

GENERAL THEMES

SOCIAL IMPACT

OWNERSHIP

EXTERNAL VIABILITY

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SOCIAL IMPACT

1. ESAF as an Instrument

ESAF lending is a conditional transfer of resources. Both the conditions and the transfer are distinctive when compared to other adjustment lending.

The conditionality is far-ranging and high-level. It covers both medium-term policy changes across the economy, and short-term monetary and fiscal management. Its high power comes from cross-conditionality, with bilateral donor and other international funding institutions (IFI) programs. Since this cross-conditionality is non-reciprocal, Fund conditions are thus at the top of the hierarchy of donor conditionality. The unique authority of the Fund derives from this hierarchy rather than from the amount of resources which the Fund transfers, which is typically relatively small in the context of overall transfers. The existence of a hierarchy reflects the donors' need for coordination: some agent must take the lead role in judging country performance. The fact that this role is occupied by the Fund reflects the primacy of short-run macroeconomic policy, given the context of a long history of macroeconomic mismanagement in most low-income countries.

ESAF as a transfer mechanism is distinctive because, with an important exception, funds accrue to the central bank rather than to the government budget. ESAF does not generate any counterpart funds. The foreign exchange is used either to increase the level of reserves or to finance a higher level of imports. That part of ESAF funds which is used for reserves provides an income for the central bank since the interest rate earned on its deposits exceeds the interest rate charged by the Fund. Potentially, the government might capture this income, although the relationship between increased central bank surpluses and transfers to the government need not be a close one. This income transfer is, however, incidental to the purpose of ESAF funds used for reserve accumulation, since the rationale is the increased level of confidence which higher levels of reserves provides. Research by the Fund has established that investor risk ratings are strongly positively influenced by the level of reserves, and in turn the risk ratings appear to be important in determining investment flows.⁵

That part of ESAF funds which is used to increase imports also indirectly benefits the budget. ESAF recipients have a high fiscal dependence upon import taxation, and the higher tariffs are,

⁵ N.U. Haque, M. Nelson, and D.T. Mathieson, "Creditworthiness Ratings: Their Political and Economic Content" (forthcoming) in P. Collier and C. Pattillo (eds.), *Risk and Agencies of Restraint: Reducing the Risks of African Investment*, London: Macmillan.

the larger is the proportion of ESAF funds which supports the budget. As with the support of the budget via increased central bank surpluses, this is an unintended effect. The major effect of ESAF import financing is, however, on relative prices. By augmenting central bank sales of foreign exchange, ESAF programs appreciate the exchange rate. This benefits net purchasers of foreign exchange, and adversely affects net sellers.

In this respect, ESAF is like a Dutch disease. Since the export sector is a net seller of foreign exchange, the consequence is that ESAF operates like a tax on the export sector. While this may appear to be a general effect of all donor transfers, in fact all non-ESAF transfers have potentially an offsetting effect. ESAF is unique in that it does not accrue to the government budget (except through the two inadvertent channels identified above). Non-ESAF transfers, by augmenting public expenditure, are able to offset the negative Dutch disease effect on the export sector by pro-export public services. For example, donor support for a road program can reasonably be presumed to lower the transport costs faced by the export sector by more than it implicitly taxes the sector through an appreciation in the exchange rate.

The exception to the above is the operation of ESAF in the Franc Zone. In the Franc Zone, ESAF of course does not affect the exchange rate. However, the Fund does allow it to be used in its entirety as direct budget support since providing balance of payments support is unnecessary in the context of French support. Hence, in the Franc Zone ESAF is likely to benefit the export sector, whereas elsewhere it is likely to be detrimental.

The model which the Fund adopts in the Franc Zone appears to have advantages which could be extended to other ESAF recipients. It is an unfortunate side-effect of present ESAF design that budget support accrues mainly to the extent that a government has high trade taxes. It is also unfortunate that ESAF is the only transfer which operates as an unmitigated implicit tax on the export sector. Since there is evidently no issue of principle in whether ESAF accrues to the budget, it might be desirable to unify the treatment of ESAF recipients by providing it as budget support in all instances.

2. Crisis Response: the Poverty Impact

To date, ESAF programs have generally commenced in the context of macroeconomic crisis, (although the form of the crisis has usually been an unsustainable fiscal deficit, or a severe decline in real incomes, rather than a run on the currency). As a result, the poverty impact of the policy package has not been foremost among the considerations of Fund staff. In recent years, there has been a noticeable increase in the attention paid to social impact in Fund documents. However, even in recent work, the discussion in effect relies upon government declarations about the efficacy of social programs. The Fund Board may need to restate the purpose of ESAFs so as to include the social concerns which it has articulated in the terms of reference for this study

as an explicit requirement. Fund work on the social impact of programs could be both more analytic and more empirically based.⁶

In analyzing the social costs of adjustment it is useful to distinguish between the two main routes by which living standards are affected by policy: changes in private incomes and in public social expenditures. A further distinction is between adjustments in which policy reform imposes substantial temporary costs *in aggregate*, and those in which losses for some groups arise predominantly because of redistributions to other groups.

Adjustment and Private Incomes

We first focus upon adjustment and private incomes. The case of temporary aggregate adjustment costs, where the entire economy initially contracts prior to sustainable growth, is exemplified by the transition economies of Eastern Europe and the former Soviet Union. Transition economies are characterised by two features which, in conjunction, produce this U-shaped response to reform. First, a large sector of the economy, typically industry, produces high-cost inputs which handicap the expansion of potentially viable sectors, and so must contract before such sectors can expand. Secondly, there is a lack of entrepreneurship, so that the pace of expansion of the newly viable sectors is slow. Thus, the aggregate economy contracts as the decline of the large, unviable sectors initially dominates the expansion of the newly viable sectors.

Some of the transition economies are also characterized by a lack of safety nets. Typically, there is no public system of welfare payments for the unemployed; there is no easy-entry job sector to which former workers of the declining sector could turn; and there is generally a less strong tradition of support through extended families than in Africa.

A few ESAF countries have all of these features of transition economies (although these were not included in our sample). Some other ESAF countries have one but not other features of transition economies. For example, Zimbabwe has a large industrial sector supplying capital goods and intermediates, much of which had to contract in order to make other activities viable on world markets. However, the social costs of this contraction were much lower than in the pure transition economies because there were already entrepreneurs able to take up new opportunities, and because there was a ready safety net through a large informal sector and a tradition of support through the extended family. In Zambia, there was less need for early contraction (since the industrial sector was largely producing final goods) but due to the long period of state

⁶We here focus on the feasibility of *ex-ante* analysis of the poverty impact of Fund programs. Whether such an extension of the work of the Fund staff is desirable is a question we will address below.

ownership, there were few entrepreneurs to take advantage of new opportunities. In Malawi, previous repression of the urban informal sector limited the main safety net for displaced urban workers.

More commonly, ESAF countries do not share any of the characteristics of the transition economies. In this major group, the social costs of adjustment arise through redistributions within the society rather than through aggregate losses. For example, in Uganda and Ghana even the early stages of reform were growth-enhancing so that in aggregate, there were immediate social benefits. However, whereas aggregate losses from transition are temporary, losses arising from redistributions are likely to be long-lasting, since the losses are usually due to relative prices changes which are intrinsic to the policy changes.

Some of those who lose are likely to be poor. However, this is not equivalent to saying that the poor lose from adjustment. Usually, distributional changes arising from policy reform tend to favour the poor, but it is important to recognize that the poor are not a homogeneous socio-economic group, so that among the poor there will often be identifiable losers. Because many of the losers from reform are non-poor, the important question to ask is not “who loses from reform?”, but rather, “who, among the poor, loses from reform?”.

In most ESAF countries, socio-economic survey data were available at the start of the reforms so that this process of identification was feasible. Typically, in our sample, this analysis was not done. A notable exception is the recognition in Malawi that the rural poor were net purchasers of maize and hence would suffer from the increases in food prices envisaged under the program. More commonly, predictable negative effects for poor groups were missed. For example, again in Malawi, it could be established from survey work that households dependent upon wage income from agricultural estates were among the poor. Wages on the estates were set through a national level government-regulated minimum wage. In the first two years of the ESAF program the nominal value of this minimum wage was not altered. As a result, due to very high inflation, the real value halved. Two years into the program the nominal wage was raised, but this delay inflicted a severe decline in real income upon a group ill-prepared to cope with it. These temporary losses of the estate workers were a transfer to estate owners, and in no way a necessary cost of adjustment. Had available information been better used, it would have been easy to protect this substantial group by adjusting estate wages for inflation.

While improved analysis of adversely affected poor groups is both necessary and feasible we will suggest below that this is not an appropriate task for the Fund.

Adjustment and Social Expenditures

Social expenditures can get squeezed during adjustment for four reasons. First, the entire economy might contract (the transition economies case), so that the protection of per capita

expenditures would require a rising share of social expenditures in GDP. An example is Côte d'Ivoire prior to 1995. If aggregate income is falling, it is unlikely to be optimal for social expenditures to be maintained constant in absolute terms, but it may be desirable for them to fall less rapidly than aggregate income. Secondly, the adjustment might involve a decline in the share of public expenditure in GDP. An example is Zambia post-1991. This is quite likely to be the case since adjustments often start from unsustainable fiscal deficits; however, it is far from universal. Attention has usually focused on whether deficits should be closed by higher taxation instead of reduced expenditure. In our sample such a criticism would not usually have been reasonable. A more sustainable criticism would be that through premature financial liberalization governments have faced sharply increased interest expenditures which have necessitated otherwise avoidable reductions in social expenditures: Zimbabwe and Zambia are examples. If GDP is not declining, there is a good case for maintaining social expenditures by increasing their share of public expenditure. Thirdly, social expenditures might get squeezed because other public expenditures are given greater priority. An example is Uganda, where the government determined that infrastructure was likely to be more productive. Fourthly, social expenditures might get squeezed because the cost of providing them rises relative to other prices. Examples of this are Uganda and Zambia.

Of these four, donors have paid most attention to the third: the share of social expenditures in the budget. However, in our sample the most important effects have come through the fourth: the change in the relative cost of providing social services. In Zimbabwe, Malawi and Côte d'Ivoire the relative cost of social services declined substantially, often converting declines in the real value of spending into increases in the volume of service delivery. In Zambia and Uganda relative price changes worked in the opposite direction. Although the relative price effect was large in each of the countries in our sample, we have found no mention of it in Fund documents. Sometimes social expenditures are reported as a share of GDP, and sometimes they are reported in 'real' terms when deflated by the GDP deflator; in each case an implicit assumption is that the deflator for social services is the same as for GDP. Generally, the large relative price effects arise from civil service wage policies and from exchange rate changes. For example, in Zimbabwe and Côte d'Ivoire civil service real wages have been sharply reduced, whereas in Uganda they have been increased. Since these changes in costs are part of the program they should be integrated into the analysis of social provision. In some ESAF countries sectoral cost and price data are not available, but in the five countries in our sample data was not a constraint.

Forecasting and Monitoring Social Costs

While it would be feasible to reduce the social costs of adjustment by better attention to socio-economic data, the Fund is not the appropriate institution for this expertise. The World Bank already undertakes considerable analysis of poverty. The Bank has a comparative advantage given its microeconomic focus and its history of household data collection. However, at present

this information is used predominantly for longer-term questions of poverty-alleviating development strategies. The appropriate way to harness this expertise into the better design of short-term stabilization programs is for the Fund to request the Bank formally to identify which groups among the poor are likely to lose from specific aspects of the program. As part of its response, the Bank should be asked to provide likely paths of the incomes of the main poverty groups and of the monitorable outputs of social services. One advantage of this is that such forecasts would then get monitored. As a result there would be a better warning system when the poor are badly affected. We should make it clear that we do not mean the income projections for poverty groups to be criteria by which a program can be declared 'off-track' in the same way as rapidly available financial targets are monitored. The delay in income data precludes such an approach. However, there is an important role for the review of program performance on poverty criteria. If program design has envisaged declining poverty whereas it is rapidly increasing, the presumption must be that either the program design was flawed or that there have been unanticipated circumstances. In either event, it would be appropriate to reconsider program design. Poverty monitoring would thereby provide some mechanism for quality control of the program in an important dimension. It is possible that the present lack of formal Fund-Bank projections and monitoring of poverty outcomes increases the fear of policy change.

Fund staff themselves could monitor social expenditures more clearly than is currently done in reports. At present, the number usually reported is the share of social expenditure in the budget. A more important number is real, per capita health and education expenditures. Where these fall during an adjustment program it is useful for Fund staff to diagnose the cause as between a decline in GDP, a decline in public expenditure relative to GDP, a decline in social expenditure relative to other public expenditure, and a rise in the relative cost of providing social services. The above is feasible on present Fund information and with present Fund expertise. A much more ambitious step would be to attend also to the efficiency of public expenditure. While this is of obvious importance, the skills required make this more appropriate for the Bank and other agencies and we do not recommend Fund involvement.

Protecting the Poor

The poor are not, in general, disadvantaged by stabilization and adjustment, in that they do not usually systematically lose more than other groups. In transition economies temporary hardship may be very widespread among social groups. In such circumstances food-for-work projects may provide a safety net into which the poorest self-select. In low-income countries the losing group is likely to be smaller but more particular. The best and most comprehensive academic study of the impact of policy reform on the poor in Africa, by David Sahn, concludes that reform will "generally have positive effects on growth and income distribution", and that "concern for the

welfare of the poor is a weak excuse for inaction and the perpetuation of failed policies”.⁷ Nevertheless, diverse sub-groups of the poor may suffer temporary or long-term losses. We have already noted the example of estate workers in Malawi. In Zambia, those maize farmers who were remote from markets suffered by the ending of pan-territorial pricing and subsidized maize meal. In Côte d’Ivoire, workers in the informal sector of Abidjan faced large losses as devaluation squeezed the expenditures of higher income groups. In Uganda, demobilized disabled soldiers lost what were in effect welfare payments. In such cases, national food-for-work programs are less effective and case-specific solutions are required.

To date, safety net programs have tended to have three weaknesses. First, they have tended to be aimed at high-profile groups which lose, such as redundant civil servants, rather than those among the initially poor who lose. Secondly, their execution has tended to be slow, and more appropriately paced for the general problem of poverty alleviation than for the specific protection of those poor who lose from reform. Thirdly, the budgets have tended to be small relative to the scale of the problem.

Sharing the Benefits

While the poor may not disproportionately suffer from stabilization and adjustment policies, large groups among the poor, such as subsistence farmers, may be slow to benefit from rising aggregate incomes. Thus, in Uganda, the benefits of income growth have to date largely missed that part of the rural population which derives its income predominantly from subsistence. In these circumstances increased delivery of public services is a means by which the benefits of growth can swiftly be spread to a majority of the population. This may give rise to a short-run trade-off between growth maximization through spending on infrastructure and poverty alleviation through spending on social services. Faced with such a trade-off there is no obviously right answer, but governments should at least be appraised of the facts. There might at least be a presumption that in a growing economy the absolute per capita supply of basic social services would continuously increase. As discussed above, because of the large relative price changes which affect social service delivery, this is not automatically achieved by increased budgetary provision as a share of GDP. There may also be a conflict between the effective delivery of social services and the operation of the cash budget. Although there is no easy answer to these problems, the present lack of clarity in the presentation of data on social provision and its relationship to GDP growth and budgetary decisions in effect biases decisions against prompt corrective action to maintain social provision on track.

3. Trade-Offs between the Short and the Long Run

⁷D.E. Sahn (ed.), *Economic Reform and the Poor in Africa*, Oxford: Clarendon Press, 1996, p. 22.

Fund programs describe both short and long-term policies and objectives, but in practice tend to give priority to the former. Performance criteria are typically defined in terms of fiscal and monetary variables, measured at high frequencies. The programs we have described in the case studies invariably also included structural reforms and growth targets but these play a lesser role in the Fund's high-level conditionality.

This is, of course, entirely appropriate when the prime objective is to stabilize the economy. However, with ESAF lending, the Fund became concerned with the issue of long-run growth. While stabilization is justifiably seen as a prerequisite for growth, this introduced trade-offs between short-run and long-run considerations. These trade-offs are not systematically analyzed in the programs. We consider five areas where this lack of analysis can be problematic.

Revenue Concerns

First, the Fund often appears to encourage revenue raising measures without considering explicitly the cost and incidence of taxation. A possible consequence of this is the continuing heavy reliance of many ESAF countries (well documented in the Staff review) on import taxation. Clearly, revenue considerations must here be balanced against the long-run welfare costs of delayed trade liberalization. In Côte d'Ivoire, the Fund argued in favour of the adoption of a high external UEMOA tariff, apparently without consideration of the long-run costs. In Uganda, there was also little reduction in the reliance on trade taxes. There was a shift from export to import taxation but we found no evidence in Fund documents that (by Lerner equivalence) import tariffs were seen as taxing exporters. The rural economy had retreated into subsistence in the pre-reform period, when exports were heavily taxed explicitly. The reversal of this retreat in the reform period was hindered by the implicit taxation of exports. In this sense trade policy failed to benefit the rural poor.

Another consequence of the Fund's revenue preoccupation arises in privatization programs. The Fund is primarily concerned with the effect of the selling of state enterprises on the budget and less with the efficiency implications of various alternative forms of privatization. This stance may encourage governments to adopt socially costly forms of privatization. An example is the privatisation of the public telephone company in Côte d'Ivoire. This was not only sold as a monopoly but prior to the privatization a regulatory framework was set up which ensured high profitability. While this obviously was fiscally advantageous (increasing the amount the government could raise from the sale), it imposed long-run costs on the economy. In this case the Fund abstained from taking a position on the microeconomics of the proposed form of the privatization, other than insisting on transparency in the bidding process.

In Fund documents we have found no analysis of the trade-off between short-run fiscal benefits and long-run social costs in such cases. As ESAF operations will increasingly involve the Fund

in areas where such trade-offs are important we recommend that they are explicitly analyzed, rather than being left implicitly to the Bank.

Sequencing Problems

Second, where ESAF programs involved both stabilization measures and structural reforms sequencing issues have been given insufficient attention in our sample countries. A common problem has been that early financial and exchange rate liberalisation has made stabilisation unnecessarily difficult. Zimbabwe offers a striking example. The removal of financial repression when the budget deficit was still quite large led to a very large increase in the government interest bill (recall that this amounted to 5percent of GDP). This made the planned, highly ambitious reduction in non-interest expenditure politically unsustainable and hence ultimately infeasible. The sequencing adopted in the Zimbabwe program was highly unfortunate. Not only did it contribute to the loss of fiscal control, making stabilization elusive, but it also led to a period of very high real interest rates, deterring investment. Errors in sequencing can therefore undermine both stabilization and (to the extent investment is reduced) structural reform. Clearly, this is not an argument for maintaining financial repression but rather for postponing financial liberalization until the budget has been brought under control.

Similarly, in Zambia domestic financial liberalization and liberalization of the foreign exchange market led to a large step-increase in the price level. The stabilization effort became itself inflationary and would have failed but for the introduction of the draconian measure of the cash budget. In Zambia the sequencing of the reforms in fact created an incentive for capital flight.

An important corollary is that such sequencing problems make it very difficult to protect desirable public expenditure. Recall that in Zambia the share of public expenditure in GDP *halved* in a two-year period. In such a context a careful consideration of the costs and benefits of public expenditure is clearly impossible. In Zimbabwe, sequencing problems contributed to avoidable reductions in per capita spending on health and education.

Errors of sequencing can also have grave implications for the poor. In Zambia, they led to a credit crunch in the private sector which delayed the emergence of rural food markets when the government withdrew from marketing.

Postponement of Structural Reform

Third, in some ESAF programs structural reforms have come too late rather than too early. Both in Zambia and Malawi growth required radical structural reforms in agriculture, with long lead times, as in the case of the rehabilitation of rural roads.

We have noted that Zambian farmers were effectively stuck in a "corner solution", specializing in maize production. The withdrawal of the government from agricultural marketing operations should have been complemented with early reforms to improve rural transport, extension and storage. Similarly, reform in the export sector required the privatisation of ZCCM but as yet this has still not been achieved.

In Malawi, the first ESAF did not even involve substantial structural adjustment and while the program for the second ESAF did involve structural reforms, the transformation of the smallholder sector has begun only quite recently. In Uganda, after a decade of SAF programs there are still elementary infrastructure deficiencies, most notably in electricity and telecommunications.

Such problems require very early action on structural measures, to be initiated when the economy is still in the stabilization phase. The failure to front-load structural reforms with long gestation lags may well be the most serious defect of structural adjustment as currently designed. Without such early initiatives there may be a long period of little growth, undermining the political support for the program.

Cash Budgets

Fourth, several countries (notably Zambia and Uganda, both in our sample) have been very successful in rapidly bringing down inflation by switching to a cash budget. However, a cash budget makes it impossible for the government to allocate its expenditure intertemporally optimally. Investment can easily be affected, even in cases where capital costs are fully borne by donors: when the cash budget prevents the government from making complementary recurrent expenditures, investments can be delayed. There is at present some concern amongst donors that the operation of a cash budget may have such adverse effects on the efficiency of expenditure that in post-stabilization economies, the instrument may have to be modified.⁸

Clearly there is no simple answer to the question when the costs imposed on the economy by intertemporal misallocation start to outweigh the benefits of the cash budget in terms of fiscal control and credibility. Fund staff recognize that cash budgets are only a short-term solution and we encourage further work on the question of the evolution of cash budgets to more sustainable systems of fiscal control. In this area the Fund could in our view play an extremely important advisory role.

Budget Deficits in Post-Stabilization Economies

⁸We consider the role of the Fund in such economies in the next section.

Fifth, probably the most damaging form of conflict between short and long run concerns arises in economies which have been successful in achieving stabilization. In such countries, such as Uganda in our sample, the traditional Fund concern with fiscal deficits needs modification. While the Fund is correct to emphasise that domestic deficit financing should always be avoided, the attempt to reduce current account and aid-exclusive fiscal deficits further (or indeed to run a surplus) has no bearing upon the control of inflation while being damaging for growth. The original Board statement of the purpose of ESAF was as follows: “to promote in a balanced manner, both balance of payments viability and growth, through mobilization of domestic and external resources...”(15 December 1987). A helpful approximation of this is to think of it as two objectives with two instruments: “to promote balance of payments viability through the mobilization of domestic resources”, and “to promote growth through the mobilization of external resources”. Since the intention was to promote each of these “in a balanced manner”, we might think of the two objectives as on average being given equal weight. In pre-stabilization environments it is evident that priority must be given to external viability. Conversely, in post-stabilization environments, where the budget deficit is covered by grants and the grant-equivalent of concessional lending, the priority for the Fund should shift to the “promotion of growth through the mobilization of external resource”. At present, the Fund gives the impression that it wishes to see aid tapered out over a quite short period in post-stabilization environments. While, as the Fund notes, there must be contingency plans for a decline in the willingness of donors to provide aid (just as there must be contingency plans for a deterioration in the terms of trade), the Fund should, to be consistent with the statement of the Board, encourage both more public and more private capital to flow into those policy environments which it deems to be satisfactory, and provide planning scenarios which show the growth path which such inflows would permit. A clear statement from the Board that the decline of aid in post-stabilization low-income countries is undesirable would be helpful and timely.

There are three disadvantages of the Fund's current approach to budget deficits in such countries. First, at least a subset of the countries which have achieved stabilization have also achieved a policy environment conducive to growth. As donors become better aware of the evidence that aid is effective in such, and only in such, economies aid flows to these countries are likely to increase. The Fund's tendency to plan for a rapid decline in aid dependency seems inappropriate in such cases: an increase in aid (and hence in the budget deficit) is both likely and desirable. If donor support indeed materializes while the Fund insists on reducing the total budget deficit (measured before grants), then aid can only be used for reducing government debt (a restriction which will almost inevitably reduce the incentive for donors to provide aid in the medium term).

Second, if targets are set in terms of the current (rather than the total) budget then aid can not only be used for retiring government debt but also for public investment. However, even in this case the approach can be detrimental to growth since recurrent expenditure (e.g., on road maintenance or on teaching materials for schools) may well be growth-enhancing. The implicit

bias in favour of investment expenditure has become a matter of concern with several of the donors in ESAF countries.

Third, budget deficit targets are based on money demand estimates which treat GDP growth as exogenous. This is of course entirely appropriate for the short-run stabilization issues for which the Fund's programming approach was developed. However, it is no longer appropriate in a context in which donors are willing to finance growth-enhancing expenditures (whether investment or recurrent expenditure).

There may be important interactions between the five types of trade-offs we have distinguished. Uganda is a case in point. As noted, Uganda is in the post-stabilization phase and the public investment programme needs to be expanded. Not only is the Fund's concern to reduce the budget deficit *excluding grants and IDA funds* here counterproductive, it also encourages increased reliance on trade and petroleum taxes (the two main revenue sources) rather than on aid. These taxes have high costs in terms of growth which can be avoided by aid financing.

Improving the analysis of the trade-offs between short-run and long-run effects is clearly essential for the success of ESAF programs. It is also important for improving the Fund's signalling function. One of the most valuable functions of the Fund is the signal of credibility which it provides to private investors by approving a program. This signal becomes noisy as its recipients become aware that the design of approved programs may be faulty and that program interruptions are indeed common.

4. The Role of the Fund in Post-Crisis Management

The Fund's traditional role is in crisis management. To date, this has also been the context in which ESAF programs have been introduced. However, in a few ESAF countries the Fund is now at a decision point since stabilization has been fully achieved and the major macroeconomic reforms have been implemented. Either the Fund maintains its exclusive focus on crisis-management and its aftermath, and so withdraws from these countries, or it maintains its relationship with the countries and extends its remit. In our sample, the clearest case is Uganda which has had a satisfactory inflation record for over five years, during which time it has adopted full convertibility of its currency. The good policy environment in Uganda and the rapidly improving risk ratings make it likely that both public and private capital inflows will increase.

The case for Fund withdrawal in such situations is that the Fund's work is done. The case for continued involvement is, first, that both investors and donors regard the environment as high-risk and need reassurance such as can be provided by Fund involvement; secondly, that ESAF governments need the continued expertise of the Fund; and thirdly, that ESAF resources are most productive in an already-reformed policy environment. Overall, we regard the case for continued

involvement as the stronger. However, each of the three arguments in favour of continued involvement requires qualification.

Investor Reassurance

The Fund's role in investor reassurance is potentially important, but to date it has not been an unqualified success. A recent econometric study found that the presence of a Fund ESAF program had no significant effect on private capital flows.⁹ This is presumably not helped by the fact that three-quarters of ESAF programs collapse or are interrupted. For the Fund to play a more positive role in raising the confidence of investors, its relations with governments need to be made more effective for signalling, and it needs to reconsider what would constitute success.

For the Fund to have a more favourable signalling role in a post-stabilization economy, it may help for the change of role from that in the stabilization phase to be clearly identified by the Fund. One option which the Fund may consider is for already-stabilized economies with a good record to be evaluated over a longer period, with more emphasis upon *ex-poste* assessment of performance and less on *ex-ante* negotiation of promises and short-term monetary targets. That is, a government would graduate from a crisis management phase of *ex-ante* negotiation, to a stabilization-with-growth phase of *ex-poste* evaluation. Such a change would enable a government to demonstrate its own choices more clearly, so that a good government could build reputation more rapidly. We might note that such an innovation might also enable the Fund to become involved in low-income countries which have not had a macroeconomic crisis and where the government consequently does not see the present style of ESAF programs as appropriate (examples being Eritrea and India). Greater reliance upon *ex-poste* evaluation would not remove the need for continuous monitoring. As Fund staff note, "without such a provision, the Fund and other donors would risk squandering their resources on an unsustainable policy regime". However, it would change its content. The major result on aid effectiveness identified by Burnside and Dollar is that it is the level of policy rather than its change which is important. Hence, the continuous monitoring role of the Fund in post-stabilisation environments would focus upon the maintenance of a few key features of macroeconomic policy, rather than upon the further improvement of other policies. In addition to this limited continuous monitoring, major reviews of performance would be conducted *ex-poste* every three years as with the present ESAF cycle. Specific arrangements would be needed for new governments. Newly-elected governments lack both a track record and responsibility for past errors and so constitute an intermediate category. When they face a pre-stabilization situation, as in Zambia in 1991, the Fund's

⁹D. Rodrik, "Why is there Multilateral Lending?", in M. Bruno and B. Pleskovitc (eds.), *Annual World Bank Conference on Development Economics, 1995*, Washington D.C.:World Bank.

approach would need to remain largely *ex-ante*, where they face a post-stabilization situation, they could reasonably be presumed to inherit the performance rating of the previous government.

A successful Fund role in a post-stabilization economy is one in which the growth rate is enhanced by increased investment. An environment of low and stable inflation is likely to be conducive to this objective but it should not be the limit of the Fund's ambition. In particular, a successful ESAF economy will be integrating into world financial markets, attracting an increasing inflow of capital relative to GDP, which finances a rising private investment rate.

The recent evidence on aid effectiveness establishes that aid is only effective in raising growth in good policy environments.¹⁰ An implication (which we have already noted in the previous section) is that aid should, and perhaps will, become increasingly targeted on the successful ESAF economies. Hence, an ideal post-stabilization ESAF country would go through a phase of rising external deficits, resulting from both private and public inflows, financing rising private and public investment. An important role of the Fund in this environment is to set these rising inflows in the context of a medium-term macroeconomic framework. Clearly, large external deficits can be either highly undesirable or highly desirable, depending upon the policy context, the growth rate, and the initial level and terms of indebtedness. By making this distinction, the Fund has an important role in reassuring both donors and private investors that in some contexts, large deficits are appropriate. This requires a very different view of external deficits from the Fund's customary work as a stabilizer where deficits are necessarily undesirable because they are a sign of unsustainable levels of consumption. A somewhat analogous argument applies to the fiscal deficit. In the context of a successful ESAF economy with a satisfactory policy environment the more grant-aid which can be attracted and used the better. It is dysfunctional to attempt to taper such aid out of the budget. The fiscal balance should be calculated so as to be inclusive not only of pure grants, such as European Union money, but of the grant element in other aid. For example, around 70 percent of IDA money should be classified as grant aid, whereas it is presently treated by the Fund as if it were fully commercial borrowing. As a result, at present the Fund seriously exaggerates the size of the fiscal deficit. Since private investors generally do little research on ESAF countries they are in no position to correct the impression conveyed by this mis-information, and so this bias can be presumed to be discouraging private investment, the opposite of the effect which the Fund should be setting as its objective in these economies.

Partly as a result of the success of ESAF, there are now several low-income African economies which have recently achieved a satisfactory policy environment. These countries (Uganda in our

¹⁰C. Burnside and D. Dollar, "Aid, Policies and Growth", Policy Research Department Working Paper 1777, World Bank, 1997.

sample) are currently growing rapidly. However, their investment rates remain low: current high growth is the temporary pay-off to policy reform. This conjunction of high growth and low investment is not sustainable: either investment must rise or growth will decelerate. The increase in investment cannot be financed predominantly from domestic savings because incomes are so low: both enhanced private and public capital inflows will be needed until incomes have risen.

Private investment is currently deterred because these environments are rated as highly risky. The risk ratings for the newly reformed economies are improving, but from a very low base, and it will take another decade before the ratings reach the level of the current NICs at which major investment inflows become likely. Recent Fund research has shown that the commercial risk ratings, although largely explicable in terms of fundamentals, are biased against Africa: African risk ratings are worse than is justified by the fundamentals. Further, recent World Bank research has shown that in the reformed policy environments aid acts as a catalyst for private investment: each dollar of aid induces almost \$2 of investment. Hence, investment inflows can be increased both by increased aid inflows and by a reduction in the perceived risks. In both of these the Fund has a key role.

The Fund can reduce perceived risks by signalling that a country has reached the phase in which the macroeconomic policy environment is satisfactory for private investment. In this phase, the key role of the Fund is the surveillance of policy maintenance through the monitoring of a few key variables, rather than the negotiation of further promises of policy change. As we discuss further in the Ownership section, the credibility of a policy environment is enhanced if it is manifest that the government has willingly chosen the policy regime. This is what we mean by 'ex post evaluation'. However, surveillance in itself may not be sufficient to achieve credible certification. To be fully credible, the Fund should put its own resources at stake and so have a Program. However, it is essential that such a program be clearly distinguished from those which are designed to cope with crisis recovery.

Countries would be seen to graduate out of a crisis period, into a second phase of rising investment, before they graduated completely out of Fund programs. The graduation into this second phase would constitute a powerful signal to the investment community. It would also constitute a signal to the donor community. As discussed above, there is now compelling evidence that aid is effective in, and only in, satisfactory macroeconomic policy environments. The Fund has a key role in certifying that such an environment has been attained. Clearly, maintained Fund financing in these environments adds credibility to the message that donor funds should appropriately increase. The Fund itself is not a development finance institution and should not become one. Rather, its new role for this group of graduated, but investment-scarce countries is temporary, in the initial phase of a reformed environment. The recent wave of reforms and temporary high growth in Africa has thus created a window of opportunity. The Fund is instrumental in whether this opportunity is seized.

Fund Expertise

Fund expertise has customarily had a dual role in ESAF countries: as the primary source of advice on macroeconomic policy, and as the highest level of conditionality on the entire process of policy reform. There is an obvious potential tension between these two roles which becomes much more acute as reform proceeds from the core macroeconomic policies of exchange rate liberalization and the reduction of the inflation tax, to the myriad of microeconomic choices facing governments. The Fund has specialized expertise in the core macroeconomic choices and correspondingly lacks expertise (as the staff recognize) in the microeconomic sphere. At present, in post-stabilization environments the Fund is tending to broaden its agenda; maintaining the same negotiating style of short-term targeting as in crisis management, while changing the content of the negotiations from exchange rate policy to the details of sectoral policy. With the growing concern over the social impact of reform, the most natural evolution of this style would be for the inclusion of social sector policies in Fund conditionality.

A corollary of this extension of the sphere of policy over which the Fund might become concerned is that the Fund and the Bank would be performing essentially the same role and the rationale for their continued distinct existence would not be obvious. In a few ESAF economies this is now the situation. In principle, there is close Fund-Bank cooperation and liaison in policy advice. In practice the situation on the ground is highly variable, but the norm is for liaison to be seriously deficient. The building of genuine detailed liaison would require major institutional change which we do not regard as realistic except in a small number of areas (most notably fiscal policy and trade policy) where Fund-Bank overlap is unavoidable. However, were the Fund to go in this direction what would be required is not expressions of goodwill, but rather formalized procedures for cross-institutional teamwork and decision rules.

The alternative is for the Fund to remain focused on macroeconomic policy, leaving microeconomic and sectoral policies to the Bank. This would imply that in a post-stabilisation environment the Fund would have a diminishing role, refocused upon managing increased external inflows in an orderly fashion. The high-level conditionality role would fade out in such economies as Fund assessment became *ex-poste*.¹¹ We find this latter model for the Fund in post-stabilisation situations more appropriate than attempting to convert it into a fully-fledged development bank or to integrate its day-to-day work much more closely with that of the Bank.

That is, we are proposing that the Fund should focus more upon its core business of macroeconomics. This would still leave an important area of overlap with the Bank with respect

¹¹See P. Collier, P. Guillaumont, S. Guillaumont and J.W. Gunning, "Redesigning Conditionality", *World Development*, vol. 25, 1997, pp. 1399-1407.

to fiscal policy. Revenue and expenditure decisions have both microeconomic and macroeconomic consequences and their reconciliation is among the most difficult policy decisions facing governments. It is unfortunate that this decision trade-off straddles the institutional divide between the Fund and the Bank. Here, it is a very high priority that the two institutions cooperate much more effectively in advising on the trade-off. For collaboration to be effective given the history of previous failure, requires not exhortation but institutional change, centred on the power of decision.

Aid Effectiveness

The new evidence on aid effectiveness shows that to date aid transfers have been ineffective both in promoting growth, except in good policy environments, and in inducing policy reform.¹² ESAF is a form of concessional lending, and like other donors the Fund needs to draw lessons from these very disturbing results. Two lessons are particularly important.

First, the attempt to induce policy reform by offering incentives has not, on average, been successful. The econometric evidence suggests that on average where reforms have taken place they have not been induced by aid but reflected the intentions of the government. The appearance of tough negotiations ("macho bargaining") and enforced government policy change, while often true at the minute-by-minute level of the negotiating table, is found to be largely a facade in the longer context of policy change. There is a danger that a culture of toughness prevails over a culture of analysis.

Second, the transfer of resources in poor policy environments is a waste, whereas in good policy environments it is productive. This implies that in the early stabilization phase the most important product which the Fund supplies is expertise, not finance. The Fund should be more circumspect in advancing money to governments which are not committed to programs. Without such commitment, the Fund and other donors risk squandering their resources on unsustainable policy regimes. Announcements such as "It's the IMF's program, we had to go along with it" (Information Minister of Zimbabwe, 17 December) are *prima facie* evidence of over-confidence in past lending. Conversely, in the post-stabilization phase, the most important product is finance rather than advice. Except in the transition economies, where there are genuinely large aggregate costs of adjustment, ESAF funds should taper in as reform proceeds, rather than taper out. Like other donors the Fund needs to unbundle its advisory and financing roles, fitting the product to the problem. Doing so would not only make ESAF funds more effective, it would also improve signalling to private investors. The tapering in of ESAF funds would come to be regarded as the

¹²See Burnside and Dollar, *op. cit.*

signal that stabilization had been completed and that a pro-growth policy environment had been achieved.

THE DETERMINANTS OF OWNERSHIP

Country Perceptions

In this section, we discuss what the country studies tell us about ownership. Next, we make recommendations as to what can be done to strengthen country ownership and finally, we explore the implications of the recommendations we make.

A number of themes stand out clearly in the country perceptions. They relate first to the Fund's image, second to the Fund's operating style and methods and third, to the impact of Fund programs. Since the third is dealt with elsewhere in our report, we confine ourselves here to the first and second.

The Fund's Image

To a very large extent, attitudes to the Fund differ according to which constituency one speaks to. For instance, businessmen in Malawi and Uganda who had lost protection, and civil servants who had lost privilege tended to be anti-Fund while smallholders whose cash incomes had improved in the wake of reforms, tended to look on the reforms favorably. Nevertheless, we found the Fund's image to be rather negative at the general popular level, and even in relatively more informed circles, and this, often undeservedly. In contrast, the Bank's image in most countries was much more favorable although the Bank was often more intrusive in the very sectors about which people complained the most. As we point out in our country reports section, the Fund often gets blamed for the iniquities of other institutions, including the Bank's and even the ILO's (Malawi). This is no doubt attributable to some confusion about the Fund's separate identity and partly also to a general impression that the Fund has a pre-eminent or over-arching role and therefore somehow influences what all other international financial institutions do.

The Fund's Operating Style and Methods

There is a widely-held view that Fund operations and dealings with government are clothed in undue secrecy. This sentiment is understandable, given that the Fund mostly deals with ministries of finance and central banks and with sensitive macroeconomic issues which obviously cannot be made matters of public discussion. What is interesting though, is that the Fund continues to be berated for its secrecy although Fund missions have, as the country studies

show, for some time now, been dealing with a broader cross-section of government officials and departments. When asked to explain this apparent paradox, many interviewees argued that meetings with people outside the core ministries and allied agencies were seldom truly consultative as only the mission leader spoke – and even he usually did no more than seek viewpoints – while other mission members simply took notes.

We heard criticism also that the range of Fund contacts was still unduly restrictive. Even in ministries of finance and central banks, many complained that only a few assigned officials participated in discussions with the Fund. Although no doubt this was a matter for government decision, it was interesting to note that many saw the Fund as partly responsible for their exclusion.

In some countries, program implementation has been slowed down by legislative processes because legislators felt excluded from government-Fund contacts, even though in some cases, Fund missions had made efforts to dialogue with them. In many of these cases, we found that the problem was the discontinuity in the membership of these bodies.

A number of ministers and senior officials we spoke to, also felt that the effectiveness of Fund missions depended much too much on the personality of the mission leader, and how experienced and confident he felt about the support of various departments at headquarters. Many felt that the mission leader's flexibility in negotiations depended too much on these factors, and that the negotiation process would be greatly facilitated if some institutional safeguards were found for reducing the role of these factors.

a) Fund Sensitivity to Domestic Political Constraints

Almost without exception, technical personnel in ministries and political leaders in the various countries who deal regularly with the Fund, complained about what they saw as the Fund's inflexible attitude in its dealings with government. They complained that the Fund often came to negotiations with fixed positions so that agreement was usually only possible through compromises in which the country negotiating teams moved to the Fund's positions.

Even in countries that had a reasonably good record of performance under ESAF arrangements, many interviewees felt that the Fund too often simply imposed its will, was generally insensitive to genuine constraints on policy making and the pace of implementation, and was too quick to dismiss policy options favored by government.

b) The PFP Process

As regards the PFP process, the predominant view - and many ministers and senior officials echoed this view with some disappointment – is that although initially the PFP had held great promise as an instrument of a genuine three-way dialogue between the government, the Fund,

and the Bank, it has become a rather routine process whereby the Fund brings uniform drafts (with spaces to be filled) from Washington, in which even matters of language and form are cast in colorless stone. Many senior officials expressed the view that the PFP document has become so uniform – it is difficult to distinguish one from the other.

Many interviewees, especially those outside ministries of finance and in the larger government machinery, who before had largely been excluded from the economic policy making apparatus, found this atrophy of the PFP process particularly regrettable.

The general yearning therefore was for the realization of a potential that never was – a truly country-specific PFP, agreed on the basis of a government-led consultation process. When asked what choice the staff had if they found government ill-prepared for or simply unable to produce a coherent draft, the recurrent response was that the staff simply had a bias against government drafts, although some officials acknowledged that Fund technical assistance could be helpful in such circumstances.

c) Fund Technical Assistance

In contrast with the generally negative perceptions about Fund-supported reform programs, we found widespread approbation of Fund technical assistance programs, even among senior officials in economic ministries who were critical of Fund negotiating strategies and programs. There is a general view that Fund technical assistance is usually unobtrusive and much more effective than bilateral programs. Many found the secondment of Fund staff of national origin, a particularly helpful form of technical assistance, both for the preparation towards Fund negotiations and also for the development of home-grown programs. Because of its effectiveness and general acceptability, Fund technical assistance, in our view, has a particular significance in the development of national ownership.

Ownership, the Negotiation Process, and Conditionality

There is one common theme that runs through all the foregoing country perceptions. At the bottom of all the concerns they reflect, is a feeling of a loss of control over the setting of the policy agenda in reform programs, as well as the pace of implementation of these policies. They therefore go to the very heart of the ownership problem.

All the available evidence suggests that conditionality-intensive programs seldom succeed in achieving their objectives. Moreover, all the parties in the development debate are agreed that ownership is the key to successful program implementation. This is true for the Development Assistance Committee (DAC) of the OECD. It is true of the Bank, the Fund, and all major regional financial institutions. Members of the DAC meeting in May 1995 at the level of development cooperation ministers and heads of aid agencies, for instance, endorsed a number

of strategic orientations that included a recognition that “developing countries themselves are ultimately responsible for their own development. For development to succeed, the people of the countries concerned must be the owners of their policies and programs.”¹³ In the same way, the final report of the DAC *ad hoc* working group on participatory development and good governance agreed on key conditions that included a recognition that “in development cooperation, legitimate ownership by the country partner is a primary objective”.¹⁴

In the Fund itself, there is a strong and genuine quest for stronger ownership of country programs. The Fund’s guidelines on the PFP state that to ensure ownership of the PFP, “the authorities should be encouraged to initiate the drafting of the PFP or to provide input on selected issues”, and also that the PFP preparation should involve “a close collaboration with the authorities, the Bank, Fund staff, key donors, and other relevant institutions”.

The World Bank, for its part, also states “typically, assistance programs that the recipient countries perceive as being imposed end in failure or have only a small development impact; government and beneficiaries do not feel they have a stake when they have not contributed to the development of a program.”¹⁵

The second PDR review report notes that “about two-thirds of the interruptions [in ESAF programs] were strongly affected by serious slippages in past policies that either weakened the government’s credibility, or produced protracted disagreements between the staff and the government on remedial measures.” Our country visits also provided evidence of a strong correlation between the degree of ownership and successful program implementation. This is borne out by the experiences of Uganda and Bangladesh before the instability of the post-Ershad period set in, and Vietnam under its go-it-alone policy, i.e., before the ESAF program, began. In the same vein, Uganda and Zimbabwe provide contrasting examples. Uganda tried a state-directed closed economy and failed, and turned to a Fund-supported program after a thorough process of national debate: the program has had a reasonable measure of success and has been sustained over a long period. Zimbabwe, on the other hand, also started with a closed economy in the immediate wake of its independence, ran into some difficulty and started reforms on the basis of a policy framework that it developed with the help of outside consultants and Bank advice, and then entered into the Fund-supported program. The first phase of the reform benefited from a substantial degree of ownership but the ESAF program ran into difficulties, partly because of weaker ownership and a less-than-spectacular program outcome.

¹³ *Shaping the 21st Century: The Contribution of Development Co-operation*, OECD, May 1996, Annex.

¹⁴ *Final Report of the Ad Hoc Working Group on Participatory Development and Good Governance*, OECD, Paris, 1997, p. 7.

¹⁵ World Bank, *Strengthening the Effectiveness of Aid, Lessons for Donors*, Washington, D.C., 1995, p. 6.

So, what can be done to foster strong country ownership and leadership of the reform process, **and** at the same time, provide assurances to multilateral and bilateral sources of external funding that their assistance will not be wasted?

At present, there is an inherent tension between national ownership and the need to provide these assurances to external agencies of support; it is not irreconcilable, but it is there. A forthcoming article by Professor Helleiner, based on a study of Tanzania's relationship with donors, illustrates this tension rather dramatically. It reports that when asked how they understood ownership, a number of donor representatives reportedly said they saw ownership as the acceptance by the recipient country of what donors want. Some of the more forthright responses included: "Ownership exists when they do what we want them to do but they do it voluntarily", "We want them to take ownership. Of course they must do what we want. If not, they should get their money elsewhere", and, "We have to pressure the local government to take ownership"!

Clearly therefore, the political problems that bedevil attempts at giving the idea of ownership an operational meaning are very real indeed. The solution, though, lies not in reducing ownership to simply getting the country to 'volunteer' to do what others want, but to find a real middle ground that balances the competing concerns through a review of the country's own decision-making and consensus-building processes, on the one hand, and the Fund's negotiation process and its conditionality regime on the other.

EXTERNAL VIABILITY

Introduction

An ESAF program influences the macroeconomic savings-investment process of a recipient country and affects its current account path because the current account balance is nothing but the savings-investment balance. Private agents are generally supposed to smoothen the consumption paths, given macroeconomic policies by the government. Accordingly, the results of the agents' intertemporal choices are the external current account path of the balance payments of the recipient country.

More precisely, the savings-investment path of a nation is the result of the aggregate savings and investment of a nation, that is, of the decisions of the economic agents in the private as well as the public sector. Private agents are supposed to optimize¹⁶ their objectives under the intertemporal budget constraints. Economic agents optimize under certain technological production constraints, given terms of trade (if a country is not too large), given intertemporal

¹⁶ "Optimize" may be too strong a word; as A.H. Simon argued, "satisfice" may be more proper.

terms of trade (conditions for external borrowing), and given bureaucratic as well as political constraints.¹⁷

Those constraints on economic behavior are certainly affected by a concessional loan like the ESAF loan. Moreover, foreign donors are influenced by the existence of an ESAF loan in determining the conditions for extending loans. (Modern information economics offers a partial explanation of this kind of mechanism by appealing to the abbreviation of information asymmetry.) On the other hand, the government budget will be additionally constrained due to the conditionalities of the ESAF program. Technological production constraints may be different because of technological progress that could be facilitated by the ESAF loan. The X-efficiency, that is, the inefficiency below the technological frontier, may be eased by the ESAF program.

The above points can be illustrated by the Irving Fisher Diagram. (Fig. 1) Consider the world consisting of two periods: Present and Future.¹⁸ The present consumption and production are depicted by the horizontal axis; the future consumption and production are depicted by the vertical axis. Let TS be the production frontier of the recipient country. Given the real rate of interest r , P_0 and C_0 indicate respectively the combination of consumption and production in the first period and the second period before the ESAF program depicted by the vertical axis.

When the ESAF program provides the possibility that the recipient country receives a concessional loan with an interest rate lower than the market rate r , then the production possibility locus of the recipient country expands like P_1EL_1 . P indicates the production combination in the present and in the future and C indicates the combination of present and future combination after the ESAF.¹⁹

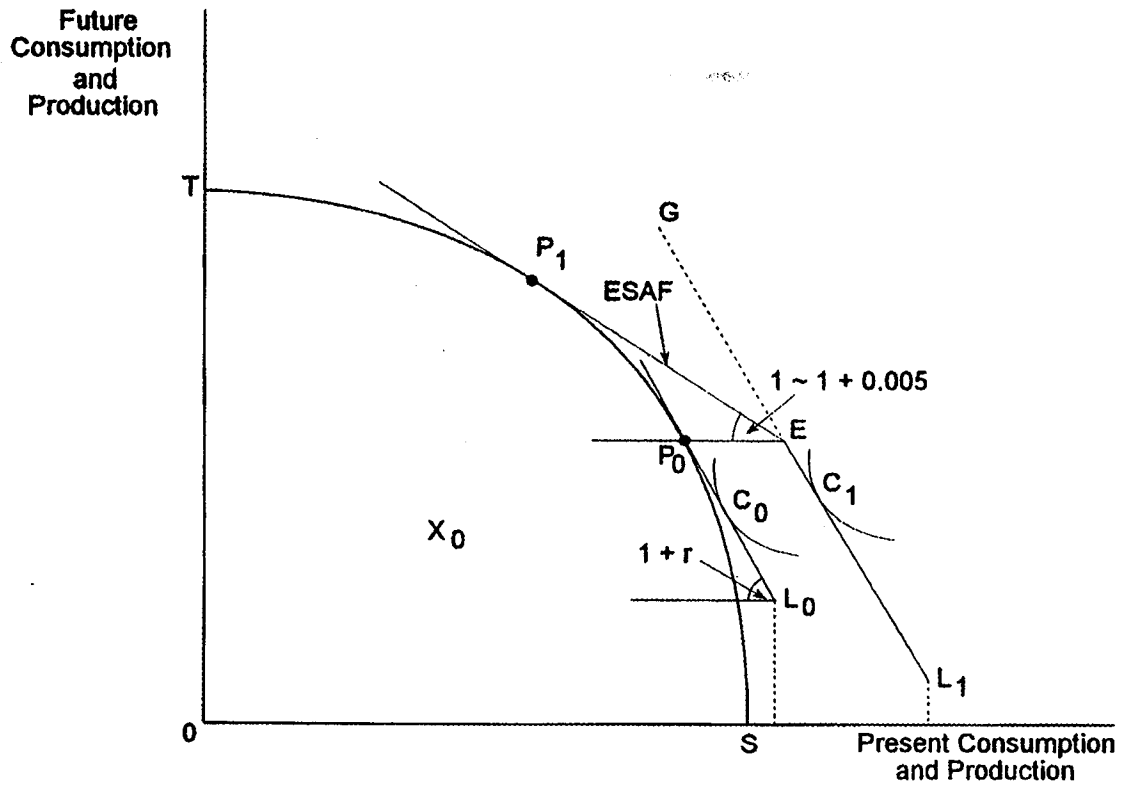
L_0 and L_1 designate the limits of non-ESAF credit. Before ESAF, the amount of credit is restricted to P_0L_0 . After ESAF it changes to EL_1 . If the country is credit-rationed, it utilizes the available credit limit so that C_0 coincides with L_0 . Also, the ESAF encourages other private lenders to lend more to the country, and P_0L_0 will be lengthened to C_0 . If the economy is still credit-rationed, EL_1 will coincide with L_1 .

¹⁷ In some situations, nations may be at their minimum subsistence level or severely credit-constrained so that the corner solution with no savings may emerge. Or, they may be too poor to plan for the future and are compelled to focus on the present. Time horizon and "patterning of time" (L.W. Doob, *Being Civilized*, Yale University, 1960) are different from nation to nation. These varieties are included here in a broader category of "satisficing" behavior under constraints.

¹⁸ Of course, the world does not end in two periods. There are multiple periods. However, since the multiple (or infinite) period analysis requires some complicated algebra, we will remain in this simple world with a simple diagram.

¹⁹ If the recipient country borrows at the rate of the concessional loan, and if it re-lends at the market rate of r to the world market, the point above E to G is attainable. We neglect such possibilities because they will hardly be realized in practice.

IRVING FISHER DIAGRAM



- TS : Production frontier
- P_0, P_1 : Production before and after ESAF
- C_0, C_1 : Consumption before and after ESAF
- L_0, L_1 : Limits for outside loans before and after ESAF
- X_0 : X - (In)Efficiency point
- L_0, L_1 : Credit limit
- r : (Real) Market rate of interest
- P_0 : Production at present before ESAF

In this framework, one can ask the following questions:

- (1) Does a nation's consumption path satisfy the non-Ponzi game conditions? Do P_0L_0 or P_1EL_1 indicate the consumption possibility in this two-period case? In other words, does the consumption path satisfy the intertemporal budget constraints? If this condition is violated, a nation takes a path that accrues an infinite amount of debt in the future. This condition rules out the national consumption behavior of continuing to borrow to consume and to repay the previous debt. Non-stationary behavior of the borrowing is one of the symptoms. In our sample countries, we did not find a likely case for the violation of the non-Ponzi condition.
- (2) What is the time horizon of nations in the sample? Because of the limitation of data, so far one example is studied, namely, the case of Bangladesh. In Bangladesh, the result of a time series analysis did not respect the hypothesis that the people's time perspective in terms of the rate of time preference was invariant with respect to before and after the initiation of the ESAF program. The results in the Appendix, however, does not support the hypothesis that after the ESAF program the time horizon or the rate of time preference was positively affected.
- (3) Are nations constrained like points L_0 and L_1 ?
- (4) Does an ESAF program help consumption smoothing over time?
- (5) Does an ESAF program increase the availability of credit to the nation?

Finally, one can ask the most difficult question:

- (6) Does an ESAF program resolve the problem of X-efficiency? That is, can an ESAF program bring the economic situation from X_0 to P_1 ?

Even from this simple theory, one can find the following. If both present and future consumption is normal, C_1 will locate on the right of C_0 . Thus, according to the conventional theory, a recipient country is expected to react to the concessional loan by increasing the deficit of the current account.²⁰

A critique of the intertemporal approach may say that the government does not behave as a maximizer. However, this does not warrant a reversion to the traditional macroeconomics taught a quarter century ago. Government behavior can be analyzed as a super-imposition on private optimizing behavior. In this respect the PDR Internal Review does not refer at all to the

²⁰For the econometric analysis of current account dynamics see, for example, Ghosh, Atish R., 1995, "International Capital Mobility Amongst the Major Industrialized Countries: Too Little or Too Much?" *Economic Journal*, January, Vol. 105, No. 428, pp. 107-122.

intertemporal aspect of the balance of payments. This aspect is the crux of the modern dynamic textbook as Blanchard and Fischer, and Obstfeld and Rogoff.

In order to assess the role of the government deficit, we have to investigate to what extent Neo-Ricardian equivalence applies to recipient countries. If equivalence holds, the government deficit will not be a serious matter. If equivalence does not hold, the deficit will be something to worry about. The conclusions of an IMF study²¹ are mixed, and will be discussed further.

An ESAF program certainly expands the consumption possibility locus of a recipient country. Funds are transferred to the foreign reserves (or SDR) account. In the accounting sense, it is distinct from a change in the budget balance, but the aggregate budget constraint of a nation is affected favorably. Quantitatively, this expansion effect is not very large relative to other private and official capital inflows, but it is large enough to offer incentives for a nation to want the ESAF funds. The last effect is reinforced by the fact that an ESAF program is often a precondition for loans by other donors.

Indicators of External Viability

What are the proper indicators of external viability or vulnerability of a nation? This question is always faced by national governments and international organizations, and is a question that has been posed specifically to us. To measure the viability of a nation, one conventionally uses a variety of indicators such as debt service ratios, (i.e., the ratio of debt service to the export of a nation), the ratio of the debt service to the GDP of a nation, the ratio of the outstanding stock of foreign debt to exports, the ratio of the outstanding stock of foreign debt to GDP, the ratio of net present value (NPV) of foreign debt to export, the ratio of NVP of foreign debt to GDP, and the proportion of exceptional financing in the total debt.

Our main task is to find the proper indicators of external viability. Indicators that grasp the dynamic optimization process are hard to find, and in practice we have to rely on those indicators that can be evaluated by observable data present at the time of decision. In discussing the meaning of various indicators and their effectiveness for assessing viability, we would like to emphasize the distinctions between static and dynamic indicators, and the distinctions between export-related indicators and GDP-related indicators. Our point is that when using the export-related measure, one assumes that all the export proceeds can be used for repayment by halting imports altogether. This is an extremely strong assumption.

²¹ Susan Schadler (ed.), "IMF Conditionality: Experience Under Stand-by and Extended Arrangements, Part II: Background Papers," IMF Occasional Paper no. 129, Washington, D.C.: IMF, 1997.

Though it may go against conventional wisdom, we argue that those ratios mentioned above, with respect to export, have such a strong bias that the viability is exaggerated in an open economy with a high propensity to export. Also, we would like to argue that almost all the indicators are static and should be supplemented, if not replaced, by more dynamic concepts. Though we recognize the difficulty of providing a universal measure of external viability, we propose two measures that take account of the dynamic or growth aspects of the economy: the real external debt burden (REDB) and the debt deepening index (DDI).

The external position of a country can be regarded as vulnerable when it does not appear to satisfy intertemporal constraints, that is, the non-Ponzi constraint. The ratio of indebtedness to GDP and the ratio of debt service to GDP are reasonable measures. The ratio of debt and debt-service to export that is more frequently used is hard to justify on theoretical grounds. At least indices relative to GDP should be taken as seriously as indices relative to export. Compare two countries that have the same debt-service to GDP ratios, but with different export-GDP ratios. Then the debt-export performance is judged to be favorable for the country with a large export-GDP ratio. The country with a higher export-GDP ratio is not necessarily healthy. At least, indicators relative to GDP should be taken as seriously as indicators relative to export.

According to modern macroeconomic theory, the normal and often desirable pattern of indebtedness is as follows for modern expositions. We call a development path "normal" when the path is to be realized by the competitive interest rate mechanism, and call it "desirable" when the path is the result of optimizing national agent. They coincide with each other when the international capital market is competitive and there is no externality.²² First, when a low-income country with scarce capital opens up its economy, the country incurs substantial international debt. The ratio of indebtedness to income may grow at first during a transition stage. In the meantime, the country begins capital accumulation. After a while it starts to gradually repay its debt. If the rate of time preference of the country is higher than the average rate of time preference of the world, then the country will remain as a debtor, but the ratio of debt to national income will become more or less constant. If the rate of time preference of the country is lower than the average rate of time preference of the world, the country will eventually repay its external debt and then become a creditor country in the world.

In other words, a nation less patient than the average nation of the world will become a debtor nation in the long run; a nation more patient than the average nation of the world will become a creditor nation. According to a stochastic version of the above theory, a nation that expects

²² See, for instance, Y. Onitsuka, "International Capital Movements and the Pattern of Economic Growth," *American Economic Review*, 1974, Vol. 64, pp. 24-26; K. Hamada, "Economic Growth and Long-Term International Capital Movements," *Yale Economic Essays*, Vol. 6 (1), 1966, pp. 49-96. See also M. Obstfeld and K. Rogoff, *Foundation of International Macroeconomics*, Cambridge, MA: MIT Press, 1996; O. Blanchard and S. Fischer, *Lectures on Macroeconomics*, Cambridge, MA: MIT Press, 1989; and R. J. Barro and X. Sala-i-Martin, *Economic Growth*, McGraw-Hill, 1995.

growing permanent income becomes a borrowing nation and a nation that expects declining permanent income becomes a lending nation. This process is characterized by the relationship of the amount of external debt (or credit) to national income and by no means by the relationship of the amount of external debt (or credit) to export.²³

In our opinion, the debt service ratio to export has less importance than conventionally considered. The debt service ratio with respect to the income variable, i.e., the ratio of debt service to GDP, has more meaning since it indicates the magnitude of debt burden relative to the scale of national economic activities. It does not need to be constant through time, however, because according to the above theory, this ratio is supposed to increase when a country opens its door to the international capital market and then decrease during the process of developing a balanced growth path.

The debt service ratio with respect to export can be misleading under certain circumstances. Suppose there are two countries, country A and country B, of identical size. The magnitude of debt service is also identical for the two economies, say at 10 percent of GNP. Suppose the propensity to export of country A is 40 percent, and that of country B is 20 percent. (Also, assume that the propensity to import of A is 30 percent and that of B is 10 percent.) The debt service ratio to export in A is 25 percent but that in B is 50 percent. Can you say country A is much more externally viable than country B? According to the above analysis, the two countries are vulnerable to a similar degree. The proponents of the debt service ratio to export seem to assume that in an emergency a nation can suspend the total import and use the total export to repay the debt. However, in a very open country like A, it is highly likely that export needs a certain amount of import, so that import cannot be suspended overnight.²⁴ A strong emphasis on the debt service ratio to export rather than to GDP should be re-examined to restore a balance between a very open economy and a relatively closed economy.²⁵

²³ If one can approximate the optimal process of borrowing and growth of a nation by its market process, then the market-financed indebtedness by FDIs and commercial lending will be seen as normal and optimal. Therefore, the ratio of exceptional financing to the total debt or to GDP may be a good indicator of the seriousness of the debt situation.

²⁴ One might argue that theoretically, the most useful concept to match indebtedness is the capacity to pay, that is, potential savings-investment balance (S-I). S-I is likely to be related to GDP rather than to export. At least, there is no theoretical ground that S-I is related to export more than to GDP. Models that consider important export sectors exclusively imply a similar result. That is, the degree of indebtedness is more directly related to the rate of time preference rather than to the openness of the economy. See Baxter, Marianne 1992 "Fiscal Policy, Specialization, and Trade in the Two-Sector Model: The Return of Ricardo?" *Journal of Political Economy*, August, Vol. 100, No. 4, pp. 713-732 and Svensson, Lars and Razin, Assaf, 1983, "The Terms of Trade and the Current Account: The Harberger-Laursen-Metzler Effect", *Journal of Political Economy*, Vol. 97, No. 1, February, pp. 97-125.

²⁵ Milesi-Ferreti, G.M. and Razin A., "Current Account Sustainability", *Princeton Studies in International Finance*, No.81, 1996, International Financial Section, Princeton, suggests that the debt service ratio is the primary index to be complemented by other measures. We would rather recommend the use of debt service/GDP ratio in general, possibly to be adjusted by other measures relative to export. Milesi-Ferreti and Razin argue that empirically export is related to capacity to repay from historical experiences. We instead cast doubt on the logical connection

In fact, the choice of denominator as export or GDP can make a drastic difference. As will be seen, the order of eligibility for a HIPC country will change from Uganda to Côte d'Ivoire depending on whether you use export or GDP.

The Fund relies on the government revenue-based and export-based indices. The former depends on the assumption that government can stop spending on government expenditures and the latter, on the assumption that imports can be stopped in order to pay the debt in an emergency. Such assumptions seem to reflect the ideas that the Fund can manage the government easily and the government policy will steer the economy to a sufficient degree.

In a broader perspective, we must notice both debt service ratios are static concepts. Take the better one, the debt service to GDP concept, for example. Suppose two countries share the same debt service ratio, say 5 percent, but country A is growing at 7 percent and country B is growing at 2 percent. If neither of these countries repays its interest obligation, nor retires or incurs any debt, the debt service/GDP ratio of country B will be increasing at the rate of 3 percent, but that of country A will be decreasing by 2 percent. For the debt in the numerator of the debt service ratio will be growing at 5 percent, while GDP in the denominator will be growing at 7 percent in country A and 3 percent in B. Thus, if the rate of interest on external debt is smaller than the rate of economic growth, the debt service/GDP ratio will be declining. It is, accordingly, crucial for the viability of the international debt position to know whether the economy is growing or not.²⁶

Obstfeld and Rogoff propose on these grounds a new measure called "real external debt burdens" (REDB). This is expressed as

$$(r - g)D/Y$$

where D is the outstanding foreign debt of the economy, Y is the GDP, r is the real interest rate paid on the debt, and g is the real growth rate of the economy. This measure (REDB) shows the necessary trade balance (surplus to a positive value) as a fraction of GDP in order to maintain

from export to the capacity to repay. IMF publications indicate that officials in research departments recognize the existence and analytical implication of those indexes. We seldom observe, however, cases where the GDP-related indexes are viewed to be as important as export-related indices like the debt service ratio in actual assessments of debt situations in recipient countries. We seldom observe cases in which the static factors are supplemented by the dynamic factors, that is, the factor due to asset dynamics and the factor due to the current account of balance of payments.

²⁶ One may say the long-term forecasts in the PFP are the long-term components of the ESAF, but we cannot help but feel that filling the forecasts becomes more like a ritual the longer the time horizon is. Forecasting is being done in an economy where the present statistics are not so accurate. There is no penalty in making a wrong forecast.

a constant debt /GDP ratio. The higher this ratio is, the higher is the likelihood that the debt is unsustainable.

We would like to propose another indicator which will be called “Debt Deepening Index” (DDI), which is defined as:

$$(r-g)D/Y-T/Y$$

where T is the current account balance excluding the debt service payment. This measure (DDI) is the percentage of GDP that the economy has to improve in the current account of balance of payments from the present value in order to keep the constant debt-GDP ratio. It is easy to see (subscript t signifies time) that:

$$\frac{d}{d_t}D_t = D_t - T_t \frac{d}{d_t}Y_t = gY_t, \text{ that } \frac{d}{d_t}\left(\frac{D_t}{Y_t}\right) = (r-q)\frac{D_t}{Y_t} - \frac{T_t}{Y_t}$$

As shown in this equation, REDB (the first term in the right hand side (RHS) of the equation) indicates the asset dynamics, namely, which of D and Y is growing faster, and that the second term in the RHS indicates the contribution of current account deficit to the D/Y ratio. In other words, the above equation indicates the interaction of asset dynamics and the influence of flow variables to the debt income ratio. DDI in the left hand side (LHS) of the equation encompasses both the asset effect (REBD) and the flow effect.²⁷

Finally, the net present value (NPV) is certainly a dynamic concept that takes account of the future payment stream of debt. Unfortunately, it is usually compared to the static flow concept such as export and income. (The inappropriateness of export as the denominator is as in the case of debt service ratio.) The comparison of the NPV of national debt and present national income is a comparison of concepts of different dimensions, stock and flow. Suppose two countries A and B have identical NPVs of foreign debt and identical current GDPs, but A is growing at 3 percent and B is at 7 percent. The future resources for B to repay the debt in the future must be much higher for country A. The problem remains as to how one can be sure of the course of future economic growth. (Similar problems exist to estimate the rate of interest to discount the future payment stream to calculate the NPV). In any case, one must be aware that the calculation of NPV of the national debt is only a half step to the dynamic treatment of the debt

²⁷ In fact, DDI is a simplified form of the viability index proposed by Cohen. See D. Cohen, “Sustainability of African Debt,” mimeo, Paris, 1995. Also, see D. Cohen, “Evaluating the Solvency of an Indebted Nation”, *Economic Policy*, November 1985.

problem. Given the above theoretical discussions, let us examine the performance of external balances of the countries we study. The movements of indexes and the comparison of indexes tell us various aspects of these economies.

We preface our analysis with some general observations which we make *ex abundanti cautela*. There are a number views and propositions that are widely held in popular and even professional circles, but which are often highly debatable. They include the following:

(i) Reduction in the budget deficit will improve the current account of the balance of payments by the same amount.

Fund research findings show that there is a negative relationship between public savings and private savings in many samples in the countries that are under the stand-by and extended arrangements. On average, private savings fell 1 percent when public savings increased 1.7 percent. This means that a 1 percent decrease in budget deficit is partially offset by about 0.6 percent decrease in private savings. The regression coefficient of the private savings on the public savings is about 0.7 and roughly coincides with this figure.²⁸

Naturally, the full Neo-Ricardian equivalence will imply a hundred percent negative offset. Therefore the private sector responds to the decline of government deficits by taking a partial account of future liabilities, and not a full account of them. In any case, this means that undue emphasis on the budget deficit may be misleading for the economy as a whole.

(ii) The more “private” lending, or the more FDI, the greater will be the probability of insolvency of the borrowing country.

Since the Fund is one of the country’s creditors, the above is also true. From the standpoint of the borrowing country, however, the above statement is dubious. New concessional loans and grants may go away if the benevolence of donors disappears. On the other hand, private flow of funds such as FDIs and commercial loans may indicate that other economic agents consider it profitable to lend to that country or to invest in its future. Private capital inflows imply the normal function of the price mechanism. It may imply as well that the borrowing country is situated near the optimal path of development in the world market.

²⁸ M. A. Savastano, “Private Saving in IMF Arrangements”, Chapter VI of S. Shadler (ed.), *IMF Conditionality: Experience under Stand-By and Extended Arrangements Part II: Background Papers*, International Monetary Fund, Occasional Paper No.129, 1995.

COUNTRY-SPECIFIC ANALYSIS

In this section, movements of indicators developed above will be illustrated by country experiences. The calculation of indicators is made using Fund statistics. We took the proxy for real debt, the U.S. dollar value of debt. In accordance with this, we took the U.S. dollar values of GNP as real GNP. Also, please note that the debt-service ratio is calculated here as the percentage of annual export rather than monthly.

Bangladesh

Compared with the pre-adjustment period (1973/74-85/86), the Bangladesh economy recovered its macroeconomic stability during the post ESAF period (86/87-94/95: SAF 86/87, ESAF 89/90-92/93), as shown in Table 1.

During the post ESAF period, there was no sign of any acceleration in real GDP growth. The growth rates remained arrested at around 4 percent. They were on average lower than the rates that prevailed in the 1970's and early 1980's.

Meanwhile, Bangladesh has accomplished a slight improvement in its investment/GDP ratio. It also reduced its level of inflation to around 6 percent, its government deficit/GDP ratio to 6.7 percent, and its current account deficit/GDP ratio to -1.1 percent. In the fiscal area, Bangladesh increased tax collection by the introduction of the VAT and by the improvement of the efficiency of tax collection.

Moreover, the export/GDP ratio increased. This export surge was mainly sustained by non-traditional exports such as ready-made garments (RMG), leather, leather products, fish and shrimp. The share of non-traditional exports (gross values) has risen from 31 percent in 1989 to 87 percent in 1995 while the share of traditional exports, i.e., jute-based exports, has declined and stands at 13 percent in 1995.

Thus, ESAF successfully brought to Bangladesh price stability, which is an important benefit. It is not clear, however, whether or not ESAF brought growth to the economy. ESAF merely sustained growth. Bangladesh may, thus, be said to be a typical case of an ESAF program that emphasized civilization but no growth.

Table 1

Comparison Pre-Adjustment and
Mid- & Post- Adjustment by Macro Key Indicators

	Pre-Adjustment			Mid- & Post- Adjustment		
	Sample	Mean	Std Dev	Sample	Mean	Std Dev
Real GDP Growth Rate	11	4.5%	0.03	9	4.0%	0.01
Current Account/GDP	11	-4.1%	0.018	9	-1.1%	0.022
Investment/GDP	11	11.7%	0.019	9	15.2%	0.023
Export/GDP	11	5.7%	0.007	9	9.6%	0.023
Inflation (CPI)	11	10.1%	0.043	9	6.4%	0.033
Government Deficit/GDP	6	-8.9%	---	9	-6.7%	---

Note: All the above figures are calculated based upon the data from IFS.

In Bangladesh, people are concerned with the need for regional coordination of trade policies which between India and Bangladesh are often emphasized. According to their view, trade liberalization without considering the relationship with neighboring countries would create the current account problems. Since Bangladesh strove toward liberalization without India's move towards liberalization, the trade imbalance against India has increased. While exports from Bangladesh to India tended to decline, imports from India tended to increase. Most of the trade deficits were financed by the continuous growth in overseas remittances, but the external debt stock has been growing gradually (Table 2).

Table 2

Key Indicators from Balance of Payments

Mil of Taka	Trade Balance	Remittance	Current Account	External Debt (mil \$)
1988-89	-67,773	26,860	-23,390	11,119
1989-90	-74,329	26,312	-26,798	12,757
1990-91	-61,499	30,169	- 5,323	13,470
1991-92	-56,918	37,237	- 8,107	13,898
1992-93P	-69,325	36,985	1,499	14,619
1993-94	-65,848	43,549	11,193	16,223
1994-95	-97,428	48,140	- 5,974	16,370
1995-96	-126,554	49,795	- 3,885	n/a

Note:

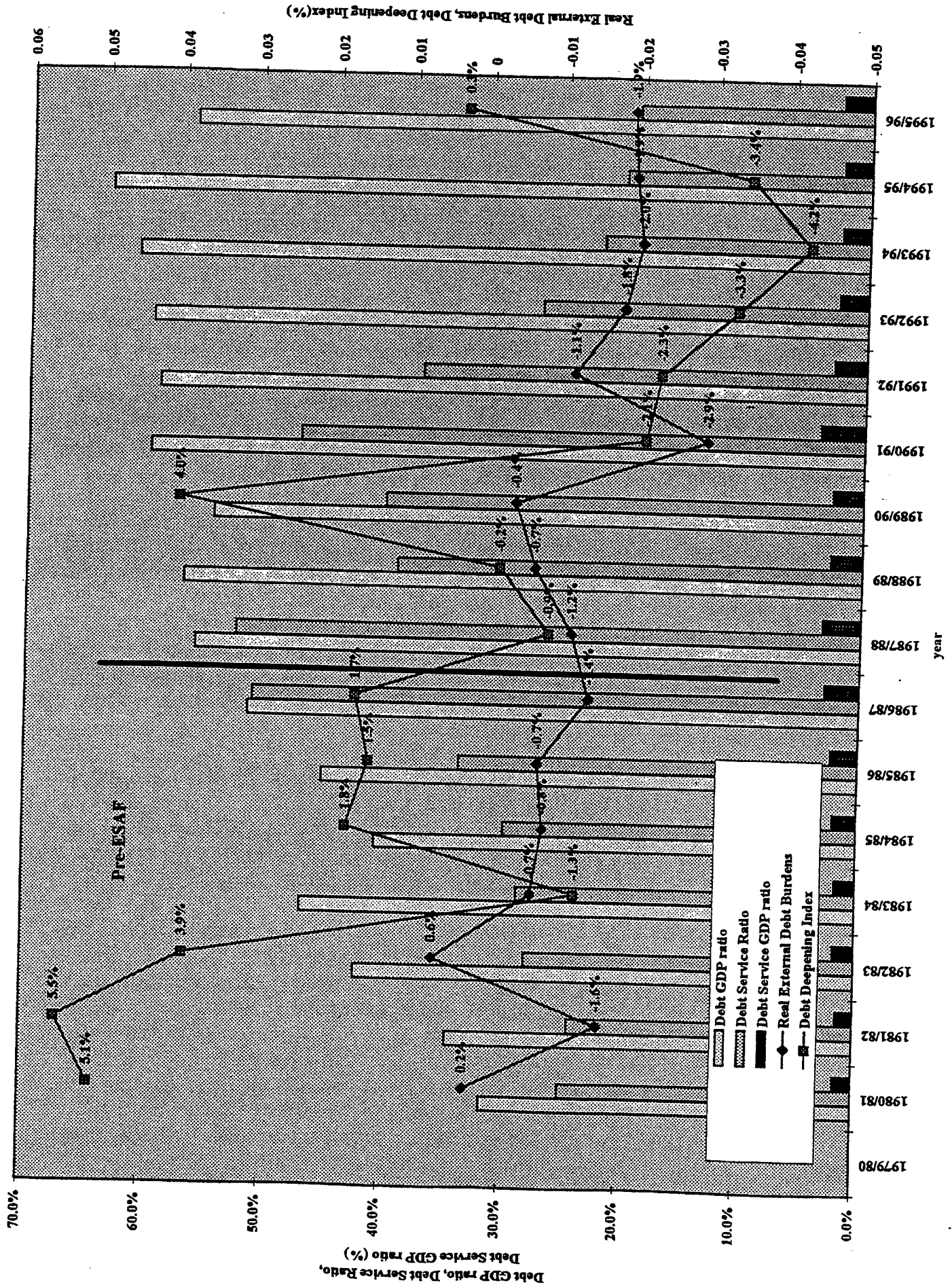
- (a) Trade Balance includes freight, insurance and net amount of other goods and services.
- (b) For up to 1991-92, the amount of remittance is substituted by "Transfer by Bangladesh nationals."
- (c) External Debt is defined as the sum of public and publicly guaranteed long-term debt, the use of IMF credit, and short-term debt.

Source:

Bangladesh Bank, Bangladesh Bureau of Statistics, *Global Development Finance* (World Debt Table).

As "Several Indicators for External Debt, Bangladesh" shows, debt service ratio increased on average, but other indicators show a declining tendency. Debt service/GDP ratios are almost constant throughout time after the adoption of ESAF. Debt/GDP ratio is slightly increasing. However, dynamic indicators are different. REDB is gradually improving, and DDI has decreased since 1990 except in the last observation. In sum, both debt service ratio and DDI indicate the improvement in external balance. Though static indicators do not show significant changes, dynamic indicators reflect the improvement in growth.

Several Indicators for External Debt, Bangladesh



Côte d'Ivoire

Côte d'Ivoire's external sector performance has been characterized by a period of high growth under improving terms of trade in the middle of the 1980s, a stagnant period of price stability under the fixed exchange rate mechanism of the Franc Zone until 1994, and a period of rebounding growth after the critical devaluation in 1994.

During the first period, economic activities were greatly influenced by a generally optimistic outlook on the economy, which in turn laid the foundation for the accumulation of later debt.

During the second period, the Côte d'Ivoire economy was constrained by the CFA Franc Zone mechanism. Indeed, the price level was stable; consumer prices decreased substantially during 1993, but GDP growth was extremely stagnant. After the devaluation, the economy rebounded. Recent data on growth are sparse, but the rebounding seems to be holding.

Côte d'Ivoire's balance of payments is distinguished by the fact that, unlike many developing African economies, the trade balance was in surplus throughout the 1980s. It is the burden of servicing the large outstanding debt that turns the current account into deficit (or barely balanced in 1994).

Now, let us apply the concepts of various indicators that we have introduced above. The paths of debt-service (/export) ratio, debt-service/GDP ratio, debt to GDP ratio, Real External Debt Burdens (REDB) and Debt Deepening Index (DDI), in a way, measure the health of a country's external position.

As will be noticed from the following chart (“Several Indicators for External Debt, Côte d'Ivoire”), Côte d'Ivoire is noted for its high value of international debt. All of the three ratios; the debt service ratio, the debt service/GDP ratio, and the debt/GDP ratio are high. The debt-service ratio is decreasing because of the openness of the economy. On the other hand, the debt/GDP ratio is growing reflecting the slow GDP growth until the devaluation.

In contrast, two measures, REDB and DDI, that are related to the change in debt/GDP ratio were reduced substantially in 1993, but grew rapidly in 1994 and 1995. This implies that if we count both debt dynamics and current account, the debt generating mechanism is still working substantially in Côte d'Ivoire. These figures confirm that Côte d'Ivoire is a country heavily in debt. Because of the fact that Côte d'Ivoire is a very open economy, the value of debt service/export ratio and debt outstanding/export ratio understate the difficulty of the debt problem. From the movement of these indicators before and after the ESAF program, whose initiation year is depicted by the solid vertical line, the external viability of Cote d' Ivoire does not seem to be affected favorably by the ESAF program. Only the debt service ratio shows some hopeful turn.

Severa. indicators for External Debt, Cote d'Ivoire

