

A Role for the International Monetary Fund in Economic Development *

1. Introduction and Background

One of the effects of the world's faltering economic performance as well as of changing political attitudes in some large and powerful countries is that the activities of international institutions in general and the International Monetary Fund (IMF) in particular have recently come under close scrutiny. Having had a significant proportion of the part allocated to it at Bretton Woods in 1944 written out by the move to generalised floating and the evolution of a non-centralised method of international reserve creation, there is now some debate as to whether the Fund can fulfil any useful role in the 1980's and beyond, and, if so, what this role should be.

The Fund has been under considerable pressure from the governments of rich and poor countries alike as well as from both ends of the political spectrum. While some industrialised country governments, and most notoriously the United States, see only a small part for the Fund to play in an international financial system dominated by private commercial banks and national monetary authorities, governments in some developing countries are highly critical of the way in which the Fund currently conducts its business and are reluctant to see its existing activities extended. Even its own management seem uncertain about what role the Fund should have. Although frequently quick to point to deficiencies in the international economic system in terms of both efficiency and equity, the Fund has usually been constrained from doing much to alleviate the situation in practical terms, either because of a shortage of resources, or because of organisational inertia, or because its

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Articles of Agreement are interpreted as defining a strictly limited role. Ultimately, of course, the Fund's role is determined by its Board of Executive Directors, and these in turn reflect the wishes of the governments represented. Where changes are advocated it is the member governments which need to be persuaded.

The argument presented in this article is that while much of its traditional role in overseeing the international financial system has disappeared, at least temporarily, the Fund's role in fostering world economic development has taken on a new urgency and importance. Many countries have moved into substantial balance of payments deficit during the 1970's and 1980's, the world economy has gone into recession, and the international banking system has become rather fragile. By providing financial assistance to those largely non-oil developing countries in deficit, the Fund can complement the private international banks and increase the stability of the world's financial system. It can also exert an anti-deflationary impact on the world economy and raise levels of real output, employment, and trade, above what they would otherwise have been. The relatively minor modifications to Fund practices needed to help realise these major objectives would certainly be within the spirit, and could easily be within the letter of the Fund's existing Articles. Their outcome would be an enhanced role for the Fund both in relation to its existing one, and in relation to that of the private international banks.

The argument supporting a role for the Fund in economic development is built up in the following way. Section 2 briefly summarizes the existing situation and identifies some of its weaknesses. Section 3 puts forward suggestions to remedy these deficiencies, and Section 4 examines some of their implications. Section 5 briefly offers a few concluding remarks.

2. Weaknesses of the Existing Situation

There are a number of channels through which the Fund may exert an influence over economic development. First, it provides a direct source of financial assistance at either near-market or concessionary rates. Second, because a large proportion of its finance is conditional, it has a considerable say in the conduct of economic policy in those

countries turning to it for financial help¹. Third, it may have a catalytic effect on private capital flows, with the negotiation of a IMF programme encouraging private banks to lend (or lend more) to countries that would otherwise have seemed less creditworthy. Finally, it advocates a liberal world trading and financial system; to the extent that it can persuade industrial countries to desist from protectionist measures it may assist the economic development of poorer countries. Let us examine these channels in more detail.

i) *The IMF as a Source of Finance: The Size of Flows*

Table 1 provides information on the quantity of finance that the Fund has made available to developing countries over recent years. Perhaps the most noticeable aspect is that the volume has been relatively small in relation to both the size of the deficits experienced and the credits provided by the private Eurocurrency banks.

Having said this, some reservations need to be made. First, in certain countries the proportion of the deficit covered by Fund finance has been significant, rising to as much as 40 per cent or more. Indeed, even the proportion of the overall deficit covered has been much higher in some years than in others rising to as much as 14 percent in 1976.² Second, although the aggregate figures suggest that the private banking sector has made a much more important contribution to financing than has the Fund, this picture is somewhat illusory. The vast majority of

¹ Finance is available from the Fund on both a low and high conditionality basis. Low conditionality finance is available under the first credit tranche, the Compensatory Financing Facility and the Buffer Stock Financing Facility and merely involves countries agreeing to make reasonable efforts to solve their payments problems. Drawings in the upper credit tranches and the Extended Fund Facility require the negotiation of a macroeconomic programme with narrowly defined and quantitatively expressed targets or 'performance criteria'. The borrowing country's government undertakes to realise these 'performance criteria' in a 'letter of intent' and the finance, which is available only in installments is conditional on compliance with the 'performance criteria'. In addition to these Fund programmes also involve preconditions — actions which must be undertaken before an agreement is put up for approval by the Executive Board — and other policy elements. Although the latter may cover a wide range of policies the availability of finance is not conditional on the agreed policies being implemented. For this reason preconditions and performance criteria form the hard core of an IMF programme. By 1980/81 about 75 per cent of new lending by the Fund involved high conditionality, the figure having been as low as 10 per cent in May 1979.

² During the 1970's, the Fund established the Oil Facility (for two years) to help deal with the implications of the first oil price increase and an Extended Fund Facility which is supposed to help deal with the structural causes of deficits. A Trust Fund financed largely from gold sales by the Fund was also set up to assist the least developed countries. The Compensatory Financing Facility was liberalised to cover increased expenditure on some imported food items resulting from shortfalls in domestic production. For further details see BIRD (1978).

private bank lending has been to a quite small elite of high and middle income countries.³ Increasingly the Fund, on the other hand, has been lending to the poorer low income countries that the banks deem uncreditworthy.⁴ Starved of commercial bank credit, these countries rely heavily on the Fund as well as on conventional aid. Third, in countries where both the Fund and the banks are involved it may well have been the Fund's involvement that enticed the banks to lend.

Returning to the overall picture, there must now be some legitimate doubt as to whether the private banks have become too heavily involved in balance of payments financing in developing countries. Many of the countries to which they have lent have encountered debt problems that have from time to time threatened the future stability of the entire international banking system. There is a case for halting, and perhaps even reversing, the move to the market place that gathered momentum in the aftermath of the first major increase in the price of oil in the early 1970's.⁵

This, of course, is not to deny that the banks have fulfilled a vital recycling function. As a result the world recession has been less deep than it would otherwise have been, and levels of world trade have been higher. And yet, at the same time, bank lending has in some ways been destabilising. Conventionally the banks have refrained from imposing conditions on their loans; there is therefore little to prevent borrowing countries from using the money acquired to finance current consumption or indeed military expenditure — uses which hardly increase economic growth or improve the balance of payments, and do nothing to enhance future ability to repay. Frequently encouraged to lend by an increase in export receipts or by the discovery of natural resources, individual banks are under some pressure to cut and run as soon as economic performance deteriorates, even though collectively there are pressures to reschedule debt to avoid default and a loss of confidence in the system as a whole. A potential implication of commercial borrowing is that key economic variables in debtor countries become highly unstable with periods of

³ In 1979, for example, Brazil, Mexico, and Argentina together absorbed 83 per cent of all net Eurocurrency lending to non-oil-developing countries, and 99.7 per cent went to just five countries. Low income countries have at times actually been net depositors with the Eurocurrency market. (KILLICK, 1981 a). See also BIRD (1981 a).

⁴ As of end 1981, some 56 per cent of outstanding IMF credits were with countries where 1978 per capita income was less than \$ 700 while only 5 per cent were with countries where it was more than \$ 3,000. Evidence for 1982 suggests that as much as two thirds of total IMF commitments are with countries where 1978 per capita income was less than \$ 700 and more than 80 per cent of these commitments were in turn with countries with per capita income of less than \$ 300.

⁵ For a clear presentation of this case see LLEWELLYN (1982).

TABLE 1

NON-OIL DEVELOPING COUNTRIES: CURRENT ACCOUNT FINANCING, 1973-82¹
(in billions of U.S. dollars)

	1973	1974	1975	1976	1977	1978	1979	1980	1981	1982
Current account deficit ²	11.6	37.0	46.5	32.0	28.3	39.2	58.9	86.2	99.0	97.0
Financing through transactions that do not affect net debt positions	10.1	13.0 ³	11.8	12.0	14.9	17.2	23.0	24.1	26.3	27.8
Net unrequited transfers received by governments of non-oil developing countries	5.4	6.9 ³	7.1	7.4	8.3	8.2	10.9	12.3	12.9	13.6
SDR allocations, valuation adjustments, and gold monetization	0.4	0.7	-0.6	-0.2	1.3	2.1	2.8	1.8	-0.2	—
Direct investment flows, net	4.3	5.3	5.3	4.7	5.3	6.9	9.2	10.0	13.6	14.1
Net borrowing and use of reserves ⁴	1.5	23.9 ³	34.7	20.1	13.4	22.0	35.9	62.1	72.7	69.2
Reduction of reserve assets (accumulation -)	-9.7	-2.4	1.9	-13.8	-12.4	-15.8	-12.4	-4.9	-1.6	-4.0
Net external borrowing ⁵	11.2	23.3 ³	32.9	31.2	25.8	37.8	48.4	67.1	74.3	73.2
Long-term borrowing	11.7	19.5 ³	26.6	27.9	26.5	35.3	37.9	45.5	55.8	59.4
From official sources	5.4	9.3 ³	11.4	10.8	12.6	14.2	15.4	20.5	20.2	22.3
From private sources	8.3	13.7	15.3	19.3	23.0	27.9	33.1	31.4	37.0	38.5
From financial institutions	7.1	12.6	13.8	17.0	19.4	23.9	32.4	30.1	35.5	37.0
From other lenders	1.2	1.1	1.5	2.4	3.6	4.0	0.8	1.3	1.5	1.5
Residual flows, net ⁶	-2.0	-3.5	-0.1	-2.3	-9.2	-6.9	-10.6	-6.4	-1.4	-1.4
Use of reserve-related credit facilities ⁷	0.2	1.7	2.5	4.4	-0.1	0.5	-0.6	1.7	5.4	6.0
Other short-term borrowing, net	0.2	5.2	6.4	12.2	0.8	4.7	10.5	19.9	13.1	7.8
Residual errors and omissions ⁸	-0.8	—	-2.7	-11.2	-1.1	-2.5	0.5			

¹ Excludes data for the People's Republic of China prior to 1977.

² Net total of balances on goods, services, and private transfers, as defined in the Fund's *Balance of Payments Yearbook* (with sign reversed).

³ Excludes the effect of a revision of the terms of the disposition of economic assistance loans made by the United States to India and repayable in rupees and of rupees already acquired by the U.S. Government in repayment of such loans. The revision has the effect of increasing government transfers by about \$ 2 billion, with an offset in net official loans.

⁴ That is, financing through changes in net debt positions (net borrowing, less net accumulation — or plus net liquidation — of official reserve assets).

⁵ Includes any net use of nonreserve claims on nonresidents, errors and omissions in reported balance of payments statements for individual countries, and minor deficiencies in coverage.

⁶ These residual flows comprise two elements: (1) net changes in long-term external assets of non-oil developing countries and (2) residuals and discrepancies that arise from the mismatching of creditor-source data taken from debt records with capital flow data taken from national balance of payments records.

⁷ Comprises use of Fund credit and short-term borrowing by monetary authorities from other monetary authorities.

⁸ Errors and omissions in reported balance of payments statements for individual countries, and minor omissions in coverage.

Source: *World Economic Outlook*, IMF, 1982.

rising domestic consumption and increasing imports being followed by periods of retrenchment, involving strict monetary restraint, exchange rate devaluation, exchange controls, and falling living standards. Such instability is not conducive to economic development. Through the conditions it attaches to its loans, the Fund has the opportunity to encourage policies that generate a much smoother adjustment path; and there can be little doubt that the Fund is in a better position than the banks to formulate appropriate conditions given its more intimate knowledge of individual countries. Indeed, the Fund is uniquely placed to offer both the financing and the adjustment elements that the world economy requires.

It is of course likely that experience will teach the banks to become more careful and prudent in their future lending policies to developing countries. Automatically, therefore, their contribution to balance of payments financing may fall as compared with the peak years of the mid to late 1970's. However, discretionary changes in international policy will be needed to ensure that the IMF is able to fill any vacuum left. Failure to fill this vacuum will impart a further deflationary effect on the world economy, as countries undertake policies to lower imports in an attempt to reduce their deficits to levels consistent with the volume of finance available. Greater IMF participation could therefore help avoid the need for corrective policies that would be expensive in terms of economic development.

ii) *The Nature of IMF Conditionality*

A weakness of existing arrangements is that as a general rule IMF conditionality has not been used in this way. The principal emphasis of IMF stabilization programmes is on credit restraint. In a representative sample of thirty programmes, spanning 1964-1979, credit ceilings clearly emerge as far and away the most frequently stipulated 'performance criterion' and specific condition for Fund assistance.⁶ The strong advocacy of credit ceilings as the fulcrum of adjustment policy is internally consistent with the Fund's view that over-expansionary demand policies are more often than not the prime cause of payments problems.⁷ In circumstances where the fiscal deficit has been allowed to

⁶ For a detailed investigation of Fund programmes, see KILLICK (1981 b).

⁷ See KILLICK (1981 b) and REICHMANN and STILLSON (1978).

grow and has been financed by domestic credit creation there can be little doubt that the imposition of financial discipline is absolutely crucial to payments correction. But in other circumstances there must be more doubt about whether credit control should be allocated the prime role or whether it should adopt only a secondary role. Imagine, for example, a situation where a developing country moves into balance of payments deficit as a result of adverse movements in its commodity terms of trade, or following a reduction in the demand for its exports caused by recession in importing countries. Now assume either that these adverse developments are not purely temporary, or that even where they are the country has insufficient reserves or access to borrowing to finance the deficit, adjustment will be needed. The domestic policy makers' objective may reasonably be expected to be the correction of the deficit with as few harmful effects on other policy objectives as possible.⁸ An adjustment strategy therefore needs to meet two criteria; it needs to be *effective* in actually strengthening the balance of payments, but it also needs to be *cost-effective*, securing this improvement at minimum welfare cost.

In the circumstances outlined above, these criteria will be met by policies which shift resources from non-traded goods (such as services and construction) into traded goods (exports and import substitutes) and which have an output-increasing effect. Policies are needed which encourage structural adaptation in production and trade. The changes needed are real ones, and the question is whether financial policies, of the type favoured by the Fund, will achieve them.

There is little reason to be sanguine. Financial restraint exerts its impact on the current account of the balance of payments by deflating expenditure so that imports are reduced to a level consistent with a given level of exports. To the extent that there is a reduction in the domestic rate of inflation relative to the world rate demand may switch towards import substitutes, while similarly there may be some increase in export demand where prices are quoted in domestic currency, or an increase in export supply as profitability rises where domestic producers simply take the international foreign currency price as given. However, the principal mechanism through which financial restraint works remains that of reducing the level of domestic expenditure. Any effects on structural adaptation are largely coincidental and may even be in the 'wrong'

⁸ Having said this, experience suggests that policymakers in developing countries often put a fairly low priority on economic stabilization, for example, Jamaica under Manley and Indonesia under Sukarno, as well as various episodes in Latin American countries.

direction. With reduced aggregate demand and increased interest rates it is likely that real output and employment will fall. Furthermore, unless imports are exclusively consumption goods or 'inessentials', it is probable that development will become constrained by a shortage of vital imported inputs and this will damage future export performance. Economic development and the longer run underlying strength of the balance of payments will further be impeded where the restriction of credit has a particularly adverse effect on export orientated infant manufacturing industry. In many developing countries this effect of rising interest rates will be more important than the extra incentive they provide for capital inflows. Thus while the restriction of domestic credit may certainly strengthen the short run balance of payments, it is likely to involve substantial costs for development and growth and even for the balance of payments in the long run.

These shortcomings of credit controls as a means of bringing about structural adjustment would, of course, not matter too much if, as the Fund claims, deficits are caused by over-expansionary domestic demand management policy. Although this may have been the case in the 1960's, there is ample evidence that it has not been true for the 1970's and 1980's, when adverse exogenous terms of trade movements have assumed much greater significance.⁹ Unfortunately whilst the causes have changed radically the Fund's prescribed cure has not. Indeed, even in cases where the Fund itself has accepted that domestic demand mismanagement has only been a secondary cause, if that, it has still gone on to advocate fairly conventional deflationary corrective medicine.

Why has the Fund been so committed to credit restraint as the centrepiece of its stabilization programmes? One explanation is that having carried out much of the pioneering work on the monetary approach to the balance of payments the Fund is merely putting theory into practice. This explanation, although perhaps not without a small grain of truth, is largely unfounded. Fund programmes, as well as much of its recent internal research (for example Khan & Knight, 1981), are not dogmatically based on any particular economic theory in a strict doctrinal sense, instead the Fund is fairly eclectic. Thus programmes sometimes stipulate exchange rate changes or advocate prices and wages control; policies which are inconsistent with 'pure' monetary models. Furthermore, unlike monetarists, the Fund shows considerable concern over the composition of the balance of payments, and in particular the strength of

⁹ For a review of the evidence see KILLICK and SUTTON (1982).

the current account. While it is true that even within a monetary model devaluation may be used as a way of speeding up a reduction in the real supply of money, through the effect that it has on increasing the price level (and possibly even the rate of inflation), the Fund's view of devaluation is as an instrument for altering *relative* rather than *absolute* prices and is therefore much more in the tradition of the elasticities approach.

An alternative explanation is that the Fund has in fact been preoccupied with balance of payments correction *per se* and has simply not been very concerned with the effects of its programmes on output and employment. This argument seems to have substantial foundation. Another, and also probably valid explanation is that ceilings on credit creation may at first glance appear to possess the qualities required of a good 'performance criterion'; data on credit may be easily collected without undue delay so that what is happening may be quickly and objectively monitored; the rate of credit creation may seem to act as a reliable barometer or indicator of overall economic performance; and credit creation may further seem to be under the control of the domestic monetary authorities. In fact all these attributes are more apparent than real. There are notorious difficulties associated with monitoring monetary aggregates; and the rate of credit creation is at best an imprecise, and may be a misleading, economic barometer. The crucial relationship for macroeconomic stabilization is that between aggregate demand and aggregate supply. Financial variables say practically nothing about what is happening on the supply side, or in the real sector of the economy. Output, productivity, investment and trade performance are neglected. Similarly by focusing attention on specific numbers, the underlying explanation of why the numbers are what they are is frequently ignored. Many significant aspects of economic performance are therefore overlooked. Finally, the degree of monetary control exerted by the monetary authorities in developing countries which have significant non-monetised sectors is often illusory. It may be technically impossible to hit precise targets, even if it were politically feasible to do so.¹⁰

iii) *The Impact of IMF Programmes*

Although *a priori* reasoning leads to the conclusion that the nature of Fund conditionality is inappropriate to the problems now faced by many developing countries, the acid test of Fund programmes is their

¹⁰ See SHARPLEY (1981) for a review of the difficulties associated with conducting monetary policy in developing countries.

actual degree of success. However, judging success is methodologically rather difficult. First, there is the problem of choosing the economic variables on which it might be expected that Fund programmes would have an influence. Clearly the most important of these is the balance of payments, but even here there is the question of which definition of the balance of payments should be used. For instance, is a programme that induces additional capital inflows a success even though it fails to strengthen the current account? Other important variables to look at are the rate of inflation and the rate of economic growth. As with the balance of payments these variables relate to the ultimate objectives or targets of programmes. In addition to these it may be useful to gauge success by what happens to intermediate instrument variables, such as credit creation or the fiscal balance. A second problem is whether the performance of key variables should be evaluated against what was happening to them before the programme or against the targets that were set for them in the programme itself, or against what would have happened had no programme been implemented. Whichever comparison is made there are difficulties: to what extent can an improvement, or indeed a failure to improve, be attributed to Fund programmes, or have other factors been at work; were the targets realistic or were they over-or-under-ambitious; what would have happened in the absence of an IMF programme, would existing policies have been retained or would an alternative adjustment strategy have been implemented? A third problem in assessing success is that programmes may have different short run and long term effects, so that any judgement as to success will depend crucially on the time period studied.

Having noted these various problems, it is interesting to find that most research, whether conducted inside or outside the Fund, fairly uniformly suggests that programmes have relatively little impact on any of the key variables mentioned above.¹¹ Even where an improvement in some aspect of the balance of payments is observed, this has normally been found to be statistically insignificant. The conclusion would seem to be that, broadly speaking, Fund conditionality is unsuccessful in its prime task of encouraging payments adjustment. Why is this so? Again, a number of explanations may be cited. It may be that governments are not implementing the programmes; that exogenous shocks, such as unforeseen terms of trade movements, push economies off the course

¹¹ See REICHMANN and STILLSON (1978), REICHMANN (1977), CONNORS (1979), and KILLICK and CHAPMAN (1982).

mapped out for them in Fund programmes; or that the programmes are themselves deficient in some way and are simply incapable of inducing the improvements in economic performance that they seek. Whichever of these explanations is accepted — and they are not mutually exclusive — the case for change is supported. Reluctance by governments to implement programmes suggests that for some reason they see the programmes as unhelpful. The vulnerability of programmes to unforeseen external events in a world which is predictably uncertain and unstable suggests that the programmes are insufficiently flexible; while as already explained, there are reasons for believing that financial restraint will fail to bring about the necessary structural adaptation. The upshot of all this is that the Fund is not fulfilling the objectives set out for it in its existing Articles of Agreement (specifically Article 1):

- (i) To promote international monetary co-operation.
- (ii) To facilitate the expansion and balanced growth of international trade, and to contribute thereby to the promotion and maintenance of high levels of employment and real income and to the development of the productive resources of all members as primary objects of economic policy.
- (iii) To promote exchange stability, to maintain orderly exchange arrangements among members, and to avoid competitive exchange depreciation.
- (iv) To assist in the establishment of a multilateral system of payments in respect of current transactions between members and in the elimination of foreign exchange restrictions which hamper the growth of world trade.
- (v) To give confidence to members by making the Fund's resources available to them under adequate safeguards, thus providing them with opportunity to correct maladjustments in their balance of payments without resorting to measures destructive of national or international prosperity.
- (vi) In accordance with the above to shorten the duration and lessen the degree of disequilibrium in the international balance of payments of members.

There is a strong case for changes in both the size and nature of Fund operations so that it may play a more significant role in meeting these aims.

3. Making Good the Weaknesses: Proposals for Change

While the Fund may be criticised for underemphasising policies which influence the real sector of the economy and overemphasising those that affect the financial sector, the 'structuralist' critique of the Fund may itself be criticised for sometimes almost totally neglecting the importance of financial management altogether.¹² Adjustment policy needs to take into account both aggregate supply and aggregate demand; neither side should be ignored. Overexpansionary demand policies can easily frustrate and impede what is an essentially supply orientated adjustment strategy, and aggregate demand needs to be held in check bearing in mind the capacity of the economy to meet it in real terms. The Fund should therefore certainly not abandon its concern with credit creation. Indeed in some cases the 'conventional' Fund programme will be both effective and cost-effective and in these cases there is little reason to change. Fund programmes should however be more flexible, more related to the causes of payments problems, and formulated in a framework which sets out to achieve balance of payments improvement at minimum cost in terms of development. In general, this involves placing more emphasis than in the past on measures which have a beneficial effect on output, investment and trade. The object is to achieve a satisfactory payments position at as high as possible a level and rate of growth of real output, and *sustainable* domestic consumption.

Given the need to shift resources out of non-traded goods production and into traded goods production, how can this be achieved? One obvious option is to use the price mechanism.

Since a greater degree of flexibility in Fund programmes is what is being suggested, it is impossible to give a precisely defined general description of what policies should be adopted. There is bound to be considerable variation between countries, depending on their different economic and political circumstances, including: the causes of the deficit, the degree of openness, the composition of imports and exports, the scope for efficient import substitution, the degree of capacity

¹² Structuralists are generally associated with the advocacy of measures, including large programmes of government spending, designed to break bottlenecks and expand production. For a statement of the 'new structuralist' critique of the Fund see TAYLOR (1981).

utilisation, the values of demand and supply price and income elasticities, the degree of financial and fiscal sophistication, the size of the non-monetised sector, the degree of real wage resistance, the quality of the domestic infrastructure, the scope for domestic energy production, the availability of commercial international credit and aid, the level of international reserves, and the nature of other government objectives.

However a strong case may be made for actively using a vitally important relative price, the exchange rate; using depreciation in developing countries as a cost-effective way of strengthening the balance of payments.¹³ The usual objection that supply elasticities are too low for it to have a beneficial influence seem to be largely unfounded, though elasticities do vary between traditional and non traditional exports and between the long and short run. Furthermore, while it may be expected to have an initially expenditure-reducing effect — which is in any case required if the current account is to improve — depreciation may help to maintain or even increase exports, output and employment. To the extent that output is increased, so are the levels of domestic expenditure, domestic credit, and imports that are consistent with balance of payments equilibrium. As far as economic development is concerned, therefore, exchange rate depreciation (accompanied by disciplined domestic financial policies) represents a superior alternative to rather more exclusive reliance on financial restraint.

In some cases, where elasticities are very low or where there is strong political resistance to the redistribution of income that it causes, depreciation may not work; in any case, it is a rather unsubtle and indiscriminate tool. It therefore needs to be complemented by more specific microeconomic policies. Again, individual circumstances will dictate what these should be, but a few examples will be indicative. Where, for instance, export supply is highly price elastic the price incentive created by depreciation may need to be partially neutralised by imposing export taxes. In the opposite situation export subsidies may be used. Indeed the fiscal system could be more widely used to encourage the growth of exports and efficient import substitutes, to reduce the size of the non-traded sector, to provide incentives for those investments which assist economic growth and the balance of payments, and disincentives for consumption, and to offset those effects on income distribution that are regarded as widening social inequities. Further-

¹³ A more detailed review of exchange rate depreciation in developing countries upon which this conclusion is based may be found in BIRD (1982 c).

more, incomes policy may be used to ensure that the fall in real wages, needed if the balance of payments is to improve in the absence of productivity growth, actually takes place. Although these measures may be quite specific to particular sectors of the economy (agriculture, tourism, or non-traditional exports), they are likely to exert a significant impact on macroeconomic variables such as the balance of payments and economic growth.

In principle, the fiscal system could be used on its own to simulate the effects of currency depreciation.¹⁴ However, the practical problems involved with doing this auger in favour of using fiscal policy as an adjunct to open depreciation rather than as a replacement for it. Similarly, although exchange controls may sometimes be a useful short run and temporary balance of payments policy since they have an immediate effect on imports, they are also subject to numerous practical problems and tend to suppress rather than correct the deficit; indeed in the long run they may have an adverse effect on both the balance of payments and economic development since they create a bias in favour of inefficient import substitution.¹⁵ Even credit policy could be used in a more sophisticated way and its potential for encouraging structural adaptation exploited more fully by discriminating in favour of activities that raise output and economic growth and strengthen the balance of payments, and against consumption. While the policy instruments listed above have not been uniformly absent from Fund programmes, they have only infrequently been used as 'performance criteria' for monitoring the implementation of programmes; even devaluation has featured as a precondition or performance criterion in only about 25-33 per cent of cases.¹⁶ An important question is therefore how the change in policy emphasis advocated above could be made operational, given that there seems no reason to abandon the concept of strict conditionality in circumstances where deficits are not self-correcting.¹⁷

¹⁴ The case for such an approach may be found in SCHYDLOWSKY (1982). For a critique see LAKER (1981). See BIRD (1982 c) for a further review of the issues.

¹⁵ See BIRD (1982 c) for a more detailed examination.

¹⁶ See KILLICK (1981 b).

¹⁷ As established in Note 1, the balance between low and high conditionality finance has shifted markedly away from low conditionality finance during the late 1970's and 1980's. Is this shift desirable? The normal defence offered by the Fund runs as follows: given the non-transitory nature of most deficits experienced in developing countries there is a clear need for adjustment; the Fund is best able to encourage this through the conditions it attaches to its financial support. Left to their own devices developing countries have insufficient political commitment to adjustment and through the provision of low conditionality finance the Fund would therefore be unlikely to do anything other than encourage the postponement of necessary adjustment, with this leading to a further

The basic idea would be to relate conditionality to a fairly wide range of instrument variables and judge programmes in terms of these and in terms of whether the ultimate targets are achieved. Programmes would then still be monitored and tested although failure to comply with policy conditions would initially trigger off consultation between the borrowing country and the Fund and a review of the programme, rather than immediately resulting in the cutting off of the further finance. During the review the reasons for failure would be examined and a decision made with regard to future financial provision. A lenient attitude would be adopted in those cases where exogenous and unforeseen factors were responsible for the programme's failure and a new programme with new conditions would be negotiated. Although with this new type of conditionality programmes would still be subject to objective and quantitative appraisal, the aim would be to shift the emphasis away from negotiating on the basis of precise financial targets and towards achieving agreement on the underlying policy approach.

deterioration in the balance of payments and an even more critical need for adjustment. This defensive position sees the causes of payments deficits as largely insignificant.

Against this it is frequently argued that the causes of deficits have an important bearing on the correct balance between high and low conditionality. Since a principal cause of the deteriorating balance of payments in many developing countries has been externally generated adverse movements in the terms of trade, the implication is drawn that countries should not be penalised through strict conditionality for problems for which they are not 'responsible'.

While the causes of deficits are highly significant, external causation is not sufficient reason for attaching low conditionality to Fund finance. First, while temporary deficits should be financed rather than corrected, in order to impose minimum cost on economic and social welfare, non-transitory deficits do require correction; second, conditionality does have a role to play in encouraging payments correction; but, third, conditionality should be appropriate to the economic characteristics of the countries concerned, with an important determinant of appropriateness being the causes of deficits.

Key problems here are to distinguish *ex ante* between deficits that are temporary and those that are permanent, and to identify the significance of external factors in explaining the deficit. In this connection, the Fund, of course, already possesses the CFF — a low conditionality facility designed to compensate countries for temporary export shortfalls as well as for certain excesses on food imports resulting from shortfalls in domestic production. However the relative importance of the CFF has declined over recent years and there would seem to be a good case for permitting more resources to be made available under it by raising the quota limits on drawing and the percentage of shortfall that may be covered. Furthermore the logic of the CFF would seem to argue in favour of extending its coverage to include all aspects of externally generated short term adverse movements in the income terms of trade. This implies compensation against import excesses arising from increases in import prices as well as against export shortfalls. While such modifications would assist countries in dealing with temporary payments problems they would at the same time ensure that where a deficit is permanent ineligibility for CFF finance would drive the country towards the strict conditionality associated with the higher credit tranches and the EFF; even where the deficit resulted from external factors for which the country was not responsible. Expansion of low conditionality lending through the CFF rather than through the lower credit tranches is preferable on the grounds that it avoids the 'moral hazard' associated with the sub-market interest charges on some Fund finance. Without the external causation element contained in the CFF countries might be encouraged to pursue over-expansionary domestic policies which result in access to relatively cheap, and in effect subsidised, resources from the Fund.

4. Implications of the Changes

Although the changes outlined above are in many ways relatively minor, they do have significant implications in a number of areas, apart from those for the world economy and international banking system discussed earlier.

(i) *For developing countries themselves*

If governments in developing countries refuse to accept the costs, in terms of domestic absorption, that balance of payments correction involve, and endeavour to avoid these by preventing real changes in the structure of the economy from taking place, then the outcome will almost certainly be that payments problems will become more firmly embedded. The adjustment that the balance of payments constraint will eventually enforce is therefore likely to be much more costly for economic development. Similarly developing countries need to be persuaded that a larger number of economic variables need to come under discussion with the Fund than has conventionally been the case, if conditionality is to be made more appropriate to their economic circumstances and is to have minimum adverse effects on economic development. This requires a considerable shift in their attitude towards the Fund.

(ii) *For relations with the World Bank*

In circumstances where the causes and cures of payments deficits may only be seen in a long term structural context the distinction between payments problems and development problems becomes largely artificial, as therefore does the traditional distinction between the Fund, as a payments institution, and the Bank, as a development one. Unavoidably, the responsibilities of the two institutions become more blurred, especially as the Bank itself has moved into structural adjustment lending which in practice incorporates many of the features included in the Fund-related

proposals discussed above.¹⁸ However, a less well defined division of labour is not necessarily a bad thing. All that needs to be ensured, through close consultation and co-operation, is that their activities are mutually reinforcing. With such co-operation a consistent set of economic policies which assist the realisation of both development and balance of payments objectives should be attainable. Under the above proposals the Fund retains the role of providing payments assistance linked to an adjustment programme in circumstances where deficits are non-temporary, and this does not constitute a break from its traditional role.

(iii) *For relations with the private international banks*

How will the private banks react to the changes in Fund conditionality? Will the catalytic effect disappear? A number of points may be made. First, as noted earlier, the importance of the catalytic effect can be overstressed, especially where the Fund and the banks are involved in different countries. Second, even where the Fund and banks are both involved, particularly in certain middle/high income developing countries, it is quite possible that the appropriate Fund programme will in fact look fairly conventional, since where excessive credit creation has caused the payments problem, emphasis on credit ceilings is quite appropriate. Third, the poor record of success of Fund programmes hardly encourages continuing confidence. This is much more likely to be provided by programmes that are successful, and the success rate may be raised by the Fund adopting a more flexible approach to conditionality which permits the root cause of the problem to be attacked. Finally, the poor record of Fund programmes has, in any case, encouraged banks to formulate their own views on the likely future economic performance of potential borrowers and to pay rather less attention to the existence of a Fund agreement.

¹⁸ See LANDELL-MILLS (1981) for a discussion of the World Bank's structural adjustment lending.

(iv) *For the duration of lending, and financing the Fund*

An approach to conditionality that emphasises real changes implies longer term lending by the Fund than has heretofore been the case, since such changes are unlikely to be achieved within one or two years.¹⁹ Longer term lending does, however, bring with it a fundamental difficulty: if the Fund is to extend its lending in this way it will initially require increased resources. With existing resources the only alternative would be to lend less in any individual year but to lend this over a longer time span. However, the need for more resources does not only arise from the proposed changes in conditionality, since, as has already been argued, there is a strong case for the IMF to take on a larger share of the task of recycling international finance in order to assist world economic development and increase the stability of the international banking system. A central question is then from where are the additional resources to come?

Broadly speaking there are five options:

- (a) increased IMF quotas.
- (b) *ad hoc* borrowing.
- (c) borrowing from private capital markets.
- (d) gold sales.
- (e) a form of SDR link.

(a) *increased IMF quotas*

In many ways this is the most straightforward alternative. It is undeniable that the ratio between quotas and world imports has fallen dramatically since the 1960's, over a time when the size of problems with which the Fund might in principle have been expected to deal has been increasing. Furthermore using increased quotas to raise resources would permit the Fund to expand that part of its lending that is at sub-market interest rates. However, increasing quotas does

¹⁹ The Fund has experimented with longer term lending particularly under the auspices of the Extended Fund Facility. However, EFF programmes have in fact contained fairly conventional performance criteria and in any case there has been a move back to shorter term lending since 1981.

have other implications. One is that the availability of both low and high conditionality finance will be increased. Indeed, given that an increase in quotas may be used to replace policies on 'enlarged access', the availability of low conditionality finance will increase proportionately more than that of high conditionality finance. A second is that increased quotas lead not only to an increase in the supply of Fund resources but also to an increase in the demand for them. Since the proposals regarding the flexibility of Fund programmes might be expected to increase the demand for Fund resources without affecting their supply, an increase in quotas may fail to compensate for the effect of the modifications. Other avenues for expanding the Fund's resources may therefore still be required.

(b) *ad hoc borrowing*

This is a means of raising resources that has been used in the both more and less recent past. Although offering a useful and often expedient way of meeting potential crises of liquidity it does not offer a satisfactory long term structured solution to the shortage of resources. It does not provide a reliable source of finance, witness the fact that, political considerations apart, the scope for future borrowing from Saudi Arabia hinges crucially on the price of oil and existence and size of the Saudi payments surplus.

(c) *borrowing from the private sector*

Direct borrowing by the Fund from private capital markets raises a number of questions. Would private banks lend to the Fund in circumstances where they are not prepared to lend to developing countries directly? Would the Fund lend on commercial terms similar to those under which it borrowed or would it attempt to transform the maturity and terms of the loans? If it were to lend on softer terms than those on which it was borrowing, where would the finance for such subsidisation come from? Would all developing countries benefit from such arrangements or would there be

distributional variations particularly between the more and less creditworthy developing countries?²⁰

The incentive for private banks to lend to the Fund would have to arise from the rate of return offered to them by the Fund and their own assessment of the risk involved in lending to the Fund, which could be influenced by the ways in which the Fund used the extra resources. If the banks assessed the risks associated with lending to the IMF as being less than those involved with lending directly to developing countries, then they might be prepared to accept a relatively lower rate of return on such loans. In terms of widening their portfolio of assets, the prospect of lending to the Fund could be quite attractive to commercial banks since it would enable them to combine relatively high return high risk lending directly to developing countries with relatively low return low risk lending to the IMF. However, it might encourage them to pull out of direct balance of payments financing, an area in which the Fund has the traditional expertise. Furthermore, IMF lending which is itself financed by commercial borrowing might be expected to possess a somewhat skewed distribution unless some form of interest rate subsidisation for ultimate borrowers could be devised.²¹ Thus it could be unpopular with low income countries. At the same time it might also be unpopular with middle income countries that might see IMF borrowing as crowding out their own direct borrowing. Countries previously enjoying access to the Eurocurrency market might be compelled to turn to the Fund and become subject to the discipline of conditionality. Of course, provided conditionality is appropriate, then from the point of view of global balance of payments correction this is not a bad thing — again the appropriateness of conditionality emerges as a central issue.

²⁰ For an attempt to answer these questions see BIRD (1981 a).

²¹ Private bank's assessment of the creditworthiness of the Fund would also depend on their estimation of the Fund's usable resources, its holdings of gold, SDRs, and currencies, and the degree of international support for its activities. Certain technical problems would be associated with direct borrowing by the Fund. For instance, its holdings of particular currencies, which could be affected by borrowing, in turn affects countries' access to Fund finance (Morgan Guaranty Trust 1980).

(d) *gold sales*

This is not a new idea since the Fund has already used the partial sale of its gold holdings to finance the operations of the Trust Fund and thereby to provide assistance, at low conditionality, essentially to the least developed countries. The Fund has in effect then accepted that this constitutes an appropriate use of its gold. The pros and cons of using gold in this way have been thoroughly investigated elsewhere.²² What emerges is that there is a strong case on grounds of equity for such sales and no legitimate argument against them on grounds of efficiency.²³

The principal problems with gold sales arise first, from variations in the market price of gold and therefore fluctuations in the receipts from selling any given quantity of gold; second, from the fact that the major beneficiaries may turn out to be the purchasers of gold, mostly industrial countries, rather than developing countries; third, from what happens when all the gold has been sold; and finally from the way in which the finance is to be used once acquired.

The first problem simply makes the exercise of maximising receipts that much more complicated; with further complications resulting from the fact that developing countries will have their own time preference rate for resources. However it has not prevented the auctioning of gold in the past. The second problem could, in principle, be dealt with by introducing some form of international gold capital gains tax. In practice it seems highly unlikely that such a tax would prove acceptable. The only practical solution would be to use IMF gold as collateral for raising private loans rather than selling it, but in this case the finance made available would not be concessionary. The third problem may be resolved by using only the interest from the investment of receipts from gold sales (possibly in World Bank projects) rather than the full capital value; although this would imply a continuing flow of finance it would, of

²² See BRODSKY and SAMPSON (1980), (1981).

²³ That gold sales are not neutral with respect to resource flows is insufficient argument when it is recalled that the existing system is not distributionally neutral.

course, also mean that less finance would be available initially. Finally the revenue raised through gold sales could be used to help finance existing IMF activities modified as suggested earlier. Alternatively it could finance subsidies on Fund finance.

(e) *an SDR link*

Most proposals with regard to the establishment of an SDR link keep the creation of SDRs separate from the activities of the General Account. In principle, however, the link could be organised so as to provide extra resources for the General Account.²⁴ In effect, SDRs would be used to augment other Fund resources. Although the mechanics by which this could be achieved are various, one important implication of this type of link is that the SDRs thus created would be allocated to borrowing countries on a conditional and quite possibly repayable basis, and would thus lose many of their previously distinctive features. It may be noted that under this form of link the appropriateness of IMF conditionality would again be a crucial issue.

5. Concluding Remarks

The argument presented in this paper is that in the present worldwide recession the IMF could make a significant beneficial contribution, and a much larger contribution than it has up to now. By means of recycling international finance, it can help maintain world aggregate demand and help avoid the demand deflationary effect that occurs if countries through lack of finance are forced to reduce imports rapidly. By enabling deficit countries to maintain imports at higher levels than would otherwise be possible, a shrinkage of world trade will be avoided, the sacrifice of economic development in the deficit countries will be minimised, and exports, output and employment in all countries will be protected. However, through the conditionality

²⁴ For more details of these schemes see BIRD (1982 a).

attached to its loans the Fund is also in a strong position to encourage adjustment policies which gradually reduce deficits by raising output and which protect economic development in the poorest countries. The Fund could be of particular assistance to low income countries.

There are strong reasons for believing that conventional Fund programmes are inappropriate for these countries. One response to this is simply to argue that what they need is more aid. Perhaps so but a more flexible approach to IMF conditionality could also be of particular relevance to them, permitting the Fund, in effect, to treat all member countries uniformly in terms of the 'adjustment effort' required of them. With only limited scope for rapid adjustment in low income countries, longer term, structurally orientated, programmes stand more chance of being successful. In addition, however, the Fund could raise the concessional element of its lending to low income countries by extending the use of interest rate subsidies. This would not require any fundamental changes to the operation of the international financial system, could generate significant financial flows to low income countries, and could be attractive to donors as a way of giving aid.²⁵ By shouldering a larger proportion of the recycling burden the Fund can therefore both reduce the fragility of the international banking system, and help offset the areas of market failure (resulting from distribution and divergences between private and social costs and benefits) associated with the private banking sector.

While it is not argued that this is the only significant role that the Fund may perform — others are overseeing exchange rate policy, and centralising and controlling the rate of international reserve creation, — the paper does suggest that the Fund's role in economic development is particularly important at the moment and that the other roles have been down played by events. At the same time, this important role only requires relatively minor internal reforms and does not involve the Fund becoming a 'soft' aid agency. Whether its member countries decide to back the Fund in fulfilling the tasks outlined here depends on how

²⁵ For a fuller discussion of the use of subsidies in this context, and some attempt at estimation see BIRD (1982 b). If more fundamental changes in the international financial system were to be countenanced, the idea of an SDR link could still be of significant benefit to low income countries that do not have access to capital markets and in any case would have to pay interest rates in excess of that on SDR net use. For a fuller discussion of why the SDR link may still be relevant to low income countries in particular and an estimation of the benefits that may in certain cases be derived see BIRD (1981 b).

committed they are to the ideas of a liberal world trading system, stable world economic growth, and international equity that underpin the Fund's Articles of Agreement.

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