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STABILISATION AND ADJUSTMENT PROGRAMS
THEORETICAL AND POLICY ISSUES

By
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CONTENTS

		Page
I.	INTRODUCTION	1
II.	ALTERNATIVE PERSPECTIVES ON STABILISATION AND ADJUSTMENT	2
III.	REFLECTIONS ON FUND-SUPPORTED ADJUSTMENT PROGRAMS	4
III.1	Changing Perspectives	4
III.2	The Macroeconomic Framework	5
III.3	The Choice of Instruments and the Pace of Adjustment	6
III.4	Issues in the Design of Fund-Supported Programs	8
III.4.1	Monetary Policy	8
III.4.2	Fiscal Policy	9
III.4.3	Exchange Rate Policies	10
III.4.4	Growth-Oriented Policies	11
III.5	Implications of Adjustment for Poverty	12
III.6	Assessing the Effectiveness of Fund-Supported Programs	13
IV.	THE SRI LANKAN EXPERIENCE	14
IV.1	External Conditions	15
IV.2	Policy Stance	15
IV.3	Economic Response	15
V.	CONCLUDING THOUGHTS	22
	REFERENCES	23

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I. INTRODUCTION

In a small open economy, like Sri Lanka's, the response to a build-up of excess domestic demand or to an exogenous shock is likely to be either an increase in inflationary pressures or (where initially the foreign exchange constraint is not binding) excessive imports leading to external payments imbalances. Both are harmful to the economy. Economic stabilisation policies aim to restore sustainability to the balance of payments, contain inflation, or both.

The concept of short-term stabilisation is appropriate where the effects of disturbances to the economy (whether endogenously or exogenously produced) can be corrected quickly and sustainably. However, the persistence of inflation and an external payments imbalance may reflect more fundamental structural distortions, often exacerbated by the particular vulnerability of developing countries to external shocks. In such cases more broadly-conceived programs of adjustment are needed to restore financial balance and to increase the economy's resilience to withstand adverse external conditions. The correction of persistent structural imbalances through longer-term adjustment policies may well include an initial stabilisation component. In this sense at least, stabilisation programs may be viewed as a special sub-set in adjustment programs.

Many developing countries, perceiving the need for far-reaching reforms during the 1980s, have especially emphasized adjustment with growth-orientation as a means of ensuring stable financial conditions. At the same time, there has been growing

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1. Resident Representative of the International Monetary Fund (IMF) in Sri Lanka (1988-1990). This paper was prepared for a seminar on stabilisation issues at the Institute of Policy Studies (IPS), Colombo, Sri Lanka, in December 1989. The views expressed are the author's, and do not necessarily reflect the views of the IMF or its staff. Comments by David Goldsbrough, Bahram Nowzad, Kunio Saito and Wanda Tseng of the IMF and C. Chanmugam and Howard Nicholas of the IPS are gratefully acknowledged.

recognition of the severe social costs of some aspects of adjustment, and increasing attention is being paid to alleviating the impact of adjustment on the poor.

This paper is intended to identify issues rather than to present a fully elaborated, formal framework. The emphasis is on policy in general terms, although some reference is made to the Sri Lankan experience. Subsequent sections are organized as follows: Section II is an overview of alternative perspectives on stabilisation and adjustment; Section III reflects on issues in the design and implementation of IMF-supported programs; Section IV briefly reviews the Sri Lankan experience with the adjustment process; and Section V suggests further issues germane to the study of instability, and its structural causes in Sri Lanka.

II. ALTERNATIVE PERSPECTIVES ON STABILISATION AND ADJUSTMENT

The objectives of stabilisation/adjustment policies are rarely in doubt: the promotion of conditions favourable to a high and stable rate of growth, which in turn requires a sustainable balance of payments, and an absence of inflationary pressure. However, prima facie, the policy prescriptions to achieve these objectives are far from uniform.

It is convenient, if a little simplistic, to portray alternative models of stabilisation along a spectrum as done by Killick and Sutton (1982). At one end is the "conventional" approach, addressing a short-term problem (e.g. a severe payments deficit) through exchange rate adjustments, and traditional demand management techniques -- fiscal and monetary policy. Further along the spectrum would be the "new orthodox" approach, supplementing short-term stabilisation with trade and financial reforms -- usually market-oriented -- designed to prevent recurring inflationary pressure or external imbalances. The "structuralist/populist" school largely eschews demand management techniques in favour of achieving stability through the removal of supply bottlenecks. At the heart of the latter argument is a distrust in the ability of the market mechanism to deliver quick responses to demand management policies.

Subsequent sections suggest that the programs supported by the IMF are widely dispersed along the spectrum, in general they are much further along (in terms of structural content) than is commonly perceived. The means of realizing the goals of sustainable non-inflationary growth, will always consist of a blend of policies to equate demand and supply. While the emphasis will depend on the source of imbalance -- excess demand may call for an initial compression -- as adjustment proceeds it may be desirable to increase the supply-orientation of the program.

Adjustment policies at the "structuralist" end of the spectrum probably have little to offer in terms of achieving sustainable stabilisation gains. Price increases and foreign exchange outflows may be contained administratively, through controls, but often at the cost of a loss in efficiency, suppressed inflation, and the advent of parallel (and by

definition, free) markets outside the control of the authorities. Also, "structuralist" adjustment cannot address short-term stabilisation needs, such as a balance of payments crisis. Nevertheless, the school makes two major contributions: first, demonstrating the characteristics of many developing countries that may diminish the effectiveness of narrowly defined stabilisation techniques; and second, emphasizing the need for fundamental reform in economic institutions.

A further dimension to the stabilisation/adjustment issue is the global origins of the shocks that have led to, or at least amplified, the need for adjustment in many countries. Where a surplus exists in one country or a group of countries it must, by definition, be offset by a deficit elsewhere. The power of developing countries as a group to shift their deficits to other, more resilient country groupings, is limited. Thus, it is appropriate to ask whether adjustment alone is adequate, or whether it should not be accompanied by sustained transfers of financial resources from the latter countries.

There may be dangers inherent in an atomistic approach to the design of adjustment programs across a large number of countries, that does not take adequate account of the global impact of those policies, or of the policies in stronger countries. Here the Fund can contribute through its broader role in multilateral surveillance aimed at preserving an orderly international system of payments (e.g. see Crockett and Goldstein, 1987).

This paper sidesteps the issue of how to determine the appropriate degree of trade-off between financing and adjustment. In the short-term, it is certainly true that the severity and pace of adjustment may be reduced by the availability of additional financing, probably on concessional terms. In the longer-term, financing carries its own costs, and is a viable option only if it is consistent with a balance of payments that is likely to be sustainable in the long-term -- including a manageable debt service burden and an adequate level of reserves -- and avoids creating excess domestic demand. Also, in the long-term, a recipient country must confront the risk of aid dependence at both micro and macro levels.

Given the global origin of some shocks, and the limited, perhaps increasingly limited real supply of concessional resources, it is easy to draw rather pessimistic conclusions about the consequences of adjustment - that adjustment inevitably leads to a highly restrictive policy stance. This is unnecessary. There is a wealth of evidence that outward-oriented policies have, in the long-term, evoked strong economic performance (e.g. see World Bank (1987)). If the adjustment program is to be comprehensive, it should tackle the structural impediments to an outward orientation in policies (trade, exchange and price restrictions, and the like).

III. REFLECTIONS ON FUND-SUPPORTED ADJUSTMENT PROGRAMS

The Fund's approach to the design and content of economic programs is eclectic. The basis of the approach lies in the Fund's global objectives of promoting an orderly international payments system, and of reducing the duration and severity of disequilibria in individual members' economies.[2] The financial resources that support adjustment programs are based on the fundamental principle of a revolving character, intended to enable the Fund to provide quick and effective assistance, and then to recover these resources for the use of other members. In this regard, the Fund plays a catalytic role in mobilizing resources from other sources such as official donors or banks.

Fund-supported adjustment programs generally are designed with the troika of objectives of promoting economic growth, balance of payments viability, and price stability. Stated thus, the objectives are not controversial, but the adoption of programs to realize these objectives by countries that face severe financial imbalances may lead to difficult considerations for governments because of the trade-offs among the three objectives.

III. 1 Changing Perspectives

The original concept of short-lived balance of payments assistance has undergone fundamental reappraisal during the 1970s and 1980s. Many economies have faced protracted stagnation or decline associated with structural distortions, inadequate domestic financial policies, highly concentrated economies, secular decline in the terms of trade, and the emergence of acute debt problems. Domestic problems have been exacerbated by structural shifts in the global economy -- the advent of a floating exchange rate regime, high real interest rates, and slow growth in the dominant markets for traditional developing country exports. Governments and multilateral institutions alike, have recognized that a succession of single-year stabilisation programs is no substitute for a medium-term adjustment program that acknowledges the fundamental nature of the imbalances, as well as the time needed to implement structural change.

Such considerations led the Fund to introduce the Extended Fund Facility (EFF) in the 1970s. Recently, following a period in which it had been little used, the Fund renovated the facility to make it particularly suitable for the middle-income countries. Even where EFF arrangements have not been adopted, traditional stand-by arrangements have come to show a more pronounced structural content.

For low-income countries, such as Sri Lanka, the structural problems are perhaps even more deep-seated, requiring longer periods for policy implementation and realization of results. To this end, the Fund established the highly concessional Structural Adjustment

2. Article I of the Fund's Articles of Agreement (amended effective April 1978) contains a concise statement of the objectives of the Fund.

Facility (SAF) in 1986. A further strengthening of the assistance available came with the subsequent establishment, in 1987, of the Enhanced Structural Adjustment Facility (ESAF), a response to the pressing needs of many low-income countries that faced exceptional difficulties.

In addition, the Fund has established another new facility, the Compensatory and Contingency Financing Facility (CCFF), that recognizes two important structural issues. The first is that there continues to be a legitimate case for the occasional use of compensatory financing, where a temporary export shortfall (or abnormal cereal import requirement) has arisen. However, repeated recourse to such a facility may point to the existence of a severe structural imbalance, e.g. in the form of excessive export concentration. Thus, large and protracted use of the compensatory element of the CCFF is associated with somewhat higher conditionality. The second feature of the CCFF is contingency financing to help countries maintain the momentum of adjustment, when adverse external shocks (such as changes in export or import prices or world interest rates) occur during the implementation of a Fund-supported program.

The World Bank's recognition that a microeconomic or sectoral approach to development should be cast in an appropriate macroeconomic framework has led to an increasing proportion of its operations taking the form of structural or policy-based lending. This, in turn, has led to increased overlapping in the concerns of the Bank and the Fund, reflected in the formal collaboration, between the two organizations, in assisting governments to prepare the Policy Framework Papers (PFPs)[3] that underpin SAF/ESAF arrangements.

III.2 The Macro-Economic Framework

The analytical framework underlying a strictly "conventional" stabilisation program assumes implicitly that productive capacity is fixed in the short term. Since it may not be fully utilized, output and income can change within limits determined by existing productive capacity. The longer term consideration, central to adjustment programs, is how to increase capacity or potential output. It is perhaps this issue, above any other, that determines the distinction between stabilisation and adjustment programs.

The stabilisation aspect of programs may be viewed by considering three economic identities, presented here verbally:[4]

(i) the external current account deficit is equal to the domestic resource balance (the difference between domestic production and the domestic absorption or use of resources);

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3. Governments of low income countries intending to apply for use of SAF or ESAF resources, prepare these papers in collaboration with the staffs of the World Bank and the IMF.
4. Those whose predilection is for algebraic presentation will find this in International Monetary Fund (1987).

(ii) the change in international reserves is equal to the current account deficit plus net foreign capital flows;

(iii) by combining (i) and (ii), the change in net reserves is equal to the domestic resource balance plus net foreign capital flows.

The third identity illustrates the rationale for focusing on external reserves as a target in Fund-supported programs. It contains the two key variables in program design: (i) the impact of policies on the domestic resource balance, and (ii) the availability of foreign financing. The domestic resource balance may be improved by policies designed either to promote output or to contain absorption. Generally, it is easier to design policies, and achieve quick results for the latter target (given the necessary political will); for this reason stabilisation programs have often concentrated on demand management.

It is useful to draw a distinction between expenditure-reducing and expenditure-switching measures. When a country needs to effect a sharp reduction in the external current account deficit, expenditure-reducing policies designed to affect absorption will have the most immediate effect. Often the source of excessive demand is the public sector, and this leads to measures to contain expenditure or increase revenue. Demand may also be contained through monetary policy, for instance, by restricting the volume of credit extended to the private sector. While the current account deficit may be reduced by demand management, realizing and maintaining a specific target calls for an additional policy instrument to restructure expenditure patterns between tradables and non-tradables (expenditure-switching). The most obvious candidate is the exchange rate, and many, though by no means all, Fund-supported programs contain a devaluation as a means of creating export incentives and reducing import demand.[5]

Raising output during the period of an adjustment program, even within existing capacity, can be difficult; raising potential output is more difficult still. The immediate distributional consequences of expenditure-switching may make governments reluctant to pursue them, with deleterious consequences for growth in the medium term. An example, is the immediacy of the impact on prices or real incomes of devaluation or subsidy elimination, contrasted with the much longer time period for the positive supply response to materialize. Even when the need to adjust is accepted, such considerations often lead governments to favour measures that reduce expenditure -- perhaps investment rather than consumption -- with evident adverse consequences for long-term growth prospects.

III.3 The Choice Of Instruments And The Pace Of Adjustment

The choice of policy instruments has to be tailored to the needs and circumstances of individual economies. There is no standard "Fund package", and it is here that the Fund

5. Devaluation can have other consequences: e.g. expenditure-reduction, and the reversal of capital flight.

becomes most eclectic in its approach. The choice is significantly determined by the level of development of specific economic institutions, the financial system, and the economy. The "menu" of options may well be similar, in a broad sense, in many countries. Policy options relate to the financial sectors (fiscal, monetary and external policies) and the establishment of appropriate incentives. In more far-reaching programs, institutions may themselves be restructured. Fiscal reform, price and trade liberalization, and exchange reform are examples.

Existing structures can influence the emphasis given to the various macroeconomic tools. For instance, monetary policy is limited where the financial system is rudimentary (open market operations may not be possible where there are only a few banks); exchange rate policy is not an available option in currency unions; the impact of fiscal policy in demand management is weakened where there is extensive control over prices, or over exchange and trade systems. Fiscal policy may also be constrained where inadequate information is available on the financial performance of public enterprises, which often impose heavy demands on government budgets and domestic credit. The analysis of such limitations to macroeconomic policy may indicate where structural reforms are most urgently needed.

In some cases it may be appropriate to create or strengthen markets; for instance, to assist in the implementation of a monetary or exchange rate policy. In Sri Lanka, the Treasury Bill auction has become a more significant institution, suggesting that most menu options are available, given that financial markets exist, no matter how imperfect they may be.

There is no unique answer for the pace at which adjustment should proceed. In practice, much of the debate, between the Fund and governments requesting support for adjustment programs, concerns the speed with which measures are to be implemented, rather than the objectives or content of the program itself. One argument often adduced, in favour of gradual implementation of stabilisation policies, is that supply-oriented policies generally have longer implementation lags than demand-management measures. Stimulating production through improved incentives -- for instance, through trade and price liberalization -- and reducing inflationary expectations, can be protracted.

A large part of the answer lies in the state of the economy when adjustment starts. Countries often acknowledge the existence of a problem, but postpone action, perhaps due to the perceived political and social costs of adjustment. In extreme cases, de facto but disorderly adjustment may occur, in the form of reserve depletion (and accumulation of external arrears), rising inflation, and economic contraction. If corrective measures are then adopted at such a late stage, there may be little alternative to the adoption of shock tactics, focusing on demand management, often with initially adverse social and political consequences. Adjustment is costly; but the absence of appropriate adjustment may be even more so.

A further consideration in determining the pace of adjustment is the availability of external financing. If a large and steady flow of additional external financing (on manageable terms) is expected, then adjustment can be phased over a longer period. In the international community there has been a recent trend to encourage policy-based aid flows. Thus, while official development assistance may be growing only slowly, there has been a significant increase in support for countries undertaking structural reform.

III.4 Issues In The Design Of Fund-Supported Programs[6]

The analytic framework (theory is too strong a word) associated with Fund-supported programs is often referred to as the monetary approach to the balance of payments. Its practical manifestation is the financial programming framework, originating with Polak (1957). The approach assumes that the money supply in an open economy is an endogenous variable, affected by the external balance of payments. Thus, it is possible to derive a relationship between the domestic component of money supply (credit) and its international component (foreign reserves), which is the seed from which the program grows. In practice, the implications of policy changes for prices and output are examined in far more detail than this over-simplified description might suggest.

III.4.1 Monetary Policy

The basic financial programming framework must be enhanced by more detailed considerations, including (i) the transmission mechanism; (ii) possible shortcomings to the framework in the short term; and (iii) a determination on a case-by-case basis of the most suitable policy instrument.

The model postulates imports as a function of nominal income in an open economy with fixed exchange rates. Any increase in domestic credit (e.g. by the public sector) would lead to higher monetary growth, and hence to a loss of reserves. With a flexible exchange rate, the higher monetary growth resulting from increased credit, might lead to a depreciated exchange rate, and a corresponding rise in the domestic price level. Even under a fixed rate regime, the domestic price level will rise to the extent that higher monetary growth will affect the prices of tradables. The consequence is that excess demand (credit expansion) may have one of two effects: a higher price level or a reserve loss. The degree to which either happens depends on the openness of the economy, and the degree of flexibility in the exchange rate.

In the very short term, the response to changes in the nominal money supply may not be instantaneous. An increase in the stock of money may result in an initial rise in real

6. The conceptual framework underlying Fund-supported programs is presented comprehensively in IMF (1987). This section selects certain issues from that study relating to the specification of monetary and fiscal policies, and the introduction of a growth-oriented approach into the design of adjustment programs. Khan and Montiel (1989) have elaborated further a conceptual framework for growth-oriented adjustment programs.

money balances, followed by a gradual decline in excess cash balances over a period of months. In such circumstances, the direct link, between changes in domestic credit and movements in external reserves, may not be evident.

A further issue is whether domestic credit is the only monetary aggregate amenable to control or whether it is possible, and more appropriate, to attempt to control the money supply, specifically reserve money. Targets for reserve money might be more appropriate with:

- a flexible exchange rate regime;
- domestic goods prices closely linked to world prices;
- strong linkages between domestic and international financial markets;
- the widespread presence of nonbank sources of finance that would render ineffective ceilings on bank credit; and
- the existence of financial instruments that would enable the monetary authorities to mop up excess liquidity easily.

In all probability, however, the state of development of financial markets in most developing countries precludes the conduct of monetary policy through the control of reserve money alone. Nevertheless, movements in reserve money provide immediate warning signals of untoward monetary developments, and can trigger action by the authorities on variables that they can influence, such as the financing of the public sector.

III.4.2 Fiscal Policy

The public sector (or central government) deficit is commonly used as a means of assessing the impact of fiscal policy on aggregate demand. Nevertheless, the deficit on its own is an imperfect indicator. First, the composition of the deficit is important, in the sense that the various sources of revenue and expenditure have different consequences for aggregate domestic demand. On the expenditure side, spending on goods and services (including wages and investment goods) has a different impact from transfers and interest payments, in the sense that the latter do not have a direct impact on aggregate domestic absorption, although they may have an impact on private disposable income and private consumption. Furthermore, public expenditure on non-tradable goods and services raises aggregate demand for domestic goods; expenditure on imports or on tradable goods may not affect aggregate demand, but does have a negative effect on the external trade balance.

Second, the means of financing the deficit is critical; domestic financing of a large deficit can create severe inflationary pressures, especially if the financing is from the banking system (the more so from the central bank), and can, in any case, result in a misallocation of resources between the private and public sectors. Even if the deficit is largely foreign financed (and on concessional or grant terms), questions of inter-

temporal resource allocation arise. A well-designed adjustment program would contain a fiscal adjustment path that is sustainable over time, taking cognisance of the availability of financing and its terms.

A third consideration, also related to sustainability, is that investment in the current period creates a future requirement for current expenditure -- for example wages and consumption goods -- in addition to the debt service costs that may arise from financing. Moreover, the purpose of expenditure is important, and the idea that "all investment is good, all consumption bad" for development, can be misleading.[7]

III.4.3 Exchange Rate Policies

The exchange rate is an efficient tool for achieving both stabilisation -- through expenditure (i.e. import) reduction -- and adjustment -- through expenditure-switching in favour of tradable goods. Thus devaluation may be reflected, with certain qualifications, in a reduction in the overall public sector deficit and in an improved external current account. Exchange rate adjustments may well have negative distributional effects in the short term, through corrective shifts in prices or on output. However, in this regard, they are no different from the corrective price adjustments that may follow, for instance, from deficit reduction achieved by subsidy elimination.

In some countries the availability or impact of exchange rate management may be diminished by institutional considerations, an extreme case being a currency union where an exchange rate policy is not available as an option to individual national authorities. Some countries opt for relatively fixed rate regimes, hoping to contain pressure on domestic prices, prevent capital flight, encourage foreign investment and trade, and provide a stable counter to changing fiscal and monetary policies. Other countries have adopted a high degree of exchange rate flexibility, which in some cases has gone as far as permitting the currency to float; for developing countries, with their limited financial markets, this last option has often taken the form of an auction administered by the monetary authority.

It is easy to argue a case for the realignment of an overvalued currency, where it can be shown that the prevailing rate has deviated from a previous value judged according to some appropriate criterion. It is more difficult to determine the proportion of an adjustment that should be borne by the exchange rate, where it is not clear that the maladjustment can be attributed to exchange rate misalignment. A critical factor may be the current strength of, and prospects for the balance of payments, including the external reserves position.

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7. New limousines (investment) do little for development, but agricultural extension (largely consumption) may do a great deal. This issue is, in part, a problem created by classification according to prevailing definitions.

It is even more difficult to determine the appropriate level of the exchange rate, in the absence of a market mechanism. Problems arise in: (i) assessing the impact on external trade, capital flows, and worker remittances, etc.; (ii) quantifying the effects, if previously a large volume of transactions occurred in parallel markets; and (iii) determining the relative size of the impact, if the program contains other measures that evoke price and output effects such as a significant liberalization.

To overcome some of these difficulties, Fund-supported programs frequently make use of the real effective exchange rate index, to help gauge at least the extent to which the exchange rate has adjusted to take account of the inflation differential between the country in question and the rest of the world.[8] Nevertheless, this analytical technique cannot address the question of the equilibrium exchange rate, since it provides an assessment of changes in the rate from a reference date, without permitting a judgment as to the appropriateness of a given rate. For this purpose a full (general equilibrium) model may be warranted, but as a rough rule of thumb, it is often possible to identify a period, on a case-by-case basis, when the balance of payments was relatively strong, and to assume that the exchange rate was not inappropriate during that time.

III.4.4 Growth-Oriented Policies

There is considerable evidence that countries adopting outward-looking policies realize considerably higher rates of growth. Thus, adjustment programs have increasingly come to focus on growth-oriented policies, a principal characteristic of which is to improve the efficiency of resource allocation. Policies frequently concentrate on the removal of barriers within existing institutions, so as to foster an outward orientation.

A variety of measures occur in programs: the maintenance of a competitive exchange rate; the abolition of domestic price controls; reducing import protection (which favours import-substituting activity at the expense of export promotion); and removing other barriers such as tariffs, quotas, and the variety of trade and payments restrictions that attempt to control imports or foreign payments. Other measures designed to increase the efficiency of resource allocation might include: containing real wage increases; removing distortions in incentive systems created by a tax system that has evolved on an ad hoc basis over the years (while at the same time preserving the tax base); and addressing the problems of the composition of the Government sector described in section III.4.2 above.

The early attempts to incorporate growth-oriented policies in adjustment programs have outrun the availability of a generally accepted formal framework that combines the growth and stabilisation objectives. Some of the obstacles that are confronted[9] include:

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8. The usual practice is to take a weighted basket of the country's external trading partners and competitors.
9. See International Monetary Fund (1987).

(i) that the basic financial programming framework formally treats economic growth as exogenously determined; (ii) that discussions of growth often fail to make an important distinction among three different sources of growth -- from more efficient use of existing capacity, from increased utilization of existing capacity (perhaps from a temporary surge in aggregate demand), and from a growth in capacity itself; and (iii) that early attempts to synthesize the Bank and Fund models have not spelled out the relationship between aggregate demand and the growth of capacity.

Recent work by Khan and Montiel (1989) has attempted to combine growth, inflation, and the balance of payments in a model that is capable of linking adjustment objectives to various policies as well as assessing the effects of changes in external financing on real and monetary aggregates. Khan and Montiel concede many areas in the model which could be extended: (i) behavioural relationships are specified in a very rudimentary fashion (e.g. the determination of interest rates is not specified); (ii) no allowance is made for lags and dynamics, it being a one-period model; (iii) growth is determined only by supply factors, with the economy being assumed to operate continually at full capacity. This last is a serious shortcoming, in that most countries which approach an adjustment program, probably do so from a position of severe capacity under-utilization.

III.5 Implications Of Adjustment For Poverty

The social implications of adjustment programs -- particularly the impact on poverty -- have received increasing attention in recent years. Fund-supported programs have been criticized for attempting too large and too rapid a compression of aggregate demand, without paying sufficient attention to the supply and welfare implications of the adjustment process. Some critics have suggested a more activist role for adjustment programs: for instance, taking more explicit cognisance of the specific institutional factors in each case, or using the adjustment process as a means of alleviating the adverse social effects of external shocks. These are immensely complex issues, but it is important that they should be confronted in the preparation of adjustment programs, especially where the imbalances are large, and the reform process long.

A study by Fund staff members[10] contains an empirical review of the experience in a number of countries that undertook adjustment programs in the early 1980s. The results, not surprisingly for such a complex area, are not clear-cut. Adjustment programs often did have undesirable distributional consequences, but stabilisation may also have had a positive effect on the long-term interests of the poor. The counter-factual case is also illuminating. In the absence of orderly adjustment, adverse distributional effects may occur for a number of reasons: (i) more wealthy income groups are better able to protect themselves against the explicit and implicit taxes that

10. Heller, Bovenberg, Catsambas, Chu, and Shome (1988). The countries covered in the study were Chile, the Dominican Republic, Ghana, Kenya, the Philippines, Sri Lanka, and Thailand.

accompany maladjustment; (ii) the poor are most prone to unemployment, the loss of earnings and the erosion of human capital; (iii) the poor are particularly likely to be locked into the types of activities associated with maladjustment (e.g. the production of nontradables); and (iv) high prices in parallel markets are likely to hurt the poor more than other groups.

Some of the negative effects of adjustment programs included: short-term costs of devaluation where the poor were locked into the production of nontradables, or where land ownership was concentrated; reduced capital expenditure leading to unemployment and loss of income in the short term and a weakening of social services; erosion of rural infrastructure may have diminished some farmers' capacity to respond to price incentives; restrictive monetary policy diminished employment opportunities and earnings for urban groups.

On the positive side, a number of features were noted: that financial reform could increase the availability of credit for the poor, especially those in agriculture; devaluation could increase the real value of earnings for producers of tradables (often the rural poor); removing price controls improves resource allocation and reduces rents emanating from political privilege; and the shifting of the composition of expenditure in favour of programs that use the skills and labour of the poor. In cases where such gains are not strong enough to offset the negative effects, then specific compensatory measures may be needed.

Adjustment programs supported by the Fund have begun to pay increasing attention to these issues, as for instance in the Policy Framework Papers[11] associated with the Fund's SAF and ESAF which contain explicit analyses of the impact of adjustment on the poor. But there is much ground to cover before poverty alleviation becomes an integral part of Fund-supported programs. Indeed, the issue remains to be settled as to whether the Fund should play a leading role in this regard, or whether the task might be better handled by other specialized agencies.

III.6 Assessing The Effectiveness Of Fund-Supported Programs

A most legitimate question is "do Fund-supported programs work?" There have been various studies,[12] many of which have drawn conclusions that are at best agnostic, if not negative, as to the impact of Fund-supported programs on growth and inflation, as well as the balance of payments itself. However, as both Khan (1989) and Guitian (1981) have suggested, the design of the studies is critical. Each suggests various possible standards: (i) the positive (or before-and-after) approach; (ii) the normative (or actual-versus-target) approach; and (iii) the conjectural approach which compares

11. Governments of low income countries intending to apply for use of SAF or ESAF resources, prepare these in collaboration with the staffs of the World Bank and the IMF.
12. These have been reviewed by Khan (1989).

performance with a simulation of performance in the absence of a program.[13] To this Khan adds a fourth, the control-group approach, which compares performance in countries with Fund programs and a control group of nonprogram countries. Guitian's conjectural approach is the most appropriate, but empirically the most difficult to achieve; however, its relevance should be borne in mind when assessing the conclusions of studies using other approaches.

Khan's "modified" control group approach -- correcting for certain biases in the selection of comparator countries -- and Donovan's (1982) paper (largely a "before-and-after" approach), reach more positive conclusions. Khan found an improvement in the balance of payments, significant for periods longer than one year. Inflation was reduced, but not to a statistically significant extent. Growth rates tended to decline in the program year, but adverse effects were reduced in subsequent years. Also, it was found that negative effects on growth were less pronounced in the 1980s than the 1970s, perhaps because of the growing emphasis on growth-oriented programs in recent years. Donovan's earlier analysis of programs in the 1970s broadly confirms these results: significant reductions were realized in adjusting countries' external deficits, while inflation and growth (especially) were less affected.

Both studies mentioned here do not attempt to measure the degree of implementation of the adjustment program. If the tests had been restricted only to those countries that had successfully implemented adjustment programs, then the results might have been still more positive. It is also instructive to consider the results of applying a strictly conjectural approach to the conclusions on growth: what would have been the growth rate -- during the adjustment period and subsequently -- if the program had not been undertaken?

IV. THE SRI LANKAN EXPERIENCE

In moving toward sustainable high growth there may be two phases. First, the restoration of growth to permit the full utilization of existing capacity, and second, increasing the potential rate of growth by expanding capacity and removing distortions in the allocative system. Sri Lanka may have been an example of the former in the late 1970s, and the greater difficulty of raising potential output -- achieving the transition between the first and the second stages -- may have been one of the constraints on growth during the mid-1980s. The structural adjustment program adopted in early 1988 could be seen as a means of facilitating this transition, i.e. initiating a renewal of the liberalization started in the late 1970s. However, the events of the last two years have contributed to declining growth and capacity utilization, accompanied by intensifying

13. Khan's variant is a comparison-of-simulations approach that compares simulated performance with and without policy.

financial imbalances, suggesting that Sri Lanka may have slipped back into the first phase. The hope is that productive capacity itself has not declined.

The attached charts 1 - 10 provide a simple graphical impression of the major changes that took place following the adoption of adjustment measures in 1977.[14] The following summary captures a number of essential points of the post-1977 period:

IV.1 External Conditions

1. The terms of trade in the late 1970s were favourable (Chart 1), but they have generally weakened through the 1980s with the exception of the 1983/84 tea boom; however, compared with other non-oil developing countries, Sri Lanka has not fared badly.

2. Net official development assistance increased strongly in the late 1970s (Chart 2) -- an event that cannot be regarded as wholly exogenous, given the sharply higher investment, and the change to policies that would have been attractive to donors.

IV.2 Policy Stance

3. Investment doubled to over 30 percent of GDP, declining gradually during the 1980s (Chart 2).

4. There was a substantial realignment of the currency in real terms (Chart 3).

5. Fiscal policy became more expansionary, with the advent of overall deficits consistently higher than 10 percent of GDP (Chart 4).

6. There was rapid expansion of monetary and credit aggregates, largely reflecting the financing needs of the public sector (Charts 5 and 6).

IV.3 Economic Response

7. Economic growth rose significantly from about 3 percent during the early 1970s to an average of about 5 percent through 1985. (Chart 7).

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14. The data were drawn from published sources, notably the IMF's International Financial Statistics, and the Central Bank of Sri Lanka's Annual Report, Review of the Economy, and monthly Bulletin.
The definitions of selected variables are as follows:
Net official flows (Chart 2) - the sum of net official capital inflows plus official unrequited transfers;
Investment - gross fixed capital formation;
Real SDR - the nominal index of the SDR deflated by the consumer price index of the industrial countries;
The Government sectoral balance is the overall deficit/surplus of the Central Government; the private sector balance is derived residually; official reserves are measured as the gross reserves of the monetary authorities.

8. The private sector resource balance fluctuated both before and after 1977, with perhaps a small decline in post-1977, possibly reflecting higher investment (Chart 4).

9. Inflation, while fluctuating sharply, has not abated (Chart 8); indeed relative to the rest of the world the differential has increased (Chart 3).

10. The external current account has deteriorated considerably during the 1980s, except in 1984 (Chart 4).

11. Although imports surged in the late 1970s, subsequent growth has been modest (if erratic). Exports have increased at a faster percentage rate than imports, though not enough to close the trade deficit (Chart 9).

12. External reserves, after a sharp initial rise in the late 1970s, fell progressively (Chart 10).

The Fund's assistance throughout this period was not confined to the support of narrowly defined stabilisation programs; the emphasis was on the major structural imbalances that characterized the pre-1977 economy. Even an initial 12-month stand-by arrangement in 1977 was designed to support the first major steps in the liberalization process, which subsequently was to be supported by an extended arrangement. The structural program initiated in 1988 was intended to address some remaining imbalances notably in the large public sector (including enterprises), and to further steps to increase liberalization.

In summary, Sri Lanka implemented a major liberalization program in the late 1970s, unleashing an immediate demand, hitherto suppressed, for imports. Export performance was not unimpressive; indeed, since 1980, export volume grew at more than twice the rate of imports. However, it was not enough to prevent a pronounced worsening of the external current account. That could be sustained only by large capital inflows. Stated alternatively: although some adjustment was achieved in the last decade (i) demand management has not been adequately implemented to contain the demand released by liberalization; and (ii) the adjustment is still in progress, with further reform needed to consolidate the gains already made.

Chart 1. Terms of Trade, 1960-88

(1985 = 100)

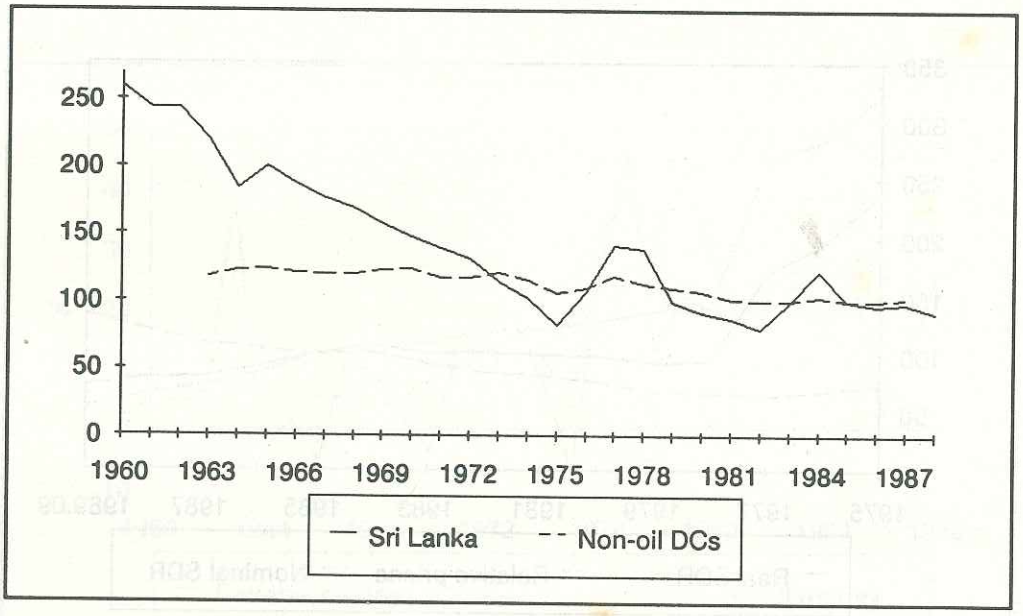


Chart 2. Investment & Financing 1960-88

(as percentages of GDP)

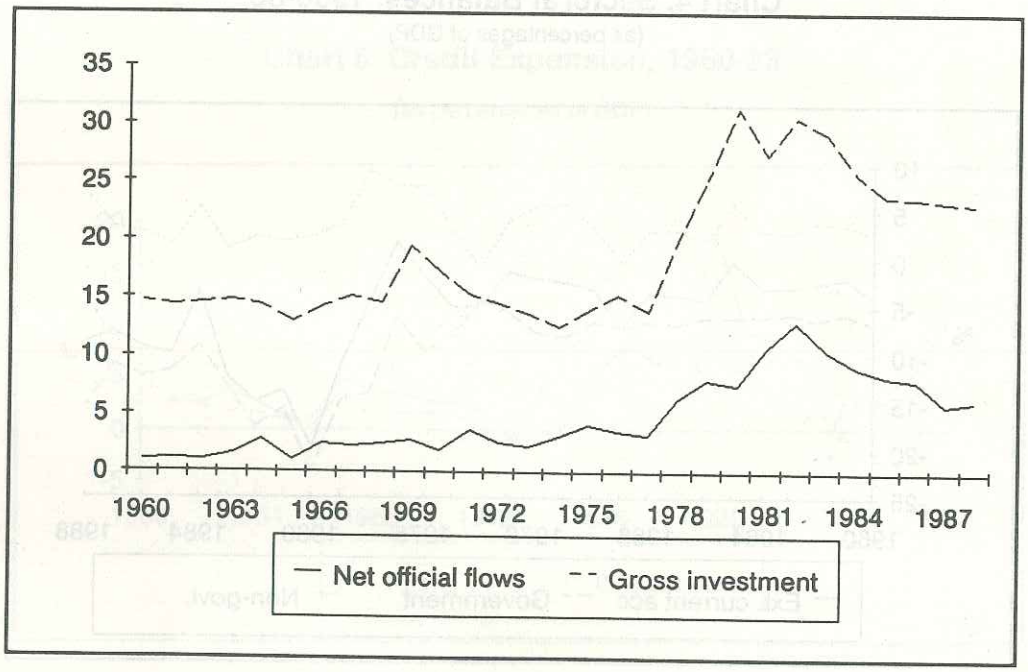


Chart 3. Exchange Rates, 1975-89

SL Rupees per SDR (1985 = 100)

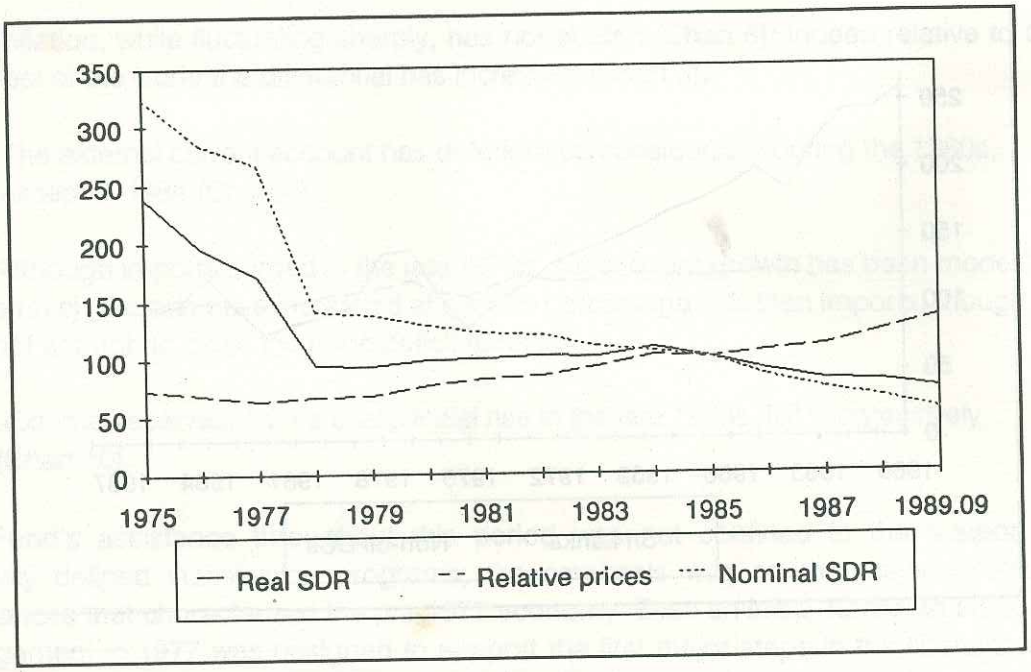


Chart 4. Sectoral Balances, 1960-88

(as percentages of GDP)

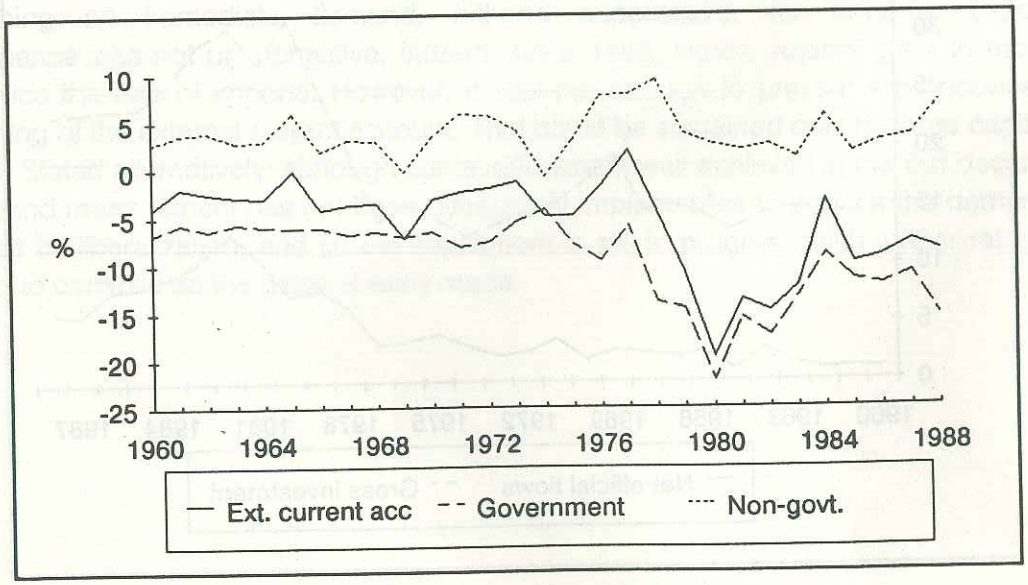


Chart 5. Monetary Growth, 1960-88

(as percentages)

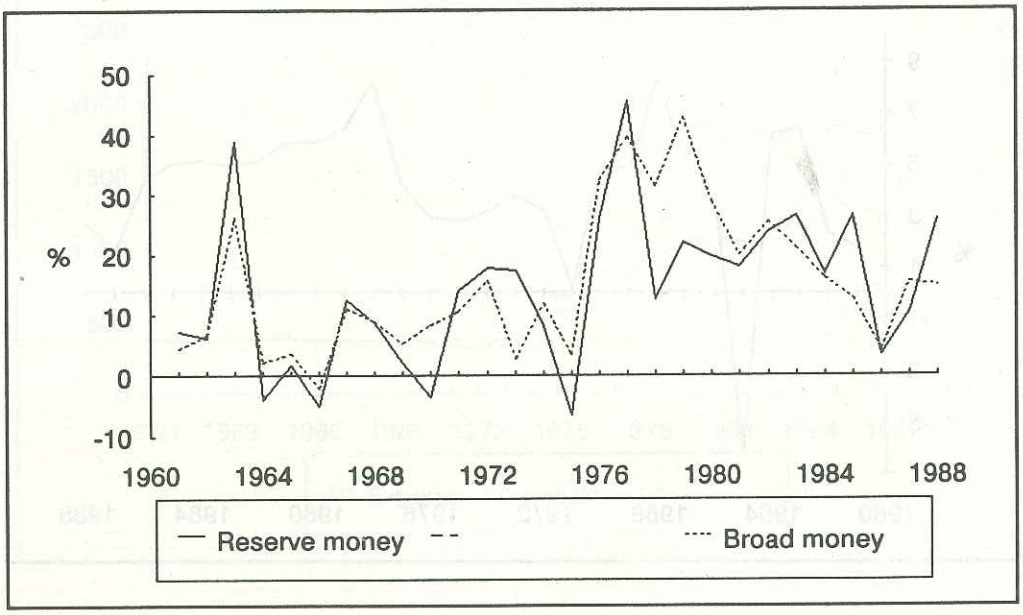


Chart 6. Credit Expansion, 1960-88

(as percentages of GDP)

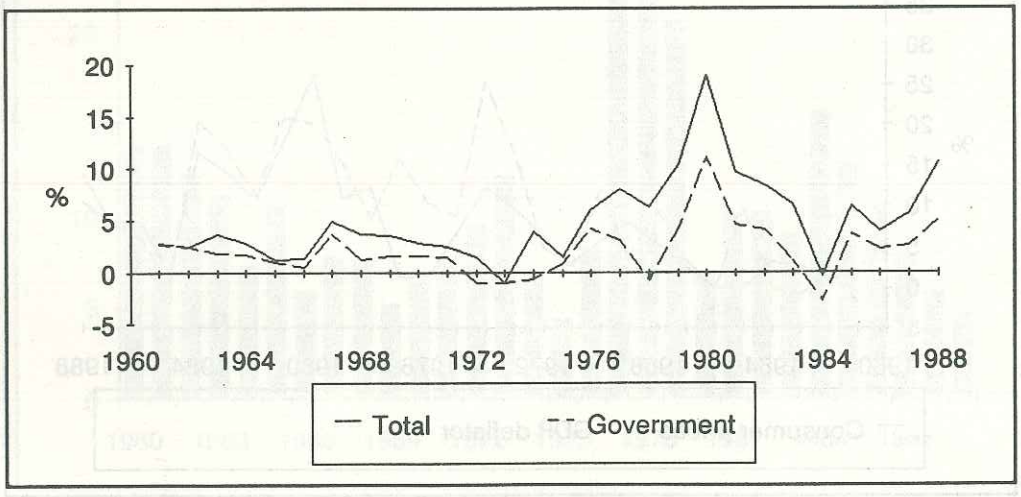


Chart 7. Growth of GDP, 1960-88

(in percentages)

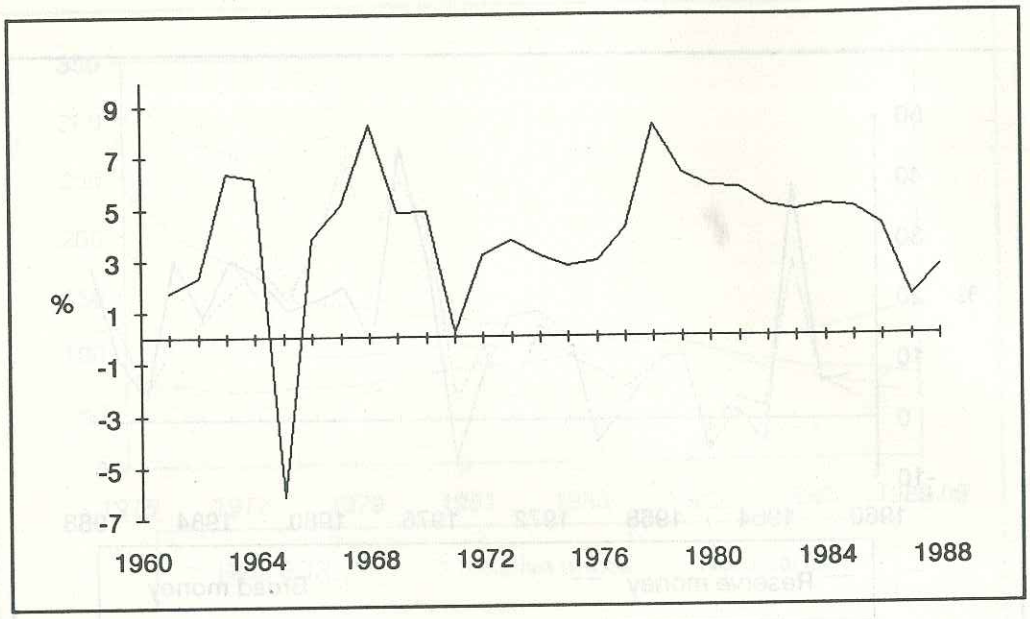


Chart 8. Inflation, 1960-88

(in percentages)

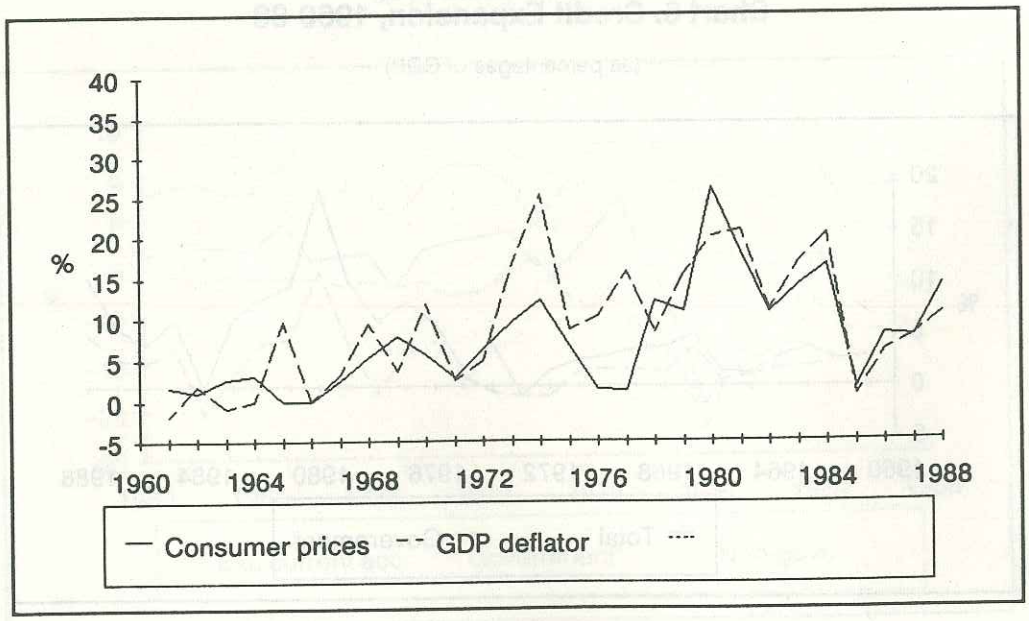


Chart 9. External Trade, 1960-88

(in billions of US dollars)

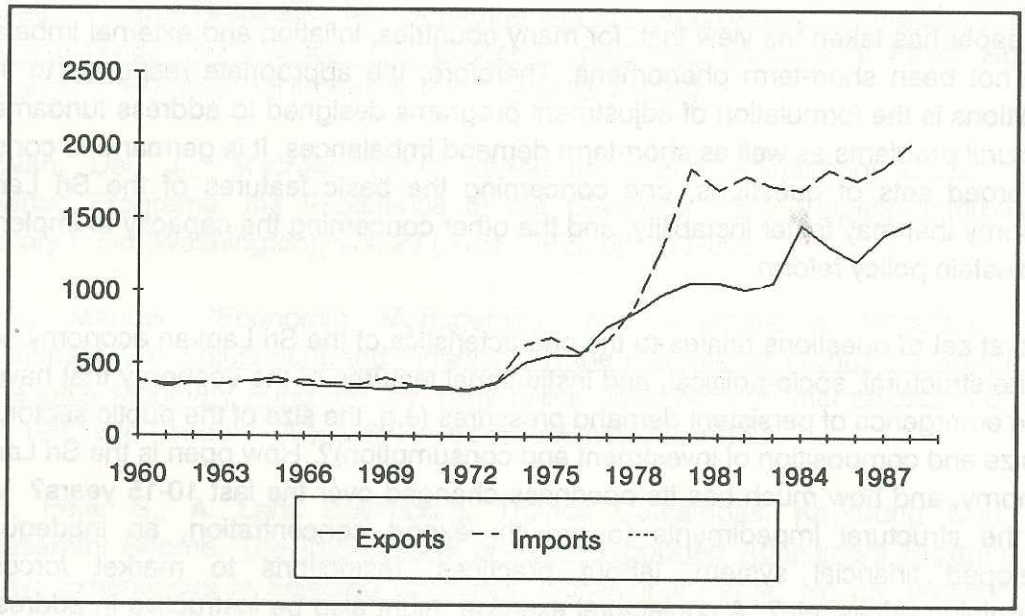
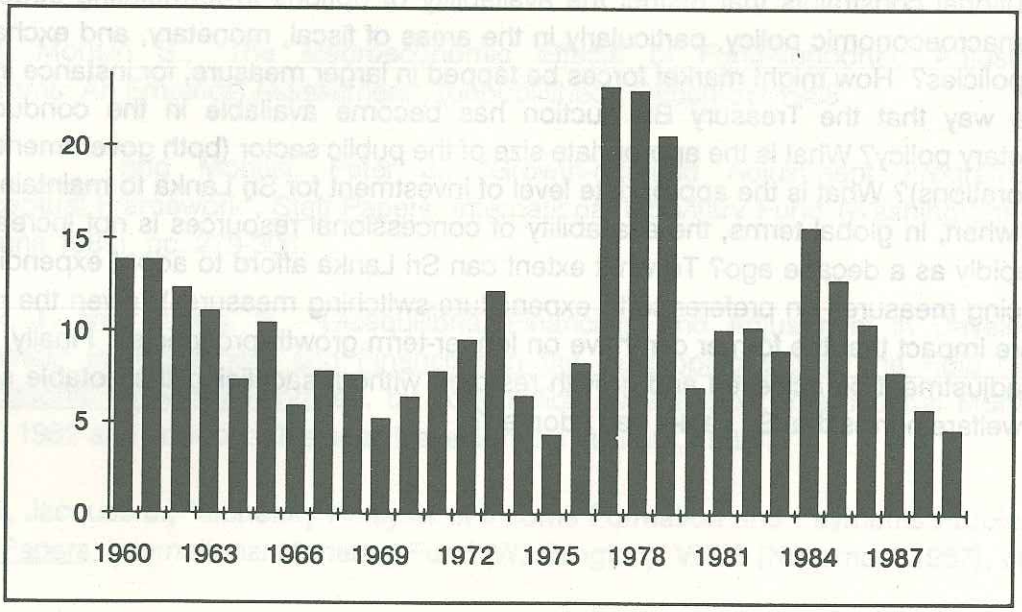


Chart 10. Official Reserves, 1960-89

(in weeks of imports)



V. CONCLUDING THOUGHTS

This paper has taken the view that, for many countries, inflation and external imbalance have not been short-term phenomena. Therefore, the appropriate response to these conditions is the formulation of adjustment programs designed to address fundamental structural problems as well as short-term demand imbalances. It is germane to consider two broad sets of questions, one concerning the basic features of the Sri Lankan economy that may foster instability, and the other concerning the capacity to implement and sustain policy reform.

The first set of questions relates to the characteristics of the Sri Lankan economy. What are the structural, socio-political, and institutional features of the economy that have led to the emergence of persistent demand pressures (e.g. the size of the public sector, and the size and composition of investment and consumption)? How open is the Sri Lankan economy, and how much has its openness changed over the last 10-15 years? What are the structural impediments to growth: export concentration, an inadequately developed financial system, labour practices, restrictions to market forces in determining prices, etc? A conjectural exercise might also be instructive in addressing the question of where Sri Lanka would have been in two contrasting scenarios: one in which the policies of the 1970s were continued, and the other in which a much higher degree of outward-orientation in economic policy formulation had been permitted.

A second set of questions relates to the capacity for policy implementation. Are there institutional constraints that restrict the availability of options in formulating structural and macroeconomic policy, particularly in the areas of fiscal, monetary, and exchange rate policies? How might market forces be tapped in larger measure, for instance in the same way that the Treasury Bill auction has become available in the conduct of monetary policy? What is the appropriate size of the public sector (both government and corporations)? What is the appropriate level of investment for Sri Lanka to maintain at a time when, in global terms, the availability of concessional resources is not increasing as rapidly as a decade ago? To what extent can Sri Lanka afford to adopt expenditure-reducing measures (in preference to expenditure-switching measures), given the more severe impact that the former can have on longer-term growth prospects? Finally, how can adjustment be achieved and growth restored without sacrificing the notable social and welfare norms that Sri Lanka has adopted?

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