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# Conditionality and the Needs of Developing Countries

by Graham Bird, Guildford\*

**The principal cause of the balance of payments deficits of the non-oil developing countries has altered since 1973: exogenous factors now play a far more important role than previously. The appropriateness of the conditions conventionally attached to IMF drawings needs to be re-examined in this light.**

The purpose of the IMF as stipulated in its Articles of Agreement is to provide member countries with temporary balance of payments support. The Fund's lending activities are therefore always likely to reflect the distribution of payments imbalances throughout the world economy. Given the overall weak balance of payments position of the non-oil developing countries (NOLDCs) since the initial increase in oil prices in 1973/74 – a position exacerbated by the second major hike in oil prices in 1979 – it is not surprising that relations between the Fund and its NOLDC members have come under close scrutiny over recent years. Such scrutiny has concentrated on two issues: first, the size of the resources made available to developing countries particularly in relation to the size of the deficits which they are encountering; and second, the nature and appropriateness of the conditions that are attached to certain classes of Fund finance.

Although the focus of this article is on the second of these issues it should be recognised that the two issues are closely inter-related. For instance a view amongst developing countries that IMF conditionality is inappropriate to their problems may deter them from turning to the Fund; again, an increase in their need for finance as reflected by a deterioration in their balance of payments may force them to borrow more from the Fund in the upper credit tranches or through the Extended Facility where stricter and more rigorous conditionality applies. This will be more so the case if the size of Fund quotas, which in turn is the main factor determining the size of the Fund's lending capacity, is not maintained in real terms.

The basic principle of Fund conditionality has not been challenged since it was introduced in the early 1950s largely, it seems, at the insistence of the United States, the Fund's major creditor. Initially conditionality was viewed as a necessary means of ensuring the temporary and revolving use of the Fund's resources, or, in other words, of ensuring that loans made by the Fund would be repaid relatively swiftly. Through time, however, the rationale for conditionality has come to incorporate another aspect, namely that the Fund should endeavour to guard against the possibility that its resources will be used to support measures which actually have the effect of making the borrower's underlying balance of payments position worse; or, putting it more positively, that the Fund should by some means encourage its resources to be used in ways that may be expected to strengthen the borrower's balance of payments. Thus the provision of finance by the Fund became connected with domestic adjustment via conditionality. The encouragement given to domestic adjustment is in turn seen as being an important component of the Fund's role in bringing about international adjustment<sup>1</sup>.

A central question to which this leads is the precise manner by which balance of payments correction is encouraged and the policies that are thereby implied and supported. Broadly speaking a balance of payments deficit reflects an excess of aggregate demand over aggregate supply. It follows that there are basically two approaches to correcting a deficit. The first is to reduce demand and the second is to raise supply.

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<sup>1</sup> Though it may be noted in passing that the Fund cannot put equivalent pressure on surplus countries to adjust.

**Table 1**  
**Performance Criteria in Upper-Tranche**  
**Standby Arrangements<sup>1,2</sup>**

|   | Number of observations <sup>3</sup> |         |         |
|---|-------------------------------------|---------|---------|
|   | 1964-69                             | 1970-73 | 1974-79 |
| 1. Credit ceilings:                             |                                     |         |         |
| (a) total domestic credit                       | 3                                   | 10      | 9       |
| (b) credit to government/public sector          | 7                                   | 5       | 7       |
| (c) credit to private sector                    | 5                                   | —       | 1       |
| 2. Devaluation                                  | 3                                   | —       | —       |
| 3. Reduction in current payments arrears        | —                                   | 1       | —       |
| 4. Minimum levels for foreign exchange reserves | 1                                   | 1       | 4       |
| 5. Restrictions on new external debt            | 3                                   | 7       | 5       |

Source: IMF.

<sup>1</sup>This table is based on a questionnaire kindly completed by the IMF for a project at the Overseas Development Institute, London, entitled *The IMF and Economic Management in Developing Countries*. While maintaining confidentiality the IMF was asked to select a representative sample of NOLDCs receiving upper-tranche standbys, excluding cases where the credit was cancelled or suspended.

<sup>2</sup>In addition to the criteria listed there are standard provisions that borrowing countries will not introduce new multiple-currency practices; bilateral payments agreements with Fund members; restrictions on current payments and on imports.

<sup>3</sup>For each entry the maximum number of observations is 10.

There can be little doubt that the second of these is the more attractive since no loss of real income or employment is involved. Unfortunately it also tends to be an alternative which only applies in the long term. Faced with the task of inducing an improvement in the balance of payments in the short term the Fund has therefore not surprisingly concentrated on demand side adjustment, taking solace in the view that over-expansionary demand policies have been by far the most frequent proximate cause of balance of payments difficulties (see below).

Although a standby agreement with the Fund involves preconditions about which it is difficult to get precise information since they are only rarely included in the "letter of intent", as well as what are often numerous policy measures affecting for instance relative prices, including taxes, subsidies, wages and interest rates, these being written into the "letter of intent", the hard core of IMF conditionality are the so-called "performance criteria". These have been defined by the Fund as "aspects of a member's policies formulated in the letter of intent in quantified and other objective terms, that are of crucial importance for the success of the programme, so that if any of them is not observed there is a signal that the member . . . should consult on any necessary adaptation of the programme before the member resumes purchases . . .". Other crucial features of "performance criteria" are that they should be susceptible to short-run adjustment, should reflect changes in overall economic performance and should

be within the control of the domestic authorities. Table 1 gives an indication of the variables normally selected as "performance criteria", and from this table the key significance of domestic credit creation strongly emerges<sup>2</sup>.

### Heavy Reliance on Credit Control

There are many reasons why the Fund has allocated a crucial role to the control of domestic credit creation. First, it is consistent with the monetary approach to the balance of payments with which, in some ways inaccurately, the Fund is often associated. Second, given the data base in many developing countries it is felt that credit is one of the few variables which may be monitored and controlled reasonably accurately. Third, by choosing an aggregate macroeconomic variable such as credit the precise policy measures by which the target is achieved are left to the discretion of the individual borrowing country, and the Fund thereby attempts to minimise its involvement in the domestic policy debate, which it feels would draw it too far into the political arena.

In fact, each of these reasons may be challenged. Empirical evidence lends far from clear support to the monetary theory of the balance of payments and in any case there is a significant amount of evidence which suggests that the conditions necessary for a monetary approach to operate do not attain in many developing countries. Furthermore monetary aggregates are actually rather difficult both to measure and to control. Also the ramifications of strict credit control cannot fail to mean that the Fund's policy will be seen as having political implications especially where the government's access to credit from the banking system is singled out for control.

Thus even though few would deny that the regulation of demand is a vital aspect of any stabilization package, the question arises as to whether credit control should have been given such a very high degree of significance relative to other factors. To rely too heavily on credit controls as an instrument of demand management may simply serve to raise the cost in terms of lost output and unemployment of achieving the necessary adjustment in the balance of payments.

Starting with the premise that adjustment costs will tend to be minimised if policy acts directly on the causes

<sup>2</sup> It would be a mistake to interpret this table as implying that performance criteria give no scope for flexibility. The range of potential credit measures, for instance, combined with the wide range of other policies that may be supported in the letter of intent, combined further with the use of waivers or modifications in about a third of Fund programmes gives the IMF considerable scope for exerting some degree of flexibility, though equally this scope is far from open-ended.

of the payments problem it is useful to examine what factors have caused the balance of payments deficits that have been observed in NOLDCs during the 1970s and into the 1980s.

### **Altered Causes of Payments Deficits**

There is evidence to support the view that the principal cause of payments deficits in developing countries may have altered since 1973. While endogenous demand policies that are over-expansionary in relation to available supply may still be an important factor, changes in exogenous variables, such as import prices and export volume, do seem to have assumed a much greater relative significance. The Fund itself has recognised the growing and frequently primary importance of exogenous factors in explaining the balance of payments deficits of developing countries.

As the Fund maintains, however, it must also be recognised that the exogeneity of causation in no way implies that adjustment is not needed. The appropriate criterion for deciding this is the degree of permanency of the deficit. Where a deficit is only temporary adjustment may be avoided and financing used instead. But where financing is inadequate in relation to the likely duration and size of the deficit adjustment will be required. The relevance of the causation of the deficit is instead in determining the most appropriate, or least cost, type of adjustment strategy. Thus while measures directed towards restraining or reducing aggregate demand may usually be expected to have a pay-off in terms of an improvement in the balance of payments they may bring about that improvement at a higher cost than would other measures.

Where deficits reflect a country's structure of production and trade, the appropriate adjustment strategy should work on these factors. In general developing countries need to raise output and to switch production into those export goods with relatively high price and income elasticities of demand and into import substitutes. The specific strategy for any particular developing country will depend on its own structure of costs. Adjustment strategies of this kind set out to change both the composition of demand as well as the composition and level of supply; in fact they are usually classified as representing a "supply side" approach.

In contrast to the more conventional aggregate "demand side" approach normally associated with the Fund, the supply side approach to adjustment has the fundamental implication that it requires a larger quantity of finance available over a longer period of time. It also

follows that exclusive reliance on demand based "performance criteria" as a means of encouraging and monitoring the success of the programme is misplaced. Again, this is not to argue that the demand side should be ignored, indeed policies resulting in excess demand will tend to disrupt a supply side programme, but that there should be balance between demand and supply side variables, and that demand policies may be required to play only a supportive role.

### **Recent Changes in Conditionality**

A case may be made that the Fund has in many ways been quick to respond to changed world economic circumstances. It has recognised that the deficits of developing countries are largely a global phenomenon reflecting the distribution of surpluses and deficits elsewhere in the world economy which cannot be explained in purely country-specific terms. It has liberalised and expanded access to its existing facilities, has introduced the extended facility for the specific stated purpose of assisting the correction of structural problems, and has extended the length of time over which countries may draw resources from it. The Fund has also undertaken a review of conditionality which appeared to suggest that a slightly more relaxed approach would be adopted with more attention being paid to domestic social objectives.

In practice the overall share of the combined NOLDC deficit covered by Fund finance remains small, access to the extended facility has remained firmly based on acceptance of demand side "performance criteria", with little relative move towards structural indicators, and although conditionality did seem to be relaxed between 1979 and early 1981, with programmes being accepted by the Fund which would not have previously been accepted, this seems to have been a temporary phenomenon and the trend now seems to be back towards tightening up on conditionality. Not that this is necessarily a bad thing. Since, as shown above, the strictness of conditionality is not the principal issue; rather it is the appropriateness of the conditions that is important. It is quite possible that a demand based programme which is less "strict" than previous programmes is at the same time less appropriate to the correction of a payments deficit than a stricter supply based programme. This distinction is aptly shown by the Fund's attitude towards devaluation, as reflected by some recent programmes. Towards the end of the 1970s there appeared to be a growing reluctance by the Fund to stipulate devaluation as a defined part of programmes. This could be interpreted as a relaxation in conditionality. But inasmuch as devaluation may

provide a way through which relative prices can be altered in favour of tradeables, then from a supply point of view such relaxation may well be seen as having been inappropriate.

### **Scope for Further Modification**

It is difficult to predict the way in which IMF conditionality will evolve over the next few years not least because there appears to be a measure of conflict within the Fund itself. The staff seem to be showing a growing awareness of the role of relative prices in both balance of payments adjustment and development. At the same time some Executive Directors seem to favour the more conventional form of demand side conditionality. The reasons for this preference reflect the belief first, that it is conditionality of this type that will maximise private banking flows to developing countries and second, that a move towards more reliance on the supply side will push the Fund too far in the direction of becoming a development rather than a monetary institution.

Although these are problems that have to be recognised, the arguments presented in this article do suggest that there is scope for modifying conditionality in such a way that the conditions laid down, and therefore the suggested cures, match more accurately the causes of the balance of payments deficit. Unavoidably this implies a movement away from exclusive reliance on a few aggregate macroeconomic variables, such as the rate of credit creation, as "performance criteria" and a move towards referring to a larger number of microeconomic variables. The case for some modification is strengthened by findings from a number of pieces of empirical research which at face value suggest that Fund programmes as currently operated do not realise their objectives. They do not appear to exert any significant beneficial effect on either economic growth or the rate of inflation, or even the balance of payments.

The change in emphasis towards a more microeconomic orientation has a number of implications both for the Fund and for developing countries. First, as noted above, the solutions to structural problems are almost by definition going to be relatively long-term and may show little pay-off in terms of the short-term balance of payments; the demand for Fund resources will therefore tend to rise and there is the question of how these resources will be provided. The most straightforward answer is to raise Fund quotas, which over recent years have fallen quite markedly in relation to the value of world trade. This would also have the likely effect of raising the proportion of drawings in the

low conditionality tranches and facilities, a proportion which has also fallen significantly during the late 1970s and early 1980s. Indeed there would appear to be some justification for purposefully restoring the relative significance of low conditionality access to Fund resources. This could be achieved by, for example, further extending the Fund's Compensatory Financing Facility which attempts to compensate countries for payments imbalances caused by exogenous factors.

One's view on the optimal distribution between low and high conditionality finance within the Fund will ultimately rest upon one's view as to whether individual countries or the IMF will come up with the best stabilization package, and, in turn, one's view on what is the best package will depend on the relative priority allotted to the balance of payments and development. Even this distinction, which has never been very easy to demarcate, has become particularly cloudy in circumstances where structural factors have become a principal explanation of balance of payments difficulties. The Fund cannot escape the fact that its programmes, although directed primarily at the balance of payments, do have implications for development, implications which should be formally taken into account.

Second, where the causes of deficits differ between countries, matching conditions to causes will increase the diversity of Fund conditionality and though this may raise the degree of flexibility that the Fund may exhibit it will also increase the likelihood that the Fund will be criticised for failing to provide uniform treatment for all countries that turn to it.

Third, as a result of exerting more influence over relative prices the Fund will inexorably be drawn into a rather more overt political role; though the suggestion that concentration on macroeconomic variables ensures the Fund a non-political image or enables the Fund to avoid decisions which have political repercussions is clearly untenable. Developing countries themselves will also have to realise that Fund influence over a larger number of economic variables is a price they have to pay in order to get a form of conditionality which is more appropriate to the nature of their structural problems. It is no use them making inconsistent demands on the Fund in terms of flexibility, uniformity, number of performance criteria, less reliance on credit creation, and so on.

Fourth, there is the problem of translating a supply side approach into variables which may be used to monitor performance. The experience of the World Bank with its structural adjustment loans suggests, however, that this problem is not unsolvable. And in

isolated and rare cases the IMF itself has shown the ability to get away from what might be regarded as their conventional stabilization package, towards giving more emphasis to supply side variables. In any case there does seem to be an argument for reducing the degree of quantitative precision involved in Fund programmes since in many cases, and particularly in the context of developing countries, to be too precise is to be too unrealistic. What seems to be vitally important is to gain agreement on the overall strategy behind the policies that are being adopted.

Up to now this article has treated non-oil developing countries as if they were a homogeneous group – this is far from the truth. A significant distinction may be made between those countries that can attract private finance and those that cannot. The latter are particularly dependent on the IMF. If the IMF proves too inflexible to respond to their needs their attention will no doubt switch to the possibility of setting up a new institution designed specifically for the purpose of helping the low income countries such as the World Development Fund proposed in the Brandt Report.

## INTERNATIONAL TAXATION

# Problems of International Development Taxes

## Illustrated by the Financing System for Science and Technology for Development

by Joachim Betz, Hamburg\*

**Attempts by the developing countries to replace the largely voluntary provision of development aid by a system that would free official resource flows from the possibility of political interference by the donors and from the need for yearly budgetary allocations have been going on for some time. The present author here examines the proposal of the Group of 77 for a Financing System for Science and Technology for Development.**

In calling for automaticity of transfers the developing countries are aiming at establishing for themselves sources of finance independent of the fluctuating inclination of donors and providing additional, untied funds on a secure, continuous and predictable basis.<sup>1</sup>

In principle there is a whole list of procedures which could meet this requirement:

- ☐ improvement of domestic budgeting procedures on the part of the industrialised countries and linking of their payments to specific target figures;
- ☐ greater involvement of multilateral agencies in the process of resource transfer;

☐ mobilisation of funds from the revenue of "international commons" (ocean fishing, offshore oil and gas, sea-bed mining, etc.);

☐ establishment of national contribution quotas accompanied by the introduction of international tax systems for development financing.<sup>2</sup>

A predictable, continuous and assured – i. e. in its tendency automatic – inflow of untied aid does not therefore necessarily imply the introduction of

<sup>1</sup> For these criteria cf. IGEFS/CRP. 9 (Intergovernmental Group of Experts of the United Nations Financing System for Science and Technology for Development), 4 November 1980.

<sup>2</sup> Cf. UNCTAD, Trade and Development Board, TD/B/C.3/161, 16 June 1980.

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