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CONTENTS

Latin America: crisis and development options <i>Enrique V. Iglesias, Executive Secretary, ECLAC</i>	7
Institutional elements of a new diplomacy for development (Notes for a book of memoirs) <i>Diego Cordovez</i>	29
Orthodox adjustment programmes in Latin America: a critical look at the policies of the International Monetary Fund <i>Richard Lynn Ground</i>	45
The adjustment process in the eighties. The need for a global approach <i>Carlos Massad and Roberto Zahler</i>	83
Global monetarism and destruction of industry <i>Victor E. Tokman</i>	107
The structural crisis in Argentine industry <i>Adolfo Dorfman</i>	123
Population, resources, environment, development interrelationships in the United Nations: in search of a focus <i>Branislav Gosovic</i>	135
Participation: the view from above <i>Marshall Wolfe</i>	155
Recent ECLAC publications	181

Orthodox adjustment programmes in Latin America: A critical look at the policies of the International Monetary Fund*

*Richard Lynn Ground***

Since its inception, the International Monetary Fund has been harshly criticized for the policy measures it has recommended. In most cases, this criticism has taken the form of an outright rejection of IMF policies, mainly because of the high economic, social and political costs they entail.

This article also takes a critical look at the IMF position; however, this criticism is based on a detailed study of the main elements of that position. On the one hand, the author analyses the orthodox adjustment paradigm, as well as recent suggestions for including in it consideration of certain structural factors, and, on the other, he discusses the recessionary bias that is inherent in that paradigm. This bias is evident both in the meagre and belated financial support given the Latin American countries by the IMF during the current crisis, and in the domestic policies provided for in the adjustment programmes it recommends.

The author's review of these domestic policies, which makes up the nucleus of the article is based on a study of the 17 IMF agreements that were in force in Latin America and the Caribbean at the end of 1983. The author lists and analyses the performance criteria, preconditions and policy understandings employed by the IMF; identifies and compares the policy mix contained in the agreements; discusses operational, intermediate and ultimate targets provided for in the agreements; and, finally, evaluates the Fund's use of fixed specific targets for its performance criteria. On the basis of this analysis, the author notes the main sources of recessive bias in IMF policies and suggests how they might be reformed.

*This article was originally written in Spanish.

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I

Introduction*

A. PURPOSE AND JUSTIFICATION OF THIS STUDY

In the absence of a new development style based on profound domestic reforms including, above all, domestic financing of capital formation,¹ there may be no clear alternative to the orthodox adjustment model. This does not mean, however, that the orthodox model is faultless, for it does in fact have a series of shortcomings that in practice cause unnecessary harm to the economy and to the welfare of the population.

One of the main purposes of this study is, in fact, to show why the adjustment model applied by the International Monetary Fund should be reformed and how this might be accomplished. The other is to provide a more detailed and systematic description of the nature and characteristics of the adjustment programmes being sponsored by the Fund.

There are two important justifications for this study. In the first place, towards the end of 1983, seventeen Latin American and Caribbean countries had entered into adjustment agreements with the International Monetary Fund. In the second place, there has always been and still

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¹We expect to discuss this subject on another occasion. Several proposals have been made for dealing with and overcoming the current crisis. See, for example, Enrique V. Iglesias and Carlos Alzamora Traverso, "Bases for a Latin American response to the international economic crisis", *CEPAL Review*, No. 20 (August 1983); "América Latina ante la recesión", *Pensamiento Iberoamericano*, No. 4 (July-December 1983); and CEPAL, "Adjustment policies and renegotiation of the external debt" (E/CEPAL/SES.20/G.17), Santiago, Chile, February 1984. See also Raúl Prebisch, *Capitalismo periférico: crisis y transformación* (Mexico, Fondo de Cultura Económica, 1981), Part Six.

remains a surprising degree of misunderstanding about the specific content of the Fund's adjustment programmes. In this regard, a comparative study of the characteristics of those programmes may be of particular interest.

We believe that this study, which makes extensive use of several new theoretical and empirical analyses of recent monetarist experiments in the centre, shows that the Fund's approach has formal and practical deficiencies which are extremely important, not only from the academic point of view, but also in light of the fact that the fate of several hundred million people, including 80% of the population of Latin America and the Caribbean, is linked to a greater or lesser degree, to the results of IMF adjustment programmes. Nevertheless, an analysis of the content of those programmes shows that some of the criticisms traditionally directed against the Fund do not seem to be justified.

The most important result of this study, however, may be the finding that the reforms of IMF policies that are proposed would almost all be quite easy to implement and would in no way make it necessary to abandon the basic principles governing the Fund's operation or the paradigm it advocates. On the other hand, I am certain that these reforms could bring about a notable improvement in the performance of those economies that are obliged by circumstances to resort to the Fund.

This article is divided into three parts. In the remainder of the first part, the nature and macroeconomic meaning of the adjustment process are discussed and a brief description of the orthodox adjustment paradigm is given. In the second part, and nucleus of the article, the recessive bias of the Fund's approach is brought out. In the first place, the performance of the Fund as a source and catalyst of external financing is evaluated. A review is then made of the domestic economic policies provided for in the Fund's adjustment programmes. This includes a study of both the approach on which they are based and their actual implementation in the 17 adjustment agreements that were in force in Latin America and the Caribbean at the end of 1983. Finally, the Fund's conditionality and its other domestic adjustment policies are critiqued and some policy reforms are proposed. The third part of the article consists of the summary and conclusions.

B. THE NATURE AND MACRO-ECONOMIC MEANING OF THE ADJUSTMENT PROCESS

It should be noted from the outset that once the need to adjust arises, it is implacable, for it is rooted in a budgetary restriction, i.e., the impossibility of absorbing (spending) more resources than are available, counting both the country's own resources and those it may borrow. A process of adjustment is inevitable whenever the gap between expenditure and income rises above a sustainable magnitude. It involves the reduction of the difference between gross domestic investment and gross national savings—or, what amounts to the same thing, the reduction of the deficit on the balance-of-payments current account—to an amount that is compatible with the expected—an eventually, the actual—flow of external financing. In this context, the central issue is how to minimize the cost of adjustment. Although the rationale of the adjustment process does not, therefore, have anything to do with the causes of disequilibria or with such policies as may be adopted—or not adopted—to deal with them, a question concerning the relevance of the duration of the source or sources of maladjustment of external accounts to the design of adjustment policies does arise.

In any case if a disequilibrium cannot be financed, there must be, and in fact will be, an adjustment. Likewise, regardless of what the origin—domestic, external or both—of the maladjustment may be, a disequilibrium between expenditure and income cannot persist without external financing. On the other hand, the questions of the duration and origins of unsustainable disequilibria are pertinent to the design of international adjustment policies; in other words, they are relevant to the determination of the optimum combination of external financing and internal adjustment. Everyone agrees in principle on this crucial matter, i.e., that for the sake of efficiency, a disequilibrium which can be attributed to temporary external factors should be financed. However, whether the international financial community is prepared to provide the resources necessary to avoid the imposition of an inefficient adjustment is another matter. In practice, the criterion that has been used to determine how strict an adjustment is to be imposed on deficit countries has not been the ideal one.

C. AN OVERVIEW OF THE ORTHODOX ADJUSTMENT PARADIGM²

Although it has undergone some changes over time, the orthodox approach to the causes and the process of adjustment still assigns a central role to money; in other words, it is still essentially monetarist. According to this approach, whenever there is inflation or an unsustainable balance-of-payments deficit, there will invariably have been an excessive supply of money in relation to the demand for real monetary balances. This is not to say that other causal factors are ignored. On the contrary, in some cases the source of the excessive growth of money—usually the public sector deficit—is believed to play a fundamental role. In principle, however, it is held that no non-monetary factor can in and of itself generate inflation or external disequilibria independently of the behaviour of monetary variables; a possibility that the real exchange rate may fall below the level of equilibrium—thus giving rise to a deficit on current accounts although not necessarily on the global balance-of-payments position—is admitted but this is also believed to be the result of an excessive creation of money.

In this paradigm, three types of policies are envisaged for orienting the adjustment process; these policies are aimed at restricting the growth of the means of payment, limiting deficit spending by the public sector, and modifying relative prices, especially the real exchange rate. Restricting monetary growth and cutting the public-sector deficit help decelerate inflation and restore a sustainable relationship between domestic expenditure and income, thanks to their depressive effects on domestic demand. The idea is to achieve this not only by reducing imports, but also by increasing exports, since the restriction of domestic demand would free, goods and services for the external market and reduce the profitability of domestic sales. At the same time, monetary restriction increases the amount of the external deficit that can be financed to the extent that an increase in domestic interest rates strengthens the balance-of-payments capital

account. Reducing the public-sector deficit, for its part, also serves another purpose, i.e., to prevent the public sector from monopolizing bank credit to the detriment of private investment during times of monetary restriction. The modification of relative prices which results from raising the real exchange rate—which in principle, can be achieved by reducing domestic inflation with respect to external inflation (or reducing the level of domestic prices as compared with external prices) or modifying the nominal exchange rate—helps curtail both external and internal disequilibria by diverting domestic expenditure from imports and exportable goods and services and encouraging the reallocation of factors of production to the sectors producing tradeable goods and services. At the same time, modification of the exchange rate can complement the depressive effect of restrictive monetary and fiscal policies on the level of domestic expenditure and of the potential expansionary effect of monetary restriction on the net inflow of capital, provided it creates an excess demand in the market for financial assets.

In addition, exchange adjustments are usually accompanied by policies that affect other relative prices, such as real salaries and wages and the real interest rate, reinforcing the impact of an increase in the nominal exchange rate on the real one.

The orthodox school is opposed to the introduction of measures, such as tariffs and controls, which affect capital flows and prices and restrict the scope of the market, in the adjustment policy, both because it is felt that such measures do not get to the root of the problem—thus only temporarily suppressing its manifestations—and because it is felt that they might be detrimental to domestic welfare. It is also argued that measures which restrict free trade undermine the basis of international prosperity.

So much for our description of the traditional model and policies. More recently, with the serious deterioration of the international economy, the accumulation of very large disequilibria and the emergence of many that were adjustment processes much more drastic than had been the case between the early 1950s and the 1970s, when the adjustment and paradigm policies were devised, concern has focused much more explicitly on the real side of the economy

²The IMF short-term adjustment paradigm is discussed in greater detail in section II.

during the adjustment process and on the effect of that process on the growth of productive capacity.³

Although this concern has not been systematically reflected in the formal structure of the orthodox paradigm, it has been evident in certain policy initiatives aimed at dealing with those cases in which the disequilibria of the external sector are very great or appear to have a structural origin, or both. In brief, in the contemporary or long-term orthodox approach, it is proposed that traditional short-term strategies for managing domestic demand be complemented with policies that have a more direct and extensive influence on the supply side, in order to eliminate structural maladjustments without excessively (unjustifiably) depressing the level of activity and the development of production capacity.

As regards the content of the Fund's programmes, the aforementioned concern led to the creation of a new facility in which the duration of adjustment programmes was extended to three years, the amount of available financing was increased and loan maturities were extended up to 10 years. At the same time, greater importance was attached to measures affecting variables such as the structure of production and of employment and the composition of expenditure and balance-of-payments accounts, whereas in the past, when priority had almost always been attached to short-term measures, these variables had been considered exogenous or unimportant. Greater importance was also attached to the microeconomic aspects of disequilibria and

hence to the use of measures which directly—or more directly—affect efficiency in the allocation and utilization of resources.

The World Bank, for its part, has responded by creating its so-called "structural adjustment loan". This facility allows longer terms—from five to seven years—for achieving the targets established; greater attention is given to policies relating to supply, and conditionality is linked solely to the adoption of specific measures. The total volume of financing available is similar to that provided under the Fund's new facility.

In their approach to structural problems and strengthening of the supply side, both the Fund and the World Bank follow the well-known neo-classical interpretation of underdevelopment, i.e., that when inadequate or mistaken domestic economic policies become chronic, they deform the structures of the economy, undermine its capacity and, in extreme cases, render it incapable of responding effectively to the changing situation—either favourable or unfavourable—of the international economy.

Within this frame of reference, the response to the major disequilibria existing at present—even if they have been caused mainly by external factors—must be the implementation of reforms—hopefully far-reaching ones—in domestic policies and institutions which restrict the scope and hinder the functioning of the market and private initiative. In brief, these reforms include, as the case may be, the liberalization of capital market transactions, including the opening-up of the balance-of-payments capital account; the liberation of the domestic price system from controls, including the opening-up—hopefully on a broad and uniform basis—of the balance-of-payments current account; and the restructuring and reduction of the size of the public sector, including the implementation of criteria of financial efficiency. Reforms in the labour market and social security, or special promotional policies, particularly for the development of the energy sector, may also be included. The interest—previously almost non-existent—in disaggregated values is also worth mentioning. For example, an effort is made not only to restore financial equilibrium, but also to decide which items of income and expenditure are to be increased or decreased, in order to reconcile financial equilibrium with structural

³See, for example, Andrew D. Crockett, "Stabilization policies in developing countries: some policy considerations", *IMF Staff Papers*, Vol. 28 (March 1981); Bela Belassa, "Structural adjustment policies in developing economies", *World Development*, Vol. 10, No. 1 (October 1982), and Ernest Stern, "World Bank financing of structural adjustment", John Williamson, ed., in *IMF conditionality* (Washington, D.C., Institute for International Economics, 1983). See also Tony Killick and Mary Sutton, "Disequilibria, financing and adjustment in developing countries", in Tony Killick, ed., *Adjustment and financing in the developing world. The role of the International Monetary Fund* (Washington, D.C., International Monetary Fund, in association with the Overseas Development Institute of London, 1982); and Moshin Khan and Roberto Zahler, "Efectos macroeconómicos de cambios en las barreras del comercio al movimiento de capitales", *Cuadernos de la CEPAL*, No. 20 (December 1982).

adjustment. Finally, one discerns a greater concern for manipulating the exchange rate in order to keep it at a realistic level.

These then would be the policies proposed under the orthodox approach for dealing with structural disequilibria. Although some of them, such as those pertaining to the increased disaggregation of financial variables, appear to have been included in all short- and long-term adjustment programmes sponsored by the Fund, in practice the new long-term orthodox adjustment programmes have done very little to solve the current crisis, inasmuch as they have not been very widely applied. Barely a dozen countries have participated in the World Bank's structural adjustment

programmes since this option was created in 1979, while, for some reason, between mid-1981 and late 1982, the Fund severely restricted the number of agreements signed under its long-term facility. As a result, the great majority of deficit countries currently adjust their economies by applying the traditional Fund programmes, in which the main tools used are short-term demand management and, in particular, management of financial variables. In any event, an analysis of the few long-term programmes entered into with the Fund shows that management of financial variables still constitutes the essence of the adjustment strategy; the rest of this article will therefore concentrate mainly on this question.⁴

II

The recessive bias of the International Monetary Fund's adjustment programmes

A. THE SHORTAGE OF EXTERNAL FINANCING

Towards the end of 1983, seventeen Latin American and Caribbean countries had entered into adjustment agreements with the International Monetary Fund. Ten of these had signed Stand-by agreements and seven had signed agreements under the Extended Fund Facility. At the same time, 12 of the countries in question had obtained loans under the Fund's Compensatory Financing Facility (CFF), ten of them on the same date that they had arranged for their adjustment programmes and two of them on a later date. One of these countries had also drawn a loan from the Fund's Buffer Stock Financing Facility (BSFF) (see table 1).⁵

⁴For critiques of the neoclassical or neoliberal interpretation of underdevelopment and of the policies proposed under this approach for overcoming structural disequilibria see Aníbal Pinto, "¿ más dilemmas and real options in current Latin American debate", *CEPAL Review*, No. 6 (second half of 1978); Raúl Prebisch, "The neoclassical theories of economic

liberalism", *CEPAL Review*, No. 7 (April 1979); Aníbal Pinto, "The opening up of Latin America to the exterior", *CEPAL Review*, No. 11 (August 1980); Celso Furtado, "Transnacionalización e monetarismo", *Pensamiento Iberoamericano*, No. 1 (January-June 1982) and Joseph Ramos, "Estabilización y liberalización económica en el Cono Sur", *Estudios e Informes de la CEPAL*, No. 38.

⁵Three other countries in the region obtained Fund financing in 1983. In two cases (Belize and Bolivia), however, the loans were obtained under the Compensatory Financing Facility (CFF) and hence did not require the borrower to carry out an adjustment programme. In the other case, El Salvador, the country's Stand-by agreement (SBA) expired in mid-1983.

Stand-by agreements (SBAs) and Extended Facility (EFF) agreements differ from agreements covered by the Compensatory Financing Facility (CFF) and the Buffer Stock Financing Facility (BSFF) both as regards level of financing and degree of conditionality. The maximum amount of resources that may be obtained under Stand-by agreements and Extended Fund Facility agreements is considerably higher than the amount available under Compensatory Financing Facility and Buffer Stock Financing Facility agreements. However, disbursements of financing provided under Stand-by agreements and Extended Fund Facility agreements are subject to certain conditions, whereas funds made available under Compensatory Financing Facility and Buffer Stock Financing Facility agreements are not conditioned; in other words, the borrower is not required to carry out an adjust-

It should be noted, in the first place, that the great majority of these adjustment programmes (SBA and EFF) did not enter into force until 1983; in other words, around one year and a half after the beginning of the worst economic recession experienced by the region since the great crisis of the 1930s. Indeed, between mid-1981 and late 1982, only seven countries (Barbados, October 1982; El Salvador, July 1982; Guatemala, November 1981; Haiti, August 1982; Honduras, November 1982; Panama, April 1982, and Peru, June 1982) entered into adjustment agreements with the Fund, while the per capita product and gross international reserves were falling more or less sharply in almost all the 30 countries included in the region at that time.⁶ Of these seven countries, only three (Barbados, Honduras and Peru) obtained, under the aforementioned agreements, financing beyond the regular credit tranche —i.e., an amount of more than 100% of their quotas in the Fund—and only one (Peru) borrowed under the ex-

ment programme. Stand-by agreements are also different from Extended Fund Facility agreements; maturities of Stand-by agreements range between one and two years, while Extended Fund Facility agreements have a maturity of three years. The total amount of resources that can be obtained under Extended Fund Facility agreements is also higher than that which can be obtained under Stand-by agreements. In general, Stand-by agreements call for "short-term" adjustment programmes and Extended Fund Facility agreements for "long-term" programmes. For information on all the Fund's facilities, see International Monetary Fund, *International Financial Statistics*, Volume xxxvii, No. 3 (March 1984).

⁶A total of 13 countries obtained Fund financing during this period. In addition to those mentioned above, the Dominican Republic (5/1982/42%), Guyana (11/1982/16%) and Uruguay (8/1982/44%) borrowed under the Buffer Stock Financing Facility. (The last figure in parentheses refers to the amount of financing obtained with respect to the country's quota in the Fund.) It should be remembered, however, that access to the Compensatory Financing Facility and the Buffer Stock Financing Facility does not entail an obligation to apply an adjustment programme designed by the Fund. Also, Dominica and Jamaica signed Extended Fund Facility agreements in February and April 1981, i.e., prior to the period under consideration. Finally, Costa Rica signed a Stand-by agreement in December 1982 but did not receive the first funds until January 1983. This country had also entered into an extended Fund Facility agreement in June 1981, but it was suspended in August 1981.

tended Fund facility—a long-term adjustment programme.⁷

In the second place, it should be noted that whereas the financing provided by the Fund in 1981 and 1982 was equivalent to 19% of the current-account deficit of the Latin American countries which obtained Fund financing, it only covered 1% of Latin America's overall current account deficit in 1981 and 2% of the deficit recorded in 1982, when the adjustment had of necessity already begun in most of the countries of the region (see table 2).

During 1983, twelve countries of the region entered into adjustment agreements with the Fund and the first long-term adjustment agreements (EFF) to have been signed since mid-1981 (except for the one signed by Peru in July 1982) were signed (see table 1).⁸ Despite the fact that in most cases the financing obtained was close or equal to the maximum (150% of annual quota) allowed under the regulations in force for Stand-by and EFF agreements and that disbursements were also made under the CFF and the BSFF, in general the intensity of the adjustment process radically increased.

Because of the very magnitude of the adjustment experienced by the region in 1983—the current-account deficit was reduced by approximately 80%, the financing granted by the Fund appears to be much more generous than it actually was, when one compares it with the *ex post* deficit (see table 2). While it is true that in some countries (Costa Rica and Haiti, for example) the adjustment was less stringent in 1983, it is no less true that these cases cannot be properly assessed without referring to the magnitude of the adjustment they had undergone in previous years. In other cases, such as that of Uruguay, where *ex*

⁷The amounts of financing received in relation to quotas were as follows: Barbados, 125%; El Salvador, 67%; Guatemala, 25%; Haiti, 100%; Honduras, 150%; Panama, 44% and Peru, 265%. It should be noted, however, that six of the seven countries in question also obtained CFF loans during that period. The dates and amounts (in relation to quotas) of these were as follows: Barbados, 10/1982, 51%; El Salvador, 7/1981, 50% and 7/1982, 50%; Guatemala, 11/1981, 100%; Haiti, 12/1982, 49%; Honduras, 11/1982, 51%; and Peru, 7/1982, 78%.

⁸With the exception mentioned, these were the first EFF agreements to be signed in the entire world since 1981.

Table I
FINANCIAL DATA PERTAINING TO AGREEMENTS BETWEEN LATIN AMERICAN COUNTRIES AND THE INTERNATIONAL
MONETARY FUND
(In force at end of 1983)^a

	Date of agreement	Duration (months)	Conditioned financing		Non-conditioned financing ^b		Total financing			Amount drawn in relation to financing ^c		
			Millions of SDRs	In relation to IMF quota ^d	Millions of SDRs	In relation to IMF quota ^d	In relation to deficit on current account ^e			On date of agreement		To date
							1981	1982	1983	Conditioned	Total	Total
<i>Stand-by arrangements</i>												
Argentina	24 Jan. 83	15	500	187	520	65	40	72	91	20	41	55
Barbados	1 Oct. 82	20	32	125	13	51	12	31	...	30	64	91
Costa Rica	20 Dec. 82	12	92	150	16	26	31	58	29	—	—	77
Chile	10 Jan. 83	24	500	154	295	91	10	19	39	24	53	63
Ecuador	25 Jul. 83	12	138	157	—	—	18	16	29	50	50	50
Guatemala	31 Aug. 83	16	115	150	—	—	20	28	34	—	11	11
Haiti	7 Nov. 83	24	60	174	—	—	16	23	19	...	...	...
Honduras	5 Nov. 82	12	77	150	23	45	36	44	48	20	39	46
Panama	24 Jun. 83	18	150	222	39	87	33	29	40	7	33	43
Uruguay	22 Apr. 83	24	378	300	—	—	47	89	224	13	13	25
<i>Extended Fund Facility agreements</i>												
Brazil	6 Jan. 83 ^f	36	239	425	965	97	17	12	24	9	26	26
Dominica	6 Feb. 81	36	9	295	2	67	21	21	...	9	26	87
Grenada	24 Aug. 83	36	14	300	—	—	22	14	...	8	8	8
Jamaica	13 Apr. 81	36	478	450	42	38	55	33	...	14	17	71
Mexico	1 Jan. 83	36	411	425	—	—	8	40	33 ^g	6	6	26
Peru	7 Jun. 82	36	650	265	192	78	18	17	22	—	23	88
Dominican Republic	21 Jan. 83	36	371	450	55	66	40	34	39	12	21	35

Source: International Monetary Fund, *Weekly Bulletin*, several issues; and ECLAC, on the basis of official information.

^aIncludes agreements in force as at 1 December 1983.

^bIncludes financing from Compensatory Financing Facility as of dates of agreements (Stand-by and Extended Fund Facility) mentioned. However, also included is SDR 499 million obtained by Brazil from that Facility in December 1982 and SDR 12.6 million obtained by the Dominican Republic from the Buffer Stock Financing Facility (August 1983).

^cPercentage.

^dAverage annual flow (without adjustments for suspension of drawings) to average value of SDR each year for all countries, except Dominica and Jamaica, for which actual figures are given.

^eThis agreement was replaced by the agreement of 24 February 1983, which in turn was replaced by the agreement of 15 September 1983.

^fSurplus.

ante the level of financing provided by the Fund deficit, in the final analysis the adjustment process appears to be relatively high in relation with the process proceeded quite steadily.

Table 2
NET FINANCING OBTAINED BY LATIN AMERICAN COUNTRIES FROM THE INTERNATIONAL MONETARY FUND AND BALANCES ON THEIR CAPITAL ACCOUNTS, 1981-1983

	Net financing from the Fund								
	Millions of SDRs			As a percentage of deficit on current account			Percentage variation of balance on capital account		
	1981	1982	1983	1981	1982	1983	1981	1982	1983
Argentina	—	—	1 121	—	—	63	-30	19	5
Bahamas	—	—	—	—	—	—	108	-43	...
Barbados	-2	21	14	—	59	...	317	-51	...
Belize	—	—	4	—	—	...	...	...	...
Bolivia	-2	17	11	-1	15	6	1 580	-52	^a
Brazil	—	—	1 339	—	—	19	32	-10	-44
Colombia	—	—	—	—	—	—	37	-29	^a
Costa Rica	44	-4	83	12	-2	22	-52	-7	-9
Chile	-55	-36	519	-1	-2	51	48	-79	-57
Dominica	5	3	1	21	21	...	-39	-63	...
Ecuador	—	—	79	—	—	8	-30	13	-34
El Salvador	32	-60	16	14	29	7	393	-22	100
Grenada	5	-1	1	24	-3	...	43	45	...
Guatemala	96	—	13	19	—	5	^b	28	-23
Guyana	11	4	-3	4	3	-2	332	5	-6
Haiti	18	11	24	6	9	14	50	-42	65
Honduras	34	62	46	8	27	22	-2	-18	-2
Jamaica	161	124	81	55	333	...	-42	508	...
Mexico	—	—	903	—	—	26	69	-98	^a
Nicaragua	-17	-4	-4	-3	-1	-1	71	-60	89
Panama	62	-4	88	15	-1	25	13	24	-29
Paraguay	—	—	—	—	—	—	-3	-22	-54
Peru	-39	256	95	3	15	8	57	54	-22
Dominican Republic	-18	44	174	-5	11	22	-36	-31	9
Saint Lucia	3	-2	—	4	-3	—	17	4	^a
Suriname	—	—	—	—	—	—	-16	-86	...
Trinidad and Tobago	—	—	—	—	—	—	36	-20	^a
Uruguay	—	87	83	—	41	99	^a	^a	^a
Venezuela	—	—	—	—	—	—	-31	^a	^a
Subtotal ^c	471	689	4 695	19	19	29 ^d e 50 ^e f	6	-9	-43 ^a e
Total ^g	338	638	4 688	1	2	58 ^h	44	-56	-73 ^a h

Source: International Monetary Fund, *International Financial Statistics*, Vol. xxxvii, No. 1, January 1984, and ECLAC, on the basis of official information.

^aDeficit.

^bChanged from deficit to surplus.

^cCountries which obtained Fund financing.

^dNot including Mexico.

^eNot including Barbados, Dominica, Grenada or Jamaica.

^fIncluding Mexico.

^gAll countries.

^hNot including Bahamas, Barbados, Dominica, Grenada or Jamaica.

It is germane to ask why the Fund's response to the most serious economic crisis since the 1930s was so limited. In effect, could it be that only 1% to 2% of the current-account deficit incurred by Latin America in 1981 and 1982 was the result of temporary external factors? Can almost all this deficit be attributed to a disproportionate growth of domestic expenditure, to permanent deterioration of the terms of trade or to an irreversible rise in international interest rates? Moreover, how can it be said for sure that the deterioration in the terms of trade or the rise in interest rates will be permanent? And even if the deficit were attributable to those factors, what sense would there be in requiring countries to make adjustments immediately, as was in fact the case? There is no question that the magnitude of the Fund's response to the crisis in the region as a whole was closely related to the slow pace at which adjustment agreements were arranged. Nevertheless, also at issue is whether the amount of financing provided by the Fund once an agreement is signed is comparable to the magnitude of the deficit that is attributable to temporary external factors.

As regards the slowness of the Fund's response to the crisis, there is no denying that a country must be willing to resort to the Fund in order for it to be able to grant resources and that there was a more or less pronounced reluctance on the part of many countries to resort to the Fund. Nevertheless, it should also be remembered that the fact that a government wishes to negotiate an agreement with the Fund does not mean that such an agreement will be signed expeditiously or even that it will be signed at all: in practice, negotiations tend to be very prolonged and complicated. It is more to the point, then, to find out whether the reluctance of many countries to resort to the Fund and the delays in signing agreements reflect shortsightedness on the part of governments or deficiencies in the Fund's approach.

As a general rule, governments are reluctant to take decisions that entail political costs over the short-term or during the term of its mandate. Also, they often act as if they thought they might be able to avoid costs that are actually inevitable. However, many observers have argued, in different media and fora, that the main reason why negotiations on adjustment agreements

usually take so long is that the Fund's policies are excessively strict.⁹ And since it can be shown that the Fund's adjustment programmes do have serious defects, governments' reluctance to follow its formula word for word is well-founded as long as they have other options. One of the main purposes of this article is to show that this is the case; at this point, however, what we wish to stress is that, according to several experts, the Fund decided to toughen its policies just at the time when the current economic crisis broke out.¹⁰

Thus, at a recent conference on Fund policies, it was stated that around the middle of 1981, this institution had made the conditions for obtaining financing from it much more stringent.

⁹See for example, United Nations, "Balance of payments adjustment process in developing countries", New York, UNDP/UNCTAD Project INT/75/015, January 1979; The South-North Conference on the International Monetary System and the New International Order, held at Dar-es-Salaam, Tanzania, from 30 June to 3 July 1980, the papers of which were published in *Development Dialogue*, 1980:2; Sidney Dell, "El Fondo Monetario Internacional y el principio de condicionalidad", *Revista de la CEPAL*, No. 13 (April 1981); and Dragoslav Avramovic, "The role of the International Monetary Fund: the disputes, the qualifications and the future", paper presented at the North-South Round Table, Tokyo, 1982, and also published in John Williamson, ed., *IMF Conditionality*, *op. cit.*

¹⁰See John Williamson (ed.), *IMF Conditionality*, Washington, D.C., Institute for International Economics, 1983, particularly the article by John Williamson himself, "The lending policies of the International Monetary Fund". On this same question, a new book, which reached us just as this article was going to press, has the following to say: "Around the middle of 1981 the experiment with a more relaxed attitude towards conditionality was put sharply into reverse, for a number of reasons. The effects of the second oil shock and of the anti-inflationary policies of the governments of major industrial countries combined to induce an unexpectedly sharp deterioration in the terms of trade of oil-importing developing countries. In consequence their balance-of-payments situation worsened rapidly and a large proportion of the Stand-by and EFF programmes entered into during 1979 and 1980 ran into serious difficulties ... In the meantime the Fund had begun to experience liquidity problems, with its resources inadequate to cope with the emerging scale of the problem. Another critical factor was the election in November 1980 of the Reagan Administration which —after a time lag— took a much harder line in the Fund's councils and which was able to form an effective coalition with other industrial countries, such as Germany and the United Kingdom, against the previous liberalization. Moreover, there had always been unease among some of the Fund's staff about the liberalization ...

Another observer who shares this interpretation has also stressed the striking change between the proportion of financing that is not conditioned and that which is. This is the main reason why, in the view of this author, during the first six months of 1982, the net new financing provided by the Fund was negative "... during the worst recession since the 1930s".¹¹

The Fund disagrees with the view that conditionality was toughened at the beginning of the economic crisis. According to the Managing Director of the Fund, "... what has really happened is not a tightening of conditionality *per se*,

Anyway, there is no questioning that a reversal occurred. To governments negotiating with the Fund in 1982 the message was an unwelcome one: more preconditions, including greater insistence on exchange rate depreciations; a wider range of policy commitments written into the programmes; ... a reduced willingness to grant waivers and modifications; shorter-leash programmes with less front-end loading. In fact, if we return to the various dimensions of conditionality, there was apparently a tightening up on almost all of them. There was also a shift back towards the short-term approach. One-year programmes were restored as the normal order of the day, although an attempt was made to retain some longer-term thinking by planning on the basis of a succession of one-year programmes. The EFF was put firmly on the back burner." See Tony Killick, "The impact of Fund stabilization programmes", in Tony Killick, ed., *The quest for economic stabilization (the IMF and the Third World)* (London, Heinemann Educational Books, in association with the Overseas Development Institute, 1984), pp. 211 and 212.

¹¹G.K. Helleiner, "The IMF and Africa in the 1980s", *Essays in International Finance* (International Finance Section, Department of Economics, Princeton University) No. 152 (July 1983), Helleiner (p. 13) notes that "reliance on borrowed resources and a policy of 'enlarged access' rather than on quota expansion and SDR allocations generated the result, no doubt intentionally, that about 80 per cent of its lending in the 1981-1982 period was accompanied by stringent conditions, because countries drawing on the Fund found themselves moving rapidly into the upper credit tranches, where stiff conditions must be met. By contrast, during 1974-1975, the last period of major net lending activity, the IMF imposed a similar degree of conditionality on only one-third of its lending".

Later on (p. 14) he states: "The IMF's shift toward the imposition of more and tougher conditions upon its lending has been accompanied by a hardening of the terms. Interest rates charged on IMF credit have been rising relative to market rates. IMF lending that is financed by borrowing rather than by agreed quota expansion must earn interest rates adequate to service the IMF's resulting debt. The failure to increase IMF quotas rapidly enough to meet demands for IMF credit thus implied the imposition of commercial rates of interest on its loans."

it is a worsening of the external conditions of the country in question and the need for more adjustments".¹²

All these interpretations show that the Fund failed to provide support, or at least timely support, during the crisis. The question is whether the procyclical policy applied by the Fund during this economic crisis is justified or not.

In the aforementioned interview, Mr. Larosière implies that the worsening of external conditions (i.e., accounts) was entirely due to an irreversible deterioration in the terms of trade and to faulty domestic financial policies. This argument may be valid for 1979-1980, when the second oil shock occurred, but it is not convincing for 1981 onwards, inasmuch as it does not take into account the fact that a significant part of the deterioration in current-account positions from that year onwards was brought about by drops—presumably temporary—in the prices of the great majority of commodities,¹³ by the unprecedented increase in international interest rates,¹⁴ and also, in 1982 and 1983, by the considerable reduction of financing from private international banks.¹⁵

¹²See "A conversation with Mr. de Larosière", *Finance and Development*, Vol. 19, No. 2 (June 1982), p. 5.

¹³Indeed, between 1980 and 1981, the average (simple) price of the 17 main export products (except petroleum) of Latin America fell by 12.3%; between 1981 and 1982, it fell by 12.2%. In 1983 there was a slight recovery by comparison with 1982. Nonetheless, compared with 1980, the 1983 average price was still somewhat below 80% of the price prevailing in 1980. In 1983, the average unit value of exports of the non-oil-exporting countries of the region was 18% lower than in 1980, having fallen by 7% in 1981, 6.7% in 1982 and 5% in 1983. See ECLA, "Preliminary overview of the Latin American economy during 1983" (E/CEPAL/G.1279) Santiago, Chile, 29 December 1983, tables 9 and 10.

¹⁴On average, the international interest rate (LIBOR) for six-month dollar deposits was 16.6% in 1981, compared with 14% in 1980, 12.2% in 1979 and 9.2% in 1978. In 1982, it fell to 13.5% and in 1983 to 9.5%. See Morgan Guaranty Trust Company, *World Financial Markets*, January 1984, table 9.

¹⁵In the absence of specific data on such financing, it should be noted that net inflow on Latin America's capital account fell by almost 54% in 1982 and 73% in 1983, after having risen by 47% in 1981. In 1983 net capital inflow was only 12% of what it had been in 1981 and 17% of what it had been in 1980. See ECLA, "Preliminary overview of the Latin American economy during 1983", *op. cit.*, table 7 and *Economic Survey of Latin America, 1982*, Santiago, Chile, December 1983 (E/CEPAL/L.286), table 30.

Although there was thus an objective basis—the lack of financing—for the drastic adjustment which Latin America had to bear, the magnitude of the adjustment seems to have been disproportionate considering the origin and foreseeable duration of the causes of deterioration of the region's external accounts. The adjustment does not seem to have been efficient either as regards Latin America or as regards the international economy. Moreover, if all these external disturbances should turn out to be irreversible, sooner or later the countries of the region would be forced to stop meeting their external commitments.

Nevertheless, the timeliness and the quantity of financing provided by the Fund cannot be assessed without taking into account the performance of the capital account, since the Fund itself holds that its role as a catalyst of financing from other sources is just as important as or more important than the financing it directly provides.¹⁶

Viewed in this context, the Fund's action appears even less adequate: although the net inflow of capital to the countries which obtained Fund financing rose by around 6%, between 1980 and 1981, it fell by 9% and 43% between 1981 and 1982 and between 1982 and 1983.

These figures hardly point to success in the Fund's role as a catalyst. Nevertheless, in light of the performance of the capital account of countries that did not resort to the Fund, it could be held that the decline in the net inflow of capital to countries that did draw resources from it would have been even greater, during 1982-1983, had Fund support not been forthcoming. Indeed, in those two years, the net inflow of capital to the region as a whole fell by 56% and 73%. The average variation in the balances of the countries that did not resort to the Fund was of course much more negative. On the other hand, in 1981 the opposite was the case: net inflow of capital to the region rose by 44%, compared with a 6% increase for countries that resorted to the Fund (see table 2).

In short, an appraisal of the Fund's role as a catalyst leads to ambiguous conclusions when

both the above criteria are considered, particularly if global figures are disaggregated.¹⁷

It is not clear, however, whether either one of these criteria is the most suitable one. Indeed, from both the analytical standpoint and that of the Fund's by-laws, it would appear that an efficiency criterion would be the most useful and suitable one to use. With this criterion, the performance of the Fund, both as regards the financing it provides directly and as regards that which it promotes indirectly, should be evaluated in terms of the magnitude of the current-account deficit which is attributable to temporary external factors.

It must be recognized, however, that no matter how inadequate Fund financing might be, without it the adjustment might have been much more stringent, as Fund representatives are prone to remind us.¹⁸ Another possibility often overlooked by those who advocate this type of approach is that had this been the case, many countries would have had to choose between eating or continuing to serve their external debt.

In any event, when viewed in this light, the appropriate criterion is not set by past results or by future goals established in the adjustment agreement itself, nor even by efficiency considerations, but rather by what would have happened in the absence of Fund financing and investment programmes.¹⁹ This type of evaluation

¹⁷As is often the case, the figures for one, two or three countries strongly affect totals or averages. For example, although the net inflow of capital to all countries which drew resources from the Fund fell by 43% in 1983, the figure would be -18% if Mexico and Brazil were left out. Likewise, while the total capital account deficit of countries that did not resort to the Fund in 1983 rose by almost 190%, if Colombia and Trinidad and Tobago were left out, the deficit for this group would only rise by a little over 17%. (For data on the region's balance of payments for the period 1980-1983, see ECLA, "Preliminary overview of the Latin American economy during 1983", *op. cit.*, table 7; and *Economic Survey of Latin America, 1982*, *op. cit.*, table 30. See also International Monetary Fund, *International Financial Statistics*, Vol. xxxvii, No. 1, January 1984.

¹⁸See, for example, Manuel Guitián, "Economic Management and International Monetary Fund Conditionality", in Tony Killick, ed., *Adjustment and financing in the developing world: the role of the International Monetary Fund* (London, International Monetary Fund, in association with the Overseas Development Institute, 1982).

¹⁹*Ibid.*, pp. 99-101.

¹⁶See again "A conversation with Mr. de Larosière", *op. cit.*, 1982.

—by counter-factual hypothesizing— is very interesting but begs the issue: whether or not the Fund is supposed to promote international prosperity and stability and, if it is, whether or not it is doing so.²⁰ Being as it is an eloquent appraisal method, it could also be used as a way of dodging responsibility for the disaster that has occurred.

The paucity of external financing with respect to the exigencies of the current economic crisis seems mostly to reflect the fact that the procedure used to set and readjust the countries' quotas in the Fund is not really based on efficiency criteria,²¹ although it may in part be influenced by the Fund's decision of mid-1981 to toughen conditionality. And there is no doubt that if behind it all there is an adequate capacity or inclination to finance an efficient adjustment process, this process will perform more stringent than necessary. At the same time, there is a risk that recession, such as the present one, will be unnecessarily severe. But it must be admitted that there is no easy solution to the problem, inasmuch as it calls for unusual initiatives such as greater disbursements of resources from creditor countries or some kind of joint action on the part of debtor countries.²² Nevertheless, there

²⁰This matter has been discussed by Sidney Dell, in "Stabilization: the Political Economy of Overkill", in John Williamson, ed., *op. cit.*

²¹See Helleiner, *op. cit.*, 1983.

²²It is conceivable, however, that more flexible use of the front-end loading procedure by the Fund could have helped, precisely because of its catalytic effect, to attenuate if not to halt the deterioration of external accounts. Although the Fund is empowered to follow this procedure in cases of very serious imbalances, it has been reluctant to do so, as may be seen from the recent experiences of the countries of the region (see table 1 and note 10). On the other hand, it is doubtful whether more extensive use of the Extended Fund Facility, which covers long-term adjustment programmes, would have made adjustment any less stringent, since the level of financing that could be obtained annually by means of the EFF is no greater than could be obtained from an SBA. In addition, countries can obtain successive SBAs or obtain an EFF loan following an SBA, or vice versa. SBAs provide no advantage other than that which might be had from knowing further in advance the amount of resources that are potentially available from the Fund. This could be important, but since adjustment policies and conditions for the disbursement of funds are renegotiated each year of an EFF loan, the probability of obtaining all the financing originally envisaged is not as great as it might seem.

are other significant deficiencies in the Fund's approach that could be remedied at no cost.

B. THE DEFICIENCIES OF CONDITIONALITY AND OTHER DOMESTIC ADJUSTMENT POLICIES

1. *The rationale and implementation of the Fund's programme*

a) *The policy mix*

i) *Definitions*

It is useful to differentiate the Fund's adjustment policies into performance criteria, pre-conditions and policy understandings.²³

The main elements of the Fund's adjustment agreements are its so-called performance criteria, which not only concern the variables on which economic policy must act, within the framework of the orthodox paradigm, in order to orient the adjustment process but are used as mechanisms for following-up on and monitoring progress towards achievement of the macroeconomic targets established in the agreement, and, as such, determine whether or not the Fund's disbursements are made as originally scheduled. This conditionality function may also have a significant impact on the level of financing from other sources, particularly from private international banks. When they are met, the performance criteria serve as a sort of "seal of approval" of the management of domestic economic policy that can be used to advantage on the international financial market. Failure to meet performance criteria could limit or even close a country's access to that market.

Performance criteria are established for each trimester covered by the adjustment agreement and, traditionally, for a particular date during that period. Fund financing is also made available on a quarterly basis, generally in equal

²³See Joseph Gold, "Conditionality", *Pamphlet Series*, No. 34 (Washington, D.C., International Monetary Fund, 1979); John Williamson, "The Lending Policies of the International Monetary Fund", in Williamson, *op. cit.*; William H.L. Day, "Domestic Credit and Money Ceilings under Alternative Exchange Rate Régimes", *IMF Staff Papers*, Vol. 26, No. 3 (September 1979); Manuel Guitián, *op. cit.*, 1981; and Russel Kincaid, "What Are Credit Ceilings?", *Finance and Development*, Vol. 20, No. 1 (March 1983).

amounts throughout the programme, and is subject to full compliance with all the performance criteria established in the agreement. Failure to meet any of these criteria automatically provides sufficient grounds for suspending financing because, for the Fund, any discrepancy between actual results and performance criteria is a signal that the adjustment is not being carried out properly and as agreed—unless evidence is provided to the contrary. If the discrepancy in question only represents a minor departure from a quantitative performance criterion, the IMF may waive the criterion that has not been satisfied and resume disbursements. Otherwise in order for the country to be able to receive further Fund financing, the original programme will have to be modified or a new agreement negotiated.

Pre-conditions and policy understanding both entail certain obligations as regards the use of what might, in general, be called policy tools, e.g., the exchange rate, government expenditure or interest rates. Nevertheless, pre-conditions are different from policy commitments because, as the name suggests, they refer to measures that must be taken *before* an adjustment agreement officially begins and financing is disbursed. Moreover, for obvious reasons, pre-conditions usually consist mainly of discreet changes in the exchange rate and measures to support it, whereas policy understandings may relate to any measure considered necessary or useful to achieve the targets set out in the adjustment programme.

It should also be noted that, contrary to the case with performance criteria, failure to comply with a policy understanding does not entail automatic interruption of disbursements of Fund financing. Nevertheless, these understandings are included within the concept of conditionality which governs use of Fund resources; non-compliance could eventually affect a country's access to Fund financing.

To understand the rationale—or lack of rationale—underlying the types of policies which the Fund employs in its adjustment programmes, one has to know more about the macroeconomic model it uses. A preliminary analysis will enable us to distinguish between policy measures which work through monetary variables and those which work through prices. In general such a dichotomy also obtains with respect to those variables that are chosen as performance

criteria and those that do not automatically condition the disbursement of Fund resources.

ii) Theoretical underpinnings

—*The means of payment (the monetary approach to the balance of payments).*²⁴ As in the case of a closed economy, the monetarist approach to economic policy in an open economy begins by assuming a stable demand function for real monetary balances.²⁵ However, contrary to the case of a closed economy, in which the authority is able to control the stock of money—which means that management of economic policy is reduced, essentially, to determining the trend of demand for money and the assets of which it is constituted—in an open economy with a fixed exchange rate, the monetary authority cannot control either the stock or flow of money. The only thing it can control is the component which originates from domestic sources, i.e., net domestic assets (which consist mainly but not exclusively of net domestic credit).

If the exchange rate were absolutely flexible, the case of an open economy would be similar, in principle, to that of a closed economy as far as the possibility of managing the money stock is con-

²⁴For a discussion of the monetarist approach to the balance of payments, see Robert Triffin, "Esbozo general de un análisis de las series estadísticas monetarias de América Latina sobre bases uniformes y comparables", in Banco de México, *Memoria: Primera Reunión de Técnicos sobre Problemas de Banca Central del Continente Americano* (Mexico, 1946); J.J. Polak, "Monetary Analysis of Income Formation and Payments Problems", *IMF Staff Papers*, Vol. 6 (November 1957); Harry G. Johnson, "The Monetary Approach to Balance of Payments Theory", *Journal of Financial and Quantitative Analysis*, Vol. VII (1972); Manuel Guitián, "Credit versus Money as an Instrument of Control", *IMF Staff Papers*, Vol. 29, November 1973. See also Jacob A. Frenkel and Harry G. Johnson, ed., *The Monetary Approach to the Balance of Payments* (London, George Allen Unwin Ltd., 1976); International Monetary Fund, *The Monetary Approach to the Balance of Payments: a compilation of studies prepared by Fund staff members*, Washington, D.C., 1977; Jacob A. Frenkel and Harry G. Johnson, ed., *The Economics of Exchange Rates* (Reading, Mass., Addison Wesley Publishing Co., 1978); and Manuel Guitián, *op. cit.*, 1982.

²⁵It also assumes stable functions for the non-banking public's demand for cash (in relation to the demand for money in the form of bank deposits) and for banks' demand for reserves (in relation to their investments); in other words, it also tends to assume a stable function for the monetary multiplier.

cerned. Indeed, an excessive supply of means of payment with respect to demand for real monetary balances is eliminated through a rise in the price level, including the price of foreign exchange, i.e., the exchange rate. However—and this is very important—as long as the authorities allow concern for exchange rate stability to condition their other policies, the money stock becomes endogenous. In other words, if in practice the authority is not prepared to allow the exchange rate to freely fluctuate, it will not be able to determine the stock of means of payment either.

As regards *net domestic assets*, the difference between an open economy with a fixed exchange rate and others is determined by the fact that in an open economy in which the exchange rate is not entirely flexible, the non-financial sector can bring its nominal money holdings in line with its demand for money by means of its transactions with the rest of the world. When faced with a surplus of money, the non-bank public can adjust its holdings to the desired level by “exporting” the surplus to the rest of the world; and in the opposite case, it can “import” what it needs from abroad. In other words, the public can reconcile its nominal holdings of money with its demand for means of payment by producing a deficit (reducing the supply of net external assets and hence of money) or a surplus (increasing the supply of net external assets and of money) in the balance of payments.²⁶

Thus, in an economy with a fixed exchange rate, the authorities will find their efforts to control the money supply frustrated to the extent that their target does not coincide with the quantity of money which the public is willing to hold. Moreover, the existence of equilibrium between the supply of and demand for money does not guarantee a parallel equilibrium in the bal-

ance of payments (this being understood as the balance which the authority considers sustainable and desirable) since, in principle, equilibrium in the monetary market is compatible with any composition of net external assets and net domestic assets. This being the case, the authorities would only be able to meet their overall external-accounts target by bringing the creation of net domestic assets in line with that target, on the one hand, and with the demand for money, on the other. In other words, in order to satisfy simultaneously the public's demand for real monetary balances and their overall goal for the balance of payments—their demand for net external assets—the authorities must adjust the supply of domestic assets. Moreover, because management of this financial variable is the key to the achievement of simultaneous equilibria in the monetary and the external markets, it is of necessity also crucial to the attainment of equilibrium in the market for goods and services, given the initial assumption of a stable demand function for real monetary balances.²⁷

These results point clearly to one performance criterion: the management of net domestic assets (of net domestic credit).

As regards *domestic and external financing of the public sector*, just as equilibrium in the money market can be achieved with any combination of net external and domestic assets, the global balance-of-payments target can be achieved with any number of combinations of current-account and capital-account balances and the residual expansion of net domestic assets can arise from different allocations as between the public and the private sectors. As a general rule, therefore, programming the supply of net domestic assets will not by itself suffice to achieve a sustainable balance-of-payments position or to promote growth and efficiency of investment; to achieve these objectives, the management of net domes-

²⁶It should be noted that in order for equivalence to obtain between the loss (or accumulation) of international reserves and the reduction (or increase) of means of payment, the overall payments balance must reflect the position of the entire banking system, or the monetary multiplier must equal one. Nevertheless, a constant monetary multiplier would be sufficient to validate the substantive results of the approach. It is also assumed that the monetary authority cannot permanently compensate for (“sterilize”) the monetary impact of external transactions.

²⁷When equilibria are achieved in N-1 markets, they are insured on all markets (here N=3). However, general equilibria of flows do not necessarily imply equilibria of stocks (in this case, money and net international reserves) in each period, unless stock equilibria are initially obtained. Moreover, inclusion of a securities market would strengthen the results of the model, inasmuch as it would make it possible to take into account the links between credit, interest rates and the balance of payments (see Manuel Guitián, *op. cit.*, 1973).

tic assets would have to go hand-in-hand with measures designed to affect the composition of the balance-of-payments and the sectoral distribution of credit.

The idea of a sustainable balance-of-payments position has to do with how much of the current-account deficit can be financed over the long-term and, consequently, with the economy's capacity to absorb (spend) available resources (real and financial, domestic and external) productively. Since the counterpart of a current-account deficit is, broadly speaking capital imports, the achievement of a sustainable external accounts position entails limiting external indebtedness so as to bring it in line with said capacity. For reasons which are not obvious from this analytical point of view, however, the Fund only recommends a restriction of the external indebtedness of the public sector.²⁸ This policy constitutes another performance criterion.

In order to protect the level of activity and the growth of production capacity at a time when restrictions are being placed on the supply of domestic credit and on external indebtedness, it is necessary to implement measures to channel available credit towards the financing of investment, including working capital (instead of towards consumption) and, in particular, towards more productive investment. For reasons that possibly have to do with its praxis, the Fund has pursued these objectives by specifically restricting bank financing of public-sector expenditures.²⁹ This policy is also used as a performance criterion.

As regards the *public-sector deficit*, ceilings on the public sector's external and domestic indebtedness with banks entail a corresponding restriction on its magnitude, the degree of which varies according to the level of development of the domestic capital market. In the extreme—but not necessarily unusual—event that there

should be no organized market for financial assets outside the banking system, this restriction is, in principle, rigorous, since deficit spending and the creation of money are one and the same. Otherwise, these restrictions do not strictly limit the public-sector deficit. Nevertheless, as is the case when there is no capital market, there is a limitation on the creation of credit and the public sector augments its absorption of bank resources, the expansion of deficit spending beyond these restrictions implies that the total amount of monetary resources available for financing private sector expenditure must be reduced *pari passu*. Therefore, when there is a domestic capital market it would be germane to accompany restrictions on credit with a performance criterion relating to the magnitude of the public-sector deficit.

These considerations emphasize the link that may exist between the public-sector deficit and the creation of money, on the one hand, and between the public-sector deficit and private investment, on the other, and hence the role that deficit spending can play in generating external and domestic disequilibria. It has been suggested that this approach might be considered a "fiscal" rather than a "monetary" one. In any event, when there is no capital market or when it is only beginning to develop, restricting the growth of the means of payment to a rate compatible with financial equilibrium will necessarily mean reducing the public-sector deficit.

As regards *net external assets*, the purpose of restricting the expansion of net domestic assets as well as of limiting domestic and external financing of public-sector expenditures is to adjust the balance of payments to a target that is considered viable. Consequently, if these performance criteria are met, it should be possible to achieve the external-accounts target, provided the assumptions and parameters of the model are valid. Nonetheless, this target is also included as a performance criterion in the Fund's adjustment programmes.

In summary, the monetarist nature of the paradigm largely explains how most of the performance criteria are chosen. From its neoclassical background (the belief that international efficiency and prosperity are maximized in markets that are free of such interferences as controls on capital flows, tariffs or quotas) issues another

²⁸State-guaranteed private external indebtedness is sometimes included as well.

²⁹Although the Central Bank cannot control its net domestic assets unless it is able to limit its public-sector financing, the issue here is the creation and allocation of credit by the entire financial system. This predisposition against the public sector is apparently based on the premise that when credit is scarce, the State always is able to outcompete the private sector for it.

criterion, the only one that is not of a quantitative nature, i.e., that no new obstacles to the international flow of goods, services and capital must be introduced. The remaining criterion, i.e., that arrears in payment must be eliminated, is also related to it.

Performance criteria for almost all adjustment programmes include restrictions on the following: 1) net domestic assets (domestic credit, plus certain minor assets, minus bank deposits of the government and other secondary liabilities); 2) net domestic credit to the non-financial public sector (domestic credit to the State, minus bank deposits of the government); 3) external indebtedness of the public sector; 4) net external assets (gross international reserves minus short-term external indebtedness), and 5) the introduction of new measures restricting external trade, remittances of factor service payments, or capital flows. In some cases, the following may also be included: 6) elimination of arrears in external payments and 7) restriction of the magnitude of the deficit of the non-financial public sector.

Criteria relating to the financial sector could in principle apply to the Central Bank or to the entire banking system, depending on which is more stable, the monetary multiplier or the public's demand for money.³⁰ The criterion relating to the overall deficit of the non-financial public sector can be eliminated when there is no capital

market outside the banking system and the one relating to external indebtedness can be extended to State-guaranteed private indebtedness if it is held that the State's total obligations are excessive. Finally, the criterion relating to payment arrears is obviously only applicable in certain cases.

The criteria relating to monetary aggregates are established as minimum (net external assets) or maximum (net domestic assets and net domestic credit to the public sector) levels for a given day in each quarter during the life of the agreement. The criterion relating to the total deficit of the non-financial public sector is usually set on an annual basis, while the one relating to external indebtedness of the public sector usually involves loans for terms of less than ten years, especially loans for terms of less than five years (except short-term supplier loans).

—*Prices.* The other major policies which the Fund employs in its adjustment programmes have to do with prices; however, these are not applied as performance criteria. Of the measures which are usually required as pre-conditions or policy understanding, the ones that are crucial to the achievement of external and internal balance are those pertaining to public finance, the exchange rate, salaries and wages and interest rates. We shall now discuss the latter three.

As regards *the exchange rate*,³¹ if it is fixed, an excessive supply of money will lead to a deficit in the global balance of payments. It is evident,

³⁰As is known, the monetary multiplier is derived from the public's preferences regarding the distribution of its money holdings between cash and bank deposits, those of the commercial banks as regards the relationship between their reserves and their liabilities, and the reserve requirements established by the monetary authority; in other words, its value depends on the demand for the monetary base (cash outside banks plus bank reserves). If the demand for the monetary base were unstable, restricting the net domestic assets of the Central Bank could hinder the achievement of any target for net external assets, regardless of whether it applies to the Central Bank or to the banking system, since the financial sector is able, through its transactions with the rest of the world, to bring its nominal money holdings in line with its demand for means of payment. In this case, in order to achieve the balance-of-payments target, the monetary authority must in fact compensate for the fluctuation of the monetary multiplier by varying its stock of net domestic assets. On the other hand, if the demand for money were unstable, the achievement of any balance-of-payments target, would involve the adjustment of the entire banking system's stock of net domestic assets.

³¹See Sidney S. Alexander, "Effects of a devaluation on a trade balance", *IMF Staff Papers*, Vol. 2 (April 1952); S.C. Tsiang, "The role of money in trade-balance stability: synthesis of the elasticity and absorption approach", *American Economic Review*, September 1961; Manuel Guitián, "The effects of changes in the exchange rate on output, prices and the balance of payments", *Journal of International Economics*, Vol. 6, No. 1 (February 1976); Carl P. Blackwell, "Reflections on the monetary approach to the balance of payments", paper presented at the Third Conference of Central Banks of the Pacific Basin on Econometric Models, Wellington, New Zealand, 8-11 November 1977; Harry G. Johnson, "Money, balance of payments theory and the international monetary problem", *Essays in International Finance* (Princeton, Princeton University, Department of Economics, 1977, No. 124, November 1977); Jacob A. Frenkel and Harry G. Johnson, *op. cit.*, 1972; John F.O. Bilson, "Recent developments in monetary models of open economies", *IMF Staff Papers*, Vol. 26, No. 2 (June 1979); Joanne Salop and Eric Spittler, "Why

however, that this type of disequilibrium can be eliminated through transactions with the rest of the world only as the monetary authority has or is able to obtain a sufficient amount of external assets and does not hinder the international flow of goods, services and capital. If international reserves run out or fall to a level the authority considers to be the minimum allowable—or if the economy's capacity for external indebtedness becomes exhausted or reaches a level considered to be the maximum desirable—an excess supply of money will have to be eliminated by reducing the stock of net domestic assets and/or by a rise in prices, including the exchange rate.

In such circumstances, the question arises whether it is advisable to choose between one policy or the other in order to orient the adjustment process. The Fund's paradigm allows for the possibility of its being necessary to act directly on the exchange rate instead of depending solely on reducing the stock of domestically supplied means of payment, in order to achieve adjustment without causing undue production and employment losses. One justification might be based on rigidities that render domestic price declines uncertain, irregular and slow or capital flows perverse or inelastic. Another might be that domestic markets for goods and assets were adjusting at different speeds. A devaluation might also be justified, from the orthodox point of view for purely pragmatic or strategic reasons, since a modification of the exchange rate is an alternative to the use of discretionary measures, such as tariffs, quotas or controls on capital movement, to offset excess demand. However, if there are rigidities in the economy's real prices a devaluation can achieve no more than a monetary deflation.

In any event, it should be noted that within the framework of the monetarist paradigm, an

external imbalance can only persist while, and to the extent that the supply of means of payment outstrips the demand for real monetary balances, regardless of what the initial causes of the maladjustment may have been. Consequently, the option is not between devaluation or deflation, but rather between a modification of the exchange rate and the degree to which monetary and fiscal policies are to be restrictive.

Let us assume that an excessive creation of domestic credit has led to a situation in which it is necessary to reverse, at least partially, the loss of international reserves. Let us assume, moreover, that the demand for real monetary balances has at the same time stopped growing—perhaps because of this same external restriction.

If the exchange rate is not adjusted it will be necessary to create a shortage of means of payment to achieve the balance-of-payments surplus, and this implies that the absolute stock of net domestic assets must be reduced. Doing this to reach an acceptable level of net external assets means, in turn, slashing the stock of net domestic credit outstanding to the private sector and/or achieving a public-sector budget surplus.

On the other hand, devaluation by transforming the value of the stock of net domestic assets into one that is compatible with the demand for real monetary balances, would "validate" the past expansion of the stock of domestically supplied money. In other words, by increasing the domestic price level, devaluation creates an excess demand for money and thereby makes it possible to achieve the desired balance-of-payments surplus without having to diminish the stock of net domestic assets and, thus, without having to reduce the indebtedness of the private sector or achieve a surplus in the public sector's budget.³² what is needed is monetary and fiscal policies that will check the domestic creation of money. Otherwise the excess demand for real balances will be decreased, both directly and indirectly.

does the current account matter?", *IMF Staff Papers*, Vol. 27 (March 1980); Ronald I. McKinnon, "The exchange rate and macroeconomic policy: changing postwar perceptions", *Journal of Economic Literature*, Vol. xix, No. 2 (June 1981), and the Report of the Conference on Exchange Rate Régimes and Policy Interdependence (sponsored by the International Monetary Fund and the National Bureau of Economic Research, Washington, D.C., 31 August 1982), in *IMF Staff Papers*, Vol. 30, No. 1 (March 1983); in particular, see William H. Branson, "Economic structure and policy for external balance".

³²To the extent that a devaluation leads to a rise in the price level, it has the side-effect of reducing the real value of non-readjustable financial assets such as the money stock. If the demand for money is a demand for real monetary balances, when the level of prices goes up there will be an excess demand for money given the existing stock, unless the public

When there are rigidities in the economy that make it impossible to offset a drop in the means of payment with an immediate deflation of the domestic level of prices or surplus in the overall balance of payments, domestic expenditure and hence the level of domestic activity must fall, to restore balance in the monetary market, i.e., to eliminate the shortage of means of payment.³³ Moreover, considering the potential output trend, unrecoverable output losses will be sustained so long as and to the extent that the reduction of the money stock is not entirely offset by adjustments in relative domestic prices and/or the overall balance of transactions with the rest of the world.

If at the same time the rigidities are uneven as between the different markets, so that adjustment processes are more speedy and uniform in the assets market than in the markets for factors and goods and services, the brunt of the balance-of-payments adjustment will fall on the capital account. Thus, an adjustment policy that depends exclusively on monetary deflation will not, under such circumstances, be sufficient in and of itself to ensure a sustainable balance-of-payments position, even if it were capable of achieving the desired improvement without causing upheavals in domestic production. In such circumstances the authority would have to use an instrument that would have a more direct effect on relative prices, i.e., the exchange rate.

Finally, the prevalence in the economy of expectations contrary to those required for an efficient adjustment via monetary deflation

expects this increase to persist, that is, to turn into inflation (in which case the demand for money may even drop). An excess demand for money can only be eliminated, in the context of this approach, by means of an increase in the interest rate, a decrease in income, an increase in expected inflation or an increase in the supply of means of payment. The simultaneous existence of a restrictive monetary policy suggests that any increase in the supply of money would have to come from foreign sources—from balance-of-payments surplus—and this is in fact the aim.

³³There may also be rigidities that make it impossible to immediately implement a monetary deflation. Also, if there is no change in relative domestic prices the reduction of domestic expenditure will have a disproportionate effect on the domestic product, unless the marginal propensity to import is greater than 1/2.

would suffice to frustrate it. For example, if a devaluation is expected, interest rates might have to reach levels that, as far as the evolution of economic activity is concerned, would be intolerably high before the shortage of money could be eliminated.

On the other hand, an exchange rate hike, in addition to being implementable instantaneously, produces a pervasive modification of relative domestic prices, unless some real prices, either for goods, factors or assets, are so rigid that they absolutely cannot be brought down. In the absence of such rigidity, devaluation would be preferable to monetary deflation as far as the effect on the stability of the product and employment and the viability of the balance of payments are concerned even if some nominal prices were resistant to decline. When and to the extent that domestic expenditure on imports and exportable goods is diverted to non-tradeable goods and to import substitutes and the factors of production are re-allocated from the sectors producing non-tradeables to those producing tradeable goods, a real devaluation compensates for the excess demand for real balances to which it gives rise. It thus reduces the extent of the depression of output below the actual or the potential level of production needed to restore money market equilibrium.

If a modification of the real exchange rate were not sufficient to improve the current account, it would not matter, for the attainment of external equilibrium, whether the nominal exchange were raised or the domestic price level were lowered. If the economy has rigidities that make a real devaluation impossible, then there would be no advantage to choosing devaluation over monetary deflation. Moreover, under such circumstances, devaluation would be equivalent to monetary deflation, since in either case adjustment would be promoted solely through the creation of a shortage of money. That is why an exchange modification is usually accompanied by measures that exercise a more direct impact on other relative prices.

Finally, expectations can also frustrate a devaluation and make it highly recessive. But these expectations should influence the timing and the magnitude of a rise in the exchange rate rather than the choice between devaluation and monetary deflation.

As regards *salaries and wages*,³⁴ the adjustment of the economy to a lower current-account deficit, implies that real salaries and wages must be affected to the extent that they determine the real exchange rate and domestic expenditure, for otherwise domestic production will be depressed beneath its potential and/or the growth rate of production capacity will be curtailed.

Increasing the real exchange rate, either in the framework of a nominal devaluation or in that of a monetary deflation, means reducing the costs of production with respect to the prices of tradeable goods and services. Although this condition puts a ceiling on the nominal increase wages and salaries may experience after a devaluation (or implies a nominal decrease in wages and salaries in the absence of devaluation), it does not mean that real salaries and wages must necessarily fall in order for the real exchange to rise.³⁵ In other words, it is conceivable—though not likely—that prevailing circumstances would be such that it would be feasible to reduce the current-account deficit without reducing real

wages and salaries or creating unemployment.³⁶

In contrast, to be able to reduce domestic expenditure with respect to the product without jeopardizing the pace of accumulation, it is usually essential to cut real salaries and wages, since otherwise it would not be possible to increase domestic savings; in other words, it would not be possible to finance the existing level of investment expenditure.³⁷

To the extent that it were necessary to diminish real salaries and wages to avoid depressing the level of activity or sacrificing future growth, such a reduction would, according to the orthodox approach, be nothing but the consequence of excessive real wage growth in the past or of a permanent loss of national income.

As regards the *interest rate*,³⁸ in an open economy with a fixed exchange rate, the monetary authority is obliged to adjust the stock of net domestic assets in order to satisfy simultaneously the public's demand for real balances and its own goal for the overall balance of payments. In this context, the interest rate becomes endogenous: the authority cannot simultaneously control the supply of monetary aggregates and the interest rate. Moreover, in an economy in which interest-bearing domestic and external assets are perfect substitutes, the domestic interest rate cannot diverge permanently from the one prevailing in the international market unless the international mobility of capital is imperfect. Also, if the economy is a small one, its interest rate will not affect the international rate.

If the exchange rate is fixed, the domestic interest rate can deviate from the external one to the extent that there are expectations of a variation in the exchange rate. Over the long run,

³⁴See, for example, Rudiger Dornbusch, *Open economy macroeconomics* (New York, Basic Books, Inc. Publishers, 1980), Part 2; William C. Cline, "Economic stabilization in developing countries", *op. cit.*, and Omotunde Johnson and Joanne Salop, "Distributional aspects of stabilization programmes in developing countries", *IMF Staff Papers*, March 1980, and Rudiger Dornbusch, "Comments", in John Williamson, ed., *IMF Conditionality*, *op. cit.*

³⁵Let us suppose that in a small economy both the value of the product and the value of consumption are made up equally of tradeable goods and services and non-tradeable goods and services; that salaries and wages represent on average 50% of the costs of production in both sectors; that no intermediate goods are imported, and that, in general, producers of non-tradeables are incapable of exerting any lasting influence on prices. In such circumstances, it is easy to show that achieving a real devaluation does not entail decreasing the real remuneration of the labour force. For example, let us assume that the nominal exchange rate rises by 60% and, consequently, that the nominal salaries and wages rise by 40%, on average. According to the above assumptions, this rise will lead to an average increase of 20% in prices of non-tradeables. Real salaries and wages will not have fallen, because their nominal increase has fully offset the variation in the domestic level of prices: $\frac{160 + 120}{2}$. Nonetheless, the real exchange rate will have risen by 33.3% (160/120). (Of course, during the process of adjusting expenditure and the product to the new relative domestic prices, the prices of non-tradeables will again rise.) (This example is similar to the one given by Cline, *op. cit.*, p. 181.)

³⁶To show how difficult it is to maintain the level of activity during an adjustment process, it is sufficient to point out that, in order to do this, the entire decrease in domestic expenditure would have to fall on imports, whereas the decrease in investment would have to fall entirely on the growth rate of production capacity (and not on its utilization).

³⁷Nevertheless, this restriction would not necessarily operate if the marginal propensity to consume out of income from profits and rents in the sector producing tradeable goods and services were lower than that prevailing in the sector producing non-tradeables, or if the efficiency of investment could be increased.

³⁸See, for example, William H. Branson, "Economic structure and policy for external balance", *op. cit.*

however, the real domestic rate would still reflect the real rate on the international market. If the exchange rate is totally flexible, the authority can, in principle, choose between managing the money supply and controlling the interest rate. In this case, however, the need for an adjustment would not arise, since the total flexibility of the exchange rate implies a balance-of-payments position that is always equal to zero. Consequently, the only case which concerns us for purposes of establishing an interest-rate policy relating to adjustment is the one in which the exchange rate is not entirely flexible.³⁹

In this context, the policy should be aimed at not hindering the spontaneous behaviour of the interest rate; otherwise the role it should play in achieving adjustment may be undermined. Let us assume that the adjustment programme creates a money shortage, whether through monetary deflation or through devaluation. The counterpart to excess demand on the monetary market is excess supply on the markets for goods and assets and it is precisely through the resolution of these disequilibria that the balance of payments is to be improved. In order to restore equilibrium on the monetary market, it is necessary to raise the interest rate so as to bring about a net inflow of external assets. Under such circumstances, the establishment of an interest rate lower than that required for balance means inverting the process of monetary deflation (or exchange devaluation) and weakening or eliminating the incentive to the net inflow of capital. On the other hand, if a rate higher than the market rate is established, the level of activity and the growth of production capacity will be sacrificed unnecessarily.

iii) Implementation of the Fund's adjustment programmes in Latin America

As regards the policy mix —performance criteria, pre-conditions and policy understandings— employed in the IMF adjustment programmes in force in Latin American and Caribbean countries at the end of 1983, it should be noted that all of them —Stand-by arrangements or Extended Fund Facility loans— are almost the

³⁹A flexible exchange rate could be stabilized, but in that case the situation would again be one in which the exchange rate was fixed or not entirely flexible.

same. As regards performance criteria, there is hardly any difference among the 17 adjustment programmes except for the fact that when the relevant agreements entered into force, some countries had accumulated arrears and others had not (see table 3).⁴⁰ It is noteworthy that all of the programmes establish ceilings on the net domestic assets of the Central Bank (and not of the overall banking system),⁴¹ and that none of them has a performance criterion relating to the deficit of the public sector.

The first similarity is rather surprising, since it is difficult to believe that the monetary multiplier is more stable than the demand for money in every one of those countries. *A priori* no definite conclusion can be reached in this respect. Empirically, the results are also contradictory.⁴² However, such a situation would appear to be the only theoretical justification for the fact that this same performance criterion is the same in all 17 adjustment programmes.⁴³

The second similarity is surprising because it is in no way obvious that all the countries in question lack capital markets outside the banking system.⁴⁴ On the contrary, there are considerable

⁴⁰Table 3 does not include the performance criterion —included in all the agreements— which precludes the application of measures that would restrict the international trade of goods, services and capital.

⁴¹In two countries (Brazil and Peru), performance criteria pertaining to monetary aggregates include, in addition to the Central Bank's balance, the balances of other State banks which act as monetary authorities.

⁴²See William Fellner, "Criteria for useful targeting: money versus the base and other variables", *Current Issues in the Conduct of US Monetary Policy, A conference sponsored by the American Enterprise Institute for Public Policy Research*, 4-5 February 1982, Washington D.C., published in *Journal of Money, Credit and Banking*, Vol. XIV, No. 4, part 2 (November 1982).

⁴³Actually, there are other alternatives (bank reserves or the discount rate, for example) to using the supply of net domestic assets as the operational variable for purposes of monetary programming. It has even been shown that there is no ideal way to manage the means of payment, i.e., no particular approach produces the best results in any given disturbance of the monetary market. In the light of these considerations, the aforementioned uniformity appears even more questionable. See Ralf C. Bryant, "Federal reserve control of the monetary stock", *Current Issues in the Conduct of U.S. Monetary Policy*, *op. cit.*

⁴⁴It may also be surprising because it is generally believed that the public-sector deficit is one of the performance criteria of the Fund's programmes.

differences among them as regards the volume of financial intermediation conducted outside banks. This uniform treatment likewise, therefore, seems neither to issue unequivocally from the theory on which the Fund's adjustment programmes are based nor to be congruent with the objective conditions prevailing in the region. Whatever may be the ultimate significance of these two apparent anomalies, a question arises as to the consistency between the content of the Fund's actual adjustment programmes and its underlying theoretical approach.

As far as policy understandings are concerned, the adjustment programmes also show a high degree of uniformity (see table 3).⁴⁵ This in itself is not so significant; what is more important is the magnitudes involved, i.e., how much the exchange rate had to be raised, to what extent it was decided to increase the government's current income, etc. Nonetheless, there are four points that should be mentioned. In the first place, this section of table 3 is enlightening because of what it omits. Indeed, whereas salaries and wages and real expenditures of the public sector are explicitly or implicitly restricted, and other key prices, such as those of public services and the exchange rate, are increased in real terms, there is no policy whatsoever that is aimed at conditioning the level of prices of goods and services in the private sector.

This asymmetry could make it difficult to obtain the conditions needed so that a restriction on the growth of money with respect to prevailing inflation—monetary deflation—may lead to a deceleration of inflation and an improvement of the external position rather than to a fall in the level of activity. If inflationary expectations are guided by past inflation, or, what would be worse but even more likely, by real rises in the exchange rate, in prices of public services and in taxes, over the short term a restriction in the growth of the means of payment would depress the domestic product without checking inflation or strengthening the balance of payments.⁴⁶ In

⁴⁵It should be noted that it was not possible to establish with any degree of certainty the existence of pre-conditions to the agreements considered here.

short, some measure or measures have to be taken to bring inflationary expectations in line with the restrictions on the remuneration of the labour force and the creation of money.⁴⁷

On the other hand in the adjustment agreements one notes a certain disaggregation of variables, a characteristic which was noteworthy for its absence in the Fund's programmes in the past. Indeed, these agreements do not dwell exclusively on the most highly aggregated variables such as the public-sector deficit; rather, they include measures pertaining to current income, certain taxes, current expenditures and capital outlays. Some of the programmes provide for increasing capital expenditures in real terms and decreasing current expenditures (see table 3).

It would be reasonable to think that this apparent trend towards more detailed policy understandings was the result of a concern for the structural aspect (the supply side) of the adjustment process. However, there is no evidence, from the available information, that the long-term adjustment programmes (EFF) provide for a more detailed set of measures than the short-term adjustment programmes (SBA). This

⁴⁶It would be enough for only one price to be inflexible to create conditions in which the product and employment, and not only the level of prices and external accounts, would fluctuate whenever there was a shock such as monetary deflation. And even if it were possible for all prices to adjust immediately, this would not be enough to prevent shocks from affecting the level of activity. Indeed, such immunity would also require instantaneous adjustments of expenditure, of the factors of production, and of capital movements to the new system of relative prices in the necessary directions and magnitudes. On the first point, see E. Malinvaud, *The Theory of Unemployment Reconsidered* (London, 1977); G. Muellbauer and R. Portes, "Macroeconomic models with quantity rationing", *The Economic Journal*, Vol. 88, No. 352 (December 1978); and William H. Branson, "Economic structure and policy for external balance", *op. cit.* On the second aspect, see, for example, Richard Lynn Ground, "El enfoque ortodoxo de ajuste: una exposición, una crítica y la búsqueda de alternativas," ECLAC Santiago, Chile, Economic Development Division, April 1984 (mimeographed).

⁴⁷The problem of the inconsistencies of economic policies in Latin American adjustment programmes is discussed by Ramos, *op. cit.*, chapter 6, and by ECLAC, *op. cit.*, 1984. See also Jorge Marshall, José Luis Mardones and Isabel Marshall, "IMF conditionality: the experiences of Argentina, Brazil and Chile", in Williamson, *op. cit.*, 1983.

Table 3
ECONOMIC POLICIES AGREED ON BY THE LATIN AMERICAN COUNTRIES AND THE INTERNATIONAL MONETARY FUND*
(Agreements in force at end of 1983)

Country	Performance criteria					Policy understandings									
	Net external assets	Payments arrears	Net domestic assets	Net domestic credit	Yearly External indebtedness	Exchange rate	Wages and salaries	Interest rates	Public-sector deficit	Current income	Current expenditures	Current savings	Capital expenditures	Total expenditures	Rates of public-sector enterprises
<i>Stand-by arrangements</i>															
Argentina	Central Bank	t	Central Bank	Public sector	Public sector	+			-	+	-	+		-	+
Barbados	Central Bank		Central Bank	Public sector	na		na		-	+	-	+	-	-	+
Chile	Central Bank		Central Bank	Public sector	Public sector	+	-	r	-	+	-	+		-	+
Costa Rica	Central Bank	t	Central Bank	Public sector	Public sector	+	-	r	-	+	-	+		-	+
Ecuador	Central Bank		Central Bank	Public sector	Public sector	+	-	r	-	+	-	+		-	+
Guatemala	Central Bank	t	Central Bank	Public sector	na		na	r	-	+	-	+		-	+
Haiti	Central Bank	t	Central Bank	Public sector	na		na		-	+	-	+	+	-	+
Honduras	Central Bank		Central Bank	Public sector	na		na	r	-	+	-	+	+	-	+
Panama			Central Bank	Public sector	na		na		-	+	-	+	-	-	+
Uruguay	Central Bank		Central Bank	Public sector	Public sector	+	-		-	+	-	+		-	+
<i>Extended Fund Facility agreements</i>															
Brazil	Central Bank-Banco Brasif	t	Central Bank-Banco Brasil	Public sector	Public sector	+	-		-	+	-	+		-	+
Dominica	Central Bank		Central Bank	Public sector	na		na		-	+	-	+	+	-	+
Grenada	Central Bank		Central Bank	Public sector	na		-		-	+	-	+	-	-	+
Jamaica	Central Bank		Central Bank	Public sector	na		na	na	-	+	na	na	na	-	+
Mexico	Central Bank		Central Bank	Public sector	Public sector	+	-	r	-	+	-	+		-	+
Peru	Central Bank-Banco de la Nación		Central Bank-Banco de la Nación	Public sector	Public sector	+	-	r	-	+	-	+	+	-	+
Dominican Republic	Central Bank	t	Central Bank	Public sector	Public sector			r	-	+	-	+	+	-	+

Source: ECLAC on the basis of official information and various national and international sources.

*The following abbreviations are used: (t) total elimination; (na) not available; (+) increase in real terms (-) decrease in real terms; (r) positive in real terms.

Table 4
 TARGETS ESTABLISHED IN AGREEMENTS BETWEEN LATIN AMERICAN COUNTRIES AND THE INTERNATIONAL MONETARY FUND^a
 (Growth rates)

Country	Date of agreement	Ultimate targets		Intermediate targets			Money		Operational targets		Policy instruments														
		Net external assets	Inflation	Ex-post real exchange rate (1980=100)					Monetary base	Public external indebtedness	Public-sector deficit (as a percentage of GDP) ^b			Net domestic credit to the public sector											
				1981	1982	1983 ^d	M ₁	M ₂			1982	1983	1984	Nominal	Real ^b										
<i>Stand-by arrangements</i>																									
Argentina	24 Jan. 83	-29	-23	-16	143	189	191	170	44	119	8.3	14.0	8.0	5.0	209	-4									
Barbados	1 Oct. 82	...	...	...	95	88	85	...	...	...	...	6.6	...	1.8	...	...							
Chile	10 Jan. 83	-23	...	-29	99	125	138	-14	-18	-18	9.4	4.0	2.3	...	10	-10									
Costa Rica	20 Dec. 82	-2	-95	-45	168	141	124	5	...	...	3.3	9.5	4.5	...	15	-40							
Ecuador	25 Jul. 83	...	-27	-10	97	107	114	41	43	44	10.0	7.5	4.0	...	29	-18									
Guatemala	31 Aug. 83	...	...	...	98	100	100	...	...	...	...	5.0	...	3.0	...	...							
Haiti	7 Nov. 83	...	...	...	103	98	...	...	...	...	...	4.8	...	...	...	...					
Honduras	5 Nov. 82	...	...	...	99	92	86	...	...	...	...	...	...	...	...	...
Panama	21 Jun. 83	...	...	...	102	100	99	...	...	...	...	...	...	...	...	...
Uruguay	22 Apr. 83	...	...	...	105	129	176	...	...	...	...	8.0	3.0	1.0	...	...							
<i>Extended Fund Facility agreements</i>																									
Brazil	First letter 6 Jan. 83	-67	-43	-22	93	95	118	60	60	63	7.4	16.9	7.9	...	98	-1									
	Second letter 24 Feb. 83	-67	-44	-23													58	58	61	7.4	16.9	8.8	...	123	9
	Third letter 15 Sep. 83	61	11.0	16.9	15.2	...	118	19
Dominica	6 Feb. 81	...	...	...	96	94	91	...	...	...	...	...	...	...	...	...
Grenada	24 Aug. 83	...	...	...	...	...	...	...	...	...	...	...	17.0	8.5 ^j	...	...							
Jamaica ^k	13 Apr. 81	17	-33	-5	97	92	87	13	15	13	11.0	...	...	...	31	18						
		14	92	9													14	16	8	10	13	
Mexico	1 Jan. 83	...	...	...	94	137	152	...	...	...	...	16.5	8.5	5.5	...	...							
Peru	7 Jun. 82	-12	-22	-9	91	94	132	57	52	51	8.8	4.0	...	2.0	9	-37									
Dominican Republic	21 Jan. 83	...	...	...	101	96	94	...	...	...	...	4.0	...	3.0	...	...							

Source: ECLAC, on the basis of official information and various national and international sources.

^aProvisional data subject to revision.

^bImplicit target for reduction of inflation, i.e., the implicit target for the growth of M₁ divided by the prevailing rate of inflation (variation in consumer price index during the 12 preceding months) at the time of entry into force of the agreement with the IMF.

^cImplicit degree of monetary deflation, i.e., the implicit target for the stock of M₁ deflated by the prevailing inflation rate.

^dThe data for 1983 represent the average from January to September.

^eThe targets for the growth of M₁ and M₂ are implicit. Calculations were made by using the monetary multiplier observed in the years preceding the entry into force of the IMF agreement, according to the formula mentioned in the text.

^fIn the case of Brazil, includes State-guaranteed private indebtedness.

^gThe figures for the first year reflect the situation prior to the agreement and the following ones refer to targets, except in the case of Peru, where only targets are shown. In 1981, its deficit was 8.0% of GDP.

^hDeflated by the prevailing rate of inflation at the time of entry into force of the agreement.

ⁱMore than 100.

^jFigures for 1985-1986.

^kApril-December 1981, unless otherwise indicated.

^lRefers to 1982, unless otherwise indicated.

is also noteworthy, since one might expect to see some difference between short- and long-term adjustment programmes, if only because the Fund itself has made statements to this effect in its documents.⁴⁸

Finally, it should be noted that although reduction of the public-sector deficit is not a performance criterion, it figures, as a major policy understanding in all the agreements (see table 3).

b) *The nature of the targets*

i) Conceptual aspects.

There are two aspects to the selection of targets in the formulation of economic policy: the selection of variables whose values are to be conditioned (i.e., target-variables) and the choice of the type of target proper. From the conceptual standpoint, target-variables may be divided into ultimate, intermediate and operational ones.⁴⁹ Ultimate targets are set for those macroeconomic variables, such as the level of activity, employment, prices and the balance of payments, which are or which reflect—in the absence of other short-term indicators—the ultimate objectives of economic policy, such as well-being and self-reliance. Intermediate targets are set for variables, such as the money supply and the real exchange rate, with which the ultimate target-variables are most closely associated but which the authority cannot control, either directly or entirely, within the relevant time span. Operational target-variables are variables which can be used by the authority to influence intermediate target-variables and, through them, hopefully influence the ultimate target-variables in the direction and to the degree desired. These are variables, such as the Central Bank's stock of net domestic assets and the exchange rate, over which the authority is able to exercise more direct and close—though not necessarily total—control.

The types of targets themselves may also be differentiated according to the degree of control they imply on the part of the authority, as follows: specific, average, ranges and fixed or flexible. We will come back to this aspect later on in the article.

ii) Targets established in the Fund's adjustment programmes in Latin America

—*Classification and calculation of targets.* As a general rule, the Fund sets the targets envisaged in its adjustment programmes for the last day of each quarter of the year following the entry into force of the agreement; in other words, it tends to use specific short-term targets. This is the nature of the most important targets, i.e., those which involve performance criteria.⁵⁰ For the sake of simplicity, however, we have calculated the targets on a 12-month basis, beginning (approximately) on the date of signature of each agreement (see table 4).⁵¹ Unless otherwise indicated, targets which are expressed as growth rates refer to variations between the date on which the agreement in question was signed and the end of the following 12-month period. These dates appear in the first column of table 4.

The ultimate targets for which we were able to obtain data or effect indirectly estimates appear in the second and third columns of the table; these refer to the overall balance-of-payments position—the variation in net external assets of the monetary authority—and inflation.⁵² The data for those targets were taken from the adjustment agreements; on the other hand, targets for inflation were derived from a comparison between targets for the growth of the supply of money (discussed below) and inflation rates prevailing at the time the agreements in question were signed. Targets for inflation

⁴⁸See Guitián, *op. cit.*, 1980 and *op. cit.*, 1982.

⁴⁹See, for example, Benjamin Friedman, "Targets, instruments, and indicators of monetary policy", *Journal of Monetary Economics*, Vol. 1, No. 2 (October 1975); and Gordon H. Sellon Jr. and Ronald L. Teigan, "The choice of short-run targets for monetary policy", *Federal Reserve Bank of Kansas City Economic Review*, April 1981.

⁵⁰It should be remembered that these targets are expressed as ceilings (in the case, for example, of the stock of net domestic assets) or floors (in the case, for example, of the stock of net external assets).

⁵¹In practice, we took the last target and compared it with the actual magnitude of the variable concerned 12 months before.

⁵²No data were available for current-account targets or—if they existed—for the level of activity.

show how much the existing rate of inflation would have to fall in order to maintain the money supply constant in real terms, from the beginning to the end of the period considered, given the target for that variable. By following the same line of reasoning, one can calculate the degree of monetary deflation that is implicit in the agreements; this indicates the degree to which there would be a real contraction in the programmed supply of money if the prevailing rate of inflation remained constant. The first figure in column 3 is the implicit target for inflation and the second one is the implicit degree of monetary deflation.

The fourth to the sixth columns of table 4 show the intermediate target-variables; the relative price system, represented by the actual trend followed by the real rate of exchange, and money (M_1 and M_2). The targets for M_1 and M_2 are implicit and were derived from the targets for the monetary base and projections of the monetary multipliers.⁵³ Alternatively, targets could have been derived for the net domestic assets of the banking system.⁵⁴

Operational targets are shown in the seventh and eighth columns.⁵⁵ Data for the monetary base were obtained directly from the performance criteria, i.e., directly from the sum of the values of the targets for the stock of net domestic

assets and the stock of net external assets of the monetary authority.⁵⁶ The targets for public-sector indebtedness were also taken directly from the agreements.

The last two columns show the targets for the deficit of the non-financial public sector and its utilization of bank credit. These have been called policy instruments (as they relate to the management of the net domestic assets of the monetary authority).⁵⁷

—*The data.* With respect to the ultimate targets, there are considerable differences in the ones concerning the variations in the monetary authority's holdings of net external assets. Indeed, some of the agreements provide for an increase; others propose that this stock be maintained constant or almost constant, and still others envisage a decrease, sometimes a very sharp one (see table 4). From this standpoint, the adjustment programmes do not appear to be very restrictive. However, such a judgement cannot be made without reference to the targets for the current account and the value of the gross domestic product.

With regard to the targets for inflation, as might be expected in the orthodox approach to adjustment, some degree of monetary deflation is implicit in all those agreements for which basic information was available, except the second year of the Jamaican EFF. In other words, at prevailing inflation rates, the targets for the variation of M_1 assumed (or assume) real reduction in the stock of means of payment in all the countries in question. The proportion fluctuated between 5% for Jamaica (in the first year of its EFF) and 45% for Costa Rica. It was between 9% and 16% for Ecuador, Peru and Argentina, 22% and 23% for Brazil and over 29% for Chile. Translated into targets for reducing inflation—i.e., inflation rates consistent with the maintenance of the

⁵³A very simple formula was used to project the monetary multipliers: an average of the average value observed in the five years prior to the agreement, of the value observed in the year prior to the agreement, and of the value which would have resulted if the trend observed between the penultimate and the last year prior to the entry into force of the adjustment programme had continued. There does not seem to be any reason for believing that this formula is any worse (or better) than any other, including those used by the Fund to calculate monetary multipliers, but we do not claim to have reproduced the calculations made by the Fund. These statistics are presented purely for purposes of illustration.

⁵⁴Indeed, that procedure would more faithfully represent the Fund's monetary programming exercises, since the monetary aggregates that have to be adjusted in order to reconcile the public's demand for money with the target for the balance of payments is the stock of net domestic assets. However, our purpose was rather to show the degree of restriction that the agreements would imply if all the targets for monetary aggregates were met. Hence, the best measure to use is the implicit target for money.

⁵⁵No information was available on targets for the nominal exchange rate.

⁵⁶In setting targets for both sources of the monetary base, the Fund in effect establishes a target for the monetary base. However, in the Fund's scheme, the operational target-variable is the monetary authority's stock of net domestic assets. On this question, see note 54.

⁵⁷It might be more appropriate to treat them as operational target-variables (linked with the achievement of targets for the sectoral allocation of credit and the composition of domestic expenditure). However, this is a secondary question and it is not necessary to go into it here.

money stock in real terms—, the figures varied between -22% for Peru (from 73% to 57%) and over -100% for Chile (from 22% to -14%). For Argentina (from 221% to 170%), Ecuador (from 57% to 41%), and Jamaica (from 19% to 13% in the first year of the agreement), they fluctuated between -23% and -33%. For Brazil, the figure was -43% (from 105% to 60%) in the first agreement and -44% (from 104% to 58%) in the second; and for Costa Rica, the implicit target for reducing inflation was -95% (from 92% to 5%). On the other hand, in the second year of the Jamaican agreement, the implicit target for expanding M_1 was way over the inflation prevailing at the time (see table 4).

Although one observes monetary policies that are generally quite restrictive and, in several cases, targets that imply drastic reductions in inflation, it would appear from the targets for monetary aggregates that the inflation the Fund is willing to "live with" can be very high. Indeed, in one case (Argentina), the implicit target for the growth of M_1 was 170%. One does not have to be a monetarist to recognize that with such a high rate of growth of the means of payment, inflation has to be very high. At the same time, these targets reveal clear differences among adjustment programmes. For example, under the programme for Costa Rica, the target for the growth of M_1 was 5% while the prevailing rate of inflation was 82%; under the programme for Peru, the implicit target for M_1 was 57% when inflation was 72%.

Finally, with respect to this question, it should be noted that if inflation were to rise instead of falling—and this did happen, for example, in Argentina, Brazil and Jamaica—the degree of monetary deflation would have intensified concomitantly, with the consequent negative effect on the level of activity, unless the supply of money were expanded more than anticipated—and this also happened in several of the same countries.

On the other hand, to the extent that monetary deflation translates into the intended deceleration of inflation, the real value of the money stock, and hence the level of activity, is unaffected. In this regard, it is worth mentioning the Costa Rican experience, where inflation decelerated markedly in the months following the implementation of the adjustment programme.

Also, the extent of monetary deflation would be lessened in so far as it were possible for monetary growth to exceed the target without accelerating inflation. Such was the Chilean experience, where M_1 rose instead of falling, while inflation remained more or less constant.

With regard to the behaviour of the other intermediate target, which refers to the system of relative prices and is very imperfectly represented here by the real *ex post* exchange rate, the figures also vary greatly, as might be expected in light of the range of objective conditions prevailing in the economies of the countries under considerations. In six of the 15 countries for which we were able to calculate it for the period in question, the real exchange rate rose; in five, it remained more or less constant, and in four, it declined. Among the countries in which it was relatively stable, in one (Argentina), it had already risen sharply in preceding years, and in one (Costa Rica) in which it fell, it had also risen markedly in preceding years.

In more than half the countries considered, the real exchange rate was much higher in 1983 than it had been in the early 1980s; in some of them—especially the larger countries—it was very much higher. Nonetheless, it does not seem correct to argue, as some do, that through its adjustment programmes, the Fund has encouraged the region to "force" its exports, i.e., to increase them beyond the volume that could be absorbed by the international economy without a drop in prices. On the other hand, this argument cannot be discarded out of hand without knowing what the pre-conditions to the agreements were. In any event, there has in fact been a dramatic readjustment of relative prices in the regional economy over the last three years: if we add the economies of Argentina (where the exchange rate rose by 91%), Brazil (18%), Chile (38%), Mexico (52%) and Peru (32%), we get 80% of the regional gross domestic product.

It should also be noted that there is no consistency in the relationship between the magnitude of the variation in the real exchange rate and the degree of monetary deflation. Contrary to what might be expected, there is not an inverse relationship between the stringency of monetary deflation and the variation in the exchange rate. However, this apparent irregularity could easily be explained by the fact that the data on the

exchange rate do not refer to the targets but rather to the rates actually obtained.

With respect to the operational targets, we have already mentioned the targets for the monetary base in the context of the discussion on monetary policy. In that regard, we pointed out how widely the targets varied, as well as the considerable growth that was envisaged in some agreements. The targets for the growth of external indebtedness of the public sector, on the other hand, are relatively uniform: between 7.5% and 11% in every case for which information is available except Costa Rica, which had one of 3%.

The targets for the deficit spending of the non-financial public sector are also quite similar. Thus, one might say that there is a rule of thumb according to which this deficit should be reduced by approximately one half in a one-year period. The only countries that depart from this norm are Uruguay, for which much sharper reductions were set, and Brazil, whose third agreement with the Fund, signed in 1983, provides for a new target that would mean just barely reducing the deficit. In the latter case, this was clearly a matter of simply acknowledging a *fait accompli*.

Although in many countries the deficit of the non-financial public sector rose in 1981-1982 (and also in 1983) as a direct result of the fall in the level of economic activity, which suggests that the deterioration of external accounts could hardly be attributed in every case to excess demand, it is no less true that, once an external bottleneck prevails—when it becomes impossible to increase the volume of imports—the expansion of the deficit tends to lead to inflation rather than to an increase in output. And when the volume of imports has to be reduced, it is almost inevitable that an increase in the public-sector deficit will lead to inflation. Here one has the aberrant situation wherein inflation (even hyperinflation) concurs with recession (even depression). In other words, whereas at full employment the present public-sector budget would presumably even show surpluses in several countries, this does not necessarily mean that a greater deficit would in practice amount to a countercyclical policy. When output growth is externally constrained one can justify reducing the deficit even if the economy is in recession—which is not to say that such a policy could be carried out at no

cost. Nor does it mean that the observed uniformity of treatment given to the countries as regards the targets for the public-sector deficit is consistent with the objective possibilities and needs of each one of them.

Like the other monetary targets, the ones for net domestic bank financing of the public sector show different degrees of restrictiveness. What is more, there does not seem to be a general rule that credit to the public sector is to be restricted more than credit to the private sector, as might have been expected. On the contrary, given the monetary multipliers for M_2 , it is evident from the relationships between the targets for the monetary base and the targets for net domestic credit to the public sector that in most cases for which data are available, the greatest restriction affects the allocation of credit to the private sector (see table 4).

In summary, as recently applied in Latin America the approach observed may be described in broad terms as one which is almost always very restrictive as regards monetary and fiscal policies and is often very aggressive as regards exchange-rate policy. Such policy thrusts are perfectly consistent with the underlying model and with the need to reduce the current-account deficit. And although there is a certain rigidity or uniformity in the policy mix—or, if one wishes, a qualitative uniformity—one cannot argue, on the basis of the figures examined here, that in applying its policies, the Fund completely disregards the variety of objective conditions obtaining in each country.

The question that one would like to answer at this point is whether the Fund's adjustment policies have—considering the magnitudes and directions involved—a recessive bias. If one relies exclusively on the figures examined here, one does not at first sight notice in most of the agreements anything that might cause such a bias, with the possible exception of the credit policy, which—contrary to all expectations—seems to have been more stringent with regard to the private sector than to the public sector. On the other hand, in at least two countries (Costa Rica and Chile) and perhaps in a third one (Brazil, in its first two agreements), the extreme restrictiveness of monetary policy would appear at first sight to show evidence of such a bias. Strictly speaking, however, one cannot give a categorical

answer to this question, in either these two or three cases or the remaining ones, without scrutinizing additional information. For example, to what extent does inflation reflect the inertia of the economic system? In a country such as Costa Rica, which does not have a recent history of inflation, a decidedly anti-inflationary policy can be much less recessive than in a country such as Argentina, in which the very impetus of inflation can cause a monetary policy that is only moderately restrictive to lead to a profound recession.⁵⁸

2. A critique of conditionality

The nature of conditionality gives rise to at least four controversial questions;⁵⁹ these pertain to the reasoning behind the application of monetary performance criteria, the choice of the monetary aggregates used as performance criteria, the choice of the most adequate régime for monetary programming and the nature of the targets.

To question the rationale behind the use of monetary performance criteria is to question the validity of the very essence of the monetarist interpretation according to which the direction of causality leads from money to the value of production and the balance of payments. We shall not explore in depth the essence of this perennial controversy;⁶⁰ rather, we shall consid-

er only a few of the weaknesses of the monetary approach to the balance of payments.⁶¹

In short, we do not aspire to reach any particular conclusions as to the principle of using monetary performance criteria, but rather to show that the formal apparatus of the Fund does not produce results as automatic and precise as claimed.⁶² To this end, we will look at the issues of the choice of the monetary aggregates to be used as performance criteria and the choice of the types of targets to be employed.

a) *Some fallacies of the monetary approach to the balance of payments*

The monetary approach to the balance of payments, which is the foundation of the Fund's adjustment programmes and particularly of its conditionality policy, has a serious flaw, namely, the identification of a balance-of-payments deficit (surplus) with an excess supply (shortage) of money.

The fallacy of this reasoning may be illustrated by analysing situations in which this identity is not valid.⁶³ Let us assume, for example, that an economy is simultaneously experiencing both a recession and a balance-of-payments deficit. The concurrent disequilibria in the domestic and foreign sectors may have been caused by a sharp drop in external demand for its exports which reduced *pari passu*, its income and its money stock. In such a situation—one characteristic of many countries of the region in recent years—, would it be right to identify the balance-of-payments deficit with an excess supply of money? Should the money supply be reduced even further in order to reverse the external disequilibrium?

Let us assume, on the other hand, that an

⁵⁸It should be remembered, however, that the Fund's adjustment programmes' policy mix does lead to a recessive bias.

⁵⁹We will not touch on the question whether the Fund's financing should or should not be subject to conditions.

⁶⁰See, for example, Don Patinkin, *Money Interest and Prices*, Harper and Row, New York, 1965; Milton Friedman, "A theoretical framework for monetary analysis", *Journal of Political Economy*, Vol. 78, No. 2, March/April 1970; Harry G. Johnson, "The Keynesian revolution and the monetarist counter-revolution", *The American Economic Review*, Vol. LXI, No. 2, May 1971; R.J. Gordon (ed.), *Milton Friedman's Monetary Framework: A Debate with his critics*, Chicago, 1974; Peter Tinnin, *Did Monetary Forces Cause the Great Depression?*, W.W. Norton and Company, New York, 1976; Robert J. Barro, "Unanticipated money, output and the price level in the United States", *Journal of Political Economy*, Vol. 86, August 1978; and James Tobin, "The monetarist counter-revolution today: an appraisal", *The Economic Journal*, Vol. 91, March 1981.

⁶¹See, for example, John Williamson, "The lending policies of the International Monetary Fund", in Williamson, *op. cit.*

⁶²Nor will we deal here therefore, with the controversy regarding the selection of the best operating régime for monetary programming. See footnote 43 above.

⁶³This presentation follows that of Alan B. Rabin and Leland B. Yaeger, "Monetary approaches to the balances of payments and exchange rates", *Essays in International Finance*, No. 148, Princeton University, Department of Economics, International Finance Section, November 1982.

international inflation leads to a balance-of-payments surplus and domestic price inflation. From the monetarist point of view, inflation is associated with an excess supply of money, but in the monetary approach to the balance of payments an overall balance-of-payments surplus is equated with an excess demand for money, i.e., insufficient stock of money. Monetarist criteria lead to contradictory results not only because they do not take external conditions into account, but also because they tend, in one way or another, to overlook the existence of goods, services, factors and assets that are not internationally traded. Indeed, a surfeit (dearth) of money with respect to demand could be the counterpart to—or imply—a shortage (a surplus) on the markets for goods, services, factors and assets that are only domestically traded. When such markets do exist, a balance-of-payments deficit (surplus) may even coexist with an excess demand for (excess supply of) money.

However, even if all domestic and foreign goods, services, factors and assets were, as is usually assumed, perfect substitutes, a shortage (surplus) of means of payment could lead both to a decrease (increase) in the level of activity and to a balance-of-payments surplus (deficit). The monetary approach breaks the link between the supply of and demand for money and the level of activity by assuming that the economy is always in a full-employment situation; or alternatively, that over the short run, the level of activity is fixed. However, as has been noted more than once, these assumptions “solve” conflicts by eliminating alternatives.

The other main proposition of the monetary approach to the balance of payments is that the monetary authority cannot compensate for (“sterilize”) the monetary impact of balance-of-payments outcomes. This idea is derived directly from the notion that the overall balance of foreign transactions is nothing but a reflection of the relationship between domestic money creation and domestic demand for money. Indeed, if domestic monetary demand determines the stock of means of payment that circulates in the economy, in static equilibrium any increase (decrease) in the supply of net domestic assets would be reflected in an equivalent loss (gain) in net external assets; in other words, in a deficit (sur-

plus) in the global balance of payments rather than in an increase (decrease) in the money stock.

This proposition, however, is also erroneous. Let us assume that an increase in international interest rates produces a deficit in the balance of payments. The stock of means of payment will, of course, simultaneously contract. At the prevailing level of demand for money this will produce an imbalance in the monetary market. Given the level of activity, the disequilibrium can only be resolved by reversing the outflow of external assets—i.e., achieving a surplus on the balance of payments— or by increasing the supply of net domestic assets. This latter option, however, is in fact, precisely a “sterilization” operation. Again, the fallacy of the monetary approach lies in the incongruity of its basic underlying assumptions.⁶⁴

Although the aforementioned fallacies do not invalidate the use of monetary performance criteria, their contemplation constitutes a point of departure for questioning the nature of the Fund’s conditionality policy. Indeed, if the monetary approach does not in fact lead to mechanical or precise conclusions, first of all a question arises as to whether the Fund’s performance criteria are consistent with the common-sense logic of the multi-stage approach to targeting. At issue is whether the variables which the Fund uses as performance criteria do or do not possess the characteristics of operational variables; in other words, the question is whether they are variables that are in fact subject to control by the economic policy-makers. The answer is unequivocal. The policy-makers cannot exer-

⁶⁴For further comments on these points and a discussion on other sources of error in the monetary approach to the balance of payments, see also Marina Whitman, “Global monetarism and the monetary approach to the balance of payments”, *Brookings Papers on Economic Activity*, No. 3, 1975; Frank H. Hann, “The monetary approach to the balance of payments”, *Journal of International Economics*, Vol. 7, No. 3, August 1977; Blackwell, *op. cit.*, 1977; Mordechai E. Krenin and Laurence H. Officer, “The monetary approach to the balance of payments: a survey”, *Princeton Studies on International Finance*, No. 43, Princeton University, Department of Economics, International Finance Section, November 1978; Branson, *op. cit.*, 1983; and Charles Collins, “On the monetary analysis of an open economy”, *IMF Staff Papers*, Vol. 30, No. 2, June 1983.

cise a reasonable degree of control, much less close control, over the stock of net external assets. Consequently, this variable cannot and should not be treated as if it were an operational variable as the Fund does in using it as a performance criterion.

If the manipulation of the stock of net domestic assets does not produce equivalent variations in the overall balance-of-payments position, the incongruency is evident. It becomes even more obvious when one considers that the balance of payments is conditioned by factors which are entirely beyond the sphere of influence of the policy-makers, e.g., the external demand for goods and services, the world supply of and demand for goods and services that the country imports and international interest rates. Indeed, any variation in these external factors would divert the overall balance-of-payments position from its target, independently of whether or not the authority had met the other performance criteria.⁶⁵

It is conceivable, of course, that policy-makers might be able to compensate for unforeseen variations in external conditions, but they would only be able to achieve the targets for the stock of net external assets if they had an unlimited capacity to act and produce immediate and precise compensatory effects. Such a feat is implausible, however, since the manipulation of operational variables does not produce automatic or precise results.⁶⁶

It is inappropriate to hold policy-makers responsible for the behaviour of a variable, such as the overall balance-of-payments position, which is not subject to its control. It makes even less sense for any deviation from the target for the stock of net external assets to automatically trigger the suspension of disbursements of Fund financing. This is, however, the situation. There is no justification for this policy, which intro-

duces a notorious recessionary bias in the Fund's adjustment programmes and should be eliminated.

The other performance criterion which seems defective is the one which restricts the external indebtedness of the public sector. We do not question the idea that the expansion of external indebtedness should be compatible with the target for the composition of the balance of payments as between the current and the capital account balances. Nor are we unaware of the fact that the restriction of public-sector indebtedness could be used as a way of holding back the growth of overall external indebtedness. The problem with this policy lies in the fact that the international financial community is not prepared to lend money to the private sector of economies which confront problems with the service of their external debts and adjustment processes; rather, if they provide any financing at all, they will do so only to the public sector. The contradiction between this reality and the performance criterion in question is evident.

b) *What type of targets?*

i) The dilemma of fixed specific targets

In the monetarist paradigm, it is assumed that the creation of the supply of means of payment is an exogenous process, i.e., that neither the non-banking public nor the financial intermediaries play any part in generating the supply of money. Under this approach to the monetary market, the banking sector does not exist and the public only intervenes with its demand for real balances. In a closed economy (or one with a fully flexible exchange rate), this demand determines the value of the means of payment which the monetary authority has elected to supply. In an open economy with a fixed exchange rate, or an exchange rate that is not entirely flexible, the process of reconciling the public's demand for real balances with the supply of means of payment can affect both the level of prices and the supply of means of payment that actually circulate in the economy. In either case, it is assumed that the monetary authority alone determines the supply of means of payment and hence, that it does so in a precise and continuous fashion. Here we have, it seems, the origin of the use of specific targets —i.e., targets referring to varia-

⁶⁵This point was brought out at a recent conference on Fund policies. See Carlos Díaz-Alejandro, "Comments", and Richard N. Cooper, "Panel discussion", in Williamson, *op. cit.*, 1983.

⁶⁶The only way such a capacity might conceivably exist would be under a totally flexible exchange rate régime. However, the Fund's approach rests on the assumption that the exchange rate is fixed, or at least not entirely flexible.

tions from one date to another—for monetary aggregates. In any event, this is the type of target which the International Monetary Fund uses for its performance criteria.

A growing outcry against this Fund policy is issuing from a heterogeneous group of experts including Dragoslav Avramovic, Richard N. Cooper, Sidney Dell, Arnold C. Harberger, G.K. Helleiner and John Williamson.⁶⁷ Their opposition to this procedure is based on both the theoretical proposition and the observed reality that it is impossible to exercise the close control over monetary aggregates that would be required to meet such targets. Contrary to the monetarist assumption, not all the factors that determine the money supply are subject to control by policy-makers. Indeed, the monetary authority is capable of exercising precise and discretionary control over only one of the factors that determine the supply of money, i.e., the required reserve ratio. Of the other four factors, three are beyond any direct Central Bank control. The non-banking public chooses the composition of its financial portfolio as between cash holdings and deposits, and the distribution of its deposits as between monetary and financial ones, while the commercial banks and similar institutions establish the relationship between their excess reserves and their liabilities. Like the money supply, the other determinant—the monetary base—is the product of decisions taken simultaneously by different agents—the monetary authority, the non-banking public, the commercial banks and the non-financial public sector. In short, the supply of money is endogenous, not exogenous.

Of the factors of expansion and contraction of the monetary base, the ones that the Central Bank can always manipulate at its discretion include the allocation of credit to the non-financial private sector and its own external liabilities (as

well as several other liabilities and assets, including the capital accounts). It can also decide how much credit to grant to the non-financial public sector if it is institutionally independent; how much to grant to the private financial sector if there is no run on the banks; and, in principle, it can also determine its holdings of external assets if it is willing to allow the exchange rate to fluctuate freely. On the other hand, it cannot programme the governments' deposits or the variation of its assets and liabilities arising from the liquidation of interbank accounts (see table 5).⁶⁸

In the light of these considerations, there is also good reason to question the assumption that the monetary authority can accurately determine the monetary base or even the supply of net domestic assets, since the capacity to do this also depends on a series of factors over which the authority has no discretionary control or no control at all (see table 5).

Now, it is true that the monetary authority could in principle control any monetary aggregate, even if some of the determinants thereof were beyond its control, provided it could predict their future trends. However, the expectation or hope that the authority might be able to achieve this as a routine matter has been frustrated, as is shown by the performance of the various developed countries that have tried to implement monetary rules—i.e., that have tried to programme the growth of a given monetary aggregate at a given rate. Indeed, not one of these countries has consistently achieved its goal. On the contrary, most of the annual results have demonstrated failure, in that they have fallen outside the proposed target range, or outside a range of (for example) four percentage points around a specific target; short-term results have been even less satisfactory. Furthermore, in most cases, the application of a monetarist rule has

⁶⁷See, for example, Dragoslav Avramovic, "Role of the International Monetary Fund. The disputes, qualifications and future"; Richard N. Cooper *et al.*, "Conclusions and policy implications", and Sidney Dell, "Stabilization: the political economy of overkill", in John Williamson, *op. cit.*, 1983; G.K. Helleiner, *op. cit.*, 1983, and "Lender of early resort: the IMF and the poorest", *American Economic Review*, Vol. 73, No. 2, May 1983.

⁶⁸One of the main functions of a central bank is to liquidate accounts among commercial banks and other financial institutions. However, the monetary authority cannot control all the factors, such as transportation, computer systems and the actual volume of transactions, which determine how the terms for payment and collection of checks and other documents vary. In practice, this account tends to be quite volatile.

been followed by a greater variability of monetary growth.⁶⁹

The fundamental difficulty lies in the fact that the determinants of the means of payment

Table 5
CONTROL OVER THE ADJUSTED CENTRAL BANK BALANCE SHEET:
SOURCES AND USES OF THE MONETARY BASE

Sources ^a		Uses ^a	
<i>Factors of expansion</i>		Cash outside banks	N
External assets	Nc	Commercial bank reserves	N
Domestic assets	Nc	Legal reserves	Dc
Credit		Excess reserves	N
To the private sector	Nc		
Non-financial	Dc		
Financial	Nc		
To the public sector	Nc		
Receipts in process	N		
Others	Dc		
<i>Factors of contraction</i>			
External liabilities	Nc		
Domestic liabilities	Nc		
Deposits of government	N		
Deposits of the non-financial private sector	Dc		
Payments in process	N		
Others, including capital accounts	Dc		

^aDc: The monetary authority is able to exercise discretionary control.

Nc: The monetary authority is able to exercise non-discretionary control.

N: The monetary authority is not able to exercise control.

⁶⁹We obtained 53 annual observations for six industrial countries (United States, 1976-1982; Canada, 1976-1982; United Kingdom, 1976-1982; Federal Republic of Germany, 1975-1982; France, 1976-1982 and Switzerland, 1975-1978 and 1980-1982) which attempted to target the growth of the supply of one measure of money or another. When a tolerance (range) of 4% was allowed for those countries (Federal Republic of Germany, 1975-1978; France, 1976-1980 and Switzerland throughout the entire period) that have employed specific targets, the rate of failure was 57%; when a tolerance of 3% was allowed for, the rate of failure was 62%. To formulate their monetary targets, the United States and the Federal Republic of Germany (since 1979) have used ranges of 3% and Canada and the United Kingdom, of 4%. For data on the United States during the period 1979-1982, see Board of Governors of the Federal Reserve System, "Monetary Report to Congress", published biannually in March and August since 1980, in *Federal Reserve Bulletin*; the data for 1976-1979 were taken from Robert H. Rasche, Allen H. Meltzer, Peter D. Sternlight and Stephen H. Axilrod, "Is the Federal Reserve's monetary control policy misdirected?", a debate sponsored by the *Journal of Money, Credit and Banking*, on 30 April 1981, Ohio State University, Columbus, and published in Vol. xiv, No. 1, February 1982, p. 129. The

statistics for the other countries were taken from Karen H. Johnson, "Foreign experience with targets for monetary growth", *Federal Reserve Bulletin*, Vol. 69, N° 10, October 1983, pp. 746-753, except for the references to the actual growth of M_2 in France, which were taken from International Monetary Fund, *International Financial Statistics*. For further comments on the question of the control of money in industrial countries, see M. Tratianni and M. Nabli, "Money stock control in the EEC countries", *Weltwirtschaftliches Archiv*, Band 115, Heft 3, 1979 and M.T. Summer, "The operation of monetary targets", Karl Brunner and Allen H. Meltzer (eds.), *Monetary institutions and the policy process*, Carnegie, Rochester Conference Series on Public Policy, a series of the supplement to *Journal of Monetary Economics*, Vol. 13, 1980. On the question of short-term monetary control, see Daniel L. Thornton, "The FOMC in 1982: de-emphasizing M_1 ", *Federal Reserve of St. Louis Review*, Vol. 65, No. 6, June/July 1983; Byron Higgins, "Should the Federal Reserve fine-tune monetary growth?", *Federal Reserve Bank of Kansas City Economic Review*, January 1982; Peter D. Sternlight, "Monetary policy and open market operations in 1981", 1982, and "Monetary policy and open market operations in 1982", *Federal Reserve Bank of New York Quarterly Review*, Vol. 8, No. 1, second quarter 1983. On the variability of the growth of

which the monetary authority does not control may vary greatly and somewhat irregularly. The recent behaviour of the monetary multiplier in the same Latin American and Caribbean countries⁷⁰ in which agreements with the Fund were in force towards the end of 1983 speak very

eloquently of the magnitude of the problem. Indeed during the period 1978-1982, the average quarterly coefficient of variation in the 16 countries in question was 16.4% for the M_1 multiplier and 17.2% for the M_2 multiplier (see table 6). This instability is, as a matter of fact, much high-

Table 6
MONEY MULTIPLIERS IN SELECTED LATIN AMERICAN COUNTRIES^a, 1978-1982^b

Country	Monetary multiplier (M_1)				Monetary multiplier (M_2)			
	Average	Minimum	Maximum	Coefficient of variation	Average	Minimum	Maximum	Coefficient of variation
Argentina	1.26	0.74	3.75	62.25	2.47	1.01	9.90	39.44
Barbados	1.50	1.32	1.74	7.69	4.69	4.21	5.64	9.68
Brazil	1.85	1.73	2.00	3.54	2.26	2.10	2.51	4.81
Costa Rica	1.42	1.01	1.85	15.51	3.28	3.01	3.65	6.06
Chile	0.85	0.60	1.32	20.99	3.10	1.76	6.40	48.42
Dominica	1.64	1.02	2.65	31.84	5.28	2.83	8.63	35.95
Ecuador	1.61	1.42	1.92	12.35	2.02	1.64	2.46	11.91
Grenada	1.28	1.11	1.49	8.35	3.13	2.66	3.91	10.91
Guatemala	1.06	0.94	1.15	4.89	2.47	2.06	2.92	12.22
Honduras	1.52	1.45	1.83	9.54	3.19	2.73	4.03	10.30
Haiti	0.97	0.66	1.53	22.31	1.82	1.32	2.48	17.25
Jamaica	1.68	1.30	2.02	11.81	4.33	3.35	6.40	19.93
Mexico	0.64	0.47	0.72	13.88	1.75	1.60	1.90	4.42
Peru	0.92	0.67	1.12	16.90	1.55	1.39	1.75	6.51
Dominican Republic	1.00	0.92	1.14	2.07	2.13	1.88	2.52	6.97
Uruguay	1.02	0.77	1.32	12.64	4.56	2.30	6.76	29.76

Source: International Monetary Fund, *International Financial Statistics*, several issues.

^aAll countries that had agreements with the International Monetary Fund in force at the end of 1983, except Panama, whose monetary accounts are not comparable with those of the other countries.

^bQuarterly figures.

er than that which is usually observed in the developed countries and would in itself make of monetary programming an enterprise highly difficult to realize with any degree of accuracy over time.

Nevertheless, it is easier to programme the supply of money than to control the money stock, since the latter depends not only on the former

but also on the demand for real monetary balances. Of the factors —interest rates, income and expected inflation— which determine that demand, there is not one that the authority can effectively control except perhaps the interest rate. But if it decides to control the latter variable, it cannot exercise any control whatsoever over the supply of means of payment.

To predict the demand for money with any degree of success would be just as or more difficult than predicting the future trend of the money multiplier. However, rather than exploring that problem, we shall consider the effect that a mistake in forecasting the demand for means of payment would have on the variation of external assets of the monetary authority. For this analy-

money after the application of monetary rules, see R.W. Hafer and Scott E. Hein, "The wayward money supply: a post mortem of 1982", *Federal Reserve Bank of St. Louis Review*, Vol. 65, No. 3.

⁷⁰Except Panama, whose monetary accounts are not directly comparable with those of the other countries.

sis, the same countries were used.⁷¹ The ratio between 1% of M_1 and the variation and the stock of net external assets of the monetary authority during a recent year (1982) was calculated for each country. The same calculations were made using 1% of M_2 and 5% of M_1 and 5% of M_2 . The results show how difficult it is to programme the means of payment and the overall performance of the balance of payments. Indeed, if the monetary approach to the balance of payments were applied mechanically, a very minor error of 1% in forecasting the demand for money would have meant, on average, a 7% difference between the target and the actual balance-of-payments result.⁷² The same minor (i.e., 1%) error in forecasting the demand for M_2 —the monetary aggregate with which the Fund usually works in its adjustment programmes— would give rise to an average error in the balance-of-payments outcome of almost 18%.

If more realistic magnitudes of prediction error —such as 5%— were used the difference between targets and actual results for net external assets would be very great. A 5% error in forecasting M_1 would have meant on average a difference of 35.6% between the target and the actual balance-of-payments result (see table 7). The problem arises, in part, from the fact that the stock of means of payment is usually appreciably greater than the holding of net external assets (see table 7).

Naturally, if the monetary authority realizes in time that the forecast for the demand for money does not reflect the real trend followed by that variable, it can —and normally should— change its (implicit) targets for net domestic assets of the banking system concomitantly. But this realization is at least as difficult a task as predicting accurately the demand for means of payment. Also, in some cases, a revision of im-

PLICIT targets might jeopardize achievement of explicit targets.

We thus arrive at the dead-end street in which the countries participating in the International Monetary Fund's adjustment programmes find themselves. If the monetary authority's control over monetary aggregates is very imperfect, the achievement of specific targets such as those used by the Fund implies the implementation of a more restrictive —and perhaps much more restrictive— policy than indicated by the targets themselves. Here is another recessionary bias of the Fund's adjustment programmes. On the other hand, an attempt to avoid an unnecessarily restrictive policy —that is, an attempt to get as close as possible to the targets without overshooting them— implies running a high risk of infringing the performance criteria and thus forfeiting access to Fund financing. But the dilemma is even more sinister. Indeed, when a country fails to meet a performance criterion, not only does it lose the right to draw on the Fund financing originally envisaged, but it also is deprived of its access to the international financial market or finds it radically reduced. Here then is another recessionary bias.

It is not surprising that, finding themselves caught "between a rock and a hard place", the governments and the people are reluctant to sign adjustment agreements with the International Monetary Fund. Nor is it surprising, in light of these considerations, that those countries which do adopt the adjustment programmes so often fail to meet the performance criteria and that their economic performance tends to be so mediocre.

ii) Alternative reform proposals

Notwithstanding the argument developed above, there is a sense in which the authority can exercise relatively strict control over the means of payment. Indeed, by extending the time horizon of control, the difference between the average outcome and an average target in relation to the standard deviation of the outcome from a specific target decreases progressively for the simple reason that the differences between outcomes and targets tend to offset each other. If targets are expressed as averages of specific (daily) outcomes, the authority can, in fact, exercise over the long haul fairly close "control" over monetary

⁷¹Except Costa Rica, for which no data were available.

⁷²It should be remembered, however, that the Fund's targets for the stock of net external assets are expressed as minimum values. Therefore, although underestimation of the demand for money would result in a difference between the result and the target, this would not entail an infringement of the target that would only occur in the case of an overestimation.

Table 7
 PERCENTAGES OF M_1 AND M_2 IN RELATION TO NET EXTERNAL ASSETS OF THE MONETARY
 AUTHORITY IN SELECTED LATIN AMERICAN COUNTRIES, 1982^a

	1% of:				5% of:			
	M ₁ in relation to net external assets		M ₂ in relation to net external assets		M ₁ in relation to net external assets		M ₂ in relation to net external assets	
	Variation between end of 1981 and end of 1982	Stock at end of 1982	Variation between end of 1981 and end of 1982	Stock at end of 1982	Variation between end of 1981 and end of 1982	Stock at end of 1982	Variation between end of 1981 and end of 1982	Stock at end of 1982
Argentina	1.0	0.8	2.8	2.4	5.0	4.2	14.2	11.9
Barbados	25.0	3.7	-66.7	9.8	-125.0	18.3	333.3	48.8
Brazil	10.0	3.6	13.3	4.8	50.0	18.2	66.3	24.2
Chile	1.1	0.4	5.4	2.0	5.6	2.0	27.0	9.8
Dominica	5.0	-5.0	16.7	-16.7	25.0	-25.0	83.3	-83.3
Ecuador	-10.1	11.0	-13.0	14.1	-50.6	55.0	-64.8	70.4
Grenada	-3.1	8.3	-6.3	16.7	-15.6	41.7	-31.3	89.3
Guatemala	-13.9	8.2	-38.6	22.9	-69.3	41.2	-192.9	114.6
Haiti	-7.2	-7.5	-14.4	-15.0	-36.0	-37.4	-71.9	-74.8
Honduras	-4.0	-4.7	-8.5	-10.0	-19.8	-23.3	-42.4	-50.0
Jamaica	-2.7	-0.6	-8.5	-1.8	-13.7	-2.9	-42.6	-8.9
Mexico	-17.0	13.7	-55.9	45.2	-84.8	68.5	-279.7	226.0
Peru	2.5	1.6	6.5	4.3	12.6	8.3	32.4	21.4
Dominican Republic	3.0	-1.5	-3.2	-6.4	-15.0	-7.5	-32.1	-16.0
Uruguay	1.2	-2.7	-9.8	-21.7	-6.2	-13.6	-49.2	-108.4
Averages	7.1	4.9	18.0	12.9	35.6	24.5	90.9	63.9

Source: International Monetary Fund, *International Financial Statistics*, several issues.

^aAll countries that had agreements with the International Monetary Fund in force at the end of 1983, except Panama (whose monetary accounts are not comparable with those of the other countries) and Costa Rica (for which 1982 monetary data have not been published in *International Financial Statistics*).

aggregates. In contrast, in the case of specific targets, the standard deviation of the outcomes is independent of the period in which control is attempted. With this type of target, the authority's ability to control the means of payment is not, in principle, greater in one year than in one quarter.

In short, the problem with specific targets is not a question of time periods. On the other hand, the usefulness of targets that are made up exclusively of averages is not clear.⁷³ It would seem, therefore, that as far as the degree of specificity is concerned, instead of specific targets such as those used by the Fund or simple averages, it would be more appropriate to use quasi-specific (or quasi-average) targets, specific ranges or quasi-specific ranges.

Quasi-specific (or quasi-average) targets are expressed as the variation between two time periods of an average value; for example, the variation between the average value recorded in December and that recorded in June. Specific ranges are expressed as an interval around a specific target; for example, if the target is a 7% variation between 31 March and 31 December, the actual result would have to be in a range of, say, 5% to 9%. Quasi-specific ranges are a combination of the two solutions just mentioned. They are, of course, the least specific of the three and are therefore the most likely to be met consistently. For the same reason, they could be achieved with a less restrictive policy than would be required for either of the other two alternatives. However, there is still another source of recessionary bias, i.e., the rigidity of the targets. Indeed, targets may also be either fixed, as are the Fund's, or contingent.

If the values of the factors determining the

⁷³See, Bryant, *op. cit.*, 1982.

monetary aggregates —monetary multipliers, demand for money and external conditions—turn out to be different than what had been forecast, the original monetary targets could become unattainable or unnecessarily restrictive. For example, suppose that the demand for money were underestimated. Under such circumstances, a loosening of restrictions on domestic credit could make it possible to achieve a higher level of activity without jeopardizing achievement of the balance-of-payments target. However, doing so would make it impossible to meet the target for the stock of net domestic assets of the monetary authority.

The solution we favour, then, is that of contingent quasi-specific ranges, because, if properly designed, it would (virtually) eliminate all the recessive bias associated with conditionality.⁷⁴ This solution would not entail, however, a policy less restrictive than the one implied by specific

targets if the authority were really able to exercise close control over monetary aggregates. Nor would it entail a policy less restrictive than the one implied by fixed targets if all forecasts concerning the factors which determine monetary aggregates turned out to be accurate.

Thus, the reform proposed would make it feasible to comply with conditionality without applying policies that were more restrictive than indicated by the targets themselves. Moreover, purging the recessionary bias from conditionality would also eliminate one of the main obstacles to more timely adjustment programmes. So, why not do it?

We do not understand why the Fund continues to use fixed specific targets, particularly when its own staff members have recognized that it is impossible to exercise close control over monetary aggregates and have recommended that targets should be made more flexible.⁷⁵

III

Summary and conclusions

Five sources of recessionary bias in the International Monetary Fund's adjustment programmes have been identified: the insufficiency of the amount of financing, the inconsistency of domestic economic policies, the use of the stock of net external assets as a performance criterion, the use of fixed specific targets for the performance criteria, and the nature of the link between external financing and adjustment agreements.

With regard to the first aspect, it was argued that the flow of external financing has not reached a magnitude compatible with efficient adjustment; in other words, it has not been sufficient to finance that part of the current-account

deficit that is attributable to temporary external factors. This inadequacy refers not only to financing provided by the Fund but also to financing from other sources. In this regard, it was held that the Fund has not satisfactorily performed the role of catalyst that it has taken upon itself.

It was argued that this first —and fundamental— problem reflects the fact that the procedure used for establishing the countries' quotas in the Fund is not adequately linked with efficiency criteria. During the period under consideration, however, the inadequacy of external financing also reflected the slowness of the

⁷⁴Obviously, this reform would not affect the link between conditionality and financing from the international financial community. However, by making it possible to meet conditionality without having to follow unduly restrictive policies, it would, presumably, prevent that recessionary bias from operating.

⁷⁵See Mohsin S. Khan and Malcolm D. Knight, "Stabilization programs in developing countries: a formal framework", *IMF Staff Papers*, Vol. 28, No. 1, March 1981. In this respect, the aforementioned Fund experts state (pages 42-43): "... even a modest extension of the financial programming framework yields a model in which the relationship

Fund's response to the economic crisis. This incongruity was attributed both to defects in the Fund's adjustment programmes which make governments and the people reluctant to resort to it, and to the toughening of conditionality precisely when the economic crisis was in the making. However, the Fund denies having toughened its conditionality.

The other four sources of recessionary bias spring from the domestic adjustment policies. In the first place, on the basis of the diversity of conditions prevailing in the different countries involved, we questioned the rationale underlying the uniformity, both in performance criteria and in operational monetary targets, observed in the 17 agreements examined.

In the second place, in each agreement we noted a certain asymmetry in the mix of policy understandings. Indeed, while in real terms wages and salaries and public-sector expenditures were restricted and other key variables, such as the exchange rate and the prices of public services, were increased, no provision at all was specifically made regarding the price level of goods and non-factor services in the private sector. It was argued that this asymmetry would seem to work against the basic condition that must prevail in order for monetary deflation to lead to deceleration of inflation and a strengthening of external accounts rather than to a decrease in the level of activity, since it would encourage—or at least it would not discourage—

the formation of inflationary expectations and price rises that would exceed the targets established for the means of payment.

On the other hand, we did not note any excessive aggregation or find a systematic recessionary bias in the magnitude and direction of the targets. Contrary to all expectations, however, in most of the agreements examined, restrictions on the availability of bank credit appear to be more stringent for the private sector than for the public sector.

The third source of recessionary bias is found in the practice of using the monetary authority's holdings of net external assets as a performance criterion. The problem arises from the fact that the authority does not exercise any control over several of the main determinants of the balance-of-payments outcome nor can it in practice compensate instantly and fully for unexpected developments. Nonetheless, it is required to do so, under penalty of losing the Fund's financial support.

With regard to the appropriateness of the performance criteria, we also drew attention to the anomaly involved in the Fund's practice of restricting the external indebtedness of the public sector but not that of the private sector. Whether this policy is based on a *laissez-faire* approach or on some other, the fact is that it clearly clashes with the marked reluctance of the international banking community to lend money to the private sector of the Third World in times of economic crisis.

The other sources of recessionary bias have to do with the use of fixed specific targets for the performance criteria. Again, the problem lies in the fact that the authority is held responsible for results which it cannot achieve with precision nor at its discretion. Moreover, it is asked to perform this feat repeatedly—every quarter of the duration of the agreement—even if the values of the determinants of the monetary aggregates turn out to be different from what had been forecast. Consequently, the authority is faced with the dilemma of having to follow a more restrictive policy than is indicated by the targets themselves or running the risk of infringing the targets and losing not only the financial support of the Fund but that of practically the entire international financial community.

between the targeted reserve increase (net international reserves or net external assets) and domestic credit (net domestic assets) is complicated and depends on the structure of the economy. Conversely, measures to hold domestic credit at some prearranged level will not result in a smooth path of accumulation of international reserves, a conclusion that holds in this model even though it neglects such complications as the effect of changing expectations on international capital flows. The practical implication is that policymakers cannot 'fine tune' domestic credit ceilings from quarter to quarter or even year to year without having much more comprehensive information about the structure of the economy than they can reasonably be expected to possess. One possible way out of this difficulty might be to devise some simple feedback rule in which the domestic credit ceilings are altered in response to current and past deviations between targeted and actual reserves". (Parentheses were added by the author of this article.)

In summary, an agreement with the Fund does not mean that a country will obtain enough financing to implement an efficient adjustment. However, if it fails to meet one of the targets provided for in the agreement —perhaps for reasons that are entirely beyond the authority's control— its access to the international financial market could virtually be closed.

The policy reforms we propose arise directly from our critique of the Fund's approach. The first and most fundamental one is that the Fund's financial capacity should be increased in order to enable it to promote efficient adjustment processes. But this proposal is unrealistic. However, a significant step could be taken without asking for more resources. Indeed, if the recessionary bias of the Fund's domestic adjustment policies were eliminated, one of the major causes of delay in responding to external disequilibria with adjustment programmes would also be eradicated. Moreover, if the Fund were to provide more of its financing at the beginning of the adjustment agreement (i.e., if it were to "front-load" the agreements), it might be able to better perform its role as a catalyst of financing from the international financial community.

With respect to the reform of domestic adjustment policies, in the first place, performance criteria (and operational targets) can and usually should, without prejudice to the principle

of equal treatment governing the Fund's operations, be adapted to the circumstances of each country whenever these circumstances might affect the outcome of the programme.

With regard to the mix of policy understandings, the most important initiative would be to add an overall incomes policy, with a view to harmonizing inflationary expectations with the restrictions placed on the remunerations of the labour force and on the growth of money, in order to deflect the shocks produced by monetary deflation towards prices and the balance of payments and away from the level of activity.

With regard to the variables and targets used for performance criteria, we advocate eliminating the use of the stock of net external assets as a performance criterion and replacing fixed specific targets by quasi-specific contingent ranges.

These last two reforms are perhaps the most attractive ones, because there is a growing consensus regarding the concepts and evidence on which they are based, they do not entail any cost and they would (virtually) eliminate the recessionary bias associated with conditionality. Indeed, they would make it feasible to comply with conditionality without applying policies that were more restrictive than necessary and, consequently, would also reduce the possibility of a country's losing access to the international financial market.