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## **CONDITIONALITY: FACTS, THEORY AND POLICY**

DRAGOSLAV AVRAMOVIC

WORLD INSTITUTE FOR DEVELOPMENT  
ECONOMICS RESEARCH  
UNITED NATIONS UNIVERSITY

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## Preface

As the International Monetary Fund began to play a central role in the management of the debt crisis during the 1980s, so the nature of the conditions attached to its assistance became even more critical to countries in payments difficulties. In many countries, the controversy about these conditions moved to the centre of the stage of political as well as economic debate. Critics challenged the prevailing assumptions and practices of the Fund in this area both on theoretical and practical grounds, while representatives of creditor countries were equally insistent on the necessity for maintaining conditionality as a means for ensuring continued adjustment of payments imbalances.

Much of this reflects natural differences of short-run interest and perspective between creditors and debtors. In the long run, however, both creditors and debtors have a common interest in the adoption of sound economic policies – which in this context refer to policies ensuring that the nature and speed of adjustment by borrowing countries is sufficient to restore, over time, their economic and financial viability. What is necessary is to develop an institutional framework which, by encouraging a sufficient degree of mutual trust and understanding, offers a more adequate recognition of this long-term common interest. The following paper by Dr Avramovic is, I believe, a contribution towards the development of such an institutional framework of cooperation.

Dr Avramovic draws on the experience of many countries in formulating his policy recommendations. I would like to draw attention in particular to the experience of Sri Lanka, which points a way which other countries might well study. As developed in detail in another paper<sup>1</sup>, the Sri Lanka adjustment experience emerges as a special case in which coordination of policies between the IMF and the World Bank together secured over a substantial period – 1977 to 1986 – the external resources inflows needed to underpin the adjustment effort. For instance, a food subsidy cut on which the Fund insisted would not in the eyes of Sri Lanka policy makers have been feasible without an assurance of support for a project package by the Bank and Aid Group. Moreover, IMF policies took into account the consideration that exchange rate corrections judged ordinarily desirable might have to await the resolution of key political issues.

“The Sri Lanka story, for all practical purposes, reads like one where the international financial institutions, i.e. the Fund and

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<sup>1</sup> *WIDER Stabilization and Adjustment Policies and Programmes, Country Study No 15, Sri Lanka*, by Lal Jayawardena, Anne Maasland and P.N. Radhakrishnan, WIDER, 1987.

World Bank, worked in unison and alongside domestic policy makers to support the development effort once the initial breakthroughs had been made in 1977, despite growing obstacles to continuing external support which might, in other circumstances, have led to a substantial reduction in that support.”

Drawing on such experiences, Dr Avramovic recommends three changes in present practices: first, the international agencies should encourage member countries requesting financial assistance to submit their own programmes of adjustment; secondly, the agencies should base lending decisions on their assessment of the debt servicing capacity and financial management of borrowers, with conditionality being normally confined to factors bearing on these two areas; thirdly, the regular exchange of information and economic policy views should be promoted to enable the policy dialogue to be continued in a consultative manner.

The centrepiece of these proposals is that responsibility for preparing adjustment programmes be transferred to national governments, thus enabling programmes to be adapted more readily to the individual country's economic and social conditions. Although other conditions may have to be satisfied for such an arrangement to be effective in particular cases, the Sri Lanka experience suggests it can be a means of mobilizing essential domestic political support for the adjustment programme. At present, the absence of that domestic political support all too often torpedoes IMF programmes before they have a chance of succeeding.

LAL JAYAWARDENA  
MAY, 1989

# Conditionality: Facts, Theory and Policy

## Summary

Three changes in conditionality of loans are proposed in this study, in order to improve the relations between developing country borrowers and international lending agencies, and make the international cooperative effort at development and stability more effective. First, the agencies should encourage member country governments requesting adjustment assistance to submit their own programmes of adjustment. The present practice of the agencies preparing country programmes should be discontinued. Secondly, the agencies should decide on their loans on the basis of their assessment of the debt servicing capacity and financial management of the borrowers, with loan conditions being normally confined to factors bearing on these two areas. This would modify the present primary emphasis of conditionality on influencing national economic policies of the borrowers in a particular direction. Thirdly, a system of regular exchange of information and economic policy views between the borrowers and the agencies should be instituted. This would enable the policy dialogue to be continued, but in a consultative manner. Brief comments on these proposals follow.

Transfer of responsibility for preparing adjustment programmes to national governments would enable the adaptation of programmes – the choice of objectives and policy instruments – to economic and social conditions in each individual case. Furthermore, this would increase the commitment of governments to the implementation of programmes.

Serious doubts exist concerning validity of several important points of the economic theory and associated policy on which the present practice of conditionality rests, and this suggests the need for its modification. These doubts refer to, first, monetary programming with its pre-set money supply targets which may lead to restrictions on output more than needed to accomplish the required balance-of-payments turnaround; secondly, financial “liberalization”, requested virtually under all circumstances, which may lead to exacerbation of inflation through rising money costs and to sustained excessive real interest rates destructive of investment over extended periods; thirdly, import liberalization, when requested in countries experiencing foreign exchange shortages, which raises further their external deficits and may lead to reductions in output and employment; and fourthly, general agency resistance to selective policies and measures which many governments wish to apply in order to minimize the deflation due to adjustment and influence

the burden-sharing among different social classes. On the other hand, there should be no serious objections to conditionality primarily focussed on the debt servicing capacity and orderly financial management in debtor countries. Included here are orderly tax administration and enforcement, tight public expenditure controls, realism of investment and financing plans, control over foreign borrowing, anti-corruption drives and enforcement, drives for accountability and sound management of public enterprises, stopping the use of government service to provide jobs, speed in decision-making and in implementation of government decisions, policies to discourage, and measures to prevent, capital flight.

The proposed institution of regular periodic exchanges of information, experiences and economic policy views between borrowing country officials and the staff of the agencies would enable the economic discussions to continue. The agencies have contributed to several important policy developments in borrowing countries in the past, such as increased emphasis on export expansion, improved public enterprise finances, higher domestic agricultural prices; and the proposed exchanges will enable them to make similar contributions in the future. The developing countries would thus continue to benefit from the staff expertise and accumulated knowledge in the agencies. The agency staff, in turn, would be able to continue to draw on the rising development management experience in developing countries and their increased ability to absorb and adapt modern technology in a number of cases. The consultative nature of the arrangement should reduce frictions between lenders and borrowers and, hopefully, make for a fruitful and continuing cooperative effort.

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The author is Economic Adviser of the Bank of Credit and Commerce International S.A. Views expressed in this paper are personal.



## **1. Introduction**

Economic policy conditions accompanying loans granted by leading international agencies to developing countries have been a major point of dispute in North-South relations for a long time. Conditionality has been increasing in recent years, and this has raised the disputes to new heights. The roots of the controversy lie in the differences of views concerning, first, the substance of desirable economic policies in developing countries on some important issues, and second, the delimitation of the roles of the agencies and country governments in designing country policies. This paper suggests a possible way in which the controversy can be approached and eventually resolved.

Chapter II describes the present system of conditionality and its evolution. Chapter III discusses the strong points of conditionality. Chapter IV focusses on its weaknesses and controversial points of the theory of economic policy on which conditionality rests. Chapter V contains this paper's proposals.

## **2. Evolution**

### *Present situation*

Four layers of conditionality are now practiced:

- (a) Demand conditionality pioneered by the IMF through their monetary approach to the balance payments. This focusses on cutting spending, primarily that of the government, currency devaluation, raising interest rates, and trade liberalization. There are now also elements of supply conditionality, mainly in eliminating price controls.
- (b) Supply conditionality, pioneered by the World Bank, originally focussed on project (or micro) formulation and implementation, dealing with pricing of products and services to be sold by the project, and its management. This was then extended to cover sectors, and now, with "structural adjustment lending" to the entire economy. The center of attention is the investment program, system of incentives, pricing, financial liberalization, and trade liberalization.
- (c) "Growth" conditionality, in application during the last two years or so, focussed on giving free hand and incentives to the private sector of the economy, including "privatization" of government-owned enterprises as much as possible, rationalization of the rest, promotion of foreign direct investment, and again, trade liberalization.
- (d) Cumulative total of (a), (b), and (c), called "cross-conditionality", where lending decisions of each agency depend on the borrower having met the loan conditions of some other agency.

This is now in increasing use, and it involves private as well as official lenders.<sup>3</sup> The breakdown in arrangements between a borrowing country and any one of these agencies – in particular the IMF and The World Bank – can have a ‘domino effect’ in relation with all other agencies.<sup>4</sup> The situation is still fluid: the number of instances of “cross-conditionality” is increasing, but it is not yet clear how firmly committed to coordinated action individual lenders feel they are.<sup>5</sup>

## *History*

Conditionality did not exist in the original IMF Articles of Agreement. The Fund started applying it since 1952, as a matter of a Board policy decision.<sup>6</sup> It has been spreading ever since. Professor Oliver, in a recent historical study, notes that “increasingly, beginning in the late 1950s, the staffs of the Fund and the Bank deeply concerned themselves with the internal economic affairs of their members, not infrequently in ways that induced headlines in the international press. These intrusions would have surprised the American delegation to Bretton Woods and would probably have infuriated the British, who regarded national economic sovereignty as an absolute, whatever might be agreed about plans for a Fund and a Bank.”<sup>7</sup>

This is now history; and we currently face a situation with a comprehensive net of conditionality, designed and implemented by a formidable international economic staff operating from powerful institutions. The number of issues they address in individual country programmes is increasing. This has led a prominent student to observe that we are now in the presence of a “Christmas tree” approach to conditionality, with new conditions being steadily added to the existing ones.

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<sup>3</sup> See Iqbal Gulati, *Aspects of Cross Conditionality*, Centre for Development Studies, Trivandrum, India, July 1986 (mimeo.).

<sup>4</sup> Sidney Dell, *The Question of Cross Conditionality*, June 1986. p. 23 (mimeo.).

<sup>5</sup> In mid-November, The World Bank went ahead with a partial disbursement of a loan to Mexico, even though commercial banks had not yet approved their part of the loan package. (*The Washington Post*, 19 November 1986).

<sup>6</sup> Sir Joseph Gold, *Conditionality*, IMF Pamphlet Series No. 31, IMF 1979, pp. 3–4.

<sup>7</sup> Robert W. Oliver, Bretton Woods: A Retrospective Essay, *The California Seminar on International Security and Foreign Policy*, June 1985, p. 41.

### ***3. Strong points of conditionality***

Conditionality has contributed to policy evolution in developing countries in four areas, thus reinforcing the effects of lending agency financial contributions:

- (a) Fiscal discipline;
- (b) Export expansion;
- (c) Proper management of public enterprises; and
- (d) Alleviation of price distortions.

Each of these areas is discussed below.

#### *Fiscal discipline*

Many problems facing developing countries – in their external accounts, domestic inflation, administrative controls, price distortions, and insufficient investment – have their origin in a fiscal imbalance. In the mid-1980s, in Argentina, “the government was unable to finance the fiscal deficit without disorganizing the monetary side of the economy, driving the economy either to hyperinflation or overkill (due to the rise in interest rates).”<sup>8</sup> Argentina is an extreme case, but in different degrees the problem appears in very many places. A reduction in the fiscal deficit appeared as one of the stabilization objectives in 86 out of 94 Fund-supported programmes examined in on recent study, or 91 % of the cases.<sup>9</sup> There have been serious disagreements concerning the feasible speed and extent of the deficit reduction proposed by the Fund, the specific expenditure categories which the Fund has singled out for cutting, the nature of particular revenue increases it has proposed, and its tendency to shift the burden of adjustment to the public sector. But the general argument that restoration of fiscal discipline is a necessary condition for growth and self-reliance is valid. In countries suffering from hyperinflation, monetary stabilization may be a pre-condition for recovery of public revenue and thus for reconstruction of public finances generally; but monetary stabilization will not be possible to sustain unless fiscal discipline is restored.

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<sup>8</sup> Roberto Frenkel, Jose Maria Fanelli, Carlos Winogard, *WIDER Country Study No. 12: Argentina*, March 1987, pp. 43–44 (see Appendix)

<sup>9</sup> Fund-Supported Programs, Fiscal Policy and Income Distribution, *A Study by the Fiscal Affairs Department of the International Monetary Fund*, September 1986, p. 33.

## *Export expansion*

Export expansion of manufactures now commands universal support. It provides for economies of scale: the larger the market in which one sells, the greater the possibilities of expanding production, perhaps at falling costs, and expanding sales, probably at unchanged prices, thus raising employment, income and profit margins and their mass. Furthermore, rising export earnings will help alleviate the foreign exchange constraint to growth – a critical issue in most developing countries. Questions have been raised concerning the effects on domestic small and medium intermediate goods producers of large exporters' free access to manufactured imports (South Korea);<sup>10</sup> and there is apprehension that excessive export subsidies may lead to "fictive" exports and may have caused terms of trade deterioration via reduced export prices (Turkey).<sup>11</sup> These are important qualifications, but they cannot eliminate the enormous advantages arising from a plentiful flow of foreign exchange, which provides room for maneuver to domestic economic policy.

The World Bank and regional development banks have financed specific investment projects in export industries of developing countries for a long time, reflecting their conviction that export growth is a priority for developing countries, both to enable them to transfer smoothly debt service on their external liabilities and to help assure a steady flow of their imported inputs. In addition, the World Bank, in its "structural adjustment loans" (SALs) provides financing for export expansion on sectoral and institutional bases. According to one study, in 14 out of 16 countries which had received SALs, one of the lending objectives was "export incentives and improved institutional support."<sup>12</sup> It is not clear from the available data how much of this lending (and other export lending) was for expansion of traditional export commodities rather than manufactures. Such primary product expansion, while it will normally assist the individual borrower over the long run, raises serious issues in periods of depressed markets, as by adding to supplies it depresses the market further, thus affecting adversely producers as a group. "The contradiction in the situation is that while it would be in the interest of commodity exporting countries as a whole to

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<sup>10</sup> Alice H. Amsden, *WIDER Country Study No. 14: Republic of Korea*, March 1987 p.8 (see Appendix)

<sup>11</sup> Korkut Boratav, *WIDER Country Study No. 5: Turkey*, March 1987, pp. 26–27 (see Appendix)

<sup>12</sup> Progress Report on Structural Adjustment Lending, *The World Bank*, R84–150, 6 June 1986, p. 7.

limit or reduce their productive capacity in a period of persistent oversupply, it appears to be in the interest of each country individually to increase its share of the global market. However, this latter route is inevitably costly and ultimately self-defeating since it adds further to downward pressure on prices.”<sup>13</sup> The issue of lending for commodities in surplus has been extensively discussed within the Bank, but it is not known that it has been satisfactorily resolved: it is a difficult issue as it sometimes affects the least advanced developing countries with few obvious noncommodity alternatives. Devaluations in commodity-producing countries, frequently a key element of IMF conditionality, also have a price-depressing effect on the world market as they stimulate additional export sales despite the surplus.<sup>14</sup> What is missing is an international commodity production plan.

### *Management of public enterprises*

Public enterprises in infrastructure, goods and services production, and trade represent a large proportion of the total in many developing countries, and their management and finances have a major effect on public finance and credit in general. Management weaknesses have been frequent, mostly because of political patronage or insufficient operational autonomy; and finances have frequently been weak because the enterprises have been used as a vehicle for subsidization of consumption, as a source of employment, or as a conduit for irregular transactions. At the same time, first-rate publicly-owned enterprises exist in a number of developing countries, in some cases at the outer edge of technological advance in key priority areas (*e.g.*, energy).

The World Bank, as an investment project lender, had concentrated on “institution building” at the enterprise and sector levels, *i.e.*, the establishment or reconstruction of publicly-owned enterprises, mostly in infrastructure, insisting on autonomous sources of

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<sup>13</sup> Alfred Maizels, *The Terms of Trade and the External Financing Problems of Commodity-Exporting Developing Countries*, Helsinki, 1986, p. 34 (mimeo.).

<sup>14</sup> An IMF staff study recognizes this, but argues that the effect will normally be small, compared with other forces operating in commodity markets. (Morris Goldstein, *The Global Effects of Fund-Supported Adjustment Programs*, March 1986.) The adverse effect remains, however, and its size can be determined only by special product-by-product investigation.

finance and independent management.<sup>15</sup> Its project loans have been conditioned by the borrowing country accepting these two principles.

This has frequently given rise to disputes, particularly concerning prices which the enterprise will charge for its services (*e.g.*, electricity rates, water rates, transport tariffs, port charges, etc.), with the borrowing country normally insisting on lower prices, and the Bank asking for more; but none of these disputes seem to have developed into a major country-Bank confrontation, although they have taken time to resolve and have therefore slowed down investment. Dr. Richard Goode, a former high official of the IMF staff, after noting that the Bank “seems to enjoy more harmonious relations than the Fund does with the governments of developing countries”, suggests that “the ability of the Bank to avoid confrontation with member governments in the past may have been due largely to the multiplicity and relatively small size of its individual loans. Applications for project and sector loans can be delayed or refused without seeming to render an unfavorable judgment on the member country’s broad policies and creditworthiness, but it may be harder to avoid such an implication if a structural adjustment loan is refused.”<sup>16</sup>

The developing countries have become increasingly aware of the need to improve and upgrade the operations and management of their public enterprises. An important step in this direction has been the establishment of the International Center for Public Enterprises in Ljubljana, Yugoslavia, aimed at mutual exchange of experience and mutual assistance.

### *Agricultural prices*

Concerned with the agricultural lag in a number of developing countries and their rising food imports, both the World Bank and the IMF have insisted on improvement of agricultural prices in these countries’ internal markets. A World Bank staff study of “price distortions” during the 1970s in 31 developing countries from all continents found that in seven ( 2 %) agriculture was effectively highly taxed.<sup>17</sup> Another Bank staff study, focussed on

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<sup>15</sup> An extensive treatment of the Bank’s practices is given in: Warren C. Baum and Stokes M. Tolbert, *Lessons of World Bank Experience*, Washington, D.C., 1985.

<sup>16</sup> Richard Goode, *Economic Assistance to Developing Countries through the IMF*, The Brookings Institution, 1985, pp. 59–60.

<sup>17</sup> Ramgopal Agarwala, *Price Distortions and Growth in Developing Countries*, World Bank Staff Working Papers No. 575, July 1983, p. 6.

agriculture in 31 African countries also during the 1970s, found that ten (33 %) showed a "high farm price discrimination", defined to exist where farmgate prices are more than 40 % below import or export parity prices on the average.<sup>18</sup>

The Bank has normally made its agricultural lending conditional on price improvement where warranted. It is not clear in how many Fund programs has this been singled out as a specific objective, although the Fund's general position on this issue is clear.

The need to provide adequate price incentives in agriculture is now recognized in a very large number, perhaps most, developing countries. In Asia, this happened already in the 1960s.<sup>19</sup> In Africa, it is happening now; there is also evidence that producer prices for food commodities in some African countries already were increasing significantly faster than world prices in the 1970s.<sup>20</sup> In five significant agricultural producing countries in Latin America and the Far East for which comparable time series are available, the "relative protection ratio" of agriculture compared to industry moved up from an average of 0.70 in the 1960s to an average of 0.82 in the late 1970s or early 1980s.<sup>21</sup> As is to be expected, industry continues to be protected relative to agriculture; but the degree has been reduced.

In contrast to their activities to improve the terms of trade of agriculture within developing countries, the Bretton Woods institutions have not given comparable attention to improving the terms of trade of developing countries-commodity producers in the world economy. The Fund has a Buffer Stock Facility to assist producer-consumer commodity arrangements, but its operations have been limited, partly because there have been too few of these arrangements. The Bank has refrained from entering the field of international commodity stabilization, and so have the regional development banks. The issue of international commodity stabilization remains open on the international agenda.

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<sup>18</sup> Kevin M. Cleaver, *The Impact of Price and Exchange Rate Policies on Agriculture in Sub-Saharan Africa*, World Bank Staff Working Papers No. 738, April 1985, pp. 8-9.

<sup>19</sup> See, Raj Krishna, *Agricultural Price Policy and Economic Development*, in: *Agricultural Development and Economic Growth*, edited by H. M. Southwart and B. F. Johnson, Ithaca, New York, 1967.

<sup>20</sup> Dharam Gai and Lawrence Smith, *Food Policy and Equity in Sub-Saharan Africa*, World Employment Research Programme, ILO, Geneva, August 1983.

<sup>21</sup> The World Bank, *World Development Report 1986*, p. 62. A ratio of 1.00 would indicate that effective protection is equal in both sectors; a ratio smaller than 1.00 means that protection is in favor of industry. The five countries covered are Brazil, Colombia, Mexico, Philippines and South Korea.

## 4. Weaknesses of theory and policy

Conditionality as now practiced rests on three elements of economic policy: first, monetary programming which is a particular form of credit policy, based on fixed money supply targets or pre-determined money supply growth rates, used as a device to reduce inflation and, accompanied by devaluation in most cases, to turn around quickly the balance of payments; second, financial liberalization, expected to result in a positive real rate of interest, which would lead to increased savings and better use of capital; and, third, import liberalization, expected to improve domestic efficiency through foreign competition and availability of imported inputs, and to lead to optimum resource allocation. Cutting across these elements and in a sense going beyond them is, fourthly, a specific philosophy of economic policy and development strategy to which the leading financial institutions lean. They have a preference for market solutions both in normal times and in periods of crisis as opposed to government intervention; and they press the case of free trade as opposed to specific country development strategies. These four propositions are discussed below.

### *Monetary programming*

Monetary programming and the associated stringent credit ceilings have not proven a successful experience either in developed or developing countries. In developed countries, its fundamental weakness has been the inability to foresee the velocity of money (*i.e.*, money/GDP ratio), a variable showing major and sudden shifts in response to changing expectations and lately to deregulation of financial markets and introduction of new credit instruments which have blurred the distinction between money and securities and made the operating target – money supply – virtually impossible to define. An unforeseen and sudden increased or decreased readiness of the public – population and business – to hold cash balances has frequently made the *ex-ante* monetary programs either insufficient or excessive, with highly destabilizing effects on interest rates and the economy in general. Some important countries have been compelled to change monetary targets mid-stream or drop them altogether, in order to avoid shortages of credit, sky-rocketing interest rates, and the associated declines in output and sales of assets at distress prices.

Developing countries moving from high inflation to stabilization through an *ex-ante* targeted reduction in money supply have experienced massive shortages of domestic liquidity when, due to existing inflationary expectations, prices did not fall as targeted, with the result that output, employment and real wages fell, while real inter-



est rates soared.<sup>22</sup> Furthermore, stringent credit controls will have the effect of reducing output to levels below those consistent with either balance-of-payments improvement or a reduction in inflation itself whenever the country experiences "cost-push" inflation, frequently resulting from decontrol of prices and elimination of subsidies under a stabilization programme.<sup>23</sup> "The basic point is that supply and demand both determine price. A policy which tries to restrain demand, and ends up by reducing supply by even more than it reduces demand, will be inflationary. And in the short run, supply may depend rather critically on the volume of credit, more so in developing countries than in advanced industrialized economies."<sup>24</sup> Requests for short-term credit to finance production for exports have been turned down merely in order to stay within overall credit ceilings.<sup>25</sup> It follows that broad guidelines rather than specific numbers should govern monetary policy.<sup>26</sup>

Devaluation has been a part of adjustment in the majority of IMF-supported stabilization programmes: 55 % of these during 1980-84 required "liberalization and reform of exchange rate arrangements."<sup>27</sup> There have been bitter disputes about the need, the extent and the effects of devaluation. Professors Krugman and

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<sup>22</sup> Joseph Ramos, *Stabilization and Adjustment in the Southern Cone of Latin America*, in SID/North-South Roundtable, *Adjustment with Growth*, Islamabad, 1985, p. 96.

<sup>23</sup> S.K. Rao, *On Negotiating with the IMF: A Note*, Seminar on Adjustment Programmes, Commonwealth Secretariat, London, June 1985, p. 3 (mimeo.).

<sup>24</sup> Kemal Dervis, 'Comment' in *Economic Stabilization in Developing Countries*, edited by W. R. Cline and S. Weintraub. The Brookings Institution, Washington, D. C., 1981, p. 503. In the same vein see Peter M. Keller 'Implications of Credit Policies for Output and the Balance of Payments' in IMF, *Staff Papers*, Vol. 27, No. 3, 1980, pp. 455-6.

<sup>25</sup> In Jamaica, in the latter half of 1985, the monetary constraints became so severe that a commercial bank cut off credit to 807 garment manufacturers who needed it because of inevitable lag in the receipt of export proceeds from the overseas contractors, resulting in work force reductions and plant closures. (Paul Chen-Young & Associates, *Critical Poverty Study-Jamaica*, Kingston, 26 September 1986, p. 40 (mimeo.)).

<sup>26</sup> This is the view of a number of analysts, see Dragoslav Avramovic, *The Role of the International Monetary Fund: The Disputes, Qualifications, and Future*, in John Williamson ed., *IMF Conditionality*, Washington, D.C., 1983, p. 600.

<sup>27</sup> IMF, *Fund-Supported Programs, Fiscal Policy and Income Distribution*, *op. cit.*, p. 12.

Taylor have argued that instead of an expected economic expansion, devaluation may lead to a contraction due to a transfer of real purchasing power toward economic sectors with high marginal propensity to save, which may then create an excess of savings over planned investment and lead to a reduction in real output and imports.<sup>28</sup> A recent IMF staff study indicated that in a developing country experiencing a fall in export receipts due to an external price fall, devaluation may fail to have the expected favorable effect on the balance of payments as domestic spending it generates could lead to a further trade deterioration.<sup>29</sup> Dr. Buira, a distinguished Mexican economic official and a former Executive Director and member of the IMF staff, has drawn attention to low supply elasticities in developing countries which may frustrate the expected effects of devaluation:

“The usual Fund analysis of the impact of devaluation on aggregate supply often neglects the consideration of elasticities. What happens, for example, if the increase in the price level of traded goods in terms of domestic currency, caused by devaluation, does not lead to an increase in the output of traded goods? In other words, what happens when, as is frequent, the price elasticities of the supply of exportable and import-competing goods is very low in the short run? The results would be that imports would not decline much in the short run in response to a devaluation, given the absence of adequate home-produced substitutes. In fact, imports will decline largely due to declines in income rather than as a result of relative price changes induced by the devaluation. Taking into account that exports of LDCs are often inelastic in the short run, the final impact of devaluation on the balance of trade is uncertain, while it is clear that it can induce contractionary effects on output and employment.”<sup>30</sup>

Similarly, Dr. Please, a former high official of the World Bank, stresses the limitations of devaluations in Africa in view of other supply constraints: “Exchange rate changes and their impact on agricultural incentives in African countries must, therefore, be conceived and implemented in the context of a package of measures. Moreover, the degree of distortion in the incentive system is so large and politically difficult to handle, and the institutional, agronomic and other barriers to a rapid supply response from farms

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<sup>28</sup> Paul Krugman and Lance Taylor, *Contractionary Effects of Devaluation*, Journal of International Economics, Amsterdam, Vol. 8, August 1978.

<sup>29</sup> Iqbal M. Zaidi, *Currency Depreciation and Nonclearing Markets in Developing Countries*, IMF Staff Papers, Vol. 33, No. 2, 1986.

<sup>30</sup> Alfred Buira Seira, *Recession, Inflation and the International Monetary System*, World Development, Volume 9, No. 11–12, November–December 1981, p. 1124, Dr. Buira is now Deputy Governor of the Bank of Mexico.

are going to take so long to deal with, that the package of measures can only be conceived and implemented over many years.”<sup>31</sup> And Professor Mellor adds that “where, as is frequently the case, total agricultural supply response is small, the main impact of agricultural (food) price increases may simply be to increase poverty.”<sup>32</sup> Finally, Dr. Blackman, Governor of the Central Bank of Barbados, summarizes the skepticism, presumably reflecting the Caribbean experience:

“In LDCs the elasticities of foreign demand for exports, and especially of the domestic supply of goods for export, are likely to be negligible. Lower export prices merely result in reduced foreign exchange earnings; increased import prices lead only to increased domestic and export prices, since a large proportion of inputs into domestic production must be imported... Devaluation as a tool of short-term balance of payments adjustment is contra-indicated, successive mini-devaluations make even less sense. To be effective such devaluations must be sharp enough to preclude the possibility of wage catch-up by trade unions.”<sup>33</sup>

None of the above proves that devaluation can or should be avoided when domestic costs and prices are out of line with international levels across the board. In fact, the experience generally suggests that a slightly undervalued rate is likely to lead to a sustained, rapid and diversified export growth. (I am assuming that traditional primary product exports are controlled to avoid world price falls.) The above arguments strongly suggest that a devaluation should not be undertaken lightly, but in the context of other measures to augment export supplies in a lasting way. Otherwise devaluation will only keep re-igniting domestic inflation and the other way around, depriving the economy, in the process, of a stable framework for making sensible investment decisions.

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<sup>31</sup> Stanley Please, *The Hobbled Giant, Essays on The World Bank*, Boulder and London, 1984, p. 67. See also, Tony Killick ‘Balance of Payments Adjustment and Developing Countries’ in *Problems of International Money, 1972–85*, edited by Michael Posner, IMF-ODI, 1986, p. 86.

<sup>32</sup> John W. Mellor, *Agricultural Change and Rural Poverty*, International Food Policy Research Institute, Food Policy Statement No. 3, October 1985, p. 3, quoted in G. K. Helleiner, *Policy-Based Lending and The World Bank: Prospects and Possibilities*, March 1986, p. 16 (draft, mimeo.).

<sup>33</sup> Courtney N. Blackman, *Adlith Brown Memorial Lecture*, Central Bank of Barbados, January 1986, p. 10.

## Financial liberalization

It is now generally agreed that increase in interest rates – a major argument for financial liberalization – cannot be confidently expected to lead to an increase in savings. According to the studies of the IMF staff:

“The evidence from developed and developing countries alike is not quite conclusive in regard to the interest elasticity of savings. For the United States, income and wealth are found to have a more predominant influence on personal savings than interest rates. For less developed countries, even allowing for the dubious nature of statistics, the evidence points toward the same kinds of doubt about the interest elasticity of savings.”<sup>34</sup>

“Despite the amount of research expended on the responsiveness of savings in general, and in developing countries in particular, it is still uncertain whether an increase in interest rates will, on balance, raise the savings rate.”<sup>35</sup>

This latter IMF study states that some recent findings indicate a positive response of savings to increases in *real* rather than nominal interest rates; but another author finds little evidence on this question, and the IMF study concludes that “it is evident from the empirical studies reviewed that the direct response of domestic private savings to variations in real interest rates is weak.”<sup>36</sup>

This leaves allocative efficiency and the attraction of foreign capital (deposits) as the main reasons for raising the rates of interest. Negative rates would lead not only to excessive monetary expansion, but also to undertaking poor investments alongside good ones. However, subsidized rates to underprivileged sectors are justified when they serve to correct existing disequilibria (*e.g.*, underpricing in agriculture): elimination of a subsidy in this case – a partial equilibrium – would make the overall situation worse. This

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<sup>34</sup> Deena Khatkate, *Analytic Basis of the Working of Monetary Policy in Less Developed Countries*, in: *Money and Monetary Policy in Less Developed Countries*, W. J. Coats and D. R. Khatkate (ed.), Oxford, 1980, p. 134.

<sup>35</sup> Mohsin S. Khan and Malcolm D. Knight, *Fund-Supported Adjustment Programs and Economic Growth*, IMF, Washington, D.C., 1985, p. 14.

<sup>36</sup> *Ibid.*, p. 13. The studies reviewed are: Maxwell J. Fry, *Savings, Investment, Growth and the Cost of Financial Repression*, World Development, Vol. 8 (April 1980); Maxwell J. Fry, *Savings, Investment, Growth and the Terms of Trade in Asia*, February 1984, unpublished, Irvine, California; Alberto Giovannini, *The Interest Elasticity of Savings in Developed Countries: The Existing Evidence*, World Development, Vol. 11, July 1983; and Donald Mc Donough, *The Determinants of Saving Behaviour in Latin America*, unpublished, IMF, April 1983.

situation is encountered frequently in conditionality applied to rural lending; and lender insistence on subsidy elimination is wrong in these cases.

A major point in dispute concerns interest rate policy during adjustment still marked by inflation. Pushing interest rates to positive real levels at all cost under these circumstances exacerbates inflation and, as has frequently happened, ends up with extremely high real rates which are then very difficult to bring down and are destructive of investment and growth for years. An internal agency study (1983) found that "rising real credit was basically the debt of the corporate sector, and so corporate debt-to-equity ratios increased. High real rates transferred producers' income from firms (equity holders) to rentiers (depositors, bondholders, foreign creditors and the like), allowing for less accumulation of retained earnings and creating a need for more borrowings to finance asset positions. And, of course, these borrowings were forthcoming because real balances of domestic credit instruments were rising in response to high real rates. Overall, we might say that sustained high real rates of interest have had a corrosive effect on the structure of enterprise finance."

Professor Taylor, looking at the same phenomena in a macro perspective, on the basis of WIDER country studies of stabilization and adjustment, 1986, observed:

"Economy-wide, both econometrics and country experience suggest that the overall saving rate does not react to the rate of interest. Even if saving propensities shift upward, extra resource flows will not materialize unless there is higher investment demand. Otherwise potential saving surpluses will vent in the form of reduced commodity purchases or speculation... The second interest rate channel involves the possibility that higher rates will not only cause contraction, but also inflation from working capital costpush..."

From the viewpoint of economic growth, the desirable long-run policy is that of a low positive real rate of interest: it will maximize investment without discouraging savings. This seems to have been the Japanese experience. If a country can attract foreign deposits – perhaps from its nationals living abroad – it should offer an extra interest margin. Countries which are not able to control capital outflow must offer a minimum critical level in competition with international interest rates in order to avoid a "liquidity trap" due to demand for foreign financial assets.<sup>37</sup> According to a recent

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<sup>37</sup> Professor Gouda Abdel-Khalek, in the WIDER study on Egypt, notes that raising interest rates on bank deposits reduces the market value of bonds, so that the observed increase in bank deposits in Egypt may have been at the expense of other types of financial assets, *i.e.*, government securities. *WIDER Country Studies No. 9: Egypt*, March 1987 (see Appendix)

Caribbean study, "The scope for independent interest rate setting is limited to a corridor around the ruling rate on international financial markets where the costs of transferring funds outweigh the potential interest gain, a margin we estimate at one or two points." <sup>38</sup> The margin should be larger in more closed economies.

### *Import liberalization*

The dominant view held in major lending agencies is that import liberalization is needed to improve the competitiveness of the entire economy, through associated pressure on costs, taking in stride, as an inevitable price of progress, closure of firms unable to stand the competition of additional imports. The improvement in allocative efficiency, it is expected, will lead to rapid export growth, and this will recoup any losses which may have occurred in the meantime.

The country studies in the WIDER project have difficulty in accepting this import liberalization thesis. The study on Peru argues that the pressure for import liberalization in the midst of a severe balance-of-payments shock – and the rejection of price controls as a supporting instrument in an anti-inflation programme – has complicated and impeded the design of a programme better suited to the situation. <sup>41</sup> The study on Mexico states that import liberalization reduces the price of tradeables relative to non-tradeables, shifting resource away from the tradeable goods sectors while simultaneously shifting the consumption towards the tradeables (which are now cheaper). Therefore, the result of import liberalization will be to weaken the trade balance and adversely affect domestic output.

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<sup>38</sup> Lance Taylor, *Varieties of Stabilization Experience: Towards Sensible Macroeconomics in the Third World*, Clarendon Press, Oxford, 1988, pp. 56–57.

<sup>39</sup> Nora Lustig, Jaime Ros, *WIDER Country Studies No. 7: Mexico*, March 1987 (see Appendix)

<sup>40</sup> DeLisle Worrell, *Adjustment Policies in Small Open Economies: Lessons from the Caribbean Experience*, Central Bank of Barbados, January 1986, pp. 37–38 (mimeo.).

<sup>41</sup> Richard Webb, *WIDER Country Studies No. 8: Peru*, March 1987 (see Appendix).

The study on Turkey finds that liberalization through its effect on import composition has worked against capital formation, in favor of consumption and current production requirements. The study on Egypt draws attention to the “basic internal inconsistency” of the stabilization programme in the insistence on devaluation and import liberalization as means to correct the balance-of-payments disequilibrium. Each of these prescribed measures is going in the opposite direction to the other.<sup>42</sup> In Hungary, a non-WIDER study country, the Government estimates that “last year’s [1985] liberalization of imports – urged ... to modernize Hungarian industry – cost around U.S. \$100 million. Another \$100 million of the trade deficit was accounted for by added imports of consumer goods. The Hungarian Government had the ‘political will’ to restrict consumption in order to regain equilibrium in the payments balance ... Import restrictions were reintroduced.”<sup>43</sup> Professor Taylor, commenting on the WIDER findings, argues:

“Advocates (of liberalization) point to three advantages. The first – conjunctural – is that removing trade barriers is anti-inflationary. ... This notion lacks decisive empirical support ...”

The second gain from liberalization is secular: according to numerous theorems of neoclassical economics, production and efficiency rise when distortions are removed. The theory is not uniformly supported by the evidence from the WIDER sample. ‘Success’ cases such as South Korea, Brazil, and Turkey are scarcely historical paragons of liberal policy; extreme antidistortionist regimes were associated with macroeconomic disaster in the Southern Cone and current stagnation in Mexico and elsewhere. These examples suggest that although liberalization is attractive intellectually to mainstream economists, its usefulness in practice depends on the circumstances. And surely, in the short run, rapid dismantlement of barriers to trade (and capital movements) can create payments problems like a shot.

Third, no one doubts that quantitative restrictions go hand-in-hand with intrusive bureaucracies, wasteful rentseeking, and so on. Retaliation on the part of trading partners to import restraints and export subsidies is known to occur. A question of rising costs and decreasing benefits to trade intervention arises, with the slopes and positions of the curves highly dependent on context.

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<sup>42</sup> Abdel-Khalek, *op. cit.*

<sup>43</sup> Statement by Mr. Ede Bako, Managing Director of the Hungarian National Bank, on the recent deterioration in the balance of payments, *Financial Times*, 28 October 1986.

The WIDER country papers emphasize the potential gains from directed intervention: import quotas, export subsidies, and a differential commercial policy regime all around.”<sup>44</sup>

Professor Helleiner arrives at the same conclusion, from a different starting point:

“Few would quarrel with the aspiration to remove or reduce import controls wherever possible. They tend to introduce inefficiency and corrupt practices when they are long maintained. But the timing of their removal and/or rationalization must be determined in the overall context of the economy’s circumstances. Some would also say that liberalization is best undertaken in the context of GATT bargaining. To advocate liberalization during periods of foreign exchange crisis is to risk the imposition of even greater economic costs upon an economy already operating under stress and below capacity. Premature and ill-timed liberalization episodes will set back the prospect for greater efficiency and improved overall economic performance in the longer run.”<sup>45</sup>

Implicit assumptions of the trade liberalization model are: first, that there is full employment in the country undertaking import liberalization, so that the labour losing jobs in industries which cannot survive, will quickly find jobs elsewhere, probably at better wages; and secondly, that the country can afford additional imports due to liberalization, and if it cannot, it should devalue somewhat more than it would otherwise do, so that it can pay for additional imports through additional exports. Neither of these two assumptions is valid in most developing countries. The labour made redundant is added to the army of the unemployed, at least until new export opportunities arise which will take time; and additional devaluation will contribute to a reduction of real wages through its effects on domestic prices, and if the country is a primary exporter (which in most cases it will be), devaluation may contribute to a deterioration in its terms of trade.

The above is not to say that cutting overly protective tariffs and monopolistic profits generated thereby and through rigid import quotas is a bad policy. Rather the emphasis here is that reform of the protective system should be pursued at a deliberate speed, with due care for employment, and, to the maximum extent possible, in exchange for trade concessions granted by other countries to the home country’s exports. Only as export industries expand and full employment is approached, can one embark on reducing import protection more generally, starting with the highest rates and moving down, making always certain that full employment is sustained.

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<sup>44</sup> Taylor, *op. cit.*, p. 50

<sup>45</sup> G. K. Helleiner, *Policy-Based Lending and The World Bank: Prospects and Possibilities*, March 1986, p. 17 (draft, mimeo.).



Deep involvement of financial agencies in import policy matters of their debtors is a relatively recent phenomenon. In the inter-war period, financial missions headed by Dr. Kemmerer to a number of developing countries, which have some resemblance to the missions of present international financial agencies, handled currency stabilization, central bank and general banking reform, and fiscal system reforms, but Dr. Kemmerer refrained from trade matters.<sup>46</sup>

### *Differences in economic policy and development strategy*

Differences between the key lending agencies and a varying number of developing countries can be summarized under two headings:

- (a) selective or generalized policies of adjustment to shocks;
- (b) The room for government intervention in the pursuit of a specific long-run development strategy.

*Adjustment to shocks.* The IMF staff has provided a lucid description of its policy and guiding principles:

“Aside from monetary [credit restraint] and exchange rate policies [frequently devaluation], a typical Fund programme calls for fiscal measures, such as reductions in government expenditures and increases in taxation, increases in domestic interest rates and producer prices to realistic levels, ... trade liberalization, and wage restraint ... Although a theoretical case can be made for controls and restrictions in the short run, in practice it has proved difficult to manage such systems efficiently and effectively over time. Furthermore, such policies, by introducing rigidities in the economy and creating incentives for the inefficient use of resources and forms of production, can turn out in the long run to be counter-productive and damaging to the growth potential of the economy ... The Fund has consistently opposed the introduction of new restrictions, as well as the intensification on a permanent basis of existing restrictions and other distortions in the trade and payments system.”<sup>47</sup> Hence a deflationary decline in output for a period is inevitable and is “a necessary part of the adjustment to eliminate underlying imbalances in the economy.”<sup>48</sup>

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<sup>46</sup> Barry Eichengreen, *House Calls of the Money Doctor: The Kemmerer Missions to Latin America*, Harvard University-WIDER, June 1986.

<sup>47</sup> Kahn and Knight, *op. cit.*, pp. 2-3.

<sup>48</sup> *Ibid.*, p. 5.

WIDER country studies have confirmed the expectation that output would fall in a generalized adjustment. They have argued that a selective adjustment, relying in part on controls, would have caused less damage to output, investment and the position of poor people. The studies could not confirm or deny the thesis of damage to long-run growth arising from controls and selective adjustment: such a thesis is beyond scientific proof, except some time after the event in a particular country, and even then it will be a subject of controversy in many cases.

Differences of views on the appropriate response to shocks are difficult to reconcile. According to Governor Blackman, speaking from a position of strength in a country which has managed the crises remarkably well:

“... the perspective of my lecture reflects my experience as a contributor to economic policy-making in Barbados over the past thirteen years. Although there have been broad areas of agreement between the IMF and the Barbadian authorities, our policies throughout the last fifteen years have been based on economic principles which, from the conventional IMF-World Bank perspective, must be viewed as distinctly heterodox. The major source of departure from the IMF-World Bank economic doctrine over the years has been over the concept of stable equilibrium and the efficacy of the free market both in the adjustment process and in the promotion of economic development.

For example, upon realigning our currency from the pound sterling to the U.S. dollar in July 1975, the Barbadian authorities revalued upwards by 10 %. We went on to enjoy five of the most prosperous years in our economic history and have maintained that parity ever since. In the high inflation years of 1973 and 1974, we rejected the prescription of positive interest rates; by 1976 inflation had fallen to 6 %. Since 1977 we have rejected the approved global credit controls and applied selective credit controls which discriminate in favour of the productive sectors. I think we have done much better than many who did otherwise.”<sup>49</sup>

The dilemma facing policy formation in a developing country, the uncertainties about the outcome of government intervention, and the political inevitability of intervention in the presence of major economic shocks are set out by Dr. Richard Webb, a distinguished economic scholar, formerly on the World Bank staff, then Governor of the Central Bank of Peru, and later Economic Advisor to the Prime Minister, in a 1986 study:

“The causes of collapse, and of the failure to recover in the last two years, are not easy to unravel ... Idle capacity and unemployment grew rapidly during 1983 as overall demand was reduced by public expenditure cuts and by capital flight created by rising inflation and generalized uncertainty. Efforts to increase the fiscal take by raising gasoline and other controlled prices (...) along with a faster daily devaluation rate, pushed inflation into three digit levels for the first time. The economy seemed to be caught in a series of vicious circles in which further adjustment efforts

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<sup>49</sup> Blackman, *op. cit.*, pp. 4-5.

had both positive and negative effects, exacting a high price in both inflation and recession, and in political erosion, for marginal fiscal and balance-of-payments improvements. Certainly, by late 1984, the severity of adjustment efforts could not prevent the eventual breakdown of normal debt service.<sup>50</sup> The [generalized] approach to adjustment proved to be highly inefficient in cost-benefit terms.

A more selective approach to adjustment would probably have been more effective. In particular, a more direct attack on the balance-of-payments deficit, combining greater devaluation with import and capital controls, would have reduced the burden on recessive income-adjustment mechanisms, including the sharp reduction of government expenditures. Industrial policy could have been even more selective, supporting activities that could generate exports or save on imports using idle capacity, and also providing quicker and more supervised financial support where the threat of bankruptcy was causing output reduction.

These suggestions add up to a heroic agenda for a country with a particularly weak administrative base and little experience in such efforts. Also, direct interventions invariably give rise to distortion, corruption and inefficiency. Nevertheless, it is hard to accept that those costs could have been larger than the massive output reduction, unemployment, and impoverishment that actually occurred.”<sup>51</sup>

*Development strategy.* The two schools in development theory – “structuralists” and “neoclassicists” – have been struggling for influence in the development finance institutions, and particularly The World Bank, since the beginning of its operations. The neoclassicists have been in ascendance during the last ten years. The conflict concerns the role of government in development strategy and policy. Neoclassicists argue that this role is simply to establish an economic environment in which free market prices will realize the efficient allocation of resources. The neoclassicists advocate “a neutral” policy regime, meaning that policies should not selectively favour priorities of sectors and industries. They allege that there are few inherent market failures and that existing market imperfections are by and large due to policy failures. The core of neoclassical prescription for a neutral policy regime is free trade. Pushed to its logical conclusion, the neoclassical view denies the need for any industrialization strategy and corresponding protection. If, as a practical matter, protection must be given, tariffs should be low and equal, in effective terms, across industries.<sup>52</sup>

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<sup>50</sup> Compared to 1982, GDP per capita in 1985 had fallen 13 %, wages in the modern sector 35 %, imports 58 %, investment 39 % and food subsidies 93 %. (Webb, *op. cit.*, p. 20).

<sup>51</sup> Richard Webb, *Domestic Crisis and Foreign Debt in Peru*, WIDER, Helsinki, August 1986.

<sup>52</sup> Howard Pack and Larry E. Westphal, *Industrial Strategy and Technological Change*, *Journal of Development Economics*, 22 (1986), pp. 88–89.

The success of the newly industrializing countries in East Asia, and particularly South Korea, in penetrating export markets and absorbing modern technology, was initially taken as a proof of the validity of the neoclassical view. Detailed research has shown that the proof is not there. "A case for liberalization cannot be based on an impartial reading of Korean economic history. The evidence supports the view that both in the 1960s and 1970s, government intervention underscored the emergence of a solid industrial structure."<sup>53</sup> "Selective intervention has contributed to the success, and it has done so by accelerating the rate of industrial growth with little if any compensating loss in efficiency terms."<sup>54</sup> Korea has moved from protected import substitution to export expansion supported and guided by the government. Like in the case of Japan, it is not the absence of government support and the free trade, but intelligent use of incentives, protection and other industrial policy which have contributed to the establishment of a powerful and most modern industry.

Excessive preoccupation with getting protection down has pushed into the background the fundamental issues of transfer and absorption of technology and its organizational arrangements. It has been forgotten that "tariffs or quantitative controls are superior to free trade if the resulting immediate loss in users' surpluses is more than offset by restriction-induced future gains in users' surpluses. Thus, in the absence of perfect tradability, restrictions to promote the acquisition of technological capability can be superior to free trade, since the acquisition of technological capability can lead to lower prices and to differentiated products that would not otherwise exist."<sup>55</sup> There are also new findings concerning infant industry protection. "The traditional version of the argument relied either on imperfect capital markets or external economies to explain why temporary protection was needed to establish an industry. In the new version, the emphasis is instead on increasing returns internal to a firm. A protected home market allows firms to move down their marginal cost curves (or down their learning curves in a dynamic model), lowering costs and raising market shares in all markets. A striking conclusion is that a protected market may actually serve as a springboard for increased exports. Recent simu-

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<sup>53</sup> Amsden, *op. cit.*, p.1.; Colin I. Bradford, Jr., 'East Asian Models: Myths and Lessons' in *Development Strategies Reconsidered*, edited by John P. Lewis and Valeriana Kallab, Overseas Development Council, Washington, D.C., 1986, discusses the extensive role of governments in South Korea and other East Asian countries.

<sup>54</sup> Pack and Westphal, *op. cit.*, p. 97.

<sup>55</sup> *Ibid.*, p. 117.

lation analyses ... seem to confirm the importance of this effect for several actual industries. The problem with applying the new infant industry argument – better described as the argument for 'import protection as export promotion' – to LDCs is that it depends on the domestic market being fairly large.”<sup>56</sup> Hence the need for economic cooperation of developing countries in suitable cases, to build an internationally competitive industry.

Most developing countries have learned from their excesses in pushing the expansion of industries which they were unable to use effectively either because specific projects failed or because foreign exchange shortages blocked the supply of imported inputs and spares; many, perhaps most, are now giving priority to export development; and most are aware of the need to promote agricultural growth. Neoclassicists, through their writings and advice, have contributed to this new awareness. But virtually all developing countries remain committed to industrialization, which calls for incentives and other government support. The ongoing depression of their export commodity prices serves to strengthen this commitment. There is a danger of a serious strain in the relations between developing countries and development finance agencies unless the latter relax their pressures for free trade.

## ***5. Suggestions for a new approach***

Three suggestions are made below. First, the financial agencies should encourage member country governments requesting adjustment assistance to submit their own programmes of adjustment; the present practice of the agencies preparing these country programmes should be discontinued. Secondly, the agencies should decide on their loans on the basis of their assessment of the debt servicing capacity and financial management of the borrowers, with loan conditions being normally confined to factors bearing on these two areas; this would modify the present primary emphasis of conditionality on influencing national economic policies in a specific direction. Thirdly, a system of regular exchanges of information and economic policy views between the borrowers and the agencies should be instituted; this would enable the policy dialogue to be continued, but in a consultative manner.

### *Country programme initiatives*

The World Bank is on record as recommending that member countries have the initiative for the preparation of adjustment prog-

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<sup>56</sup> Paul Krugman, *New Trade Theory and the Less Developed Countries*, WIDER, Helsinki, August 1986, pp. 25–26 (mimeo.).

rammes. The Bank's 1986 report on Africa lists several areas in which further steps should be taken to strengthen the system of developed-developing country cooperation:

"First, governments in Africa must be seen to have the prime responsibility for designing their adjustment and investment programs and for coordinating aid and other financial flows. Donors can assist in the task – but they should not undermine this responsibility by trying to negotiate their own favorite package of policy reforms or by promoting their own pet projects. To this end, the African countries must strengthen their core ministries of finance and planning, and the units that coordinate their foreign assistance."<sup>57</sup>

Mr. Conable, the Bank's President, hoping to avoid frictions over lending conditions, says he wants the developing countries themselves to come up with the policy changes that they think will spur faster growth – rather than have conditions imposed by the institution.<sup>58</sup> A World Bank staff study suggests that "the creation of an institutionalized process under which reform is analyzed and pursued may be more important than achieving policy reform targets involving specific price and exchange rate levels. Prices and exchange rates can always be changed again, in the wrong direction. However, solidly established processes for analyzing and implementing policy reform may have a more durable impact in the long term. In addition, the process of analyzing may uncover some of the unknowns regarding agricultural growth. Thus the reforms pursued should be regarded as a process, rather than a condition to be achieved."<sup>59</sup>

I have not come across similar statements of the Fund, but they may exist. A recent Fund staff study, talking about the present practice, says that the Fund designs country stabilization programmes: but another study stresses that they are "Fund-supported" rather than "Fund" programmes, adding that "the country plays an active role in its formulation."<sup>60</sup> The issue of responsibility for the preparation of country stabilization programmes must have been discussed repeatedly in the Fund.

First, the fundamental advantage of a country-prepared programme is that it would reflect its views on economic policy better than a mixed parentage programme, and it would represent its

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<sup>57</sup> The World Bank, *Financing Adjustment With Growth in Sub-Saharan Africa, 1986–90*, February 1986, p. 38.

<sup>58</sup> As reported in *The New York Times*, 30 September 1986, following the interview.

<sup>59</sup> Cleaver, *op. cit.*, p. 28.

<sup>60</sup> Fund-Supported Programs, Fiscal Policy and Income Distribution, *op. cit.*, p. 3.

commitment to carry out the programme. The WIDER Tanzania study, for example, argues that since policy reforms have to be implemented by government, it is their commitment that will enable the adjustment effort to be sustained. Purely 'imported reforms' via conditionality alone will have limited effectiveness. Thus while using coordinated conditionality in aid disbursement to encourage change, the key initiative role has to remain with the concerned government. Informed dialogue rather than unilateral conditionality pressure from outside creates better political environment for adjustment internally.<sup>61</sup>

The second advantage of a nationally-generated programme is that it would lead to a country-specific treatment of the adjustment problem, adapted to individual circumstances. Dr. Frances Stewart, in a pioneering study proposing country-generated adjustment programmes, suggested that this may lead to a new typology of programmes:

"While Fund conditionality tends to be rather stereotyped – a single model applied to most countries – it is likely that there should be a number of alternative models, incorporating special economic and political factors. It seems probable that different packages would be suitable for low-income countries dependent on primary products, for mineral exporters, for countries with a strong manufacturing sector that has been inward-directed and for countries with outward-oriented manufacturing sectors. Other factors would be a country's size and political variables."<sup>62</sup>

The third advantage of nationally-formulated programmes is that they would be based on better information. As argued by Professor Kenen, "The Fund may have more experience than any government, but it cannot be expected to have more information. It may know more about the international economy because of its ability to gather and integrate information from many governments. It is not likely to know more about each national economy."<sup>63</sup>

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<sup>61</sup> Benno J. Ndulu, *WIDER Country Studies No. 17: Tanzania*, March 1987 (see Appendix). According to a senior World Bank official, "perhaps the most general conclusion that can be drawn from the Bank's experience to date is the importance of recipient's commitment to a particular course of reform for the ultimate success of the policy package." (Constantine Michalopoulos, *World Bank Programs for Adjustment and Growth*, Washington, D.D., February 1987, p. 33 (mimeo).)

<sup>62</sup> Frances Stewart, *Alternative Conditionality*, in *SID/North-South Roundtable*, *op. cit.*, p. 214.

<sup>63</sup> Peter B. Kenen, *Financing, Adjustment and the International Monetary Fund*, The Brookings Institution, 1986, p. 49. The same point has been stressed by Professor Edmar L. Bacha.

The subject-matter of nationally formulated adjustment programmes should not be expected to be much different from that under the present programmes – problems do not change because the procedure has changed – with one major additional element. The developing countries will normally insist on adjustment with growth and therefore on the integration of growth objectives in financial programmes. As argued by Dr. Buira:

“Developing countries in general attach greater weight to their development than do creditors. For them, the distinction between balance of payments and development finance is somewhat artificial, since they see the development of foreign exchange earning ability and the structural transformation of their economies as the means that will ultimately permit attaining a healthy and durable balance of payments position. The immediate objective of Fund programs has been the correction of the balance of payments problems. Occasional references in programs to growth rates are usually assumptions or forecasts rather than targets. In fact, growth objectives are not an integral part of the program in the same way that balance of payments or fiscal objectives are. This points to a serious imbalance in the design of programs ... A Fund program may integrate the growth objective by setting a positive global growth goal coupled with the external financing required to attain it.”<sup>64</sup>

More generally, differences between the present and the nationally designed programmes will appear mostly in proposed remedies and policy instruments.

The majority of countries have sufficient staff to put together adjustment programmes suitable for discussion with external lenders. Some countries will probably need assistance. It could be provided by the lending agencies; by consultants; United Nations and UN Economic Commissions; or by a special advisory staff group which may be set up under the Chairman of the Group of 24 (developing countries) which operates within the Bretton Woods institutions or under the Chairman of the Group of 77 (developing countries) whose offices are at the United Nations. There may be yet other possibilities. It may also be possible to obtain UNDP support for this work. The benefits and costs of each solution should be considered further.

### *Agency responsibilities*

In assessing loan requests and the associated country programmes, financial agencies have three main responsibilities: to assure, first, that borrowed funds will be used to promote economic growth and stability of the borrowing country; secondly, that loans will be ser-

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<sup>64</sup> Ariel Buira, *Adjustment with Growth and the Role of the IMF*, 20 December 1986, pp. 16–17 (mimeo.).



viced and repaid; and thirdly, that the broad interests of country membership as a whole – increased world income, employment and trade – will be helped.

Mr. Sidney Dell, Dr. Stewart and Dr. John Williamson agree that there is a difference between what “the Fund has a right to insist on when it makes a loan – the assurance that a programme adequate to secure a payments turnaround will be implemented”<sup>65</sup> (*i.e.*, that the loan will be repaid) – and the use of “its unique lending position to impose a particular set of policies on borrowing countries, which it believes is good for them: this is what Sidney Dell has described as the ‘grandmotherly’ function.”<sup>66</sup> The situation is probably similar with respect to World Bank’s “structural adjustment loans”, although full details are not yet available. Project and sector loans do not raise this problem as long as they do not deal with economy-wide policy issues. There is no dispute about the repayment function and project sector conditionalities; it is agreed that they make it possible for the financial institutions to discharge their responsibilities. The dispute is about the “grandmotherly function.”

The financial agencies take greater risks than commercial lenders as they continue to lend when commercial lending has stopped, and they normally charge lower interest rates than the market despite the greater risks. These extra risks could be taken as a justification of the “grandmotherly function.” In actual experience, the risks have proven small, however: most debtors have consistently given priority to servicing the agency loans, even at most difficult times. Under these circumstances, it is difficult to justify the “grandmotherly function” of the scope and depth it has obtained, particularly when there is a dispute concerning the economic theory on which substantial parts of this “function” rest.

Conditionality has two aspects: the need for orderly financial and administrative management, and changes in economic policy. The first aspect – orderly management – is indispensable under any circumstances and in any social and economic system. Included here are orderly tax administration and enforcement, tight public expenditure controls, realism of investment and financing plans, control over foreign borrowing, anti-corruption drives and enforcement, drives for accountability and sound management in public enterprises, stopping the use of government service to provide jobs,

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<sup>65</sup> John Williamson, *The Lending Policies of the International Monetary Fund*, in John Williamson ed., *IMF Conditionality*, The Institute for International Economics, 1983, p. 632.

<sup>66</sup> Stewart, *op. cit.*, pp. 201–202; Sidney Dell, *On being grandmotherly: the evolution of conditionality*, Essays in International Finance No. 144, Princeton, 1981.

speed in decision-making and in the implementation of government decisions, policies to discourage, and measures to prevent, capital flight. The other aspect of conditionality – economic policy – is a matter which by its nature does not tolerate uniform treatment or a uniform doctrine or ideology. It affects income distribution, the strategy of resource allocation, the role of the government in economic life, the degree and the method of involvement in international trade, in short the essential philosophy of public policy. The interest of creditors in the economic policy of their debtors cannot be denied as it affects the service and safety of their claims. On the other hand, creditors should not assume the role of makers of national policy in debtor countries: it is the political leaders of these countries who carry the responsibility for possible mistakes and pay for them with their jobs, and in extreme cases even with their lives.

A possible way out of this dilemma is to confine conditionality to factors bearing on debt servicing capacity and sound financial management, and at the same time institute a system of exchange of information, experiences and views on economic policy at regular intervals, on a consultative basis. Financial agencies would then have the opportunity to convey any concerns they may have, and debtors to present their views and expectations. Such consultative arrangements would preserve the beneficial aspects of the country-agency relationship, while reducing the frictions and confrontations. The high professional quality of the staff of the agencies and their enormous accumulated knowledge and experience would continue to be available to developing countries; the agency staff would continue to benefit from a first-hand exposure to reality in developing countries; and while it is only realistic to expect that problems in country-agency relations will continue to exist, perhaps the way of resolving them would be smoother.

## **APPENDIX**

### ***WIDER Stabilization and Adjustment Policies and Programmes Country Studies***

- No. 1 Reginald H. Green: GHANA
- No. 2 Manuel F. Montes: THE PHILIPPINES
- No. 3 Bill Gibson: NICARAGUA
- No. 4 Rolph van der Hoeven and Jan Vandemoortele: KENYA
- No. 5 Korkut Boratav: TURKEY
- No. 6 José Antonio Ocampo and Eduardo Lora: COLOMBIA
- No. 7 Nora Lustig and Jaime Ros: MEXICO
- No. 8 Richard Webb: PERU
- No. 9 Gouda Abdel-Khalek: EGYPT
- No. 10 José Pablo Arellano, René Cortázar and Andrés Solimano:  
CHILE

- No. 11 Dionisio Carneiro: BRAZIL  
No. 12 José Maria Fanelli, Roberto Frenkel and Carlos Winogard:  
ARGENTINA  
No. 13 Pronab Sen: INDIA  
No. 14 Alice H. Amsden: REPUBLIC OF KOREA  
No. 15 Lal Jayawardena, Anne Maasland and P. N. Radhakrishnan: SRI  
LANKA  
No. 16 Jacques Hiey Pegatienan: COTE D'IVOIRE  
No. 17 Benno Ndulu: TANZANIA

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