and interest rates, meanwhile, failed to keep up with a sharp acceleration in the rate of inflation; external competitiveness weakened further and financial disintermediation (whereby money assets were replaced by nonfinancial assets) proceeded apace. In these circumstances, the narrowing of the current account deficit by more than one half between 1977 and 1978-79 was forced by the lack of external financing and accomplished chiefly through a drastic curtailment of imports. In turn, widespread shortages of essential inputs led to a drop in industrial output and exacerbated the rate of inflation. In 1979, the average rate of inflation escalated to more than 70 percent, while real GNP fell for the first time in more than two decades.

Parallel with the economic deterioration, Turkey underwent a major political and social crisis. Weak left-of-center and right-of-center coalition governments rapidly succeeded one another, unable to cope with growing labor strife and urban terrorism.

Sociopolitical conditions

It was against this background that in January 1980 a two-month old minority government unveiled a comprehensive economic policy package based on an outward- and market-oriented approach, breaking with the inward-looking *étatist* strategy of the previous five decades. However, civil unrest continued through most of 1980, as evidenced by close to 200 politically motivated murders a month, while labor negotiations became increasingly confrontational, often involving prolonged strikes and lockouts.

The breakdown of law and order was halted by a military takeover in September 1980. From the outset, the military government endorsed the economic policies of the previous government (retaining key members of the former economic team) and announced its intention to return the country to civilian rule at the earliest opportunity. In November 1982, a new constitution was approved by referendum, and as mandated by the constitution, a president was elected for a seven-year term with extensive authority. Despite some limitations on political parties and candidates, in November 1983 the first

This article draws on the author's Structural Reform, Stabilization, and Growth in Turkey, *published by the Fund as Occasional Paper No. 52 (May 1987), price $7.50.*

parliamentary elections were held since the advent of military rule. The new government –which since then has withstood additional electoral tests in the context of an apparently broader political participation–stepped up the pace of structural reform.

In spite of a temporary suspension of some civil liberties, in particular immediately after the military intervention, since September 1980 Turkey has enjoyed a considerable degree of political and social stability. Since its inception in January 1980, successive administrations–both civilian and military–have been firmly committed to the adjustment program, notwithstanding occasional slippages in implementation. Economic policies have been subject to intense public debate; however, except for groups adversely affected by certain measures, the program seems to have been supported, or at least tolerated, by large segments of the population.

External assistance

In support of the program, in June 1980 the Fund approved a three-year stand-by arrangement for SDR 1,250 million (625 percent of Turkey's quota at that time) which was fully utilized, followed by a one-year stand-by for SDR 225 million (75 percent of quota); the latter was cancelled and replaced in April 1984 by another arrangement of the same magnitude. In all, over the period 1980-85, the Fund made available SDR 1.7 billion (of which SDR 1.5 billion was utilized), while the World Bank extended $1.6 billion in five consecutive structural adjustment loans–besides sizable project loans. Turkey also received concessional balance of payments credits in excess of $1.5 billion from official sources, under the auspices of the Organisation for Economic Co-operation and Development (OECD) and from Saudi Arabia. Over the program period, balance of payments assistance from the Fund, the Bank, and bilateral sources totaled more than $5 billion. In addition, more than $6.5 billion in short-and medium-term obligations, including interest payments, falling due in 1980-84 (some of them restructured previously) were restructured through the OECD and by private creditors.

Structural reform

Domestic pricing. In 1980 the government freed private sector prices and sharply adjusted prices of basic commodities and services produced by SEEs and state monopolies. Except for a few items whose prices continued to be subsidized, SEEs were instructed to set prices on the basis of cost developments. Subsidies on agricultural products and inputs were also reduced considerably.

Interest rates. After several small increments, time deposit rates were decontrolled in July 1980, allowing commercial banks to determine rates by agreement among themselves. Since December 1983, the central bank has reviewed and set ceilings on deposit rates at least every three months taking into account fluctuations in the rate of inflation; on the lending side, banks were allowed to set nonpreferential rates freely. Since around mid-1981 and except for parts of 1983 and 1984, key time deposit and lending rates have been positive in real terms.

Wage determination. In September 1980 the authorities introduced an incomes policy that has been followed until the present. Centrally determined wage increases on the basis of yearly inflation targets–but lagging behind actual price developments–became mandatory for the public sector and have been used as guidelines in the private sector.

Exchange rate policy. Following a 33 percent devaluation of the Turkish lira in January 1980, the central bank began to adjust the exchange rate with increasing frequency so as to compensate for differences in inflation rates at home and in major industrial partner countries; since May 1981 adjustments in the nominal rate have taken place daily. Over the 1981-85 period, the lira was depreciated in real terms on average by about 4 percent a year, although subject to some short-run fluctuations connected with efforts to dampen inflationary pressures--particularly in the later part of 1984.

Foreign trade and investment. By the end of the 1970s, Turkey had a highly restrictive import regime characterized by quotas, licensing, tariffs, tariff-like charges, and an advance deposit requirement. These restrictions were relaxed significantly in 1980-81, and a further major liberalization took place in 1984 when most imports were freed from licensing. By the end of 1985, quantitative restrictions had been removed, many tariff rates were lowered, and deposit requirement rates reduced to a low level. Fiscal and financial export subsidies, which had been intensified in the initial phase of the adjustment program, were trimmed starting in 1984; also, export restrictions (licensing and price controls) were abolished in 1984. Restrictions on direct investment inflows were eased considerably.

Exchange and payments. Early in the program, most multiple currency practices and bilateral payments agreements were terminated, and foreign exchange regulations affecting commercial banks and exporters were eased. In January 1984, the exchange and payments system was liberalized in several important respects: domestic banks were allowed to engage in foreign exchange operations within broad limits; the surrender requirement was reduced substantially on export earnings; foreign exchange deposits, yielding market interest rates, could be opened and used without limits; and restrictions on foreign travel and other invisible transactions were eased and simplified.

Financial sector. Between 1983 and 1985, the liquidity and reserve requirement system was simplified and made more effective: legally required ratios were unified and lowered, the time period permitted for compliance was shortened, and interest payments on reserves were abolished. Preferential credit facilities were reduced. Major banking reform legislation was completed in April 1985, with provisions on capital requirements, contingency reserves, accounting and reporting standards, deposit insurance, branch banking, and ownership and management requirements. Also, a number of institutional measures were taken to develop capital markets.

Nonfinancial public enterprises. From the outset of the program, the authorities acted not only to adjust the prices of SEEs toward covering production costs, but also enforced a hiring freeze and slowdown of wage increases. The concomitant reduction in financing needs permitted a sharp cutback in bank lending and budgetary transfers to SEEs. In October 1983, the legal basis for SEE reform was established, requiring SEEs to be run along commercial lines. By the end of 1984, SEEs had lost almost all preferences accorded previously as regards taxes, tariffs, and credits. In May 1986, the government obtained legislative authority to sell SEEs to the private sector.

Taxation. In 1981, personal income tax brackets were raised sharply to compensate for inflation, while marginal tax rates were restructured providing for a gradual reduction of all rates over a four-year period. The corporation income tax was unified for all corporate taxpayers, including SEEs. In 1984, there were substantial cuts in the rates of withholding taxes on financial income and transactions. In January 1985, Turkey substituted a 10 percent value-added tax for production taxes and other duties.

Demand management

Whereas steady and significant progress was made in implementing structural measures, demand management was applied unevenly. Following a restrictive stance in 1981-82, financial policies were relaxed until 1985 when they became somewhat tighter again.

As a result both of expenditure restraint and of some rise in tax effort, the ratio of the consolidated central government budget deficit to GNP was more than halved between

Turkey: selected economic indicators, 1977-85

	1977	1978	1979	1980	1981	1982	1983	1984	1985
				(Annual percentage change)					
Real GNP	3.9	2.9	−0.4	−1.1	4.1	4.6	3.3	5.9	5.1
Implicit GNP deflator	24.5	43.8	71.1	103.8	41.9	27.5	28.0	50.1	43.6
Interest rate (percent per annum)[1]	4.8	6.6	9.0	10.8	34.5	37.5	30.0	44.8	45.9
Real broad money (M2)	0.6	−7.9	−10.2	−22.6	21.6	33.1	7.6	−0.2	12.5
Terms of trade	−0.6	−7.0	−0.3	−22.7	−3.6	−0.6	−6.0	0.6	−1.2
Real effective exchange rate[2]	1.0	−3.8	12.7	−22.8	1.9	−11.4	−1.9	−2.1	−0.1
				(In billions of dollars)					
External current account balance	−3.1	−1.3	−1.4	−3.4	−1.9	−0.9	−1.9	−1.4	−1.0
Merchandise exports, f.o.b.	1.8	2.3	2.3	2.9	4.7	5.9	5.9	7.4	8.3
Balance of payments assistance[3]	—	0.3	0.3	1.0	0.8	1.2	0.8	0.9	0.2
				(In percent of GNP)					
Public sector borrowing requirement[4]	11.3	10.5	8.5	10.2	6.5	6.1	6.4	8.1	5.2
Debt service ratio (percent of foreign exchange earnings)[5]	23.3	26.2	23.5	24.0	22.4	25.2	28.0	24.8	29.3

Sources: Data provided by the Turkish authorities; and Fund staff estimates.
[1]After-tax six-month time deposit rate.
[2]Weighted by the geographic distribution of Turkey's 1980 merchandise exports to major industrial countries. An increase indicates appreciation.
[3]Gross disbursement of general purpose balance of payments loans from the IMF, World Bank (SALs), and other official sources.
[4]Borrowing requirement of the central government, local governments, and nonfinancial SEEs.
[5]Amortization of medium- and long-term obligations plus interest payments, after debt relief.

1980 and 1982, from over 5 percent to 2 percent. The financial position of SEEs also improved. Thus, the public sector borrowing requirement fell by more than 4 percent of GNP, facilitating a tight monetary policy stance. In the latter part of 1982, however, financial policies began to ease. In the wake of a financial crisis in the middle of that year–brought about largely by interest-rate deregulation in the absence of safeguards against unsound financial practices and protection of bank deposits–monetary control was eased. Encouraged by a temporary deceleration in the rate of inflation, in 1983 the authorities lowered time deposit rates significantly.

As inflation reaccelerated, from the end of 1983 onwards, on various occasions the authorities sought to reinstate monetary tightness through a more active interest rate policy, reductions in rediscount operations and increments in the legal liquidity ratio. These steps, however, were not sufficient to offset the liquidity injection associated with the improved balance of payments position, rapid accumulation of newly opened foreign exchange deposits–left outside the scope of monetary control–and ongoing financial innovations.

The main obstacle to sterilizing the liquidity buildup stemming from external sources and from financial reforms was the deterioration in public sector finances. Failure to take adequate budgetary action to compensate for the impact of tax rate cuts led the consolidated budget deficit to rebound to nearly 5 percent of GNP by 1984. The slippage in the budget was largely corrected in 1985, when the introduction of the value-added tax contributed to a reduction in the budget deficit to the equivalent of around 2 percent of GNP. Meanwhile, there were further gains in the profitability of nonfinancial SEE operations, with the operating surplus of enterprises rising from virtually nil in 1980 to about 4 percent of GNP in 1985, while the net inflow from the consolidated budget (i.e., transfers less direct taxes), in excess of 4 percent of GNP, turned into a small net outflow.

Economic results

Restrictive demand management led to a rapid deceleration of the inflation rate from 104 percent in 1980 to about 28 percent in 1982. Spurred by the decontrol of time deposit rates and the downturn in the rate of inflation, real broad money balances increased by two thirds between 1980 and 1982. The revival of financial intermediation facilitated a significant recovery of fixed capital formation and output. Following a two-year contraction, real GNP growth exceeded 4 percent in both 1981 and 1982; real private fixed investment rose above 5 percent in the latter year. Despite a marked deterioration in Turkey's terms of trade and weakening in import demand abroad, the external current account deficit was cut from $3.4 billion in 1980 to $0.9 billion in 1982, as export volume more than doubled and workers' remittances and other income from services increased significantly. The foreign balance contributed almost one half of real GNP growth in 1981-82.

In 1983 there was a setback in overall performance. Real GNP growth fell by more than 1 percentage point and the external current account deficit rose to $1.9 billion owing in part to a weather-related shortfall in agricultural production and a weakening of export prices. In addition, relaxation of financial policies contributed to an acceleration of domestic demand growth, thus exacerbating the external imbalance, while some necessary price adjustments were postponed until after the November elections.

In 1984, the delayed price adjustments in combination with a stepped-up depreciation of the lira, removal of export restrictions and sustained surge in domestic demand, resulted in an inflation rate in excess of 50 percent. Real GNP growth rebounded to nearly 6 percent partly on the strength of an export-led expansion of industrial output. With the enhanced competitiveness of the lira and the liberalization of the trade regime, the external

current account deficit fell to $1.4 billion. By the end of 1984, gross foreign exchange reserves of the banking system had reached an unprecedented level of $3.1 billion, equivalent to nearly four months of imports.

In 1985–the first year without debt relief and without a stand-by arrangement with the Fund since 1978–Turkey made further progress toward adjustment. Buoyed by a continued rise in merchandise exports and a strong growth in tourism, the current account deficit was reduced further, to $1 billion or 2 percent of GNP, while economic growth remained at 5 percent. The introduction of the value-added tax contributed to a surge in the annualized rate of inflation to close to 60 percent in the first quarter; however, by the end of the year, the rate of inflation fell below 40 percent. At end-1985, total external debt stood at $25.4 billion (equivalent to almost one half of GNP), of which $6.6 billion constituted short-term obligations–one half in the form of emigrants' deposits.

Overall, the Turkish recovery was underpinned by a dramatic growth and diversification of exports of goods and services (construction, transport, and tourism). Between 1980 and 1985, the share of merchandise exports in GNP had more than tripled, to an unprecedented 15 percent. Although aided to an extent by Turkey's geographical location, successful market penetration can be ascribed chiefly to the application of appropriate policies--notably, a flexible exchange rate and external liberalization. The share of Turkish exports in total exports of non-oil developing countries to industrial countries rose from less than 1 percent to near 2 percent and to Middle East partner countries from 4 percent to 20 percent during this period.

International capital markets reacted favorably to Turkey's external performance. In addition to project-related borrowing and trade credits, Turkey obtained spontaneous medium-term balance of payments support loans totaling $1 billion over the period 1983-85 from commercial banks abroad. At the same time, however, multinational firms did not expand operations significantly in Turkey; in spite of the liberalized treatment of incoming foreign investment, their perception seemed to be that the economic environment was not yet sufficiently stable.

The least tractable aspect of the adjustment effort centers on the program's social consequences. Here, data are limited. Arguably the increase in the recorded rate of unemployment (from about 15 percent to over 16 percent) between 1980 and 1985 stemmed largely from a structural decline in agricultural employment and a marked deceleration in the growth of demand for Turkish workers abroad, rather than from economic policies. Indeed, during the program period, the annual growth in nonagricultural employment averaged almost 3 percent, notwithstanding the freeze on public sector hiring. Further, while average gross real wages are estimated–on the basis of data on a limited sample of the workforce–to have fallen more than 3 percent yearly since 1980, the real take-home pay of workers (after taxes and transfers) is estimated to have increased yearly by about 3 percent in the private sector and by close to 5 percent in the public sector.

Conclusion

The adjustment program adopted by Turkey in 1980 has been reasonably successful in reducing the external disequilibrium, bringing down the rate of inflation and restoring a satisfactory growth rate, despite a sharp deterioration in the terms of trade and weakening in foreign demand. This performance–when compared with a number of less successful experiences elsewhere–is attributable to the combination of three basic elements that were present in the Turkish case. First, apart from some slippages in policy implementation–in particular as regards demand management in 1983-84–the Turkish program consisted of a fairly comprehensive, consistent, and well-sequenced set of stabilization and structural measures. Second, these economic policies were implemented in a stable social and political climate that evolved shortly after the beginning of the program; moreover, with minor exceptions, the authorities were deeply committed, while the population, albeit with some reservations, tacitly endorsed the adjustment program. Third, the program was supported with external assistance by multilateral institutions, official sources, and commercial banks, in an amount broadly commensurate with the financing need and the policy effort. ■

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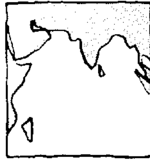


Growth and Adjustment in South Asia

Experiences of Bangladesh, India, Pakistan, and Sri Lanka in implementing adjustment programs supported by the extended Fund facility

Bijan B. Aghevli, In-Su Kim, and Hubert Neiss

During the late 1970s and early 1980s, the international economy experienced the re-emergence of serious payments imbalances, primarily reflecting the sharp increases in oil prices and the precipitous decline in commodity prices. These imbalances were particularly pronounced in the non-oil developing countries, which suffered not only from the marked deterioration in their terms of trade, but also from the ensuing recession in the industrial countries and the sharp rise in international interest rates. The severe external payments difficulties facing these countries led to a substantial increase in the number of adjustment programs supported by Fund resources under stand-by and extended arrangements, from 54 (with a total commitment of SDR 8 billion) during 1976-78, to 88 (committing SDR 24 billion) during 1979-81.

This increase in Fund-supported programs was accompanied by a growing emphasis on structural adjustment to strengthen productive capacity and foster growth. In view of the substantial payments imbalances and the apparent persistence of the shift in the terms of trade, the adjustment strategy generally attempted to supplement traditional demand-oriented policies with more comprehensive structural polices. These policies were designed to improve resource allocation, promote domestic investment and savings, and strengthen external competitiveness. This shift in the adjustment strategy was reflected in a marked increase in member countries' recourse to extended arrangements with the Fund, which were designed to provide medium-term assistance to cope with structural imbalances. Among the members that entered into such arrangements were four South Asian countries–Bangladesh, India, Pakistan, and Sri Lanka–which together accounted for more than half of the total commitment of Fund resources under the extended facility during 1979-81 (Table 1).

This article reviews the design and implementation of the growth-oriented adjustment programs adopted by the four South Asian countries, and attempts to analyze the impact of both policy and exogenous variables on actual developments during the program periods.

Table 1
Arrangements of South Asian countries under the extended Fund facility

	Date of agreement	Original expiration date	Date of cancel-lation	Amounts in millions of SDRs: Commit-ted	As percent of quota[1]	Drawn
Bangladesh	Dec. 1980	Dec. 1983	June 1982	800	(351)	220
India	Nov. 1981	Nov. 1984	May 1984	5,000	(291)	3,900
Pakistan	Nov. 1980	Nov. 1983	—	1,268	(445)	1,079
Sri Lanka	Jan. 1979	Dec. 1981	—	260	(219)	260

Source: IMF
[1]Based on the size of quota at the time of the inception of the programs.

Background

The four countries initiated adjustment efforts in the late 1970s before the introduction of the extended arrangements with the Fund. Except in India, these efforts to counter a deteriorating external position were supported by regular stand-by arrangements with the Fund. However, despite the progress made in achieving economic adjustment, the four countries continued to face a number of deep-rooted structural problems that required sustained reform efforts over the medium term. While the extent of these problems varied across the countries, a number of common factors are identifiable.

At the time the adjustment efforts were launched economic growth in most South Asian countries was hampered by inefficiencies in key economic sectors, industrial and infrastructure bottlenecks, and cost-price distortions arising from infrequent adjustments of both administered prices and the exchange rate in the face of domestic inflation. Further, adverse weather disrupted agricultural production and, in the case of India, also interfered with power generation. Fiscal conditions remained weak because of low and inelastic revenue and rapidly rising government expenditure propelled by increas-

ing social and development needs. The fiscal imbalance was a primary reason for excessive monetary expansion, and consequent inflationary pressures.

Meanwhile, weak production bases, together with inadequate producer incentives, continued to constrain the countries' export capacities. At the same time, rising domestic demand led to strong import demand, which was suppressed through tight exchange and import controls at the expense of economic efficiency. These strains on the domestic economies and the balance of payments positions were intensified by the marked deterioration in the terms of trade and the subsequent slowdown in export markets.

Design of extended programs

The adjustment strategy adopted by the countries under review was to strengthen productive capacity and promote economic expansion in a climate of financial and external stability. Higher economic growth rates were to be realized by supply-side measures designed to raise both domestic investment and savings and to improve the efficiency of production and resource allocation. The latter goals were to be achieved primarily by correcting cost-price distortions, relaxing restrictive industrial regulations, and liberalizing trade policies. All these policies were to be accompanied by restrained financial management aimed at maintaining price stability in order to facilitate structural adjustment. In view of the relatively long gestation period of structural programs, the external current account position was expected to improve only gradually.

Underlying the supply-oriented adjustment strategy was the recognition that there was substantial scope for export growth and import substitution in these economies through the removal of structural imbalances and bottlenecks. The strategy was also consonant with the urgent developmental need to provide employment for the growing labor forces and to alleviate poverty. The adjustment programs were, to varying degrees, incorporated into national development plans.

The adjustment programs of all four countries envisaged a substantial increase in domestic investment. In view of the major role of the public sector in these countries, the government was expected to take the lead in expanding investment. In general, public sector investment programs were to be reviewed and reoriented in close consultation with the World Bank to improve infrastructure, exploit comparative advantage, and avoid projects with excessively long gestation periods. Most programs foresaw a broadened role for private investment, encouraged by the adoption of policies conducive to liberal industrial and import licensing arrangements and to foreign collaboration.

The increase in domestic investment was to be financed by greater domestic resource mobilization, mainly through the public sector. The government budget was expected to generate larger savings through tax reforms, reductions in subsidies, and restraint in wage outlays. Substantial savings were also to be generated by nonfinancial public enterprises primarily through flexible pricing policies and the rationalization of their operations. The programs also generally stressed the need for encouraging private savings through flexible interest rate policies, introduction of new financial instruments, and strengthening of financial intermediation.

The alleviation of cost-price distortions was seen to be essential for improving resource allocation and stimulating production. Procurement prices were to be increased substantially, particularly for those agricultural commodities that were either exportable or import substitutes. Administered prices for industrial outputs were also to be adjusted more flexibly to reduce distortions. Furthermore, increased financial incentives were designed to improve the profitability and external competitiveness of the export sector, which had been adversely affected by heavy indirect taxes and inflationary pressures. A flexible exchange rate policy responding to developments in domestic and external prices would support these measures.

A crucial element of the adjustment programs was the liberalization of restrictive industrial and import regulations which had been pervasive. In order to encourage private sector production and facilitate modernization, the programs called for the simplification of licensing approval procedures and for the easing of regulatory restraints on capacity utilization and expansion, particularly in India. The liberalization of imports was aimed primarily at ensuring increased access to raw materials and intermediate goods so as to alleviate supply bottlenecks and improve international competitiveness. Imports of capital goods were also to be liberalized in order to improve the efficiency of domestic production and investment. The program in Pakistan envisaged a shift from quantitative restrictions to tariffs for regulating imports and protecting domestic industry.

Notwithstanding the emphasis on structural measures, prudent demand management remained a principal element of the adjustment programs, as financial and price stability was viewed as a fundamental prerequisite for successful economic adjustment. A major policy objective was the strengthening of the budgetary position through measures to increase revenue and restrain expenditure. The programs sought to reduce substantially the overall budget deficit and thus government recourse to bank borrowing. At the same time, they envisaged restraints on the growth of liquidity and domestic credit to moderate inflationary pressures while supporting economic growth and private sector activity.

Performance under programs

The performance of the four economies with respect to growth, inflation, and external adjustment was uneven: India and Pakistan broadly achieved the original objectives of the programs, while Sri Lanka and Bangladesh were less successful in meeting all their targets. Generally, the average economic growth during the program period was broadly in line with program targets (Table 2). In the case of India and Pakistan, a favorable growth outcome was accompanied by relative financial and price stability and a larger-than-anticipated improvement in the external current account deficit. In contrast, Sri Lanka suffered from both intensified inflation and a marked deterioration in its current account balance. In the case of Bangladesh, program objectives in terms of both growth and inflation were not met and the reduction in the current account deficit was made possible only through a drastic cut in the issuance of import licenses. The Fund's extended arrangement with Bangladesh became inoperative during its first year.

The path and pace of adjustment in these economies were influenced significantly by unanticipated developments in exogenous factors and policies. Droughts during the programs adversely affected growth in Bangladesh, India, and Sri Lanka. The task of adjustment was further complicated by the prolonged international recession and by a precipitous decline in export prices that reinforced emerging fiscal difficulties, especially in Bangladesh and Sri Lanka. On the other hand, all four countries benefited from higher-than-expected remittances particularly from oil exporting countries, and from only moderate increases in oil prices (which were especially important for India).

The extent of policy implementation also varied across the four programs. On the whole, significant progress was made in the area of pricing policy: incentives to agricultural producers were raised, subsidies were reduced, and the financial position of public enterprises was improved. The price adjustments, however, did not eliminate certain costly subsidies or mobilize sufficient resources for investment in some cases. However, implementation of structural measures, especially those aimed at increasing

Table 2
Selected economic indicators of four South Asian countries
(In percent)

	Pre-program	Program annual average		Post-program annual average[1]
		Targets	Outcome	
Bangladesh				
Real GDP growth	3.5	7.2	3.7	3.1
Inflation (Consumer Price Index)	18.5	11.5	14.4	10.2
External current account as proportion of GDP	−11.5	−12.09	−10.6	−8.1
Exports *(In billions of dollars)*	2.4	0.9	0.7	0.8
Imports *(In billions of dollars)*	2.4	2.8	2.5	2.4
India				
Real GDP growth	7.8	4.8	5.3	4.0
Inflation (Wholesale Price Index)	18.2	9.3	6.1	6.4
External current account as proportion of GDP	−1.6	−2.1	−1.6	−1.4
Exports *(In billions of SDRs)*	6.6	9.5	7.6	8.6
Imports *(In billions of SDRs)*	12.3	15.4	13.2	13.3
Pakistan				
Real GDP growth	7.3	5.7	6.5	5.3
Inflation (Consumer Price Index)	10.7	10.0	8.4	8.0
External current account as proportion of GDP	−4.5	−4.6	−3.3	−4.2
Exports *(In billions of dollars)*	2.4	3.2	2.6	2.5
Imports *(In billions of dollars)*	4.9	6.2	5.6	6.0
Sri Lanka				
Real GDP growth	5.8	6.0	6.0	5.1
Inflation (GDP deflator)	7.8	11.7	18.1	15.1
External current account as proportion of GDP	−5.5	−10.8	−14.9	−10.4
Exports *(In billions of SDRs)*	0.7	0.9	0.8	1.1
Imports (*In billions of SDRs)*	0.8	1.2	1.4	1.8

Source: IMF
Note: dates for pre-program, program, and post-progam periods are defined as follows:

	Pre-Program period	Program period	Post-program period
India	1980/81	1981/82–1983/84	1984/85–1985/86
Pakistan	1979/80	1980/81–1982/83	1983/84–1984/85
Sri Lanka	1978	1979–1981	1982–1984
Bangladesh	1979/80	1980/81–1981/82	1982/83–1984/85

[1] Partly preliminary.

tax revenue, mobilizing private savings, and relaxing industrial and import controls, was weaker than envisaged. Measures taken to promote exports were also modest. Financial policies were generally restrained in India and Pakistan, but they turned out to be expansionary in Bangladesh and Sri Lanka.

Production, investment, and prices. The favorable growth performance achieved by India, Pakistan, and Sri Lanka was generally associated with higher agricultural production. This reflected the effects of policies to increase the area under irrigation and to stimulate the spread of modern production techniques and inputs, particularly fertilizer; the use of fertilizer was encouraged by reducing its price and by strengthening support services to farmers (India and Pakistan). Notwithstanding recurrent adverse weather, substantial progress was made in Bangladesh, India, and Pakistan toward self-sufficiency in foodgrain production.

Industrial developments were also generally encouraging. Manufacturing registered a strong expansion in Pakistan, as a result of new capacity for import substitution, fuller capacity utilization, and improved availability of imported inputs. The growth of India's manufacturing sector remained well below program targets, reflecting the impact of the world recession and continued domestic controls. However, performance in basic industries and infrastructure generally improved, and bottlenecks were reduced substantially. The production of oil increased robustly in both India and Pakistan, leading to a substantial reduction in oil imports in the former.

Domestic investment relative to GDP was below target in both India and Pakistan. Public investment in these countries was lower than expected because of limited resource mobilization by the public sector. In India, private investment was constrained by weak domestic and external demand in the aftermath of the oil price increases and by uncertainties over the relaxation of industrial regulations and import controls. Sri Lanka was successful in achieving the program growth target, but at the expense of excessive expansion of public sector investment; private investment in the country also remained buoyant, aided by monetary and fiscal concessions and low prices for imported capital goods.

Despite the importance attached to domestic resource mobilization, savings fell short of program targets in all four countries. Shortfalls were registered by both the public and private sectors in the case of India. In India and Sri Lanka, private savings were adversely affected by drought-induced declines in agricultural income, a sharp fall in the terms of trade, higher energy prices, and weak policy initiatives. Weaker than expected domestic resource mobilization, however, was partly offset by buoyant workers' remittances in most South Asian countries.

Inflation subsided broadly in line with program targets in India and Pakistan, as restrained financial policies and improved supplies more than offset the increases in administered prices. In Sri Lanka, however, the rapid expansion in domestic credit, combined with a sharp increase in international oil prices, gave rise to strong inflationary pressures, and the program targets were exceeded by a wide margin. Inflationary pressures were also strong in Bangladesh.

External developments. The cumulative current account deficit in India and Pakistan over the program period was substantially smaller than targeted. Bangladesh also kept its current account deficit below target, primarily through a substantial tightening of import licensing. In contrast, the current account deficit in Sri Lanka exceeded the program target because of higher imports and poor export performance.

Stronger net exports of services (workers) and private transfers (remittances) helped limit the deficits in India and Pakistan. In the former, a significant decline in imports, mainly because of reduced oil imports, also contributed to the lower deficit. The growth of non-oil imports was generally slower than expected in these countries, largely because of the improved domestic availability of key agricultural commodities and industrial inputs.

Exports were considerably below expecta-

tions in all four countries. The cumulative shortfall in export earnings largely offset the gains achieved in lowering imports in India and Pakistan. In most countries, the average growth rate of export volume was below that achieved by non-oil developing countries during the corresponding period. The disappointing export growth performance reflected the severe international recession, lingering domestic impediments to export development, and generally weak external competitiveness.

Post-program developments

During the program period, the South Asian countries stepped up their efforts at structural adjustment. The progress made in this area, however, was relatively limited, partly because of the intensity of structural imbalances before the programs, but also because of delays in policy implementation and the lags before policies become effective. In order to sustain the structural adjustment efforts, most countries introduced follow-up measures after the Fund-supported structural adjustment program came to an end.

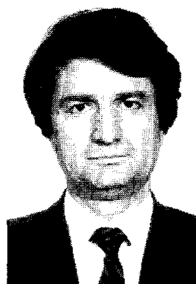
In India, significant liberalization measures were taken during 1985 in the areas of industrial licensing, import policy, and tax and financial reforms. The coverage of antimonopoly legislation was reduced considerably through a substantial increase in the asset limit and the exemption of a large number of industrial groups from restrictions on capacity expansion. In addition, most of the exempted industries were no longer required to operate under licenses and large companies were permitted to diversify their operations. Regulations applying to foreign collaboration and investment were liberalized with a view to facilitating import of technology. Substantial progress was made toward a more liberal import regime through the removal of licensing requirements, simplification of procedures, and the termination of monopoly imports by public corporations for a wide range of materials and components. In the area of tax policy, the structure of direct tax was rationalized, with a substantial reduction in tax rates and an increase in the exemption limit for personal income tax, in order to foster private sector growth and reduce tax evasion. Steps were also taken to alleviate rigidities in the interest rate structure through an increase in interest rates on government securities. Complementary action is now under consideration for further financial sector reform.

In Bangladesh, an adjustment program was reinstated in 1982/83 and supported by a new stand-by arrangement. Under the new program, the fiscal position was improved by increasing taxes, reducing subsidies, and adjusting key administered prices. At the same time, exchange rate policy was conducted more flexibly and a more liberal import policy was pursued with a view to improving the efficiency of the economy, especially that of the export sector. Adjustment efforts were stepped up in 1985/86 supported by another stand-by arrangement, in order to deal with a re-emerging deterioration in the balance of payments and weakening in growth performance.

The authorities in Pakistan continued to pursue flexible pricing policies for petroleum and gas, leading to a significant increase in petroleum production and to the containment of petroleum subsidies. However, further progress toward structural adjustment was needed in key areas, including tax reform, liberalization of import controls, and promotion of manufactured exports.

The pace of structural adjustment in Sri Lanka was slowed by the deterioration in national security, while the need for urgent action was softened by a marked boom in export prices of key primary commodities in 1983/84. The authorities, however, have been cognizant of the need to overcome the long-standing structural weaknesses in the economy, especially the diminishing growth potential of the narrowly based export sector, a weak budgetary process, and the poor performance of public enterprises. The first step in a phased program of tariff reform was undertaken in late 1984.

Notwithstanding the further steps some of them have taken, continued adjustment efforts remain essential in the South Asian countries, particularly in the areas of export development, economic efficiency, and public finance. During the post-program period, export volume growth has remained generally low, partly reflecting slow improvement in economic efficiency. With the exception of Sri Lanka, the fiscal deficit has widened, as expenditure has risen rapidly in the face of stagnant revenues; in the case of Sri Lanka, a large cutback in current expenditure resulted in a substantial decline in the fiscal deficit. The weak management of public enterprises has remained a source of low productivity and financial instability in most countries.



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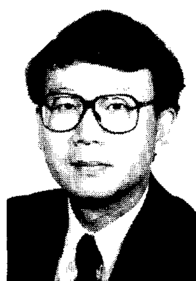

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Conclusions

The adjustment strategy of Fund-supported programs underwent a major shift in the late 1970s in response to the change in economic environment arising from the sharp rise in oil prices and the associated imbalances in members' payments positions. Adjustment programs placed greater emphasis on structural measures to promote domestic resource mobilization, alleviate price distortions, ensure increased access to imports, and reorder investment priorities in countries that sought Fund assistance.

The adjustment programs adopted by the four South Asian countries, which have much in common in the way of economic legacy and structures, were framed against this emerging shift in the Fund's adjustment strategy. Under the programs, these countries were generally successful in achieving their growth objectives, despite a deepening of the international recession and adverse weather conditions. Notwithstanding this growth performance, the extent of structural adjustment achieved in key areas was below expectations. Public sector resource mobilization was constrained by inadequate returns from improvements in the tax systems and by rising current expenditure.

The most disappointing development for all four countries was the continued weakness in export performance. Export growth was below that achieved by other developing countries, mainly because of low productivity growth and inadequate financial incentives. Despite some progress in liberalizing trade

regimes, the continuing tight control on imports constrained improvements in economic efficiency and export growth. Although there appears to be further scope for external adjustment through efficient import substitution in these countries, the strong development of the export sector is crucial for achieving external viability over the medium term. In these circumstances, continued progress in liberalizing industrial and import controls and in improving the profitability and external competitiveness of the export sector remains essential.

The experience of the South Asian countries during the program periods confirms that restrained financial management plays a major role not only in improving the balance of payments but also in facilitating structural adjustment. The cases of Bangladesh and Sri Lanka demonstrate that, in the absence of financial stability, it is difficult for the authorities to focus their attention on structural adjustment. In addition, financial instability tends to exacerbate existing cost-price distortions, resulting in inappropriate investment patterns and inadequate savings. In view of the dominant role of fiscal operations, success in demand management will inevitably require bold actions to reform the tax systems and limit the excessive expansion in current expenditure.

The slower-than-expected progress in undertaking structural adjustment was primarily attributable to delays in policy implementation. These delays were associated both with long and careful preparations required for most of the structural measures and with weaknesses in administrative capacity for effective policy implementation. These technical and administrative constraints were compounded by social and political resistance to structural reforms. In view of the lengthy process of forming a political consensus for reform, the required measures were implemented only gradually in these countries.

In conclusion, our review of the structural adjustment experiences of Bangladesh, India, Pakistan, and Sri Lanka suggests that successful reforms require considerable preparation so that they can be implemented swiftly when the conditions are ripe. Further structural adjustment can only be successful if the momentum of economic reforms that are initiated under a Fund-supported program is sustained beyond the period of the program. Ultimately, it is the commitment of governments to reforms that determines the pace and intensity of structural adjustment. It is, therefore, encouraging that in all four countries structural efforts have been continued and, in some areas, intensified following the Fund-supported adjustment programs. ■

Adjustment with growth: Colombia's experience

Resolute domestic policies, combined with external financial and policy assistance, can help achieve both

Miguel Schloss and Vinod Thomas

A characteristic of the first half of the 1980s has been the external debt problems facing many developing countries, especially in Latin America, and the efforts to cope with them. It has become increasingly apparent that domestic policy adjustments, especially if they are to be politically and socially acceptable, are unlikely to be sustainable over the medium term unless they are accompanied by economic growth.

The experience of Colombia during this period illustrates the scope for adjustment with modest growth based on domestic policy reforms and coordinated support from the international financial community. In the wake of increasing external sector problems, Colombia adopted in stages a package of stabilization measures affecting exchange rate, fiscal, monetary, and external borrowing policies, supported by pro-trade reforms and investment programming aimed at maintaining growth. This was an important step in the development of a growing consensus regarding the need for a medium-term approach to adjustment and structural reforms. The understandings reached among the government authorities, the commercial banks, the IMF, and the World Bank concerning the economic program, and the associated financing support and monitoring arrangements, described below, are the major elements of the Colombian program.

There are significant differences between the Colombian case and that of many other major debtor countries. Most important, perhaps, is that Colombia had not overborrowed in the 1970s and become embroiled in severe debt-servicing difficulties; the ratio of total debt service to exports of goods and services in the early 1980s was about 30 percent. While the country's terms of trade declined sharply in the early 1980s from their high levels during the coffee boom (1976–80), they were similar to the levels of the first half of the 1970s. Overall, the Colombian economy has not been characterized by severe distortions, and the needed adjustment was, therefore, relatively mild. Nevertheless, Colombia faced a potential balance of payments crisis in the first half of the 1980s, and the process of anticipating and averting it, while addressing medium-term growth issues, makes the Colombian case an interesting one. It is also worth noting that each country experience would be in some sense unique, and this factor should not detract from drawing useful lessons.

Need for adjustment

Colombia has achieved significant economic growth over the past quarter of a century, contributing to the transformation of a predominantly rural economy into one that is more diversified, urbanized, and industrialized. Successive governments have, by and large, shown pragmatism in policy making, placing a premium on gradualism and caution. Major policy swings have been avoided, including the temptation to borrow excessively from external sources during the 1970s. Despite these positive elements, however, certain shifts in economic policy—partly triggered by external factors—led to economic difficulties in the first half of the 1980s.

An outward-looking, growth-oriented strategy pursued from the mid-1960s to the mid-1970s produced impressive results in performance (see table). In particular, noncoffee exports took advantage of the more liberal trade policies: in addition to an increase in traditional exports, such as textile and leather goods, a variety of products, such as flowers, children's books, stoves, and workers' gloves, registered an impressive showing. In the second half of the 1970s, economic developments were dominated by a boom in export earnings from coffee (and also from unrecorded exports) and, partly as a result, the outward-looking policies with strong incentives for non-coffee exports began to weaken. The coffee revenue boom which lasted until 1980, together with favorable external conditions (e.g., for borrowing), sustained growth and employment.

The post-1975 policies led to certain structural weaknesses, which were further compounded by developments in the early 1980s. The coffee boom of the 1970s set in motion two forces that contributed to a significant appreciation of the real exchange rate. First, the real exchange rate may be thought of as the price of tradable goods relative to that of nontradable goods; higher disposable incomes generated by the boom increased the demand for both. The prices of tradables are largely determined internationally, whereas the prices of nontradables tend to rise in view of the increased demand, implying an appreciation of the real exchange rate. Second, the accumulation of foreign exchange, not fully offset by higher imports or by sterilization, produced increased domestic credit expansion, higher inflation, and an appreciation of the real exchange rate.

While the coffee boom was over in the early 1980s, the growth in aggregate demand was maintained through higher public expenditures and foreign borrowing, thus sustaining inflation and the appreciation of the real exchange rate. This, together with worsening external conditions—that is, falling commodity prices and a tightening of capital markets—created serious difficulties for the external sector. Mainly in view of Latin America's debt problems, Colombia also suffered cuts in trade credit lines and normal commercial bank lending. At the same time noncoffee exports declined and international reserves fell sharply (see table). The balance

of payments problems served to highlight a variety of constraints of a short- and medium-term nature. With an appreciated exchange rate, Colombia began to lose ground in international markets not only in commodities experiencing falling prices but also in such items as textiles in which the country traditionally had a comparative advantage.

In addition to a correction of the exchange rate, the trade regime needed reform in several ways: a reduction in import restrictions, a better functioning of the duty drawback schemes (i.e., tax credit in the equivalent amount of customs duties paid on imports of designated inputs), the removal of export barriers, and improvements in export quality. Equally fundamental, the underlying fiscal deficit had to be reduced, along with the rate of domestic credit expansion, in order to permit a reduction in inflation and an improvement in Colombia's competitiveness. Medium-term support to such macroeconomic reforms needed to be provided through better public investment programming and sectoral policies.

Historically, Colombia's economic performance has been influenced by coffee cycles. A basic difficulty affecting the external sector has been judgments concerning the duration of external shocks—whether coffee price booms or reversals in capital flows—and, therefore, the speed and degree of needed domestic policy adjustments. The problems of the early 1980s led to considerable debate regarding the appropriate policy responses. Eventually the authorities implemented a tax reform and adjustment program, discussed below, to avert a potential economic crisis. As a result, major economic indicators showed a sharp improvement in the economy by 1985; in particular the balance of payments strengthened while modest growth was maintained. Subsequently, coffee prices rose significantly in the first half of 1986, further improving the reserve position. The availability of increased resources provides the possibility for maintaining and firming up adjustments while revitalizing growth. It also calls for sustaining the incentives for non-coffee production and exports, and maintaining monetary and price stability.

The 1985 economic program

Key to the program have been stabilization measures reducing the public sector deficit and the rate of monetary expansion. Revenue measures produced additional revenues for the Central Government of 47 percent and, combined with expenditure reductions, lowered the overall public sector deficit as a percentage of GDP by over one third to less than 4 percent in 1985. At the same time, Central Bank financing of the deficit was cut by about three fourths. A concerted exchange rate policy, namely an acceleration of the depreciation of the currency, brought about an unprecedented 30 percent depreciation of the real exchange rate by the end of 1985.

Meanwhile, a gradual opening up of the trade regime began, paving the way for more medium-term adjustments in the future. During 1985: (1) the number of items under the free license regime was increased by 1,135 (out of a total of 5,011 items), raising the share of free imports from 30 percent to 56 percent of the value of total imports; (2) the number of prohibited items has declined from 828 to 69; (3) tariff reform has produced a reduction in the average tariff level from 36 percent to 28 percent in 1985, accompanied by a reduction in dispersion of tariff rates; and (4) the number of items affected by export restrictions has been reduced from 729 to 175.

In a complementary effort, the Government has been revising its public investment plans, reducing their scope to match available resources and reorienting their composition. In scaling down the public investment and borrowing targets in line with the requirements of the stabilization program, emphasis has been placed on investments geared toward export-oriented activities and essential infrastructure development (such as ports and rural roads), postponing or redesigning large lower-yielding investments, particularly in power and transportation. The analysis of the investment program has, in principle, placed emphasis on the following criteria, while their implementation is to be followed up over the medium term: (1) increasing output rapidly; (2) reorienting production toward exports and efficient import-competing goods; (3) supporting quick-yielding infrastructure investments, particularly those that enable the use of existing facilities more intensively; and (4) increasing domestic resource mobilization.

Economic performance, adjustment, and growth, 1970–86

(Annual averages)

	Export-led growth	Coffee boom	Growth recession		Adjustment with growth		
	1970–75	1976–80	1981–83	1983	1984	1985[1]	1986[1]
Performance indicators							
GDP growth	5.7	5.5	1.3	1.6	3.2	2.9	4.5
Export growth[2]	6.9	7.4	−5.2	−11.9	9.8	13.9	22.0
Import growth[2]	2.2	11.1	3.2	−8.4	−7.8	0.8	2.5
Inflation rate	17.1	24.5	24.9	19.8	16.4	24.0	20.0
Current account/GDP ratio	−2.9	1.2	−6.5	−7.3	−5.3	−3.9	−0.5
Reserves (months of imports)	2.7	8.1	7.9	5.0	3.1	3.5	4.6
Debt-service ratio[3]	22.7	14.7	31.1	36.9	37.2	38.2	34.0
External factors							
Nominal coffee price index[4]	84	133	88	89	98	99	135
Net capital inflow (US$m)[5]	284	543	1,699	1,014	710	1,576	1,000
OECD growth rate	2.1	3.6	3.3	2.3	4.7	3.0	2.0
Domestic policy							
Real exchange rate index[6]	89	85	75	75	82	107	110
Money base growth	23	35	18	14	18	27	28
Public sector deficit/GDP ratio	3.0	5.5	6.8	7.6	7.6	3.7	2.0
Imports[2]/GDP ratio	15	15	17	16	14	16	17

Sources: Colombian Ministry of Finance, IMF and World Bank estimates, and OECD *Outlook*.
[1] *Preliminary. Note that the significant improvement expected in the balance of payments in 1986 is partly the result of the coffee boom.*
[2] Goods and nonfactor services.
[3] As a proportion of exports of goods and services.
[4] 1970 = 100.
[5] Capital account balance, including errors and omissions.
[6] The calculations are based on a trade-weighted currency basket, with 1975 = 100. An increase is defined here as a depreciation of the peso.

Financing arrangements

Fundamental to the adjustment program has been a restoration of normal credit lines (about $1.5 billion annually), a resumption of commercial bank lending to the country, increased exposure of the World Bank and the Inter-American Development Bank, and the underlying policy understandings among the Government, the World Bank, and the IMF. On the basis of the latter arrangements, a $1 billion commercial bank loan was signed at

the end of 1985. The World Bank's enhanced support was illustrated by the approval of a first policy loan in 1985, the Trade Policy and Export Diversification (TPED) loan for $300 million, and a second policy loan in 1986, the Trade and Agricultural Policy (TAP) loan for $250 million, which are to be seen as part of a total financial package in support of the program. The IMF's Board approved a *sui generis* monitoring arrangement without a stand-by arrangement for 1985–86.

These arrangements were set up against the backdrop of the World Bank's role in Consultative Group Meetings, which go back to 1961 when the first Bank-sponsored meeting was held for Colombia. In line with the shift from official to private lending for Colombia, the meetings in the 1980s have included representatives not only of the Government but also of commercial banks, and in 1983 for the first time, exclusively private financial institutions and representatives of export credit agencies. In the wake of the external sector difficulties, the commercial banks, in 1984, sought monitoring of macroeconomic performance by the Fund and of certain structural reforms by the Bank as a condition for restoring capital flows to Colombia. Together with overall assessments of the economy by both institutions, an arrangement has been established whereby the Fund would monitor stabilization performance (including fiscal, monetary, and exchange rate policies) and the World Bank would focus on trade and public investment (including import liberalization, export promotion, and investment priorities). Pursuant to these understandings, agreements in principle were reached on providing for the financing needs of Colombia at a bankers' meeting for Colombia during April 16–19, 1985.

Following the restoration of the lines of credit, the term facility of $1 billion was subsequently negotiated with commercial banks for 1985–86 to be disbursed in six quarters beginning with the third quarter of 1985 and ending with the fourth quarter of 1986. Conditions of the initial loan drawdown were confirmation by the Fund that the 1985–86 program would qualify for a stand-by arrangement had one been requested, and meeting of the target agreed with the Fund for end-June 1985. Subsequent quarterly drawdowns required Fund certification of satisfactory performance in the previous quarter. Disbursements in 1986 were also subject to Fund approval of the 1986 economic program and compliance with quarterly targets, as well as release of the World Bank's second tranche of the TPED loan. (This schedule, however, was delayed because the signing of the $1 billion loan took place at the end of 1985, and the financing became available for 1986.) The first Bank review was held in February 1986 and satisfactory performance enabled the release of the second tranche of the TPED loan. The review took into account the findings of the Fund, which conducted its review of the program at the same time. In connection with the TPED and TAP loans and subsequent sectoral adjustment loans, the Bank was to assess the medium-term policy performance, particularly in the areas of trade, and the investment and borrowing programs. Under the terms of the lending facility, Colombia undertook to make available to commercial banks the Fund and the Bank reports.

Lessons of experience

A well-designed and executed adjustment program is key to addressing the external sector and debt problems, although the decision-making process is by no means likely to be easy. In Colombia, opposition to import liberalization has been strong, as has been the case in regard to fiscal restraint. What has emerged from the country's experience, nevertheless, is the importance of accepting trade-offs and disagreements pragmatically, and acting decisively. Policy actions were taken in Colombia with a view to averting a crisis, even if somewhat late, rather than in reaction to one. The willingness and ability to stay the course, in the face of short-term costs, are equally important. Recent sweeping reforms in other Latin American countries perhaps also reflect the growing recognition of such an approach.

Consensus building, which is essential to sustaining adjustment, requires a significant amount of time and the capacity to experiment. Addressing simultaneously the stabilization and adjustment requirements has been essential in Colombia; this is likely to be the case in other countries, although the phasing and sequencing of measures would depend on individual circumstances. The pace of reforms would have to take into account the sustainability of change, especially when various interest groups are affected. In Colombia private interests are represented in the Government decision-making process in a variety of ways: the participation of private sector representatives in the boards of government bodies; management of the Coffee Fund by the coffee producers together with the Government; and rotation of managers and personnel between the public and private sectors. Policy making has often been based on broad consensus and, as a result, policy changes have been gradual. In certain situations, therefore, such as the Colombian case, there may be a premium on gradualism in policy change, and on balancing economic, political, and social considerations, in order to avoid costly policy reversals.

While stabilization is essential, the goal of sustaining growth puts increasing emphasis on adjustments of trade and public investment policies. Where budget deficits are to be cut, some pruning of investment might follow once consumption expenditures are lowered and revenues are increased. To the extent that public investment is to be contained, even greater emphasis would need to be placed on a careful review of the program to ensure the protection of high priority projects and to facilitate greater yields per unit of investment. Similarly, to prevent demand management from unduly restricting imports, reforms of the trade regime to reduce any anti-export bias and to promote exports are desirable. Colombia has been able to combine a sharp reduction in the fiscal deficit with a vigorous real exchange rate depreciation and a gradual opening up of imports, thereby improving incentives for exports. In Colombia and elsewhere, support for increased domestic resource mobilization and export generation over the medium term is critical for sustained growth.

Structural changes—in macroeconomic policy and in sectoral and institutional areas, including the elimination or restructuring of state enterprises—need to be considered. Although they have a positive impact on economic growth, structural adjustments are often more difficult for governments to implement than a cut in expenditures or monetary restraint. Sometimes the negative impact of such adjustments is felt by some sectors before the positive effects are experienced in others. To be sure, an adjustment in the exchange rate and producer prices may have an immediate and favorable impact on growth, but the full impact may take time to emerge. Linking macroeconomic policies to sectoral reforms and financing would be key to minimizing the costs of adjustment at the sectoral level. Colombia's second policy loan seeks to improve agriculture's ability to adjust to macroeconomic reforms by improving investments, particularly in less accessible regions, and strengthening input supplies. In the financial sector, the Government has been assisting in the capitalization of entities facing severe problems, thereby improving the ability of the financial sector to adjust to the macroeconomic reforms.

The external financial community

The IMF and the Bank share common and complementary objectives: sound macroeconomic policies are an essential base for implementing structural reforms, and economic stability promotes sustained economic growth. Furthermore, the financial community has found that the Fund's macroeconomic country reports together with the Bank's assessments of the economy, the sectors, and the investment program provide a firmer base on which assistance programs may be

formulated and financing requirements evaluated. In this manner the Bank and the Fund have complemented one another to assist Colombia with its adjustment efforts.

Considerable flexibility has been a helpful feature of the Colombian experiment. For example, external debt targets vary within a range depending on debt policies that can, in turn, be affected by the extent of the coffee boom. Moreover, flexibility has facilitated the coordination of decision making of the country, the IMF, the commercial banks, and the World Bank. Coordination of financing among the above and other external financing agencies is also desirable. While it is important for development agencies to frame assistance in a medium-term setting, it may also be important to be flexible and responsive to new development opportunities arising because of changing economic conditions. In this context, and as is being considered for Colombia, bilateral agencies might provide a proportion of their lending in quick-disbursing, untied assistance to support improved policies in addition to that for individual projects.

Timely mobilization of external private capital is also necessary. The catalytic role of policy-based lending by the Bank—by associating commercial bank financing with such lending operations—and the Fund's policy advice and monitoring role are a key aspect of the Colombian experience. Mobilization of private equity financing, involving reviews of the country's endowments, priorities, policies, and regulatory environment, is also likely to become increasingly important. In the Colombian case, the views of the various participants have gradually converged, although the financing interests of export credit agencies might be better tailored to the needs of adjustment.

In recent years, various proposals have been advanced, aimed at substituting generalized solutions for the present case-by-case approach to the debt management problems. They are all born of a conviction that the debt-servicing problems confronting many developing countries cannot be managed within the existing world economic framework characterized, inter alia, by historically high real interest rates and significantly curtailed commercial lending. These schemes have not achieved broad-based acceptance, particularly as they affect conflicting interests among countries and institutions. What the Colombian experience suggests, however, is that with an appropriate adjustment and stabilization program, suitable monitoring arrangements, and associated policy-based lending and support by multilateral agencies, commercial bank lending can be resumed at reasonable levels, with favorable effects for creditworthiness and economic growth. F&D

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Photos by Michele Iannacci for F&D

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IB-1083