

**AN EVALUATION OF IMF STRUCTURAL ADJUSTMENT
PROGRAMMES: LESSONS FOR SOUTH AFRICA**

THESIS

**SUBMITTED TO RHODES UNIVERSITY IN FULFILMENT
OF THE REQUIREMENTS FOR THE DEGREE OF**

MASTER OF SOCIAL SCIENCE

BY

NUNO BEROLSKY

FEBRUARY 2000

ABSTRACT

The mixed results of International Monetary Fund structural adjustment programmes in less developed countries are a major motivation for this research. Explanations must be advanced as to what may inhibit the success of such programmes. South Africa has often found itself in a precarious position- with a deteriorating balance of payments, a position similar to other countries that have accepted IMF loans. Furthermore, South Africa undertook an IMF loan in 1993.

Financial support from the IMF incorporates structural adjustment programmes. These may include measures such as tighter monetary policy, reduction in the budget deficit, exchange rate devaluation and ceilings on domestic credit with increased interest rates (Ferguson, 1988). These policies illustrate the principle of 'conditionality,' whereby access to further loans is conditional on certain criteria being met, such as reduced budget deficits and inflation rates.

The principle of conditionality has met with a great deal of criticism. Bacha (1987) and Dell (1982) argue that these aggregate demand-reducing conditions more often than not stagnate domestic economies, worsening the balance of payment and result in programme breakdowns. Essentially, they refer to the IMF conditions as 'unrealistic.' The IMF denies this, arguing that shortfalls are mainly due to a lack of political commitment to carry out its conditions (Winters, 1994). This issue of conditionality will be examined in detail, using three specific case studies.

The aim of this study is to examine the characteristics of Brazil, Mexico and Zambia to see whether or not the IMF programmes were successful. Guidelines will be established for South African policy from these case studies. South Africa is trying to adjust to the competitiveness of the international economy. At the same time, the need for reconstruction and development exerts increasing pressures on the balance of payments.

Guidelines are established for a successful economic adjustment for South Africa. The research concludes that South Africa is certainly in line for a successful transformation. The rigidities are not as extensive as has been the case in Brazil and Zambia. Institutionally, South Africa is sound. However there are still challenges in this area, such as export diversification and economic stability to attract foreign investment.

ACKNOWLEDGEMENTS

I would like to express gratitude and thanks to my supervisors Professor Antrobus and Bongani Khumalo for all their effort and guidance.

Thanks are also due to the all the members in the Economics Department for making my years at Rhodes most enjoyable.

Love and gratitude to my parents, Len and Dina, as well as my brothers Sascha and Hugo for all their support. Special thanks to Andrew Grewar for helping with the editing.

TABLE OF CONTENTS

Chapter One — Introduction	1
1.1 Methodology.....	2
1.2 Objectives of the Study	4
Chapter Two — The International Monetary Fund	7
2.1 The Origins of the IMF.....	7
2.2 Rules of Decision Making in the IMF	9
2.3 The Structure of Decision Making in the IMF	11
2.4 The IMF’s Mandate.....	11
2.5 Forms of IMF Support.....	12
2.5.1 Special Drawing Rights.....	13
2.5.2 Regular Credit Facilities.....	14
2.5.3 Stand-by Arrangements.....	15
2.5.4 The Extended Fund Facility (EFF)	16
2.5.5 The Compensatory and Contingency Financing Facility (CCFF)	16
2.5.6 Buffer Stock Financing Facility.....	17
2.5.7 The Oil Facility	17
2.5.8 Enhanced Structural Adjustment Facility	18
2.6 The Issue of Conditionality.....	18
2.7 Conclusion	24
Chapter Three — The Role of the IMF in the International Monetary System.....	26
3.1 Introduction	26
3.2 Objectives of the IMF	26
3.3 The Internal and External Problem	28
3.4 Causes and Indicators of External Imbalance	30
3.5 Instruments and Targets for Balance of Payments Equilibrium.....	33
3.6 Approaches to Balance of Payments Difficulties.....	36
3.6.1 The Elasticities Approach.....	36
3.6.2 The Absorption Approach.....	40
3.6.3 The Monetary Approach	44
3.6.4 The Portfolio Approach	53
3.7 The IMF Adjustment Model	56
3.8 Selecting Cost-Efficient Balance of Payments Policy.....	72

3.9	Implications for Overall Policy	74
3.10	Conclusion.....	75
Chapter Four	— The Case Studies.....	78
4.1	Introduction	78
4.2	Zambia.....	79
4.2.1	The Zambian Economy up to 1982	79
4.2.2	Zambia and the IMF.....	83
4.2.3	Evaluation of the IMF Programme	84
4.2.4	Impact on the Structure of the Economy	90
4.2.5	The Breakdown of Externally Sponsored Reform	94
4.2.6	Zambia and the IMF in the 1990s.....	95
4.2.7	Summary	96
4.3	Brazil	97
4.3.1	The Period of Industrialization and Debt Rolling	97
4.3.2	The State of the Brazilian Economy in 1982.....	100
4.3.3	The IMF Programme	101
4.3.4	An Evaluation of the IMF Programme	102
4.3.5	Impact on the Structure of the Brazilian Economy	107
4.3.6	Brazil and the IMF in the 1990s.....	108
4.3.7	Summary	109
4.4	Mexico	111
4.4.1	Mexico's Industrialization between 1950 and 1980	112
4.4.2	The Debt Crisis	116
4.4.3	The IMF Programme	117
4.4.4	An Evaluation of the IMF Programme	118
4.4.5	Impact on the Structure of the Economy	122
4.4.6	Mexico and the IMF in the 1990s.....	124
4.4.7	Summary	127
4.5	Conclusion	128
Chapter Five	— South Africa under Two Economic Regimes.....	131
5.1	Introduction	131
5.2	South Africa's Economic Regime between 1900 and 1993	131
5.3	South Africa's Balance of Payments Performance between 1946 and 1984	133
5.4	The Debt Crisis of 1985.....	136

5.5	Economic Performance between 1984 and 1993	138
5.6	The IMF Programme	141
5.7	Economic Policy Changes since 1993	142
5.8	Economic Performance between 1994 and 1997	145
5.9	The Two Regimes.....	148
5.10	Policy Implications for a Successful Stabilization.....	149
Chapter Six — Conclusion		157
Appendices: Figures and Macroeconomic Indicators.....		165
Appendix 1		165
Figure 1:	The Polak Model	165
Appendix 2: Macroeconomic Indicators for Zambia (1978–1987).....		166
Table 1:	Macroeconomic Indicators for Zambia.....	166
Table 2:	International Indicators for Zambia	167
Appendix 3: Macroeconomic Indicators for Brazil (1978–1987).....		168
Table 3:	Brazil’s Macroeconomic Indicators.....	168
Table 4:	Brazil’s International Transactions.....	169
Table 5:	Brazil’s exports	170
Appendix 4: Macroeconomic Indicators for Mexico (1978–1987)		171
Table 6:	Macroeconomic indicators for Mexico.....	171
Table 7:	Mexico’s International Transactions.....	172
Table 8:	Exchange Rates and Debt Service Ratio	172
Table 9:	Mexico’s Export Diversification	173
Appendix 5: Macroeconomic Indicators for South Africa		174
Table 10:	South Africa’s Macroeconomic Indicators (1984–1994).....	174
Table 11:	South Africa’s Balance of Payments Indicators (1984–1994).....	175
Table 12:	South Africa’s Macroeconomic Indicators (1994–1998).....	176
Table 13:	South Africa’s Balance of Payments Indicators (1994–1997).....	177
Appendix 6: Economic Indicators for the 1990s.....		178
Table 14:	Macroeconomic Indicators for Zambia (1988–1998).....	178
Table 15:	International Indicators for Zambia(1988-1998).....	179

Table 16:Brazil's Macroeconomic Indicators(1988-1998).....	180
Table 17: Brazil's International Transactions(1988-1998).....	181
Table 18: Macroeconomic indicators for Mexico (1988-1998).....	182
Table19:Mexico'sInternationalTransactions(1988-1998).....	183
References.....	184

CHAPTER ONE — INTRODUCTION

The International Monetary Fund (IMF) was created after World War II to help with the management of a stable exchange rate system and to be a source of revolving international liquidity. The first function disappeared with the collapse of the Bretton Woods exchange rate regime. The second function is what concerns this thesis, that is the provision of temporary liquidity on more attractive terms than those offered by commercial banks to countries experiencing balance of payments disequilibrium, and providing assistance for a smooth structural adjustment.

The chief means by which the IMF provides assistance is through Stand-by Arrangements, by which the Fund assures a member that it will be able to borrow foreign exchange over a specified period, provided the member abides by the terms of the arrangement. While the principle of conditionality is, by and large, not contested, there are misgivings about the design and application of conditionality.

The IMF structural adjustment programmes undertaken by Zambia, Mexico and Brazil are explored in detail. Each country undertook loans due to balance of payments difficulties experienced. The ability of the countries to successfully undertake these IMF programmes was determined by the structure of the economies and their ability to transform, as well as the existence of institutional rigidities.

With the South African economy in crisis, the country was obliged to obtain finance from the IMF. In 1993 South Africa received an IMF loan in the form of a Compensatory and Contingency Financing Facility. The conditionality in the loan was not as strict as some other IMF loan facilities would prescribe. The objective of the loan was to bolster the level of reserves. However, the instability in the world economy could well lead to further borrowings, with higher conditionality. For a better understanding of what South Africa can expect, and if possible, avoid, it is imperative that caution is taken and lessons learnt from other IMF programmes. This is especially important in light of the promises embedded in the Reconstruction and Development Plan (RDP). There are fears of a potential conflict between RDP objectives and those required by the IMF (Padayachee, 1994b: 25).

The South African economy has some serious structural problems, causing it to remain vulnerable to a balance of payments crisis; for example the currency crisis which occurred in 1996 due to large capital outflows. A low national savings rate is a critical weakness. Gross domestic savings as a percentage of gross domestic product deteriorated from 17% in 1996 to 15% in the second half of 1998, compared to an average of 24% during the 1980s (South African Reserve Bank Annual Report, 1998: 12). With government dissaving, and South Africans in general not saving enough, there was little cash left for the investment levels required to make the economy grow at a higher rate. Low growth rates and rising unemployment contribute to the unacceptable level of crime, and create the potential for increased social instability. Furthermore, inflation has remained higher than that of South Africa's main trading partners. This has compounded by low levels of productivity. All these factors affect investor confidence, both domestic and foreign.

The low rate of saving domestically, means that South Africa is reliant on foreign savings. Foreign capital inflow is necessary to finance investment and the current account deficit on the balance of payments. This reliance on foreign capital is in itself a weakness.

Since 1994 capital inflows have been the norm, made up of short-term portfolio investment and the long-term, and more stable, foreign direct investment (FDI). It is the large dependence on portfolio investment, which has resulted in vulnerability, should investor sentiment change. This happened in 1996 and again in 1998. On both occasions the rand depreciated. This resulted in higher interest rates and lower reserves, putting a further damper on growth prospects.

For some time it has been argued that by 1997/8 South Africa's economy was fundamentally strong, allowing it to remain relatively unscathed during the Asian crisis in 1997. However, external shocks from Asia and Latin America during the second and third quarters of 1998 impacted negatively on the economy.

1.1 Methodology

The effects and appropriateness of stabilization programmes are hotly disputed. There are many methodological pitfalls in the way of arriving at conclusive evidence on the effects of IMF

programmes. Killick, Malik and Manuel (1992: 576) point out that many factors influence the performance of an economy, and it becomes difficult to disentangle the effects of factors other than those of the IMF programme. Difficulty arises over which performance criteria should be analysed, as well as the period of analysis. The task is made more complicated due to the varying rigour of policy conditionality and the degree of its implementation.

There are five distinct methodologies commonly used in evaluating IMF structural adjustment programmes. The before and after approach has generally been the most widely used. This approach involves comparing economic indicators during or after a programme with those pertaining prior to the implementation of the programme (Winters, 1994: 452). The advantage of such an approach is the ease with which calculations can be done, as one needs only compare macroeconomic outcomes before and after a programme is implemented. However, the approach is based upon the *ceteris paribus* assumption, implicitly treating all changes as effects of the programme itself (Killick, 1995: 606). Khan (1990a: 200) argues that this approach is a poor estimator of the counterfactual. Non-programme determinants such as international interest rates, industrial countries' growth rates and domestic factors such as the weather, change all the time. Thus the before and after approach results will have some bias.

The with-without approach compares macroeconomic performance during a programme with that of a control group of countries without programmes (Khan, 1990b: 198). Assuming that both programme and non-programme countries face the same external environment, then comparing with-without outcomes should reflect the effects of the programmes. The problem in this approach is that IMF programme countries are not randomly selected, in that they were selected due to their relatively poor economic performance. Thus there would be biased results, as the outcomes are determined by the differences in the respective starting positions.

The actual versus target approach involves comparing actual outcomes of key macroeconomic variables to the targets specified by the IMF. The extent to which the targets were met provides a measure of the success of the programme. However, little insight is offered with respect to how the IMF's programme affected the macroeconomic performance of the country. For example, if the actual outcome fell way short of the targets, due to over-ambitious targets, then the success

would be questioned even though the effects on macroeconomic performance were positive (Khan, 1990a: 20).

A further approach commonly used is that of case studies, whereby detailed studies are undertaken. Specific countries may be chosen, based on certain criteria, and an in-depth study made, to examine macroeconomic variables (interest rates, budget deficits, balance of payments etc.) as well as microeconomic issues. Case studies therefore have the advantage of not being based on generalizations, but of providing detailed examinations. The disadvantage is that they do not easily allow generalization across countries. This may be overcome to an extent by undertaking a number of case studies.

1.2 Objectives of the Study

It is intended here to examine various countries using the case study approach, and to see how the theoretical models outlined in Chapter Three have performed under various conditions. As mentioned earlier, a fairly detailed analysis will be made of each country's economy, followed by generalizations about the conditions necessary for a successful economic adjustment, or impediments to one.

As IMF programmes are complex in nature, so are the effects they have on the economy. The detailed analysis provided by case studies highlights important information regarding the effects of these programmes and recommendations for sustainable programmes. As mentioned earlier, it is acknowledged that there are weaknesses in using this approach. First there is the fact that it is difficult to generalize from a small sample. Second, the time periods of the conditionality were not the same and thus there is no control for changing world conditions. It was recognized that while the 1990s data for each of these case studies was available, this particular period would not have been suitable. A justification is provided in Chapter Four. Lastly, although the period of investigation of the case studies takes place in the 1980s, valuable lessons can still be learnt for South African economic policy in the future. Although certain country-specific characteristics are taken into account during the implementation of IMF programmes, their theoretical framework is universal. In the 1990s, IMF loans have gone further by providing loans to cushion certain

elements of the economy. However, the underlying features of the IMF and its model are still the same.

The countries selected are Brazil, Mexico and Zambia. The reason for choosing these particular cases is explained in Chapter Four. The study will describe and examine the policies required by the IMF and the reasons for them, and then evaluate their economic performance and the structural impact on the economy. Finally, the viability for South Africa accepting IMF loans will be assessed, based on the results of the study. The objective is to establish guidelines for a successful economic adjustment for South Africa should IMF assistance be required.

The basic underpinnings of the International Monetary Fund are outlined in Chapter Two. The origin of the IMF is briefly looked at. Thereafter its roles as set out by the Articles of Agreement, and the various facilities offered are described. Finally, the issue of conditionality is examined.

The purpose of Chapter Three is to provide some theoretical background to the situation of balance of payment disequilibrium. To start with, the reasons for a balance of payments disequilibrium are examined. This is followed by the various approaches to balance of payments difficulties. These are the elasticities approach, the absorption approach and the monetary approach. This provides insight into the policy prescriptions.

The aim of Chapter Four is to appraise IMF programmes in three case studies. The economies of Zambia, Brazil and Mexico are examined. The reasons for economic crises are detailed. Thereafter, the performance of the various economies is evaluated and the structural impact of IMF programmes on these economies is examined.

Chapter Five investigates South African economic policy and performance under two different economic regimes, focusing on their response to economic shocks or crises. It looks at the country's economic development between 1984 and 1993, and its development between 1994 and 1997 under the austerity style policies favoured by the IMF.

Chapter Six discusses some possibilities facing the South African economy. Lessons are drawn from the case studies, with the aim of providing a framework for a successful structural adjustment programme.

CHAPTER TWO — THE INTERNATIONAL MONETARY FUND

2.1 The Origins of the IMF

A new international economic order came into existence at the end of the Second World War. Its establishment was undertaken largely under the leadership of the United States and the United Kingdom.

The Second World War brought about significant changes to the international monetary system. The war brought about a realization on the part of the USA that it would be best to move away from her isolationist role and play a more prominent part in the world economy. The success and prosperity of the non-communist world was dependent on this change in policy. A new international monetary system was thus sought by both Britain and the USA. By 1941, officials from both countries were focusing on the format which the postwar international economy would take. Both agreed in principle that flexible exchange rates and the use of competitive devaluations to export unemployment ('beggar-my-neighbour' policies) which were popular during the wars, were no longer acceptable (Winters, 1994: 416). Initial discussion was centred on the question of how trade was to be conducted. Britain favoured a liberal financial system offering substantial credit because of the huge debts accruing to the empire. The USA, however, proposed a strict financial system and open trade.

Britain's aspirations were embodied in the 'Keynes Plan' of 1941. Keynes had produced a text which had circulated through the British Treasury, while in the United States, Harry Dexter White drew up a proposal for an inter-allied stabilization fund. In 1942 the two proposals were exchanged and studied by the respective governments. During this deliberation, both parties made many modifications.

Initially, Keynes proposed to give precedence to national as opposed to international objectives, due to the experience of the chaotic 1930s. Keynes intended avoiding a recurrence of the growing unemployment situation, and was in favour of countries maintaining a certain degree of independence in the execution of national policy. Britain however, motivated by a large debt (especially to the USA) which needed financing, gradually moved away from this position and

became increasingly willing to participate in a multilateral world order. Britain had sold all her foreign assets and thus lost the yields from those assets which would normally have been used to finance the importing of raw materials and foodstuffs. She therefore needed access to the world market in order to increase exports to finance her imports (Van Der Wee, 1991: 427).

Britain, and indeed the world, was in fact becoming increasingly dependent on the USA. In view of the concern expressed that a USA depression would rapidly spread to the rest of the world, Keynes proposed that a supranational institution be established in order to place the world economy under its guardianship (Ferguson, 1988: 24).

Keynes suggested establishing a 'clearing union' where all countries would have accounts, denominated in a common unit named the 'banco'. International imbalances would be settled by shifting bancos from one country's account to another's. Countries experiencing either a balance of payments surplus or deficit would be obliged to adjust, mainly through a change in their exchange rates. The world's money supply would therefore be controlled, and used as a policy instrument (Winters, 1994: 414).

By providing European countries with credit, the governments would be able to continue with their expansionary policies despite the presence of balance of payments deficits. On the other hand, the United States, with her balance of payments surplus, would be pressured by the institution to adjust her policies by liberalizing imports (Van Der Wee, 1991: 428). A provision was made whereby countries undertaking loans and those enjoying a surplus would both have to pay interest. This provision was an instrument designed to motivate countries to follow through on their adjustments (Williamson and Milner, 1991: 379).

White reversed the Keynes Plan by advocating precedence to international objectives over national objectives. The White Plan (1943) was based on the principle of economic planning and control. Two supranational institutions were proposed, a Stabilization Fund and a World Bank (Van Der Wee, 1991: 427). It was further proposed that a pool of gold and currencies be created and placed under the control of the Stabilization Fund. The Fund would lend to countries suffering from temporary deficits out of its pool of resources (Williamson and Milner, 1991: 379).

All countries would be obliged to contribute gold and national currencies, and in turn be entitled to borrow from the group under strict conditions, should the need arise.

The Fund was to have access to \$5 billion. The World Bank however, was to have access to a far greater amount with a view to expanding international liquidity. White argued that both these supranational institutions would acquire significant control over member states with loans. The control would reign particularly over adjustments in exchange parities and international capital movements (Van Der Wee, 1991: 427).

To summarize, Keynes sought to involve countries with a balance of payments surplus in correcting their disequilibrium. The proposed International Clearing Union would act as a central bank for all central banks. The White Plan put forward the notion of correcting balance of payments disequilibria by making parity adjustments. The responsibility of restoring equilibrium was with the deficit countries.

Once Britain and the USA had substantially agreed on basic bilateral issues, wartime allies were invited to attend a conference to draft the Articles of Agreement of the World Bank and the International Monetary Fund (IMF). The Bretton Woods Agreement of July 1946 owed more to the White Plan than the Keynes Plan, thereby reflecting the power and influence of the USA.

2.2 Rules of Decision Making in the IMF

The IMF was set up, together with the World Bank, at the United Nations Monetary and Financial conference held at Bretton Woods, New Hampshire in 1944, when the original Articles of Agreement were drafted. It commenced its operations in 1946 with a membership of thirty-eight countries (Eshag, 1983: 252).

The Fund was established essentially to supervise the system of stable exchange rates agreed to at the United Nations Monetary and Financial Conference, to prevent competitive devaluations, and to offer short term finance to members with balance of payments difficulties, under certain safeguards (Eshag, 1983: 256). Since 1944, amendments have been made to the Articles of Agreement. In 1969, provision was made for the creation of Special Drawing Rights (SDRs), and

in 1978, changes were made to reflect the erosion of the fixed exchange rate system towards a flexible exchange rate system (Killick, 1984a: 128).

The constitution of the IMF embodied in the Articles of Agreement enshrines the purpose, membership, management and operations of the IMF. Amendments must be approved by three fifths of the members, having 85% of total voting power. The US has approximately 20% of the total voting power, and is therefore empowered to block any proposed modification. A combination of the UK and any other two major industrial countries such as France, Germany or Japan could also block any proposed changes (Eshag, 1983: 253).

The Articles of Agreement stipulate a formal apparatus for decision making in the IMF, operating essentially by two rules. The rule of weighted voting power prescribes that members of the IMF are assigned proportioned voting power on the basis of predetermined criteria. Votes are weighted on the basis of the quotas allotted to each member (Ferguson, 1988: 62). Members are allocated quotas (expressed in millions of SDRs), based upon the size of the particular economy, its participation in world trade and various other factors, such as political influence, which may have a bearing (Killick, 1984a: 130). In other words, the distribution of the quotas is intended to reflect the relative economic importance of member countries, and their capacity to contribute financial resources required by the Fund. The quota therefore determines voting strength and the amount of credit for which the country is eligible.

These criteria have dictated that major countries in economic terms have been assured of an overwhelming dominance with regards to voting shares, while the smaller countries (mainly but not exclusively developing countries) have had a minority share-holding in decision making (Ferguson, 1988: 64). There has in fact been widespread dissatisfaction, given that even though less developed countries (LDCs) collectively comprise 86% of the total membership, they can command only 42% of the total votes. Developed countries, on the other hand, argue that it is their currencies that are utilized to enable the Fund to meet its lending purpose. Furthermore, their share of world trade is even greater than their voting strength in the Fund (Killick, 1984b: 131).

The second important rule for decision making within the Fund is that of majority voting. Most decisions taken by the Fund require a majority vote, but higher majorities may be necessary for certain categories of decisions, which are clearly identified in the Articles of Agreement (Ferguson, 1988: 63)

2.3 The Structure of Decision Making in the IMF

Constitutionally, the IMF has a tripartite structural division. There is a Board of Governors, an Executive Board and a Secretariat. These structures were given clearly defined functions in the Articles of Agreement. A further structure is the Interim Committee, which was founded in 1974 (Ferguson, 1988: 68).

The supreme decision-making body is the Board of Governors. This is mainly made up of the ministers of finance and central bank governors, who meet annually. The Interim Committee of Governors plays a role in advising the Board of Governors on changes in the world's economic system, the international monetary system and the role of the International Monetary Fund. It has become a vital body in the structure, and meets two to three times a year (Killick, 1984a: 132).

The Executive Board is responsible for the everyday running of the Fund, which includes, *inter alia*, due consideration of requests for financial assistance, policy decision making and policy recommendations to the Board of Governors. The Executive Board is also obliged to appoint themselves a chairman (Killick, 1984a: 129).

2.4 The IMF's Mandate

As is apparent from Article I(v) of the International Monetary Fund's Articles of Agreement, access to the Funds resources (or the ability to make drawings) is intended to be confined to those countries with balance of payment difficulties. Thus, it states that one of the purposes of the Fund is:

“To give confidence to members by making the general resources of the Fund temporarily available to them under adequate safeguards, thus providing them with an opportunity to correct maladjustments in their balance of payments without resorting to measures destructive of national or international prosperity” (International Monetary Fund, 1968: 2).

The IMF was not created as an agency for the funding of economic development. Rather, it was established in order to provide short-term finance for members faced with balance of payment difficulties. It is therefore important that repayments are made such that resources will be available for other members.

This is consistent with the IMF mandate to facilitate the expansion and growth of international trade in order to encourage economic prosperity for all members (i.e. the promotion of economic and financial cooperation among the Fund’s members) (Wapenhans, 1994: 41). Further objectives include the promotion of exchange rate stability and the elimination of foreign exchange restrictions (Guitian, 1995: 795). The classical IMF intervention is therefore designed to restore equilibrium as a precondition for growth.

2.5 Forms of IMF Support

Each member country pays a subscription to the Fund equivalent to its allocated quota. Twenty-five percent is payable in Special Drawing Rights (SDRs) and the remainder in the members’ national currencies. The Fund uses quotas to assist those in balance of payments difficulties (Killick, 1984a: 132).

Although, in nominal terms, the value of quotas had increased by 1983 almost tenfold from their initial values of 1947, the effect of world inflation and the growth in the volume of trading had eroded the real value of the quotas. The surplus liquidity held by the Fund during the 1970s was largely eroded during the 1980s by increased lending. The IMF was in fact obliged to borrow in the early 1980s. For example, in 1981 the Fund borrowed 8 billion SDRs from Saudi Arabia over two years and 1.3 billion SDRs from developed countries.

Also to blame for the real erosion in the value of quotas, is the inclination of the developed countries to promote growth in world trade. For example, whereas in 1948 the total IMF quotas were 16% of the estimated value of world imports, by 1980, due to the increase in world trade, the quota value was just less than 4% (Eshag, 1983: 254). The financial assistance the Fund can provide to members from its general resources has consequently been detrimentally affected. As a result, special facilities financed with borrowed resources have been established.

2.5.1 Special Drawing Rights

The IMF provides international liquidity and balance of payments support through various forms. To qualify for loans beyond a certain level, the country must prepare a 'letter of intent' indicating that certain policies will be pursued (Cooper, 1992: 73). The IMF makes finance available to its member countries under various forms, depending on circumstances such as the nature of macroeconomic and structural problems that need to be addressed. Resources are available from both the IMF's general resources and its concessional financing facilities (Guitian, 1995: 826).

The scheme of Special Drawing Rights (SDRs) was the result of international monetary reform which looked to augment international liquidity, and was a result of the negotiations which took place to create a new reserve asset (Williamson and Milner, 1991: 385). The SDRs were established in 1969 under the first amendment to the Articles of Agreement.

The SDRs are an unconditional reserve asset allocated in proportion to quotas, to members participating in the Special Drawing Right Department (Eshag, 1983: 254). In other words, the SDRs are a form of interest-bearing international money created by the Fund in order to supplement international reserves, and are to be accepted in settlements of transactions. SDRs are allocated to the participants in proportion to their respective quotas. The SDRs' value is determined daily, based on the weighted average of five key exchange rates. These are the pound sterling, the French franc, the yen, the US dollar and deutschemark. As a result, the SDRs' value is more stable than any other one of the currencies, as their movements tend to cancel each other out (Killick, 1984a: 133).

SDRs are used in much the same way as gold. They are sold by a country with a deficit to a strong currency country in exchange for currencies that would be usable in the exchange markets.

The IMF is authorized to designate which strong currency countries receive SDRs. The use of SDRs is restricted to countries in deficit (Williamson and Milner, 1991: 385).

SDRs are created by allocating them to members in proportion to their quotas in the Fund, and may be used to buy national currencies, settle loans or act as security for loans. There are no repayment schedules, but members using SDRs must pay a market related interest to holders of surplus SDRs, i.e. members whose holdings are below their original allocation pay interest on the difference, while those whose holdings are above their original allocation receive interest on their surplus (Winters, 1994: 424). The rate of interest is determined by a formula based on short-term market interest rates in Japan, Germany, the UK, France and the USA (Eshag, 1983: 254).

2.5.2 Regular Credit Facilities

The International Monetary Fund's resources are available to members on a short to medium term basis only when they are in balance of payments difficulties. Members draw on the resources by purchasing other members' currencies in exchange for their own, under obligation to repurchase an equivalent of its own currency within a given period of time. Strictly speaking therefore, members do not borrow, but purchase from the Fund's foreign currencies, and repurchase instead of repaying loans. Purchases from the Fund are generally referred to as IMF drawings, while repurchases are referred to as 'repayments of loan' (Eshag, 1983: 287).

Credit facilities can be made available to members under the reserve tranche, or the credit tranche. The portion of a member's quota that the Fund holds in SDRs (or other reserve asset) is designated as the reserve tranche. Thus it is owned by the member, who therefore has the right to make use of it (Killick, 1984a: 33). A member can draw the full amount of the reserve tranche at any time, without policy conditions or repayments. The reserve tranche does not constitute use of IMF credit and is therefore not subject to any service charges or interest charges (Guitian, 1995: 827).

Under the credit tranche, IMF credit is made available in tranches of 25% of a member's quota. The first 25% of a country's quota is the first credit tranche, and access is semi automatic. The member need only demonstrate that there is a balance of payments need and a reasonable effort is being made to solve the problem. No performance criteria are referred to (Guitian, 1995: 826).

2.5.3 Stand-by Arrangements

Credit tranches over and above the reserve, and first credit tranches generate controversy. These are known as the Stand-by Arrangements or Extended Facility Arrangements (Killick, 1984a: 134). The conditionality applied by the Fund in authorizing drawings in the first credit tranche is very much more liberal than that applied to the higher credit tranches. Whereas in the first credit and reserve tranches no specific conditions or performance criteria are required save for very mild conditions of reasonable effort, any drawings beyond these are normally made in instalments of one year and are conditional upon the observance of specific performance criteria. Hence the name 'conditional credit' (Eshag, 1983: 257).

The Fund's primary objective is balance of payments viability. Emphasis is also placed on other goals, such as price stability and encouraging international trade (Eckaus, 1982: 774). Requests for credit tranches beyond the first require justification, and a Stand-by Arrangement must be negotiated.

Stand-by Arrangements give members the right to draw a certain amount over a given period. As mentioned elsewhere, the release of funds is conditional on performance criteria being met through a stabilization programme. Examples of such criteria include credit policy, government borrowing, trade restrictions and reserve levels. These criteria allow members and the IMF to assess the progress of a member country. If the criteria are not being realized, no further drawings will be authorized until the parties have met (Killick, 1984a: 827).

The Stand-by Arrangement therefore serves as an assurance that the members will obtain the specified drawings during the period, provided of course that the conditions of the agreement have been observed. According to Eshag (1983: 259), the Stand-by Arrangement is an instrument created solely by the Executive Board during the course of the Fund's operations. It cannot be

found in the Articles of Agreement. Furthermore, the concept has undergone a considerable transformation. Originally set up to provide a confirmed line of credit, it has become the main instrument of conditionality, ensuring that beyond the first credit tranche Fund resources are made available to member countries providing that certain policies are observed.

A Stand-by Arrangement typically covers a 12 to 18 month period. They can sometimes extend up to 3 years. Repayments have to be paid within 3 to 5 years (Guitian, 1995: 827).

2.5.4 The Extended Fund Facility (EFF)

The Extended Fund Facility (EFF) was set up in 1974 to meet the needs of countries experiencing special circumstances in their balance of payments difficulties. Unlike the credit facilities referred to above, the support is usually for longer periods and larger amounts (Killick, 1984a: 134). The programme runs for three years and repayment over ten years. The objective of this type of support is to assist the respective members to overcome balance of payments difficulties which have resulted from structural problems. Conditions are the same as those prescribed in Stand-by Arrangements (Woodward, 1992: 40).

The EFF allows a country to draw beyond its quota for up to two to three years (Havnevik, 1987: 11). This is conditional on certain performance criteria being met. With the introduction of this credit facility, the Fund implied that balance of payments difficulties could be caused by structural factors. The facility is authorized only after the Fund is satisfied that substantial amounts of resources are required, and a programme has been presented setting objectives and policies to meet them (Eshag, 1983: 273).

2.5.5 The Compensatory and Contingency Financing Facility (CCFF)

The Compensatory Financing Facility was introduced in 1963 in response to the United Nations' repeated demands and concerns over the commodity problem faced by developing countries (Ferguson, 1988: 171). According to Eshag (1983: 270), this was the first important step taken by the Fund in acknowledging that primary export countries may require special assistance because of a shortfall in export earnings due to factors beyond their control.

Before offering assistance, the Fund must be satisfied that the shortfall is short-term and attributable to factors beyond the relevant member's control. The facility's conditionality is mild, but requires that the recipients undertake a Fund programme. The repayment terms and interest rates are the same as those prescribed in the case of a Stand-by Arrangement (Kumar, 1989: 772). Access is determined by a formula measuring the deviations of exports from an average value. The amount of credit may not exceed 100% of quota (Killick, 1984b: 135).

The contingency facility was established in 1988, with the objective of helping members to maintain their reform efforts when faced with unforeseen external shocks (Guitian, 1995: 796).

2.5.6 Buffer Stock Financing Facility

Established in 1969, this facility may be used by countries experiencing balance of payments difficulties for the purpose of financing international buffer stock agreements. Drawings are subject to low conditionality.

Members must show a balance of payments need before the IMF undertakes to help with finances. Drawings have to be repaid within three to five years. According to Guitian (1995: 831), no drawings had been made between 1985 and 1995. At the time there were no outstanding credits under this facility. Credit of up to 50% of quota may be granted. Although the conditionality is slight, this facility has been little used.

2.5.7 The Oil Facility

This facility operated from 1974 to 1976. The objective was to ease the impact of rising oil prices on the balance of payments (Havnevick, 1987: 12). The resources were provided by OPEC members and other countries with strong balance of payments. In effect, this facility channelled funds from balance of payments surplus countries to deficit countries (Eshag, 1983: 272).

Conditionality from this facility was also liberal. Although some OPEC countries had surpluses following the second oil shock in 1979, no such facility was set up (Killick, 1984a: 134).

2.5.8 Enhanced Structural Adjustment Facility

Two new facilities were established during the 1980s, the Structural Adjustment Facility (SAF) and Enhanced SAF (ESAF). The intention behind their establishment was to meet the needs of low income countries which could not afford the high interest rates attached to Stand-by Arrangements and EFFs. They focus more heavily on structural adjustment, and are subject to low conditionality. In fact, the funds are provided with an interest rate of 0.5% and a repayment period of up to ten years (Woodward, 1992: 39).

In 1994 the decision was made to halt new commitments under the SAF and rather expand the resources available under the ESAF. Since this decision, the ESAF arrangements have become the principal means by which the IMF provides financial support. They continue in the form of low conditionality.

These measures are intended to support strong medium-term structural adjustment programmes. A policy framework paper must be developed by the members with the assistance of IMF staff. The paper should describe the objectives and policies intended during a three year period. This is meant to serve as a means of strengthening collaboration. The paper is updated annually (Guitian, 1995: 796).

2.6 The Issue of Conditionality

IMF-supported stabilization programmes are made up of three chief components; the preconditions, the performance criteria, and other non-binding elements which may be written into the letter of intent. Other aspects which are linked to 'conditionality' include the degree of Fund flexibility over criteria or willingness to make modifications, the amount of front-end loaning and the frequency of the performance tests before the next instalment is made available.

According to Killick (1984b: 189), there is a great deal of interaction between IMF staff and that of the respective governments, with annual consultations, meetings and in some cases (where there are substantial users of IMF facilities) daily communication on fiscal and monetary affairs. As a result, it can be quite difficult to differentiate between the components of a programme that

owes its existence to the IMF. The extent to which the Fund becomes involved in domestic policy depends on the views of each party, (the closer they are the less difficulty there may be in organizing the programme details), the personalities involved, past experience in terms of relations, and the extent to which the country may have adhered to past conditions.

Preconditions are the policy measures which must be executed before an agreement will even be presented to the Executive Board of the IMF for approval. They need not necessarily be written into a letter of intent. The most common types of preconditions include exchange rate actions (devaluations), interest rate policy, pricing policies, tax measures, reduction in government expenditure and the liberalization of trade.

As noted above, future access to IMF funds is largely dependent on a country's effort and ability to abide by and meet certain performance criteria. These performance criteria gauge the respective member's degree of success in implementing the programme, and the extent to which the Fund's resources are being used appropriately.

The performance criteria are generally formulated by the Fund staff. The theoretical foundation for this is a neoclassical approach to the balance of payments, though other approaches are also used. A Financial Stabilization Programme is prepared, outlining the policies to be pursued and the performance criteria to be met in an effort to overcome the balance of payments difficulties. The policies and intentions are stated in the 'Letter of Intent'. A 'Stand-by Arrangement' is formulated with the selection of performance criteria.

The performance criteria consist predominantly of monetary and fiscal targets which must be achieved over the period of the Stand-by Arrangement. At the end of each period the targets are checked for compliance. If satisfactory, a further fraction of the agreed drawing right will be released. A failure to comply with the targets automatically interrupts the relevant country's right to further drawings in terms of the Stand-by Arrangement.

The performance criteria are macroeconomic in character. They generally include credit ceilings, devaluation, restrictions on new external debt, reduction in current payments, minimum levels of foreign exchange reserves and trade liberalization. Other criteria which may be included in an

IMF agreement include real wage decreases, the elimination of subsidies and other forms of government interference (Pastor, 1987: 67).

While the preceding paragraphs explain the nature of conditionality, the principal arguments that have been waged over the issue of IMF conditionality will now be discussed. There can be little debate that conditionality is required by the IMF as security for repayment as well as an adequate safeguard. Security is required to ensure repayments after certain targets are met, and that member countries are pursuing corrective policy measures as stipulated by the letter of intent. A measure of conditionality is argued to be legitimate and necessary. According to Havnevik (1987: 16), conditionality is the price to be paid by borrowing countries for access to resources. However, when it comes to the matter of how conditionality should be designed and how it could best be achieved, the debate is hotly disputed.

Guitian (1995: 795) explains the rationale behind conditionality. The availability of resources coupled with an absence of conditionality would tend to lessen a country's concern about the avoidance of imbalances. This availability of resources carries with it the risk of 'moral hazard,' which must be contained. The existence of conditionality, in itself, minimizes the risk of moral hazard. Further disbursements of resources depend on the adoption of adjustment measures which ensure that an imbalance will be redressed.

Furthermore, in lending resources to member countries, these resources make up the IMF's asset portfolio. By lending to members, the IMF invests its resources in their economies. Conditionality is therefore also an investment to protect the quality of the assets. Once the policies (or conditions) are prepared, the IMF urges members to pursue the measures as early as possible, the aim of which is to minimize the members' cost as well as the risk to the IMF investment (Guitian, 1995: 796).

The IMF has been criticized for the nature of the conditionality. The Fund has been labelled 'monetarist,' accused of being hardline and doctrinaire in terms of the monetary solutions, while ignoring structural elements of the balance of payments problem as well as the effects on development (Payer, 1974: 17). In response to the criticism of being inflexible and dogmatically monetarist, it can be argued too that the IMF has a host of different facilities for those countries

with exogenously caused balance of payments problems (e.g. CFF) and for those caused by structural difficulties (e.g. EEFF) (Bird, 1984: 175). Furthermore, the Fund argues that it is not purely 'monetarist'. For example, often a devaluation is incorporated which is not of part of the monetarist paradigm.

In its defence, the IMF argues that its role is as a monetary institution, and not a development agency, the latter being a concern of the World Bank. The IMF's role is to sort out the short run balance of payments problem, and not to deal with the underlying structural problems which may exist. Although there may be some room for dissatisfaction amongst developing countries, the problems are not that clear cut.

The argument against the Fund in terms of development effects, such as those on income inequality and employment, goes further towards criticizing the IMF for ignoring the political and social consequences of its policies. The effects of lower real wages, higher real interest rates and decreased government expenditure are difficult pills to swallow, and often result in anarchy. (Recent examples have been riots in Zimbabwe about food prices.) In its defence, the Fund argues that these impacts are indeed taken into account, having been prescribed in the 1979 Guidelines on Conditionality (Winters, 1994: 455).

Some of the features of these Guidelines include the possibility of Stand-by Arrangements being of longer time scale and the acceptance by the Fund of the need to take heed of domestic, social and political factors. The aim is therefore to try and provide a balance between demand management to the balance of payments and a supply approach (Ferguson, 1988: 21).

According to Bacha (1987: 1458), the programmes developed by the Fund are too strict, and therefore have the tendency to overkill domestic demand. Brazil's three-year programme was cancelled before its second year because the country could not meet its monetary and fiscal targets even though the balance of payments targets were fulfilled. In Mexico's case the fiscal targets were met, but the targets on the current account were not. Bacha concludes that the Fund tends to implement stricter domestic performance criteria than necessary to obtain the balance of payments objectives.

Dell (1982: 598) agrees that the Fund's policy on attacking inflation has resulted in an overkill of the domestic economy. He points out that trade-offs with other objectives do not appear to be considered. The stringency of the conditions is argued to be disproportionate to the need to safeguard the repayments, especially as the IMF credits have often been small relative to the country's total foreign exchange obligations.

Guitian (1982: 76) believes that a balance must be struck between flexibility and uniformity. The two important principles of conditionality do not necessarily conflict. The principle of uniformity cannot be applied regardless of a country's circumstances, neither can individual circumstances be given such weight that uniformity loses its shape.

Guitian (1995: 806) also argues that the Fund has indeed been quite flexible, and this is evident in the way adaptations in conditionality practice have occurred due to the changing international economic environment. For example, the IMF established the EFF in 1974 to provide countries with severe balance of payments problems with medium term assistance. In 1979 the Guidelines on Conditionality were concluded. They stressed the importance of early adjustment, the key sensitive policy areas likely to be affected (fiscal, credit, exchange rates), and acknowledged the importance of paying regard to members' objectives and circumstances. The Guidelines also provided the basis for further reviews of conditionality.

Loxley (1986: 119) points out that the Fund's poor record in Sub-Saharan Africa is a strong practical argument against the IMF's approach. There is little evidence that performance by low-income countries in terms of balance of payments, inflation, savings, investment and growth has been any better for those countries with Fund programmes than those without. Furthermore, the Fund itself admits that only in a minority of cases are the targets actually met by African countries. There is an increasing trend for programmes to break down in their first year. The Fund contends, however, that slippages in implementation were to blame, as a result of unforeseen developments, lack of political support, overoptimistic targets and limitations in administrative infrastructure. Had adjustment efforts been intensified, the Fund argues, performance may have been better.

However, Loxley (1986: 120) argues that it was not due to slippage but rather a lack of flexibility in programmes to accommodate developments, and the setting of targets which were not feasible in economic, administrative and political terms. Mwakani (1986: 109) contends that while the Fund may try to help countries attain a viable balance of payments in the medium term with reasonable price and exchange rate stability, as well as an acceptable and sustained level of growth, its policies do not sufficiently take into consideration the peculiarities of developing countries. The Fund is deemed to possess an unrealistic attitude to those countries. It also displays a lack of non-uniformity to specific countries with differing economies and thus different needs.

Eckaus (1982: 774) echoes these sentiments against the IMF's uniform approach to different situations. Firstly, he argues that the balance of payments problems are different in developing and developed countries. Developing countries are typically capacity constrained while advanced countries are not. The sources of their problems are also different, and these should be taken into account. "Mexico's problems are not those of Jamaica. Portugal's are not those of India, and so on" (Eckaus, 1982: 774). Forms of adjustment should be different for those countries. Secondly, the importance of adjusting conditionality to the particular conditions of each country requesting assistance implies a case for more rather than less detailed terms of conditionality. Lastly, although it may be easier for countries to agree to simple macroeconomic conditions than to detailed stipulations, the likelihood of failure to meet simple targets may be greater than if they had been more detailed.

Eckaus (1982: 772) acknowledges that there are economic and political dangers in moving to more detailed conditionality requirements. The benefits lie in the ability to design conditions suited to each case, and which are therefore less uniform and more flexible. In terms of flexibility, more instruments may be used to attain objectives. Overall, Eckaus concludes that the monetary controversies should not be argued. The focus should rather be on the ways in which the Fund could perform its functions more efficiently with regard to each country.

According to Dell (1982: 598), high conditionality in the upper tranches is unwarranted because the causes of the deficit have been beyond the country's control. He submits that countries should be afforded the opportunity to select appropriate domestic policy. An extension of this argument relates to the cause of disequilibrium. Critics of the Fund hold external shocks responsible for

causing disequilibrium (Winters, 1994: 453), which is further argued to be permanent in nature (Bird, 1984: 173). The Fund replies that disequilibrium is in fact temporary in nature, and a result of domestic mismanagement. This forms the basic premise for and fundamental purpose of the IMF, to assist countries with short term balance of payments problems.

The Fund has also been accused of being ideologically biased, favouring the industrialized countries, whose economies are run along free market lines. Payer (1974: 69) shares a structuralist and dependence viewpoint that the Fund is dominated by industrial countries, and therefore pursues their interests. These interests are said to involve exploitation and domination of developing countries in terms of ensuring that Westerners are able to infiltrate developing markets. An even more extreme criticism is that Fund programmes are used as an instrument by the capitalist states to bring about the downfall of the developing countries' governments.

Regarding political will, Ferguson (1988: 217) acknowledges that for reforms to take place, political support is required in order to succeed. Hence the need for feasible conditionality. Herbst (1990: 950) found that IMF packages can result in a risky political climate, as some interest groups stand to lose out on their vested interests. This is especially so in countries where the regime is based on coercion rather than those in power through votes. A short solution in these circumstances may be to tie the reform to the conditionality so as to oppose the inclination not to undertake reform. Undertaking politically risky programmes may require the assurance of long-term flows of concessional aid. Nelson (1984: 984) points out that commitment is crucial to the government for a sustainable programme. However even if commitment is strong it may still be insufficient to overcome political obstacles unless programmes are designed in a manner that addresses these obstacles. For political sustainability, one requires strong political commitment to the programme, and the capacity to implement it.

2.7 Conclusion

This chapter has looked at the origins, aims of the IMF and the various mechanisms by which it functions. It has also examined the various loan facilities and the different forms of conditionality attached to them. The level of conditionality demanded by the IMF depends on the type of loan facility undertaken, and this in turn depends on the causes and magnitude of the economic crisis

suffered by a country. The concept of conditionality has naturally provoked debate, and the main issues have therefore been presented.

The following chapter will provide a more detailed examination of the various approaches to balance of payments difficulties. The IMF model is eclectic, drawing mainly on the monetary approach but also incorporating other approaches.

CHAPTER THREE — THE ROLE OF THE IMF IN THE INTERNATIONAL MONETARY SYSTEM

3.1 Introduction

As mentioned in Chapter Two, the IMF approach is based on a neoclassical approach to the balance of payments. This chapter examines the major weaknesses and strengths in the theory underpinning the IMF's approach to balance of payments disequilibria. Various approaches to balance of payments difficulties and the policy implications are examined. Thereafter the IMF model and its policy implications are analysed. The theoretical foundation is essential in order to understand the IMF's prescriptions to countries experiencing balance of payments difficulties.

In considering balance of payments disequilibria, a distinction should be made between temporary and more fundamental disequilibria. A temporary deficit on the balance of payments, such as may arise from a decrease in export proceeds due to a seasonal decline in agricultural exports, need not involve any significant corrective actions. If there is confidence amongst market participants that the deficit is temporary and will be corrected in, say, a few months' time, the deficit can be financed from the country's foreign reserves or short-term capital inflows. A more fundamental balance of payments disequilibrium is one that is likely to persist if the fundamental factors determining the balance of payments remain unchanged.

It is these more fundamental disequilibria and determining factors that are at issue here. The adjustment of the balance of payments to disequilibrium situations can be achieved through relative price changes and/or income changes, and monetary changes can also play a role. Over time, a number of theories or approaches to the adjustment of balance of payments disequilibria have been developed. These are the *elasticities approach*, the *absorption approach*, the *monetary approach* and the *portfolio approach*.

3.2 Objectives of the IMF

As mentioned in Chapter Two, the IMF's mandate is to finance temporary balance of payments disequilibria. The broad objectives of IMF adjustment programmes include the attainment of viable

balance of payments, low inflation and long-term growth. The term commonly used for such measures is macroeconomic adjustment, and entails short-term economic objectives.

The need for a macroeconomic adjustment (or stabilization) programme generally arises from a persistent balance of payments problem considered to be temporary in nature. In other words, the country is not receiving enough foreign exchange from its exports and needs to borrow from abroad to finance its debt service burden (Woodward, 1992: 32). This is generally a result of an imbalance between aggregate domestic demand and aggregate supply capacity, adversely affecting the price level and the balance of payments (Sutton, 1984: 1). While inflation can be tolerated over a relatively long time, the balance of payments deficit can only be tolerated so long as the economy can finance it through its reserves. However, once reserves start to run down, borrowing may have to take place. Thus it is usually a persistent balance of payments deficit that will require macro-stabilization.

Sutton (1984: 4) argues that supply shocks have been a major cause for the debt problems of non-oil-producing developing countries. The instability of export earnings and deteriorating commodity terms of trade result in temporary disequilibria. During the 1980s, large permanent or persistent deficits resulted mainly from higher oil prices and sluggish export earnings due to the worldwide recession, rather than domestic macro mismanagement. Khan (1990b: 195), on the other hand, contends that although some blame can be placed at external supply shocks, often it is inappropriate policies that result in the all too rapid expansion of aggregate demand relative to the productive capacity of a country's economy. Assuming that domestic supply is inelastic, Khan warns that if the relative expansion of domestic demand is not dealt with, a widening of the current account deficit results. This will lead to a fall in international competitiveness, higher inflation, lower GDP growth and a heavier foreign debt burden.

The primary role of the IMF is to give confidence to its members by making its resources temporarily available to them under certain safeguards. Policy packages are designed for countries with balance of payments problems, and include measures to restore a sustainable balance between aggregate demand and supply, as well as expanding the production of tradeables.

Debtor governments therefore pledge to take up the policy intentions as set out by the Fund after discussions between government and Fund officials. Ideally, the package should reflect the particular economic situation of a country's economy, taking into account the government's preferences. The IMF programmes are short term in nature, and therefore used when the country has had an exogenous shock. Persistent debt is dealt with more specifically under the World Bank's structural programmes.

3.3 The Internal and External Problem

A country can be said to be in a condition of internal equilibrium when the volume of aggregate demand is adequate, ensuring full utilization of its productive capacity and stable domestic prices (Eshag, 1983: 212). This implies that the economy is at full employment levels. The extent to which internal disequilibrium is occurring can be measured by the level of idle productive capacity and the inflation rate.

The primary reason for seeking price stability is that inflation can hinder development in many ways. First, price rises are likely to lead to a fall in real wages and therefore a redistribution of income towards profits. This redistribution stimulates the production of luxury goods, leading to lopsided development. Secondly, inflation has an adverse effect on both the current and the capital account of the balance of payments, aggravating the foreign exchange constraint. Domestic inflation in relation to trading partners may encourage imports and discourage exports until the exchange rate is altered. A capital outflow may be induced due to expectations of price increases, providing an incentive for businesspeople to convert to other currencies with more stable prices. Thirdly, inflation introduces an element of uncertainty that may impede the planning of consumption and investment. Lastly, if allowed to continue, there is a social risk of riots and the economic risk of hyper-inflation resulting.

External equilibrium signifies an equality of receipts and payments on the combined current and capital accounts of the balance of payments. External disequilibrium may indicate a situation where the deficit or surplus on the current account has not been entirely offset by flows into the capital accounts (Winters, 1994: 343).

External equilibrium may exist when a country can finance a deficit on the current account through capital inflow. Clearly, there is a limit to the amount of capital available at any point in time. To maintain external equilibrium, the authorities should contain the deficit on the current account within the bounds prescribed by the availability of such capital.

Recognizing a balance of payments problem is one of the major difficulties policy makers face. The meaning of a balance of payments disequilibrium is not as simple as it is often thought to be, and is important in ensuring that the correct policy design is pursued. The balance of payments disequilibrium is frequently taken to be synonymous with a current account deficit. This, however, can be a misleading indicator. The current account deficit may be temporary, or offset by capital inflows, therefore not making it much of a problem. The difficulty arises in the financing of the current account deficit. This could be done through the running down of reserves or by borrowing, which may be very limited. Secondly, capital inflows could finance the deficit, yet these could also be volatile and unreliable (Bird, 1984: 86).

On the other hand, the absence of a current account deficit does not necessarily imply that the balance of payments is in a healthy position. For example, the current account could be maintained by the pursuance of domestic policies that reduce demand for imports by deflating domestic demand or imposing import controls. Symptoms of such policies will include high unemployment levels, spare productive capacity and a low rate of growth. Although the balance of payments might be healthy from the exterior, the problem is suppressed. However, Bird (1984: 86) stresses that this does not mean that the current account is unimportant. An important objective of stabilization policy is to strengthen the current account by encouraging resources into the tradeable sector. Thus, there is no single definition of balance of payments disequilibrium. Rather, it depends on the conditions pertaining to the situation at the time.

Killick and Sharpley (1984: 17) offer a complex definition for the maintenance of long term balance of payments equilibrium:

“Balance of payments equilibrium exists when, in a normal year, the basic balance (or that balance chosen as most appropriate for the country in question) approximates zero in conditions where: there are no major unwanted restrictions

on trade and payments; external debts and debt servicing are not regarded as too large; foreign exchange reserves are regarded as adequate; and the maintenance of unwantedly deflationary domestic policies.”

While the balance of payments may appear to be in a healthy state, the existence of exchange controls, import duties, high debt payments or deflationary domestic policies should actually all constitute warning signals to policy makers about the balance of payments. It is important to look at other indicators (such as money supply, inflation, etc.) other than just the balance of payments accounts and the general domestic policy being pursued.

3.4 Causes and Indicators of External Imbalance

Large increases in global payments disequilibria took place during the OPEC quadrupling of oil prices in the 1970s. There is evidence supporting the idea of external sources playing major roles in the crisis experienced by many Less Developed Countries (LDCs). It is argued that the structure of world demand and oligopolistic pricing policies in industrial countries resulted in deteriorating terms of trade for LDCs. A large body of evidence supports the proposition that the balance of payments situation of non-oil producing LDCs can best be understood in the global context.

Dell and Laurence (1980: 33) analyse the deteriorating trade account of non-oil producing LDCs. During the period 1962–1972, endogenous factors were found to be particularly influential in the deterioration of the balance of payments. However, during the years 1973–1976 exogenous factors became more prominent. Khan and Knight (1982: 495) conclude that the worsening of the trade account was mainly due to exogenous factors. These findings are at odds with the IMF emphasis on over-expansionary domestic demand being the underlying cause for balance of payments problems.

Various internal factors are argued to affect a country's balance of payments adversely. Deficiencies in the fiscal system may cause misallocation of resources between sectors. Exchange rate controls encourage costly import substitution and penalize exports and transfer pricing by multinationals, thereby reducing the incentive for further investment, which reduces foreign

exchange earnings and government revenue. Bird (1984: 94) contends, however, that such features do not explain instability and deterioration in the balance of payments, but are rather more suited in explaining general balance of payments weakness or vulnerability. Consequently, deflating demand will not be the most cost effective policy.

Eshag (1983: 220) argues that there are three important characteristics of the structure of production in developing countries that render them particularly vulnerable to internal and external disequilibrium. Firstly, the rate of increase in the supply of food and other wage goods has been slow in relation to the growth of domestic income. Urbanization of the work force due to the expansion of industrial activities produces an increase in private income and in the demand for food which is not always matched by an increase in the supply of such goods. The result is a persistent pressure of demand leading to a rise in internal prices, and a deterioration in the balance of payments because of the increase in food imports. Secondly, production bottlenecks result from deficient transport and communication services. Owing to these structural characteristics, attempts to increase production capacity may be more likely to result in price rises and a growth in imports. Lastly, the commodity composition of trade has contributed to the instability of the balance of payments. Export diversification is therefore essential.

Instability refers to both temporary fluctuations as well as more persistent or recurrent difficulties in the balance of payments and inflation. Killick and Sharpley (1984: 15) use the term disequilibrium to entail both temporary and persistent balance of payments and inflation problems that reveal imbalances in the economic system. Accordingly, the objective of economic management should focus on smoothing out fluctuations and eliminating unwanted trends.

A balance of payments disequilibrium may result from adverse movements on the capital account. These capital movements can be readily detected and the causes explained. Deterioration in the current account indicates that growth in the value of exports has been less than that of imports. This may be attributed to a worsening in terms of trade or a slower increase in the volume of exports compared with imports. An examination of the prices of exports and imports identifies the changes in the terms of trade. However, changes in volume may be caused by a variety of factors such as the rates of exchange, which determine the competitiveness of exports and import competing industries, as well as changes in government measures related to foreign trade such as

tariffs. Thus the volume of imports and exports, and the capital account would be indicators of external equilibrium.

The instability of export earnings is also an indication of temporary disequilibria. This is due to the fact that LDCs have had volatile export commodity prices. This can be measured as the average annual percentage deviation from the exponential trend of export earnings. Another measure is the variation in commodity terms of trade. Dell and Lawrence (1980: 49) found that LDCs showed consistently greater instability in export earnings than developed countries. The instability could be attributed to a lack of diversification from primary production to manufacturing in the face of unexpected shocks.

Such short term instability has welfare costs. Due to the LDCs' instability (in terms of balance of payments), a higher level of reserves has to be held, therefore locking up resources that could otherwise have been used for investment and consumption. The unpredictability of incomes derived from exporting, fluctuating reserves and sudden payment crises all increase the risks of investment, thus discouraging saving and hampering growth.

However, it is the persistent current account trends that cause more damage. As opposed to developed countries, LDCs consistently had current account deficits between 1973 and 1981. Low income and non-oil-importing countries performed especially poorly. Nevertheless, current account deficits should be used with caution as sufficient indicators in developing countries. As noted earlier, in order to cut down on imports, LDCs generally make great use of exchange controls for balance of payments purposes.

Another measurement of the balance of payments pressures is the number of debt renegotiations. From 1945 to 1976 an average of two countries per annum engaged in debt renegotiations. By 1981 this had jumped to eight countries per annum. The number of Stand-by Arrangements with the IMF is another indicator, as the number of LDCs undertaking such agreements have grown (Killick and Sharpley, 1984: 23). Nevertheless, these do not necessarily infer an external imbalance.

3.5 Instruments and Targets for Balance of Payments Equilibrium

Fund resources, usually in the form of Stand-by Arrangements, are used by countries facing temporary balance of payments problems. The programmes pursued are designed to correct any maladjustments in the balance of payments. The exact policy measures prescribed depend on the causes and duration of the balance of payments disequilibria.

According to IMF staff members Reichman and Stillson (1978: 293), the most common cause of balance of payments disequilibrium has been overly expansionary domestic demand policies. As a result, the programmes have included policies designed to restore the imbalance in the balance of payments. The instruments have included limits on credit, adjustments in the exchange rate and the elimination of trade restrictions so as to remove distortions in prices and costs. Furthermore, use has been made of fiscal and monetary policy measures in an attempt to reduce aggregate demand (Eshag, 1983: 260). These have been a common feature stipulated by the agreements with the IMF.

First, one should start by examining fiscal policy as an instrument. Real government expenditures and revenue can be affected by current and capital outlays, the tax structure and its rates, and the prices charged by government enterprise. These instruments are controlled by the authorities, and changes in them will affect the budget deficit.

Sharpley (1984: 60) argues that while such fiscal instruments can be controlled theoretically, practically the capacity and willingness of governments to undertake discretionary fiscal policy is uncertain. A higher tax burden may not be politically possible, and even if it were, difficulties in collecting revenue would exist. Curbing the budget deficit via reduced real expenditure in the long run would also result in political upheaval, due, for example, to reduction in social services or the wage bill. Difficulties also exist regarding the time lags of such a policy.

The Fund's pursuit of monetary policy since the 1950s rests with the notion of monetary statistics being readily available. The monetary approach allows for an approximate analysis of monetary data. Lastly, it has been argued that control of domestic credit creation was already relied upon, especially in Latin America (Eshag, 1983: 283).

The potential for using monetary policy (controlling the money supply) in LDCs depends on the controllability of the components of the monetary base. The traditional tools of monetary policy include open market operations, reserve requirements, and ceilings on bank credit. For the implementation of monetary policy, a major task is selecting the appropriate demand functions that are most stable and reliable, and over which the authorities have considerable control (Sharpley, 1984: 65). According to Park (1973: 387), however, choosing the most predictable indicators of the demand for money may not be the aggregate that the authorities are most able to control. (Studying many indicators may be better.) The financial aggregates chosen for monitoring will be a compromise between controllability and indicativeness, depending on the financial statistics available.

Credit ceilings are among the most popular components of the Fund programmes. It is argued that credit ceilings are a good monitoring device, especially in countries that may have data shortages. According to Killick (1984b: 215), the IMF staff treat the credit ceiling as a residual of other policy decisions such as fiscal policy and the exchange rate. However, Killick questions whether such a monitoring device is efficient or accurate, due to endogenous or exogenous factors. Thus a government that follows the agreed measures may end with a higher-than-expected credit rate. Even in sophisticated banking systems, monetary targets have their difficulties (Dell, 1982: 606).

The use of the credit ceilings is also the result of the Fund's research on the balance of payments performance. The research resulted in the Polak model, which will be described later. This resulted in the monetary approach to the balance of payments. The basic premise of the monetary approach argues that the domestic credit ceiling is a result of the view that changes in the money supply and credit in the economy have a strong impact on aggregate demand and the balance of payments.

This relationship can be expressed as $\Delta MS = D + \Delta R$, where MS is the money supply, D is domestic credit creation and R is international reserves. The equation indicates that the change in the money supply is dependent on the amount of credit creation and on the balance of payments developments. Of the two determining factors, credit creation is more subject to control or

influence by the monetary authorities (Furness, 1983: 136). Interest rates can be used to affect credit creation negatively. However, this model has been criticized, and there is a question mark over the use of credit ceilings.

High real interest rates are often a result of financial reform. The argument behind the raising of real interest rates is that this stimulates household savings and increases the savings deposited in financial institutions. Due to the higher cost of capital, there is a move away from capital intensive techniques towards more labour intensive techniques. As savings are institutionalized, high interest rates may enhance control of the monetary base by the monetary authorities, facilitating open market operations. High interest rates may also help develop a domestic capital market, permitting more effective use of open market operations. Furthermore, they could lead to the more efficient transformation of mobilized funds into real capital (Sharpley, 1984: 80).

The IMF has often prescribed the use of a devaluation, based on the elasticities approach. It acts upon the assumption that a persistent deficit in the balance of payments is an indication that a country's exchange rate is at an unrealistic value (overvalued), and therefore there is a basis for a devaluation. The realistic exchange rate is presumed to reflect the purchasing power parity of the currency. The devaluation can influence the current account through two channels. First, if wage increases lag behind the increase in prices, the current account should improve as a result of lower consumption and imports. Secondly, the devaluation is meant to have the effect of increasing the profits of the export sector and raising domestic prices of tradeable goods. What happens to the balance of payments, however, depends on the elasticity of the supply and foreign demand of exports and the elasticity of demand for imports. The higher the elasticities, the greater the improvements of the balance of payments should be. However, the theoretical validity of the above is questioned regarding the LDCs.

From the instruments and targets used by the IMF, it would be wrong to view the IMF's policies and conditions as rigorous in applying the monetarist model. In examining the current account and balance of payments, the IMF is concerned with fiscal matters. It also draws from the absorption approach, which is expenditure reducing, and aims to use devaluations as a policy instrument. Thus there may be closer links than might be thought between the Polak (monetarist approach) and the Keynesian models. In other words, they are not mutually exclusive, since the overriding

objective in both is an attempt to strengthen the balance of payments. Other objectives such as inflation and distribution of income are secondary, if they feature at all.

Trying to achieve internal and external equilibrium can lead to policy dilemmas. For example, the balance of payments may be positively affected by an IMF programme, while the fiscal deficit rises. This is known as the assignment problem. If the fiscal deficit is a performance indicator, failure in this regard could lead to sanctions.

Spraos (1986: 1) argues that the Fund uses many instruments. Targeting the volume of credit, the public sector deficit, as well as a devaluation, leads to inefficiencies and possible conflict, as mentioned in the previous paragraph. He argues that the balance of payments should be the only target, as the other instruments are not directly linked to the balance of payments. It should therefore be left to the domestic policy makers to make their own decisions.

3.6 Approaches to Balance of Payments Difficulties

This section will analyse the various approaches to the balance of payments. These theoretical underpinnings are essential to understanding the IMF approach to the balance of payments, and in particular, why devaluations are often prescribed.

3.6.1 The Elasticities Approach

The elasticities approach was developed by Fritz Machlup (1939), who sought to analyse the impact on the trade accounts of the changes in relative prices induced by a devaluation. Although first proposed by Alfred Marshall, the theory was further developed by Lerner, Robinson and Machlup (1937). The approach asks what happens when prices change, assuming income is constant. Any changes in relative prices are argued to be a result of changes in the nominal exchange rate, determined by the authorities rather than market forces.

The elasticities approach focuses on the current account. Any changes in the relative prices exert an impact on the flow of goods and services. Emphasis is placed on the shape of the demand and supply schedules for foreign exchange. The net result of a devaluation on export earnings and the

import bill depends on the elasticities of demand and supply in the export and import markets, which vary between countries (Bird, 1984: 101).

Using the small country assumptions, the theory argues that LDCs' supply and demand curves for foreign exchange will be elastic. The assumption is made that the supply of imports will be almost perfectly elastic. A LDC may import as much as it wants at the world price without being able to influence this price, as it makes up a small proportion of world supply. Thus, a devaluation will result in reduced demand for imports as they become more expensive (Williamson and Milner, 1991: 195).

As for exports, it is assumed that the demand for exports is perfectly elastic, as the small country sells all it can on the world market. A devaluation in this case results in the supply of exports increasing as they become cheaper on the world market. Under such assumptions, devaluation results in an improvement in the trade balance (Bird, 1984: 100). Thus the value of exports receipts due to a devaluation depends on whether the demand for exports is elastic.

To sum up then, under the small country assumption, the foreign demand for exports and the import supply are infinitely elastic. For LDCs that can sell as much as they wish at the current world price, two elasticities are important, ignoring the effect on the capital account. On the export supply side, the price elasticity must exceed zero to increase the supply of foreign exchange. On the import demand side, the price elasticity must be greater than zero to reduce the demand for foreign exchange. Taking the import demand and export supply together, the Marshall-Lerner condition states that devaluation will improve the current account provided the absolute sum of the price elasticities of export supply and import demand is greater than zero (Du Plessis *et al.*, 1996: 246).

According to Södersten and Reed (1994: 618), the general consensus is that the Marshall-Lerner condition may be greater in the long run than in the short run. Initially the effect will be an increase in the value of imports while the local currency value of exports does not change. The result is a deteriorating trade balance. The short-term response may actually be perverse.

Winters (1994: 278) argues that an important factor in the short run is the currency in which trade is invoiced. Unfortunately, most trade in the few months following a devaluation will have been arranged prior to the event. Furthermore, most of international trade is invoiced in the exporter's currency. This accounts for the usual initial worsening of the trade balance after a devaluation. Once the trade takes place, considering the new relative prices, then an improvement should occur. This phenomenon is known as the J-curve, which shows an initial deterioration in terms of trade following a devaluation.

Studies have been done on the effects of a devaluation. Cooper (1971: 77) studied twenty-four devaluations of LDCs over the period 1959–1966. Though the effective devaluation varied between imports and exports due to different rates of tariffs and export subsidies for different traded goods, the results showed that the devaluations nearly always generated a relative rise in the domestic price of traded goods. Connelly and Taylor (1976: 858) further confirm the findings. In eight devaluations examined over a two-year post-devaluation period, the prices of traded goods were found to have risen by an amount close to the devaluation, while the general price level rose by half as much.

Bhagwati and Oritsoka (1974: 434) studied the performance of non-industrial countries, and found that in the majority of cases export earnings and export volumes increased following the devaluation. The response of exports to a devaluation seemed to rely on the level of development, type of export and the concentration and structure of trade. Small least developed countries exporting little more than tree crops had relatively low short run export supply response, with export earnings reliant on variations in weather and fluctuations in world demand. More developed LDCs exporting agricultural goods with shorter gestation periods, minerals and manufactured goods, experienced significant supply response of exports to devaluations. The Krueger and Bhagwati project (in Bird, 1984: 104) made similar findings, with responses of non-traditional exports usually stronger than traditional exports.

Donovan's (1981: 715) study also suggests that export response to price incentives created by devaluation was quite high for both traditional and non-traditional exports. However, the elasticity for certain primary commodities was found to be higher in the long run than in the short run. In eight of the twelve cases studied, Donovan found that real export growth was encouraged in

relation to average world performance, taking a three-year post-devaluation period. The evidence at a one-year post-devaluation period was more mixed, therefore supporting the idea of lower short run elasticity. Those countries adopting liberalization showed marked export growth, whereas those that had shortages of imported inputs showed restrained export growth. Countries that relied heavily on primary commodities did not seem to increase their long-term export volumes in response to a devaluation.

However, Bird (1984: 106) argues that the elasticity optimism of Donovan's results may be attributed to a bias in the sample, by concentrating on LDCs that made use of the IMF and pursued devaluations. Even within the sample studied, there were three countries (namely, Zambia, Bolivia and Jamaica) that showed lower export volumes after devaluation. It is difficult to generalize from Donovan's findings, especially for low-income countries with poorly developed financial markets and infrastructure.

The response of import demand to a devaluation is generally difficult to isolate. What happens to import demand depends crucially on what other policies are pursued simultaneously to devaluation.

Import liberalization and expansionary demand management policies are most likely to result in increased import volumes, even though the initial effects of the devaluation through increased import prices and reduced real expenditure will tend to cause a contraction. Many ambiguities exist. For example, the substitution effect away from imports may be neutralized by increased income, due to increased earnings and therefore a resulting increase in imports. Increased export supply could result in an increase in imported inputs. It is for these reasons that imports have been found to increase following a devaluation, and therefore the ultimate improvement in the balance of payments may be smaller than expected (Bird, 1984: 105).

Donovan (1981: 727) concludes that real import growth following a devaluation was higher in both the short run and the long run. Although imports did rise by more than the average where import liberalization took place, such countries also had rapid export growth, thus to some extent neutralizing the impact on the current account. For those countries where the expenditure-reducing effects of a devaluation on imports were stressed in the IMF programmes' Letters of Intent, import growth declined in the long run. In other words, it appears that the price elasticity of import demand is sufficient to enable devaluation to reduce the demand for foreign exchange

and improve the current account. However, this may not always happen, due to other circumstances. Khan (1974: 698) also found high elasticities. Almost all fifteen of his sample of developing countries showed price elasticities close to one.

Based on empirical evidence, it seems that the majority of LDCs' elasticities are adequate to ensure the strengthening of the current account due to a devaluation. This 'elasticity optimism' is shared by the IMF, which is why a devaluation is commonly prescribed in their programmes. However it has also been argued that 'elasticity pessimism' is more realistic for third world countries, and therefore a devaluation on its own may not be enough to improve the balance of payments.

3.6.2 The Absorption Approach

It was mentioned in the previous section that a devaluation on its own may be enough. IMF programmes are often a combination of devaluations and deflationary macroeconomic policy. The absorption approach provides a rationale for this policy measure.

The absorption approach also places an emphasis on the current account, concentrating on the relationship between income and imported goods and services. It focuses on the effects of a devaluation on the level of real expenditure.

The absorption approach was developed by Sydney Alexander, and published in 1952. It was a response to the Elasticities Approach, arguing against the latter's restrictive assumptions. A macroeconomic perspective of the balance of payments is provided. Emphasis is given to the role of income changes due to the adjustment process. Following Södersten and Reed (1994: 619), the absorption model can be presented in its simplest form, in the following way.

The Absorption Model

The model begins with the well known national income equation.

$$Y = C+I+G+X-M \dots\dots\dots(1)$$

where Y is the national income, C is private consumption, I is private investment, G is government expenditure, and X and M represent exports and imports respectively.

Total domestic expenditure is defined as absorption (A). Therefore:

$$A = C+I+G \dots\dots\dots(2)$$

Thus:

$$Y = A+X-M \dots\dots\dots(3)$$

Which is rewritten as

$$X-M = Y-A \dots\dots\dots(4)$$

Consumption demand is assumed to be a function of income after tax (disposable income), and the rate at which this occurs is determined by the marginal propensity to consume. Investment is assumed to be an inverse function of interest rates, while government expenditure is an autonomous component. Imports are a positive function of income.

The trade balance on the left hand side of the equation is equal to the difference between total domestic income and absorption. Or, the difference between real income and absorption determines the current account. If domestic income (output) is greater than domestic absorption, there must be a surplus on the current account (or trade balance). A current account deficit implies that absorption exceeds income (Kreinin, 1987: 147).

The indirect effects on absorption

A country experiencing a deficit in the current account may decide to devalue its currency. From equation (4), the current account can only improve if there is a reduction in absorption relative to output. It is important to differentiate between the case of underemployment and the case where the economy is at full capacity, or full employment.

The first effect on income is called the idle resources effect by Winters (1994: 291). The devaluation's price effects are argued to stimulate the production of exports and of import

competing goods. If there are idle resources in the economy the expansion will not be entirely at the expense of non-traded goods. Thus the income level is increased directly. But if the economy is operating at full employment, the income level cannot rise. This will push up prices and may reduce the effectiveness of the devaluation (Södersten and Reed, 1994: 621). With underemployment, the possibility of a beneficial effect of devaluation seems good. However, monetary and fiscal policy should be employed to decrease absorption relative to income. On its own the devaluation may not be enough.

The second effect is the terms of trade effect on income. The terms of trade report the rate at which a unit of exports can be transformed into a unit of imports. A deterioration in the terms of trade due to the devaluation has a negative impact on the income level (Winters, 1994: 292). Södersten and Reed (1994: 622) suggest that the reason for this is that imports are usually diversified over products. The foreign currency prices paid by the country devaluing are not likely to change much. With regard to exports however, exporters are more likely to reduce their foreign currency prices so as to boost sales. In other words, the devaluing country therefore has to export a greater volume in order to maintain the previous volume of imports. Thus the income level is negatively affected.

The direct effect on absorption

There are various ways in which a devaluation may reduce absorption. This is especially so if the economy is at full employment, and the decrease in absorption is required.

The first is the devaluation effect on income distribution. According to du Plessis *et al.* (1996: 252) it is assumed that in the short run the devaluation leads to an increase in profits at the expense of wages. If wage earners have a higher marginal propensity to consume than profit earners, a reduction in absorption will result. These effects may be reinforced if there is a progressive tax system. In the long run, the increased profits can result in increased investment, which may offset some of the short-term effects.

Income distribution may also take place between sectors in an economy (Winters, 1994: 291). Sectors will suffer according to the amount of imported inputs or intermediate goods used.

Furthermore, the ability to raise prices differs amongst different sectors. This depends largely on competition from imports and the level of market power (Södersten and Reed, 1994: 622). Clearly, the effect is not easily determined, as it depends on the marginal propensity to absorb across many different sectors.

Another influence on direct absorption is the real balance effect. Given real income, it is assumed that society has an optimal level of real balances. A devaluation increases the price level, and people will therefore replenish their real balances by saving more. The effect is a reduction in the rate of absorption (Winters, 1994: 291).

In certain circumstances, devaluation leads to inflation, resulting in decreased competitiveness. Absorption can be cut via the distributional channel. A one-off devaluation results in an increase in the price level, and tends to increase the nominal value of any level in income. A country with a progressive tax system will obtain increased tax revenue, greater than the increase in the price level, as taxpayers have been moved into higher tax brackets. Thus absorption is cut, and income is redistributed from the private sector to the public sector, so improving the trade balance. However, with persistent inflation, the opposite effect could result. If the acceleration of the price level is greater in proportion to the real value of tax collections, income is distributed to the private sector. This is because the tax collected over time depreciates in real value owing to the persistent increase in inflation.

As a result, it can be seen that a devaluation itself is not enough to improve the trade balance and balance of payments. Devaluation should be accompanied by deflationary macro-policy to reduce absorption. It must be said, though, that IMF programmes generally employ deflationary measures as well as devaluations.

Absorption may also be reduced via the monetary channel. Assuming the money supply is kept constant, devaluation causes a decrease in the real money supply. Through the transmission mechanism, the result is an increase in interest rates, choking off investment, consumption and therefore absorption (Williamson and Milner 1991: 203).

Bird (1984: 106) points out that there is broad support for the notion that a devaluation in developing countries will initially tend to reduce real expenditure, as demand-deflationary influence may emanate from the trading sector. A devaluation may result in increased domestic expenditure on imports if there is inelastic demand for imports, resulting in a reduction in aggregate demand for domestic output. In other words, the higher the marginal propensity to import and the lower the price elasticity of the demand for imports, the greater the net reduction in domestic expenditure. This may be offset where the domestic currency value of export earnings rises as exporters try to increase the capacity, and may cause an increase in domestic expenditure.

3.6.3 The Monetary Approach

The IMF approach to balance of payments difficulties is based on the monetary approach. It is of particular importance to this analysis because it reveals the role of monetary policy in stabilizing the balance of payments.

While it is argued that the monetary approach originates from the eighteenth century contributions of David Hume, credit for the modern monetary approach has gone to James Meade (1950s) and the contributions made by Harry G. Johnson and Robert A. Mundell in the 1960s.

Practically all literature on the monetary approach was related to the absorption approach, especially the version published in the IMF staff papers by Sidney Alexander in 1952. The concepts of the absorption approach were the building blocks for the monetary approach, most notably, that the success of exchange rate adjustment depends on monetary factors; and the analysis itself uses monetary concepts.

The paper published by Polak in 1957 is regarded as the starting point of formal research on the monetary approach by the IMF. Other papers were written by Polak and White in 1955, by Hicks, Dorance and Aubanel in 1957 (on the distinction between internal and external sources of monetary expansion) and by Holtrys on the principle that only domestic credit expansion can be treated as an autonomous variable.

The essence of the monetary approach is an analytical formulation emphasizing the interaction between supply and demand for money in determining the country's overall balance of payments position. In an open economy, changes in the supply of domestic money can be caused by domestic credit creation and the foreign exchange activities of the central bank. Money market disequilibria are reflected in changes in nominal income and in the country's foreign reserve stocks (Blejer *et al.*, 1995: 712). The monetary approach, in contrast to the elasticities and absorption approaches, stresses the irrelevance of decomposing the balance of payments, therefore making little distinction between current and capital accounts. The balance of payments is seen as a reflection of the interaction between the demand for and supply of money; with the reserve changes providing the means by which monetary equilibrium is maintained (Bird, 1984: 87).

A formal treatment of the monetary approach will now be given, based on the framework provided by du Plessis *et al.* (1996: 252). A small country version is used. The reason for this is that developing countries meet the small country criteria (Crockett, 1981: 59). The country is therefore a price taker on world markets, and foreign interest rates and foreign prices are fixed exogenously.

The model is based on various assumptions. These assumptions guarantee the independence of the real economy from all monetary phenomena.

(1) A stable money demand function

The demand equation can be written as

$$L = kPY \dots\dots\dots(1)$$

where L is the demand for nominal money balances, Y is real national income, P is the domestic price level, and k shows the effect of an increase in money income on the demand for money income. This function is assumed to be stable, thus k is a constant.

An increase in real national income (-Y) results in an increase in the transactions demand for money, therefore increasing the demand for nominal money balances (-L). An increase in the price level (-P) reduces real money balances (L/P) and because k is constant, results in an increase in the demand for nominal money balances (L).

(2) Flexible prices and perfect markets

The assumption is made that prices are always flexible and markets operate perfectly. As a result there is always full employment. Thus if prices increase wages increase immediately.

(3) Purchasing Power Parity Assumption

The exchange rate (e) is assumed to adjust to the ratio of domestic price level (P) and the rest of the world's price level (Pw).

$$e = P / P_w \dots\dots\dots (2)$$

or $P = eP_w$

where e is the price in the domestic currency of one unit of foreign currency. To make it simple, it is also assumed that the price levels take into account the same basket of goods. Lastly, the prices of goods between countries are assumed to equalize due to arbitrage taking place.

(4) The money supply

The money supply (M) is assumed to be dependent on the supply of 'high powered' money (H).

$$M = mH \dots\dots\dots (3)$$

where m is the money multiplier. Furthermore, the supply of high powered money (H) is broken down into two parts, currency and central bank deposits held by clearing banks (D) and the reserves of foreign currency (R).

$$M = m (D + R) \dots\dots\dots(4)$$

Assuming m is constant, the change in the money supply is rewritten as:

$$dM = m (dD + dR) \dots\dots\dots(5)$$

Rearranged:

$$dR = 1/m dM - dD \dots\dots\dots(6)$$

Equilibrium

When the money market clears, from equation (1) the following takes place:

$$dL = k (PdY + YdP) \dots\dots\dots(7)$$

Setting $dM = dL$

$$dR = k/m (PdY + YdP) - dD \dots\dots\dots(8)$$

From the above, changes in foreign exchange reserves may be the result of changes in national income, changes in price levels, or in the domestic component of high powered money. However, following the assumptions of constant national income at full employment ($dY = 0$), fixed exchange rates, and given foreign price levels ($dP = 0$), the only other possible source of change is the domestic component of the money supply (dD).

Policy Implications of the Monetary Approach

The monetary approach is an analytical formulation that emphasizes the interaction between the supply and demand for money in determining a country's overall balance of payments position. When expansion of the money supply is not consistent with an equivalent change in demand, a stock disequilibrium in the money market arises. This affects the spending patterns of economic agents.

When money supply grows faster than demand, the excess flow of money gives rise to an excess demand of goods and non-monetary goods. In an open economy, a change in the money supply is caused by domestic credit creation. The monetary approach emphasizes that money market disequilibrium is reflected in changes in national incomes (prices and output) and in the country's foreign reserve stocks. The approach concentrates on the relationships between the supply and demand for money on the one hand, and prices, output and the balance of payments on the other.

A surplus in reserves occurs when there is an excess demand for money balances, exceeding the money stock. If the demand is not met domestically through an increase in domestic money supply, funds from abroad will be attracted to satisfy it. This could come in the form of direct investments by foreign companies, or portfolio funds. The result is a surplus in the reserves, assuming no intervention by the authorities to sterilize the inflow of funds.

This surplus is temporary and self correcting. It will only continue as long as there is an excess demand for money. Once the excess demand is eliminated by increased money stock, equilibrium will return. Once the money stock reaches a certain level, to meet demand, the inflow of funds will cease, and so too will the external surplus (Blejer *et al.*, 1995: 713).

Continuous surpluses can occur under conditions of continuous increases in demand for money over the rise in money stock. This increase in demand for money is brought about by an increase in income in excess of the rate of growth in domestic credit creation, causing continuous excess demand for money.

A deficit in the balance of payments reflects an excess supply of money. In this case the stock of money is greater than the demand for money. To get rid of the excess supply, people increase purchases of foreign goods and services, or invest abroad. The result is a deficit.

Again, though, the deficit is self correcting or temporary, assuming the monetary authorities do not create new domestic credit. The deficit lasts until the excess supply is dissipated abroad, stopping when stock equilibrium is restored, or in other words, when the money stock has declined to the

desired balance. A continuous deficit could occur if the conditions persist, that is, if the growth rate in money supply exceeds the growth rate in income.

The monetary approach therefore view balance of payments problems as transitory, or self correcting, provided there is no sterilization. The implication is that a balance of payments policy is not required, except for the control of credit creation. Balance of payments adjustment policies are ineffective, except in the short run. In the long run, the only possible remedy to a deficit is a reduction in the rate of money creation (Kreinin, 1987: 163).

The monetary authorities may respond to a balance of payments deficit by counteracting the excess demand for money by using monetary expansion. This response is known as sterilization (Södersten and Reed, 1994: 637). However, this results in a continued balance of payments deficit and a fall in reserves.

The theory states that deficits can be cured by cutting the money supply to match demand. Furthermore, reducing the rate of credit to improve the balance of payments will have no adverse effects in the long run on employment and output, though there may be some short-term effects (Bird, 1984: 95).

Devaluation of a country's currency raises the currency price level of importables and exportables, as well as that of non-traded goods. The demand for nominal money balances is a stable function of the money income. As the general price level increases, the demand rises for nominal money balances, creating a balance of payments surplus. Since the money supply is not initially affected, an inflow of money from abroad takes place. A balance of payments surplus is created. This state is temporary, until the stock money equilibrium is restored. In the long run, the devaluation has no effect on real economic variables. The only difference is that it raises the price level (Winters, 1994: 305).

Continuous real growth in GDP raises the demand for nominal real balances. Again, if this demand is not satisfied domestically via an increase in domestic money supply, a balance of payments surplus arises. Monetarists therefore maintain that if a country's growth rate is faster than the world average, then the growth rate of its reserves will also be greater.

Regarding interest rates, a rise in domestic interest rates increases the cost of holding money, producing a decrease in the demand for money. The excess supply of money is dissipated abroad, causing a deficit. This would be temporary until the stock imbalance is restored. Clearly this prediction is opposed to other theories such as the Portfolio Approach, which contends that a rise in domestic interest rates results in capital inflow, and therefore a surplus on the balance of payments.

When the assumption is altered to allow for flexible exchange rates, continuous equilibrium is maintained. If there is an increase in the money supply, an excess supply of money is created. The resultant outflow depreciates the currency, raising the price level as well as the demand for money, and establishing a new money stock equilibrium. The implication is that the floating exchange rate restores the effectiveness of domestic monetary policy in the short run. No deficits are created, as would have happened under fixed exchange rates (Kreinin, 1987: 163).

Under fixed exchange rates, the quantity of money adjusts gradually through reserve flows to restore equilibrium. Floating exchange rates allow for a change in the valuation of money stock instantaneously through domestic price changes brought about by an exchange rate adjustment. The floating exchange rates are not necessary for balance of payments equilibrium in the long run because imbalances are gradually self correcting under fixed exchange rates (Kreinin, 1987: 164).

The monetary approach is important for exchange rate determination. Other things being equal, the exchange rate appreciates as the country decreases its money supply. Or, conversely, the exchange rate depreciates when there is an increase in the money supply (Södersten and Reed, 1994: 567).

Critique of the Monetary Approach

The monetary approach emphasizes the monetary implications of balance of payments disequilibria, rather than asset stock. While these are important factors, as shown above, they are predominantly influences under certain assumptions or circumstances. Such assumptions are important in building

a theoretical model in terms of simplification. It is generally recognized that the monetary approach has made a valuable contribution to the understanding of the balance of payments, but it has also been subjected to various criticisms.

The broad monetarist view has been that inflation and balance of payments difficulties are usually caused by allowing aggregate demand to run ahead of aggregate supply. Reform can therefore be approached within a framework of restrained demand within an economy's supply capacity. However, one level of criticism is from structuralists, who contend that structural rigidities in the pattern of production and demand prevent the redirection of resources towards the external sector.

There is no doubt that the structures of developing countries differ markedly from those of more industrial countries. Certain features exist which determine the degree to which monetary restraint will have any success. Rigidities may exist when one or few economic agents have substantial market power and when inflation expectations become entrenched in the short to medium term. There are various other characteristics which may have made the balance of payments adjustment more difficult.

A feature of developing countries is the rudimentary nature of capital markets. Sharpley (1984: 69) points out that the undeveloped nature of financial institutions and markets in developing countries imposes technical limitations on the use of monetary policy. Killick (1984b: 219) contends that it is improbable that monetary policy in terms of credit ceilings can shoulder the monitoring burden due to 'data shortage'. Crockett (1981: 61) argues that the banking systems often operate under constraints, for example lending ceilings and limitations on interest rates. The result is increased difficulty in using traditional monetary policy instruments. Furthermore, the ability of the financial system to efficiently mobilize and allocate savings becomes more difficult. Lastly, if a country's currency is thinly held, monetary policy faces difficulty in inducing accommodating inflows of funds to finance the imbalance.

In contrast, Rhomberg and Heller (1977: 38) suggest the following reasons as to why the monetary approach places an emphasis on monetary variables. Many developing countries lack the detailed national accounts needed to apply Keynesian analysis. The availability of financial data is argued to

be easily available. Secondly, the use of monetary policy as an instrument of balance control has been heavily relied upon, especially in Latin America. Lastly, analysis of monetary aggregates is argued to be quite easy, allowing for short visits by Fund staff to undertake many different missions.

Another characteristic of developing countries is the low substitutability between export goods, import goods and non-traded goods. This applies to countries that export raw materials, and where the domestic demand for the export is often small relative to total output. On the import side, domestic manufacturing caters to lower income consumers and imports of a luxury nature. Thus the restraint of domestic demand may not release the exportable output, as would be the case in an industrial country. The adjustment mechanism requires a change in sectoral pattern of output by withdrawing factors of production for non-traded goods into exporting and import substituting activities. This takes longer, and in the interim may cause unemployment (Crocket, 1981: 59). These rigidities are ignored in the monetarist approach. The devaluation adjustment takes longer, delaying adjustments and creating short term disequilibrium.

Stabilization involves reducing the growth rate of demand for money relative to supply, and switching part of the output from servicing domestic demand to a potential external demand. The assumptions of the 'Global Monetarists' result in a frictionless world, and therefore no adjustment costs. A reduction in demand results in loss in output, but the unemployed resources are absorbed into other uses.

Various distortions can result in bottlenecks, constraining the supply capacity. Distortions are generated by minimum wage laws, and other factors of production. Other price distortions also lead to a disproportionate investment being directed towards goods free to move, such as jewels and real estate; in other words it leads to inefficient investment. Inappropriate interest rates therefore lead to distortion in the allocation between consumption and capital formation (Crocket, 1981: 75). Thus the IMF's conditions of deregulation of prices and trade liberalization.

The monetary approach concentrates on the direct impact on imports, while playing down lasting influences on real output and employment. Research by Khan and Knight (1981: 41) shows that attempts to improve the balance of payments by credit policy may result in significant and

undesirable effects on employment and output. This is especially so in the short run. Research by Aghevli and Rodriguez (1979: 52) further confirms that monetary restraint has a negative influence on real variables. It also suggests that this may even be so in the long run.

There has been controversy over the money demand function. The monetary approach assumes that this is a stable function of a few variables, including income, interest rates and prices. Johnson (1977: 264) says that a proper test of the monetary approach must be a test of the stability of demand for money.

According to Levecic and Rebmann (1991: 189), econometric studies in the 1950s and 1960s showed that the money demand function was stable for the UK and the USA. Judd and Scadding (1982: 1014) performed a survey of the post-1973 literature on the money demand function. Prior to 1973, the evidence accumulated from the research implied the existence of a stable function. Research by Goldfield in 1973 showed this to be true. However in 1974 the forecasts began to overpredict real money balances. By 1976 the tests were yielding even more errors. This evidence suggested that the money demand function had shifted, or the demand for money had become unstable. Crockett (1981: 78) argues that although the function varies between countries, the available evidence indicates that stability is sufficient to act as a fulcrum for the monetary approach.

The monetary approach has established that rapid credit expansion is likely to result in balance of payments difficulties, and that financial discipline is necessary to avoid balance of payments disequilibria. However, the assumptions and predictions must be tested. At present there is no clear proof, due to mixed results.

3.6.4 The Portfolio Approach

The Portfolio Approach is a stock theory, and is really an extension to the monetary approach. Capital movements are now seen to be based on how rational individuals distribute their wealth between different assets to maximize their utility (Södersten and Reed, 1994: 556). Portfolio movements are responsive to short non-macroeconomic conditions. The portfolio approach

therefore attempts to explain the capital account by considering other financial assets besides money.

Central to the theory is the idea that investors seek to distribute their wealth between various assets in a way that will maximize their utility. As the income yield is rarely certain, the rational investor takes into consideration the expected return and risk of his assets. Personal preferences will influence the trade-off between them (Williamson and Milner, 1991: 228). The objective of distributing wealth over various assets is to spread the risk and maximize returns.

A simple framework is provided by du Plessis *et al.* (1996: 263). In dealing with financial assets, it is assumed that wealth holders have a choice of three assets. The range of assets include domestic money, domestic bonds and foreign bonds. The financial wealth (W) is assumed to be given at a certain level. The portfolio includes a mix of domestic money (M), domestic bonds (B) and foreign bonds denominated in foreign currency (F).

The demand equations are given as:

$$M = M(I-, I^*-)W \dots\dots\dots (1)$$

$$B = B(I+, I^*-)W \dots\dots\dots (2)$$

$$ef = f(I, I^*+)W \dots\dots\dots (3)$$

$$W = M + B + ef \dots\dots\dots (4)$$

Domestic interest rates are represented by I and foreign interest rates by I*. The '+' or '-' to the right of the interest rate terms illustrate the effect that a change in the interest rates will have on the left hand side of the equations.

Clearly, the demand for each of the three assets depends on domestic and foreign interest rates, and the level of wealth. A further assumption is made in fixing the supply of these assets.

The demand functions state the obvious. In equation (1), the domestic and foreign interest rates are negatively related to the demand for money (M). An increase in the domestic interest rate will increase the cost of money and therefore cause a rise in the opportunity cost of holding money.

This would lead to a switch to domestic bonds. Equation (2) states that an increase in the domestic interest rate has a positive influence on the demand for domestic bonds due to higher returns being available. An increase in foreign interest rates (I^*) has an inverse relationship with domestic bonds. With higher returns in foreign bonds, the rational investor switches to foreign bonds. Equation (3) illustrates the demand for foreign bonds as ef , due to the exchange rate, since foreign bonds are denominated in foreign currency. The effects of the interest rates are reversed. An increase in domestic interest rates results in lower demand for foreign bonds. An increase in the foreign interest rates results in an increased demand for foreign bonds (du Plessis *et al.*, 1996: 264).

It is assumed that investors are risk averse yield maximizers. This means that if given two assets with the same expected yield, the asset with the lower risk will be chosen. Or conversely, if two assets have the same risk, then the asset providing the highest expected yield will be selected. The rational investor, faced with many assets with varying risk and returns, will diversify the portfolio to spread the risk (Williamson and Milner, 1991: 228).

The gains to be made from diversification of assets depend on the covariance, or relationship between the two risks of the assets. A positive covariance between the assets implies no gains from diversification. However, the less correlated the yields, the greater are the gains to be made by holding various assets (Södersten and Reed, 1994: 560). Regarding international capital movements, the conclusion on covariance is significant. It is argued that in general, returns from different countries are less closely correlated than between the yields within a country. This leads to the expectation of investors holding assets from different countries in order to gain from diversification. This is argued to be good news for developing countries. The implications are that investors may place a proportion of their investments in developing countries, as long as the risks are inversely correlated to the risks in developing countries.

The portfolio approach has implications for countries that rely heavily on monetary policy. According to stock theory, a rise in domestic interest rates would provide a one-off capital inflow as portfolios are re-arranged to take gains from more attractive yields. Thus the present capital inflow is dependent on the last period's inflow and present interest rates.

For countries highly dependent on capital inflows, the implications are important. The model implies that in order to keep attracting capital, a continued rise in domestic interest rates is required to attain continued one-off increases in capital inflow, as opposed to just keeping a constant interest rate differential (Williamson and Milner, 1991: 231). Financing a current account deficit would require continued increases in interest rates. The only time interest rates would not have to increase would be if there was an increase in wealth (W) due to savings. An increase in wealth can result in increased capital inflow as portfolios get larger. This is known as the portfolio growth effect.

3.7 The IMF Adjustment Model

This section will analyse the basic macroeconomic model utilized by the Fund. While the policy packages typically advocated by the Fund may be detailed and complex, the quantitative underpinnings are quite simple. The structure of IMF programmes is built upon a framework linking the financial sector to the balance of payments, known as the monetary approach to the balance of payments. The approach ensures consistency between the monetary impact of policy changes and the desired balance of payments outcome. Khan *et al.* (1990: 156) provide a general framework to start with.

The framework is a consistent accounting framework and divides the economy into four sectors, namely, the private, public and foreign sectors, and the domestic banking system. The private sector is assumed to own all the factors of production, while the banking system is assumed to consist solely of the central bank.

The sale of current output yields nominal income (Y) to the private sector, which it uses to pay taxes (T) and purchase goods for consumption (C_p) and investments (\dot{K}) (interest payments and receipts are ignored, to keep it simple). The private sector's net accumulation of financial assets consists of money (\dot{M}) and foreign assets (\dot{F}_p), minus borrowing from the banking system (\dot{D}_p). Therefore the budget constraint facing the private sector is:

$$Y - T - C_p - \dot{K} \equiv \dot{M} + \dot{F}_p - \dot{D}_p \dots \dots \dots (1)$$

The public sector receives taxes (T) and uses the proceeds for consumption (C_G), no investments being engaged. Any surplus is devoted to the accumulation of foreign assets in the form of foreign assets (F_G) minus the borrowing from the banking system ($\ddot{A}D_G$). The budget constituent, therefore, is:

$$T - C_G \equiv \ddot{A}F_G - \ddot{A}D_G \dots \dots \dots (2)$$

Regarding the foreign sector, revenue is received in the form of imports purchased by the domestic economy (Z), while it spends (X) on domestic exports. If revenue exceeds expenditure, the foreign sector buys back the liabilities from the domestic and private sectors as well as acquiring reserves from the domestic banking system ($\ddot{A}R$). The constraint is therefore:

$$Z - X \equiv - (\ddot{A}F_p + \ddot{A}F_G + \ddot{A}R) \dots \dots \dots (3)$$

The central bank is assumed to act simply as a financial intermediary, acquiring assets in the form of international reserves and claims on the domestic private and public sectors, and supplying its own liabilities in the form of money to the private sector. Thus:

$$\ddot{A}M \equiv \ddot{A}R + \ddot{A}D_p + \ddot{A}D_G \dots \dots \dots (4)$$

Summing (1) to (4), one obtains the national income accounting identity, which is used to discuss the approach of the Fund:

$$Y - C_p - \ddot{A}K - C_G - X + Z \equiv 0 \dots \dots \dots (5)$$

The Fund's approach to balance of payments adjustment has evolved out of work done by IMF staff in the 1950s and 1960s. It has been formalized in a number of papers, most importantly those by Black (1957) and Robichek (1967) (Khan *et al.*, 1990: 158). Given that the IMF's mandate is to finance temporary balance of payments disequilibrium, when balance of payments deficits are not temporary, corrective policy measures must be rendered. Thus the formulation of such

measures requires an explicit model linking policy instruments, controlled by the authorities, to the balance of payments.

The basic assumptions are:

1. Real GDP is exogenously determined

$$Y = Py \dots\dots\dots (6)$$

where P is the general price level and y is GDP. The change in nominal output can be approximated as:

$$\dot{Y} = \dot{P}y_{-1} + P_{-1}\dot{y} \dots\dots\dots (6')$$

Last year's real GDP (y_{-1}) and last year's price level (P_{-1}) are predetermined, assuming for simplicity that they are very small.

2. The velocity of money is assumed to be constant

$$\dot{M}^D = v\dot{Y} \dots\dots\dots (7)$$

where v is a constant, and M^D is the demand for nominal money balances.

3. The money market is assumed to be in flow equilibrium. Thus:

$$\dot{M}^S = \dot{M}^D = \dot{M} \dots\dots\dots (8)$$

where M^S is the supply of money, and this condition implies that the public will succeed in adding to its cash balances.

Equations (6'), (7) and (8), with identity (4), allow the balance of payments (\dot{R}) to be expressed as a function of exogenous and policy variables. This is done by taking first differences in equation

(6) and substituting successively into equations (7), (8) and (4), where \ddot{M} is now interpreted as the flow supply of money. The resultant expression can be derived as follows:

$$\ddot{R} = v\ddot{P}y_{-1} + vP_{-1}\ddot{y} - (\ddot{D}_p + \ddot{D}_G) \dots\dots\dots(9)$$

Equation (9) is therefore the fundamental equation of the monetary approach to the balance of payments which was pioneered by the Fund. The carets (^) over the flow variables (D) identify those policy variables controlled by the monetary authorities. The balance of payments is expressed as the difference between the private sectors flow demand for money and the flow of domestic credit. This increase in domestic credit will be offset by decreases in foreign reserves. Thus, equation (9) provides the rationale for the use of credit ceilings as a performance criterion. By monitoring the domestic credit, it is possible to determine whether the programme is on track in achieving the increased reserves.

Clearly, the demand for money is critical for changes in domestic credit to have a predictable effect on the balance of payments. The demand for money has a stable relationship to a limited set of independent variables. According to Khan *et al.* (1990: 160), although the extreme view is assumed that the income velocity for money is constant, it does not materially affect the analysis. All that is required is that the demand for money responds in a predictable fashion over the programme period to changes in variables such as real income and prices.

Two endogenous variables are contained in equation (9), \ddot{R} and \ddot{P} . It is however not possible to find a unique solution for both on a given expansion of domestic credit. This indeterminacy is removed by taking into account the balance of payments identity in equation (3) and an import demand function. With imports being a function of nominal GDP, and 'a' the marginal propensity to import,

$$Z = aY$$

Therefore,

$$Z = a(Y_{-1} + P_{-1}\ddot{y}) + ay_{-1}\ddot{P} \dots\dots\dots(10)$$

Equation (10) is obtained by substituting $(Y_{-1} + \ddot{Y})$ for Y and using equation (6). Substituting equation (10) into the balance of payments identity (3) after solving for \ddot{R} , results in:

$$\ddot{A}R = (X - \Delta F) - a(Y_{-1} + P_{-1} \ddot{A}y) - ay_{-1} \ddot{A}P \dots\dots\dots (11)$$

Equation (11) defines a second relationship between $\ddot{A}R$ and $\ddot{A}P$. This is the Polak model. The workings of the Polak model are depicted in Figure 1 (in Appendix 1).

Equation (9) is depicted as the straight line MM, while equation (11) is shown as the straight line BP with intercept $X - \Delta F - a(Y_{-1} + P_{-1} \ddot{A}y)$ and the negative slope of $-ay_{-1}$. The intersection of MM and BP yields equilibrium levels of the balance of payments ($\ddot{A}R_0$) and inflation ($\ddot{A}P_0$) at point A.

A reduction in the rate of credit expansion shifts the locus MM vertically upward, causing equilibrium to move northwest from A along locus BP. The credit contraction therefore results in the reduction of inflation and improved balance of payments performance ($\ddot{A}R$).

Since changes in the rate of domestic credit expansion can only move equilibrium along BP, any combinations of $\ddot{A}P$ ($\ddot{A}R^*$, $\ddot{A}P^*$) that do not lie on the BP locus, cannot be attained with only the domestic credit instrument. But incorporating the exchange rate as a policy tool provides a way out of the dilemma.

The Polak model can be identified by introducing the equation:

$$\ddot{A}P = (1 - \epsilon) \ddot{A}P_D + \epsilon \hat{A} \hat{\epsilon} \dots\dots\dots (12)$$

Where P_D is the index of domestic prices, ϵ is the share of importables in the overall price index and $\hat{\epsilon}$ is the exchange rate (the domestic currency price of a unit of foreign currency).

Thus, an additional endogenous variable is introduced in the form of $\ddot{A}P_D$ and an additional policy instrument $\hat{A} \hat{\epsilon}$.

Equation (10) is modified to allow the volume of imports to depend on the relative price of importable goods in terms of domestic goods:

$$Z = Z_{-1} + (Z_{-1} - b)\hat{\epsilon} + b\Delta P_D + a\Delta y \dots\dots\dots(10')$$

where b measures the responsiveness of the volume of imports to the relative price of importables.

According to (10'), an increase in domestic real GDP and domestic prices will raise the spending on imports, while a devaluation will reduce imports if the volume of imports is sufficiently responsive to relative prices.

Equation (4') is changed to reflect the valuation effects of exchange rate changes on the central bank's balance sheet.

$$\Delta M \equiv \Delta R + \Delta R_{-1}^f + \Delta D_p + \Delta D_G \dots\dots\dots(4')$$

Where R_{-1}^f is the foreign currency value of the previously existing stock of foreign exchange reserves and ΔR now refers to $\hat{\epsilon}\Delta R^f$, which is the balance of payments in foreign currency at the current exchange rate.

Finally, the volume of imports is assumed to depend on the relative price of foreign goods in terms of domestic goods. Net foreign capital is assumed to be exogenous in foreign currency terms:

$$X = X_{-1} + (X_{-1} + c)\hat{\epsilon} - c\Delta P_D \dots\dots\dots(13)$$

$$\Delta F = \Delta F(1 + \hat{\epsilon}) \dots\dots\dots(14)$$

Substituting (12) into (9) (derived from (4')), as well as (13), (14) and (10'), into balance of payments identity (3), allows the expanded Polak model to be expressed:

$$\Delta R = v_{y,-1}(1 - \hat{\epsilon})\Delta P_D + (v_{y,-1}\hat{\epsilon} - R_{-1}^f)\hat{\epsilon} + v\Delta y - (\Delta D_p + \Delta D_G) \dots\dots\dots(9')$$

$$\ddot{AR} = (X_{-1} - Z_{-1} - \ddot{AF}) + [X_{-1} - Z_{-1} - \ddot{AF} + (b+c)]\ddot{A}\hat{e} - a\ddot{A}y - (b+c)\ddot{A}P_D \dots \dots \dots (11')$$

The expanded Polak model can be analysed as earlier, except that the variable on the horizontal axis is now $\ddot{A}P_D$ (the change in domestic prices). Now, control over the exchange rate allows the authorities to shift the locus such that a better balance of payments can be attained. Points such as B may be attained by adjusting $\ddot{A}\hat{e}$ such that the locus BP shifts and passes through point B, and moving to intersect BP at point B by adjusting the expansion of domestic credit. Therefore, with two instruments at their disposal, authorities can attain targeted values for inflation and the balance of payments.

The extension to the monetary model is pursued due to the fact that in practice, the ceiling on expansion of total domestic credit is frequently accompanied by a sub-ceiling on the expansion of credit to the non-financial public sector. This is helpful in two ways. Firstly, the sub-ceiling assists in the monitoring of the overall credit as, given the IMF's experience, violations of credit ceilings frequently tend to originate from excessive expansion of credit to the public sector. Secondly, the public sector sub-ceiling ensures that the availability of credit to the private sector is not curtailed excessively by the overall credit ceiling. Thus, the expansion of credit to the private sector functions as a secondary target in Fund programmes. A private target ceiling of $\ddot{A}D\ddot{p}$ can be achieved using the expansion of credit to the public sector as an instrument. Therefore:

$$\ddot{A}D_G = \ddot{A}D - \ddot{A}D\ddot{p} \dots \dots \dots (15)$$

Meanwhile, the target value of private credit expansion is typically related to the projection for nominal GDP. Thus, it may be predicted that the expansion of credit to the private sector keeps pace with the increase in nominal GDP. Therefore equation (16) fixes the public sector's deficit from the financing side.

$$\ddot{A}D\ddot{p} = (D_p/Y)_{-1}\ddot{A}Y \dots \dots \dots (16)$$

From the budget constraint:

$$T - C_G \equiv \Delta F_G - \Delta D_G$$

The public sector must adjust to the programmed deficit by either increasing revenue or decreasing expenditure.

While the IMF is strongly influenced by the monetary approach, it still takes into cognizance the composition of the balance of payments. Specific targets are set for the current account, and concern is expressed over the ratio of imported goods and the commodity composition of merchandise exports. However, the IMF's primary concern is in encouraging countries to achieve viable balance of payments where the current account deficit can be financed on a sustainable basis, by net capital inflows on terms compatible with the level of development and growth. That is, the IMF takes into account the availability of long and short term capital inflows (Bird, 1984: 88).

The first basic proposition of monetarism is that there "are strong functional connections between money or credit creation and nominal income, and between nominal income and imports" (Eshag, 1983: 244). The second proposition of the monetarists regards the balance of payments as essentially a monetary phenomenon, or in other words, as determined by the supply of and demand for money.

The second proposition is based on an accounting identity, which states that any change in the overall balance of payments (as reflected in reserves) must necessarily be statistically equal to the difference between the supply of and demand for money (Eshag, 1983: 224).

$$R + D = M$$

R = reserves

D = domestic credit creation

M = money supply

A deficit on the balance of payments implies a loss of reserves. From the above equation it follows that if there is a deficit, it must be accompanied by either credit creation (increase in D) or a fall in M (dishoarding). However, dishoarding is temporary in nature, therefore the balance of payments

deficit can only be accompanied by an increase in domestic credit creation. In other words, additional credit creation will ultimately leak out abroad (Williamson and Milner, 1991: 208). To keep the external account in balance and the change in international reserves to zero, it is only necessary to ensure that domestic credit creation is equal to the change in the demand for money (Eshag, 1983: 245).

However, Eshag (1983: 246) argues that the second proposition is superficial, concerned with the symptoms rather than the causes of the imbalances. Therefore, it offers little value for diagnostic purposes and may lead to policy prescriptions which are irrelevant at the time and even harmful. Theoretically, Eshag argues that it is illegitimate to draw on causality, presuming that external balances are caused by excess domestic credit creation in relation to the demand for money. The causality in the accounting identity could go either way (i.e. identities and correlations are neutral as regards causation). The identities themselves cannot serve any purpose in the diagnosis of imbalances and the prescription of remedies.

Policy Implications of the IMF Model

As has already been stated earlier, the need for a macroeconomic adjustment programme, whether supported by the IMF or otherwise, arises when countries are experiencing debt problems. Supporters of the IMF contend that this is the result of imbalance between domestic aggregate demand and aggregate supply. Others argue that this imbalance follows external shocks, worsening the terms of trade. IMF supporters say that the imbalances can be traced to inappropriate domestic policies resulting in excessive aggregate demand relative to the growth of the productive capacity of the economy. If allowed to persist, one can expect a widening of the current account deficit, loss of competitiveness, distortions in relative prices, declining growth rate and a heavy debt burden.

The main objective of the Fund in these circumstances is designing a policy package to restore the balance between aggregate demand and supply and expanding the production of tradeables. The main target is therefore to reduce the country's need for financial assistance by improving the balance of payments. The reduction of inflation is a secondary target. The rules, as set out in the

Articles of Agreement and interpreted by Executive Agreement, require the correction of balance of payments problems in a relatively short time, and keeping down the need for foreign exchange.

The analytical model underlying the IMF package is based on monetarism, through models by various economists such as Polak and Dell (1982) and Diaz-Aliejandro (1984). The IMF's approach relies on credit restraint and possibly a devaluation to achieve the desired improvement in the balance of payments.

The IMF model is an amalgam between simple Keynesian and monetarist theories. From the monetarist approach the assumption is made of a stable relationship between money supply and income, in other words, a stable income velocity. The assumption of a stable relationship between imports and income, or a stable propensity to import, draws from the Keynesian approach (Furness, 1983: 267).

The IMF model serves to provide an explanation of the Fund's approach to stabilization. Ceilings on domestic credit creation are emphasized because the Stand-by Arrangement is based on the view that changes in the supply of money and credit have a strong impact on aggregate domestic demand and a related effect on the balance of payments. Domestic credit is therefore a key determinant of the balance of payments and plays a key role in correcting balance of payments difficulties. This explains the appearance of credit ceilings in adjustment programmes.

The IMF model implies the removal of price distortions. Trade liberalization, financial liberalization and a devaluation are implied, as imports are a function of the exchange rate and income. Tariffs are used to maintain foreign exchange and prevent a devaluation of the currency. Thus an overvalued exchange rate is an indicator of unsustainability. The removal of tariffs and a competitive exchange rate are therefore objectives of the model.

The design, influenced by the monetarist approach, features tightening of monetary, fiscal and credit policies. These may include

- reducing the budget deficit (reducing spending, increasing taxes),

- reducing government borrowing,
- raising real interest rates,
- credit ceilings,
- lower subsidies, and
- trade liberalization.

The above policies are intended to reduce aggregate demand. A devaluation of the exchange rate is another element of most programmes and is intended to increase the cost of imports in domestic currency in order to reduce them, as well as increasing competitiveness in the export industry. In the long term, this will attract investment into the industry, thus resulting in increased output of tradeable goods and strengthening of the balance of payments. The higher interest rate should prevent further devaluation of the currency, by attracting foreign capital.

The monetary approach still plays an important role in the underlying complex packages of policy measures with various multiple targets. But the typical programme could also include policies to increase investment and efficiency, trade liberalization, wage policies external debt policies and privatization. The Fund has an eclectic approach. There are a range of variables that may be affected. It can be seen that the IMF programmes have also taken to include some 'structural' features.

A critique of the IMF model

As has been mentioned earlier, the IMF model of adjustment can be summarized as removing price distortions and shifting industry to be outward orientated. The policy recommendations include the liberalizing of foreign exchange, restoring the real effective exchange rate, removing protectionist barriers, tight control of credit and monetary policy, and reducing the role of government through expenditure reductions and privatization. According to the IMF, the above measures will make

industry more competitive and export orientated, responding to the comparative advantage of each country's resources.

Stein (1992: 89), however, argues that such prescriptions are more likely to deindustrialize the existing manufacturing base in African countries, without significant replacement. He contends that there are problems with the methodology of the IMF model. He argues that the need for adjustment is a product of the IMF model of adjustment, which is based on a series of theoretical assumptions.

Economic models make use of assumptions for simplification and explanation purposes. Some assumptions may be necessary assumptions, whereby their removal would lead to a breakdown in the model. Simplifying assumptions, on the other hand, merely simplify the model. For example, the IMF model's assumption that there are only two countries serves to simplify.

The IMF approach is a product of the rational-deductive method, since the behaviour of the agents is predetermined by a set of rational rules which are deductively poised. Like other neoclassical models rational, predictable behaviour arises from market signals. Unfettered markets would normally lead to indicators reflecting scarcity and choice. Decision-making under these conditions will lead to efficient choices on production, reflecting the comparative advantage of the country as long as exchange rates are adjusted in line with relative inflation rates. A crisis is attributed to distortions in market signals. Prices may be prevented from reflecting scarcity, and barriers may exist which inhibit the agents in the economy from acting in a rational manner (Edwards, 1985: 140).

Stein (1992: 89) points out that the IMF approach is axiomatic in order to specify culpability so that policy recommendations may be met. Consumers and private producers are presupposed utility and profit maximizers that respond efficiently when market signals are coined. On the other hand, the public sector's behaviour is assumed to be a product of utility maximizing design of politicians to stay in power. As a result the politically rational choices lead to economically irrational results, disrupting the efficiency of the market. The public sector and its policies is therefore viewed as the source of the distortions in the market. For various reasons which will be mentioned, the approach is being internally inconsistent and exclusionary.

Firstly, the combination of demand restraints via the control of monetary aggregates and supply inducements via correct market signals are often in conflict. For example, credit controls are fundamental in controlling demand and inflation. However, devaluations and interest rate increases augment operational costs. The tightening of credit creates difficulty for industries to expand supply and meet export targets. Furthermore, the cost of obtaining foreign and domestic funds for investment increase with a devaluation and tightening credit. Another example of conflict occurs as cutbacks in government spending on infrastructure and therefore inhibiting export orientated manufacturing and agriculture. Devaluation and liberalization of exchange controls have also been in conflict with IMF priorities. For example, an auction was introduced in Zambia in 1985, and by 1987 the Kwacha had fallen to K21:\$1. Consequently, the inflation rate increased considerably, curtailing the supply of inputs (Stein, 1992: 89).

Fundamental for the IMF model is the assumption that the velocity of money is constant. It is based on the quantity theory of money, whereby the price level is proportional to the money stock. In other words, it is based on the notion of the neutrality of money. A great deal of controversy clearly surrounds the quantity theory of money.

Up to the early 1970s the Keynesian policy was dominant, committed to a full employment policy, and relatively stable prices. The quantity theory of money was viewed as being unimportant. However, after the late 1970s there was a revival in the quantity theory. At the time, rapid monetary growth was accompanied by accelerated inflation and unemployment.

Research has led to differing conclusions about the quantity theory of money. That of Lucas (1980: 1010) and Lothian (1985: 834) supports the neutrality hypothesis. However, research by Gupta and Moazzami (1991: 1089) contradicts this hypothesis, raising questions about its universality.

Kaldor (1980: 295) argues that the causal effect between money supply and the level of prices is reversed. Rising costs are reflected in rising prices, and rising prices are reflected in rising money supplies. Thus the money supply accommodates rising prices. Furthermore, the velocity of circulation is more variable in the medium-term than monetarists assume.

Although the notion that the velocity of money is constant has been questioned, the velocity appears to be stable. According to Furness (1983: 146) not too much should be read into estimates of velocity, especially in developing countries where the data may be unreliable. Thus, while the velocity may not be constant, the apparent stability should be enough to uphold the IMF model.

There are standard criticisms of the IMF model, since it is based on the monetarist approach. These have already been mentioned in the critique of the monetary approach to balance of payments problems. The rudimentary nature of capital markets in less developed countries imposes limitations on monetary policy. The controversy over the money demand function has also been discussed. For example, Spraos (1986: 12) argues that because the IMF pioneered the monetary approach does not give it licence to make use of domestic credit as a linchpin in its programmes due to the breakdown of the money demand function in the 1970s. Although there is conflicting evidence regarding the stability of this function, it was concluded that stability is sufficient to uphold the model.

Overall, the IMF model relies on assumptions which are by no means realistic. The debate over the neutrality of money, for example, is hotly disputed. The model is also limited by the assumption that prices continuously adjust to maintain flow money market equilibrium. According to Khan *et al.* (1990: 176) introducing short term dynamic behaviour through lags in adjustment of prices would reveal useful insights, although no change in overall conclusion would result.

The model can also be criticized for the exclusion of interest rates and wages, which play a role in IMF policy. Introducing such variables could be done, although that would make the model very complex. However, Khan *et al.* (1990: 176) argue that one of the important reasons for the model surviving despite the assumptions, is the simplicity of the model. Little information is required, and it is easy to apply. Furthermore, the diversity of developing countries in terms of production, financial development and trade regimes require a flexible approach to the design of programmes.

Economic models are based on behavioural assumptions which, inevitably, are never realized in practice. There is a heavy reliance on the income velocity function and money demand function. These assumptions are necessary assumptions for the IMF model to work, and to justify the relationship between domestic credit and the balance of payments. The greater the variability of these functions in practice, the less useful the model will be.

There has been much debate over the assumptions, and thus it appears that the analytical model and empirical foundations are less than fully secure. While there have been questions over the validity of the assumptions, it has been argued that they are sufficient. While the velocity of money may not be constant, it appears to be stable. The demand for money has also been argued to have some degree of stability. The model provides a means of assessing, approximately, the relationship between domestic credit creation, exports and capital receipts on the one hand, and income on the other.

As mentioned earlier, the IMF model is also criticized for excluding structural phenomena. Stein (1992: 92) argues that the elasticity problem of agriculture is an impediment to the IMF model. On the demand side elasticities relative to a high market share are already problematic in Africa in primary commodity. There is the possibility of declining revenues due to increased supply. On the supply side, agricultural response is often constrained in low income countries by poor infrastructure, poor health and lack of assured water supply. However, it is these which are affected in adjustment programmes when government expenditure is reduced. Furthermore, an insufficient supply of agricultural goods may hamper industrial expansion. Rising debt service ratios means that increases in capital inflow have mostly been used to pay back debt, rather than as a means of expanding export promotion. The reduction in real wages as part of the process of removing price distortions and encouraging labour intensive production. However, low wages are not enough to attract investments, there is a need to compete in terms of infrastructure and an educated labour force. Lastly, the IMF model is argued to not incorporated class as a variable. In reality however, the deregulation of state controls and creation of market incentives presupposes the existence of a class willing and able to respond. Overall, Stein points out that the IMF model is more likely to be deindustrializing.

As mentioned earlier, the IMF model implies the removal of price distortions in order to maintain a competitive exchange rate. This entails trade liberalization and a devaluation of the exchange rate. These are key policies often stipulated in structural adjustment programmes.

Criticism has been levelled at the use of devaluations as an answer to structurally based balance of payments deficits. Dell (1982: 599) argues that the devaluation may have an inflationary impact and no sustained benefit for the balance of payments when for structural reasons the export supply cannot be increased quickly enough. This will impact on income distribution, and may well have political and social repercussions.

Schydowsky (1982: 102) points out that developing countries have low elasticity in supply of exports and demand for imports, and the devaluation will have inflationary pressures. Loxley (1986: 121) argues that the devaluation requires a well developed manufacturing sector to respond to the price incentive, which many developing countries do not have. In fact, they rely mainly on primary exports such as crops, which take time to respond, longer than the periods the IMF seeks. According to Kaldor (1983: 37), a devaluation may be justified if large subsidies and tax breaks are implemented.

Trade liberalization is another instrument which has been widely criticized. The removal of trade restrictions, it is argued, leads to the liquidation of domestic industries and therefore worsening unemployment (Budhoo, 1994: 21). The indigenous manufacturing sector may well struggle in competing with foreign producers who are able to achieve economies of scale and therefore lower unit costs. It has been argued that the use of multiple exchange rates allows the government to discriminate between various imports and exports depending on their price elasticities and the level of development (Bird, 1984: 172). Others argue that trade liberalization results in takeovers by multinational companies and a loss of finance from that used for the importation of non-essentials (Payer, 1974: 172).

Mawakani (1986: 110) points out that developing countries have a weak structure, and this prevents them from competing with industrialized countries in the manufacturing sector. Liberalization should be gradual, over a long time, not within the IMF's desired short term range. Dell (1982: 606) agrees with Mawakani, that some countries are better equipped than others in

their capacity for adjustment. Some countries may find it easy to compress imports, while others are better equipped in terms of skills and resource availability for developing import substitutes. This goes back to the argument against uniformity of the Fund's conditionality.

The Fund is also criticized for the use of pinpoint targeting, whereby various targets are stipulated. Nyirabu (1986: 36) points out that monetary policy may be less effective in developing countries, especially African countries. These economies are characterized by ill connected money markets and structural rigidities. A major constraint is the problem of monetary data, which is viewed as being quite inaccurate due to 'errors and omissions' which make up a large proportion of available data. Loxley (1986: 124) agrees, and goes further to say that the lack of data and skilled staff can result in time lags between the emergence of a problem and its identification.

Dell (1982: 609) contends that trying to meet targets stipulated by the agreements should not be very significant. How can it be possible for developing countries to reach targets when even developed countries struggle? Germany and Switzerland have had the most success in conducting monetary policy while being 'relaxed' about adherence to monetary targets. Evidence in a study by the Federal Reserve concludes that there is an approximately two year lag between monetary restraint and its effects on prices. Even the United States and the United Kingdom have constantly had mean errors in their forecasting.

3.8 Selecting Cost-Efficient Balance of Payments Policy

Choosing the correct balance of payments policy is a major problem facing policy makers. Some developing country policy makers are unwilling to recognize the need for adjustment, and to recognize that in order to improve the balance of payments position sacrifices have to be made in terms of other domestic objectives. This is a major hurdle for efficient balance of payments policy.

Even with commitment to act, the problem remains of selecting the appropriate strategy from a range of alternatives, given the conditions. The dynamics of the balance of payments make this a difficult task (Bird, 1984: 86).

The notion of a 'cost effective balance of payments adjustment' is important when it comes to balance of payments policy. It is not enough that policies are just effective in reducing the fiscal deficit. They should also do the least possible damage to economic growth, employment and income distribution (Bird, 1984: 91). Setting up policy to strengthen the balance of payments situation inevitably results in various conflicts. Such measures used by policy makers may conflict with other domestic policy objectives, such as economic growth, employment, welfare programmes, consumption and others (Killick and Sharpley, 1984: 18).

The more appropriate objective of policy makers would therefore be to improve the balance of payments with minimum costs of adjustment. Furthermore, in pursuing policy correctness and minimum adjustment cost, the appropriate strategy needs to be selected. The appropriate policy response will depend on the source of the disequilibrium. It is therefore important that once policy makers recognize the balance of payments problem, they find the causes, and go on to apply the corrective balance of payments policy (Killick and Sharpley, 1984: 19).

Failure to explore the causes of the balance of payments problem could result in policy measures unrelated to the cause which may seem appropriate in that they correct the balance of payments. They increase the cost in terms of the effect it has on growth, employment and development in general. For example, following an adverse movement in the terms of trade, a policy of domestic demand deflation, while reducing the demand for imports, (and strengthening the balance of payments) it will also affect unemployment and other areas. However, pursuing policies directed towards strengthening the competitiveness of tradeables will strengthen the current account in the balance of payments, while at the same time achieving higher levels of output and employment by encouraging export growth rather than import contraction (Bird, 1984: 92).

There are various external and internal (exogenous and endogenous) causes of disequilibrium. As we have seen, choosing the most cost-effective adjustment policy depends on the root source of the deficit. Exogenous sources of disequilibrium are beyond the control of domestic policy makers, emanating from world economic conditions or acts of God such as floods, and droughts. Endogenous sources are within the influence of government and policy makers, such as excess domestic demand. Thus the correct policy needed to cope with disequilibrium will differ according to circumstance.

3.9 Implications for Overall Policy

A range of specific balance of payments policies are available to LDCs. The policies fall into different theories of the balance of payments. They include instruments such as the exchange rate, and domestic demand management, which includes exchange controls, tariffs, and fiscal and monetary policy. A distinction is made between those policy instruments which are expenditure reducing, and those which involve expenditure switching in order to rectify the balance of payments deficit.

Expenditure reducing policies consist mainly of demand management policies, such as fiscal and monetary policy. Expenditure reducing policies are a general part of the IMF's mandate, the general aim being to reduce absorption (domestic expenditure) (Williamson and Milner, 1991: 205).

If real domestic output cannot be increased, then the correction of the current account deficit must entail a reduction in absorption (i.e. consumption or investment). This is true even if the demand for domestic output by foreigners rises, since this demand may only be met if the resources demanded by foreigners are freed by residents. Increased absorption of domestic and foreign output by foreigners involves lower absorption of domestic and foreign output by domestic residents. This correction of the deficit can only be achieved if there is a reduction in real domestic expenditure. In other words, unless there is increased output, a correction of the deficit cannot be costless in terms of lower absorption.

Expenditure reducing policies serve to lower domestic income, therefore reducing expenditure on traded as well as non-traded goods. By reducing the demand for imports, such restrictive policies could be sufficient to sort out the deficit. Furthermore, the decrease in expenditure induces a fall in prices of domestic goods, thereby encouraging a switch away from foreign output towards domestic output. The resources will have been freed by the decrease in domestic expenditure in order to cope with the increased demand. But this relies on the assumption that the expenditure reductions affect traded goods and not just non-traded goods.

This may hinge on the degree of substitutability between export goods, import goods and non-traded goods. In LDCs, the degree of substitutability is often low, so that domestic reduction may not immediately release the extra exportable output if the pattern of exports does not match domestic absorption. Therefore there will be a slow process of adjustment with changes from non-traded goods and traded goods.

Expenditure-switching policies are those policies which are able to influence international competitiveness more conventionally. Exchange rates are the leading example, but others include tariffs, export subsidies, quantitative restrictions and forms of credit facilities (Williamson and Milner, 1991: 205).

As long as the change in the exchange rate is real rather than being neutralized by inflation, devaluation engineers a transfer of expenditure from residents to foreigners, lowering the incentive for residents to buy foreign goods and raising the incentive for both residents and foreigners to buy domestic goods. This is done by using the devaluation to change the price of domestic output relative to that of the foreign output.

While expenditure-reducing policies may be used on their own to correct a deficit, a devaluation on its own is insufficient. Expenditure-switching policies may need to be accompanied by a policy of domestic expenditure reduction. In conditions of under-capacity (spare capacity) the induced demand for the exports and import substitutes may be met, but when there is full capacity the extra demand will generate inflation. Thus a policy measure may be needed to free up resources for the extra demand (Bird, 1984: 91).

3.10 Conclusion

The four approaches to the balance of payments adjustment process described above may be considered as distinct theories of the balance of payments that should be regarded as alternatives in explaining the adjustment process. However, it is clear from a comparison of the characteristics of the three approaches that they are to a large degree complementary rather than alternative approaches, each considering a part of the balance of payments adjustment process.

The elasticities approach is a microeconomic theory of the trade balance. The focus is on the effects of relative price changes. The only balance of payments items considered are the imports and exports of goods and services, i.e. the components of the trade account (balance) of the balance of payments. Capital movements are completely ignored. The elasticities approach also ignores the income effects of an exchange rate change (ie the effects of the increased production for export and the increased domestic production of importable goods). This implies that the elasticities approach is a partial equilibrium approach.

The absorption approach is explicitly macroeconomic in nature. It views the balance of payments as the difference between domestic production and expenditure. It specifically provides for the income effects of the balance of payments adjustment process neglected by the elasticities approach. However, it also does not consider the whole of the balance of payments. Capital movements (the capital account) are ignored since the focus is exclusively on the current account of the balance of payments. The absorption approach also does not provide for the monetary effects or aspects of the adjustment process.

The monetary approach complements the other two approaches in that it emphasizes the monetary aspects of the adjustment process and provide for the role of capital movements (since it considers the overall balance). It also differs in that stock concepts and stock equilibria are emphasized. The elasticities and absorption approaches concentrate on the relationships between flow variables (as they focus exclusively on the trade components of the balance of payments). The monetary approach considers the balance of payment flows as changes in stocks and defines equilibrium in terms of stocks. Thus the balance of payments will be in equilibrium if the stock demand and supply of money in the respective countries are in equilibrium.

The portfolio approach is an extension of the monetary approach. The focus is on capital movements in the capital account and interest rates, considering other financial assets besides money. Wealth holders are assumed to have a choice between domestic money, domestic bonds and foreign bonds. A rise in domestic interest rates provides a one off capital inflow.

The analysis of the analytical IMF model reveals a framework linking the financial sector to the balance of payments, providing the rationale for credit restraint. The balance of payments is

expressed as the difference between the private sectors flow demand for money and the flow of domestic credit.

Although based on monetarism, the IMF approach is clearly eclectic. IMF stabilization programmes designed to deal with balance of payments deficits typically involve deflationary fiscal and monetary measures, devaluations and credit restraint. Structural features have also been included, such as privatization, trade liberalization and wage restraint.

CHAPTER FOUR — THE CASE STUDIES

4.1 Introduction

This chapter examines three case studies of LDCs in which the IMF has intervened. In each case, the country's economic problems are set out, followed by an evaluation of the IMF programme, and of its impact on the structure of the country's economy. The countries examined are Brazil, Mexico and Zambia.

The period of investigation with respect to the case studies varies. The respective periods evaluated reflect the length of time for which the IMF programmes were pursued before breaking down. Although the period examined is the 1980s, the IMF programmes offered similar prescriptions, and were extensively pursued. Viable comparisons can be made as a result. They therefore offer valuable insight into what inhibits a successful adjustment programme. An examination of these countries in the early 1990s may not have provided as valuable an evaluation and would not have been possible to make a reasonable comparison for the following reasons. The IMF prescriptions were pursued on an *ad hoc* basis. The IMF reforms prescribed in the programmes were not fully implemented due to political unrest. The reforms were later reinstated before again being discarded. The period was therefore characterised by a lack of commitment or ownership by these governments as they switched between various heterodox economic policies and the reforms prescribed by the IMF intermittently. An evaluation of the data would not have been comparable due to the inconsistency of the policies pursued.

Important lessons can be learnt from these case studies. Besides the fact that IMF programmes remain fundamentally the same, there are many similarities between these countries and South Africa. Firstly, all three of them pursued policies of Import Substitution Industrialization (ISI). Each had a legacy of manufacturing sectors that were protected from international competition. Secondly, their economies were poorly diversified. The Zambian economy was especially dependent on copper for its foreign exchange. Although not to the same degree, Brazil and Mexico were still uncomfortably reliant on their primary commodities. Thirdly, like South Africa's economy, each of these economies, to varying degrees, displayed high levels of poverty and socio-

economic inequality. Finally, each of these countries has embarked on paths of democratic and economic transformation.

Beyond the similarities however, there are many structural and institutional differences that affected the economies in various ways. These differences and difficulties in these countries are important indicators of the potential as well as the limits imposed on developing countries. An examination of the factors either hampering or motivating reforms provides information which may improve South Africa's chances of successful economic reforms.

4.2 Zambia

The following section examines the background to the Zambian post independence economy to explore the origins of the Zambian economic crisis. The IMF's involvement in the economy is analysed and evaluated.

4.2.1 The Zambian Economy up to 1982

By the time independence for Zambia arrived in 1964, the economy was based mainly on copper mining, financed by British and US capital. Foreign investment was directed towards the exploitation of the rich deposits in the copper belt. On the whole, the country's infrastructure was geared towards supporting the mining industry. The copper revenues supported a large urban labour pool of indigenous workers and a small European community of commercial farmers, business owners and mine managers. Little investment took place outside the mineral sector, and mining profits were mostly expatriated rather than reinvested. Indigenous participation in the economy was negligible, limited largely to miners and tradesman. The majority of the local population were subsistence farmers, remaining untouched by the prosperity of the European community (Hawkins, 1991: 841).

After independence, the newly elected United National Independence Party (UNIP) advocated strong government intervention as a tool to replace capitalism with socialism. The new president, Kenneth Kaunda, initiated reforms to dismantle the colonial regime. The first Zambian National Development Plan aimed at providing free education up to university level, improving and

subsidizing public transport, exempting the low income groups from tax, and abolishing bicycle tax, poll taxes and other similar taxes (Mijere, 1988: 45). Broadly, an attempt was to be made to raise the level of training and education, provide better housing and infrastructure and increase employment.

The development strategy entailed nationalization, import substitution and significant welfare benefits, including free education and housing. This pattern of development was facilitated by the economic boom which existed due to the high price of copper. The mining industry was the dominant earner of foreign exchange, earning approximately 90% of Zambia's foreign exchange. There was a large dependence on copper as a primary commodity, not in a processed form (Burdette, 1988: 78).

The welfare policies were consolidated in 1968 with further economic reforms announced by the Zambian government. Kaunda was dissatisfied with the private companies, excessive local borrowing, under-capitalization and the transfer of profits outside Zambia. The Zambian government therefore took effective control (share holding) of foreign private companies. In 1969 control was taken of the mining corporations (Mijere, 1988: 44).

During this time, Zambia adopted the strategy of creating an indigenous industrial sector via 'import substitution'. The aim was to reduce its dependence on foreign manufactured goods and to develop local industry. At the same time a large public sector was created and maintained by the copper revenues under government control (Hawkins, 1991: 842). The manufacturing sector enjoyed high levels of protection and was therefore inefficient in export markets, and in fact dependent on copper foreign exchange earnings to finance the importation of raw materials and capital goods (Jones, 1994: 26).

Jones (1994: 28) points out that price signals and incentives were accorded a minor role in decision making, imposing a severe burden on the limited human resources in management and economic analysis. The nationalization of companies became threatened financially due to inefficiency and centrally imposed pricing policies. According to Hawkins (1991: 841), by 1972 the large government-owned enterprise comprised 52% of total manufacturing output, employing one third of the work force.

Hawkins (1991: 842) contends that dominance of the government had a few key weaknesses. Firstly, the government-owned enterprises relied heavily on government subsidies, and therefore high copper prices and foreign exchange, to import the necessary inputs, even though parastatals were created to be 'import substitution' industries. Secondly, in order to assist with the importing of inputs, an overvalued exchange rate was maintained. While it made imported inputs cheaper, it also had the effect of making Zambian exports in general uncompetitive in the world market. Production was therefore limited to domestic consumption. Lastly, the subsidies and reduced competition resulted in inefficiency within the government-owned enterprises.

Notwithstanding the fact that private business was still important, it suffered due to the policies pursued. Sectors where the state did not dictate, such as banking, commercial farming, construction and manufacturing remained strong. However, they were also hampered by low competitiveness due to the overvalued exchange rate, heavy tax burdens to support the public sector and expensive import input costs.

Until the early 1970s, Zambia had a favourable balance of payments, and therefore accumulated external reserves. The first signs of the problem of Zambia's copper dependence were seen in 1973. The world oil crisis and the resulting increase in the price of oil, created a huge oil import bill and thus higher costs. By 1975 the price of copper began to fall due to the cautious approach of the developed countries regarding the oil crisis and recession. This led to increased usage of substitutes for raw materials and their recycling (Fundanga, 1989: 142). The formation of OPEC together with large cutbacks in production and the ensuing recession, as well as the Vietnam War, all culminated in general uncertainty worldwide.

The problem was exacerbated by unusually high copper prices during 1973 and 1975. This stimulated copper production and increased volumes. In the same year the price of copper dropped from £ 1400 per ton on the London Metal Exchange to £ 576 per ton. This fall was a consequence of over-production, as world production was approximately 20% greater than world consumption at the time. The fall in worldwide demand can be attributed to a worldwide recession after the first oil crisis.

In view of Zambia's dependence on copper, the decline in the export price of copper occasioned a fall in export revenues. In the years following the fall in the copper price, the Zambian economy essentially collapsed. GDP collapsed to such an extent, that in some years a negative GDP growth rate was experienced. By 1977 foreign exchange reserves had been exhausted, while production slowed due to lack of supplies of inputs. Unemployment and inflation levels began to rise.

Zambia's poor economic performance continued during 1978 when GDP growth rate was 1.6% (Table 1). This was attributed to the poor performance of the mining sector. The reduction in worldwide oil imports had a marked effect on the mining sector and raised the cost of capital. During the mid 1960s, Zambia had experienced gross fixed investment (gross fixed capital formation) of up to 29 to 30% (GFCF). By 1978 this had fallen to 23%, falling further to 22.1% in 1979. This is attributed to government's attempts to maintain high levels of expenditure even in the face of a recession. An overvalued exchange rate was preserved from 1978 to 1982 (see Table 2), until an agreement was negotiated with the IMF in 1983.

The poor performance of the balance of payments accounts between 1978 and 1982 is also illustrated in Table 2. During the 1970s and 1980s Zambia suffered from severe current account instability, high inflation and unmanageable fiscal deficits. The current account was in a deficit for the entire period, except for 1979. Poor agricultural performance resulted in the need to import food. Export growth fell while imports rose sharply, particularly in 1979 and 1980, because of the overvalued exchange rate. At the same time the capital account was also in deficit. Consequently, a rapid erosion of reserves took place.

Between 1978 and 1982 a low GDP growth rate and a rising inflation rate prevailed. In the face of this, the budget deficit (GD in Table 1 in the appendix) also increased. As a percentage of GDP, the deficit grew from 5.3% in 1978 to 8.2% in 1979. By 1980 the budget deficit had extended itself to 23.2% of GDP.

4.2.2 Zambia and the IMF

Zambia suffered from frequent balance of payments deficits and foreign exchange shortages during the 1970s and 1980s, which necessitated a series of negotiations with the IMF. The first drawing by Zambia was in 1971. At the time it was a relatively small loan. From 1976 onwards the drawings escalated as the economy deteriorated.

In 1976 Zambia signed a Stand-by Agreement for SDR 62 million over twelve months. The loan was not particularly large, and so had few conditions attached to it. The conditions that were set, however, included a 20% devaluation and ceilings the money supply, on government credit, and on overall credit (Kayizzi-Mugerwa, 1991: 852).

By 1978 Zambia's economy had deteriorated further, and the IMF obliged by offering loans with more severe terms. The package included a 10% devaluation, cuts in government food subsidies and reduced internal borrowing. A further agreement with the IMF in 1981 resulted in the IMF offering the use of its extended finance facility (EFF) for aid worth SDR 800 million. The facility essentially demanded a restructuring of the economy, with the objective of correcting the balance of payments difficulties by diversifying exports using various instruments. Another objective, although not as important as increasing exports, was to attain price stability.

In previous chapters it was noted that the IMF encourages policies that liberalize trade. It tries to get countries to stimulate exports and diversify away from primary commodities, and create an investor-friendly climate so as to encourage capital inflows. Various conditions are set, including reduced budget deficits, ceilings on credit and devaluations. There may be some conditions which are pertinent to the particular country, such as deregulation of prices and interest rates, and sometimes wage restraint.

The IMF advisers were of the view that the Zambian economic crisis was caused by "unsound economic and financial policies" which were pursued by the government. As long as the government subsidized commodities, controlled prices and interest rates and engaged in an overvalued exchange rate, they said, the crisis would worsen the balance of the payments (Mijere, 1988: 49). A restructuring of the economy was required in order to obtain loans.

In Zambia's case, the IMF's conditions included ceilings on government and overall credit, and a reduction in the government deficit from 12% to 7% of GDP. During 1981, most of the fiscal targets were met by the Zambian government, and interest rates were increased. However, the balance of payments and domestic credit targets were not met. This resulted in the cancellation of the arrangement in July 1982. By December 1982, Zambia deregulated the prices of commodities produced by public enterprises. The only prices still under government control remained maize, wheat, flour, bread and candles. The currency was devalued by 20% and interest rates increased in January 1983. In July 1983 the Kwacha devalued a further 15% (Hawkins, 1991: 843).

In 1983 a Stand-by Arrangement was negotiated, whereby a loan of SDR 270 million was approved. Again the conditions included reduced money supply, reduced credit, reducing government deficit to 5.6% of GDP and a further devaluation of 20%, and later the currency was allowed to float. Wage increases were restricted to 5% (Fundanga, 1989: 144). The targets of the 1983 agreement were initially met by the Zambian government, particularly the fiscal targets, and a devaluation of 35% took place. The targets on wages were also achieved following protracted negotiations with the trade unions.

A further Stand-by Arrangement was reached in 1984 worth SDR 225 million. Again, the elements included credit ceilings and money supply ceilings, and a reduction in the budget deficit. In October 1985, the system of auctioning the foreign exchange was introduced and interest rates decontrolled (Fundanga, 1989: 143).

By 1984 Zambia had utilized various facilities on offer at the IMF. These included regular credit tranches, an oil facility, a compensatory financing facility and stand-by agreements. All had conditions attached, although to varying degrees.

4.2.3 Evaluation of the IMF Programme

This section examines the main features of Zambia's programmes with the IMF, during the period 1978 to 1986, as the IMF programme was discontinued in May 1987.

Exchange Rate Policy

Until 1983 Zambia preserved an overvalued fixed exchange rate. The IMF blamed an overvalued exchange rate for the poor performance of the economy in the foreign trade sector. The agreement with the IMF in 1983, however, envisaged drastic economic changes regarding the determination of exchange rates. The emphasis was also on a movement towards a fluctuating (floating) exchange rate mechanism. Devaluations were to be implemented by fixed percentages as stated in the IMF programme. The rationale behind the devaluation was that it would result in increased export revenue and reduce the demand for imports. This was partially based upon the IMF's elasticity optimism, discussed in Chapter Three. In the course of 5 years, 1983 to 1988, the Kwacha's official value fell by 85% against the US dollar (Kayizzi-Mugerwa, 1991: 854).

By October 1985, the IMF had pressurized the Zambian government into adopting a new foreign exchange system (Kayizzi-Mugerwa, 1991: 856). In the face of chronic shortages of foreign exchange and reduced competition, Kaunda recognized that the Kwacha was hopelessly overvalued against the US dollar. In 1985, on agreement with the IMF, the foreign exchange auction system was introduced. A devaluation was intended to stabilize the balance of payments, while monetary and fiscal discipline was meant to improve the domestic fiscal imbalance.

A new committee, the Foreign Exchange Auction Committee (FEAC), chaired by the general manager of the Central Bank of Zambia and including the Minister of Finance, was established to conduct a weekly auction of all foreign exchange. The Kwacha would be determined by foreign exchange auctioning. The FEAC would conduct weekly auctions, making allocations to government, mining companies, Zambia Airways and Zambia-Tanzania pipelines. These parastatal institutions were excluded from bidding for foreign exchange, but would get the foreign exchange at a rate determined by the bidding process. The actual exchange rate would be determined by the marginal bid, a bid which fully exhausts the weekly foreign exchange (Mwanza, Muramba, Kakuwa, 1992: 137).

The purpose of the new system was to diversify the economy from its dependence on the export of copper, towards agriculture and manufacturing. The Minister of Finance was of the view that the

new auction system would allow both the manufacturing and agricultural sectors to increase employment. This would promote self sufficiency in food production, generate exports and therefore reduce the reliance on copper. It would also assist income distribution and promote the development of raw materials (Mijere, 1988: 50). However, the above cause-effect relationship did not materialize. As we shall see, the auction system resulted in panic in the business community, due to the uncertainty of the Kwacha exchange rate and rising inflation.

The early stage of the auction system succeeded rapidly in its primary objective. Table 2 illustrates the fall in the real exchange rate of the Kwacha in 1985. In the first week the exchange rate fell from $K2.2 = \$1$ to $K5 = \$1$. It was more successful in devaluing than the IMF staff had thought. The rate of devaluation stabilized, depreciating steadily until June 1986. At this stage the Kwacha was $K7.5 = \$1$ (Jones, 1994: 34). However, by December, the Kwacha had devalued to $K15 = \$1$. In one month in 1987 the rate fell to $K21 = \$1$.

In July/August 1986 the auction was modified to a 'Dutch Auction' in which foreign exchange was still allocated to the highest bidders, but the successful bidders paid the price they bid, not the marginal market clearing price (Mwanza *et al.*, 1992: 139). The objective was to curb the devaluation of the Kwacha, and even allow it to appreciate. This worked initially, as a nominal appreciation occurred. However the credibility of the auction had begun to collapse. Firms lost confidence that foreign exchange would be freely available, and during this time there was increased inventory build-up.

By the end of 1987, the Kwacha had depreciated to $K21 = \$1$. A two tier system was introduced in April. Two auction rates were set. One rate was for government transactions, debt service repayments and agricultural payments, and was determined administratively. The other auction rate determined the exchange rate for other users. However, within three weeks the second rate had depreciated to $K21 = \$1$, and the auction was thereafter abandoned. The Kwacha was then fixed at $K8 = \$1$ due to the uncertainty created by the auction (Jones, 1994: 35).

Inflation

The depreciation of the Kwacha was accompanied by sharp increases in inflation between 1985 and 1987. This caused considerable economic uncertainty, as business operations and planning became increasingly difficult (Mwanza *et al.*, 1992: 138). The average annual price index increased from 35.3% in 1985 to 52.1% in 1986 (Table 1).

The effect of devaluation on inflation caused increasing concern to the Zambian government, which attributed inflation to the high correlation between the exchange rate and the price level in an import-orientated economy. The World Bank, on the other hand, attributed the inflationary pressure to the effects of high inflationary expectations, which boosted increases in the price level (Jones, 1994: 34). Thus, inflationary rigidities were said to exist in the economy, and these prevented the IMF programme from lowering the inflation rate.

According to Mijere (1988: 54), the auction system, and the consequent uncertainty in the exchange rate, caused panic. As a result of the devaluation of the Kwacha, the price of petrol increased by 100% within ten days of the auction system's introduction. The Prices and Incomes Commission research results illustrate the price increases of essential commodities. Estimates were that the cost of the commodity basket had gone up by 53.5%. As the majority of workers' wages had in fact remained static since October 1985, their buying power had decreased by approximately one third since the introduction of the auction system. At the same time, the cost of public transport increased by 75%, while reductions in subsidies on essential commodities like mealie meal meant many people could no longer afford their staple diet.

The auction has been accused of being inflationary, favouring the imports of luxury goods and discriminating against small firms with limited access to credit lines. The system was perceived negatively, particularly with regard to the adverse effects it had on the poor. In addition, the auction became a focus of popular discontent due to its association with the IMF and the range of other features of the programmes.

However, according to Collier (quoted in Jones, 1994: 35), the inflationary impact of the auction has been overestimated. He contends that the CPI was biased in its weightings and its use of

official prices, and therefore over-stated the inflation levels. Furthermore, the price increases were of a one-off nature.

The Balance of Payments

The rationale behind the devaluation (auction system) was to reduce imports and increase the level of exports, and thereby improve the balance of payments. However, due to lack of resources and infrastructure, local production never took off and no significant improvement occurred. Table 2 illustrates the continued current account and capital deficits between 1980 and 1986. Imports grew rapidly. Their annual percentage growth was high in 1979 and 1980. Thereafter the rate declined for a few years. But in 1984 it rose again to 21.2%, to 66.9% in 1985 and reached 121.3% by 1986. This occurred despite the devaluations. The trend can be attributed to liberalization of trade, as well as the dependency of the economy on imported inputs. Strong growth of imports generally takes place when the GDP growth rate reaches higher levels.

Export growth, on the other hand, was slow, despite the price incentives offered by the devaluation. According to Mengistaeb (1995: 108), the changes in real exchange rate were not accompanied by significant changes in the value of exports. His research shows that neither exports nor imports were significantly affected by devaluations. Reasons for this were that the country's primary commodity, copper, continued to be displaced by other metals, and that it had a low demand price elasticity at an international level. Recession in the industrialized countries in the 1970s and 1980s also contributed to the stagnation of demand and the fall in commodity prices. Attempts to increase the volume of exports through a devaluation only worsened the over-supply of primary commodities and ensured a fall in their price. Lack of export diversification undoubtedly played a role in Zambia's unsuccessful attempts to improve the balance of payments by means of currency devaluations.

Weeks and Mosley (1996: 181) offer three reasons why Zambia's export volume did not respond positively to a devaluation as predicted by the elasticity approach. Firstly, the world market prices for major minerals are quoted in dollars, or in the case of copper, pounds at the London Metal Exchange. Thus a country can make its output cheaper by price cutting rather than devaluation. Secondly, large state ownership in the sector implies that production decisions may not be made on

the basis of profitability. Lastly, the production of other potential exports is stimulated if the depreciation of the real exchange rate translates into an increase in the price of tradeables relative to non-tradeables. Agriculture seems to have shown no sustained shift in relative prices, and although a price shift did occur in the manufacturing sector, it was only after a relatively long time. It should be added that this shift was not associated with any particular policy regime.

The main reasons given for the failure of the Zambian devaluations to improve the balance of payments are diminishing government investment expenditure and export revenues. This was due to the fall in the copper price and resultant fiscal constraint (Mijere, 1988: 671). Clearly, the IMF's elasticity optimism regarding the devaluation was unfounded in Zambia's case, as there were too many rigidities preventing the adjustment taking place.

Furthermore, the supply response of manufacturing to the relative price change was limited because production in mining-specific subsectors had a particularly high import content. Also, most subsectors depended to a great extent on tariffs, which fell away when liberalization was implemented. In conclusion, it is clear that the required relative price adjustments did not occur.

The capital account experienced continued capital outflow between 1978 and 1986. According to Fehnel (1997: 373), the initial environment assessment was flawed, due to the faulty assumption that the Zambian government had sufficient resources to make the adjustment. It is generally recognized that the implementation of stabilization policies was itself unstable, thereby reducing the policy's credibility in the eyes of foreign investors (Mijere, 1988: 56). This could account for the continued outflow of capital.

Interest Rate Policy

From 1984 to 1986 interest rates were decontrolled, as required by the IMF packages. The interest rates (discount rate) accordingly jumped from 14,5% in 1984 to 30% in 1986 (Table 1). While this increased the cost of the government's growing debt, it also encouraged savings and the efficient allocation of resources (Kayizzi-Mugerwa, 1991: 845). The control of interest rates during the auction system pursued the objective of curbing excess demand for credit.

This had a negative effect on new investments in the economy, however, due to the high cost of borrowing, and therefore also affected unemployment. Those hardest hit were holding large foreign exchange loans, for importing machinery, for example. Apart from high borrowing costs, they also had to deal with the low exchange rate, making investment even more difficult. The high real interest rates had the effect of increasing the cost of borrowing at a time when everything else was also becoming more expensive. All of this had a stagnating effect on economic activity.

4.2.4 Impact on the Structure of the Economy

As stated earlier, copper dominated the Zambian economy. The country had one of the world's most concentrated and least diversified export sectors. In the 1970s copper accounted for 90% of export earnings. The fall in the copper price had a devastating effect on the economy in the 1970s. One of the desired objectives of the adjustment was to shift resources towards tradeable commodities, in order to diversify exports.

Table 2 shows the extent to which copper makes up total exports. The figures point to a slight improvement, if any, in diversifying exports away from copper (even though 1986 shows virtually none, at 97.3%).

According to Weeks and Mosley (1996: 176), in 1970 iron ores and minerals accounted for 99.1% of export earnings, declining to 80% in 1985. However, the difference listed as manufacturing was actually virtually all copper in various degrees of processing. In real terms the export contribution of ore and minerals fell to only 96.7%. The shift towards non-mineral manufacturing exports did not materialize. Thus the goal of reducing the economy's dependence on copper appears to have failed completely.

The Agriculture and Manufacturing Sectors

The agricultural industry was particularly hard hit by the development policies pursued. Between 1965 and 1973 exports were negligible, and agricultural growth was only at 2% on average (Jones, 1994: 26). In 1965 agricultural exports amounted to \$15 million, but by 1970 they had fallen to \$8

million. During the same period imports rose from \$30 million to \$70 million. In 1965 agriculture's percentage of GDP was 14%, and by 1985 it was only 11%, forcing Zambia to import large quantities of agricultural products. According to Hawkins (1991: 842), the lack of growth of the agricultural industry was a result of the priority given to the rest of the economy in terms of skilled labour, foreign exchange and infrastructure. Furthermore, government control of the food market dampened the prices of agricultural produce, and exports again remained uncompetitive because of the overvalued exchange rate.

The exchange rate overvaluation discriminated strongly against the agricultural sector. Starved of vital imported items, agricultural production dropped from 750 000 metric tonnes in 1976 to 382 000 in 1980 (Burdette, 1988: 120). Price control by the National Agricultural Marketing Board (NAMBOARD) created a bias against possible agricultural exports. The pricing and marketing of maize led to excessive production of maize compared to other grains.

The early 1980s saw an improvement in the sector's performance, with high growth rates in the production of seed, sunflowers and sugar. Between 1982 and 1985, the decontrolling of prices, and marketing of all crops except maize and fertilizer, had some positive impact on investment in agriculture. With the liberalization of agricultural trade, reform was extended to the long ignored agricultural sector for the first time. Prior to the reforms, the sector was characterized by neglect in terms of government investment and large subsidies to consumers of maize, administered throughout by the inefficient NAMBOARD. Due to the high proportion of the population working in this sector and the great prospects of export diversification, the incentives for reform were high (Hawkins, 1991: 846).

However, export diversification was limited for various reasons. The system of subsidies lowered costs, and thereby encouraged resources and production in the maize market. However this incentive also resulted in inefficiencies in production. The 40% devaluation of the Kwacha was not enough to make agricultural exports viable. Lastly, the government continued to influence the prices of import-substituting crops in an unpredictable manner (Jones, 1994: 37).

NAMBOARD and the Provincial Co-operative Unions had a poor record, making late payments to farmers if any at all, while late delivery of seed and fertilizer were also a feature. With the removal

of subsidies on maize, sporadic food riots broke out throughout Zambia. A problem with the auction system was that funding by the IMF and World Bank was either late or inadequate. This affected imported inputs. For example, by the time funds were available for imported inputs such as fertilizer, the planting season was already underway (Mwanza *et al.*, 1992: 142).

With the mines struggling to break even in the 1970s due to the drop in copper prices and increased costs, other sectors began to feel the pinch. Manufacturing had always been dependent on the foreign exchange earned by the mines, to purchase foreign inputs such as technology, raw materials and machinery. The contribution of manufacturing to GDP, in 1970's prices, shrank from K170 million in 1976 to K162.9 million in 1980. The chronic problems for the mining sector continued in 1980s, again seriously affecting manufacturing. The inability of the mines to generate foreign exchange, meant that in 1982 Zambia's imports had dropped to about a third of what they were in 1970 (Jones, 1994: 28).

According to Burdette (1988: 118), capacity utilization rates were low in companies in the manufacturing sector in the early 1980s. For example, Consolidated Tyre Services, Zambia Steel and Building Supplies, Livingstone Motor Assemblers and Monarch Construction Company were all using only about 33% of their capacity at this time. These low rates were crucial, particularly as these companies were vital for other sectors. The abysmal rates were connected to the shortage of forex to purchase inputs.

Hawkins (1991: 118) points out that the 1985 reform did have some positive results. Industrial output, even though depressed by the low copper price, managed an increase of 7.8% in 1985. Capacity utilization due to new access to imported inputs increased from 38% in 1985 to 54% in 1986. The private sector's share of imported manufacturing inputs rose from 50% before the auction to 60%, while manufacturing exports increased tenfold in 1986. Agriculture also improved its performance. After a long decline in wheat production due to price controls, the production of wheat increased from 10 000 tons in 1985 to 18 000 tons in 1986. Agriculture exports increased by 530 tons in 1985 compared to 225 tons in 1984. A maize surplus was reported in 1986. In sum, after three years of negative growth, Zambia's GDP growth rate reached 2.1% in 1985 (Table 1). By the end of 1986, economic reform had clearly achieved some of its goals.

The budget deficit, money supply and debt service

In order for a devaluation to work, cutbacks in government expenditure are necessary, in terms of reduced subsidies and higher interest rates. However, this has a severe impact on the country's people. Reduced spending on health and education hits at the heart of what is essential for development and future growth. The burden of this type of economic reform therefore falls most heavily on the poor.

In Zambia, continued budget deficits increased the demand for domestic credit. Via the Bank of Zambia, this led to increased money supply, pushing up inflation and reducing domestic incomes. Money supply grew at a rate of 41,5% in 1985 and 87,1% in 1986. (See Table 1, where this growth is shown as M1.) Statistics on broader forms of money supply are not available in the International Financial Statistics due to the poor availability of data.

With money supply and the budget deficit increasing, one has to question the degree to which the Zambian government pursued the targets that were set. Given the inherent difficulty encountered in trying to increase government revenues, the targets on the budget deficit were not achieved after 1983. The government's deficit is illustrated in Table 1 (see Appendix). An explanation may be the high debt service requirements of the Paris Club (1983).

The IMF condition of continued service of the loans is always a feature of their programmes. However, by 1985 the debt had risen to \$581 million, while forex earnings were \$700 million. The servicing of the debt implied an 83% debt service ratio, leaving very little to finance the rest of the economy. The Kwacha's devaluing exchange rate made the servicing even more difficult, and had a negative effect on the deficit (Fundanga, 1989: 145). A large debt service ratio such as this placed enormous constraints on the economy.

Gross fixed capital formation

Macro-economic policy was now much less stable, while the process of liberalization was not focused. Both these factors had a negative effect on investment. In the space of a decade,

investments in the form of gross fixed capital formation fell by more than half, from 23% in 1978 to the extremely low levels of 10.8.7% in 1985 and 8.8% in 1987 (Table 1). Declining investment, high interest rates and the macro-economic instability mentioned above seriously constrained Zambia's recovery, particularly in the realm of job creation. The employment rate fell from 23.9% in 1980 to 13.4% in 1986. The Gini Coefficient was estimated to be 0.59 in 1985 (Weeks and Mosley, 1996: 191).

4.2.5 The Breakdown of Externally Sponsored Reform

The Zambian economy began to crumble in 1987 with increased inflation, lower investment, lower GDP and large outflow of foreign funds in 1986 via the auction. Pressure on the currency increased as fears arose that the system was not sustainable.

During the early part of 1987 tensions between the Zambian government and the staff of the IMF became clearly evident. Maize meal subsidy reductions were revoked, while the auction was suspended, and a nationalization of the milling industry took place. According to Kydd (quoted in Jones, 1994: 31), the IMF and the government had points of conflict. The IMF was pushing for a 75% increase in the fuel price and 113% increase in fertilizer prices. Furthermore, higher real interest rates (with inflation at the time about 50 to 60%) were asked for. Civil service increases were to be held at 10%.

In May 1987 the Zambian Government decided to discontinue its arrangement with the IMF, blaming the IMF's policies as unrealistic and incapable of removing the country from turmoil. Instead the economy moved back towards the 'command economy' approach of the 1980s. The New Economic Recovery Programmes (NERP) was introduced with the aim of increasing growth.

The main feature of the NERP was a breakaway from the conditionalities imposed by the Fund (and the World Bank), and was similar to the command policies of the 1950s and 1960s. Imports and exports were to be controlled, as well as interest rates and prices. In the short run stability was achieved. Losses stemming from the auction had been controlled and inflationary pressure dampened due to price controls, and thus less labour interest.

4.2.6 Zambia and the IMF in the 1990s

Zambia was declared ineligible to use IMF financial resources on September 30, 1987, following the accumulation of overdue financial obligations to the IMF. In 1989 Zambia's 'growth from own resources' programme, launched in 1987, collapsed. The government of President Kaunda again embarked on an orthodox adjustment programme.

According to Adam (1995: 736) the stabilization efforts were inconclusive during the first two years of the programme. Although many price controls were dismantled and liberalization of the foreign exchange and payments system were achieved, macroeconomic stability worsened after October 1991 following the election of the new government. The cessation in donor disbursements, a surge in domestic financing from pre-election wage commitments and a drought in 1992 contributed to the instability. However, there was a strong reduction in the fiscal deficit and domestic credit by 50% in real terms by mid-1993. This did not reduce the inflation rate due to inflationary expectations and a lack of policy credibility and commitment following a lack of commitment by the government to previous reform. In July 1992 a rights accumulation programme (RAP) was implemented to facilitate the clearance on arrears on debt to the IMF. A series of targets for domestic credit to government, privatization and specific liberalization measures were the centrepiece of the overall programme. Domestic and foreign investors viewed the attainment of these RAP targets as an indication of the government's commitment to the broader adjustment programme (IMF Survey, 1996: 12).

The exchange rate was unified in October 1992, and interest rate controls removed in March 1993. On December 6, 1995, the IMF lifted Zambia's ineligibility to use its financial resources. A three-year ESAF arrangement and a one-year SAF arrangement were approved. According to the IMF Annual Report (1996: 121) the main objective was to strengthen the stabilization programme, reduce inflation to single digits, achieve real growth and increase the level of foreign reserves. A fiscal surplus, a cut in wage expenditure, privatization (160 companies in 5 years) and a reduction in broad money growth to 13% by the first half of 1996 from 40% in 1995, were also required.

A high level of inflation continued to exist between 1988 and 1990. By 1992 it had reached a chronic level of 191.3%. Thereafter inflation seemed to be falling towards the levels quoted in the

adjustment programmes, reaching 34.2% by 1994. Clearly this can be attributed to the higher interest rates, lower government expenditure and budget deficits and much slower money growth which occurred during 1992 and 1993 (Table 14). However the commitment by the Zambian government to the proposed reforms did not last long.

The mid 1990s were characterized by slow privatization with only 12 of the state owned companies being privatized. A growing government deficit reached 6.6% by 1997 from 3.7% in 1994 fuelled in part by an increase in government expenditure from 13.1% in 1994 to 39.2% by 1997. The money supply growth figures (M1) that had been brought under control to 22.3% by 1992 was again allowed to rise to higher levels by 1995 (Table 14).

These inconsistencies in economic policy during the 1990s illustrates a definite lack in commitment by the Zambian government in adhering to the adjustment programmes' prescriptions. This lack of will has meant that attempting to measure the impact of the adjustment during this particular period would be fruitless.

4.2.7 Summary

It can be argued that the Zambian government's ability to manage fiscal, monetary and exchange rate policy in such a difficult and unfamiliar environment was inadequate. The IMF programmes focused on reducing subsidies, currency devaluations (in the form of the auction), wage freezes and trade liberalization. The objective was to reduce the role of the government sector and improve growth rates. These policy prescriptions were based, though, on certain assumptions which did not hold for Zambia.

The policy reforms failed to improve the balance of payments. The assumptions underlying the elasticity optimism did not hold in Zambia's case as the devaluation did not result in an adjustment to increase output and exports. The main reasons include the low international price elasticity for copper, the fact that the price is set at the London Metal Exchange and the extent to which the economy was undiversified.

The existence of many rigidities impeded the success of the stabilization programme. The highly import orientated economy resulted in rising inflation due to the devaluation which took place. Furthermore, combatting inflation proved to be difficult because of inflationary expectations. Inefficiency on the government's part also proved to be a stumbling block. Inconsistent decision making in NAMBOARD and in the running of the auction only served to create economic instability. Finally, the fast rising debt service ratio made it all the more difficult to reinvest in the economy.

Moreover, one must take note of the Zambian government's failure to reduce its budget, and its increasing of the money supply. It is difficult to fault the programme when the government did not stick to the targets that had been set.

4.3 Brazil

Brazil's case is interesting in that it does not meet the image of capital flight, overvaluation or massive inefficiency in the public sector typical of other LDCs. Increased interest rates and sharply augmented debt burdens are viewed as being the immediate causes of the country's debt crisis.

4.3.1 The Period of Industrialization and Debt Rolling

Brazil's military government under General Geisel came into power via a *coup* in 1964. An ambitious programme of stabilization and development was pursued. Deflationary policies were implemented as soon as an agreement had been reached with the IMF. The policies included restrictions on real wages, credit restrictions, allowing repatriation of profits by multinationals and the guaranteeing of political stability. This was all in aid of creating a favourable investment climate for foreign capital.

From 1968, however, these deflationary policies were displaced by growth policies designed to bring about rapid industrial expansion. These investment programmes were titled National Development Plans (NDP). These plans, and the second NDP in particular, were focussed on the development of consumer goods, investment goods and the arms industry, in an attempt to put

Brazil in the industrialized nation category (Korner *et al.*, 1987: 75). Attention was devoted to large scale development projects in the power producing industry, the steel industry, the nuclear sciences (regarded as a substitute for crude oil) and in transport infrastructure.

Such large scale development could not be financed by Brazil on her own. The industrial process could only be financed by falling back on overseas savings, in other words, taking up loans from international banks. The 1950s saw a large flow of funds from the USA into Brazil. During the 1960s there was increased capital inflow from the US government, used by Brazil to finance projects. During the 1970s, however, US funds came increasingly from private banks rather than direct investment and multi-lateral loans. According to O'Brien (1993: 88) the emergence of private banks as the main source of funds reflected the development of the private global market. This international money market grew from \$650 billion in 1975 to \$2100 billion in 1984. This growth was accelerated by the recycling of OPEC surpluses, which resulted from oil price increases during 1974 to 1979, through private banks. With a larger demand for funds from newly industrialized countries than from industrialized countries, a great proportion of funds was directed towards the newly industrialized countries, including Brazil.

During the 1970s international interest rates were very low, encouraging countries to borrow and banks to lend. O'Brien (1993: 89) contends that this borrowing and lending took place in the belief that countries could not go bankrupt. Consequently, governments enjoyed a large amount of capital inflow with very few conditions to finance development plans.

From the outset, the industrialization strategy proved to be too debt ridden. The import substitution industries were capital intensive and therefore highly dependent upon constant importation of high quality investment goods and semi-manufactured goods. The balance of payments was increasingly burdened by the increased importation of agricultural products due to the unmodernized domestic agriculture sector. The industrialization process was largely orientated towards road transport, and, with the slow tapping of domestic energy resources, the developing economy was becoming increasingly dependent upon importing oil. The strategy was therefore reliant on low international interest rates, stable oil prices and the rolling over of debts.

The oil price shock of 1973/4 hit Brazil hard. Industrial countries passed their own increased energy costs on to the prices of investment goods. At the same time, due to the recession foreign countries' imports were cut and Brazil was again affected. During this time the balance of payments came under pressure. The current account deficit increased between 1975 and 1981 even though there was strong export growth, particularly in 1979 and 1980 of 22.24% and 32.1% respectively (refer to Table 4). The worldwide rise in interest rates also affected the size of debt repayments. Both the oil, and the interest rate hikes had an inflationary effect. The inflation rate increased by 36.75% in 1978, and by 58.17% in 1979 (see Table 3).

Instead of adopting deflationary policies, the government decided to pursue an aggressive response, and risk inflation. The policies were designed to improve the balance of payments through increased usage of foreign debt. International banks regarded Brazil as an attractive destination and her problems as temporary in nature, and showered the country with loans. Between 1973 and 1979 the debt increased fourfold, and was used for the large national developments (Korner *et al.*, 1987: 76). Approximately 75% of the debt at the beginning of the 1970s was obtained through private companies and multinationals (Altwater, 1991: 143). As the decade went on, this trend reversed, with Brazil's national public companies receiving most of the debt, and thus increasing the national debt service ratio. By 1978 the debt service ratio had reached 52.2%, compared to 27% in 1970 (World Bank, 1979: 180). The rising worldwide interest rates resulted in interest repayments alone becoming increasingly costly. It became clear that Brazil's export surplus would have to be used almost exclusively for interest repayment.

It was not until the second oil price shock of 1979 that Brazil was plunged into a debt crisis. With US interest rates continuing to rise during the world economic crisis, the debt service burden became enormous due to the larger repayments. At the same time, the industrial countries took up protectionist policies to protect their economies from the crisis. Brazil was caught up in a vicious circle of taking loans to pay back old debts and interest.

Creditors now began to worry about whether Brazil would have the capacity to pay back the loans, particularly as a Brazilian economic collapse would threaten the world monetary and financial system. To avoid losing credit-worthiness altogether, the Brazilian government decided to pursue more deflationary policies in an endeavour to improve its balance of payments. This succeeded in

restoring some confidence among the international banks. This programme was effective in changing the trade deficit of 2.8 million U.S dollars in 1980 into a surplus of 1.18 million U.S dollars in 1981. (Refer to Table 4.)

4.3.2 The State of the Brazilian Economy in 1982

At the end of March 1982, the net reserves of Brazil's central bank were in the red, indicating the country's inability to deal with a liquidity crisis. Table 4 illustrates the difficulties in the balance of payments. The current account deficit increased between 1978 and 1982. By 1982 it had reached 16.3 million U.S. dollars. The trade balance, however, was positive in 1981 and 1982. Thus, the current account remained in deficit because of the large debt repayments and increased short-term borrowing, with the debt service ratio reaching 82.2%. Again this is illustrated in Table 4. Despite capital inflows and a positive trade balance, the balance of payments languished as reserves declined.

The expansionary policies pursued by the government increased indebtedness. This, together with global recession and higher interest rates resulted in the poor performance of the economy. By 1982 the Brazilian economy was in the middle of a recession. The GDP growth rate was -4.2% in 1981, and 1.1% in 1982. Inflation was 91.2% in 1981 and 97.9% in 1982 (see Table 3).

In August 1982 Mexico alarmed the international community by announcing that it could no longer service its foreign debt. According to O'Brien (1993: 93), the debt crisis was due to factors beyond the debtor's control. The change in economic policies in the US caused interest rates to rise, and resulted in capital leaving Brazil. With the already enormous debt growing ever larger, interest repayments were much higher. Whereas between 1973 and 1979 the US prime rate averaged at about 6.7%, between 1979 and 1982 the average increased to about 15.5%. By 1983 an increase in the interest rate by 1% cost Brazil about \$750 million (O'Brien, 1993: 94). The debt crisis was the result of higher interest rates, deteriorating terms of trade, increasingly protectionist policies pursued by industrial countries, and oil price hikes.

The external shocks together with amortization of past debts and short term repayments resulted in the economies of many countries folding. Following Mexico's crisis, Brazil was no longer regarded

as being creditworthy, and overall confidence was lower. The level of capital inflow to finance the balance of payments halved. The international banks made it clear that availability of fresh loans depended on an agreement with the IMF, which the Brazilian government had been trying to avoid. Capital outflow and a large current account deficit due to the increased debt servicing to 82.2% resulted in balance of payments difficulties (see the figures for 1982 in Table 4).

4.3.3 The IMF Programme

With foreign exchange reserves declining rapidly, Brazil reached an agreement with the IMF. A letter of intent was signed on 6 January 1983. The IMF loan was worth approximately \$5 billion.

The content of the stabilization programme was prescribed to Brazil in order to correct the balance of payments difficulties and obtain price stability. The targets included reducing the balance of payments deficit to 2% of GDP during 1983, and by 1985 the deficit was to be reduced by a further 1%. The budget deficit target was a reduction to 8.8% of GDP from 15% in 1982, reducing the deficit by half in 1983.

Restrictive monetary policy in the form of a reduction in the credit supply and an increase in interest rates was prescribed. Cuts in subsidies for nationalized companies and services for wheat, sugar, oil derivatives and agriculture also featured. The objective was to curb aggregate demand and reduce the inflation rate. Furthermore, a reduction in real wages and the abandonment of the indexing of wages to the inflation rate were other features of the programme.

Trade was to be liberalized, removing export duties and import controls. In order to attract foreign investment, legislation was to be introduced to allow profit transfers. Monthly devaluations of the Cruzeiro were to be 1% higher than the inflation rate, to provide an incentive for exports. This was to make sure that a real depreciation of the exchange rate took place.

The ultimate objective of these measures was to restore confidence in the Brazilian economy, in an effort to attract foreign investment. This would be achieved through the creation of an investor friendly climate. Reduced government interference in the economy was essential, allowing the

economy to be governed by market forces and thereby reducing the inefficiency of government. In order to achieve these objectives, an improved balance of payments, reduced inflation rate and stable economic policy were required.

4.3.4 An Evaluation of the IMF Programme

After the second oil shock of 1979, Brazil adopted more orthodox policies, in order to decrease government control and allow individuals to adjust and stabilize the economy through market activity. The reforms included mini-devaluations, decreasing public sector expenditure, slowing credit growth, decontrolling interest rates and limiting wage movement. These reforms were stated in the IMF agreements in an attempt to stabilize the current account and balance of payments.

Table 3 illustrates that the end result was a deep recession. Output (GDP growth) declined from 9.2% in 1980 to -4.2% in 1981, 1.1% in 1982, and -2.7% in 1983. The inflation rate more than doubled from 82.2% in 1980 to 203.3% in 1984. As Table 4 shows, however, the recession did nothing to reduce the current account deficit.

The following section looks at Brazil's response to this crisis between 1982 and 1988. First the country's trade and payments are analysed, followed by issues relating to the fiscal budget, privatization, monetary policy, and debt equity swaps and their impact on income distribution.

Trade and Payments

Table 4 shows that Brazil's trade performance and balance of payments improved in response to the debt crisis and subsequent reforms. A combination of export growth and import substitution resulted in large trade surpluses from 1983 to 1986. This is in contrast to the large trade deficits prevalent up to 1980 and poor trade surpluses in 1981 and 1982.

These improved trade flows can be attributed largely to the real exchange rate depreciations of the 1980s. Cardoso and Dantas (1990: 131) make the point that Brazil's success in the 1980s was due also to the combination of import substitution and export diversification that had been implemented

during the 1960s and 1970s. The industrial sector, originally established behind protectionist barriers, had grown in efficiency, expanding into intermediate and capital goods. Through export incentives and subsidies, manufactured exports had been actively promoted.

Exports showed a steady improvement from 1983 to 1988. This is attributed to the economic growth in the OECD countries, particularly the USA. Baer (1989: 34) attributes the improvement in exports to policies pursued in the mid-1970s. The country now exported commodities that it used to import, such as aluminium, paper, and pulp. However, the extent to which Brazil's imports were restrained becomes clear when the improvement in the current account is examined (see Table 4). By 1988, import volumes were actually 23% lower than in 1979, even though GDP was 29% higher. Thus, import reduction was a central element of the Brazilian balance of payments adjustment.

The success achieved in the balance of payments adjustment is attributed to successful import restrictions and to active policy in the 1970s that directed investment towards import substitution. Bulmer-Thomas (1994: 380) argues that the trade account may have recovered because Brazil was able to spread the burden between import suppression and export promotion. The many large import substitution projects pursued in the early 1980s made it easier to suppress imports. Meanwhile Brazil's commitment to export promotion in the 1980s may have provided a framework for increased exports. The volume of exports jumped by almost 50% between 1982 and 1985 (International Monetary Fund, 1998: 222).

Table 4 shows how well the real depreciation worked in promoting exports and restricting imports. The result is evident in the favourable trade balances. However, Cardoso and Dantas (1990: 133) note that the reduction in imported inputs due to import substitution should not be over exaggerated, as artificially low levels of investment helped to keep imports in check. Such a pattern may not be consistent with sustainable development. It should also be pointed out that in the attempt to reduce imports, trade liberalization did not figure high in Brazilian economic policy. By 1986 import restrictions were still almost the same as they had been at the time of the balance of payments crisis.

Thus, it may be argued that the IMF's devaluation policy helped to sort out the current account deficit in the balance of payments. The result was a reduction in imports and an increase in exports. However, other factors may have contributed to this success. The IMF policies pursued indicate that Brazil had the capacity, skills and resources to be efficient and competitive in certain industries. The declining GDP during the recession also played a role in the reduction of imports.

A further important consideration regarding Brazil's trade performance relates to the country's use of debt as an integral part of development. Trade surpluses were used to pay interest on government debt. Table 4 shows the high debt service ratio, particularly during the years from 1982 to 1986. The implication is that the higher the debt service ratio the less money available for spending within the economy, as most of it flows straight back out of the country in repayments.

Inflation

From 1973 there was a sharp rise in inflation. In 1974 the inflation rate doubled. The high rate of inflation is indicated in Table 3. There is clearly an upward trend as inflation increased by 97.9% in 1982. By 1985 the inflation rate had reached 228.8%, and 158.4% in 1986. The figures indicate that the IMF programme was not successful in attaining price stability.

The debate over the origins of inflation has also intensified. Those belonging to the orthodox school of thought, believe that the high rate of inflation can be blamed not on the oil shocks, but on excess liquidity due to expansionary policies pursued by government (Baer, 1989: 139). The neostructuralists argue, however, that inflation is not a monetary phenomenon, but stems rather from the monopoly power of firms, unions and the state.

Although the devaluations contributed significantly to the creation of a trade surplus, they also added to the inflationary pressures. The link between the trade surplus and the high inflation rate is important. The surplus was used to pay the interest on government debt. However, the government had financed the debt by issuing domestic debt and printing money, which in itself created an inflationary pressure. The need for real devaluations implies larger debt service

repayments, increasing the budget deficit. This in turn increases money creation and therefore inflation (Bulmer-Thomas, 1994: 391).

Attempts to bring about price stability in the face of chronic inflation were hampered by inflationary rigidities. The first type are known as institutional rigidities. This is a consequence of backward indexation, whereby payments that are made under the terms of a contract are linked to changes in the price level. A second source of rigidity is expectational rigidity, where a lack of conviction exists amongst the population that the government can in fact bring down the inflation rate. Kiguel and Liviatan (1992: 44) remark that confidence in government is lost through previous failures on its part to maintain the fiscal balance required for low inflation.

External and internal shocks need not be inflationary if the sectors are willing to absorb higher input prices by reducing income. In Brazil this was not the case after 1973. For political reasons, the government was not willing to fight the inflationary process of indexation. As a result of the oil price rise, international interest rates rose and devaluation substantially accelerated the inflation rate.

Chronic inflation was propagated by the ability of producers to obtain compensation from the State for income eroded by inflation. It was thus easy to pass the costs on to consumers, generally through the indexation of financial instruments and subsidized credit for agriculture. Moreover, the introduction of wage indexation in 1979 further entrenched the mechanisms propagating inflation. The Brazilian economy was quite heavily indexed, transferring past inflation to present. It is therefore difficult to blame the IMF for the high inflation rates.

It seems therefore that the IMF was not successful in controlling rising prices, despite Fund conditionality. The IMF orthodoxy blamed the Brazilian government's failure to adhere to fiscal and monetary discipline. However, neostructuralists argue that the problem is more deep rooted than that. The IMF was criticized for their reliance on market forces to break expectations, while at the same time inflationary expectations were sustained by devaluations, nominal interest rate increases and public sector tariffs.

GDP Growth

As can be seen in Table 3, Brazil's GDP growth rate expanded considerably between 1978 and 1980. This growth was gained through the increased use of debt. Between 1981 and 1983 (the recession years) the GDP growth rate fell by 5.1%. The recovery of 1984 to 1986 saw a slight rise in GDP (back to 1980 levels). By 1987 the GDP growth rate was 17.7% higher than in 1980. Thus it seems that the austerity programme resulted in an improvement in the GDP growth rate.

The Public Sector

One of the IMF conditions stated in the stabilization programme was a commitment by Brazil to reduce the fiscal deficit through increases in revenue and cuts in expenditure. Table 3 illustrates what happened to the budget deficit as a percentage of GDP.

Growing interest payments on internal and external debt made it difficult to cut down on expenditure. Altwater (1991: 142) points out that economic policies were limited to attempts at raising new loans in order to meet interest and loan repayments which grew from year to year. Despite the fact that \$96.56 million was repaid in interest and loans, Brazil's indebtedness rose from \$53.85 million to \$93.13 billion between 1980 and 1985.

According to Bulmer-Thomas (1994: 394), total central government expenditure increased from 27% of the GDP in 1981 to 51% of GDP in 1985. Furthermore, policies to increase the tax revenue were met with little success, due both to the recession and flight into the informal sector because of tax concessions to stimulate exports (O'Brien, 1993: 96).

Brazil's tax burden declined from 24.1% of GDP in 1980 to 21.7% in 1984 (Baer, 1989: 128). Subsidies declined by 3.6% of GDP in 1980 to 1.6% in 1984, while at the same time, interest on public debt rose from 1.9% to 6.3% in 1984. Thus, the net government disposable income fell from 10.1% to 5.4% in 1984. The cutback fell mostly on salaries and wages, even though government employment increased by over 32% between 1979 and 1984. Financial expenditure continued to rise, due to great indebtedness and the devaluation of the currency (Baer, 1989: 130).

Table 3 shows two alternative measures of the budget deficit. The nominal public sector borrowing requirement (PSBR) moves with inflation. When there was rapid inflation in the 1980s the PSBR moves with it. If inflation were to cease the PSBR would shrink to the actual budget deficit corrected for inflation. The operational deficit gives a better measurement of the budget deficit than the PSBR by subtracting the monetary correction payments, although it is still not a perfect inflation-adjusted measure (Cardosa and Dantas, 1990: 141).

The PSBR (GBD in Table 3) increased in 1983 to 20.1% of GDP, rising to 22.3% of GDP in 1984 from its previous level of 12.4% of GDP in 1981. This can be attributed to the increased domestic cost of servicing the external debt due to the real devaluation. The operational deficit also declined during this period. By 1987 the PSBR had reached high levels again, as did the operational deficits. Overall, both measurements illustrate the difficulty that Brazil had in reducing the budget deficit. By 1987 it had in fact begun to increase (Table 3).

4.3.5 Impact on the Structure of the Brazilian Economy

The diversification away from Brazil's traditional export industry (coffee) towards non-traditional exports such as soybeans, iron ore and sugar is shown in Table 5. In 1978 coffee as a percentage of total exports was 15.21%. By 1980 this was down to 11.25% and by 1987 it was down to 7.32%. Manufactured exports (semi-processed and processed) accounted for 5% of exports in 1964, but by 1985 they accounted for 66% of exports (Baer, 1989: 121).

According to Bulmer-Thomas (1994: 600), the recession during the 1980s resulted in a negligible rise in net output in the manufacturing sector. The share of manufacturing to GDP declined from 33.2% in 1980 to 30.3% in 1985. The agricultural sector, which was a major source of employment, grew with the help of ISI and new opportunities for non-traditional exports such as soybeans. The share of agriculture in the GDP rose from 10.5% in 1980 to 12.1% in 1985.

Gross Fixed Capital Formation

Table 3 shows the fall in gross capital formation in proportion to GDP during the period 1982 to 1985. Bulmer-Thomas (1994: 399) blames this fall on the recession and the higher interest rates,

which retarded private investment. This was reflected in falling domestic and foreign savings (Baer, 1989: 120). The bank rate increased from 49% in 1982 to 219.4% in 1985, and 391.5% in 1987. This was part of the restrictive monetary policy prescribed by the IMF in its programme. Clearly, a high interest rate prevailed between 1983 and 1987 (Table 3).

The investment trend can also be attributed to macroeconomic instability. According to Rodrik (1990: 934), the inability by the government to bring the fiscal budget under control caused instability. Instability and rising inflation in turn lowered investor confidence and investment.

4.3.6 Brazil and the IMF in the 1990s

Between 1989 and 1994 Brazil followed the trend common to other emerging economies, as private capital inflows increased at a dramatic rate. Net private flows averaging \$39 million between 1988 and 1991 increased 25 times, and since 1992 small current account deficits have been financed and therefore contributing to an increase in foreign reserves. However, the capital inflow consisted mainly of short term portfolio investments. Net direct foreign investment as a share of private capital fell from 22% in 1992 to 5% in 1997, increasing slightly to 11% in 1994 (Cardosa and Goldfajn, 1998: 169).

Mexico's financial crisis at the end of 1996 led to an immediate cutback in capital flows. Investors reacted by reducing their short term portfolio capital believing that the Mexican crisis would compromise all other emerging markets.

A sharp reduction in short term portfolio investments occurred during the fourth quarter of 1994 and the first quarter of 1995. The net capital flow was insufficient to finance the growing current account deficit resulting in a loss in foreign reserves of \$8 billion (International Financial Statistics, 1998: 269).

The US and IMF provided \$20 billion through the Exchange Stabilization Fund, and a further \$17.8 billion from the IMF to support reforms. The reforms included privatization, the deindexation of the economy, tight monetary policy and trade liberalization.

The capital provided appears to have insulated the Brazilian economy from the crisis. The capital account grew as capital inflows returned to Brazil. By 1995 the capital flows were \$3.5 billion as opposed to \$1.7 billion in 1994 (Table 17). Again Brazil was able to finance a growing current account deficit between 1994 and 1996 as foreign reserves grew from \$3.9 billion to \$6 billion. However, although the reliance on portfolio investments has fallen, it is still high, making Brazil vulnerable to any change in sentiment (IMF Economic Review, 1998: 36). The Real Plan introduced in 1994 proposed the gradual removal of indexation to achieve stability and policy credibility. Inflation fell from a yearly average of 2668.5% in 1994 to 18.2% in 1996. Real GDP fell from 5.8% in 1994 to 2.9% in 1996 (Table 16), while unemployment increased slightly from 5.1% in 1994 to 5.4% in 1995 (IMF Economic Review, 1998: 34).

Whilst it can be said that during the 1990s Brazil experienced chronic inflation, current and capital account instability, one cannot assume that it was a result of the prescriptions provided by the IMF. The IMF policies were not consistently or vigorously pursued for a long enough time. Table 16 illustrates the existence of growing operational deficits, overvalued exchange rates and a rising debt service ratio (Table 17). The low level of ownership and will in following the IMF prescriptions accordingly makes it futile linking the economy's performance to the IMF adjustment programme.

4.3.7 Summary

Brazil's stabilization programme was successful in achieving its main priority. The IMF's measures did have a positive effect on the balance of payments. During 1982/3 the trade deficit was turned into a surplus. It should be remembered that this is the IMF's main objective, as prescribed by the mandate. The aim is to correct balance of payments maladjustments by improving the current account and thereby increasing reserves. Inflation is of secondary importance.

However, closer analysis reveals higher inflation, unemployment and increasingly uneven income distribution. According to Baer (1989: 121), the burden of the adjustment programmes in the early 1980s fell heavily upon the lower income groups. The Gini Coefficient also increased to 60% in

1983, illustrating the uneven distribution of income (Bulmer-Thomas, 1994: 402). By 1987, the poorest 20% received a mere 2.4% of income (World Bank, 1992: 226).

Bulmer-Thomas (1994: 395) argues that it was the failure to meet the IMF targets which played a role in hampering successful adjustment. Brazil signed seven letters of intent within a few years and often targets were not fulfilled. The IMF blamed the Brazilian government for a lack of monetary and fiscal discipline. Killick and Malik (1992: 624) point out that while some provisions were undertaken, political and bureaucratic resistance prevented the improved fiscal discipline required for stabilization. Others, such as Dell (1982: 598), believe that the orthodox programmes are in fact too severe for developing countries with acute balance of payments problems.

Structuralists and neostructuralists may argue that Brazil's case is a good example of the limits of the IMF approach. While the external accounts improved significantly, inflation more than doubled, and restrictive monetary policy led to higher real interest rates. This in turn led to the lowest fixed capital formation ratio in the postwar period, of 16% of GDP in 1986.

Where the monetarist model implicit in the IMF programmes links external and internal equilibria, in Brazil this did not happen. The policies leading to external equilibrium were sources of internal disequilibrium. The policies which led to trade surpluses also led to increased inflation, higher interest rates, lower investment and a declining GDP.

However, the results of inflation are not so clear cut. As stated earlier, the heavy indexation of the Brazilian economy was a mechanism propagating inflation. The IMF should not have assumed that orthodox policies would be successful under such conditions. An alternative may have been to pursue a heterodox programme. Kiguel and Liviatan (1992: 44) define the heterodox programme as a combination of tight fiscal and financial policies and a fixed exchange rate with the temporary use of price and wage controls. The controls are a temporary device to bring down inflation rapidly. The main difference between orthodox and heterodox programmes is in the initial stage. Heterodox programmes had success in Israel in 1985 and in Mexico in 1987.

The IMF policy measures have been criticized for the social effect they had on the Brazilian people. According to Korner *et al.* (1987: 78), wage restraints were a major part of the stabilization policy. Reduced wages and cuts in subsidies, coupled with rapid inflation, hit the poor hard. The government's wage policies became increasingly unpopular with the people. As a result, as the standard of living dropped, strikes and looting increased.

Rodrik (1990: 935) points out that continued macro-economic instability, due to the Brazilian government's inability to bring the fiscal deficit under control, resulted in new packages being undertaken virtually every six months. The difficulties facing an unstable economy, and the temporary policies pursued, led to hyperinflation. Such erratic policy making resulted in lower private investment.

The targets set by the IMF do seem to have been pursued by the Brazilian government. Korner *et al.* (1987: 79) contend that it made every effort to comply scrupulously with IMF demands. But powerful resistance from the people precluded the government from implementing its policies to the full.

4.4 Mexico

In August 1982, Mexico announced a moratorium on external debt repayments. The foreign exchange markets also closed. By the end of the year, an IMF loan had been taken.

In October 1982, Mexico and its creditors agreed to participate in a \$12 billion rescue package engineered by the IMF. The accord came at a time when the collapse of the oil price from \$25 to \$12.50 per barrel precipitated a fall in revenue of approximately 50% (Bulmer-Thomas, 1994: 380). During 1986, the economy contracted by about 4%, while inflation accelerated to an annual 105.7% (Table 6). This financial and economic debacle sparked off widespread debate on the causes, consequences and costs of debt and the nature of the IMF austerity programme imposed during 1983–1986.

Supporters of the IMF packages believe that financial concessions and programmes of economic reform were needed for balanced and sustained growth. But their critics argue that the so-called

rescue packages merely increase long term debt and lower living standards. These issues will be addressed against the background of the underlying structure of the economic crisis. More specifically, one has to wonder how Mexico, with over 72 billion barrels of oil and gas reserves, wound up in such economic straits.

The following section briefly reviews the economic situation of Mexico during the course of its industrialization up to the 1980s. Thereafter the austerity programmes and their consequences will be analysed and evaluated.

4.4.1 Mexico's Industrialization between 1950 and 1980

From the 1940s to 1970, economic development in Mexico was based upon an import substitution strategy, partially supported by revenue from tourism and the exporting of primary products (Mares, 1985: 672). By the end of the 1960s, Mexico had enjoyed two decades of rapid GDP growth, controlled inflation and steady industrial and agricultural production. On the face of it all, it would seem that the pursuit of ISI had resulted in growing prosperity.

However, it can be argued that there were structural problems inherent in the ISI strategy. The most notable symptom was the growing imbalance in the external accounts. A current account surplus of \$58.7 million in 1950, became a deficit of \$300.5 million in 1960, worsening to \$945.9 million in 1970 (Ayala and Duran, 1986: 243). This growing deficit, although financed by foreign borrowing and direct foreign investment, suggests that Mexico was struggling to generate the savings necessary for the required investment expenditures necessitated by the capital intensive import substitution strategies.

Long-term net foreign capital inflow increased considerably during the 1960s and accelerated between 1970 and 1975. Most of the country's debt was of a public nature. Mexico's external public debt as a percentage of GDP rose from 9.7% to 24.4% between 1960 and 1975. The external debt service ratio deteriorated from an average of 21.5% in the decade 1960 to 1970, to a level of 26% by 1975. The average for Latin America during the same period was 14.8%. As with the rest of Latin America, a large proportion of the debt originated from private sources after 1966.

Of the total private debt between 1965 and 1970, 50% came from mostly US banks (Ramirez, 1989: 146).

During the 1960s, once the initial part of ISI had been completed, it became apparent that, due to the high capital output ratios of new projects, a limit to the import compression had been reached. The growing industrial sector necessitated the importing of sophisticated machinery and equipment which could no longer be produced domestically (Ayala and Duran, 1986: 24). Hence ISI failed to reduce Mexico's dependence on the international economy.

Mexico's development from 1950 to 1970 was not self-generating. Growth was dynamic in sectors such as the consumers' sector, but lagged in capital and agriculture. This unbalanced growth resulted in the balance of payments deficits, financed by rising debt.

A change in the industrialization process during the 1970s occurred due to the deteriorating economic and political development. The Echeverria administration of 1970 to 1976 embarked on an ambitious programme of accelerated import substitution in the capital goods sector to reduce the country's growing current account deficit.

According to Ayala and Duran (1986: 245), priority was given to the energy sector. Massive increases in government spending occurred, rising from 21% to 36% of GDP between 1970 and 1976. However, as the private financial system was unable to finance this, the Bank of Mexico utilized the printing press to finance the growing public sector deficit, which had grown to 9.9% by 1976. As a consequence of the increase in the money supply from 7.5% in 1971 to 25% in 1974, inflation increased from 3.7% in 1971 to 22.5% in 1975. Dissaving resulted, due to negative yields on bonds, encouraging capital flight. The government had no option but to increase the public sector's indebtedness by 83% between 1973 and 1976 (Ramirez, 1989: 149).

By 1976 these expansionary demand policies led to increased wages, while excessive monetary expansion resulted in a short period of GDP expansion coupled with rising inflation. The balance of payments crisis worsened, and the current account deficit quadrupled. At the same time, there was capital flight due to the negative interest rates, as well as uncertainty among private investors as to whether the exchange rate, which had been fixed since 1954, could be maintained. The debt service

ratio had also worsened considerably, to 38.3%, from a level of 21.7% in 1970 (World Bank, 1986: 213).

In view of these economic events, the Jose Lopez Portillo government (1976–1982) agreed to implement an economic package prescribed by the IMF. The orthodox stabilization programme viewed the government's fiscal deficit as the root cause of the economic crisis. The solution thus consisted of reducing government intervention, eliminating the government deficit, and liberalizing commerce. At the end of 1976 the peso had devalued from 12.5 to 19.7 pesos to the US dollar.

Ramirez (1989: 149) states that these measures were implemented in varying degrees during 1977. The result was a reduction in GDP growth to 3.4%, a fall in the government deficit from 9.9% to 5.2% of GDP, and a deceleration in the rate of price increases. Furthermore, the Bank of Mexico's reserves increased from negative \$320.9 million in 1976 to \$504.2 million. There was a 28% increase in the voluntary savings of the public sector.

The three-year austerity programme petered out when in 1978 it was discovered that Mexico had 40.194 million barrels of proven oil and gas reserves compared to 6.338 million barrels in 1976. By 1981 the reserves stood at an impressive 72 billion barrels (Bulmer-Thomas, 1994: 383). Thus, Mexico was transformed into an energy superpower. The capability increased beyond meeting its own needs, but also to developing exporting capacity during a period of rising petrol prices. In anticipation of a steady flow of income from future oil sales, the government abandoned austerity for a path of free spending in 1978. The results in terms of certain mass variables were impressive.

As Table 6 reveals, GDP grew at 8% per annum between 1978 and 1981. At the same time, though, inflation increased to 28.7%, due to the expansionary monetary and fiscal policies, while the government deficit rose to 5.2% as a percentage of GDP.

Complacency appears to have arisen, in particular with regard to a growing dependence on oil exports as a source of income. Between 1979 and 1982 the ratio of crude oil exports to total exports rose from 44.4% to 72.1%. This is shown in Table 9. According to Ramirez (1989: 151), a high tax was placed on the earnings of the state petroleum corporation (PEMEX), therefore

creating a revenue structure vulnerable to changes in the international oil price. Of the total tax revenues raised by the government during 1979 and 1981, PEMEX contributed an average 25%.

Another discouraging trend between 1979 and 1981 was the ever increasing government budget deficits. According to Table 6, the deficit as a percentage of GDP (in 1990 prices) rose from 0.8% of GDP in 1979 to 5.27% in 1981. According to Branford and Kucinski (1990: 70), heavy investments were made in hydroelectricity, and IMF loans were paid off. The deficits were financed by heavy borrowing from private and public foreign sources. Total public foreign debt increased from \$18 billion in 1976 to \$55 billion in 1982 (Ramirez, 1989: 151).

As stated earlier in this chapter, during the 1970s there was an optimism about developing countries. With the low levels of international interest rates, governments were encouraged to borrow as much as possible. A further factor, according to O'Brien (1993: 88), was the decision to recycle OPEC surpluses through private banks. As a result, these banks found themselves with large amounts of money which they wished to lend at profitable interest rates. Total public and private debt (disbursed debt) rose from \$49.3 billion in 1980 to \$85.8 billion at the end of 1982. The debt service ratio (including interest and amortization) as a percentage of total exports increased from 41.8% in 1980 to 63.2% in 1982 (refer to Table 8). Some of the debt was used to finance the increasing trade deficit.

External indicators also revealed some growing structural problems in the Mexican economy. Despite the rapid rise in merchandise exports from 9.2 billion dollars in 1979 to 19.1 billion dollars in 1981, which was mostly due to growing oil exports, imports rose at an even faster rate. As seen in Table 7, the result was an increasing trade deficit from 2.8 billion dollars in 1980 to 4.1 billion dollars in 1981. The current account deficit was even worse, due to interest payments on debts. An overvalued exchange rate made imported consumer goods cheap and arguably, tempted Mexicans to invest abroad in the US.

The difficulties associated with exchange controls resulted in capital flight during periods when confidence in the Mexican economy waned. According to Branford and Kucinski (1990: 78), capital flight may have increased to \$2.3 billion a year. At the same time large capital outflows took place, particularly in 1981 and 1982. This can be seen in Table 7, where the capital account

balance decreased from a surplus of 15 billion dollars in 1981 to a deficit of 5.5 billion dollars in 1982. By 1983 the capital account had a deficit of 9.8 billion dollars. The capital flight is attributed to a falling oil price in mid-1981 and a loss of confidence in the Mexican economy.

4.4.2 The Debt Crisis

By February 1982, as a result of the worldwide recession, falling oil prices, rising interest rates in the United States, and weak reserves, the Peso was devalued by 67%. Mexico had not succeeded in creating an infrastructure independent of petroleum. As a result, the economy arrived at a mono-product dependency on petroleum as an export, while at the same time accumulating huge foreign debts. In 1982, the contraction of worldwide demand for oil reduced the country's export earnings and caused the current account deficit to rise to 5.8 billion dollars (Table 7). Furthermore, the state's ability to obtain further foreign credit was abruptly curtailed.

As a result of this inability to raise further funds for debt servicing, the Mexican economy continued to deteriorate. By August 1982, the crisis had reached unmanageable proportions. A moratorium on external debt payments was declared, as was the closure of the foreign exchange markets. A few days later, the foreign exchange markets were opened with the announcement that an international assistance package was being negotiated.

The rescue package consisted of \$1 billion advance payments to exports to the US strategic petroleum reserve, \$1 billion of US guarantees for purchase of US agricultural goods and a further \$1.85 billion from the Bank of International Settlements. Further negotiations were already underway with the IMF for a structural loan allowing Mexico to draw on credit lines totalling \$3.9 billion between 1983 and 1985. Finally, a two-tier exchange rate system had been implemented. The Free Rate would reflect daily forces of demand and supply, used for non-essential transactions. The Controlled Rate applied to government approved transactions such as debt service repayments and the imports of essential capital and material inputs (Ramirez, 1989: 152).

Despite these efforts, capital flight continued, resulting in the Portillo administration nationalizing the banking system and imposing strict exchange controls. These measures were designed to place

the state firmly in control of the banking sector, which it blamed for the crisis. The then director of the Central Bank, Carlos Tello, objected to IMF stabilization programmes.

4.4.3 The IMF Programme

Mexican economic policy during 1981 and 1982 was contrary to the fundamentals of the 'Washington Consensus'. The budget deficit was running at 5.2% of GDP in 1981, and 8.6% by 1983, with little concern for the level of fiscal imbalances (Table 6). Far from moving towards privatization, during 1982 the government nationalized the commercial banks. Exchange rate stability was regarded as a symbol of pride rather than something which had to be abandoned once in a while for consistency. The annual inflation rate hovered around 54% and appeared to be out of control (Table 6).

Upon taking office in December 1982, the new administration, with a strong belief in market forces, set about to reverse the nationalist policies of the previous government. For example, the exchange controls were dismantled and replaced with a dual exchange rate system, while by the end of 1982 a bill was passed authorizing the government to sell off 34% of the nationalized banks' assets.

Following the fall in oil prices during 1981, debt had grown in 1982 alone from \$55 billion to \$80 billion. Mass capital outflow had put pressure on the exchange rate, resulting in a devaluation in February 1982. The increased debt and loss of reserves resulted in the August 1982 financial crisis. The new Mexican government, under Miguel de la Madrid Hustado, showed its clearest indication of a shift in policy with the adoption of an IMF austerity programme, whose central tenet was fiscal austerity (Aggarwal, 1991: 148).

The essential features of the programme included:

- a reduction in the public sector deficit from a level of 9.8% of GDP in 1982, to 8.5% in 1983, 5.5% in 1984, and 3.5% in 1985;

- an increase in the prices charged for goods provided by the public sector by removing subsidies;
- a move towards the elimination of import licensing requirements; and
- a concerted effort by both the public and the private sectors to promote non-petroleum exports

(Ramirez, 1989: 155).

The austerity programme had various objectives. Firstly, to improve the balance of payments position by improving the current account, using the devaluation to increase the incentive for exports and reduce imports. A surplus on the current account was required to meet interest payments. Secondly, it aimed to pursue price stability through restrictive fiscal and monetary policy in an effort to curb domestic demand. Third, the intention was to curtail speculation and promote exchange rate stability with an undervalued exchange rate. Finally, the government acknowledged that government-led expenditure could not continue, due to the inefficiency that came with it. These policies were an attempt to regain the private sector's confidence, particularly after the nationalization of the banking sector in 1982, and to increase capital inflows.

4.4.4 An Evaluation of the IMF Programme

Inflation

The austerity measures imposed by the IMF during 1983 initially had some encouraging results. As Table 6 indicates, the inflation rate was reduced from 80.8% in 1983, to 59.3% in 1984 and 57.7% in 1985. This is attributed to the fiscal and monetary discipline pursued by Mexico. Table 6 confirms a falling budget deficit from 8.6% of GDP in 1983, to 2.4% of GDP in 1986. Money supply (M3 in Table 6) slowed from an annual growth rate of 72.8% in 1982 to 37.9% in 1985. By 1985 and 1986 the growth was even higher, at 74%. Nominal interest rates rose sharply, from 45.75% to 88.57% in 1986, although in real terms they remained quite low.

However, by 1986 the inflation rate rose again to a level of 91.3%. By 1987, the inflation rate was at 143.6% following aggressive devaluations. The reductions in the government budget were accompanied by devaluations. But because of Mexico's reliance on imports, these devaluations merely aggravated the inflation rate. Inflationary rigidity existed in the form of inflationary expectations, which is characteristic of a country with chronic inflation. Clearly, given these circumstances, the IMF programme was unable to attain price stability.

The Government Budget

Mexico's fiscal accounts were corrected impressively. (This can be seen in Table 6.) The government budget deficit (GBD) fell from 8.6% of GDP in 1983 to 4.5% in 1984. In 1985 it had been reduced to 3.2% of GDP and to 2.4% in 1986. The downside to this was that with non-interest public expenditure under attack to service external debt, social spending on health and education went into a decline. Between 1983 and 1988, social spending, primarily on education and health, contracted by 33.1% (Lustig, 1995: 78). According to Killick and Malik (1992: 674), real public investment fell by 35% in 1984, as the government cut back on the budget.

GDP Growth

Mexico's sluggish GDP growth is illustrated in Table 6. The economy went into recession in 1982 as the GDP growth rate fell to -0.1% in 1982 and then to -5.2% in 1983. In 1984 and 1985 the GDP growth rate averaged 3.2%, but in 1986 it declined to -4%, recovering slightly to 1.1% in 1987. The years between 1982 and 1987 showed increasing economic decline. Fixed investment averaged 21% of GDP in the period 1970 to 1981, but from 1982 to 1985 investment fell to 18% of GDP (Lustig, 1992: 233). The recession was caused by the drastically reduced government budget and the tight monetary policies.

The Exchange Rate, the Balance of Payments and Trade Liberalization

With large debt commitments to foreign creditors, it was clearly stated by the government that it intended negotiating huge payments on its \$60 billion public foreign debt (Lustig, 1992: 233). The

debt had to be financed by a trade surplus. Thus, the debt servicing would require a major shift in the external accounts, from a trade deficit to a trade surplus.

The exchange rate was devalued in 1982, and further devaluations took place until 1987 (Table 8). Ten Kate (1992: 669) notes that the exchange rate devaluation played a prominent role in keeping imports low and increasing exports, particularly during trade liberalization. Furthermore, the devaluation gave rise to undesirable inflationary pressures, which at the end of 1987 led to the collapse of macro-economic policy. After 1987, however, the exchange rate devaluation slowed considerably, resulting in a large increase in imports.

Initially the devaluations worked well. During 1983, Mexico recorded a 5.8 billion dollar surplus in the current account, after having been in a deficit for many years (see Table 7). In 1982 the trade balance went into a surplus of 6.7 billion dollars. This can be attributed to the real, effective exchange rate devaluations (one of the Fund's conditions), which provided a disincentive against imports and simultaneously boosted exports.

However, from 1983 to 1984 the nominal exchange rate devaluation was kept just below the domestic inflation rate, resulting in the real exchange rate appreciating during this period. This had a negative effect on exports, and imports began to grow again. This in turn resulted in a deteriorating trade account, from a level of 13.7 billion dollars in 1983 to 7.1 billion dollars in 1985. The current account declined from 5.8 billion dollars in 1983 to 0.8 billion dollars in 1985 (Table 7). As a result, the exchange rate devaluation was accelerated during 1985. Again the inflation rate began increasing, although the external equilibrium target was improving. It seems that the targets of internal equilibrium and external equilibrium were irreconcilable.

In 1985, a new trade policy was implemented in an attempt to rectify the poor performance of the economy, particularly the rapid deterioration of the current account and non-oil exports (Beristain and Trigueros, 1990: 156). It was decided that an ambitious trade liberalization programme would be pursued.

Previous attempts to liberalize trade had been unsuccessful. After the oil boom of the late 1970s, Mexico's per capita income approached that of lower advanced countries such as Portugal and

Greece. However, this growth was almost exclusively based on crude oil export earnings and foreign borrowing. By the early 1980s, with the weakening oil price and global interest at high levels, the Mexican economy gradually drifted into trouble. This resulted in the reversal of the moderate trade liberalization attempts of the 1970s and the debt crisis of February 1982. As noted earlier, dual exchange rates were imposed, the official exchange rate and the market exchange rate. Import restrictions were imposed in September 1982.

Before liberalization in 1985, the Mexican import regime consisted mainly of *ad valorem* import tariffs, quantity restrictions in the form of licensing or quotas, and official minimum prices for customs valuation. The quantity restrictions were the most restrictive element of the import regime. When there was trouble with the balance of payments, there were sharp increases in licences. At times when the balance of payments was in a favourable position, there were declines in licences (Ten Kate, 1992: 662).

The July 1984 reform hastened the elimination of licences for approximately 3600 tariff lines, with the tariff slightly increased to compensate for the low protection level. The aim was to make the import regime more transparent. According to Ten Kate (1992: 663), the average rate of licensing fell from 92.2% in June 1985 to 47.1% in December 1985. Thus, less than half of the domestic production was now protected by import licences.

For the first time in the history of Mexico's trade policy, liberalization took place at a time when the balance of payments was in disequilibrium. The exchange rate was now relied upon to bring the balance of payments back into equilibrium. During 1986 the devaluation rate was above the inflation rate, causing a real depreciation. Despite the collapse of the oil price, this gave rise to an improvement in the trade account, with non-oil exports growing from 3.7 billion dollars 1986 to 7.1 billion dollars in 1987 (Table 7).

Such a favourable position saw further liberalization of the import regime. The 100% tariff level was removed, leaving the highest level at 50%. Plans were set for a further reduction to 30% level, and 0% by 1988. Commitments with GATT signalled the intention of policy makers.

Overall, the impact of the measures was considerable. At first, a trade and current account surplus was attained in 1983. To a large extent the burden of adjustment from imports to exports was borne at first by import suppression. Initially, the real devaluations increased merchandise exports in 1983 and 1984. This is clearly seen in Table 7. At the same time the inflation rate increased, due to higher import costs and the economy's dependence on imports. In real terms, therefore, the devaluations were in fact appreciations. The nominal value of exports fell between 1984 and 1986. Merchandise imports fell from 15 billion dollars in 1982 to 12.4 billion dollars in 1986. Only in 1985 did the real appreciation of the exchange rate lead to a slight rise in merchandise imports. After a few hiccups, the current account had been successfully maintained, despite hindrance from the inflation rate.

More money flowed out of Mexico during 1985 than in either of the previous two years. This is illustrated in Table 7, where net capital flows are shown to have been negative during 1983 and 1985. This was due to reduced foreign loans, amortization payments and capital flight. Ramirez (1989: 158) argues that the capital flight can be largely attributed to the government's failure to maintain the devaluation in line with inflation. The result, in 1985, was that the rate of devaluation of the real exchange rate slowly drove a wedge between the official exchange rate and black market rate. The earthquake of 1985 compounded Mexico's problems. Some estimates were that \$5 billion escaped the country during 1985.

Despite the capital outflows in 1985, reserves increased as the current account improved. The balance of payments showed significant overall improvement by 1986 and 1987.

4.4.5 Impact on the Structure of the Economy

The adjustment to the external shock led to stagflation, a combination of recession and inflation. Nominal money wages could not keep up with the accelerating inflation rate. The result was a fall in real wages. Bulmer-Thomas (1994: 400) notes that the real wage in 1990 was only 44% of its level in 1980. This was in spite of the slowing down of inflation.

Despite the government's minimum wage adjustments of 50% during 1983, the real minimum wage dropped 38% between 1982 and 1986, as can be seen in Table 6. According to the World Bank

report (1986: 223) the decline in real wages was greatest in the agriculture sector (31.3%) and smallest in transport and communications (22.6%), and construction (24.4%).

Although real wages in Mexico were lower, there were no strikes or other large-scale political or social unrest. The reason may be that other sources of non-wage income meant that the cuts did not affect household incomes to the extent they might have (Lustig, 1995: 74). This is supported by the figures, which show that real private consumption per capita declined cumulatively by 11.1% between 1983 and 1988, whereas real wage income fell by 41.5% during the same period. The non-wage income share of total income rose from 60% in 1980 to 71.5% in 1988. Increased non-wage income is attributed to rising profits in the modern sector of the economy, as the profit margins rose in most manufacturing sectors during 1982–1987 (Ize, 1990: 41).

Despite the continued lagging performance of the economy, employment during the 1980s was higher than at the time of the oil boom. This may be attributed to the downward flexibility of real wages. The rise in employment is illustrated in Table 6. In 1986, unemployment was down to 4.3%, compared to 6.7% in 1983. The decline in real wages allowed firms to keep labour costs in check while faced with declining demand, and thus without reducing employment. Furthermore, it allowed the government to reduce expenditure without resorting to lay-offs. When lay-offs did take place, informal employment rose.

Gross Fixed Capital Investment

Table 6 shows a high growth rate in gross fixed capital investment (GFCF) between 1982 and 1985. This may be attributed to the fact that although there were increases in the nominal interest rate, the real interest rate was kept quite low due to the high levels of inflation. The high growth rate in money supply (M3) may also have contributed to the high levels of gross fixed capital investment.

Diversification

By 1986 Mexico had diversified its export base. Crude Petroleum and products made up 34% of total exports as opposed to 72.1% in 1982 (refer to Table 9). According to Alarcon and McKinley (1992: 78), a wider range of sophisticated exports had become top items for export. These

included piston engines, telecommunications and electrical power machinery. The greatest growth rates of exports from 1975 to 1985 include electrical machinery (207%), passenger motor vehicles (380%), telecommunications equipment (468%) and electrical power machinery (342%).

The agricultural sector, on the other hand, had a low level of growth. The share of agriculture in GDP was 8.2% in 1980. In 1985 it was 8.5% and in 1990 it dropped again to 7.5% (Bulmer-Thomas, 1994: 401). This might be attributed to the ignorance of the sector by the various governments. Lustig (1995: 76) argues that the poor performance of the late 1980s is attributable to bad weather conditions, reductions in subsidies and credit, and a fall in new investments.

On the whole, though, the outcome of trade liberalization was favourable. According to Beristain and Trigueros (1990: 159), access to imported inputs had an important effect on domestic costs of produce, allowing for the expansion of non-oil exports. This is important in terms of countering the effects of the drop in the oil prices and austerity, thus minimizing the contractionary effects. Furthermore, during 1985 and 1988 there was a significant increase in imports and exports of goods whose production processes are subject to economies of scale, such as chemical products, iron and steel.

A further change was the selling of state-owned enterprises (privatization). This policy was linked to attempts to reduce the fiscal deficit by selling state owned enterprises in order to reduce losses and expenditure (Bulmer-Thomas, 1994: 394). Of the 1155 entities in government hands in 1983, only 496 remained by 1989, the rest either having been liquidated or transferred to local governments (Beristain and Trigueros, 1990: 48).

4.4.6 Mexico and the IMF in the 1990s

In May 1989, the IMF approved a three year extended arrangement for SDR 2.7 billion. In January 1990 the arrangement was augmented to SDR 4.66 billion. In May 1992 it was extended for another year. According to the IMF Survey (1993: 269) the objectives of the medium term programme included a reduction in the overall public sector deficit, deregulating the financial

system by removing controls on interest rates, privatization, removing mandatory lending by the commercial banks to the public sector at below market interest rates.

Between 1988 and 1994 the exchange rate system was modified several times. Initially, the exchange rate was completely fixed, but gradually moved to a system based on a pre-announced rate of devaluation with the actual devaluation set below the inflation rate. In 1991, in accordance with NAFTA, an exchange rate band was adopted with a sliding ceiling (Calvo and Mendoza, 1996: 238). The aim was to reduce inflation and ensure labour's support for the economic programme. This was accompanied by prudent monetary and fiscal policies, trade liberalization and the relaxation of foreign ownership in the stock market.

Thus the main feature of the reform included a fundamental opening to international competition, privatization and deregulation, a predetermined nominal exchange rate anchor, supported by restrictive monetary and fiscal policy, and a broad fiscal and economic agreement between the government, the unions and the private sector.

There were some encouraging features in the economy. Between 1988 and 1994 real GDP averaged 2.4%. The primary budget deficit had fallen to 3.1% by 1992 from 5.2% in 1989, and inflation was reduced from 26% in 1990 to 9.7% in 1993 (Table 18). Financial reforms and lower inflation allowed a fall in real interest rates from a yearly average of 16% in 1988 to 3% in 1992 (IMF Survey, 1993: 271). Gross reserves had reached a record peak in 1993 of US \$26 billion (International Financial Statistics, 1998: 623). These reserves reflected the private inflows. Approximately half of these capital inflows were portfolio investments. According to Edwards (1998: 13), foreign holdings of Mexican securities reached 50% of the country's GDP. However, the external current account deficit rose from 2.2% in 1988 to 7.1% of GDP in 1992.

In December 1994 the Mexican economy was shaken by the collapse of the peso due to investor concerns about the growing current account deficit, rising US interest rates and political upheaval. Interest rates were increased sharply in an attempt to stabilize the currency. The peso was allowed to move to the more depreciated bands of the exchange rates band. There was also a significant loss in reserves between January and April in 1995.

Calvo and Mendoza (1996: 237) attribute the fall in the peso and reserves to imbalances between stock of liquid financial assets and gross reserves. However, imbalances such as the overvalued exchange rate and large current account deficits were not as much to blame. Banking fragility and exogenous shifts in world capital flow contributed to the currency vulnerability. This led to falling reserves as the currency's peg was abandoned. The capital outflows are explained by the 'herding' by global investors. The capital outflow is attributed to political uncertainty and rising US interest rates. With the removal of capital controls in 1989, international fund managers were free to move large volumes of funds in and out of Mexico. The large dependence on portfolio capital resulted in the crash.

Edwards (1998: 4) argues that the overvalued exchange rate and large portfolio capital inflows were a result of the 'overoptimism' of the media, financial experts and multilaterals. The reforms were highly praised despite the poor economic results. Thus the Mexican 'miracle' was invented by these institutions, which generated a capital inflow and the real appreciation of the peso. The overvalued peso and large current account deficits, poor savings, modest growth and large portfolio investment were ignored.

According to the IMF Survey (1995: 188), Mexico's reliance on short term debt financing made it more vulnerable to liquidity crisis. The increased need in 1993/4 to finance short-term dollar-indexed peso dominated government securities known as tesobonos added to the stress. The short term maturity led to the liquidity crisis.

A fragile banking sector is argued to have played a role in the crisis. According to Gonzalez-Hermosillo, Pazarbasioglu and Billings (1997: 296), non-performing loans of the banking industry increased from 5.5% in 1992 to 7.3% in 1993 and 8.3% in September 1994. Furthermore, the bank sector's riskiest assets relative to capital increased from 56.3% in 1992 to 69.6% in 1994. A negative macroeconomic shock therefore put the stability of the financial system at risk.

In 1995 and 1996 a programme formulated by the government and supported by the IMF was undertaken to address the liquidity problem as short term obligations fell due. The external financing was required to support the conversion of short term debt, to help domestic commercial banks to meet their short term obligations and ease investors' concerns about the situation. The

objectives included a reduction in the external account deficit, lowering inflation and higher GDP growth. The programme was centred on a policy of wage, price and credit restraint and privatization.

As with Zambia and Brazil, there was a low level of commitment on the part of the Mexican government to the IMF prescriptions during the 1990s. The existence of a high monetary growth and budget deficits is shown in Table 18, and the high debt service ratio in Table 19 points towards this conclusion. This may also have contributed to the low level of confidence shown by international investors. Having studied the period it was evident that the economic data is therefore not a reflection of the IMF policy as such, but rather the *ad hoc* policies pursued by the government.

4.4.7 Summary

Between 1983 and 1986, the Mexican economy underwent various reforms, including currency devaluation, privatization and trade liberalization. Although sometimes hindered by chronic inflation, the balance of payments improved. As noted earlier, this was due more to the compression of imports than the response of exports to devaluations. The end result was inflation-induced real appreciation. The economy was also successful in diversifying the percentage of exports from crude oil. But in spite of all this, the IMF programmes were unable to curb inflation. There were two primary reasons for this. On the one hand, rigid inflationary expectations sustained the period of chronic inflation. On the other hand, the economy depended too heavily on imports due to the pursuance of ISI.

The fact that inflation accelerated during 1987, despite tighter fiscal policy, led to the diagnosis that it was not caused by excess aggregate demand (Beristain and Trigueros, 1990: 158). This interpretation justified the incorporating of heterodox policies into the stabilization programme. The opinion that excessive aggregate demand was not inflationary resulted in price controls. However, according to Table 6, the percentage growth in money (M3) was high between 1982 and 1986, and may have boosted the inflation rate.

Ramirez (1989: 160) argues that the limited progress made during Mexico's stabilization programme carried a social and political cost. The little progress was based upon Mexico's continued ability to generate export surpluses in order to finance outstanding debt. Opportunities for higher growth and living standards were forgone, because of the negative flows entailed in servicing debt. In fact, real wages and standards of living fell, since food subsidies were lower and the prices of public transport and health care were higher (Lustig, 1992: 93).

Overall, the stabilization programme had adverse effects in terms of lower GDP and real wages, hyperinflation and constant debt servicing. Clearly the burden of the IMF programme appears to have affected the poor. Although this was not an intended outcome, greater attention should have been paid by the IMF to take the social side into account and provide financial cushioning. The balance of payments difficulties, however, were corrected despite the inflation.

4.5 Conclusion

Almost all IMF stabilization programmes are aimed at curbing effective demand and promoting the market mechanism, although the number and content of performance criteria and policies may vary from country to country. While the theoretical framework of the IMF model and its prescriptions are similar in each case, success in attaining the objectives has been mixed.

From evidence in the case studies, it emerges that the success of the market related policies advocated by the IMF is limited by structural rigidities. It appears that the IMF is to blame for ignoring these rigidities.

For example, the devaluation failed to improve Zambia's balance of payments, due to structural factors such as the inability of the manufacturing sector to respond to the stimulus. The fact that the copper price is set at the London Metal Exchange and not by free market forces was not taken into account by the IMF.

Although the balance of payments improved in the cases of Brazil and Mexico, it was hindered by high inflation and real appreciation of the exchange rate. In fact, the improvement was a result of import reduction, rather than improved exports in response to the devaluations.

The influence of devaluation on the current account is likely to be more favourable in semi-industrialized developing countries. Zambia's poor diversification hampered the supply response to the devaluation, and contributed to the failure to meet the balance of payments objective.

While a devaluation tends to boost profits in the export sector and to raise domestic prices of domestic tradeable goods, the effects of such price changes and profit incentives on the balance of payments are less certain. It depends largely on the elasticity of supply and demand for exports, and the elasticity of demand for imports. The higher these elasticities, the greater the gains in the balance of payments are likely to be from a devaluation.

In all three case studies, the low supply elasticities hindered the stabilization programmes. Zambia's reliance on primary commodities, especially copper, and its low price elasticity at an international level, resulted in exports not being significantly affected by the devaluations. Furthermore, the high import content of mining production hindered the supply response of manufacturing to the relative price change as costs increased. A central point from the case studies is that a lack of supply response limits the success of the IMF stabilization programmes.

In none of the case studies was the objective of price stability achieved. Attempts to achieve price stability were hampered by chronic inflation and inflationary rigidities. Inflationary expectations and institutional rigidities, such as the backward indexation that existed in Brazil, clearly inhibit the ability of an IMF stabilization programme in achieving price stability. The high import content orientated economies may also have contributed to the higher inflation, which in turn inhibited real devaluations.

A lack of commitment on the part of the government in pursuing IMF objectives also plagued the stabilization programmes. For example, both Brazil and Zambia failed to reduce their budget deficits as proposed by the IMF. In Zambia's case, the money supply growth was not curtailed. This type of behaviour adversely affects the credibility of policy, making it even more difficult to combat inflationary expectations, reduce uncertainty or increase domestic or foreign confidence in the policies.

Reducing budget deficits is never easy, especially when there is large-scale unemployment. Under these conditions, political resistance to the policies may have contributed to the lack of commitment.

Overall, the IMF stabilization programmes resulted in lower investment, lower wages, high inflation and higher unemployment. Under such macroeconomic instability in terms of inflation, wage indexation and growing budget deficits, reforms were unsustainable and unsuccessful.

From the evidence, macroeconomic stability is essential for successful stabilization programmes. It is important that the institutions are in harmony with domestic policy. In trying to reduce inflation and inflationary expectations, the appropriate policy would be to influence the formation of expectations.

Commitment by the government is essential for credibility for future dealings with the IMF, as well as to create investor confidence. Furthermore, possible structural rigidities which may exist and inhibit supply response must be taken into account.

CHAPTER FIVE — SOUTH AFRICA UNDER TWO ECONOMIC REGIMES

5.1 Introduction

In the preceding analysis in Chapter Four, it has been established that the IMF structural adjustment programmes work better under certain conditions than others. Unstable macroeconomic policies, high inflation, government inefficiency and a lack of diversification have hindered these programmes in cases such as Zambia, Brazil, and Mexico.

Chapter Five compares the performance of South Africa's economy under two different economic regimes. The intention is to examine what happened to the economy after the debt crisis in 1985, and compare this with what happened after the currency crisis in 1996. The two periods were characterized by differing economic regimes.

First, a brief description of the industrialization process is given, together with a description of the economic regime at the time. Next the balance of payments between 1946 and 1984 is examined in order to provide insight into the volatility of South Africa's balance of payments. Thirdly, explanations are sought for the debt crisis of 1985. The performance of the economy under the economic regime of the period is evaluated. Fourthly, South Africa's arrangement with the IMF, and the change in economic policy is detailed. The performance of the economy between 1994 and 1997 is evaluated, concentrating on the effects of the 1996 currency crisis. Lastly, conclusions will be drawn from the comparison.

5.2 South Africa's Economic Regime between 1900 and 1993

Import substitution has been maintained in South Africa since the late 1920s via trade policy. Protection has been moderate and selective for those firms which supply a substantial portion of the domestic market against normally priced imports. The trade regime has been very specific regarding protection and export incentives. The system was designed on a case by case basis which has made it very difficult to determine which industries benefited most (Fallon and Perreira da Silva, 1994: 80). Tariff-based protection has also been moderate, but it was accompanied by a wide ranging system of quantitative restrictions (Belli *et al.*, 1993: 2).

The pursuit of ISI continued until government commissions, such as the Reynders Commission (1972), began to advise a more export orientated policy. Since the 1970s South Africa has made substantial progress with regard to trade liberalization. Quantitative restrictions have gradually been replaced by tariffs and export incentives have been improved. Although import liberalization began during the early 1980s, tariff protection is given to industries requiring it. In 1985 periodic surcharges were still used, imposed at a level of 10% (Economist Intelligence Unit, 1986/7: 44). In 1988 the surcharge had grown to 60% in an effort to contain imports. Reductions in the surcharge were introduced in March 1991.

Exchange controls were also a feature of the South African economy. From the end of the Second World War until 1971, the South African exchange rate was dominated by the Bretton Woods Arrangements of fixed but adjustable exchange rates. Members were obliged to maintain their exchange rates within 1% on either side of the stated parity rates. According to Natrass (1990: 267) the South African currency was devalued once in 1948, by 30%.

Although the currency remained stable between 1945 and 1971, there were significant changes in exchange control. Due to various social disturbances during 1960, in 1961 the exchange control regulations were tightened. A limit was placed on the outflow of capital by blocking the repatriation of foreign investments from the country.

In 1971 the system of fixed exchange controls began to break up throughout the world. The trend was towards freely floating exchange rates. South Africa pursued this course of action. In 1974 the system of 'independent managed floating' was pursued. Smaller and more frequent adjustments were made. In 1976 exchange controls were relaxed with the strengthening of the balance of payments. The security rand was introduced through which purchases and sales of non-resident owned balances took place (South African Reserve Bank Quarterly, 1978: 5).

In 1977 the De Kock Commission of Inquiry into the Monetary System and Monetary Policy was appointed to do research on the exchange rate system. An interim report was published in 1979, recommending the further relaxation of exchange controls. A unitary exchange system with no exchange controls and flexible rand levels was envisaged in the long run. However, in the short

term a dual exchange rate was introduced via the financial rand, which replaced the securities rand in 1979.

The main feature of the reform was that foreigners could now acquire quoted securities and non-quoted securities in South African companies using the financial rand. Further reform in the form of foreign direct investment by residents would also go through the financial rand (van der Merwe, 1995: 4). Although the financial rand was basically determined by market forces, the Reserve Bank could intervene.

Following further reforms during 1980 and 1981, the dual exchange rate system was abolished together with exchange control over non-residents. Initially the reward was an inflow of capital (Nattrass, 1990: 268). During 1984 and 1985, social disturbances and the fall in the rand led to massive capital outflows. The withdrawal of foreign credit lines as well as the temporary postponement of repayments in August 1985 led to the re-introduction of capital controls in September 1985. This was an attempt to prevent further capital outflows. The financial rand was also reintroduced.

5.3 South Africa's Balance of Payments Performance between 1946 and 1984

It is necessary to provide a brief background to the volatility of South Africa's balance of payments. Mohr (1991: 48) identifies some underlying reasons for the balance of payments constraint. Political unrest tends to erupt whenever domestic spending is curtailed for a long period of time. Such action leads to a loss in foreign confidence, and therefore to capital outflows. The unequal income distribution places pressure on government spending and implies a narrow tax base. Rapid population growth and large scale unemployment necessitate increased domestic spending and economic growth to provide job opportunities. The need for growth and redistribution is vital, and any sign that these are not being attained may negatively affect capital inflows. The high capital intensity of production exacerbates the need for imported inputs, contributing to the expenditure elastic demand for imports. When the economy grows, imported inputs tend to increase rapidly. Capital inflows, or a current account surplus, are required to finance these. Lastly, the major source of instability in the domestic economy is its heavy dependence on gold mining and primary

exports as a source of income, foreign exchange and employment. This is because the prices of these commodities are so subject to fluctuation.

According to Van Der Walt and De Wet (1993: 3), South Africa's economic history has been dominated by balance of payments problems. This is not a problem unique to South Africa, as all countries may experience a balance of payments crisis from time to time. However, South Africa's balance of payments problems have become progressively worse and more frequent.

Between 1946 and 1976, South Africa could afford to run deficits on the current account of the balance of payments, as they were financed by net inflows of foreign capital into the capital account. During this period, current account surpluses were recorded in only six years, while net capital outflows were recorded in only eight years. After 1976 the situation changed drastically. Current account surpluses and capital account deficits became the norm, due to the political climate in the country (Kahn, 1992: 94). In 1979 and 1980 the strength of the gold price resulted in current account surpluses, creating scope for repayments. However, any current account surpluses have had to be manipulated in order to finance capital flight and repayments of foreign debt.

Mohr (1991: 52) emphasizes that although South Africa could afford to run current account deficits during the fifties, it does not imply that there were no balance of payments constraints. Pressure on the reserves took place whenever capital inflows did not meet the current account deficits. When this pressure on the reserves existed, contractionary monetary and fiscal policies and stricter import controls had to be applied. During the 1950s and 1960s, any pressures were really only the result of import growth being too rapid due to increases in spending.

Between 1950 and 1976, South Africa experienced a number of economic windfalls which created additional leeway on the balance of payments (Mohr, 1991: 53). Gold production received a boost in the early 1950s with the commissioning of the Orange Free State gold fields, as well as other mines in Eastern and Western Transvaal. Except for 1951, when imports increased by 50%, South Africa had never experienced a deficit on the trade balance until 1970.

The early 1970s saw the next major fortuitous event in the form of an increase in the price of gold, which granted temporary respite to the current account deficit that had emerged in 1971. However, by 1974 a trade deficit was again recorded in the wake of the first oil crisis (an increase in the oil price) while gold's price began to weaken at the same time. The deficit persisted even with the devaluation of the rand in September 1974 (South African Reserve Bank Quarterly, 1975: 11). As mentioned earlier, the result was the need for contractionary fiscal and monetary policy. The capital flight which resulted due to the Soweto uprising was dampened by the renewed strength of the rand.

From 1976 onwards, a new type of balance of payments constraint was faced by South Africa. Due to the re-emergence of net outflows of foreign capital with the advent of the Soweto uprising, the country was no longer able to run a current account deficit with substantial financing or borrowing. A zero balance on the current account now had to be aimed for. In other words, because of the low level of reserves, economic policy had to be geared towards balancing the trade balance (Mohr and Rogers, 1991: 91).

At the same time there was a significant shift towards market-orientated monetary and exchange rate policies. This was partly based on the belief that market-related changes in interest and exchange rates would facilitate domestic adjustment to external shocks, and relieve the pressure on reserves and exchange controls. This drive towards the market at macroeconomic policy level coincided with the strengthening of the gold price and the readily available foreign loan capital.

According to Mohr (1991: 53), by the end of the 1970s, the South African Reserve Bank was bullish regarding world demand and the gold price. It was therefore expecting an improvement in the balance of payments. However, in 1982 and 1983 the gold price fell, while a worldwide recession in the wake of the second oil crisis and a severe drought contributed to falling GDP. This was followed by a gold-led boom and consumption boom, increasing imports. To protect the reserves and the rand, interest rates were raised by 3% in August 1984, along with other measures to dampen demand. These measures soon had the desired effect on domestic spending and the current account, but were detrimental to levels of output and employment.

5.4 The Debt Crisis of 1985

1985 was a watershed year in economic terms for South Africa. Foreign debt had increased by about 50% in dollar terms and about 500% in rand terms as short term debt increased almost sevenfold. In 1985 a major international bank refused to provide further rollover facilities, which resulted in similar refusals by many other of South Africa's foreign bank creditors (Van der Walt *et al.*, 1993: 3).

Instead of allowing the rand to collapse, the South African Reserve Bank decided to declare a moratorium on foreign debt repayments. As mentioned in the previous section, there had been an easing of exchange controls up until the early 1980s. In 1985 strict exchange controls and a dual exchange rate system were reinstated to eliminate further capital flight. Although the debts were subsequently successfully renegotiated with creditors, the incident was reinforced by the negative impact it had on the economy, and the political uncertainty that followed in its wake.

According to Bell (1993: 92), the fundamental cause of the economic crisis in the mid-1980s was a drastic decline in the value of South Africa's exports during the period 1980 to 1985. South Africa's total exports increased at an annual 22% in the 1970s. However, from 1980 to 1985 they fell by 9% per annum. The fall took place among all the sectors during this period. The fall in mining exports to 9.1% from 24.6% between 1970 and 1980 was of particular significance, in view of their major contribution to South Africa's total exports. This is attributable to the fall in the gold price. The lack of diversification in the South African economy made it vulnerable to shocks. Table 11 shows that gold's contribution to exports was 46% in 1984.

There are many different views as to the causes of the debt crisis and the cause of capital outflows. Mohr (1991: 56) argues that the roots of the crisis can be traced to a variety of domestic and international economic and political developments since the early 1970s that led to deteriorating growth as well as deteriorating perceptions regarding potential growth. These included capital flight, swings in the terms of trade and the movement towards short-term loan financing. The crisis set in when Chase Manhattan called for the repayment of all debt, with large capital flight taking place.

Van der Watt and De Wet (1993: 12), on the other hand, argue that it was the move towards market orientated policies that made South Africa vulnerable. The relaxation of exchange controls and the move towards a single floating exchange rate came at a time when the country was incapable of competing internationally.

Another reason for the 1985 crisis was the collapse of the manufacturing and gold mining sectors during the early 1980s. These sectors were key sources of profit in the domestic economy. The collapse of the gold price from \$850 per ounce to \$300 an ounce in early 1985 affected the gold mining sector's profitability. According to Harris (1989: 182), the index of the manufacturing sector's output dropped in 1982 from 135 to 117 later the same year.

The world recession also affected exports. Oil price hikes, and the fall in the gold price resulted in the balance of payments being in deficit in 1981, 1982 and 1984. By 1985, however, the current account moved back into a surplus, following the austerity measures taken in August 1984 when interest rates increased from 22% to 25% and exchange controls were imposed. While such measures helped sort out the balance of payments, they depressed the manufacturing sector and increased unemployment (see Table 10).

General economic mismanagement is also argued to have caused the failure of the South African economy (Mohr, 1991: 55). As mentioned earlier, the Reserve Bank was unduly optimistic in 1980, expecting a higher gold price, extra reserves and an economic upswing. However, its planned market-orientated policies, based on these perceptions, were soon discarded. The poor performance of the economy contributed to net capital outflows, due to lack of investor confidence. Bell (1993: 93) notes, "it was the excessively optimistic domestic and foreign expectations, and their subsequent disappointments in the context of an uncertain and fluctuating gold price, which produced the gold crisis."

The consequence of the debt crisis was a sudden, massive increase in net transfers of resources abroad. This required an equally large increase in the surplus on the current account. According to Bell (1993: 90), the most urgent requirement for economic recovery was to increase the availability of foreign exchange to pay for imported inputs. This required an increase in the rate of growth of exports, while still allowing for ISI.

5.5 Economic Performance between 1984 and 1993

As noted earlier, the balance of payments position has been a major constraint since 1976 on the process of development and growth in South Africa. Following any meaningful increase in the growth rate imports tend to rise very quickly. This is due to the high component of imported machinery and equipment required when expansion of the productive capacity of the economy takes place. If exports do not rise (at least equivalently) a balance of payments crisis results, forcing policy makers to switch from an expansionary stance to a more restrictive one. Such policies often abort economic upswings, as higher interest rates dampen investment and GDP growth. They also negatively affect the policy credibility. On the other hand, if there are substantial capital outflows, a crisis in the balance of payments may ensue if the current account does not improve. Loans may be undertaken from the IMF or World Bank. The ability to obtain loans from these institutions is a measure of a country's creditworthiness. This balance of payments constraint can sometimes also result in exchange controls, import controls and tariff measures to protect the balance of payments position.

During the early 1980s, the deterioration of the current account was at least partly covered by additional capital inflows. These came either in the form of additional investment in the private sector or in a compensatory manner in the form of loans raised by the South African authorities, aimed at supplementing gold and foreign exchange reserves. Table 11 illustrates the current account deficit in 1984 of R2517 million. The value of the capital account was R1151 million.

The debt crisis caused a major capital outflow in the capital account in 1985. The capital account moved from a surplus of R1151 million in 1984 to a deficit of R8442 in 1985. This is shown in Table 11.

After the debt crisis, between 1985 and 1992, South Africa was forced to manage a current account surplus, the cumulative amounting to R40 billion. This was approximately the amount of the cumulative surplus which had to be engineered in the current account (Bank of Lisbon, 1993: 1). According to the South African Reserve Bank Quarterly (1993: 28), this was due to higher merchandise exports of 8.5% per annum since 1985, and lower imports resulting from a depressed

economy. The total cumulative outflow of capital between 1985 and 1992 amounted to R47.2 billion, exceeding the surplus in the current account and resulting in lower reserves.

The movement in the real exchange rate is illustrated in Table 11. Clearly the devaluation of the currency in 1985 and 1986 provided a boost for exports, and a strong current account in 1985 and 1986. At the same time, import growth was slowing down. This is attributed to the declining GDP growth rate, falling from 5.1% in 1984 to -1.2% in 1985 due to the restrictive policies adopted since late 1984, such as the higher interest rates and low budget deficits as a percentage of GDP.

During the period from 1985 to 1993, restrictive monetary and fiscal policy had to be pursued. This is examined in detail in the following paragraphs. As mentioned above, due to the high import capacity, every time the economy expanded, imports would quickly rise, and this resulted in the cooling off of the economy.

In 1993 the current account had a comfortable surplus of R5829 million, due to excellent performance in exports, increasing by 6%. This was attributed to pronounced increases in the exports of manufactured exports due to the depreciation of the rand. This neutralized the increase in merchandise imports. However, there was a continued large net outflow of capital valued at R15 021 million, which is attributable to political uncertainty and a strong US dollar. More than 90% of the outflow was in the form of short term capital. Net gold and foreign reserves therefore decreased by R9 192 million. In order to support the level of reserves the monetary authorities had to make drawings of R7.1 billion on foreign credit facilities, some of which included an IMF loan (South African Reserve Bank Quarterly, 1994: 10).

Between 1984 and 1993, the South African capital account was characterized by capital outflows. A current account surplus therefore had to be engineered to prevent further losses to the level of reserves. The restrictive monetary and fiscal policies were a constraint on the economy. These capital outflows can be attributed to political and economic uncertainty.

Earlier in the chapter the easing of exchange controls was discussed. Up to 1985, various exchange rate and exchange control reforms had taken place. However, in an attempt to stem the capital

outflow, the financial rand and other exchange controls were then re-introduced. Thus there was an change in economic policy. Potential investors view economic policy stability as an important characteristic for stability. The response of the South African government to the debt crisis damaged investor confidence in the stability of the economy.

Once investor confidence has been damaged, it takes a lot of hard work and stable policy decision making by a government to restore confidence. The figures in Table 11 illustrate the damage done to the capital account until 1993, and the rest of the economy in terms of GDP, employment and investment due to the restrictive fiscal and monetary policy pursued because of the lack of domestic as well as foreign savings.

According to Mohr (1991: 46), South Africa's real GDP grew at about 5.5% during the 1970s and 3% during the 1980s. This occurred against a background of change in economic policy and various international disturbances, and political factors too. Immediately after the debt crisis, the GDP growth rate fell to -1.2% in 1985 and 0.3% in 1986.

As mentioned earlier in this section, these low GDP growth levels can be attributed to the higher nominal and real interest rates and lower budget deficits (refer to Table 10). There was little growth in employment during this period. According to Table 10, most of the growth that did take place was in the public sector. The private sector growth remained subdued to the recession and high interest rates, as well as rationalization taking place to cut costs (South African Reserve Bank Quarterly, 1987: 4).

The money supply (M3), clearly fell from a high of 23.2% in 1984 to 12.3% in 1985 and 9% in 1986. The budget deficit decreased from a level of 2.4% of GDP in 1984 to 1% in 1985 and 1986. The higher nominal interest rates of 20% had a detrimental effect on gross domestic fixed investment, with a negative rate prevailing between 1984 and 1987.

During 1986 and 1987 there was a decrease in the annual percentage gross domestic fixed investment (GDFI). In 1986 the growth was -18,6% on the year before. Except for 1988 and 1989, large negative percentages were experienced between 1985 and 1993 (Table 10). Real gross domestic fixed investment fell dramatically at 0.9% per annum after 1981. A major reason, apart

from political factors, according to Strydom (1991: 375), was the higher cost of investment. The depreciation of the rand and import surcharge played a role. So too did the rapid rise in nominal interest rates from 4% in 1979 to 22% in January 1985. Savings as a percentage of income fell from 12.7% in 1979 to 1.3% in 1990.

The excess demand of the early 1980s is measured by the large current account deficits, and the weak currency influenced the inflation rate positively. The first quarter of 1984 saw inflation up 10% on the previous year, accelerating to 20% in the first quarter of 1986. Thereafter it went down gradually, but still remained in double figures.

During the 1980s and early 1990s, budget deficits as a percentage of GDP were rising, as is illustrated in Table 10. This was a symptom of the Apartheid government's commitment to a large bureaucracy, political subsidies and expensive security forces. At the same time the South African Reserve Bank tried unsuccessfully to reduce the money supply. This is illustrated again in Table 10, as M3 rose from 9.3 % in 1986, to 27% in 1988.

By the early 1990s South Africa had officially gone into recession. The GDP growth rate fell to 0.3% in 1990. By 1992, GDP growth was -2.2%. The CPI was at 15% by 1991. The balance of payments was taking strain as reserves were run down while capital outflows continued.

5.6 The IMF Programme

South Africa, a founder member of the IMF, received her first IMF loan in 1957/8, apparently on far easier terms than countries in Latin America. Further loans on easy terms were received between 1968 and 1970. In 1976/7 the Fund granted more assistance to South Africa than all other African nations put together (Junne, 1991: 214). Between 1980 and 1985, as the balance of payments worsened, a loan of US \$1.1 billion for standby credit was granted. Thereafter the availability of loans to South Africa dried up due to rising opposition to South Africa's political policies.

The IMF approved a loan of \$850 million to South Africa in December 1993. The loan was a Compensatory and Contingency Financing Facility (CCFF). The CCFF has been described in detail

in Chapter Two. This loan was made in order to support some balance of payments difficulty following a decline in agricultural exports and increase in agricultural imports due to the drought (South African Reserve Bank Annual Report, 1994: 26). The loan was intended to bolster reserves and ease pressure in monetary and exchange rate policy. The letter of intent committed the government to some conditionality. The conditions were:

- reduce the budget deficit to below 6%;
- control spending rather than increase taxes;
- continue tight monetary policy;
- pursue policies of wage restraint;
- do not introduce further exchange controls;
- liberalize trade, simplify the tariff system and phase out non-tariff barriers; and
- restrain wage increases.

5.7 Economic Policy Changes since 1993

In 1993, Dr Stals, then Governor of the Reserve Bank, stressed that a solution to reducing the vulnerability of the balance of payments requires domestic saving and investment to be in long run equilibrium, aligning domestic production and expenditure and improving the efficiency of domestic industries (Stals, 1993: 31). These are the objectives of the economic adjustment programmes of IMF, to restore equilibrium in the economy.

The measures pursued under monetary, fiscal and trade policy since 1993 clearly show that an austerity stabilization programme has been in place. This is similar to the policies as prescribed by the IMF.

Liberalizations of exchange controls took place between 1994 and 1995. In March 1995 the dual exchange rate system was abolished. Exchange controls remained, however, regarding foreign investments made by South African residents. Further reforms took place in July 1995 allowing insurance companies, pension funds and unit trusts to undertake foreign investment by way of asset swaps (van der Merwe, 1995: 9).

Most of the quantitative limits on current account transactions were abolished in 1997. The annual travelling allowance by citizens has been increased (to R400 000), and so too has the amount private individuals are allowed to invest abroad, up to R200 000 (South African Reserve Bank Annual Report, 1997: 19). Other concessions which took place during the course of 1998 include allowing South African institutional investors to invest up to 15% of their total assets abroad. Companies can also retain foreign currency earnings abroad for up to 180 days and transfer up to R50 million from South Africa to finance investments outside the country.

With the appointment of Derek Keyes as Minister of Finance came new economic policy. Immediately the focus was on reducing government expenditure and the budget deficit as a percentage of GDP. Money supply targets in 1993 were reduced, signalling an intention of strict monetary policy (South African Reserve Bank Quarterly, 1993: 18).

During 1993 a restrictive monetary stance was pursued by the Reserve Bank. Table 11 shows that while the money supply (M3) has been constant, nominal commercial bank lending rates and real interest rates have been rising steadily since 1994. Meanwhile the budget deficit has been falling steadily since 1996 to 1998, from 6.7% to 4.5%.

Since 1993 privatization has built up some steam. During 1996 the South African government succeeded in privatizing five regional radio stations for R451 million, while Telkom was partially sold (30% sold) (South African Reserve Bank Annual Report, 1997: 54). During 1997 further privatization of government assets took place: Sun Air, another radio station and a 20% stake of the Airport's Company was sold off to an Italian company (South African Reserve Bank Annual Report, 1998: 55).

Trade and industrial policies, which were previously highly protective, inward orientated and primarily focused on self sufficiency; were restructured towards a more outward orientated economy capable of competing effectively in export markets. In 1994, with the agreement with the World Trade Organization, a commitment was made to reduce import tariffs, remove import surcharges and phase out General Export Incentive Scheme (GEIS). Since 1994 trade tariffs have been lowered by 8 percentage points. GEIS was terminated on 11 July 1997 (South African Reserve Bank Annual Report, 1998: 19). Import surcharges were abolished on 1 October 1995. Much of the state protection began to disappear as privatization and liberalization became economic trade policy.

In 1994 Mr Keyes shared some assumptions with the IMF and World Bank on policy. The main assumption was that domestic and foreign investment would respond well to stable monetary and fiscal policy as well as a stable political situation. A firm policy stand was taken in June 1995, with the release of a major economic strategy entitled GEAR.

In mid-1996 the plan for Growth, Employment and Redistribution (GEAR) became the strategic development strategy. GEAR provides the familiar global economic orthodoxy linked to the IMF. It focuses on discipline in fiscal and monetary policy, increasing public and private investment, pursuing a stable exchange rate, reducing tariffs and encouraging a strategy of export-led growth and privatization (Munslow *et al.*, 1997: 49). This is just like the conditions set out so often by the IMF for debtor countries. The Minister of Finance, Mr Keyes, stated that GEAR was the way to achieve the RDP, growth and redistribution.

The overriding objectives of the government's fiscal policy in GEAR were:

- to reduce the overall budget deficit to 4% in 1997/8 and to 3% in 1999/2000;
- to avoid permanent increases in the overall tax burden and limit the ratio of tax on GDP to 25%;
- to reduce consumption expenditure by general government relative to GDP to about 18% by 2000; and

- to strengthen the government's contribution to gross domestic fixed investment by allowing government real-investment growth to continue at an average annual rate of 7% until year 2000.

A protocol was also developed containing a programme of asset restructuring and changes in ownership of state entities (South African Reserve Bank Annual Report, 1997: 54).

5.8 Economic Performance between 1994 and 1997

In 1994 the current account was transformed into a fairly large deficit. This was due to a large increase in domestic expenditure and thus a large increase in the quantity of imports. The value of imports exceeded that of exports, resulting in a trade deficit. Luckily, the balance on the capital account changed to a net inflow of capital. This is attributed to South Africa's favourable credit rating and the normalization of international financial relations. The net inflow of capital (R5 352 million) during the year exceeded the deficit on the current account, and the balance was used to shore up the reserves to R3 121 million (Table 13). A steadier exchange rate was the result.

With the economy experiencing an upturn during 1995, increasing demand saw a steep rise in the value and volume of merchandise imports. Even though merchandise exports grew, it was not enough to prevent a substantial current account deficit deterioration. During the year, an even larger net capital inflow of R21 733 million took place, consisting mostly of loan capital and portfolio equity to finance the current account deficit. This capital inflow was responsible for an increase in reserves and gold.

South Africa's reintegration into the international economy and the new political order led to a large inflow of capital from other countries. After 1994 the capital account was in surplus, showing the perceptions of foreign investors. Besides political stability, stable macroeconomic policy played a major role. Various investor-friendly policy changes were made. GEAR policy entailed reducing the large budget deficits of the late 1980s and early 1990s, as well as reducing inflation. Although the large capital inflow had positive spinoffs in the economy, it had also made the South African

economy more vulnerable to international financial markets, especially when a large part of the capital inflow was in the form of short-term capital, or 'hot money.'

In mid-February 1996, the South African economy had its first experience of the risks of relying on short term capital inflows, when on February 16th the rand went into 'free-fall.' The South African Reserve Bank argued that it was unfounded rumours about President Mandela's health and uncertainties about the removal of capital controls and future policy stance that precipitated the change in international investors' sentiment (South African Reserve Bank Annual Economic Report, 1996: 17).

According to the Economist Intelligence Unit (1998: 41), the rand fell from levels of R3,65:\$1 during most of 1995, to R4:\$1 in March 1996. By mid-December the currency was trading at R4,7:\$1, therefore having depreciated by 30% against the US dollar during 1996. Table 13 illustrates the real effective exchange rate depreciating during 1995, and especially during 1996. Falling interest rates were put on hold, rising by 1% to 16%, to ward off speculation on the rand and buffer the reserves. Despite the upheaval, further exchange control liberalization took place on 14 June 1996. The EIU (1998: 42) point out that this smooth easing of exchange controls provided a boost to investor confidence. Many more reforms took place during 1994, such as the termination of GEIS.

The deficit in the current account shrank during 1996. This is attributed to the slowdown of volume and value of imports due to a decline in the overall level of aggregate domestic expenditure. Exports experienced a strong rise. This turnaround was due to the depreciation of the rand in early February, increasing the prices of imports. The net outflow of capital in the third quarter turned into net inflow (due to the fall in the rand) in the last quarter of 1996. This inflow was larger than the deficit on the current account, resulting in an increase in gold and foreign reserves. This resulted in the rand strengthening moderately due to positive sentiment.

By 1997 the depreciation of the rand during the previous year had resulted in consolidation. The deficit still grew but only to R8 813 million, due to a sharp increase in the value of merchandise imports, which was only partially offset by a small increase in merchandise exports. The capital account saw an inflow of R20 246 million. However, the net inflow of long-term capital declined.

The long-term capital inflows were dominated by portfolio investment flows. Obviously this type of investment is less stable than foreign direct investment (FDI), and the flow can be easily reversed and have a destabilizing effect. Reserves increased by R11 433 million.

One can see how growth depends on either a manufactured current surplus, or if its in deficit, a large capital inflow. With most of the capital being in the form of portfolio investment, any change in sentiment would be a cruel blow to the balance of payments position and the growth prospects of South Africa, unless borrowing is undertaken from institutions such as the World Bank and the International Monetary Fund.

Inflation seemed to have submitted to the restrictive macroeconomic policy. By 1993 the CPI fell to 9.7%, after being quite high since the mid-1980s. This trend continued until 1997, with the CPI down to a level of 0.8%. Other factors which Dr Stals believes have played a role are the wage restraint and the capacity under-utilization of the last few years (EIU, 1995/6: 17).

Throughout the 1980s, gross domestic fixed investment was at very low levels, with negative annual growth rates (Table 10). However, the gross domestic fixed investment annual percentage has been increasing since 1994. The South African Reserve Bank (Annual Report, 1996: 7) attributes this to a positive sentiment in the recovery of the economy, as the GDP growth rate increased by 2.7% in 1994, thus moving out of the negative territory of the early 1990s.

This favourable improvement in the capital account allowed for the generation of a large current account deficit without restricting economic growth. According to the South African Reserve Bank (Annual Report, 1996: 1) the large demand for capital and intermediate goods was financed by the inflow of capital. Exports have increased too, even though liberalization of the trade regime was taking place.

The GDP growth rate in 1998 so far (first two quarters) is 0.5% (South African Reserve Bank Quarterly, 1998: 122). The South African Reserve Bank (Annual Report, 1998: 6) attributes this to the slowdown in the economies of Japan and East Asia. However, gross domestic fixed investment grew at 6.7% in the first quarter, and 8% in the second quarter.

Inflation (CPI) has declined to 5.2% in June 1998 (South African Reserve Bank Quarterly, 1998: 141). This is attributed to the continued restrictive monetary policy since 1998, the lowering of import tariffs since 1996, low oil prices, and low import prices for South-east Asia due to competitive devaluations.

Employment levels have been nosediving. According to the South African Reserve Bank (Annual Report, 1998: 13) the average annual level of employment has declined by 7.5% between 1990 and 1997. Reasons offered include the recession, changing technologies, declining commodity prices (especially gold) and the objective of government to establish a smaller and more efficient public service.

A closer examination will now be made of the trends in the public and private employment sectors. As can be seen in Table 12, total formal sector employment has been in decline since 1994. The private sector's formal employment level has been deteriorating throughout this period. However, the public sector's level of employment experienced a sharp rise in 1994 of 10.3%, notwithstanding the recession. Yet overall, employment also decreased, up to the first quarter of 1998. The deteriorating level of employment is bad news for the government, and perhaps the IMF and GEAR policies.

Nominal remuneration per worker in the non-agricultural sector decelerated from 18.2% in 1989 to 13.5% in 1994. This trend continued into 1995 to a level of 11.7%, and 10.2% in 1996 (see Table 12). A slight acceleration was experienced in 1997 to 11.4%. The South African Reserve Bank (Annual Report, 1998: 14) attributes this decline to lower inflation and tight monetary and fiscal policy.

5.9 The Two Regimes

As we have seen, between 1984 and 1993 South Africa responded to the debt crisis by reverting back to exchange controls and increased protectionism. The result was a continued outflow of capital in the capital account during these years due to a loss in confidence by investors. This led to increased pressure on the current account surplus. The devaluations of 1985 and 1986 helped in creating the current surplus, as did the effect of the recession on imports.

The period was characterized by the large budget deficits and growth in money supply in an attempt to bring the economy out of the recession and turn the current account into a surplus. The economic performance was poor. The GDP growth rate remained low, except in 1988. High real interest rates prevailed to combat the double-digit inflation rate, hampering gross fixed investment, GDP, employment growth and private consumption expenditure.

In contrast, between 1993 and 1997, economic policy has been characterized by trade, privatization and financial liberalization. Even in the face of the currency crisis in 1996, policy has remained stable. Investors' confidence improved and capital inflows were the result. The positive capital account allowed for the production of a ballooning negative current account

The GDP improved considerably between 1994 and 1997. Restrictive monetary and fiscal policy was pursued, and there was a reduction in real wages. The budget deficit as a percentage of GDP fell from 6.8 in 1994 to 5.6 in 1997. The money supply was kept constant, while nominal and real interest rates remained high. The balance of payments improved due to the capital inflows. The devaluations cushioned the crisis. One may also note the reduction of the economy's dependence on gold in Table 12, reducing its vulnerability to shocks.

Inflation has been brought down to single digit figures. The higher levels of gross domestic investment illustrate the increased confidence in the economy. Employment figures however, are very worrying. Although there was a slight increase in employment levels between 1993 and 1997 as the economy's GDP grew, the increase was not large enough. This may be attributed to the restrictive monetary and fiscal policies pursued. As long as this figure keeps getting worse and the real wage gets worse, the probabilities increase of a new redistributive economic regime being put in place.

5.10 Policy Implications for a Successful Stabilization

South Africa is becoming increasingly integrated into the world economy. Economic reforms have been undertaken as a means of improving the performance of the economy. Calitz (1997: 323) contends that the welfare benefits to be derived are correlated to the extent to which the principles,

policies and practices are adhered to, which ensure that growth in the world economy will benefit South Africa via trade and foreign investment.

This has been realized by those parties in South Africa who previously found themselves on either side of the political and ideological divide, but now find their viewpoints have converged. The ANC has abandoned nationalization as a policy, while the Business sector has increased involvement in social upliftment. The outcome has been the macroeconomic strategy for Growth, Employment and Redistribution (GEAR), a synthesis of business and labour. As mentioned in Chapter Five, the policies pursued since GEAR are included in a typical IMF package.

South Africa's shift to structural reform is a strategy that has been global. The strategy of fiscal and monetary discipline, freer trade and privatization have swept the globe since the international debt crisis of 1982. Such reform has been vindicated by the IMF and World Bank.

Rodrik (1996: 15) argues that the most important lesson to be learnt from the debt crisis and reforms undertaken is that failures were not due to microeconomic policies. He points out that the root of the problems lay in non-sustainable macroeconomic policies due to bureaucratic or institutional deficiencies.

For example, during the reform package, Brazil's indexation had been institutionalized. This made it extremely difficult to bring down the inflation rate. At the time a real depreciation of the exchange rate was being pursued. The chronic inflation continued due to indexation and inflation expectations, resulting in a real appreciation of the exchange rate. The difficulty in controlling the inflation rate hampered the adjustment process.

Several factors hampered the governments of Zambia and Brazil in their efforts to bring their budgets under control. Government inefficiency and lack of commitment to the adjustment process contributed to this. Furthermore, devaluations and higher interest rates increased the debt service ratio, increasing the pressure on government budgets. In Zambia's case, inefficiency was also found in government committees. Investment was impeded, for example, by erratic decision making within NAMBOARD.

In South Africa, reform (or restructuring) towards the development of a market based economy takes place in the context of the constitutional recognition of private property and the constitutional independence of the South African Reserve Bank. Commitment by the government to an outward orientated economy has been shown by trade and financial liberalization.

Calitz (1997: 327) points out correctly, that the test for economic reform is not the mere application of policy. The reform should stem from a 'self confined' understanding of the best interests of the country. With the increasing integration into the world economy, some autonomy is lost. But this does not mean that government has no authority over economic management. Policies can be pursued which will best service its own interests.

There are areas in South Africa where the institutional developments do seem lacking. There is concern over competition policy and lack of flexibility in the labour market. There is also concern about law and order, and safety of private property. For a market economy to develop, a firm basis of private property is obviously an important condition. Disregard for private property allows for the threat of macro-populist policy changes, away from the orthodox policy being pursued presently. Such institutional developments adversely affect the confidence of potential investors in stable macroeconomic policy, and could result in capital outflows and a balance of payments problem.

According to Klitgaard (1991: 5), there are various legal and institutional foundations that are required for a free and efficient market:

- a stable and credible currency;
- a well functioning legal system, with well enforced contracts and property rights;
- ample information on prices, quantities and qualities for labour and products;
- an efficient capital market and banking sector; and
- a low level of corruption.

These are an important basis for the success of the reforms prescribed by the IMF. Unfortunately, in South Africa at present, there are indications that corruption is prevalent in public management, hindering the government's ability to reduce the budget deficit. The movement towards free markets should help reduce corruption and inefficiency.

Successful structural adjustment also hinges on the level of export diversification. The failure to rectify the balance of payments in Zambia, for example, was largely attributed to the lack of diversification. Dependence on copper as a source of revenue made Zambia susceptible to shocks. Furthermore, Zambia failed to significantly alter this situation, as the manufacturing sectors had a limited response. A lack of infrastructure also played a role in the unsuccessful attempt to increase exports and keep imports down. This is attributed to the high import dependency of the manufacturing sector. The elasticity optimism shared by the IMF was not evident. In fact it has been argued that the demand elasticity for copper was low, with exports failing to respond to the change in relative prices caused by the depreciation.

The IMF prescribed a devaluation, as it viewed the South African exchange rate as overvalued. For a successful supply response, it is important to promote manufacturing exports and to be less dependent on primary commodities which have low elasticities. Although the proportion of primary exports to manufacturing exports has fallen, there is still room for improvement. The manufacturing sector has been inhibited by low productivity and low gross domestic fixed investment. International demand for primary products is growing slowly as developed countries expand their output of manufacturing output without substantially increasing their need for primary and semi-manufactured products. Diversification in the make-up of exports is essential to increase the likelihood of devaluation improving the balance of payments with the Marshal-Lerner conditions holding.

South Africa's poor export performance has inhibited a faster growth rate, due to the country's heavy dependence on imports, in particular capital equipment. While a devaluation may stimulate exports, the high marginal propensity to import results in higher imported input costs. The need to

be competitive may result in cost cutting and increased unemployment. The increased import costs may therefore inhibit future export growth and retard economic growth.

Brazil managed to engineer trade surpluses between 1983 and 1986. In contrast to Zambia, Brazil's pursuit of import substitution policies in the 1960s and 1970s and of export promotion in the 1980s, are argued to have played a role in the successful improvement of that country's balance of payments. Import substitution policies provided a good base for local manufacturing, while export promotion provided incentives for exports.

The diversification away from gold during the 1990s, mentioned in Chapter Five, increases the likelihood that the IMF model could stabilize the South African economy. This is in contrast to Zambia's case, where dependence on copper played a role in the failure to stabilize the balance of payments. Both Mexico and Brazil had diversified economies, promoting stabilization.

South Africa has a relatively diversified economy, with the mining and manufacturing sectors playing prominent roles in exports. The reliance on gold is not what it used to be, and there is still room for improvement in the diversification. South Africa's pursuit of ISI and export promotion will be an advantage in the adjustment process, as witnessed in the case of Brazil. Furthermore, the neglect of the agricultural sectors in Zambia and Mexico did not do the adjustment process any good.

Rodrik (1990: 935) contends that stabilization seems to be an ongoing process with most countries having difficulty implementing policies such as reducing fiscal deficits and trade liberalization. Attempts to do so lead to instability in the macro economy and lower private investment. Sustainability is important, as the promotion of investment and growth depends on a degree of certainty. Rational agents endorse consistency in economic policy. Thus, policy sustainability is more important than carrying out reforms under macro instability.

The programme should focus on sustainable policy rather than enduring harsh reform measures at a time when it is least likely to succeed. Policy is likely to be unsustainable if implemented in the midst of pervasive macroeconomic and political instability. When capital is mobile and there is instability and uncertainty regarding future economic policy, capital will leave the country and

investment will decrease. Commitment to the economic policy is vital. If the stated policy is not carried through, credibility is lost and investor confidence is reduced.

Also important for stability are sustainable exchange rates that are not overvalued. Rodrik (1990: 940) notes that many countries have been forced to undertake exchange reforms. While timely devaluations are a key to macroeconomic stability, there are circumstances under which too much flexibility can be destabilizing. A real depreciation could result in increased price expectations and interest rates. In many countries, (e.g. Zambia) structural adjustment programmes have included institutionalized exchange rate auctions to ensure flexibility. In practice such attempts to stimulate free-floating exchange rates entail high risk and financial instability, due to their thinness of trade. Developing countries cannot be expected to have stable exchange rates when even the stronger international currencies gyrate. On the whole, realistic but controllable exchange rates are central to structural adjustment programmes.

Brazil and Zambia tried reform in the face of macroeconomic uncertainty. Their inability to bring their fiscal deficits under control resulted in instability. Capital outflows, high inflation and lower investment were the results of new policy packages undertaken every six months. Mexico also undertook various reforms during uncertainty. The uncertainty underlying these reforms was the root cause of their instability, and led to heterodox programmes involving exchange controls and wage controls. This only served to create even more uncertainty and unsustainability. The importance of making sure first time around that the policies pursued will be sustainable is crucially dependent on the existence of macro-stability.

The lesson is to introduce reforms that are sustainable. The priority must be to maintain stability. In the long run this will be more beneficial for investor confidence and capital inflows.

Mosley and Toye (1988: 410) found that countries who minimized slippage by sticking to reforms as indicated performed better than those who did not. Furthermore, when it comes to stability, tariff liberalization cannot take place in the presence of a large fiscal deficit or balance of payment deficit.

A vital lesson that South Africa can draw from the case studies is the importance of low inflation. Clearly the adjustment process does not work in an environment of high or chronic inflation. Once there is hyperinflation, the adjustment programmes have failed to rectify the balance of payments. Both Mexico and Brazil had chronic inflation that could not be reduced due to expectational rigidity, and in Brazil's case, indexation. The high inflation rates hindered real depreciation of the exchange rates, and their effect on exports was consequently muted. Furthermore, in such an economic environment, reforms were met with scepticism regarding their sustainability.

It appears that there are high social costs to the IMF stabilization programmes. Prescribed lower real wages, as well as the fall in economic growth are obviously undesirable. This is especially so where a large portion of the population is unemployed and unskilled. Political instability may result, inducing a fall in commitment to the stabilization effort, due to populist macro-economic pressures. It is vital that government and the IMF take these risks into account, and prepare to cushion the fall in real wages.

Moll (1991: 325) points out that macroeconomic populism is "characterized by the belief that income redistribution can be achieved via changes in the level or structure of aggregate demand, at little or no cost." COSATU has called for an alternative populist strategy, advocating a more inward and interventionist policy for purposes of redistributing wealth in South Africa (Padayachee, 1994a: 84).

According to Mohr (1993: 3) macroeconomic populism places emphasis on redistribution, while underrating the effects of inflation, large budget deficits and external constraints due to the reaction of potential investors to such policy. Moll (1991: 326) comments that this type of policy is based on the theoretical error that there are no trade-offs between redistribution and other welfare objectives. He emphasizes the point that proposals for such policy require extensive research. At this stage research is lacking, and so is evidence for macro-populist policy.

The contrast is clear. The IMF prefers growth first and redistribution later. The RDP, on the other hand, intends to integrate growth, development, redistribution and reconstruction into a single programme.

Padayachee (1994a: 85) argues that the IMF poses a threat to social welfare in South Africa. With a large electorate who have been impoverished, little improvement in living standards could increase the threat to our fledgling democracy. There is also the possibility of policy reversals in line with redistribution. De Wet (1995: 486), on the other hand, points out that disciplined fiscal and monetary policy is essential for stability and improved consistency.

CHAPTER SIX — CONCLUSION

The study has examined the role of the IMF adjustment programme. The IMF model and the various approaches to balance of payments have been critically examined. The IMF model itself has been criticized as being based on assumptions that may not hold, especially in less developed countries. Structural adjustment works better under certain conditions, and these tend to be lacking in many less developed countries. In order to establish the conditions necessary for a successful structural adjustment in South Africa, this study has evaluated the impact of IMF programmes on the economies of Brazil, Mexico, and Zambia.

The purpose of the IMF is to promote international monetary co-operation. More specifically, the function of the IMF is to facilitate the expansion of international trade, promote an orderly and stable foreign currency exchange markets, and to contribute to balance of payments adjustment.

In furthering these objectives, the IMF monitors members' macroeconomic policies and makes financial resources available to them in times of balance of payments difficulties, through various financing facilities. Of course, access to such finance is dependent on the member country's ability and effort in meeting certain performance criteria.

The IMF conditionality to such financing is fiercely debated. The IMF argues that the existence of conditionality minimizes the risk of 'moral hazard'. Furthermore, conditionality is required as security for repayment. However, at the same time conditionality also poses a threat to sovereignty of the member countries regarding policy making. The IMF has also been lambasted as a neo liberal institution forcing painful policies that benefit financiers as opposed to helping the poor. Furthermore, it has been accused of fostering moral hazard in the financial markets and bailing out incompetent governments.

The IMF prescriptions are based on a neo-classical approach to the balance of payments. The IMF model links the financial sector to the balance of payments, providing a rationale for credit restraint. The IMF approach is eclectic, based predominantly on monetarism, as well as the absorption and elasticities approach. The prescriptions typically involve deflationary fiscal and monetary policies,

devaluations and credit restraint. Furthermore, some typical structural features involve privatization, trade liberalization and wage restraint. Thus, the basic tenet of the IMF doctrine is that macroeconomic stability and a liberal market based economy are important prerequisites for sustainable economic growth.

However, there are limitations regarding the IMF model. The market-based instruments prescribed may be of limited importance to developing countries where capital and labour markets may in fact be rudimentary. Furthermore, the assumptions underlying the IMF model are by no means universal. It has also been argued that country specific structural phenomena are usually excluded.

It was demonstrated in Chapter Three that the IMF model provides the theoretical framework for the IMF's approach. The model provides a rationale for the use of credit ceilings, as well as the removal of price distortions. The intention is to reduce aggregate demand as well as to make industry more competitive and export orientated.

However, Chapter Three also questions the IMF model and the effectiveness of the market-based instruments it proposes in developing countries, where the capital and labour markets may actually be quite rudimentary. The case studies in Chapter Four unveil many price distortions and rigidities, which are found to impair the IMF's structural adjustment programme.

Each of the case studies has mainly focused on the IMF prescriptions and its impact on the economy during the 1980s. It has been recognized that there is data available for the 1990s. However, having studied the period it was evident that for the purpose of evaluating the IMF's impact on the economies significant conclusions could not be drawn. As the IMF policies were not vigorously undertaken for long enough periods of time and on an *ad hoc* basis, it has been difficult to evaluate the economic performance to such an adjustment programme.

Each of the case studies were evaluated in detail in the 1980s. The IMF prescriptions were pursued with commitment and for a longer time scale before they were abandoned. These allow for more accurate evaluations to be made on the impact of the IMF programme on the economies. The case studies provide a platform for evaluating the IMF stabilization programmes and their limitations. It

was found that the success of a stabilization programme depends largely on the extent of the rigidities in an economy, and the ability to restrain domestic demand. Valuable lessons can be learnt as to what inhibits these programmes.

The existence of high inflation, minimum wage laws, low real interest rates and overvalued exchange rates lead to distortions in the allocation of resources, and thereby stifle capital formation and the ability to increase capacity. The existence of institutional price structures such as wage indexation and minimum wages for political reasons will also inhibit stabilization. Persistent inflationary expectation makes the problem more complex. Expenditures switching policies may also be inhibited by low supply elasticities. Rudimentary capital markets are often a characteristic of developing countries, restraining the effective use of monetary policy.

The case studies allowed for a detailed evaluation of how successful the IMF prescriptions were in attaining targets, as well as the features, which inhibit or enhance the success.

Various rigidities inhibiting the Fund's programmes emerged in the selected case studies. The institutional existence of wage indexing and inflation expectations had an adverse impact on the balance of payments. The high inflation rate hindered the effectiveness of devaluation on exports. The balance of payments hindered by specific structural rigidities such as an over reliance on a few primary commodities and the failure of supply to respond, and in Zambia's case ignoring the fact that the price of copper was determined at the London Metal Exchange and not by free market forces.

Thus the Fund can be criticized for ignoring certain structural rigidities, and placing too much reliance on market forces. The commitment by domestic policy makers to implementing the prescriptions has also been questioned.

One of the most important lessons learnt is that economies do not operate in a vacuum. It must be observed that all economies influence, and are influenced to differing degrees, by each other in a complex and sometimes hostile economic environment. The last fifty years has witnessed a

progressive liberalization of trade and the expansion of international capital flows. This process has deepened in the last twenty-five years as these capital flows have become increasingly globalized.

As markets become more sophisticated, the large volume of funds has made the movement of capital extremely volatile. This volatility is in turn determined by weak banking institutions, a lack of transparency in capital flows, and an environment where the regulation and supervision of financial institutions does not keep up with the transparency with which the markets have evolved.

The resultant increased vulnerability of emerging markets to crisis and contagion can be reduced through economic management based on open and integrating policies, and structural reforms. These reforms foster increased confidence levels from the markets. Furthermore, factors such as political stability, prudent fiscal and monetary policy, lower debt levels, smaller current account balances and reform in the labour market are important variables in assessing a country's risk profile, which in turn affects portfolio investment and foreign direct investment (FDI). Commitment to the reforms set by the IMF is also closely examined. Otherwise known as ownership, political and economic 'will' are viewed positively by the markets.

Contagion tends to hit those economies which are weak, unable and unwilling to fulfil their obligations. Macroeconomic stability and credibility are extremely important incentives for attracting investment. A secure and efficient business environment obviously plays an important role when potential investors make their decisions. This is increasingly so as the global funds become larger and vulnerable to changes. Volatility is a concern as too much volatility in the capital markets can result in the country going out of equilibrium. Therefore, how economic policymakers react to a crisis is extremely important when investors evaluate potential risk and return.

Brazil is an example of how policymakers reacted positively to the emerging market crisis in 1998. Instead of opting for the closing of the economy by way of exchange controls like Malaysia did, the authorities persisted with the IMF reforms, which were already underway. Despite a turbulent economic environment the adjustment package reforms were carried out, displaying determination and commitment. While the ploy of using capital controls to moderate capital flows may work in

the short term; it is unlikely to benefit in the long run due to inefficiency and restricted access to future market capital access.

It is important that IMF reforms are pursued diligently. The doctrine that macro-economic stability and a liberal market based economy is a prerequisite for sustainable economies is now viewed as orthodoxy in most countries. As the worlds' economies become increasingly integrated, the best functioning economies and financial markets most likely to bounce back from a crisis are based on strong institutional framework and regulation. Together with a well-defined legal and judicial system, these form the structure that helps markets work efficiently and promotes good governance. A sound financial system whereby assets and bad loans are reported realistically, market-based solutions to bank failures as opposed to the public sector bailouts, and prudent regulation and supervision of the system.

Thus, stable macroeconomic policies and a sound financial system must be supported institutionally by laws, regulations and standards for sustainable reforms and long term economic growth. Ownership entails a commitment by the public and the government to the prescribed reforms and is crucial for a sustainable IMF programme. Furthermore, it must be realized that there are rigidities common to developing countries that must be acknowledged and overcome.

It must be acknowledged that although the IMF's role and prescriptions have changed during the 1990s, they are still based on the neo-classical fundamentals discussed in chapter three. The decade has seen a move towards focussing on the financial sector health, the banking system and poverty alleviation. Some innovations have been put forward in trying to provide assistance to those low-income countries hit by external shocks. With this objective the IMF has been focussing on raising finance for the concessional facility, as well as for the initiative for debt relief. A soft loan arm has been created, known as the Poverty Reduction and Growth Facility. The IMF has in the past been criticised for ignoring the social effects. However, over the last decade there has been a move towards supplying support for the poor. In fact, the Fund is sometimes criticized for becoming another aid agency providing medium term aid like the World Bank. In 1998 the size of the quota was increased and the New Arrangements To Borrow facility was introduced in a move towards increasing the resources available to the IMF. The IMF has also aimed at developing international

standards in a bid to improve the standard and the availability of information in attempting to increase the efficiency of the capital markets and reduce its volatility. This has resulted in the Basle Banking standards, the Special Data Dissemination Standard and international accounting standards.

Over the last few years there have been refinements in the design of the programmes. The changes are crucial in an increasingly changing economic environment. At the forefront has been the realisation that the importance of the capital markets as the capital flows become larger. Overall, by improving the quality of information, strengthening the financial and banking sectors and improving macroeconomic policy the IMF hopes to increase economy's resilience to future crisis.

Although modifications have been undertaken, the approach is not radically different to that of the case studies examined here. Important lessons have been learnt regarding the South African economy. These changes are taking place to cushion the effects on the poor. The case studies revealed an adverse effect on the unemployment rates and real wages that are clearly not the objectives South Africa must strive for. Maintaining the reforms prescribed by the IMF will benefit in the long run, hopefully establishing a stable business environment to attract investment and create jobs. In the meantime help from the IMF is essential to lower the burden on the poor if the programme is going to survive.

Complying with the IMF reforms, even during a crisis or contagion, is essential in helping to prevent recurrence and lessen the severity of future economic shocks. Whilst such action could result in capital outflows in the short term, in the long run there will be the benefit of capital inflows as a sign of confidence by the markets. It is therefore imperative that South African economic policymakers are willing to adhere to the prescriptions. As mentioned earlier, following this course of action should inspire confidence in investors. A stable macroeconomic and business environment will strengthen the economy in the long run, creating incentives to save and invest, as well as reducing the vulnerability to adverse external shocks.

As mentioned in Chapter Five, the South African economy is strengthening in some areas, such as inflation, but struggling to create employment and improve economic growth. The main dangers are those of violence, unemployment and a breakdown in the protection of private property. There are also factors that could lead to reversals of the country's economic policy towards more expansionist or populist policies. With a growing urban proletariat as well as worsening income distribution, there are calls from COSATU for macro-populist economic policy.

Overall, South Africa is in a strong position for a successful adjustment. The low inflation is conducive to a successful real depreciation of the exchange rate. The institutional rigidities are not as apparent as in Zambia and Brazil. There is no price indexation, and privatization and trade liberalization are well underway. The economy is relatively diversified, certainly better than in Zambia's case. South Africa possesses a well developed financial and banking sector. Finally, commitment to sound macroeconomic policy (GEAR) has been evident, and this is important for sustainability and a successful programme of economic adjustment.

South Africa is engaged in a precarious balancing act. Trade-offs have to be made between equity and efficiency. The country's policymakers face many challenges, with growing unemployment and a lack of economic growth.

Policymaking should be based on the input from the government, trades unions and the IMF. This teamwork is crucial for sustainable policy decisions. The IMF will obtain a knowledge of possible rigidities in the economy that may hinder stabilization, while the government obtains an understanding of the IMF and its prescriptions and how they may affect the economy. It is essential that priorities are drawn, as GEAR is within the framework of the RDP, and there will be conflicting interests. For example, in the context of inequality and high unemployment, the restrictive monetary and fiscal policies, together with lower real wages, could lead to political resistance and instability. Co-operation between the groups is therefore important to prevent the pursuit of unsustainable policies.

Although the dependence on primary commodities has been reduced, there is still room for improvement. The manufacturing sector must be geared towards being more competitive, in order

to move away from exports with low demand elasticity. This will help to prevent turbulence in the current account.

Overall, it has been argued that sustainable reform requires macroeconomic stability, and therefore certainty. Implementing reforms in the face of macro instability such as high inflation and large budget deficits leads to programme breakdowns. Commitment by domestic policy makers to reform and a reduction in corruption are vital. A lack of commitment and the existence of corruption adversely affect credibility and possible future dealings with multi-lateral institutions. In the light of the case studies, it is of utmost importance that stable institutions are in place for a successful IMF stabilization programme. Macroeconomic stability, commitment and credibility are important to build up investor confidence, which is essential in a global economy. Although there are many hurdles that have shown up in the case studies, it is essential that South Africa show commitment in continuing along the road to openness and economic integration. This is especially so in times of crisis when there will be temptation to move into a protective shell. In the long run this help insulate the economy from external account deterioration due to the relatively undiversified economy. Prompt and determined policy reforms are important to reduce financial imbalances, improve private sector confidence and attain a higher level of economic diversification.

It is clear from the case studies that a successful IMF stabilization programme has been inhibited by factors other than those proposed by the theory underlying the programmes.

Future research is required on institutional development in South Africa, with special attention to corruption. There is need for research on microeconomic policies to combat the weakness of South Africa's institutions. Stronger institutions are crucial for a stable and sustainable economic adjustment. Research is also required into the effects of IMF prescriptions on the largely unskilled and unemployed labour force. This is essential in order to find ways of cushioning the burden on the poor, and will go a long way to preventing political resistance to the IMF prescriptions.

APPENDICES: FIGURES AND MACROECONOMIC INDICATORS

Appendix 1

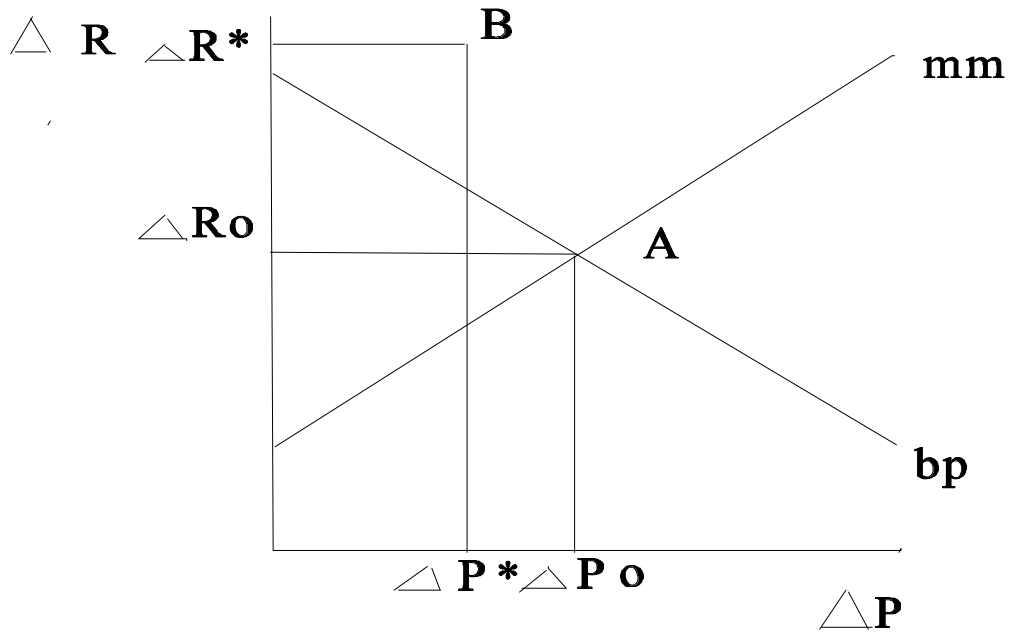


Figure1: The Polak Model

Source: Khan *et al.* (1990).

APPENDIX 2: MACROECONOMIC INDICATORS FOR ZAMBIA

Table 1: Macroeconomic Indicators for Zambia (1978–1987)

Year	1978	1979	1980	1981	1982	1983	1984	1985	1986	1987
GDP	1.6	6.2	3.6	4.9	-2.2	1.4	-1.1	2.1	0.3	-0.1
GFCF	23	22.1	18.3	17.8	17.1	16.7	15	10.8	9.2	8.8
GD	5.3	8.21	23.2	16.2	17.3	11.1	8.2	13.8	16.6	15.4
P	16.1	10.8	13.4	15.2	12.8	20.1	22.9	35.3	52.1	44.3
I	6	6.5	6.5	7.5	7.5	10	14.5	25	30	14
M1	1.02	30.1	0.6	8.6	22.3	15.3	9.4	41.5	87.1	98.2

Source: Adapted from *International Financial Statistics* (IMF, 1998)

GDP=real gross domestic product in 1990 prices.

GFCF=Gross fixed capital formation as a percentage of GDP in 1990 prices.

GD=Government's budget deficit as a percentage of GDP.

P=Annual percentage Consumer Prices.

i=the bank rate.

M1=Annual percentage change.

Table 2: International Indicators for Zambia (1978–1986)

Year	1978	1979	1980	1981	1982	1983	1984	1985	1986
Current account	-281	78	-516	-729	-562	-263	-147	-395	-348
Capital account	-17	-41	-21	-13	-4	-8	-6	-3	-3
Level of reserves	342	-68	225	464	370	21	89	-181	134
Real effective exchange rate	104.4	102.4	132.7	135.7	151.2	140.2	120.5	-91	57.3
Imports	-7	22.3	41.8	3.41	2.35	-24.6	21.2	66.9	121.3
Exports	-3.01	68.4	-5.62	-5.09	-2.23	10.43	14.78	25.75	51.8
Copper exports	87	82.6	85.4	88.3	90	88.3	87.12	79.9	97.36

Source: Adapted from *International Financial Statistics* (IMF, 1998)

Current account=in millions of U.S. Dollars.

Level of reserves=in millions of U.S. Dollars.

Capital account=in millions of U.S. Dollars.

Real Effective exchange rate=real in 1990 prices.

Imports=year on year percentage.

Exports=year on year percentage.

Copper exports=copper exports as a percentage of total exports.

APPENDIX 3: MACROECONOMIC INDICATORS FOR BRAZIL

Table 3: Brazil's Macroeconomic Indicators (1978–1987)

Year	1978	1979	1980	1981	1982	1983	1984	1985	1986	1987
P	36.7	58.1	82.2	91.2	97.9	179.2	203.3	228.0	158.4	337.9
GDP	5.01	6.7	9.23	-4.2	1.1	-2.7	4.8	7.5	7	3.4
GFC	27.1	25.2	27.2	23.5	24.3	20.8	17.9	18.4	18.3	18.1
GBD	13.8	15.4	13.9	12.6	16.1	20.1	22.3	25.3	12.4	29.3
OD	6.1	6.8	6.2	5.9	5.2	4.1	3.8	4.1	3.9	5.1
i	33	35	38	49	49	156.6	215.3	219.4	50.7	391.5

Source: Adapted from *International Financial Statistics (IMF, 1998)*

P=consumer prices, percentage change over previous year.

GDP=Gross domestic product, percentage change over previous year.

GFC=Gross fixed capital formation, percentage of GDP in current prices.

GBD=Government budget deficit (PSBR as defined by IMF).

OD=Operational deficit.

i=The bank rate as a yearly percentage.

Table 4: Brazil's International Transactions (1978–1986)

year	1978	1979	1980	1981	1982	1983	1984	1985	1986
current account	-6996	-10516	-12831	-11764	-16341	-6834	33	-280	-5311
capital account	-40	38	25	13	8	-3	-6	-7	1
exports	4.6	22.2	32.1	15.6	-13.3	9.1	24.1	-6.06	-13.1
imports	13.4	31.8	27.8	-3.7	-12.6	-19.7	-8.7	-04.1	7.8
trade balance	-1158	-2717	-2823	1185	778	6469	13086	12466	8304
debt service ratio	52.2	59.5	51.7	53	82.23	72.8	71.3	72.3	73.5
Real effective exchange rate	96.2	96.3	100	115.2	109.1	130.1	134.6	138.6	147.8
Level of reserves	-4628	2900	3469	-622	7541	11251	-7169	573	3856

**Source: Adapted from *International Financial Statistics* (IMF, 1998)
Inter Development Bank (1995)**

current account= in millions of U.S. Dollars.

capital account=in millions of U.S Dollars.

exports= year on year percentage.

imports= year on year percentage.

exchange rate=the real effective exchange rate, where 1990=100.

Level of reserves= in millions of U.S Dollars.

trade balance=in millions of U.S Dollars.

debt service ratio=as a percentage of GDP (includes interest and amortization).

Table 5: Brazil's Exports (1978–1987)

	1978	1979	1980	1981	1982	1983	1984	1985	1986	1986	1987
coffee	15.21	11.38	11.25	6.6	8.2	8.8	8.7	8.7	8.1	7.9	7.32
soybean	11.91	10.6	11.2	13.99	10.13	11.73	10.1	10.1	7.61	7.61	8.21
sugar	1.81	1.73	4.61	2.86	1.67	1.69	1.21	0.67	0.72	0.73	0.62
iron ore	8.18	8.21	7.81	7.73	9.28	6.1	5.92	5.92	7.21	7	6.51

Source: Adapted from *International Financial Statistics* (IMF, 1998)

These exports are each shown as a percentage of total exports.

APPENDIX 4: MACROECONOMIC INDICATORS FOR MEXICO

Table 6: Macroeconomic indicators for Mexico (1978–1987)

Year	1978	1979	1980	1981	1982	1983	1984	1985	1986	1987
GDP	8.3	9.3	8.2	8.3	-0.1	-5.2	3.5	3.5	-4	1.1
P	18.1	19.52	27	28.7	55.8	80.8	59.7	57.7	91.3	143.6
GBD	5.3	0.8	2.4	5.2	4.1	8.6	4.5	3.2	2.4	4.7
GFC	13.6	18.2	24.2	32.7	45.7	68.34	114.5	195.2	332.6	817.9
i	10.53	15.02	22.46	30.77	45.75	59.19	49.47	63.36	88.57	103.07
M3	35.2	37.06	39.45	58.3	72.8	68.1	72.1	37.9	74.8	150.4
Un	6.2	5.3	4.7	4.4	3.9	6.7	6.16	5.2	4.3	2.8
RW	103.2	104.8	100	109.5	105.7	75.3	67.2	70	64.7	63

Sources: Adapted from *International Financial Statistics (IMF, 1998)*
World Bank Development Reports (Various issues)
Inter Development Bank (1998)

GDP=annual percentage.

P=consumer prices at an annual percentage.

GBD=primary budget deficit as a percentage of GDP in 1990 prices.

GFC=GFC as a percentage of GDP in 1990 prices.

i=the bank rate.

M3=annual percentage.

Un=annual percentage of unemployment.

RW=the real wage.

Table 7: Mexico's International Transactions (1978–1987)

	1978	1979	1980	1981	1982	1983	1984	1985	1986	1987
current account	-3172	-5409	-10422	-16240	-5889	5866	4183	800	-1377	4247
capital account	3552	3571	9129	15001	-5500	-9811	-5010	-4911	2231	3343
Level of reserves	-409	-315	-817	-1274	3354	-3102	-3390	2434	-595	-5986
imports	27.3	52.8	54.4	28.9	37.4	30.3	34.3	15.3	24.9	48
exports	32.1	54.4	56.6	29.2	32.5	7.57	34.31	29.6	-18.5	26.6
trade balance	-1745	-2830	-2830	-4099	6795	13762	12029	7130	3725	7189
merchandise exports	6031	9231	15121	19101	21212	22312	24196	21664	16159	20495
merchandise imports	8051	12181	18990	25311	15001	8550	12167	14534	12433	13306

Source: Adapted from *International Financial Statistics* (IMF, 1998)

The current account, capital account, change in reserves and trade balance are in millions of U.S Dollars.

Imports and exports are annual growth rates in %.

Merchandise exports and imports in millions of U.S Dollars.

Table 8: Exchange Rates and Debt Service Ratio

	1980	1981	1982	1983	1984	1985	1986
debt service ratio	41.8	42.9	63.2	49.2	50.1	51.2	52.2
real exchange rate	91.2	90.1	113.4	123.2	106.8	99.96	92.1
official exchange rate	24.51	56.4	120.09	167.83	257	611.77	803.1

Sources: Inter Development Bank (1998)

Adapted from *International Financial Statistics* (IMF, 1998)

Table 9: Mexico's Export Diversification (1978–1987)

	1978	1979	1980	1981	1982	1983	1984	1985	1986	1987
crude	34.2	44.6	61.2	65.3	72.1	62.3	61.3	58.7	34.8	36.9
coffee	6.3	5.2	2.2	1.1	1.2	1.5	1.8	2.2	4.1	2.2
shrimp	2.1	3.7	1.9	1.2	1.5	1.8	1.7	1.4	1	0.8

Source: Adapted from *International Financial Statistics* (IMF, 1998)

Crude Petroleum as a % of total exports.

Coffee as a % of total exports.

Shrimp as a % of total exports.

APPENDIX 5: MACROECONOMIC INDICATORS FOR SOUTH AFRICA

Table 10: South Africa's Macroeconomic Indicators (1984–1994)

	1984	1985	1986	1987	1988	1989	1990	1991	1992	1993	1994
GDP	5.1	-1.2	0.3	2.1	4.2	2.4	-0.3	-1	-2.2	1.1	2.7
CPI	11.7	16.2	18.6	16.1	12.9	14.7	14.4	15.3	13.9	9.7	9
M3	23.2	12.3	9.3	17.4	27.6	22.4	12.4	12.3	7.9	7	15.7
BD	-2.4	-1.1	-1	-2.4	-0.6	-0.2	-1.6	-2.7	-4.5	-8.5	-6.8
i	22	21.5	14.2	12.5	15.3	19.8	21	20.3	18.9	16.2	15.6
Ri	10.3	5.3	-4.3	-3.6	2.4	5.1	6.6	5	3.6	6.5	6.6
PCE	4.6	-3.5	0.2	3.9	5.3	2.7	2.9	-0.5	-1.4	0.3	3.1
GDFI	-1.5	-7	-18.6	-5.1	12.6	6.5	-2.3	-7.4	-5.3	-2.8	8.7
Public Empl.	2.6	-0.5	1.6	1.6	1.4	1	0.1	1.6	1.2	-1.25	10.3
Priv. Empl.	1.16	-0.6	1	0.5	1.2	0.5	-0.7	-3.4	-2.9	-2.4	-1.1
Total Empl.	1.5	-0.6	-0.09	0.9	1.5	0.7	-0.5	-2	-2	-2.1	2.6

Source: Adapted from the *South African Reserve Bank Quarterly (1998)*,
World Bank African Development Indicators (1997)

GDP=annual percentage change.

CPI=annual percentage change.

M3=annual percentage change.

BD=budget deficit as a percentage of GDP.

i=nominal commercial bank lending rate.

Ri=real interest rate.

PCE=Private consumption expenditure at an annual percentage rate.

GDFI=gross domestic fixed investment rate at an annual percentage rate.

Table 11: South Africa's Balance of Payments Indicators (1984–1994)

	1984	1985	1986	1987	1988	1989	1990	1991	1992	1993	1994
REE	129.9	98.5	91	102.6	97	97.4	100	104.7	107.9	106.0	101.3
Current account	-2517	5208	6328	6708	3383	3467	5324	6187	3940	5829	-2231
Capital account	1151	-8442	-5285	-3564	-6863	-4704	-2410	-4775	-6212	-15021	5352
Change in Reserve	-1366	-3234	1042	3144	-3480	-1237	2914	1412	-2272	-9192	3121
Merch. exports	12768	19977	24336	25827	31267	39085	42735	44709	49010	56512	64592
Merch. imports	21519	23165	25636	28773	38940	44322	43408	47385	51883	59869	76251
Trade balance	-8751	-3168	-1300	-2946	-7673	-5237	-673	-2676	-2873	-3357	-11659
Gold as a % of exports	46.1	42.5	39.8	41.1	38.7	32.8	29.6	30.5	27.2	28	25.5

Sources: Adapted from *International Financial Statistics (IMF, 1997)*
South African Reserve Bank Quarterly (1990)

REE= real effective exchange rate.

All the above except for REE, are in millions of Rands.

Table 12: South Africa's Macroeconomic Indicators (1994–1998)

	1994	1995	1996	1997
GDP	2.7	3.4	3.2	1.7
CPI	9	8.6	7.2	6.8
M3	15.7	15.2	13.6	17.2
BD	-6.8	-5.7	-6.1	-5.6
i	15.6	17.9	19.5	19.25
Ri	6.6	9.3	12.3	12.45
PCE	3.1	4.7	3.9	2
GDFI	8.7	10.3	7.8	3.5
Public sector employment	10.3	-0.7	3.6	-0.5
Private sector employment	-1.1	0.5	-0.4	-2.5
Total change in employment	2.6	0	-1	-1.8
RPW	13.5	11.7	10.2	11.4

Sources: Adapted from *International Financial Statistics (IMF, 1997)*
South African Reserve Bank Quarterly (various issues)
Economist Intelligence Unit (various issues)
World Bank African Development Indicators (1997)

GDP= annual percentage change.

CPI= annual percentage change.

M3= annual percentage change.

BD=budget deficit as a percentage of GDP.

i= nominal commercial bank lending rate.

Ri= real interest rate.

PCE= Private consumption expenditure at annual percentage change.

GDFI= gross domestic fixed investment at annual percentage change.

The quarterly figures have been seasonally adjusted.

The employment figures are percentages.

RPW=remuneration at current prices per worker in private and public sectors.

Table 13: South Africa's Balance of Payments Indicators (1994–1997)

	1994	1995	1996	1997
REE	101.3	98.1	90.4	90.08
Current account	-2231	-12659	-8479	-8813
Capital account	5352	21733	3856	20246
Change in Reserves	3121	9077	-4623	11433
Merch. Exports	64952	82128	101451	114142
Merch. Imports	76251	98442	117748	130844
Trade balance	-11299	-16314	-16297	-16702
Gold as a % of exports	30.7	19.9	20.8	18

Source: Adapted from *International Financial Statistics (IMF, 1997)*
South African Reserve Bank Quarterly (various issues)

REE= real effective exchange rate.

The current account, capital account and change in reserves are in millions of Rands.

APPENDIX 6: ECONOMIC INDICATORS FOR THE 1990's

Table 14: Macroeconomic Indicators for Zambia (1988–1998)

Year	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998
GDP	-1.1	1.2	-0.1	0.1	-1.8	6.8	-8.6	-4.3	6.1	2.2	2.1
Debt service ratio	39.3	45.1	52.1	30.8	45.8	26.9	33.7	35.9	31.2	39.2	34.1
GE	28.6	21.9	34.6	26.6	32.4	13.1	21.2	37.1	39.2	--	--
GD	11.6	7.9	4.2	21.1	6.5	6.2	3.7	6.7	4.4	6.6	5.4
P	63.8	56.1	50.3	93.2	191.3	188.0 7	34.2	46.2	46.27	24.8	34.3
i	15	22.3	17.6	15	47	72.3	20.5	40.2	47	17.7	--
REE	103	111.2	141.1	125.7	95.7	108.6	104.5	100	104.6	125.3	114.5
M1	64.5	51.9	62.1	77.3	22.3	26.1	42.6	61.1	19.3	31.1	16.9

Source: Adapted from *International Financial Statistics (IMF, 1998)*

Adapted from *International Financial Statistics (IMF, 1999)*

GDP=real gross domestic product in 1990 prices.

GFCF=Gross fixed capital formation as a percentage of GDP in 1990 prices.

GD=Government's budget deficit as a percentage of GDP.

P=Annual percentage Consumer Prices.

i=the bank rate.

M1=Annual percentage change.

Debt service ratio=as a percentage of GDP.

GE=government expenditure as a percentage of GDP.

Real Effective Exchange rate= in 1995 prices.

Table 15: International Indicators for Zambia (1989–1998)

Year	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998
current account	-293	-219	-594	-306	-562	-263	-147	-395	N/A	N/A	-300
capital account	-17	-41	-21	-13	-4	-8	-6	-3	N/A	N/A	10
Level of reserves	342	-68	225	464	370	21	89	-181	N/A	N/A	100
Real effective exchange rate	104.4	102.4	132.7	135.7	151.2	140.2	120.5	-91	N/A	N/A	50
imports	-7	22.3	41.8	3.41	2.35	-24.6	21.2	66.9	N/A	N/A	12
exports	-3.01	68.4	-5.62	-5.09	-2.23	10.43	14.78	25.75	N/A	N/A	5
copper exports	87	82.6	85.4	88.3	90	88.3	87.12	79.9	N/A	N/A	97

Source: Adapted from *International Financial Statistics (IMF, 1998)*
Adapted from *International Financial Statistics (IMF, 1999)*

Current account=in millions of U.S. Dollars.

Level of reserves=in millions of U.S Dollars.

Capital account=in millions of U.S. Dollars.

Imports=year on year percentage.

Exports=year on year percentage.

Copper exports=copper exports as a percentage of total exports

Table 16: Brazil's Macroeconomic Indicators (1988–1998)

year	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998
P	489.3	1289	2937.7	440.9	1008.7	2148.5	2668.5	84.4	18.2	25.1	17.5
GDP	6.1	--	-0.04	0.3	-0.82	4.1	5.8	4.2	2.9	3.1	3.9
GFC	17.2	17.3	20.1	18.8	18.4	19.1	20.2	20.5	18.3	19.5	18.1
GBD	15.2	17.6	17.2	19.7	22.1	20.1	19.2	22.1	21.9	17.2	16.2
OD	4.3	6.9	1.3	1.4	2.2	2.1	1.9	4.9	3.5	2.9	0.6
i	2282	38341	1082.8	2494.3	1489	5756.8	56.4	39	23.9	45.2	39.4

Source: Adapted from *International Financial Statistics (IMF, 1998)*

Adapted from *International Financial Statistics (IMF, 1999)*

P=consumer prices, percentage change over previous year.

GDP=Gross domestic product, percentage change over previous year.

GFC=Gross fixed capital formation, percentage of GDP in current prices.

GBD=Government budget deficit (PSBR as defined by IMF).

OD=Operational deficit.

i=The bank rate as a yearly percentage.

Table 17: Brazil's International Transactions (1988–1998)

year	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998
current account	4156	-1002	-3823	-1450	6089	20	-1153	-18136	-23248	33840	--
capital account	3	23	35	42	54	81	173	352	494	-1042	--
exports	28.8	1.7	-8.6	0.6	13.2	10.2	11.2	5.2	2.3	5.3	-13.1
imports	1.9	24	13.1	1.8	-0.9	23.3	31.1	49.4	6.2	12.3	7.8
trade balance	19168	16112	10747	15223	15329	14239	10861	-3157	-5453	-8367	-8801
debt service ratio	56.2	37.7	23.2	23.9	21.7	25.8	33.8	41.9	47.8	51.2	45.1
REE	125.1	115.6	100	120.7	138.1	131.8	115.3	94.4	93.2	109.3	-112.1
Change in reserves	-742	-893	-474	369	-14670	-8709	-7215	-12920	-8326	-7251	-3214

Source: Adapted from *International Financial Statistics (IMF, 1998)*
Adapted from *International Financial Statistics (IMF, 1999)*
Inter Development Bank (1995)

current account= in millions of U.S. Dollars (Data for 1998 is not available).

capital account=in millions of U.S Dollars (Data for 1998 is not available).

exports= year on year percentage.

imports= year on year percentage.

exchange rate=the real effective exchange rate, where 1990=100.

Change in reserves= in millions of U.S Dollars.

trade balance=in millions of U.S Dollars.

debt service ratio=as a percentage of GDP (includes interest and amortization).

Table 18: Macroeconomic indicators for Mexico (1988–1998)

Year	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998
GDP	-1.2	0.9	2.9	3.1	3.3	1.7	4.5	-6.4	-2.1	1.2	1.41
P	21.8	20.1	26.6	22.7	15.5	9.7	6.9	35	34.4	36.2	31.3
GBD	2.6	5.2	0.7	2.6	3.1	4.1	3.8	3.2	2.4	2.9	2.1
GFC	19.1	17.9	18.3	19.2	20.4	18.5	19.3	16.1	17.2	19.4	21.3
i	69.15	44.99	34.76	19.28	15.62	15.03	14.1	48.44	31.39	19.8	24.76
M3	-44.1	190.2	81.5	22.8	28.9	16.2	83.4	44.7	22.3	35.7	21.6
Un	4.2	2.9	2.7	2.8	3.4	3.7	6.2	5.5	4.3	4.5	4.2

Sources: Adapted from *International Financial Statistics (IMF, 1998)*
Adapted from *International Financial Statistics (IMF, 1999)*
World Bank Development Reports (Various issues)
Inter Development Bank (1998)

GDP=annual percentage.

P=consumer prices at an annual percentage.

GBD=primary budget deficit as a percentage of GDP in 1990 prices.

GFC=GFC as a percentage of GDP in 1990 prices.

i=the bank rate.

M3=annual percentage.

Un=annual percentage of unemployment.

Table 19: Mexico's International Transactions (1988–1998)

	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998
current account	-2374	-5825	-7451	-14888	-24442	-23400	-29662	-1576	-2328	-7454	-15787
Change in Reserves	-409	-542	-3261	-8420	-1173	-6057	-18398	-9648	-1806	-10513	-2118
imports	28081	34766	41592	49966	62130	65366	79346	72453	89469	109808	125243
exports	30692	35171	40711	42687	46196	51885	60882	79542	96000	110431	117500
debt service ratio	36.5	36.7	23.2	26.3	37.5	39.4	30.3	32.4	44.9	42.1	36.4
real effective exchange rate	103.5	100.2	100	90.9	86.6	80.5	85.7	115	105.8	102.1	109.6
trade balance	2611	405	-881	-7451	-15934	-13481	-18464	7089	6531	623	-7743

Source: Adapted from *International Financial Statistics (IMF, 1998)*
Adapted from *International Financial Statistics (IMF, 1999)*
Inter Development Bank (1998)

The current account, capital account, change in reserves and trade balance are in millions of U.S Dollars.

Imports and exports are in millions of U.S dollars.

Debt service ratio=as a percentage of GDP.

Real effective exchange rate=1990 is the base year.

REFERENCES

- Adam, C. (1995)** “Fiscal Adjustment, Financial Liberalization, and the Dynamics of Inflation: Some evidence from Zambia” *World Development*, 23 (5), 735–750.
- Adelman, I. and Taylor, J.E. (1990)** “Is Structural Adjustment with a Human Face possible? The case study of Mexico” *The Journal of Development Studies*, 26, 387–407.
- Aggarwal, V.K. (1991)** “Interpreting the History of Mexico’s External Debt Crisis” in Eichengreen, B. and Lidert, P., eds. *The International Debt Crisis in Historical Perspective*. London: MIT Press.
- Aghevli, B.B. and Rodriguez, C.A. (1979)** “Trade Prices and Output in Japan: A Simple Monetary Model” *IMF Staff Papers*, 26, (4) 38–53. Washington, D.C.: IMF.
- Alarcon, D. and McKinley, T. (1992)** “Beyond Import Substitution: the restructuring projects of Brazil and Mexico” *Latin American Perspectives*, 19 (2) 44–72.
- Altvater, E. (1991)** “Brazil: The Giant’s Debts” in Altvater, E., Hubner, K., Lorentzen, J. and Rojas, R., eds. *The Poverty of the Nations: A Guide to the Debt Crisis from Argentina to Zaire*. London: Zed Books.
- Ayala, J. and Duran, C.R. (1986)** “Development and Crisis in Mexico: A Structuralist Approach” in Hartlyn, J. and Morley, S., eds. *Latin American Political Economy: Financial Crisis and Political Change*. London: Westview Press.
- Bacha, E.L. (1987)** “IMF Conditionality: Conceptual Problems and Policy Alternatives” *World Development*, 15 (12) 1457–1468.
- Baer, W. (1989)** *The Brazilian Economy: Growth and Development*. New York: Praeger.
- Baer, W., Biller, D. and McDonald, C.T. (1989)** “Austerity Under Different Political Regimes: The Case of Brazil” in Handelman, H. and Baer, W., eds. *Paying the Costs of Austerity in Latin America*. Boulder: Westview Press.

- Balassa, B. (1984)** “Adjustment Policies in Developing Countries: A Reassessment” *World Development*, 12, (9) 955–972.
- Bank of Lisbon International (1993)** “The Balance of Payments Constraint on Economic Development in South Africa” *Economic Focus*, no. 123.
- Bell, T. (1993)** “Should South Africa Further Liberalise its Foreign Trade?” in Lipton, M. and Simkins, C., eds. *State and Market in Post Apartheid South Africa*. Johannesburg: Wits University Press.
- Belli, P., Finger, M. and Ballivan, A. (1993)** “South Africa: A Review of Trade Policies” in The World Bank: Informal Discussion Papers on Aspects of the Economics of South Africa. Discussion Paper no. 4. Washington D.C.: World Bank.
- Benjamin, N. (1992)** “What happens to Investment under structural adjustment: Results from a Simulation Model” *World Development*, 20, (9) 1335–1344.
- Beristain, S. and Trigueros, I. (1990)** “Mexico” in Williamson, J., ed. *Latin American Adjustment: How much has happened?* Washington, D.C.: Institute for International Economics.
- Bhagwati, A. and Onistuka, Y. (1974)** “Export-import responses to Devaluation: Experience of Non-Industrial Countries in the upper credit tranche, 1969–1978.” *IMF Staff Papers*, 21 (2) 414–461. Washington, D.C.: IMF.
- Bird, G. (1984)** “Balance of Payments Policy” in Killick, T., ed. *The Quest for Economic Stabilisation: The IMF and the Third World*. London: Heinemann.
- Bird, G. (1987)** *International Macroeconomics: Theory, Policy and Applications*. London: Macmillan.
- Bird, G. (1996)** “Political Economy of International Monetary Reform—Introduction” *The World Economy*, 19 (2) 149–172.
- Blejer, M., Khan, M.S. and Masson, P.R. (1995)** “Early Contributions of Staff Papers to International Economics” *IMF Staff Papers*, 42 (4) 707–733. Washington, D.C.: IMF.

- Blumenfeld, J. (1992)** “The International Dimension” in Schrire, R., ed. *Wealth or Poverty: Critical Choices for South Africa*. Cape Town: Oxford University Press.
- Branford, S. and Kucinski, B. (1990)** *The Debt Squads: The US, the Banks and Latin America*. London: Zed Books.
- Budhoo, D. (1994)** “The IMF and World Bank Wreak Havoc on Third World” in Danohar, K., ed. *50 Years is Enough: The Case against the World Bank and the IMF*. Boston: Southend Press.
- Bulmer-Thomas, V. (1994)** *The Economic History of Latin America Since Independence*. New York: Cambridge University Press.
- Burdette (1988)** *Zambia: Between Two Worlds*. London: Westview Press.
- Calitz, E. (1997)** “Aspects of the Performance of the South African Economy” *The South African Journal of Economics*, 63 (3) 314–333.
- Calvo, G.A. and Mendoza, E.G. (1996)** “Mexico’s balance of payments crisis: a chronicle of a death foretold” *Journal of International Economics*, 41 (3), 235–264.
- Cardosa, E.A. and Dantas, D. (1990)** “Brazil” in Williamson, J., ed. *Latin American Adjustment: How much has happened?* Washington, D.C.: Institute for International Economics.
- Cardosa, E.A. and Dornbusch, R. (1991)** “Brazilian Debt Crisis: Past and Present” in Eichengreen, B. and Lidert, P., eds. *The International Debt Crisis in Historical Perspective*. London: MIT Press.
- Cardosa, E.A. and Goldfajn, I. (1998)** “Capital Flows to Brazil: The Endogeneity of Capital Controls” *IMF Staff Papers*, 45 (1), 161–202. Washington, D.C.: IMF.
- Chiwele, D. (1996)** “Economic Adjustment: The Mining Sector and the Real Wage” in Harvey, C., ed. *Constraints on the Success of Structural Adjustments Programmes in Africa*. London: Macmillan.

- Chiwele, D. and Colclough (1996)** “Public Sector Effectiveness in Zambia” in Harvey, C., ed. *Constraints on the Success of Structural Adjustments Programmes in Africa*. London: Macmillan.
- Clifton, E.V. (Dec. 1990)** “Real Interest Rate Targeting — An Example from Brazil” *IMF Working Paper*. Western Hemisphere Department. Washington, D.C.: IMF.
- Coetzee, Z.R., Gwarada, K., Naude, W.A. and Swanepoel, J. (1997)** “Currency Depreciation, Trade Liberalisation and Economic Development” *The South African Journal of Economics*, 65 (2) 165–190.
- Connelly, M.C. and Taylor, D. (1971)** “Adjustment to Devaluation with Money and Non-traded Goods” *The Journal of International Economics*, 6, 289–298.
- Connelly, M.C. and Taylor, D. (1976)** “Testing the Monetary Approach to the Balance of Payments” *The Journal of Political Economy*, 84, 849–860.
- Cooper, R.N. (1971)** “Currency Devaluation in Developing Countries” in Ramis, G., ed. *Government and Economic Development*. New Haven: Yale University Press.
- Cooper, R.N. (1992)** *Economic Stabilization and Debt in Developing Countries*. Boston: MIT Press.
- Corden, W.M. (1992)** *International Monetary Fund: The New Palgrave Dictionary of Money and Finance*. London: Macmillan.
- Cordo, V. and Fischer, S. (1995)** “Structural Adjustment, Stabilisation and Policy Reform: Domestic and International Finance” in Behrman, J. and Srinivasan, T.N., eds. *The Handbook of Development Economics*. Amsterdam: Elsevier.
- Crocket, A.D. (1981)** “Stabilization Policies in Developing Countries: Some Policy Considerations” *IMF Staff Papers*, 28, (1) 54–78. Washington, D.C.: IMF.
- Day, W.H.L. (1979)** “Domestic Credit and Money Ceilings Under Alternative Exchange Rate Regimes” *IMF Staff Papers*, 26 (3) 490–511. Washington, D.C.: IMF.

- Dell, S. (1982)** “Stabilization: The Political Economy of Overkill” *World Development*, 10 (8) 597–612.
- Dell, S. (1986)** “The History of the IMF” *World Development*, 14 (9) 1203–1212.
- Dell, S. and Lawrence, R. (1980)** *The Balance of Payments Adjustment Process in Developing Countries*. New York: Pergamon.
- De Rosa, D.A. (1990)** “Protection and Export Performance in Sub-Saharan Africa” *IMF Working Paper*. Washington, D.C.: IMF.
- Demery, L. and Addison, T. (1987)** “Stabilisation Policy and Income Distribution in Developing Countries” *World Development*, 15 (2) 1483–1498.
- De Wet, S.L. (1995)** “The Prognosis for Growth and Development in South Africa” *South African Journal of Economics*, 63 (4) 259–276.
- Donovan, D.J. (1981)** “Real responses associated with exchange rate action in selected upper credit tranche stabilization programmes” *IMF Staff Papers*, 28 (4) 698–726. Washington, D.C.: IMF.
- Dornbusch, R. (1982)** “Stabilisation Policies in Developing Countries: What have we learned?” *World Development*, 10 (9) 701–708.
- Du Plessis, S.P.J., Smit, B.W. and McCarthy, L. (1996)** *International Economics*, 2nd ed. Johannesburg: Heinemann.
- Eckaus, R. (1982)** “Observations on the Conditionality of International Financial Institutions” *World Development*, 10 (9) 767–780.
- Economist Intelligence Unit (1985–1996)**. London: Redhouse Press.
- Edwards, C. (1985)** *The Fragmented World: Competing Perspectives on Trade, Money and the Crisis*. London: Methuen.

- Edwards, S. (1998)** “The Mexican Peso Crisis” *The World Economy*, 21 (1), 1–30.
- Eshag, E. (1983)** *Fiscal and Monetary Policies and Problems in Developing Countries*. Cambridge: Cambridge University Press.
- Faini, R., De Melo, J., Senkadji, A. and Stanton, J. (1991)** “Growth Orientated Adjustment Programmes: A Statistical Analysis” *World Development*, 19 (8) 957–968.
- Fallon, P. and Perreira de Silva, L.A. (1994)** “South African Economic Performance and Policies.” *Informal Discussion Papers on Aspects of the Economy of South Africa*. Discussion Paper 7, April. Washington, D.C.: World Bank
- Fehnel, D. (1997)** “Donors and Development” in Fitzgerald, P., McLennan, A. and Munslow, B., eds. *Managing Sustainable Development in South Africa*. Cape Town: Oxford University Press.
- Ferguson, T. (1988)** *The Third World and Decision Making in the International Monetary Fund: The Quest for Full and Effective Participation*. London: Printer Publishers.
- Fundanga, L. (1989)** “The Role of the IMF and World Bank in Zambia” in Ominode, B., ed. *The IMF, the World Bank and African Debt, vol 1: The Economic Impact*. London: Zed Books.
- Furness, E.L. (1983)** *Money and Credit in Developing Africa*. London: Heinemann.
- Gold, J. (1988)** “Mexico and the Development of the Practice of the IMF” *World Development*, 16 1127–1142.
- Goldin, I. and Evans, D. (1991)** “Trade Reform and Structural Adjustment” *The South African Journal of Economics*, 5 (1) 238–257.
- Gonzalez-Hermosillo, B., Pazarbasioglu, C., and Billings, R. (1997)** “Determinants of Banking System Fragility: A Case Study of Mexico” *IMF Staff Papers*, 44 (3), 295–314. Washington, D.C.: IMF.

- Guitian, M. (1982)** “Economic Management and Conditionality” in Killick, T., ed. *Adjustment and Financing in the Developing World: The Role of the International Monetary Fund*. Washington, D.C.: IMF.
- Guitian, M. (1995)** “Conditionality: Past, Present, Future” *IMF Staff Papers*, 42 (4) 792–834. Washington, D.C.: IMF.
- Gupta, K.L. and Moazzami, B. (1991)** “On Some Predictions of the Quantity Theory of Money” *Southern Economic Journal*, 57 (4) 1085–1091.
- Hahn, F.H. (1977)** “The Monetary Approach to the Balance of Payments” *The Journal of International Economics*, 7, 231–249.
- Handelman, H. and Baer, W. (1989)** “Introduction: The Economic and Political Costs of Austerity” in Handelman, H. and Baer, W., eds. *Paying the Costs of Austerity in Latin America*. Boulder: Westview Press.
- Harris, L. (1989)** “South Africa’s External Debt Crisis” in Ominode, B., ed. *The IMF, the World Bank and African Debt, vol. 1: The Economic Impact*. London: Zed Books.
- Havnevick, K. (1987)** “IMF and World Bank in Africa: Conditionality, Impact and Alternatives” *Seminar Proceedings* no. 18, Chapter 1. Scandinavian Institute of African Studies.
- Hawkins, J.J. (1991)** “Understanding the Failure of IMF Reform. The Zambian Case” *World Development*, 19 (7) 839–849.
- Helleiner, G. (1989)** “International Policy Issues Posed. Sub-Saharan Africa Debt” *The World Economy*, 12 (3) 779–792.
- Helleiner, G.K. (1992)** “The IMF, the World Bank and Africa’s Adjustment and External Debt Problems: An Unofficial View” *World Development*, 20 (6) 779–792.
- Helleiner, G., Cornia, S. and Jully, R. (1991)** “IMF Adjustment Policies and Approaches and the Needs of Children” *World Development*, 19 (12) 1823–1834.

- Henning, C.R. (1996)** “Political Economy of the Bretton Woods Institutions” *The World Economy*, 19 (2) 173–194.
- Herbst, J. (1990)** “The Structural Adjustment of politics in Africa” *World Development*, 18 (7) 949–958.
- Heyns, J.S. (1995)** “Aspects of fiscal policy in South Africa” *The South African Journal of Economics* 10 (2) 150–172.
- Holden, M. (1989)** “A Comparative Analysis of Structural Imbalance in the Face of the Debt Crisis” *The South African Journal of Economics*, 57 (1) 22–34.
- Holden, M. (1992)** “Trade Reform: Finding the Right Road” *The South African Journal of Economics*, 60 (3) 249–262.
- Hope, K.R. and Kayira, S. (1997)** “Development Policies in Southern Africa. The Impact of Structural Adjustment Programmes” *The South African Journal of Economics*, 65 (2) 258–274.
- Hudson, M. (1992)** *Trade, Development and Foreign Debt, Volume 2: International Finance*. London: Pluto Press.
- Inter Development Bank (1985)** *Economic and Social Progress in Latin America: 1985 Report*. Washington, D.C.: Inter Development Bank.
- Inter Development Bank (1992)** *Economic and Social Progress in Latin America: 1992 Report*. Washington, D.C.: Inter Development Bank.
- Inter Development Bank (1995)** *Economic and Social Progress in Latin America: 1992 Report*. Washington, D.C.: Inter Development Bank
- Inter Development Bank (1998)** *Economic and Social Progress in Latin America: 1992 Report*. Washington, D.C.: Inter Development Bank
- International Monetary Fund (1968)** *Articles of Agreement of the IMF*. Washington, D.C.: IMF.

- International Monetary Fund (1993)** *IMF Survey*, Nov. 18. Washington D.C: IMF.
- International Monetary Fund (1995)** *IMF Survey*, June 19. Washington D.C: IMF.
- International Monetary Fund (1996)** *Annual Report*. Washington D.C: IMF.
- International Monetary Fund (1996)** *IMF Survey*, Jan. 8. Washington D.C: IMF.
- International Monetary Fund (1998)** *IMF Economic Review*, No. 1. Washington D.C: IMF.
- International Monetary Fund (Various years)** *International Financial Statistics*. Washington, D.C: IMF.
- Ize, A. (1990)** “Trade Liberalization, Stabilization, and Growth. Some notes for the Mexican Experience” *IMF Working Paper*, No. 15. Washington, D.C.: IMF.
- James, H. (1995)** “The Historical Development of the Principle of Surveillance” *IMF Staff Papers*, 42 (4) 762–790. Washington, D.C.: IMF.
- Johnson, H.G. (1977)** “The Monetary Approach to the Balance of Payments” *The Journal of International Economics*, 7, 257–268.
- Johnson, V.E. (1990)** “Financial Market Constraints and Private Investment in a Developing Country” *IMF Working Paper*, No. 15. Washington, D.C.: IMF.
- Jones, S. (1994)** “Structural Adjustment in Zambia” in Van der Geest, W., ed. *Negotiating Structural Adjust in Africa*. London: United Nations Publications.
- Judd, J.P. and Scadding, J.L. (1982)** “The Search for a Stable Money Demand Function: A Survey of the Past 1973 Literature” *The Journal of Economic Literature*, 20 (3) 993–1023.
- Junne, G. (1991)** “South Africa: Apartheid and International Indebtedness” in Altvater, E., Hubner, K., Lorentzen, J. and Rojas, R., eds. *The Poverty of the Nations: A Guide to the Debt Crisis from Argentina to Zaire*. London: Zed Books.

- Kahler, M. (1990)** “Orthodoxy and its Alternatives: Explaining Approaches to Stabilization and Adjustment” in Nelson, J.M., ed. *Economic Crisis and Policy Choice: The Politics of Adjustment in the Third World*. Princeton: Princeton University Press.
- Kahn, B. (1992)** “Foreign Exchange Policy, Capital Flight and Economic Growth” in Abedian, I. and Standish, P., eds. *Economic Growth in South Africa: Selected Policy Issues*. Cape Town: Oxford University Press.
- Kaldor, N. (1980)** “Monetarism and UK Monetary Policy” *Cambridge Journal of Economics*, 4, 293–318.
- Kaldor, N. (1983)** “Devaluation and Adjustment in Developing Countries” *Finance and Development*, 20 (2) 35–38.
- Kayizzi-Mugerwa, S. (1991)** “Understanding the Failure of IMF Reform. The Zambian Case” *World Development*, 19 (7) 851–865.
- Kemp, T. (1993)** *Historical Patterns of Industrialisation*, vol. 2. Oxford: Blackwell.
- Kenen, P.B. (1987)** “What Role for IMF Surveillance?” *World Development*, 15 (12) 1445–1456.
- Khan, M.S. (1974)** “Import and Export Demand in the Developing Countries” *IMF Staff Papers*, 21(3) 678–693. Washington, D.C.: IMF.
- Khan, M.S. (1990a)** “Evaluating the Effects of IMF-supported Adjustment Programmes: A survey” in Phylaktis, K. and Prodham, M., eds. *International Finance and the Less Developed Countries*. London: Macmillan.
- Khan, M.S. (1990b)** “The Macroeconomic Effects of Fund Supported Adjustment Programs” *IMF Staff Papers*, 37 (2) 195–230. Washington, D.C.: IMF.
- Khan, M. and Knight, M.D. (1981)** “Stabilisation in Developing Countries. A Formal Framework” *IMF Staff Papers*, 28 (1) 1–53. Washington, D.C.: IMF.

- Khan, M. and Knight, M.D. (1982)** “Some Theoretical and Empirical Issues Relating to Economic Stabilisation in Developing Countries” *World Economy*, 10 (9) 482–496.
- Khan, M.S., Montiel, P. and Haque, N.O. (1990)** “Adjustment with growth. Relating the Analytical Approaches of the IMF and the World Bank” *The Journal of Development Economics*, 32, 155–179.
- Khatkhate, D. (1982)** “National and International Aspects of Financial Policies in LDCs: A Prologue” *World Development*, 10 (9) 689–694.
- Kiguel, M.A. and Liviatan, N. (1992)** “When do Heterodox Stabilisation Programmes Work. Lessons from Experience” *The World Bank Research Observer*, 7 (1) 35–57.
- Killick, T. (1984a)** “The Third World and Decision Making in the International Monetary Fund” in Killick, T., ed. *The Quest for Economic Stabilisation: The IMF and the Third World*. London: Heinemann.
- Killick, T. (1984b)** “IMF Stabilisation Programmes” in Killick, T., ed. *The Quest for Economic Stabilisation: The IMF and the Third World*. London: Heinemann.
- Killick, T. (1987)** “Reflections on the IMF and World Bank Relationship” in Havnevik, K.J., ed. *The IMF and World Bank in Africa, Vol.1: Conditionality, Impact and Alternatives*. Uppsala: Scandinavian Institute of African Studies.
- Killick, T. (1995)** “Can the IMF Help Low-Income Countries? Experiences with its Structural Adjustment Facilities” *The World Economy*, 18 (4) 603–616.
- Killick, T. (1996)** “Principles, Agents and the Limitations of BWI Conditionality” *The World Economy*, 19 (2) 211–229.
- Killick, T. and Malik, M. (1992)** “Experiences with IMF Programmes” *The World Economy*, 15 (5) 599–632.
- Killick T., Malik, M. and Manuel, M. (1992)** “What can we know about the effects of IMF Programmes?” *The World Economy*, 15, (5) 575–597.

- Killick, T. and Sharpley, J. (1984)** “Extent, causes and consequences of disequilibria” in Killick, T., ed. *The Quest for Economic Stabilisation: The IMF and the Third World*. London: Heinemann.
- Klitgaard, R. (1991)** *Adjusting to Reality*. San Francisco: ICS Press.
- Korner, P., Maass, G., Siebald, T. and Tetzlaff, R. (1987)** *The IMF and the Debt Crisis: A Guide to the Third World’s Dilemmas*. London: Zed Books.
- Kreinin, M.E. (1987)** *International Economics, A Policy Approach*, 5th ed. London: Harcourt Brace Jovanovich.
- Kumar, M.S. (1989)** “The Stabilizing Role of the Compensatory Financing Facility. Empirical Evidence and Welfare Implications” *IMF Staff Papers*, 36 (4) 771–808. Washington, D.C.: IMF.
- Lamounier, B. and Maura, A. (1986)** “Latin American Political Economy” in Hartlyn, J. and Morley, S.A., eds. *Financial Crisis and Political Change*. Boulder: Westview Press.
- Levacic, R. and Rebmann, A. (1991)** *Macroeconomics: An Introduction to Keynesian-Neoclassical Controversies*. London: Macmillan.
- Lothian, J.R. (1985)** “Equilibrium Relationships between Money and Other Economic Variables” *American Economic Review*. 75 (4) 828–843.
- Loxley, J. (1986)** “Alternative Approaches to Stabilization in Africa” in Helleiner, G.K., ed. *Africa and the International Monetary Fund*. Washington, D.C.: IMF.
- Lucas, R.E. (1980)** “Two Illustrations of the Quantity Theory of Money” *American Economic Review*, 70 (5) 1005–1014.
- Lundahl, M. (1996)** “The Post Apartheid Economy, and After?” in Petersson, L., ed. *Post Apartheid Southern Africa: Economic Challenges and Policies for the Future. Proceedings of the 16th Arne Ryder Symposium 23–24 August, 1996, Lund, Sweden, 21–43*.

- Lustig, N. (1992)** “Equity and Growth in Mexico” in Teitel, S., ed. *Towards a New Development Strategy for Latin America*. Washington, D.C.: Inter-American Development Bank.
- Lustig, N. (1995)** “Mexico: The Social Costs of Adjustment” in Lawton, J.A., ed. *Privatisation Amidst Poverty: Contemporary Challenges in Latin American Political Economy*. Miami: North South Centre Press.
- Makgetla, N.S. (1986)** “Theoretical and Practical Implications of IMF Conditionality in Zambia” *Journal of Modern African Studies*, 20 395–422.
- Malan, P. and Bonelli, R. (1992)** “The Success of Growth Policies in Brazil” in Teitel, S., ed. *Towards a New Development Strategy for Latin America: Pathways from Hirschman’s Thought*. Washington, D.C.: Development Bank.
- Mares, D.R. (1985)** “Explaining Choice of Development Strategies: Some suggestions from Mexico, 1970–1982” *International Organization*, 39, 667–698.
- Mawakani, S. (1986)** “Socio-economic Situation in Africa” in Helleiner, S.K., ed. *Africa and the International Monetary Fund*. Washington, D.C.: IMF.
- McCarthy, C.L. (1988)** “Structural Development of the South African Manufacturing Industry” *The South African Journal of Economics*, 56 (1) 1–23.
- Mengistaeb, K. (1995)** “Devaluation: The response of exports and imports” in Mengistaeb, K. and Logan, C., eds. *Beyond Economic Liberalisation in Africa*. London: Zed Books.
- Mijere, N.N.J. (1988)** “African Socialist Ideologies and the IMF Policies for Economic Development — the Case of Zambia” *African Review*, 15 (1) 41–59.
- Miles, M.A. (1979)** “The Effect of Devaluation on the Trade Balance and the Balance of Payments: some new results” *The Journal of Political Economy*, 87 (3), 600–620.

- Moham, V. (1997)** “Civil Service Reforms in Africa: Problems and Prospects” in Fitzgerald, P., McLennan, A. and Munslow, B., eds. *Managing Sustainable Development in South Africa*. Cape Town: Oxford University Press.
- Mohr, P. (1991)** “Notes on the Balance of Payments and Economic Activity and Policy in South Africa” *SATEB*, 66 (November) 46–62.
- Mohr, P. and Rogers, C. (1991)** *Macroeconomics*. Johannesburg: Lexicon.
- Mohr, P.J. (1993)** “Will South Africa fall into the Populist trap?” Economic Policy Study Group. Occasional Paper 5.
- Moll, T. (1991)** “Growth Through Redistribution: A Dangerous Fantasy” *The South African Journal of Economics*, 59 (3) 313–330.
- Moll, T. (1993)** “Once a dog, always a dog? The Economic Performance of Modern South Africa” Unpublished paper prepared for ESM Research Conference, 1994, RAU (28–29 November).
- Montiel, P. (1984)** “Credit and Fiscal Policy in a ‘Global Monetarist’ Model of the Balance of Payments” *IMF Staff Papers*, 31 (1) 685–707. Washington, D.C.: IMF.
- Mosley, P. and Teye, J. (1988)** “The design of structural adjustment programmes” *World Development*, 16 (2) 395–413.
- Munslow, B., Fitzgerald, P. and McLennan, A. (1997)** “Sustainable Development: Visions and Realities” in Fitzgerald, P., McLennan, A. and Munslow, B., eds. *Managing Sustainable Development in South Africa*. Cape Town: Oxford University Press.
- Mwanza, A.M., Mwamba, N. and Kakuwa, E. (1992)** “The Structural Adjustment Programme in Zambia: Lessons from Experience” in Mwanza, A.M., ed. *Structural Adjustment Programmes in SADC: Experiences and Lessons from Malawi, Tanzania, Zambia, Zimbabwe*. Harare: Sapes Books.

- Nattrass, J. (1990)** *The South African Economy: Its Growth and Change*. Cape Town: Oxford University Press.
- Naude, W.A. and Brixen, P. (1993)** “On a Provisional Computable General Equilibrium Model for South Africa” *The South African Journal of Economics*, 81 (3) 153–241.
- Nelson, J.M. (1984)** “The Political Economy of Stabilisation: Commitment, Capacity and Public Response” *World Development*, 12 (10) 983–1006.
- Nelson, J.M. (1990)** “The Politics of Economic Adjustment in Developing Nations” in Nelson, J.M., ed. *Economic Crisis and Policy Choice: The Politics of Adjustment in the Third World*. Princeton: Princeton University Press.
- Nyirabu, C.M. (1986)** “View from Africa” in Helleiner, G., ed. *Africa and the International Monetary Fund*. Washington, D.C.: IMF.
- O’Brien, P. (1993)** “The Latin American Debt Crisis” in Riley, S.P., ed. *The Politics of Global Debt*. London: St Martins Press.
- Padayachee, V. (1994a)** “Dealing with the IMF: Dangers and Opportunities” *The SA Labour Bulletin*, 18, 83–88.
- Padayachee, V. (1994b)** “Can the RDP Survive the IMF?” *The SA Labour Bulletin*, 18 25–30.
- Park, Y.C. (1973)** “The Rate of Money in Stabilisation Policy in Developing Countries” *IMF Staff Papers*, 20 (2) 379–418. Washington, D.C.: IMF.
- Pastor, M. (1987)** *The International Monetary Fund and Latin America*. London: Westview Press.
- Payer, C. (1974)** *The Debt Trap*. Harmondsworth: Penguin.
- Perriera, L.C., Marava, U.J.M. and Przeworski, A. (1993)** *Economic Reforms in New Democracies: A Social Democratic Approach*. London/New York: Cambridge University Press.

- Polak, J. (1995)** “Fifty Years of Exchange Rate Research and Policy of the International Monetary Fund” *IMF Staff Papers*, 42 (4) 734–760. Washington, D.C.: IMF.
- Porter, R.C. and Ramey, S.I. (1982)** “An Eclectic Model of Recent CDC Macroeconomic Policy Analyses” *World Development*, 10 (9) 751–767.
- Ramirez, M.D. (1989)** “The Social and Economic Consequences of the National Austerity Programme in Mexico” in Handelman, H. and Baer, W., eds. *Paying the Costs of Austerity in Latin America*. London: Westview Press.
- Reichman, T.M. and Stillson, R. (1978)** “Experience with programmes of balance of payments adjustment: Stand-by arrangements in the higher tranches” *IMF Staff Papers*, 25 (2) 293–308.
- Rhomberg, R.R. and Heller, H.R. (1977)** *The Monetary Approach to the Balance of Payments*. Washington, D.C.: IMF.
- Rodrick, D. (1990)** “How should structural Adjustment Programmes be Designed?” *World Development*, 18 (7) 933–947.
- Rodrik, D. (1996)** “Understanding Economic Policy Reform” *The Journal of Economic Reform*, 34 (1) 1–23.
- Roe, A.R. (1982)** “High Interest Rates: A New Conventional Wisdom for Development Policy? Some conclusions from Sri Lankan Experience” *World Development*, 10 (3) 211–222.
- Rogers, C. (1986)** “The Theory of Monetary Policy Reconsidered” *Studies in Economics and Econometrics*, 25 13–50.
- Rojas, R. (1991)** “Mexico: Five Years of Debt Crisis” in Altvater, E., Hubner, K., Lorentzen, J. and Rojas, R., eds. *The Poverty of the Nations: A Guide to the Debt Crisis from Argentina to Zaire*. London: Zed Books.
- Ruccio, D.F. (1991)** “When Failure Becomes Success: Class and the Debate Over Stabilisation and Adjustment” *World Development*, 19 (10) 1315–1335.

- Sachs, J. And Zini, A. (1996)** “Brazilian Inflation and the Plano Real” *The World Economy*, 19 (1), 13–37.
- Sahn, D.E. (1992)** “Public Expenditure in Sub Saharan Africa During a Period of Economic Reforms” *World Development*, 20 (5) 673–694.
- Scammel, W.M. (1980)** *The International Economy Since 1945*. London: Macmillan.
- Schadler, S. (1995)** “Can the IMF Help Low-Income Countries? A Reply” *The World Economy*, 18 (4) 617–623.
- Schdlowsky, D.M. (1982)** “Approaches to Economic Management” in Killick, T., ed. *Adjustment and Financing in the Developing World: The Role of the International Monetary Fund*. Washington, D.C.: IMF.
- Schmulow, D. and Greyling, L. (1996)** “Monetary Policy in the New South Africa: Economic and Political Constraints” *The South African Journal of Economics*, 64 (3) 175–190.
- Sharpley, J. (1984)** “The Potential of Domestic Stabilisation Measures in Developing Countries” in Killick, T., ed. *The Quest for Economic Stabilisation: The IMF and the Third World*. London: Heinemann.
- Smit, B. (1992)** “Secular Trends in South African Macroeconomic Data” in Schrire, R., ed. *Wealth or Poverty: Critical Choices for South Africa*. Cape Town: Oxford University Press.
- Smit, B.W. and Mocke, B.A. (1991)** “Capital Flight from South Africa: Magnitude and Courses” *The South African Journal of Economics*, 59 (2) 101–116.
- Södersten, B. and Reed, G. (1994)** *International Economics*, 3rd ed. New York: Macmillan.
- South African Reserve Bank, Annual Report (1994).**
- South African Reserve Bank, Annual Report (1996).**
- South African Reserve Bank, Annual Report (1997).**

South African Reserve Bank, Annual Report (1998).

South African Reserve Bank Quarterly (1975) June.

South African Reserve Bank Quarterly (1978) June.

South African Reserve Bank Quarterly (1987) March.

South African Reserve Bank Quarterly (1993) The Balance of Payments Constraint on Economic Growth in South Africa. March.

South African Reserve Bank Quarterly (1994) March.

South African Reserve Bank Quarterly (1995) March

South African Reserve Bank Quarterly (1996) March.

South African Reserve Bank Quarterly (1998) June.

South African Reserve Bank, Quarterly Bulletin. June 1993. Special Supplement — South Africa's Balance of Payments, 1946–1992.

Spraos, J. (1986) “IMF conditionality” in Seiler, E., ed. *Essays in International Finance*. Princeton: Princeton University Press.

Stals, C. (1993) “The balance of payments constraint on economic growth in South Africa” *South African Reserve Bank Quarterly*, March.

Standish, B. (1992) *Economic Growth in South Africa: Selected Policy Issues*. Oxford: Oxford University Press.

Stein, H. (1992) “Deindustrialisation, Adjustment, the World Bank and the IMF in Africa” *World Development*, 20 (1) 83–95.

- Stewart, F. (1991)** “The Many Faces of Adjustment” *World Development*, 19 (12) 1847–1864.
- Streeton, P. (1987)** “Structural Adjustment: A Survey of the Issues and Options” *World Development*, 15 (12) 1469–1483.
- Stiles, K.W. (1991)** *Negotiating Debt: The IMF Lending Process*. Oxford: Westview Press.
- Stiles, K. (1990)** “IMF Conditionality: Coercion or Compromise?” *World Development*, 18 (7) 959–973.
- Strydom, P.D.F. (1991)** “After Apartheid: Collecting Economic Failure” *The South African Journal of Economics*, 59 (4) 371–383.
- Sutton, M. (1984)** “Introduction and Survey of Companion Volumes” in Killick, T., ed. *The Quest for Economics Stabilization: The IMF and the Third World*. London: Heinemann.
- Tanzi, V. and Blejer, M. (1982)** “Inflation, Interest Rate Policy, and Currency Substitutions in Developing Economies: A discussion of Some Major Issues” *World Development*, 10 (9) 781–789.
- Teital, S. and Thoumi, F.E. (1986)** “From Import Substitution to Export. The Manufacturing exports Experience of Argentina and Brazil” *Economic Development and Cultural Change*, 34 (3) 455–490.
- Ten Kate, A. (1992)** “Trade Liberalization and Economic Stabilization in Mexico: Lessons of Experience” *World Development*, 20 (5) 659–672.
- Van der Hoeven, R. (1991)** “Adjustment with a Human Face: Still Relevant or Overtaken by Events?” *World Development*, 19 (12) 1835–1845.
- Van der Merwe, E.J. (1995)** “Exchange rate management policies in South Africa: Recent experience and prospects” *South African Reserve Bank Occasional Paper*.

- Van der Walt, J.S. and De Wet, G.L. (1993)** “The Constraining Effects of Limited Foreign Capital on the Economic Growth of South Africa” *The South African Journal of Economics*, 61 (1) 3–13.
- Van der Wee, H. (1991)** *Prosperity and Upheaval: The World Economy 1945–1980*. Harmondsworth: Penguin.
- Wapenhans, W. (1994)** “Political Economy of Structural Adjustment” in Van der Kraaij, F., ed. *Structural Adjustment and Beyond in Sub Saharan Africa*. London: Villiers Productions.
- Weeks, J. and Mosley, P. (1996)** “Structural Adjustment and Tradeables: A Comparative Study of Zambia and Zimbabwe” in Petersson, L., ed. *Post Apartheid Southern Africa: Economic Challenges and Policies for the Future. Proceedings of the 16th Arne Ryder Symposium 23–24 August, 1996, Lund, Sweden, 171–200*.
- Williams, L.A. (1994)** *International Economics*. London: Harper Collins.
- Williamson, J. and Milner, C. (1991)** *The World Economy*. New York: Harvester Wheatsheaf.
- Winters, L.A. (1994)** *International Economics*. London: Routledge.
- Woodward, D. (1992)** *Debt, Adjustment and Poverty in Developing Countries, Vol. 1: National and International Dimensions of Debt and Adjustment in Developing Countries*. London: Printer Publishers.
- World Bank (1979)** *World Development Report*. Washington, D.C.: World Bank
- World Bank (1986)** *World Development Report*. Washington, D.C.: World Bank
- World Bank (1992)** *World Development Report*. Washington, D.C.: World Bank
- World Bank (1993)** *An Economic Perspective on South Africa*. Washington, D.C.: World Bank
- World Bank (1997)** *African Development Indicators*. Washington, D.C.: World Bank