Experience Under the IMF's Enhanced Structural Adjustment Facility

IMF POLICY DEVELOPMENT AND REVIEW DEPARTMENT

The IMF supports reform in poor countries through its Enhanced Structural Adjustment Facility (ESAF). An IMF study found that policy gains under ESAF have helped improve growth and living standards and progress toward external viability.

ESAF and its precursor, the Structural Adjustment Facility (SAF), were set up to assist low-income countries address deep-seated and persistent economic problems, as part of a broader effort involving support from the World Bank and other agencies and donors in the international community (Box 1). When they applied for SAF or ESAF assistance, many of these countries were struggling with the legacy of development strategies based on state intervention, public ownership, and protectionism. These policies had stifled entrepreneurship, promoted waste and corruption, and exacerbated their economies' vulnerability to economic shocks. In many countries weaknesses had been masked during the 1970s by heavy foreign borrowing and improving terms of trade. But when world commodity prices plummeted and interest rates rose in the early 1980s, both the debts and policies they had financed became unsustainable.

The immediate need in most of these countries was to bring some order to external cash flow positions, through a combination of debt relief or rescheduling and new resource flows. Even though many countries had already begun reform programs supported by IMF stand-by arrangements, their external situations were precarious—current account deficits (excluding transfers) averaged 12–14 percent of GDP; scheduled debt service was typically 35–40 percent of exports; and official reserves were uncomfortably low.

These countries were suffering from more than a temporary liquidity problem. Stuck in a cycle of low saving, weak external positions, and slow growth, they were falling behind other developing countries in terms of per capita income; their saving rates were half the average of other developing countries; they had larger budget deficits, higher inflation, heavier external debt burdens, more distorted exchange systems; and their fast-growing populations were worse off in terms of education, health, and life expectancy.

The adjustment strategy

Programs supported by SAF and ESAF arrangements, while tailored to the diverse needs of individual countries, share core objectives:

- raising saving rates,
- securing financial stability,
- liberalizing and opening economies to foreign trade,
- reducing state intervention and making markets more efficient,
- reorienting government spending and improving revenue collection, and
- mobilizing external resources.

Reforms to achieve these objectives would have been challenging to implement in the best of times, but the global environ-

Box 1

The Enhanced Structural Adjustment Facility

In the mid-1980s, the IMF recognized that some of its low-income member countries needed highly concessional financial support on a longer-term basis than it was able to provide through its existing financing mechanisms. It therefore set up the Structural Adjustment Facility (SAF) in 1986, and the Enhanced Structural Adjustment Facility (ESAF) one year later. Under ESAF arrangements, the IMF extends support for 3-year structural adjustment programs aimed at fostering sustainable growth and strengthening the country's external position. Based on their per capita incomes, 79 IMF member countries are now eligible for ESAF assistance, and the IMF is currently supporting ESAF programs in 34 countries. As of the end of June 1997, cumulative commitments and disbursements totaled $10.9 billion and $ 7.7 billion, respectively. ESAF loans carry an annual interest rate of 0.5 percent; repayments are made semiannually, beginning 5-1/2 years and ending 10 years after disbursement.

Recognizing its usefulness, the IMF's Interim Committee agreed in September 1996 to continue to support ESAF as a financially self-sustaining facility that would continue to be the centerpiece of the IMF's strategy to help low-income countries.

The IMF study reviewing experience under the ESAF will be published shortly. The study's recommendations on enhancing program design were broadly endorsed by the IMF's Executive Board.

ment during the past decade—falling commodity prices in the late 1980s and early 1990s, and the industrial country recession of 1991–93—made the challenge harder still. One-fourth of ESAF countries experienced war or civil strife during this period, making it difficult to formulate, much less to implement, policies. Natural disasters such as drought and cyclones also took their toll in some countries. ESAF countries suffered throughout the past decade from restricted access to key export markets in the industrial world, particularly in agriculture, textiles, and clothing. However, market conditions improved after 1993, when global demand and nonfuel commodity prices rebounded, while world energy prices remained subdued. Civil conflicts—with some exceptions—subsided. This generally more favorable climate probably contributed to the widespread improvement in growth rates in ESAF countries during the last three years.

Box 2

ESAF countries covered in the study

The study divided the 36 countries under review into five regional groupings, as follows:

CFA Africa	Other Africa	Asia	Latin America and Caribbean	Transition economies
Benin	Burundi	Bangladesh	Bolivia	Albania
Burkina Faso	The Gambia	Nepal	Guyana	Cambodia
Côte d'Ivoire	Ghana	Pakistan	Honduras	Kyrgyz Republic
Equatorial Guinea	Guinea	Sri Lanka	Nicaragua	Lao P.D.R.
Mali	Kenya			Mongolia
Niger	Lesotho			Vietnam
Senegal	Madagascar			
Togo	Malawi			
	Mauritania			
	Mozambique			
	Sierre Leone			
	Tanzania			
	Uganda			
	Zimbabwe			

What has been accomplished?

The IMF study reviews the experience of 36 countries that received support under the SAF/ESAF in the context of 68 multiyear adjustment programs over 1986–94. (Box 2). The study found that these countries now had economies that were materially stronger and more market-oriented than a decade ago. Substantial policy gains, where achieved, had contributed to growth and living standards and to progress in most countries toward external viability. At the same time, progress was uneven, reflecting in large part policy weaknesses. Most countries continued to fall short of their potential.

Fiscal consolidation. The programs' goal was to cut budget deficits (excluding grants and interest payments) by a little under half over a three-year period or by about 3 percentage points of GDP, on average. Whether this adjustment was to be achieved by cutting expenditures or increasing revenues varied from country to country, but most programs were designed to boost capital spending while selectively cutting current spending in relation to GDP. Of the savings sought in current spending, roughly half was to come from the wage bill and half from subsidies and transfers (through, for instance, reduced support for public enterprises and better targeting of consumer subsidies). Many programs included pledges to strengthen health and education spending and incorporated safety net measures for vulnerable groups. On the revenue side, programs aimed to shift the burden from nontax to tax revenues and from direct to indirect taxation (especially to broad-based consumption taxes), and to improve revenue from tax and customs administration reforms.

The shift from current to capital expenditure did occur, albeit to a lesser extent than hoped. More encouragingly, the available data suggest that roughly three-fourths of the ESAF countries increased spending on health and education. Many countries also cut military spending. Nevertheless, on average, only about half of the targeted reduction in budget deficits was achieved. Performance varied widely, and almost half of the programs produced no improvement.

The reasons for these shortcomings were complex. Revenues fell short of targets in two-thirds of the programs and, on average, were barely changed from pre-program levels. Missed deficit targets were more closely associated with expenditure overruns, however, as governments failed to cut civil service staffing levels or trim subsidies, including to public enterprises. Other factors included the weakness of budgetary institutions and difficulties in broadening tax bases.

Inflation reduction. Programs succeeded in reducing high inflation rates. However, with a few exceptions (notably, the CFA franc countries), they failed to bring inflation rates down to single digits on a sustained basis. Inflation remained high in most of non-CFA franc Africa. Inflation in Asian ESAF countries was generally stable, at around 10 percent.

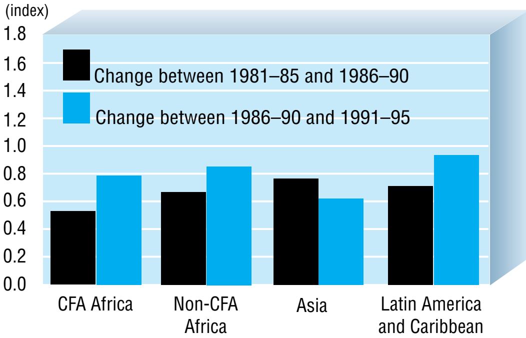
Structural reform. Progress in structural economic reform among ESAF countries was profound but uneven (Chart 1). With advice and support from the World Bank and other agencies as well as from the IMF, significant advances were made in deregulating the pricing and marketing of goods, and price-setting mechanisms for products still subject to controls became more rational. Many countries eliminated distortions in their foreign exchange systems, although foreign exchange markets commonly remain subject to restrictions on capital transactions. The easing of trade barriers got off to a slow start but accelerated in the 1990s.

Reforms of public enterprises were an important component of programs in two-thirds of the ESAF countries, but progress was slow and protracted. The biggest problems were typically in the strategic sectors, where attempts to restructure large enterprises were disappointing. Managers did not change their ways, despite the introduction of performance contracts, and governments tended to replace direct budgetary support with quasi-fiscal assistance such as tax concessions and loan guarantees.

Reforms of financial systems had mixed results. Most countries liberalized interest rates, eliminating negative real interest rates in many cases, and began to develop financial markets and to move to indirect instruments of monetary control. However, weaknesses in countries' banking systems remained pervasive, impairing their ability to mobilize and allocate resources efficiently. While reforms sought to strengthen banks' financial positions, improve decision making, and strengthen supervision, progress was hesitant. Banking reform seems to have been hindered by the dearth of local banking skills, a failure to expand

Chart 1

The pace of structural reform in ESAF countries [1]



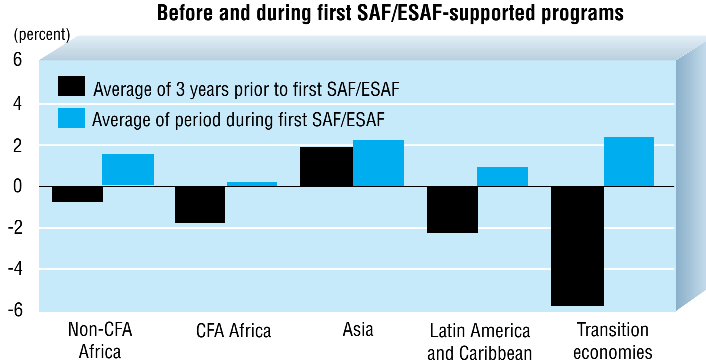
Source: IMF staff.

[1] An index of reform was calculated covering the extent of price controls and state intervention in marketing, the exchange system, the trade system, the financial sector, and the public enterprise sector.

Chart 2

Real per capita GDP growth

Before and during first SAF/ESAF-supported programs



Source: IMF staff.

competition, and the unwillingness of governments to stop pressuring banks to lend to uncreditworthy public enterprises.

Programs were designed to make a positive contribution to strengthening property rights and improving economic aspects of governance, directly, for example, by promoting reform of land tenure systems and the adoption of more liberal and transparent foreign investment codes, and indirectly, by reducing the distortions and regulations that feed corruption. Assessing overall progress in this area is particularly difficult, but the evidence suggests that property rights improved in roughly two-thirds of ESAF countries (mainly in Asia and Latin America and the Caribbean, but also in some African countries) and deteriorated in one-third.

Openness. ESAF countries made modest progress toward increasing the outward orientation of their economies. Liberalization of exchange and trade regimes, nominal depreciation, and fiscal adjustment led to a steady depreciation of the real exchange rate in all regions after 1985, which contributed to the growth of foreign trade as a share of GDP in almost all regions. However, ESAF countries in Africa and Latin America and the Caribbean suffered major losses in export market share throughout the 1980s (although these losses were stemmed or even reversed in the early 1990s), while Asian ESAF countries' share of export markets rose steadily from 1985 to 1995.

Economic growth. Growth in most countries improved over the adjustment period. In the early 1980s, real per capita GDP in nontransition ESAF countries was declining annually by almost 1.5 percent, on average. But it rose at a positive annual rate of about 0.3 percent in the early 1990s (Chart 2) and to 1 percent during 1994–95.

Important as these gains are, however, there are other, less sanguine perspectives. First, since output expanded less rapidly in ESAF countries than in the rest of the developing world over the past decade, per capita incomes fell further behind. Living standards and social indicators improved in ESAF countries, but more slowly than in the rest of the developing world. Second, not all ESAF countries shared equally in the recovery. The turnaround in economic growth was most pronounced in some of the ESAF countries in Latin America and the Caribbean. Although per capita GDP growth rates in 8 of the 22 African ESAF countries were higher than the average for all developing countries during 1986–95, other African countries saw only a small degree of convergence toward the average growth rate of the developing world.

External viability. The IMF study measured progress toward external viability—a situation in which the external current account can be financed by normal and sustainable capital flows—based on three ratios: debt-service burden to exports, debt-service burden to GDP, and reliance on exceptional financing. Of 27 nontransition countries where data permit an assessment, 12 can be said to have made "clear" progress toward external viability, meaning all 3 ratios showed improvement or remained stable, and 9 made "limited" progress, meaning that only 1 of the ratios had deteriorated. Six countries made no apparent progress toward external viability. The decisive factor appears to have been economic growth—export growth, in particular. In countries that made "clear" progress, annual growth rates for real GDP and export volumes were 3 to 6 percentage points higher, on average, than in countries that made no progress.

Lessons for program design

Countries undertaking SAF and ESAF-supported programs have clearly brought their economies a long way from the doldrums of the early 1980s. Developments in the last 1–2 years have been especially encouraging. While this may owe something to the favorable global environment, the liberalization and restructuring over the past decade give grounds for believing that durable gains in economic potential have been achieved in these countries. Nonetheless, ESAF countries are still among the world's poorest and must therefore aim for faster economic growth than other developing countries on a sustained basis if they are to close the large gap in living standards. This is not in prospect so long as their investment and domestic saving rates continue to fall so far short of those in the rest of the developing world. The mutually reinforcing objectives of growth and external viability call for ambitious strategies that are resolutely implemented.

In their discussion of the report, the IMF's Executive Board agreed that achieving greater success in cutting government budget deficits must be at the heart of the strategy for ESAF countries. While greater attention needs to be paid to factors that could increase incentives for private saving, numerous empirical studies have concluded that public saving is the quickest and surest way to raise national saving. Weak fiscal discipline inhibits growth through other channels, too—by contributing to chronic inflation, weak external positions, and stop-go policy implementation. With these interrelationships in mind, the IMF study's proposals for strengthening ESAF-supported programs focused on a stronger and reoriented fiscal adjustment effort; a more resolute approach to reducing inflation; a more focused, concerted push on crucial structural reforms; and steps to encourage sustained policy implementation.

Growth-enhancing fiscal adjustment. By and large, fiscal adjustment thus far in ESAF-supported programs has been modest. For many countries, simply meeting targets more or less as ambitious as those set in the past would represent a significant advance, while for others the objectives themselves should be more ambitious. A general aim in most countries should be to raise national saving rates significantly over the course of an ESAF-supported program. The means to achieve the required additional adjustment, however, may have implications for economic growth, as well as for the path of adjustment itself. Although there was scope for increased revenue in some cases, significant deficit reduction will have to come from structural reform on the expenditure side, in the civil service and public enterprises in particular. Such reforms can be costly in the short term (requiring redundancy payments, for instance); where necessary, deficit targets should accommodate these costs, provided that the medium-term savings are reasonably assured.

How government spending is cut is important, and expenditure that is growth-enhancing should be protected. This would include productive capital spending for key infrastructure and high-priority spending on health and education. Social spending is of considerable importance, given that rapid population growth and inadequate investment in human capital appear to be the dominant factors behind Africa's relatively sluggish growth rates. The quality of social spending is as important as its quantity, however. Hence, devices such as "core" budgets to protect such spending, while helpful in some circumstances, cannot be a substitute for careful monitoring of the delivery of social services. Improvements are needed in the quality and availability of expenditure data to ensure the adequacy and efficiency of spending on priorities such as these, as well as to monitor more closely the effectiveness of social safety nets. Efforts to reduce the civil service wage bill, reform public enterprises, and reduce unproductive spending should also be intensified. Finally, improved and more transparent budgeting and expenditure control systems are needed.

Inflation reduction. The evidence suggests that those countries with inflation rates stuck in double digits are sacrificing growth. The potential gains from achieving and maintaining inflation in the single-digit range appear to be substantial, not only for increasing output growth but also for improving income distribution. Growth may benefit from low inflation directly, through improved resource allocation and higher investment, or indirectly, as a result of the broad-based reforms that are typically needed to sustain low inflation. Thus the full benefits are likely to accrue only in response to an anti-inflation strategy that is comprehensive and consistent.

SAF and ESAF-supported programs have in fact consistently targeted single-digit inflation. Yet they have also frequently failed to achieve this goal. One possible reason for this is that the extent of fiscal adjustment needed may have been underestimated. Another is that most programs (excluding, of course, the CFA franc countries) lacked an effective nominal anchor, possibly because the likely fiscal stance was thought to be incompatible with such an anchor, particularly in light of concerns about competitiveness.

Strong and durable adjustments of public sector imbalances will be critical to greater success in reducing inflation. In some cases where the exacting prerequisites of a formal nominal anchor—staunch adherence to fiscal discipline and minimal indexation—are feasible, an announced commitment to targets for the nominal exchange rate, monetary growth, or the inflation rate itself could facilitate the move to low inflation. The potential risks associated with nominal anchors would need to be carefully considered in each case, however, and exchange rate pegs would need to be accompanied by a clearly articulated exit strategy.

Structural reforms. The supply response to macroeconomic adjustment will be quicker and stronger if accompanied by structural reforms that stimulate private investment and entrepreneurship. Many ESAF countries have achieved a great deal already. The challenge now is to move forward with the "second generation" of reforms—those where progress has lagged, or where more can be done to raise countries' economic potential. These areas would include: foreign trade and investment liberalization, public enterprise reform, bank restructuring, and strengthened property rights. Many aspects of these reforms lie within the domain of the World Bank, and strengthening policies and their implementation would involve continued close coordination and collaboration with the World Bank. Technical assistance to improve institutional capacity would also be important.

Sustaining programs. As many as 28 of the 36 countries covered in the study experienced significant interruptions during or between SAF/ESAF-supported programs, in most cases as a result of poor policy implementation. Policy slippages undermine economic performance, both directly and through their effects on investors' and market sentiment. The resulting loss of credibility is costly even when policy adjustments are subsequently made to retrieve the ground lost.

The reasons for program interruptions were complex. Political factors were frequently at play, including lack of public support for adjustment policies, governments' reluctance to confront special interest groups, poor organization, and governance-related problems. In some cases, political disruption was so severe as to preclude effective formulation or implementation of policies. In less extreme cases where policy slippages were a dominant factor, the IMF study found that the likelihood of interruptions might have been reduced by more intensive program monitoring and more proactive technical assistance. More consistent contingency planning against shocks beyond the government's control (e.g., terms of trade or weather-related shocks) might also have helped.

Differing views were expressed by the Executive Board on whether the IMF should go beyond these steps, and be more cautious and selective in supporting countries' programs where the government's ability to commit to the program was in question. Some Executive Directors favored remaining engaged, if necessary with a slower pace of adjustment and reform, while others suggested that greater selectivity would be helpful in motivating strong reform programs. F&D

The IMF study discussed in this article will be complemented by an external evaluation of the ESAF, which is scheduled to be completed in late 1997, and which will examine the social impact of and policies in ESAF-supported programs, external viability, and issues relating to the national "ownership" of programs.