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DEVELOPMENT AND INTERNATIONAL ECONOMIC COOPERATION

Economic stabilization programmes in developing countries

Report of the Secretary-General

CONTENTS

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CONTENTS (continued)

I. INTRODUCTION

1. Economic policy in a very large number of developing countries in the 1980s came to be dominated by serious macroeconomic problems of external and domestic balance and by the constraints arising from the stabilization and adjustment programmes put in place to face those problems. The trend has continued into the 1990s. Balance-of-payments problems stemmed from an unfavourable conjunction of factors - mainly, a persistent decline in commodity prices leading to strong deterioration in the terms of trade of most developing countries, a sharp rise in real interest rates as compared to the 1970s, and an abrupt and large drop in capital inflows into these countries, in particular after the debt crisis of 1982. These developments seriously complicated the problems of domestic macroeconomic management in many countries. In more than two thirds of the developing countries, and in particular in Africa and in Latin America, real income per capita declined in the 1980s, suggesting the pervasiveness of the unfavourable external shocks and inappropriate domestic policies. 1/

2. Lack of perseverance in domestic adjustment efforts and a dearth of external financial support underlie the many frustrated stabilization attempts of the last decade. Even in the rare cases where a modicum of price stabilization was obtained, economic stagnation continued to be the rule.

3. The past decade was frustrating in economic results, yet rich in economic experience. Economic policy lessons accumulated, mostly from the many failures but also from the few successes. A better understanding emerged about what works and what does not work in terms of stabilization and adjustment policies.

4. This experience has been examined extensively at the professional level in recent years. 2/ The experiences of individual countries were subjected to professional scrutiny in response to the need for improved efficiency in multilateral policy-based lending. Unresolved issues abound and generalizations are hard to obtain, but a certain degree of convergence has been reached on themes that only 10 years ago were the object of fierce doctrinaire debate. Old truths reaffirmed their validity, but many new elements were added to the understanding of growth-oriented adjustment in developing countries.

5. The present report, prepared in response to General Assembly resolution 45/194 of 21 December 1990, seeks to spell out the lessors of these experiences and debates, with the purpose of contributing to the improvement of future stabilization and adjustment attempts, and particularly to clarify the help that the international community could offer to the adjustment efforts of individual developing countries.

6. Section II discusses the changing views on stabilization and adjustment issues. Whatever their origins, persistent balance-of-payments disequilibria have been the main reason for policy-based lending. As more and more

developing countries faced acute foreign exchange shortages and slipped into arrears, joint packages of policy-based loans became an inevitable part of the effort of multilateral institutions to prevent a major financial collapse. In the post debt-crisis situation, recovery of favourable growth prospects required more than simple short-run stabilization based on demand controls in order to reverse aggregate overspending. The idea behind structural adjustment loans was to provide finance for balance-of-payments viability while stimulating the implementation of structural reforms whose purpose is to create a favourable domestic environment for economic growth. The debates about the early short-term programmes associated with International Monetary Fund (IMF) lending are reviewed first. A presentation is made of the so-called Washington consensus, as embedded in the current medium-term joint IMF/World Bank adjustment packages. Heterodox stabilization experiments are also discussed. A tentative conclusion is derived about what would constitute today's prevalent view on growth-oriented stabilization programmes for developing countries.

7. Section III deals with socio-political aspects of stabilization and adjustment policies in developing countries. These tended to be neglected in the past but are today recognized as central for the success of such stabilization and adjustment efforts.

8. Section IV elaborates on new themes that have entered the agenda of debate on stabilization policies and adjustment programmes for developing countries during the last decade. These themes are:

(a) Policy shocks, or "big bangs", versus gradualism;

(b) Scope versus intensity of policy reforms;

(c) Sequencing of policy reforms;

(d) Permanent fiscal adjustment and public sector reform;

(e) Coordination of private sector investment decisions;

(f) Public investment in infrastructure;

(g) Sectoral policies;

(h) Policy stability and sustainability;

(i) Temporary price controls and income policies;

(j) Nominal anchors and financial safety nets;

(k) Debt reduction for low-income and middle-income countries;

(l) Special problems of formerly socialist economies.

9. Even though most of these themes remain controversial, in the last section (v) a set of conclusions is presented on the role that policy-based official lending could play in support of growth-oriented stabilization programmes in developing countries.

II. EVOLVING VIEWS ON STABILIZATION POLICIES

10. It is hard to envisage growth-oriented stabilization and adjustment in developing countries without sustained growth of the world economy and favourable external conditions. The increasing interdependence of the global economy meant also the strengthening of linkages between the developed and the developing economies through international trade, commodity prices, interest rates and capital flows. These linkages open opportunities but can also be a source of disruptions and uncertainty. International cooperation to provide a stable and supporting international environment will affect the prospects for growth and the success of adjustment policies of developing countries.

11. Long-term growth prospects depend on the continued expansion of international trade. Export-led growth needs expanding markets. Domestic demand-based development, if world trade does not grow and if key markets become increasingly protected, if it is a possibility at all, is open to very few and at the price of enormous slow-down in the transmission of technological innovation. The success of national domestic policies depends even more on the predictability, transparency and reliability of a given set of international rules for trading accepted and implemented by all trading partners. The uncertainty regarding those rules given the present doubts over the final outcome of the Uruguay Round of multilateral trade negotiations is an extra hurdle for countries implementing reforms of their trade policies.

12. In a scenario of low world economic growth, the prolonged weakness of commodity prices in real terms is likely to continue into the 1990s. Instability of export earnings is particularly difficult to absorb in poor and indebted countries. The design of stabilization and adjustment policies has to incorporate, through contingency arrangements, the possibility of large terms-of-trade shocks to individual countries resulting from volatility and decline in real primary commodity prices.

13. The prospect that real interest rates will remain high in the 1990s underscores the need of collective efforts to revitalize economic growth and development, by reducing the cost of international finance to developing countries, by easing the debt burden of developing countries in support of growth-oriented reforms, by reducing fiscal imbalances in developed countries that tend to absorb world savings, by reducing uncertainties and by increasing opportunities for trade and investment. Stability of the external environment would decrease the rate of failure of stabilization and adjustment packages.

14. The General Assembly at its eighteenth special session, in June 1990, reached a consensus in which it recognized that the revitalization of economic growth and development of developing countries required an improved

international economic environment. It stated also that "a gradual convergence of views on economic policy, including the need for sound macroeconomic policies and enhanced competition, is emerging". 3/

15. The early stabilization programmes usually associated with IMF stand-by arrangements, specially in Latin America, were based on a simple diagnosis of the balance of payments and inflation difficulties of those countries. The fundamental problem was "excess government spending", which was at the root of both the international reserve losses and the domestic inflationary pressures. A complementary problem was that of overvaluation of currencies, supported by quantitative import controls and designed to reduce artificially the costs of imported wage goods and industrial inputs. Finally, private savings were discouraged by the maintenance of negative real interest rates, supported by discriminatory credit rationing.

16. The stabilization programmes of the Fund were thus dominated by two fundamental prescriptions: balance the budget, and get the prices right. Cuts in government overspending, large devaluations and positive real domestic interest rates would allow a suppression of the rationing mechanisms for foreign exchange and domestic credit allocation, while resolving the balance of payments and inflation difficulties. 4/

17. This view paid little attention to the existence of domestic structural problems and adverse external environments. The first, as manifested by slow price responses, foreign exchange shortages and reduced domestic savings, were according to the Fund doctrine the consequences of an overambitious State-led import substitution industrialization. External difficulties were also disregarded; it was argued that developing economies were very small vis-à-vis the rest of the world and hence faced an infinitely elastic external demand for their exports and an infinitely elastic external supply of foreign capital: if they did not export more or attract more foreign investment, it was because domestic incentives were wrong.

18. The Fund was designed in Bretton Woods as a monetary institution, to provide short-term financial support. Long-term loans to support development were the World Bank's domain. The profiles of the two institutions, however, became increasingly intertwined when the World Bank started emphasizing policy-based lending in the early 1980s, having started lending for structural adjustment in 1980. As a consequence of the first oil shock, later reinforced by the second oil shock, the 1979 interest rate shock, the back-to-back world-wide recessions of 1980 and 1982 and the 1982 collapse of international bank lending to developing countries, by the end of the 1980s adjustment lending represented almost one third of the Bank's total lending commitments.

19. This sequence of negative external shocks, comparable in magnitude only to those of the 1930s, made it clear that developing countries did face an extremely adverse external environment. A major structural adjustment effort was required, and this could not be achieved with only the traditional Fund policy recommendations.

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20. The accumulated experience with Fund programmes also indicated several limitations. Some of the most salient are as follows. Firstly, large devaluations proved to be inflationary in a context of real wage resistance, as a consequence of which programme countries frequently did not manage to meet the Fund's inflation targets. Secondly, large devaluations frequently caused significant drops in industrial output, as imported intermediary products became suddenly too expensive, while exports did not always respond sufficiently. Large devaluations also tended to affect negatively the governmental budget, in cases in which revenues from import and export tariffs were small when compared to public sector external debt service. Thirdly, budget adjustments made under the pressure of meeting three-month targets frequently proved to be short-lived. In the short-run, Governments generally succeeded only in "deficit repression", often obtained through the suspension of much needed but easy to cut investments in social and economic infrastructure; growth-oriented "deficit suppression", as required for sustained price stability, would require a longer-term horizon. Fourthly, private savings did not respond positively to the very high real interest rates normally accompanying Fund programmes: on the contrary, the financial fragility brought about by the impact of high real interest rates frequently led to bankruptcies and financial collapses, besides increasing the costs of servicing the government domestic debt.

21. In this reconsideration of the content of Fund programmes, the contribution of the World Bank was to emphasize that, besides stabilization, developing countries also needed structural adjustment to be achieved by the adoption of liberal economic policies. Three new tenets were thus added to the original two-pronged policy advice. This revised package became increasingly associated also with the lending programmes of the regional development banks. The new Bank/Fund adjustment recommendations, which are sometimes referred to as the "Washington consensus", have five principles: 5/

(a) Budget balancing;

(b) Relative price correction;

(c) Trade and foreign investment liberalization;

(d) Privatization;

(e) Domestic market deregulation.

22. Trade liberalization was to be achieved in a sequence of moves, starting with the replacement of quotas by tariffs, followed by a process of tariff unification and finally a programmed reduction of the unified tariff, until reaching substantially free trade a few years hence. Foreign investment liberalization essentially meant non-discriminatory treatment vis-à-vis investment by domestic residents.

23. Privatization involved, firstly, the devolution to the private sector of formerly private firms that for one reason or other had fallen in the hands of the public sector; secondly, the closure of loss-making public enterprises,

with the establishment of bankruptcy proceedings to deal with such cases; and thirdly, the transfer to the private sector of large public firms that were in the past thought to be of strategic importance.

24. Domestic market deregulation involved policy actions in goods market, labour markets and financial markets. Typically, the objective was to free those markets from governmental controls, letting prices be determined freely by supply and demand. Mechanisms to guarantee free competition and a prudent bank regulatory framework should however be established. Deregulation would also involve the introduction of an adequate legal system for the protection of property rights, as well as the prevention of the abuse of market power. 6/

25. One welcome consequence of this expanded agenda was the recognition by the Bretton Woods institutions that adjustment in developing countries was a more complex task and would take longer than originally envisaged in the early Fund doctrine. Stabilization and balance-of-payments problems could not be dealt with productively within a short-term perspective but should rather be viewed as an integral part of the development challenge. The traditional view remained that building the confidence of the private sector, through a combination of fiscal discipline and liberal economic policies, was all that was required for a successful growth-oriented adjustment effort.

26. The "heterodox approaches" 7/ that were attempted in the 1980s tried to take account of inflation rigidities and slow price responses in a policy framework that ascribed an enhanced role to direct government coordination of prices and incomes. The need for rational controls, which attempted to violate not equilibrium price movements but only those movements derived from backward-looking expectations, led to policy recommendations for price and exchange rate controls and de-indexation. Unsuccessful heterodox programmes tended to downplay the need for an early fiscal adjustment, on the theory that substantial fiscal gains would be generated by successful price stabilization, 8/ and the seigniorage revenues accruing as a consequence of the remonetization of the economy.

27. Many heterodox attempts fell into the trap of outright abandonment of fiscal adjustment and ended up in the road of populism - in the sense that the need for short-term political approval took prevalence over long-term sustainability of the programme. Premature reflating of the economy, inadequate changes in relative prices, disregard of economic incentives to recover investment and abuse of temporary import liberalization (as a means to repress domestic price increases in the presence of inappropriate exchange rates) are the main elements defining the inconsistency of several failed attempts at heterodox stabilization. The Peruvian case, during the inti plan, epitomizes the worst outcome of such experiments, although different dosages of the same ingredients are found in Brazil's cruzado plan and Argentina's austral plan.

28. The failure of the populist experiments with expansionary stabilization helped to sober up the IMF critics. A better understanding was obtained of the "narrow limits of the possible" in the short run and of the need for a

thorough public-sector reform, to maintain the much-needed government investments in social and economic infrastructure, without the need to resort to inflationary financing.

29. A narrowing of the gap between previously irreconcilable approaches has recently become apparent. This "professional convergence" that seems to be in progress is in part a consequence of a reflection on the failures of the most extreme versions of both orthodox and heterodox programmes. But in part it is also a reflection on the successes of experiments that managed to blend orthodox and heterodox elements. 9/

30. Thus, Israel, since 1985, and Mexico, since 1987, have managed a blend of orthodox and heterodox components in their stabilization programmes. These programmes emphasized fiscal discipline and market-oriented policies but did not shy away from the adoption of incomes policies as a means of achieving rapid deflation with reduced output losses. Brazil in the mid-1960s offers an early example of a successful heterodox stabilization programme.

31. The successful industrialization drives of Taiwan, Province of China, and the Republic of Korea also helped to temper the enthusiasm of the Washington consensus participants for the power of purely liberal economic policies to promote growth-oriented adjustment. These cases confirmed that fiscal discipline and trade orientation are essential ingredients of successful adjustment efforts, but they also showed the importance of the coordinating role of the Government in the areas not only of human development (health and education) but also of technological adaptation, provision of long-term finance and in the design of a performance-oriented industrial policy.

32. In trade policy, one source for the generalized recommendation for more openness was the survey of 41 economies analysed in the 1987 World Development Report. The evidence on the association between openness and growth has since then been qualified by several studies. Moreover, recommendations on trade policy regimes for developing economies cannot ignore what is happening to the general economic environment, to world trade and to financial flows at the time trade policy is enacted. 10/

III. SOCIO-POLITICAL DIMENSIONS OF STABILIZATION AND ADJUSTMENT

33. The analysis of the experiences with structural adjustment and stabilization policies in the 1980s have led to another consensus: the importance of local government "ownership" of the programme. The basic idea is very simple: even the best policy package cannot succeed in a country if the Government in charge of its implementation does not see the package as expressing its own intent. That simple idea has important practical implications both for the design of policy strategies and for the discussions between multilateral agency officials and local authorities on the details of the programmes. It means, for example, that there is little hope for the successful implementation of policy moves that had been decided upon after "negotiation of conditionalities as in a bazaar". 11/

34. Adjustment policies tend to be costly in political terms, subjecting local Governments to a series of pressures. Those pressures usually stem from at least three sources: beneficiaries of the previous status quo; transient bearers of the burdens of adjustment in terms of output losses, sectoral unemployment and investment dislocations; and, of course, sceptical critics whose voices gain resonance with the time elapsed before results are recognized as beneficial. One reason for the early abandonment of policy reform may be that the Government itself - or the majority coalition - is not convinced it is on the right economic policy track, being at best convinced that it has to display some discipline to enhance the "goodwill" of donors, creditors or international partners. This means that the fragility of domestic political support is one of the weakest points of most adjustment reforms. 12/

35. Another source of political resistance that may jeopardize success of the programme is a negative short-run impact on low-income groups. This may be specially serious when policy moves are very radical to start with and therefore tends to provoke serious sectoral dislocation of resources and employment for a period of time that may turn out to be politically unsustainable. Thus, with the move to a long-term policy perspective, the social dimensions of adjustment are part of the discussions on the design of adjustment programmes. 13/ Safety nets should be developed to protect the poor from such short-run dislocations of the stabilization programme.

36. Poverty levels and social indicators have to be explicitly considered as a constraint to the enactment of policies, otherwise adjustment will be seen at best as a costly, and in many cases unjustified, manner to gain access to foreign exchange. No political support for sustainable economic policies will be constructed, but rather the incentives will be to devise ways to circumvent the conditionalities of multilateral agencies.

37. It needs to be recognized that a wide gap exists between adjustment to a new set of international constraints in the case of an organized market economy and in the case of a developing economy after a decade of frustrated macro-policies, low economic growth and worsening social conditions. Existing imbalances tend to reinforce and strengthen one another, as policy distortions pile up as a result of protracted adjustment. After a long period of artificial controls, not only may market distortions be the rule and rent-seeking opportunities develop profound roots in the institutional and social codes but their removal may require more than legislative changes and political will. It requires consistent policies for a long period in which actual results will not be available to guarantee the political sustainability of those initiating the programmes.

38. This is particularly dramatic when policy reforms take place in the wake of a major change in economic rules regarding property rights and the role of the State. In a significant number of sub-Saharan countries, the frustrated attempts after decolonization to build socialist economies on top of deep-rooted tribal customs have now been replaced by equally frustrated attempts to create capitalism overnight. There seemed to be a hope in some

countries that the mere announcement of the new regime, with the support of international multilateral agencies, would bring in foreign capital. In the present situation, it is unlikely that voluntary investment will be forthcoming just because their Governments have managed to approve legislation welcoming foreign capital. This certainly does not mean that the legislation should not be passed, but political support for it should not be based on false hopes, or else there will be no stability of the rules concerning private investment. This stability is perhaps the most important requirement for the attraction of foreign capital.

39. The conclusion is that the likelihood of a long delay between the adoption of a policy package and its political rewards needs to be taken into consideration in choosing the strategy to carry out the programme. First, nothing is gained by making a governmental team accept a programme the contents of which it does not believe in. Secondly, measures to prevent temporary negative effects of the programme for lower-income groups should be reckoned among the programme costs in order to stop such effects from developing into a strong political coalition against the programme. The effort for economic stabilization should not be an excuse for narrowing the role of the meaningful actors in influencing the country's destiny. The need for a steady and consistent course of economic policy has, in the past, been used to justify authoritarian regimes, which, it was claimed, provided a better environment for economic adjustment. If any conclusion may be drawn from the 1980s in this respect, it would be that dictatorships have not been able to provide an institutional ambience in which economic policy adjustment could be kept on a consistent path. A significant number of developing countries have in the 1980s moved towards more open political regimes. The new democracies face the hard challenge of generating the political basis for viable long-run economic development. Thirdly, external support for reasonable measures based on an inconsistent political coalition may end up in higher policy instability, as frequent changes in policies may be required, leading to higher uncertainty.

IV. NEW ELEMENTS IN STABILIZATION AND ADJUSTMENT PROGRAMMES

40. The wealth of experience with stabilization policies in developing countries added many new elements to the older debates. There is an ongoing controversy regarding most of these new issues.

A. Shocks versus gradualism

41. The controversy over shocks versus gradualism first arose in the context of close to three-digit inflations in the 1960s and three-digit inflations in the 1970s. A certain consensus seems finally to have come out of those debates, as enriched by the stabilization experiences of the 1980s. To fight an inflation spurt in a normally non-inflationary economy, the best policy is a monetary shock, which reveals clearly to all economic agents that the central bank is unwilling to accommodate inflationary behaviour. To fight a

chronic inflation, the same would be recommended, provided that the government deficit has been suppressed and that a sharp deindexation of prices and wages can simultaneously be obtained. A lot can indeed be said in favour of a policy shock when stabilization is the sole issue. Curiously enough, the most enthusiastic defenders of "heterodox" stabilization shocks in the 1980s were the critics of the "orthodox" shocks of the old Fund programmes. In the context of stabilization, therefore, shock treatments seem today to be favoured both from the orthodox and heterodox points of view.

42. More recent debates about the advantages and disadvantages of a big bang of liberal economic reforms tend to blend two different issues: on one side, stabilization-cum-adjustment in the context of the post-debt crisis Fund/Bank packages, and, on the other side, the conversion of formerly centrally planned socialist economies into profit-led capitalist economies.

43. Regarding stabilization-cum-adjustment, the evidence from the successful cases - Chile today, Turkey in the 1980s, Brazil in the 1960s - and even of more moderate successes, like Ghana and the United Republic of Tanzania in the 1980s, suggests that growth-oriented stabilization requires a long time and hence much prudence in the introduction of liberalization reforms, regardless of whether the programme started with a policy shock in the context of an IMF-supported programme or with a gradual home-grown approach.

44. In the case of the conversion of formerly socialist economies, early enthusiasm for a big bang seems to be giving way to a more moderate approach, emphasizing the definition of a nucleus of essential policy changes, based on a careful analysis of specific country situations. This change of heart occurred after a series of frustrated experiences with big bangs, like the Yugoslavian programmes of the 1980s and those implemented in Guinea-Bissau and Mozambique, not to mention the more recent case of Poland.

45. Even in the case of policy reforms proposing a less radical change than outright conversion to capitalism, the initial enthusiasm about policy shocks has evolved towards a more carefully defined "sequencing" of policies. There is now a more pragmatic approach towards the definition of a subset of priority policy changes. This is being viewed as a wiser strategy than adopting an encompassing policy package, which runs the risk of a demoralizing failure. It means, firstly, giving priority to the elimination of the bigger distortions, as, for example, those generating a risk of hyperinflation, or causing a sharp curtailment of foreign exchange supply. Secondly, it means placing a high value on sustaining near price stability - even when there is no immediate risk of hyperinflation - as a prerequisite for a successful adjustment programme. This involves leaving efficiency-raising measures to a second round of reforms.

46. The debate on shocks versus gradualism also evolved in the direction of a more meaningful and operational discussion concerning the scope and the intensity of policy changes.

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B. Scope of policy reforms

47. Recent economic reform experiences teach some important lessons about the advisable scope of policy reforms. First, the nature of the most obvious imbalances and distortions is critical to the choice of measures to be taken at the start of the programme. Thus, the hyperinflation threats in some Latin American countries and the foreign exchange starvation more typical of African economies are polar cases, requiring totally different policy priorities at the start of a reform programme. The hyperinflation menace that plagued a few centrally planned developing countries when they introduced market-oriented reforms, such as Viet Nam and Yugoslavia, are again of a different nature.

48. A country plagued by open or repressed hyperinflation may not be dollar-constrained in the short run, as the disorganization of the economy may have done the job of curtailing domestic absorption and imports, besides enhancing the attractiveness of export-related activities. A safety net of foreign exchange support may, however, be needed in order to sustain an anti-inflationary shock that has to signal the Government's renunciation of inflationary finance.

49. A small economy starved of foreign exchange, as in sub-Saharan Africa, exhibits a different picture. Removal of exchange rate distortions may simply generate a more disorganized economy if delays in supply response and the lack of credibility of government policies owing to past failures are not taken into account when implementing, for example, a drastic cut in government expenditures.

50. Once the focus of the first moves of policy reform is decided upon, however, there remains the issue of the intensity of each move: by how much to devalue, by how much to correct public prices, how much to raise interest rates - or whether to free them from controls. Such decisions should take into account, firstly, that the stabilization policy game will be played for a long time in the future and, hence, short-run advantages of big moves should be counterbalanced by the need of maintaining policy consistency for a long time. A second consideration is the political and economic strength of the groups negatively affected by the policy moves and the possibilities open to the Government to target measures to compensate or protect those losing from the policy. If the political economy is not right, prudence should be adopted in changing relative prices. A third consideration is that after a large devaluation (if it increases the supply of foreign exchange) or an overadjustment of public sector prices (if it provides higher government revenues), the Government has more room to use nominal anchors than otherwise would be the case.

51. The conclusion is that the essential elements that should be included "up front" in a policy package cannot be determined in advance but depend on the perceived constraints to a minimally acceptable operation of the economy. In most cases, the imbalances that tend to clog a country's markets and prevent the economic system from functioning in the short run are untrammelled inflation and acute foreign exchange shortages. The scope of the policy

packages should concentrate as much as possible on removing the most visible constraints, and the intensity of the policy moves should take into consideration that the policy game will probably be played for a long time in the future. This leads to the problem of sequencing.

C. Sequencing

52. Adjustment measures can all be announced in a single package, but not all of them can be introduced from one day to the next. This poses the problem of the appropriate sequencing of reforms. The World Bank has stressed the need to stabilize the economy first before adopting structural adjustment measures (such as liberalization, deregulation and privatization), and finally to invest and grow.

53. The perception of the need for this type of sequencing seems to have been originally developed as a reaction to the failures of the so-called "open monetarist" experiments of the mid-1970s in the Southern Cone of Latin America. In these cases, liberalization measures tended to precede fiscal adjustment. These experiments proved to be short-lived, since they ended in major balance-of-payments crises.

54. Latin America was also the stage for a second group of failed stabilization experiments in the mid-1980s, the so-called "expansionary stabilization" attempts in Argentina (austral plan), Brazil (cruzado plan) and Peru (inti plan). In these cases, temporary wage and price freezes were used not simply as coordination mechanisms - which is the positive role that they might perform - but rather as inadequate substitutes for the fiscal and monetary adjustment, which the Governments of those countries were unable or unwilling to introduce and maintain.

55. This second set of failed expansionary experiments taught that the old virtues of fiscal discipline, monetary stringency and undistorted pricing may not be sufficient, but are indeed necessary ingredients of any sustainable stabilization attempt. Growth resumption is the final objective, but it cannot be reached until some critical intermediate steps are undertaken.

56. The first set of failed open-monetarist experiments taught, firstly, that fiscal adjustment has to precede liberalization, otherwise speculative runs are inevitable, and secondly, that deregulation should start in those markets which adjust more slowly - that is, the labour market, then the goods markets and, finally, the financial markets. Otherwise, the tendency will be for overshooting of exchange rates and interest rates, given that financial markets are much faster to react to price stimulus than the other two.

57. Liberalization of financial markets has in fact been a frequent objective of structural reform. The basic aim is clear: to create conditions for interest rates applying to different forms of debt to reflect rates of returns and asset preferences of wealth-holders. The hope is that, with a movement in the direction of competitive financial markets, rates of return on capital

will reflect relative scarcities so as to make more attractive those uses of capital which make the best out of the existing investment opportunities. Typically, repressed financial markets are heavily regulated, varying from a complete public sector monopoly of financial intermediation to direct controls over transactions or ceilings on borrowing and lending rates, protection of domestic banks, and a wide range of direct and compulsory channelling of funds to government-defined investment priorities. In parallel, informal lending at very high interest in the so-called "curb market" proliferates. Liberalization in this context usually means freeing interest rates on loans from financial intermediaries and returns on financial assets so that a higher proportion of private savings may be channelled through financial markets.

58. This is one example where wrong sequencing may be disastrous. Financial markets tend to show abundant distortions almost everywhere; hence, the temptation towards premature deregulation is strong. The result of premature deregulation - as the Latin American example vastly shows - may be high volatility of interest rates induced by speculative behaviour, increased uncertainty as to the costs of loans without any favourable counterpart in financial deepening, widespread priority to "financial thinking" in private business before flexibility in the savings/investment intermediation is achieved and, finally, facilitated capital flight in the presence of high uncertainty in domestic markets before foreign capital can be captured under the new policy regime.

D. Public-sector reform

59. A critical element in the sequencing of reforms is fiscal adjustment. Durable fiscal adjustment takes time to achieve. What can be used in the short-run are temporary stop-gap measures, such as a one-time steep increase in public sector prices, infrastructure investment reduction, payment delays to domestic creditors and suppliers, postponement of salary adjustments to government employees and an external public sector debt moratorium. This is deficit repression, not deficit suppression. With these measures, even if the three-month performance criteria monitored by IMF can be met, the fundamental fiscal unbalance problem would remain unsolved.

60. Deficit suppression - that is, attaining a budget that is sustainable over a longer period - might involve divestiture, deregulation, tax changes, debt consolidation, changed personnel policies and an incentive-focused public sector administrative framework. It also involves putting in place a new monetary regime, capable of avoiding the emergence of quasi-fiscal deficits in the central bank accounts, even when the fiscal accounts of the central Government are under control.

61. This means that permanent fiscal adjustment requires deep institutional changes in the way that the central Government operates and interacts with other public sector entities and with the private sector. What is needed is the suppression of the potential budget deficit that arises from all the contingent governmental liabilities accumulated through the years, in the

context of a statist soft-budget economic regime, in favour of different interest groups both inside and outside the public sector. Budget-deficit suppression requires in fact a thorough public sector reform involving at least two elements: measures to improve the efficiency of the economy and measures to increase public savings. This requires broadly understood fiscal reform, usually involving debt restructuring (domestic and foreign), elimination of rent-seeking entitlements, closure of hopeless State enterprises and adoption of a more adequate tax system. But it usually involves also the elaboration of constitutional rules and a performance-oriented regulatory framework for State intervention that makes irresponsible deficit spending more difficult and the rules of the game for private investors more stable.

62. The problem is that permanent fiscal adjustment as illustrated by the tasks behind public-sector reform and the corresponding legislative process takes time; in the beginning of the programme, only temporary measures are at hand, but the introduction of a deep public-sector reform programme cannot wait for stabilization to be achieved, for this will not happen until economic agents are convinced that a permanent fiscal adjustment is taking place. Hence, the critical role that international cooperation in the form of sectoral adjustment loans, designed to support a thorough reform of the public sector, may have in the design of stabilization programmes.

E. Private investment coordination

63. One of the main lessons of experience is that stabilization in chronically high inflation countries is a process that takes time - not a year or two, but more likely a decade or so.

64. Once inflation reaches hyperinflationary levels, as in Bolivia in the early 1980s, inflation may fall rapidly, almost instantaneously, once a sharp anti-inflation programme is implemented. This is because such economies become substantially dollarized, in terms of price and wage setting and financial assets. In these cases, a sharp fiscal adjustment, accompanied by the pegging of the domestic currency to the dollar, is able to produce almost instantaneous price stability.

65. Even in such rare cases, however, in order to avoid a collapse of the stable exchange rate regime, fiscal overkill and supertight money seem to be required to establish confidence in the new economic policy stance. These contractionary policies are, however, inimical to the generation of an adequate economic climate for growth restoration.

66. Chile is perhaps the only example of a country with chronic inflation that has managed successfully to stabilize its economy (but even today the inflation rates are in the 20 per cent annual average range). The lesson that can be drawn from Chile is that curing chronic inflation by orthodox methods can be successful, but the treatment may take a decade or even more. During this period, fiscal and monetary discipline must be maintained persistently.

It is persistence rather than the specific types of exchange-rate or wage policies that seems to be the key to success. The main drawbacks of this success are the relatively low average growth rate and the severe crises that shook the Chilean economy along the way.

67. The successful stabilization experience of Chile and the still ongoing ones of Israel and Mexico confirm the old truths that fiscal austerity, competitive real exchange rates, sound financial markets and deregulation are required for stabilization, and that they provide the preconditions for a resumption of growth. These cases, however, also show the need to distinguish between necessary and sufficient conditions. Adjustment is strictly necessary, but it may not be sufficient. Because they have an option to wait, asset holders tend to postpone repatriation of flight capital, and investors tend to delay initiating projects. This creates an important coordination problem, a new element in growth-oriented stabilization programmes, which traditional approaches did not normally recognize.

68. Because physical investment is partially irreversible, rational behaviour by the private sector calls for withholding investment until much of the residual uncertainty regarding the success of the reforms is eliminated. Without investment, reforms are less likely to prove sustainable; but investment will not be forthcoming in the presence of uncertainty as to future policies. Hence, the discomforting conclusion that the success of policies may depend in no small part on the psychology of private-sector expectations.

69. A reform can end up being reversed for no other reason than a shared expectation that it will not last. Even if this expectation is not based on underlying fundamentals, it can prove self-fulfilling. This is particularly troubling today in Argentina, Brazil and Peru, where economic agents, after having witnessed a series of failed stabilization attempts, prefer to wait before making irrevocable investment decisions.

70. The conclusion is that there is a need for a coordination mechanism that overcomes the competitive market tendency to wait. Political economy considerations need to be brought in. What markets consider a sufficient policy action may simply be beyond the political scope of democratic Governments. If Governments went far enough to create the incentives that would motivate a return of capital and the resumption of investment on an exclusive economic calculation, the implied real wage cuts might be so extreme that on political grounds asset holders might consider the country too perilous a location. In the aftermath of a major macroeconomic shock, competitive markets by themselves may be unable to restore equilibrium. A coordination mechanism as provided by sectoral policies seems to be necessary for growth resumption after stabilization is achieved.

71. The role of expectations and of the "option to wait" highlights the strategical importance that stabilization loans may have in helping reformist Governments to get through with their programmes. A decisive step in that direction would be the support of creditor countries for the suspension of external debt service for a substantial period of time. This could provide

the necessary financial safety net, not only to dissuade potential speculative attacks, but also to induce investors to reverse capital flight and start investment projects. External support can feed domestic confidence and thus avoid the trap of self-fulfilling negative expectations about the prospects of an adjustment programme.

72. The 1985 Israeli stabilization exemplifies the point. The $US 1.5 billion stabilization loan provided by the United States was never disbursed, in the sense of being transformed into imported goods, but this does not mean that it was useless. On the contrary, without such insurance, the Government of Israel would probably have fallen prey to a speculative attack on its currency and would not have been able to buy the time necessary to set the stabilization effort on solid grounds.

F. Nuanced approaches to public investment

73. An outcome of several stabilization attempts in the 1980s was a reduction in investment (see the table) as a response of total investment to a decline in public investment, which was a consequence of cuts in the fiscal budget. The conventional wisdom used to be that a reduction in public investment due to austerity measures affecting public expenditure as a whole would make room for private investment, which had previously been crowded out by excessive government capital outlays in presence of limited savings. Government investment would thus advantageously be replaced by profit-oriented private investment, with positive gains for overall productivity from a better use of scarce savings.

74. Empirical evidence obtained in the 1980s regarding complementarity between public and private investment has shown that decreases in public investment may be detrimental to private investment in the long run even if public investment may dislocate private investment in the short run. The quality of public investment seems to be a critical growth-inducing factor, particularly in cases where an inadequate infrastructure requires the development of large and indivisible public projects to enhance private profitability prospects. 14/ Thus, the adverse impact of certain public expenditure cuts goes beyond the reduction in activity of the private sector - in particular, in the construction sector - which occurs when the Government stops contracts for public works.

75. Cuts in government outlays that have important positive crowding-in effects may have two undesirable consequences for private investment: interruption of feasible projects due to lack of complementary infrastructure works and increased uncertainty.

76. Negative long-run consequences of adjustment programmes could therefore be avoided if indiscriminate reductions in public investment were replaced by a more judicious analysis of priorities concerning investment programmes. Growth performance following adjustment programmes could be improved by greater awareness of the complementarities between public and private investment.

Table. Investment by developing countries, 1980-1989

(Percentage of GDP)

Country and grouping	Gross domestic investment 1980	1985	1989
All developing countries, by region	25.2	23.2	24.7
Latin America	24.0	17.6	20.0
Africa	23.1	19.0	19.3
West Asia	21.3	21.6	22.0
South and East Asia	26.4	24.9	26.7
Mediterranean	22.5	21.5	22.9
by analytical grouping			
Capital-surplus countries	20.9	21.8	24.9
Capital-importing countries	24.2	20.8	22.7
Energy exporters	25.1	21.6	21.4
Energy importers	23.4	20.1	23.2
Recent surplus economies	34.3	26.1	29.6
Other countries	22.3	18.6	20.9
Memo item			
Sub-Saharan Africa	20.0	18.4	21.6
Fifteen heavily indebted countries	23.9	16.4	19.8
Selected developing countries			
Argentina	22.2	8.5	12.0
Bangladesh	15.1	12.5	11.7
Brazil	22.9	16.7	22.4
China	32.2	38.7	36.4
Côte d'Ivoire	28.2	12.6	10.3
Egypt	27.5	26.7	19.3
India	22.8	25.9	23.0
Indonesia	24.3	24.0	23.5
Kenya	30.0	25.9	25.5
Mexico	27.2	21.9	19.3
Nigeria	20.5	7.5	12.5
Peru	27.5	22.4	19.9
Republic of Korea	31.7	29.3	34.5
Sudan	15.1	4.5	9.1
Thailand	26.4	24.0	32.5
Tunisia	29.4	26.6	22.8
Turkey	21.9	21.0	22.4
United Republic of Tanzania	23.0	15.7	21.2
Zambia	23.3	14.9	16.6

Source: World Economic Survey 1991 (United Nations publication, Sales No. E.91.II.C.1), table A.12.

77. There is also a need to reverse the squeeze on the Government's financial capacity that has occurred as part of the process of deterioration of the fiscal accounts. The fiscal deficit can be seen as the excess of public investment over public saving. Public revenues have grown more slowly than government consumption plus debt servicing in virtually every country. The recovery of public savings has thus become one of the most important yet neglected issues of fiscal adjustment in post-debt crisis stabilization programmes. As external debt has become ultimately public, even where it started as predominantly private, servicing the debt absorbs public savings. This is especially important in countries where the Government is a net buyer of foreign exchange, as well as an important investor or source of long-term finance for the private sector. A greater emphasis on the recovery of public savings should allow for a smaller negative effect of stabilization and adjustment policies on the rate of investment, public as well as private. At the same time, international cooperation to solve the debt problem would allow a higher share of domestic savings to be devoted to investment. 15/

G. Sectoral policies

78. Sectoral policies are a potential coordinating mechanism, capable of reducing the uncertainty that constricts private investment in the aftermath of stabilization experiences.

79. The issue of private investment behaviour following stabilization policies goes beyond the question of "private versus public" investment mentioned above. It bears upon the Government's ability to convey clear-cut and sustainable views on issues such as the relative roles of private firms and government enterprises, and on its ability to define long-term investment priorities receiving sustained political support, as expressed in legislative measures and governmental action.

80. There is no substitute for a clearly defined set of structural policies as a means of increasing the private sector's expected profitability and reducing the variance of the long-run scenarios projected by potential investors. Thus, basic positions on strategic issues - such as property rights, development of human resources and stimulus to acquire the scientific capabilities to absorb and adapt technological progress - have been taken in all cases of long-run success of stabilization and adjustment policies.

81. In every case of high investment rates, as in the Republic of Korea, Singapore and Thailand, close connections between a growth-oriented Government and a profit-motivated business community have helped to strengthen private investment through direct channels, such as special credit allocations, but also through sustained support for the appropriate education of the working force at all levels.

H. Getting the policies right

82. In a context of broad policy reforms, private investors may be more sensitive to the uncertainty - that is, to the variance - than to average expected profit. It is the variance and the risk that makes the difference between staying in business or closing down. Policy reforms that appear desirable on standard economic grounds will backfire if they induce doubts as to their likely survival. Reform packages that emphasize policy stability and sustainability are likely to bring greater pay-off in terms of investment and growth than policies that, though they focus on economic liberalization and getting the prices right, do not generate credibility because they ignore the impact on the government budget, the supply of foreign exchange or the uncontrollable reactions of affected interest groups.

83. The re-evaluation of successful experiences of growth after early adjustment policies has qualified previous conclusions about the role of non-interventionist policies in the success stories of outward-oriented market-based fast growth economies of East Asia. 16/

84. The emphasis on the quality of government intervention is the essence of a more balanced conclusion about those success stories. At stake is the ability of Governments to follow incentive-oriented policies that do not go against market signals, even if prices have to be subjected to distortions derived from the presence of subsidies and protective barriers.

85. The lessons to be drawn when one compares the success stories with the obvious failures or even with the aborted successes of the 1970s lead to the simple but frustrating conclusion that government interventions may either enhance or hamper market opportunities. How to foster the first type of intervention and avoid the second is a complex question of political economy to which there can be no simple answers. Some economists conclude that the requisites for "good" government intervention are so extreme that they prefer to live with the market imperfections. Others conclude that these imperfections are too pervasive in developing countries and that the task of formulating and implementing market-enhancing intervention policies is a must for growth recovery.

86. For faster growth, subsidy allocation and other government support has to be monitored to yield results regarding output, exports, technological advance, within a set time-frame, as exemplified in various countries in East Asia. It must not be a permanent mechanism to guarantee artifical private profits.

I. Temporary controls

87. Attempts at stabilization based on direct price controls or more narrowly defined income policies, disregarding fiscal and monetary discipline, have by and large been unsuccessful. A strong argument in favour of temporary controls remains none the less: successful stabilization attempts based on

"fundamentals" may gain political support and imply less output loss when incomes policies are used to avoid unfavourable effects stemming from backward-looking expectations and institutional rigidities in contracts, which are the rule rather than the exception in countries with a long inflationary experience.

88. The weakness of the use of temporary controls in the search for more political support is that they tend to be self-perpetuating. The political economy of the situation is such that there always seems to be a good case for postponing fiscal adjustment and extending price controls.

89. A sensible administration of price controls is crucial to the success of the stabilization attempt. Set prices should not divert considerably from equilibrium prices, otherwise they will be hard to maintain. Price controls can take the form of a freeze on government prices, the exchange rate and some reference wage such as the minimum wage or public-sector wages. If an unfavourable inflationary shock occurs, the pegged values will look more and more unsustainable, and therefore a wave of pessimistic expectations may ruin the stabilization effort. Pressure for devaluing depends on the perceived timing of the balance of payments deterioration *vis-à-vis* the possibilities of finding foreign finance; this may turn out to be crucial to the policy options faced by the Government.

90. The same problem emerges when public-sector deficit prospects deteriorate because public-sector tariffs and prices are part of the nominal anchors. The consequences for the stabilization effort will depend on complicated and difficult assessments of the short-run versus the long-run effects of inflation on the fiscal budget.

91. When stabilization fails, an overextension of price controls is bound to bring, *a posteriori*, the worst consequences in terms of distortions, institutional instabilities and overall damage to government credibility, with negative repercussions for future stabilization rounds.

J. Nominal anchors

92. The long-term purpose of an adjustment programme is to create conditions for an institutional set-up in which a flexible economy may develop into a prosperous one. In such a set-up, relative prices in general and the real price of foreign exchange in particular should signal economic scarcity.

93. The stabilization of the real exchange rate may however conflict with the need to stabilize the nominal exchange rate to ensure a rapid disinflation. This is the nominal anchor aspect of exchange rate policy.

94. If fiscal stabilization is taking place, the central bank is no more obliged to adopt an accommodating monetary policy to finance the budget deficit. Should the central bank define its monetary policy in terms of a money target or an exchange rate rule?

95. If inflation were in fact to stop suddenly, real money demand would increase significantly, hence some monetary accommodation would be necessary: prefixing monetary expansion targets under these circumstances would be quite risky. It would be better to proceed with caution as evidence for increased real money demand becomes clear.

96. However, monetary expansion could safely take place by monetizing foreign exchange inflows at a fixed nominal exchange rate. In that case, the central bank would simply be remonetizing the economy following the decline in inflation, with a marginal 100 per cent reserve backing. This option implies the existence of large foreign exchange reserves or a sizeable inflow of hard currency, but it does not eliminate the need to maintain a proper relation between the increases in money supply and in nominal income. Fixing the nominal exchange rate is an attractive option in that it establishes an immediate focal point for coordinating price expectations and price-setting.

97. Moreover, in an economy that has gone through a long period of disorganizing inflation and unsustainable balance-of-payments prospects, it may not be feasible to define and implement a credible economic policy unless a fairly stable prospect for the exchange rate is offered as a nominal anchor, an element of economic calculus, and a substitute for wildly divergent expectations concerning nominal values.

98. In some concrete experiences, such as in Mexico, a fixed exchange rate played a significant supporting role in defining the minimum consensus around the possibilities of stabilization. This is particularly relevant when the economy has already undergone strong fiscal adjustment, when relative prices are not perceived as unsustainable and when the benefits of reduced variability clearly outweigh the risks of enlarging the distortions that may be associated with maintaining a fixed exchange rate in a world of floating rates. In the case of Mexico, there was also a long historical experience with fixed exchange rates.

99. Although some previous overvaluation, such as that preceding the Mexico experiment in 1987, is obviously helpful at the onset of the stabilization attempt, there seems to be no substitute for strong external support either from bilateral or multilateral lending agencies. When local money cannot credibly be anchored in firm precommitments of local policy makers to disinflation at all costs, the best confidence-building alternative to ensure the inward mobility of flight capital may be stand-by external finance.

K. Debt reduction

100. One common feature of the post-debt-crisis adjustment programmes was the limited size of the favourable changes in flows - such as primary budget deficits, trade account deficits - which could rapidly be obtained in a growth-oriented context. The costs of servicing a debt overhang turned out to be too high to be compensated for by sustainable budget surpluses or trade surpluses. The limitations of traditional policies, aimed at controlling

domestic absorption in the presence of a high and hard to finance external debt, had a domestic counterpart in the difficulties to control and reduce the domestic public sector debt.

101. In countries that have experienced a long period of high inflation, virtually no public debt finds voluntary holders in the domestic market. The consequence is that policies aimed at reducing the stocks of debt are needed to complement flow-oriented deficit-reducing policies.

102. External debt reduction and restructuring are also essential inputs to stabilization programmes in heavily indebted developing countries. Deeper cuts in commercial bank debt than hitherto will be required for the second layer of countries that are waiting in the wings, and with increasing interest arrears, for Brady Plan operations. Regarding official debt reduction of the low-income countries, the Toronto Terms are increasingly recognized as insufficient. The London Summit of 1991, in paragraph 44 of its Economic Declaration, agreed on the need for debt relief to the poorest, most indebted countries well beyond Toronto Terms. It has also been increasingly difficult to leave out of rescheduling operations the debt of the least developed countries to the international financial institutions. Middle-income countries' debts to official agencies deserve treatment equivalent to what has been given to Egypt and Poland. 17/

103. Many African countries are currently undertaking adjustment programmes which have revealed themselves extremely difficult to sustain and have brought proportionately little relief to balance-of-payments pressures. Debt relief started as a response to African problems and a good deal more will have to be forthcoming.

104. Two conclusions emerge from recent experiences: the first is that the expected time for results should be fairly long in the case of African economies - as in similarly war-devastated economies in Central America. The second refers to the domestic costs of long debt-rescheduling negotiations.

105. The first aspect poses a challenge to the multilateral agencies: a significant effort should be made to define the appropriate time-frame for policy-based loans for the most fragile economies. This requires special funding with flexible time spans and a carefully designed system of monitoring and provision of policy advice, with the maximum use of locally based research capability.

106. A substantial effort has been and is currently being made by the national economies and by multilateral agencies and many bilateral aid agencies in the direction of providing Africa, and sub-Saharan Africa in particular, with much needed investment in human resources and academic research capable of improving economic management. Support for locally based research is essential in order to increase efficiency in the use of domestic and international resources for the improvement of overall economic and social conditions in the region.

107. The second aspect refers to the protracted process of debt-related discussions and negotiations. Although some progress has been achieved in the past few years, there is a need for greater recognition of the costs to poor countries of long and painful negotiations concerning a by and large unserviceable external debt. The consequence of the present negotiation rites is that scarce human and financial resources that could be better used in improving economic management are absorbed in long and futile discussions.

L. Policy reform in formerly socialist economies

108. In countries where thorough institutional reforms are expected as part of comprehensive political change, as is the case of installing a market-based system in formerly socialist economies, bold packages may be seen as a one-way ticket to a new regime. This does not mean, however, as recent experience in some African countries illustrates, that such packages are disappointment-proof.

109. Serious possible conflicts have to be taken into consideration: price liberalization, exchange rate devaluation and full monetization of salaries and wages involve the conversion of special buying rights, consumption cards and particular monetary compensations into comparable sums expressed in national currency with general purchasing power, disguising drastic changes in relative incomes that may occur in the process of reform.

110. The temptation to take the three steps - price liberalization, exchange rate devaluation and full monetization of wages and salaries - at once is great. But one usually cannot tell with a reasonable margin of error how much devaluation is necessary and there is seldom a "free market" for exchange to which one might resort.

111. Removal of a dualistic pricing system has been tried in several developing countries, with different degrees of friction and success. Full monetization of wages and salaries will expose inequalities disguised behind a swarm of buying rights, access to imports at preferential exchange rates and loans from official banks under heavily subsidized interest rates.

112. Inflation may be generated from attempts at recovering real incomes by nominal corrections of wages and salaries, by overburdening the fiscal budget and by printing money to finance the extra charges. Such distributive conflicts easily result in inflation if budget constraints are soft and this may wreck an otherwise coherent initial adjustment attempt. A second round of adjustment is then required, with budget cuts, firing of government employees and more devaluation, defining a picture of institutional reform failures not conducive to a social consensus.

113. The road leading to capitalism may thus turn out to be paved with inflationary spurts, fierce distributive conflicts and several rounds of stop and go. Evidence of the advantages of a gradual approach to institutional reforms seem to be far from convincing, but a long period of adjustment, requiring strong external support, seems hard to avoid.

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114. Moreover, more drastic changes in the rules of the game are not necessarily convincing where several shocks have already been experienced in repeated attempts to deal with long-established distortions and resistant inflation-perpetuating institutions. These considerations add weight to some spurned aspects of gradualism. A steady course of consistent policies seems to be an essential element to re-establish confidence in a country's governability and essential stability.

V. CONCLUSIONS FOR POLICY-BASED LENDING

115. Effective, credible and sustainable policy changes have better chances to succeed in implementing growth-oriented stabilization with the help of foreign lending. This seems to have been a feature of all success stories. However, it is not clear whether external support should favour big bangs. From the orthodox and "fundamentalist" viewpoint, the probability of success of policy changes depends on the internal consistency of the policies and on policy credibility, which in turn depends on policy consistency. Long lags certainly may pose difficult challenges for the sustainability - political as well as economic - of policy reforms. But if one believes that there is little one can do to reduce lags in expectations, because they are related to the time economic agents take to learn that the Government will not retreat, then one will favour big bangs and be pessimistic about the possibilities of a less ambitious approach as a means of gathering political support and increasing the odds of success. A broadly based liberalizing shock and convincing cuts in government spending would seem to be the only hope for success in stabilization policies, no matter how long it takes for results to appear.

116. The best one could hope for would be to shorten the time lag of the economy's response to fundamentalist policies by learning from other country's experiences. Unfortunately, the record of existing successes stops short of providing a reasonable vade-mecum for economic policy prescriptions beyond very general elements around which one may identify the minimum of convergence previously analysed.

117. One must also reckon with the evidence showing that slow results and deteriorating credibility of a big bang tends to contaminate new efforts, as policy package after policy package is abandoned or reformulated with unsatisfactory results and little correction of long-term economic conditions. A large proportion of failures in post-debt-crisis adjustment have followed this pattern of stop-and-go, with limited progress and increased instability. A recent study suggests that 50 per cent of 242 IMF programmes in the past decade were not completed and that higher instability was the general result of non-implementation. 18/ If policy-based lending is not able to increase the chance of success with the passage of time, there is very little to recommend it.

118. One lesson of these experiences is that the "policy shock" package bias should emphasize the time element, rather than the large scope. It should be able to relieve immediate constraints so as to gather support for a long-term

endeavour, although the announcement should include all the elements recognized as necessary for a consistent programme. Temporary controls may be introduced, while keeping an eye on the temptations to bow to immediate, even if unsustainable, results that tend to substitute the overextension of controls for the progress in attacking the fundamental causes of imbalances.

119. If an early reduction of some critical imbalance is not achieved but the programme is judged to be on the right track, supplementary finance would permit the programme to stay on track. Tranching of policy-based loans has been a traditional way to allow limited support for a policy move that is in the correct direction but the intensity of which is thought unconvincing. This may indeed be a convenient way to start a programme whenever there seems to be strong political resistance to adjustment. Tranching may be a useful way to prevent a partial adjustment package from developing into an unwarranted protracting of structural changes. Its most common pathology, however, is to make the period between reviews too short.

120. Excessive conditionality can be another undesirable by-product of a programme that is too encompassing. This has been a common source for waivers in the adjustment programmes in the 1980s. The consequences may be more serious than mere bureaucratic congestion: credibility may be seriously impaired if too many targets require waivers.

121. Contamination of the credibility of some parts of a programme may arise from failures in other, less feasible, ones. Conditionalities that are not fulfilled lead to long delays in disbursing and do harm to the package as a whole, which becomes underfunded. To the recommendation that tranching should be longer, one might add that it should also be parsimonious.

122. Government "ownership" is an essential prerequisite for success. In order to bend the odds in favour of successful adjustment, multilateral lending to local "government-owned" programmes must reward sustainability. To achieve this, it is essential that the design of the programme be based on a diagnosis of the most important distortions and imbalances afflicting the country and that there be concern with realistic targeting and timing for tranching, and with reducing the social costs of a long-lasting structural adjustment.

123. Among the roles of multilateral financing in the context of stabilization and adjustment programmes, the following might be underscored:

(a) Helping the Government prevent the aggravation of economic and social conditions of the poor;

(b) Providing foreign exchange support for dollar-starving economies while fundamentals are being taken care of but immediate results are not yet available;

(c) Facilitating debt relief and renewed access to international capital markets;

(d) Increasing the credibility of local money through the provision of a financial safety net to sustain a realistic exchange rate parity;

(e) Increasing overall economic flexibility through the financing of the costs of deregulation and other market enhancing policies;

(f) Financing the costs of adjustment associated with privatization and public-sector reforms, with a view to increasing policy effectiveness and recovering investment in social and economic infrastructure;

(g) Funding the implementation of sensible sectoral policies, capable of reducing the time lags of private investment response to economic stabilization;

(h) Providing contingency support in case of abrupt variations of interest rates or of the prices of primary commodities when they are much more unfavourable than envisaged during the design of the country programme.

Notes

1/ See World Economic Survey 1988, chap. VIII, World Economic Survey 1989, chap. VIII, and World Economic Survey 1990, chap. VII (United Nations publications, Sales Nos. E.88.II.C.1, E.89.II.C.1 and E.90.II.C.1).

2/ For example, the World Institute for Development Economics Research Conference on Stabilization and Adjustment Policies in Developing Countries (Helsinki, August 1986); the International Monetary Fund/World Bank Seminar on Growth-oriented Structural Adjustment (Washington, D.C., 1987); or the Symposium on Structural Adjustment, External Debt and Growth in Africa, sponsored by the Association of African Central Banks and IMF (Gabarone, February 1991).

3/ Declaration on International Economic Cooperation, in particular the Revitalization of Economic Growth and Development of the Developing Countries. See General Assembly resolution S/18/3 of 1 May 1990, annex.

4/ See International Monetary Fund, "Theoretical aspects of the design of Fund-supported adjustment programs. Occasional Paper 55 (Washington, D.C., September 1987).

5/ See John Williamson, "What Washington means by policy reform", in Latin American Adjustment. How Much Has Happened?, J. Williamson, ed. (Washington, D.C., Institute for International Economics, 1990).

6/ More recently, other elements have been considered in lending and debt negotiations, such as the environment, women's participation, spending for arms, and human rights.

Notes (continued)

7/ The "heterodox" approach was a reaction to the failure of "orthodox" policies (tight fiscal and monetary policies and devaluation of the exchange rate) in anti-inflationary programmes in countries with chronic inflation. A heterodox approach is an orthodox one plus income policies (wage and price controls) and a nominal anchor. As pointed out by Bruno (1991), programmes of price and wage controls have inaccurately been termed "heterodox" shocks. Price controls do not do away with the need for monetary and fiscal discipline in heterodox experiments.

8/ Declining inflation would reverse the so-called Olivera-Tanzi effect - that is, the loss in real tax revenues which occurs as a consequence of the time-lag between tax accrual and tax collection when inflation increases.

9/ Discussing national policies in pursuit of the national and collective self-reliance of developing countries, while denying autarky as a viable course, the Report of the South Commission is indicative of changed views on development policy. See "The challenge to the South: an overview and summary of the South Commission Report" (A/45/810), and The Challenge to the South: The Report of the South Commission (Oxford, Oxford University Press, 1990).

10/ The universal validity of recommendations for openness is questioned, for instance, in S. Chakravarty and A. Singh, "The desirable forms of openness in the South", paper prepared for the World Institute for Development Economics Research, July 1988; and H. W. Singer, P. Gray and Lance Taylor, "Economic openness: problems to the century's end, paper prepared for the World Institute for Development Economics Research, April 1988. Also in "African alternative framework to structural adjustment programmes for socio-economic recovery and transformation" (E/ECA/CM.15/6/Rev.3), doubts are expressed about the benefits of full trade liberalization in the African situation.

11/ See G. K. Helleiner "The IMF, the World Bank, and Africa's adjustment and external debt problems: an unofficial view", paper presented to the Symposium on Structural Adjustment, External Debt and Growth in Africa, held at Gaborone, February 1991.

12/ The significance of domestic political support and of the institutional set-up has been highlighted in "African alternative framework to structural adjustment programmes for socio-economic recovery and transformation" (E/ECA/CM.15/6/Rev.3).

13/ UNICEF and the concept of "adjustment with a human face" played an important role in bringing into the debate the impact on the most vulnerable groups. The first of the UNICEF studies on this issue was Adjustment with a Human Face, G. Andrea Cornia, Richard Jolly and Frances Stewart, eds. (Oxford, Clarendon Press, 1987).

Notes (continued)

14/ See, for instance, J. Greene and D. Villanueva. "Private investment in Developing Countries". IMF Staff Papers, 38, No. 1, (Washington, D.C., March 1991).

15/ The origins of the steep decline in net investment in many Latin American countries during the 1980s and its links to the adverse evolution of external variables and of public finance were examined in "Changing production patterns with social equity: the prime task of Latin American and Caribbean development in the 1990s" (LC/L/548, 14 February 1990). The Economic Commission for Latin America and the Caribbean (ECLAC), has also undertaken, with UNDP support, a series of studies under the Fiscal Policy Project, as part of an assessment of the process of adjustment, stabilization and development in Latin America. See in particular ECLAC, America Latina: la politica fiscal en los anos ochenta. Serie Politica Fiscal 2, Proyecto Regional de Politica Fiscal CEPAL/PNUD (Santiago de Chile, 1989).

16/ See Alice Amsden, Asia's Next Giant (New York, Oxford University Press, 1989) and L. Lau (ed.), Models of Development - A Comparative Study of Economic Growth in South Korea and Taiwan (San Francisco, Institute for Contemporary Studies, 1986).

17/ See the report of the Secretary-General on external debt and development to the forty-sixth session of the General Assembly (A/46/415).

18/ See T. Killick and M. Manuel, "What can we know about the effect of IMF programmes", mimeo. (London, Overseas Development Institute, May 1991).

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