Structural adjustment, economic growth and the aid-debt service system

Chapter 4

A. Introduction

During the 1990s there were profound changes in the national policy environment in many LDCs. These changes were mainly brought about within the framework of structural adjustment programmes guided by the IMF and World Bank. The process began in the early 1980s with World Bank structural adjustment loans, but in general, LDCs were not in the vanguard of this movement.[1] However, this situation changed radically following the introduction by the IMF of the Structural Adjustment Facility (SAF) in March 1986 and its extension in September 1987 into the Enhanced Structural Adjustment Facility (ESAF). Indeed, the ubiquity and scope of economic reforms undertaken in ESAF-supported programmes can be said to have been the main new feature of the LDC national policy environment in the 1990s.

The SAF/ESAF was a lending facility under which low-income countries were provided with highly concessional assistance from the IMF which was conditional on the implementation of an agreed three-year programme of policy change, consisting of three annual programmes with an agreed timetable which was monitored. The importance of ESAF loans stemmed less from the amount of resources provided than from the access which an IMF agreement provided to other official resources. Without an IMF ESAF agreement, it was impossible to have debt rescheduling through the Paris Club. Moreover, an ESAF programme was often a precondition for grants and loans by bilateral donors, and financing from other international financial institutions in low-income countries. ESAF-supported programmes thus shaped policy change in LDCs, and also acted as the framework for obtaining concessional finance and debt relief in the 1990s.

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In November 1999 the ESAF was transformed into the Poverty Reduction and Growth Facility (PRGF), which will now shape policy change and condition access to official finance and debt relief in most LDCs. But in order to assess the implications of the new facility for LDCs, it is necessary to have a clear understanding of how the ESAF worked and draw appropriate policy lessons from this experience. The present chapter thus examines the working of ESAF programmes in LDCs, whilst the next chapter will focus more closely on the nature and potential effects of the transformation of the ESAF into the PRGF.

The present chapter addresses five major questions:

1. What were the objectives and strategy of SAF/ESAF-supported programmes? (Section B)
2. What was the extent of policy reform in LDCs under SAF/ESAF programmes? (Section C)
3. What were the outcomes of SAF/ESAF policy reforms in LDCs? (Section D)
4. What mechanisms underlie the performance of SAF/ESAF policy reforms? (Sections E and F)
5. What are the policy implications? (Section G)

The analysis of the policy reforms draws, in particular, on the results of three evaluations made by, or for, the IMF – an early evaluation of effects (Schadler et al., 1993); an internal evaluation after 10 years (IMF, 1997), generally known as "the internal evaluation"; and a specially commissioned "external evaluation", which focuses on social effects, progress to external viability and ownership (IMF, 1998) – as well as on the background studies for the internal evaluation, which provide the most complete empirical evidence on the effects of SAF/ESAF-supported programmes (Bredenkamp and Schadler, 1999).[2]

B. The objectives and strategy of SAF/ESAF-supported programmes

The two basic objectives of the SAF/ESAF-supported programmes were (i) to promote sustained higher growth, with an improvement in living standards; and (ii) to promote progress towards external viability, which was understood as meaning that external current account deficits could be financed by "normal" and "sustainable" capital flows. Most of the countries, including the LDCs, which used the facility had low savings, investment and growth, and government and external accounts were in chronic imbalance. A number of LDC SAF/ESAF users had already undertaken stabilization under IMF Stand-by Arrangements or the Extended Fund Facility. Nearly all had high and often increasing debt and debt service ratios,[3] and all were resorting to "abnormal", "exceptional" financing in some form, either accumulating arrears to external creditors, rescheduling interest and/or principal repayments, or receiving balance-of-payments support from multilateral organizations (Schadler et al., 1993: 22–23). Sustaining multilateral debt service was becoming a particular problem by the mid-1980s. IMF debt service increased from 12 per cent of total debt service of LDCs in 1977 to 30 per cent in 1986, and in that year, multilateral debt service constituted almost half of total LDC debt service.

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The adjustment strategy under SAF/ESAF arrangements was two-pronged. The first prong was policy reform, which entailed measures to control aggregate demand as well as supply-side measures to address the structural problems which were leading to low savings, investment and efficiency. The second prong was the mobilization of external resources to ease temporarily the external financing constraint and help move economies towards a higher growth path and external viability.

The policy reforms were based on the view that the structural problems were by and large the legacy of protectionist, inward-oriented and dirigiste development strategies with extensive public sector involvement and regulation of the economy. They sought to reduce the institutional rigidities and structural distortions which rendered the supply side of the economy inefficient and unresponsive to market signals. Central policy changes were: exchange rate adjustment and public expenditure reduction as central elements of stabilization; trade liberalization; the reduction of the role of the State in production and distribution, in controlling prices, and intervening in exchange and product markets; liberalization of the financial sector; and the restructuring of government expenditure through privatization and civil service reform. These measures were expected to support higher growth and external viability by reducing inflation, augmenting savings, increasing the efficiency of resource allocation and rationalizing government expenditure.

The mobilization of external resources was complementary to policy reforms, and had two elements. On the one hand, efforts were made to increase the

volume and concessionality of official finance provided to low-income countries undertaking programmes. On the other hand, efforts were made to reduce the scale or timing of debt service payments through either increasing the concessionality of debt rescheduling agreements with Paris Club creditors (from Toronto to London to Naples terms), or, if absolutely necessary, tolerating the build-up of arrears to creditors. The shift to increasing concessionality was particularly important in African LDCs, where the growth of the external debt burden can be related to the terms of official lending in the late 1970s and early 1980s (see chapter 3, box 3). The process of resource mobilization was also supported by the Special Programme of Assistance for Africa (SPA), which was initiated in 1987 (World Bank, 1998).

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C. The scope of SAF and ESAF policy reforms

Thirty-three out of the 48 LDCs have engaged in SAF or ESAF programmes since 1988, including 27 African LDCs, 5 Asian LDCs (including Yemen), and Haiti. Of those 33 countries, one third have been under IMF-supported programmes for over half the total number of months between the beginning of 1988 and the end of 1999, and 27 countries have been engaged in implementing agreed policies for three years or more in that 12-year period (chart 36). The LDCs that have not engaged in this process are seven island LDCs (Cape Verde, Kiribati, Maldives, Samoa, Solomon Islands, Tuvalu and Vanuatu), some of which were ineligible for the facility because of their higher income levels; some States experiencing severe civil conflict or sanctions by the international community (Afghanistan, Angola, Liberia, Myanmar and Sudan); and Bhutan, Djibouti and Eritrea.

There have been intermittent interruptions in many programmes (see section E below), some countries have gone further than others, and all policy conditionalities have not been equally met. Four LDCs – Comoros, the Democratic Republic of the Congo, Sao Tome and Principe, and Somalia – are also not identified in IMF evaluations as "ESAF-programme countries", as they only undertook SAF programmes (or, in the case of the Democratic Republic of the Congo, undertook a SAF programme and an ESAF in the late 1990s).[4] But, in spite of interruptions, and also policy slippages (which have generally been due to problems of meeting fiscal targets), profound policy changes have occurred in countries undertaking SAF/ESAF programmes. The most extensive structural reforms have occurred in the deregulation of pricing and marketing, particularly in the important markets for agricultural products and inputs; the easing of trade barriers, particularly curtailing quantitative restrictions; reform of foreign exchange regimes; and liberalization of interest rates. But less progress has been made with financial sector reforms and privatization. Moreover, fiscal targets have been difficult to meet.

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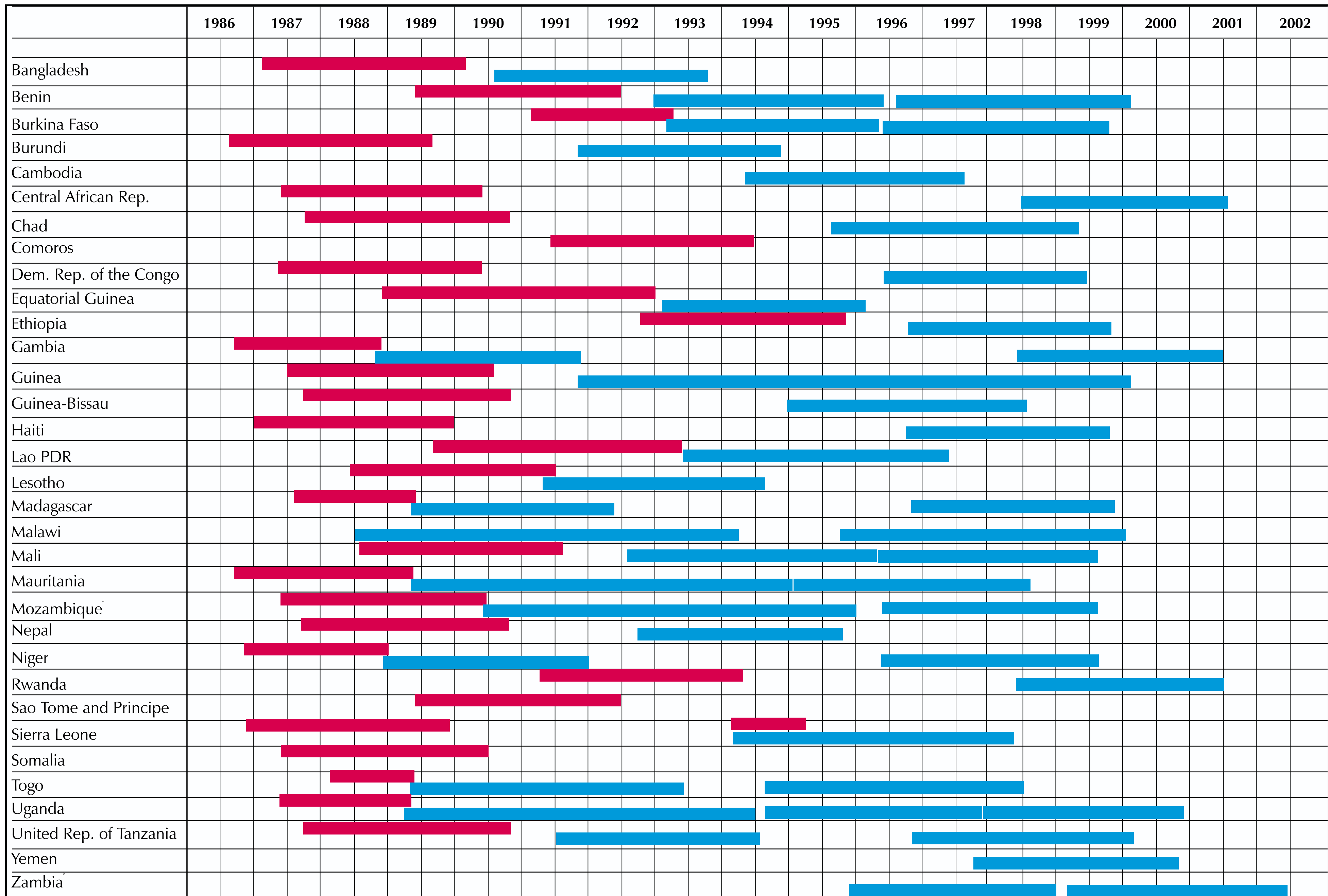
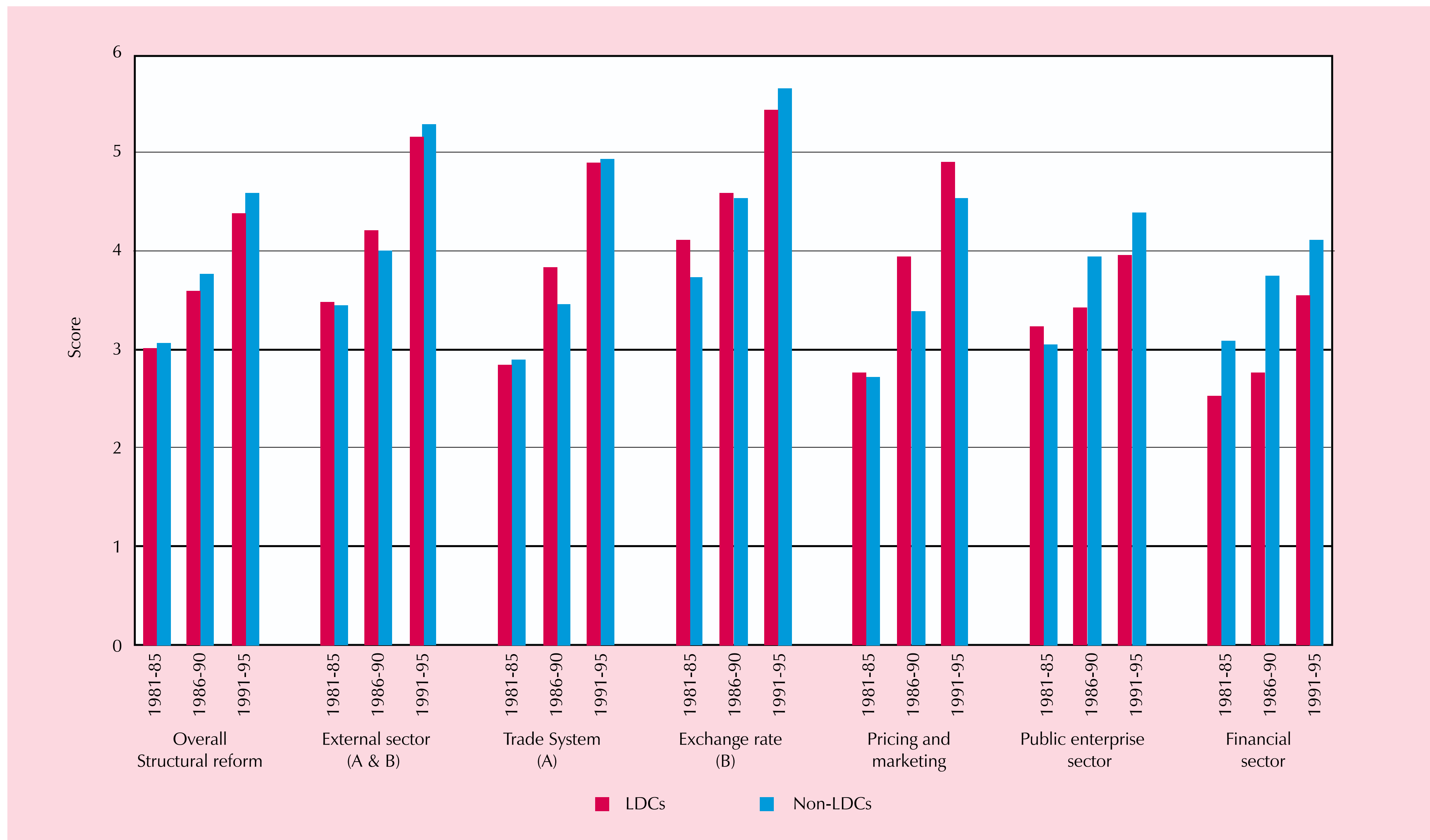
Evidence for the status of structural reforms in 30 ESAF programme countries, including 19 out of the 29 LDCs which the IMF identifies as ESAF programme countries, during the period 1991–1995, and for the pace of change between 1981–1985 and 1991–1995, is provided in one of the background studies for the IMF internal evaluation (Dicks-Mireaux et al., 1999). This shows that the LDCs have kept up with other developing countries in the sample in all areas except financial sector reform and the reform of public enterprise sector, and that they had gone further than the other developing countries in the area of pricing and marketing reforms (chart 37). The extent of reform is classified as low (score 1–2), moderate (3–4) or high (5–6) relative to a specified notion of "best

Chart 36: The timing of SAF and ESAF arrangements in the LDCs, by country



Source: IMF, Annual Reports (various issues). *Notes:* 15 LDCs are not using IMF facilities: Afghanistan, Angola, Bhutan, Cape Verde, Djibouti, Eritrea, Kiribati, Liberia, Maldives, Myanmar, Samoa, Solomon Islands, Sudan, Tuvalu and Vanuatu. *a* ESAF date of expiration extended to June 1995 and amount increased to 130.1 million SDRs. *b* SAF undisbursed amount of 182 million SDRs in 1995 was arranged under a one-year arrangement in 1996. In 1998/1999, the amount of 254 million SDRs was approved under an ESAF arrangement for the period of March 1999 to 2002.

CHART 37: STATUS OF STRUCTURAL REFORMS IN ESAF-PROGRAMME COUNTRIES, 1981–1995: LDCS AND OTHER DCS



Source: UNCTAD secretariat calculations, based on Dicks-Mireaux et al., 1999.

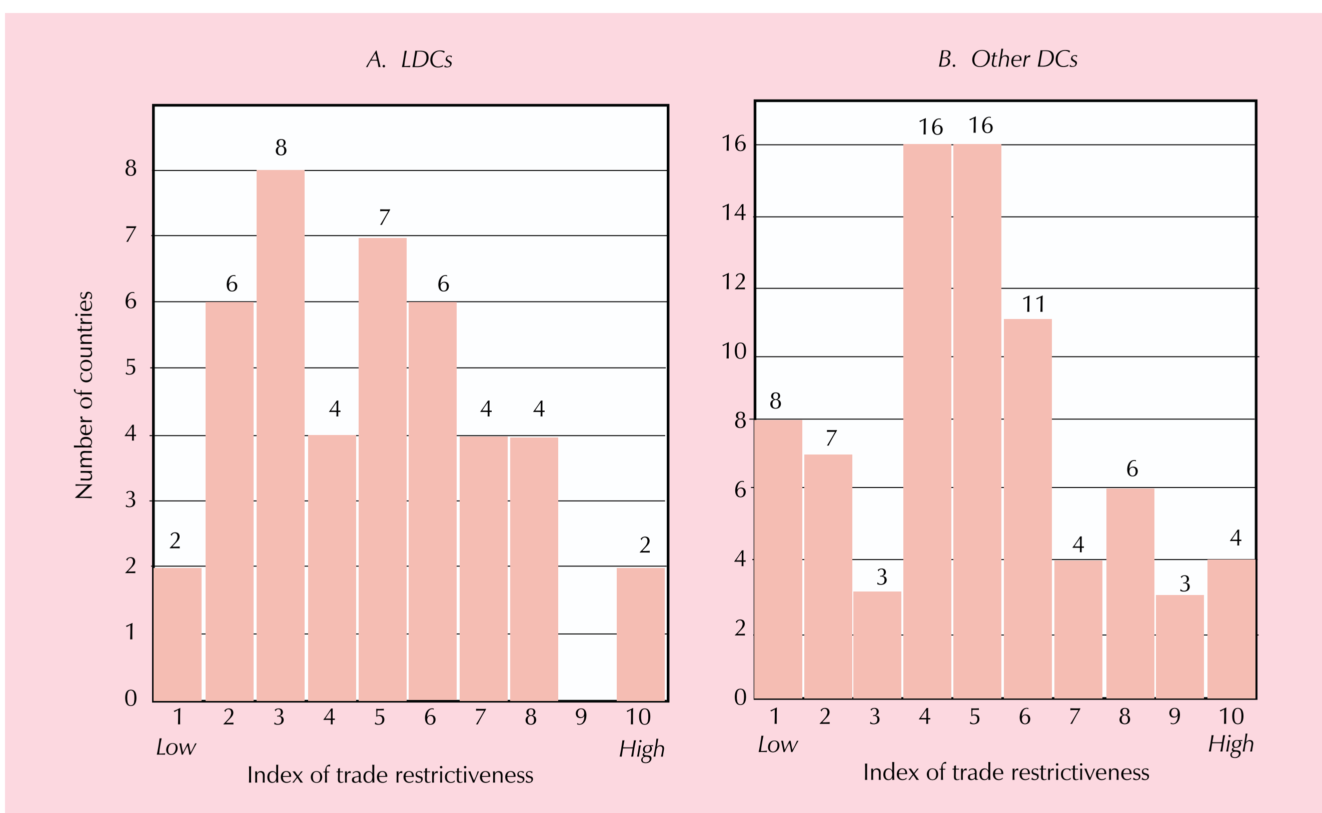
Note: The extent of reform is classified as low (score 1–2), moderate (3–4) or high (5–6) relative to a specified notion of "best practices" (5–6) or to an average for all DCs (3–4).

practices" (score of 5–6) or to an average for all developing countries (3–4). More than half of the LDCs in the sample are in the high group for structural reforms with regard to pricing and marketing, exchange systems and trade regime.

LDCs have actually gone further than other developing countries in dismantling trade barriers.

This data set has not been continued. But recent evidence on the trade regime – using the IMF index of trade restrictiveness – shows that LDCs have actually gone further than other developing countries in dismantling trade barriers. In 1999, for 43 LDCs for which data are available, 37 per cent had no or minor non-tariff barriers coupled with average import tariff rates of below 20 per cent, while among the 78 other developing countries recorded only 23 per cent were in this category. Sixty per cent of the LDCs in this sample had average import tariff rates which were below 20 per cent and non-tariff barriers were

CHART 38: TRADE RESTRICTIVENESS FOR THE LDCS AND OTHER DCS, 1999
(Index)



Source: IMF estimates, based on the following classification scheme:

Tariffs	*Open*	*Moderate*	*Restrictive*
Open	1	4	7
Relatively open	2	5	8
Moderate	3	6	9
Relative restrictive	4	7	10
Restrictive	5	8	10

Tariffs are classified as follows:

Open, average tariff range 0≤t<10 per cent. Relatively open, average tariff range 10≤t<15 per cent. Moderate, average tariff range 15≤t<20 per cent. Relatively restrictive, average tariff range 20≤t<25 per cent. Restrictive, average tariff range 25 per cent or over.

Non-tariff barriers are classified as follows:

Open, NTBs are either absent or minor. Less than 1 per cent of production or trade is subject to NTBs. Moderate, NTBs are significant covering at least one important sector of the economy but not pervasive. Between 1 per cent and 25 per cent of production or trade is subject to NTBs. Restrictive many sectors or entire stages of production are covered by NTBs. More than 25 per cent of production or trade is subject to NTBs.

moderate in the sense that they are not pervasive, covering less than 25 per cent of production or trade (chart 38).[5]

With regard to financial openness, evidence from African LDCs indicates that broad changes have been made (Gelbard and Leite, 1999). For 24 LDCs for which there are data, 19 were identified as either closed or minimally open in 1987, but by 1997 only 6 were in this category, and whereas none were classified as largely open in 1987, 9 (over one third) were so classified in 1997. Twenty-three out of the 24 countries were identified as financially repressed in 1987, but in 1997 only 4 countries were in that category, and although none were identified as largely liberalized, 14 were somewhat liberalized (table 22).

TABLE 22: STATUS OF FINANCIAL LIBERALIZATION AND FINANCIAL OPENNESS: AFRICAN LDCS

Country	Financial openness[a]				Financial liberalisation[b]			
	1987		1997		1987		1997	
	Index[c]	Quartile	Index[c]	Quartile	Index[c]	Quartile	Index[c]	Quartile
Angola	15	Closed	23	Closed	0	Repressed	23	Repressed
Benin	38	Minimally open	77	Largely open	20	Repressed	43	Minimally liberalized
Burkina Faso	38	Minimally open	69	Somewhat open	20	Repressed	73	Somewhat liberalized
Cape Verde	38	Minimally open	62	Somewhat open	0	Repressed	47	Minimally liberalized
Comoros	38	Minimally open	62	Somewhat open	20	Repressed	27	Minimally liberalized
Central African Rep.	31	Minimally open	46	Minimally open	20	Repressed	23	Repressed
Dem. Rep. of the Congo	23	Closed	46	Minimally open	20	Repressed	50	Somewhat liberalized
Equatorial Guinea	31	Minimally open	62	Somewhat open	20	Repressed	69	Somewhat liberalized
Eritrea	31	Minimally open	54	Somewhat open	0	Repressed	3	Repressed
Ethiopia	15	Closed	23	Closed	0	Repressed	7	Repressed
Gambia	62	Somewhat open	85	Largely open	44	Minimally liberalized	69	Somewhat liberalized
Guinea	31	Minimally open	54	Somewhat open	20	Repressed	63	Somewhat liberalized
Guinea-Bissau	54	Somewhat open	92	Largely open	20	Repressed	30	Minimally liberalized
Lesotho	23	Closed	46	Minimally open	20	Repressed	52	Somewhat liberalized
Madagascar	54	Somewhat open	69	Somewhat open	20	Repressed	61	Somewhat liberalized
Malawi	31	Minimally open	46	Minimally open	20	Repressed	43	Minimally liberalized
Mali	31	Minimally open	77	Largely open	20	Repressed	68	Somewhat liberalized
Mozambique	38	Minimally open	62	Somewhat open	0	Repressed	63	Somewhat liberalized
Niger	54	Somewhat open	85	Largely open	20	Repressed	67	Somewhat liberalized
Sao Tome & Principe	38	Minimally open	54	Somewhat open	20	Repressed	40	Minimally liberalized
Togo	46	Minimally open	77	Largely open	20	Repressed	68	Somewhat liberalized
Uganda	46	Minimally open	92	Largely open	20	Repressed	67	Somewhat liberalized
United Rep. of Tanzania	46	Minimally open	85	Largely open	20	Repressed	68	Somewhat liberalized
Zambia	62	Somewhat open	85	Largely open	20	Repressed	67	Somewhat liberalized

Source: Gelbard and Leite (1999).

a The financial openness index combines features that reveal the degree of openness of the financial system and its integration into the world market:
Are there significant restrictions on the purchase of domestic financial assets by non-residents? On the purchase of foreign exchange or foreign financial assets by residents?
Is there a parallel market for foreign exchange? In such a case, is the exchange differential vis-à-vis the official rate normally lower than 10 per cent?
Is there a multiple exchange rate system? A forward exchange market? An exchange tax?
Are there controls on interest payments? On profit/dividend payments? On liquidation of direct investment?
Are there repatriation requirements for service earnings?
Has the country commited itself to avoid imposing restrictions on payments and transfers for current transactions and adopting discriminatory currency arrangements and/or multiple currency practices related to current transactions?

b The financial liberalization index measures the absence of financial repression by taking into account whether credit controls are used and whether interest rates are market-determined and positive in real terms:
Are interest rates liberalized?
How many years have real lending interest rates and real deposit rates been positive?
Is an informal financial sector significant?
Are selective credit controls absent?

c These indices are measured on a 0–100 scale. The higher the value of the index, the higher the degree of financial openness or liberalization. Countries have been grouped into four broad categories, depending on the quartile in which their overall index falls.

Finally, most LDCs now have liberal or relatively liberal FDI regimes, in terms of remittances of dividends and profits and capital repatriation. In a sample of 45 LDCs for which data are available, only 9 maintain strict controls on such capital transfers. Twenty-seven countries have adopted a free regime, guaranteeing transfers; and 9 countries have a relatively free regime, either by controlling capital repatriation (while allowing free remittances of dividends and profits) or by requiring the Government's prior authorization of transfers (UNCTAD, 1997).

The degree of policy change which has occurred in the LDCs is often underestimated. But it should not be surprising. On the one hand, the prospect, held out by economic theory, that the poorest countries could reap the greatest benefits from globalization by pursuing vigorous liberalization offered a strong incentive for domestic policy-makers concerned to accelerate economic growth and improve living conditions within their countries. On the other hand, lack of access to alternative sources of foreign capital together with tight conditionality forced the pace and shape of reform. It is telling in this regard that empirical research has found that "there is a clear inverse relationship between the use of conditionality and the recipient government's access to alternative sources of capital" (Killick, 1998: 12). Moreover, the ways in which new conditionalities have been entering into the agendas of the World Bank and the IMF have been through the periodic replenishments of their concessional windows, including in particular IDA and ESAF (Kapur, 1997; see also Kapur and Webb, 2000).

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D. Outcomes: economic growth and progress to external viability

Although the overall growth performance of LDCs undertaking SAF/ESAF-funded programmes improved after they undertook economic reforms, the improvement was slight for the six years after programmes were initiated. Focusing on ESAF-programme countries for which data are available, and excluding the extreme positive and negative cases (Equatorial Guinea on the one hand, and Guinea Bissau, Rwanda, and Sierra Leone on the other hand), the average real GDP per capita was declining by 1.4 per annum in the three years before the programmes were initiated, was stagnant in the three years after and then declined by 1.1 per cent in the next three years (table 23). The dispersion

TABLE 23: ECONOMIC PERFORMANCE OF THE LDCS, BEFORE AND AFTER THE ADOPTION OF SAF/ESAF PROGRAMMES

	3 years before	1st 3 years after	2nd 3 years after	1996–1998
Average annual growth rates (%)				
Real GDP per capita (%)	-1.4	0.0	-1.1	1.9
Exports of goods and services (constant 1995 $)	1.1	5.2	4.5	9.8
Gross domestic investment (constant 1995 $)	0.8	1.2	0.7	6.3
Average annual ratio (as % of GDP)				
Gross domestic investment	16.3	19.3	19.3	19.7
Gross domestic savings	-0.8	1.0	-0.1	2.8

Source: UNCTAD secretariat estimates, based on World Bank, *World Development Indicators 2000* and *Global Development Finance* 2000.

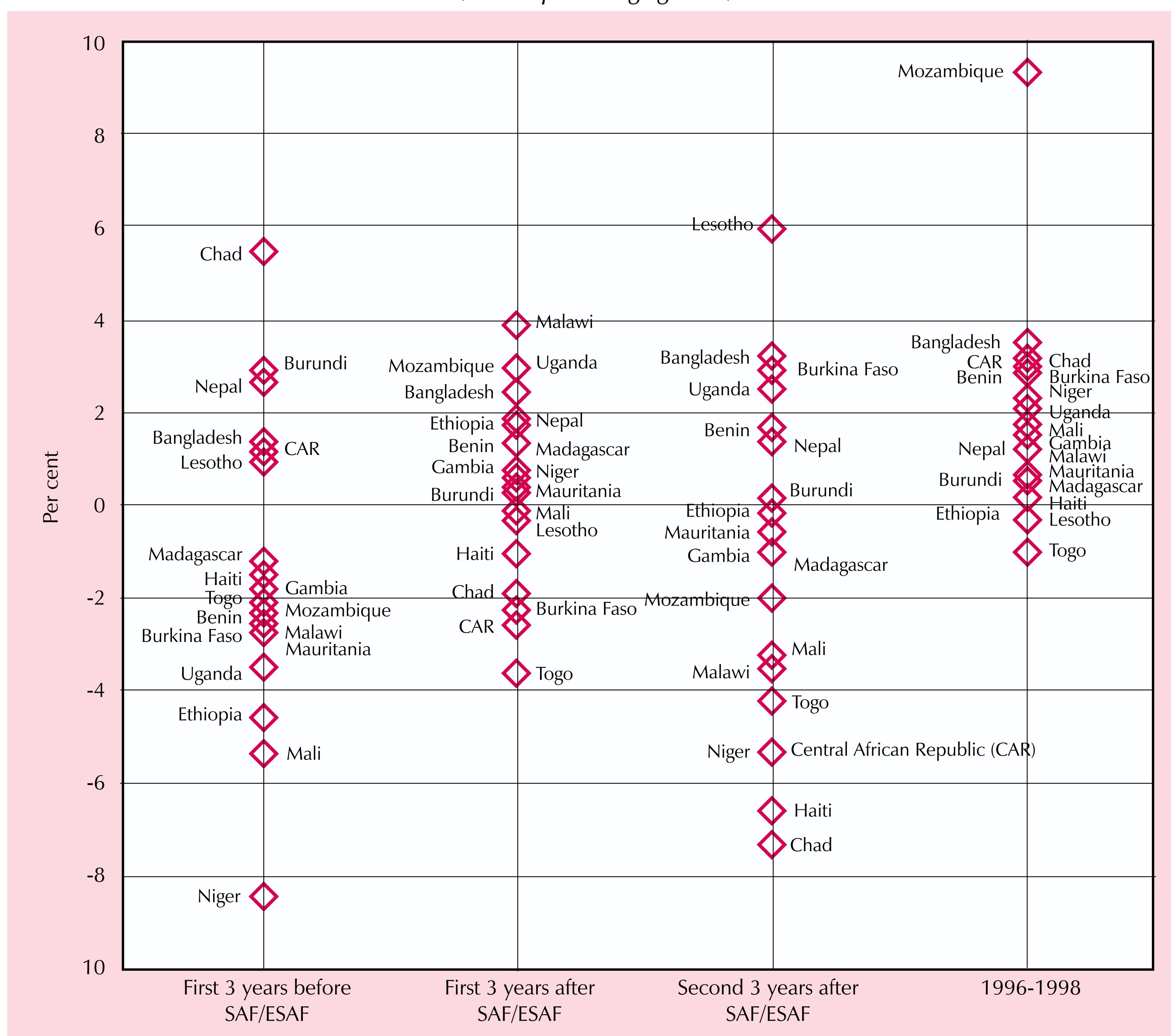
Note: The sample includes all LDCs for which data are available and which are identified by the IMF as ESAF-programme countries, except Equatorial Guinea, Guinea-Bissau, Rwanda and Sierra Leone, which are outliers. The countries are: Bangladesh, Benin, Burkina Faso, Burundi, Central African Republic, Chad, Ethiopia, Gambia, Guinea, Haiti, Lesotho, Madagascar, Malawi, Mali, Mauritania, Mozambique, Nepal, Niger, Togo and Uganda.

in growth rates decreased markedly in the first three years after SAF/ESAF-funded programmes, and then increased again in the next three years (chart 39). There is an acceleration of export growth in the first three years after initiating ESAF reforms, and gross domestic investment increases as a proportion of GDP. During 1996–1998, real GDP per capita growth picked up to 1.9 per cent per annum, and there is a further acceleration of export growth and gross domestic investment. But domestic savings, though they improved, remain very low.

Regarding progress to external viability, it is apparent that in 1998, the latest date for which data are available, 25 of the 33 LDCs which initiated SAF or ESAF programmes had levels of indebtedness which were unsustainable according to the criteria which the international community has recently adopted under the enhanced HIPC Initiative to judge debt sustainability. What is particularly troubling is that the situation was apparently worse in 1998 than at the start of the decade. The ratio of the total debt stocks to GDP increased in 18 out of the 29 ESAF programme LDCs and the ratio of total debt stocks to exports of goods and services plus workers' remittances increased in 17 out of 29 ESAF – programme countries.[6] One positive aspect of the situation is that rates of indebtedness began to decline more generally in ESAF-programme LDCs in the

CHART 39: REAL PER CAPITA GDP GROWTH RATE IN THE LDCS INITIATING SAF/ESAF PROGRAMMES DURING 1987–1992

(Annual percentage growth)



Source: UNCTAD secretariat estimates, based on World Bank, *World Development Indicators 2000.*

period 1994-1998. But this pattern applies to all LDCs, and not simply those that have engaged in reforms.

E. Mechanisms: differential performance under ESAF economic reforms

The extent to which these outcomes can be attributed to domestic policy changes, the external economic environment, and uncontrollable events such as the weather, is a highly controversial issue. The central methodological problem in evaluating effects of the reforms is determining a counterfactual, which specifies what policies would have been adopted and what outcomes would have occurred in the absence of ESAF support, against which to compare actual outcomes. The most widely applied methodology entails comparisons between countries which did and countries which did not adopt ESAF-supported programmes, on the assumption that countries which did not receive support provide an appropriate counterfactual for those which did.

Using this methodology, IMF studies show that ESAF programmes have been successful (IMF, 1999a; IMF, 1999b). The latest published work evaluating the programmes (undertaken by IMF staff) confirms the main conclusions of the internal evaluation finding that "for output growth and the debt/service ratio, sizeable beneficial effects that are statistically significantly different from zero are identified", whilst "the effects on inflation are not significantly different from zero" (Dicks-Mireaux et al., 2000: 521). However, this study also conducts diagnostic tests of the validity of the assumption that the policy reaction function for countries which do not receive support describes the counterfactual for countries that do receive support. These diagnostic tests indicate that this assumption is unreliable and thus the differences in performance cannot reliably be attributed to the ESAF programmes. The results, it is argued, raise questions about the validity of other evaluations of the programmes which use this methodology, and it is concluded that "on the basis of this study, it cannot be ruled out that the inherent limitations of panel data covering countries facing highly diverse circumstances render it impossible to obtain reliable estimates of the independent effects of IMF-supported lending" (p. 522).

This is a sobering conclusion. It implies that the efficacy of the economic reforms, on which so many lives and livelihoods now hang, is, and must remain, an act of faith. However, rather than trying to answer the question whether economic reforms work by comparing differential outcomes between ESAF and non-ESAF countries, it is now more important to understand the mechanisms through which programmes do, and do not, work. This shifts emphasis away from comparisons between those who undertake and those who do not undertake reforms towards the differential performance amongst countries pursuing the programmes, and in the same country over time. The question becomes why have these had more positive outcomes in some countries than others, and at some times rather than others; and if positive outcomes have occurred, how sustainable are they.

1. The role of external finance and global market developments

The basic mechanism through which ESAF-funded programmes boost economic growth in LDCs is by increasing their access to concessional financing.

In countries which are rationed out of international capital markets and with severe balance-of-payments constraints, such access is fundamental to growth prospects. It is particularly important if an ESAF loan is a precondition for other official finance on concessional terms.

As the IMF's External Evaluation points out, ESAF loans, reinforced by increased concessional finance from other donors, expand consumption and production possibilities (IMF, 1998: 37–39). Typically, the increased supplies of foreign exchange associated with the initiation of an ESAF programme have enabled the rehabilitation and full utilization of existing capital stock rather than the creation of new capital. But expanded official flows in import-strangled economies can also render many more potential investments remunerative (Helleiner, 1992: 780–781), and the cheapening of the price of wage goods has often led to the flourishing of informal sector activities (Wuyts, 1998).

These reforms acted as a gatekeeper for official finance rather than opening up access to private finance.

Table 24 provides evidence of the changes in official financing associated with the initiation of ESAF-funded reform programmes. The most striking feature is that a comparison of the five years before and the five years after the start of such a programme reveals that average annual grants per head increased by over 100 per cent in real terms in 20 out of 29 cases and by over 68 per cent in a further 6 cases. The average interest rate on new official loan commitments was 1 percentage point lower in 16 cases and the average grant element in official loans was 10 percentage points higher in 16 out of the 29 cases.[7]

As chart 40 shows, these reforms acted as a gatekeeper for official finance rather than opening up access to private finance. In almost half of the cases, the average annual ratio of net ODA to GNP increased by over five percentage points between the five years before and after the initiation of reforms. But the ratio of net FDI to GNP declined in almost half of the cases, increasing by over 1 per cent in just five cases.[8]

In those countries in which external indebtedness declines, it is possible to discern the beginnings of a virtuous circle in which decreasing external debt is associated with increasing domestic investment, which is associated with increasing exports, which in turn contributes to a further lessening of the external debt burden.

The positive effects of enhanced access to concessional finance have been reinforced in some countries by positive global market developments. The importance of this is underlined in the early internal evaluation of SAF and ESAF programmes conducted by the IMF. Comparing countries making more or less progress to external viability, the study found that "the striking difference between the two groups is in external developments. The deterioration in the terms of trade in the countries with weaker performance was a large multiple of that in the countries with stronger performances" (Schadler et al., 1993: 38). For LDCs undertaking ESAF programmes, the importance of terms-of-trade movements is apparent in the difference between economic performance in the early 1990s and 1994–1998. Moreover, during the latter period, whether debt-to-export ratios were rising, declining or more or less stable is closely related to export price developments. Export value growth exceeded export volume growth in 13 out of the 15 SAF/ESAF-programme LDCs in which the debt/export ratios were falling by more than 2 per cent per annum, whereas export volume growth exceeded export value growth in 12 out of the 16 countries where debt-to-export ratios were rising, stagnant or falling very slowly (table 25).

In those countries in which external indebtedness declines, it is possible to discern the beginnings of a virtuous circle in which decreasing external debt is associated with increasing domestic investment, which is associated with increasing exports, which in turn contributes to a further lessening of the external debt burden. This is apparent in that not only is there a strong relationship between reduction in debt-to-export ratios and export growth (as indicated above), but also there appears to be a relationship between rates of

TABLE 24: GRANTS AND CONCESSIONALITY OF NEW OFFICIAL LOANS CONTRACTED BEFORE AND AFTER THE INITIATION OF SAF/ESAF PROGRAMMES

	Initiation year	5-year average Real grants per capita ($)			5-year average official interest rate (%)			5-year average official grant element (%)		
		Pre-SAF/ESAF	Post-SAF/ESAF	% change	Pre-SAF/ESAF	Post-SAF/ESAF	difference	Pre-SAF/ESAF	Post-SAF/ESAF	difference
Bangladesh	1987	3.3	6.7	104.6	1.4	1.2	-0.2	72.9	74.2	1.3
Benin	1989	7.4	25.0	239.1	3.1	1.1	-2.0	55.4	74.2	18.7
Burkina Faso	1991	11.9	23.6	98.4	2.3	1.0	-1.3	59.7	75.9	16.2
Burundi	1986	5.3	13.2	147.8	2.8	1.2	-1.6	55.6	73.5	17.9
Cambodia	1994	6.9	20.3[a]	194.8	0.2	1.7[a]	1.5	15.9	71.6[a]	55.7
Central African Rep.	1987	9.0	24.8	175.5	2.6	1.7	-1.0	58.6	69.1	10.5
Chad	1987	9.5	20.0	110.3	2.3	1.8	-0.4	43.5	68.4	24.9
Equatorial Guinea	1988	22.4	60.1	168.5	1.7	1.3	-0.4	66.7	69.8	3.0
Ethiopia	1992	9.3	8.8	-4.6	2.7	1.2	-1.6	50.7	73.9	23.2
Gambia	1986	18.7	44.3	136.9	3.6	1.2	-2.4	48.1	68.3	20.2
Guinea	1987	4.2	20.8	389.1	3.1	2.2	-0.8	51.2	61.3	10.0
Guinea-Bissau	1987	20.3	42.6	110.2	2.9	1.2	-1.6	50.4	68.2	17.7
Haiti	1986	4.4	13.5	208.4	2.2	1.2	-1.1	66.4	58.7	-7.7
Lao PDR	1989	4.4	14.7	230.9	0.2	0.8	0.6	88.0	80.0	-8.0
Lesotho	1988	18.3	30.7	68.3	2.2	2.9	0.7	63.6	55.8	-7.8
Madagascar	1987	2.9	16.7	467.3	4.6	1.8	-2.8	42.8	68.6	25.8
Malawi	1988	5.4	25.4	368.8	2.5	1.4	-1.1	64.3	73.7	9.5
Mali	1988	11.1	20.8	87.5	1.8	1.3	-0.5	64.9	68.8	3.9
Mauritania	1986	24.5	42.5	73.3	2.7	2.2	-0.5	52.9	61.4	8.6
Mozambique	1987	6.7	43.9	553.9	3.4	1.5	-1.9	42.0	71.2	29.1
Nepal	1987	2.7	7.3	174.2	1.2	1.0	-0.2	76.1	78.4	2.3
Niger	1986	9.0	21.4	136.4	3.7	1.7	-2.0	49.1	66.9	17.8
Rwanda	1991	11.8	60.1	409.3	1.5	0.6	-0.8	71.5	63.5	-8.0
Sierra Leone	1986	4.5	8.3	83.7	1.3	1.7	0.4	67.8	68.8	1.0
Togo	1988	11.4	22.2	94.6	2.4	0.8	-1.7	63.7	62.3	-1.3
Uganda	1987	2.6	14.0	439.3	3.1	1.7	-1.4	57.2	67.5	10.4
UR of Tanzania	1987	8.4	22.5	168.0	2.6	1.6	-1.0	54.7	70.7	16.0
Yemen	1997	6.8	7.4[b]	8.3	2.1	0.5[b]	-1.6	59.8	81.7[b]	21.9
Zambia	1995	59.9	28.3[c]	-52.8	2.0	1.1[c]	-0.9	66.5	75.6[c]	9.1

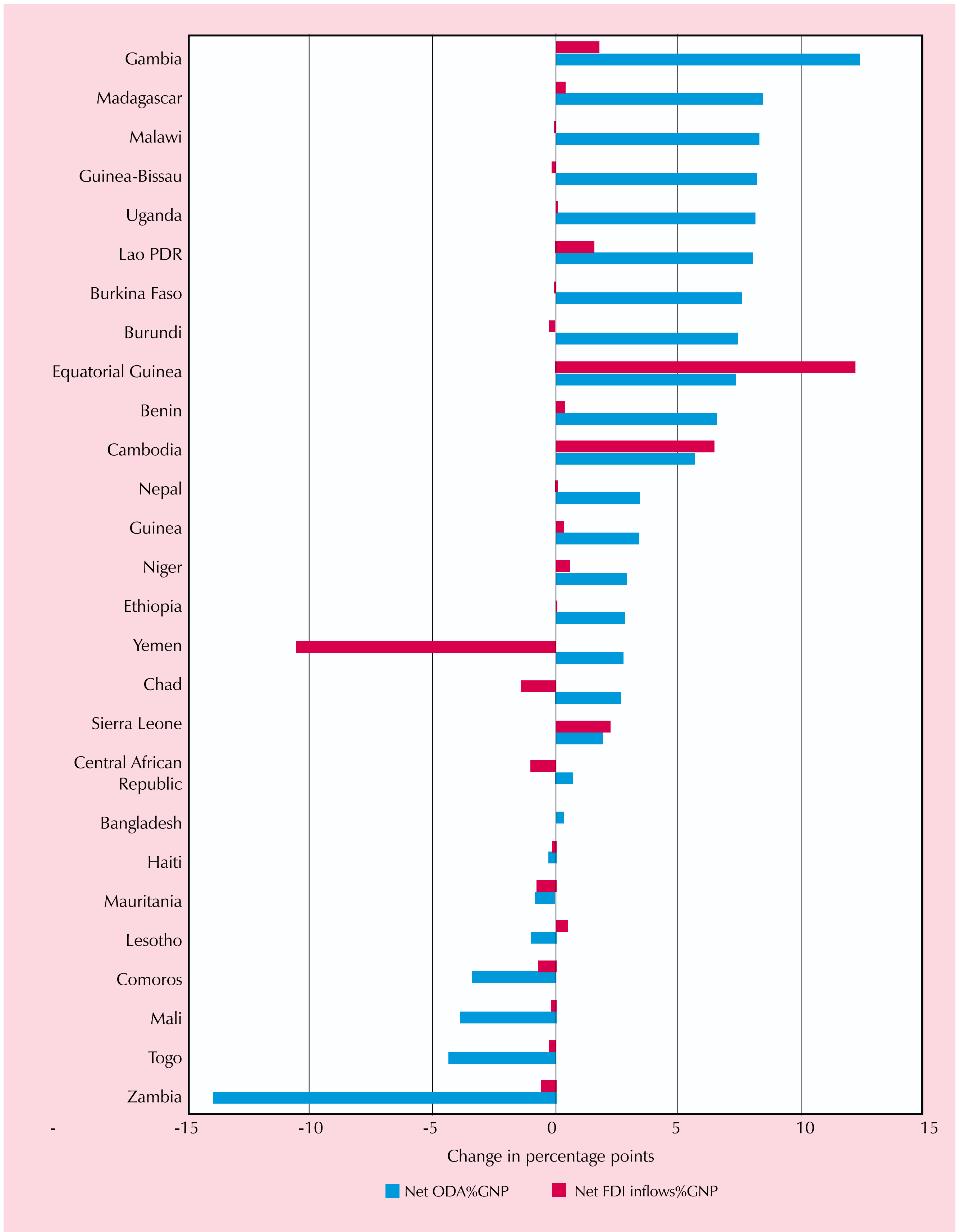
Source: UNCTAD Secretariat estimates, based on World Bank, *Global Development Finance 2000*, and on OECD-DAC database.

a 1995–1998 average.
b 1998 figure.
c 1996–1998 average.

decline in debt-to-GDP ratios and rates of growth of domestic investment (chart 41). This may be a purely accounting relationship, but how policy can best catalyse and sustain virtuous relationships between reduced external indebtedness, investment and export growth merits closer study. It would appear that one channel for this is through increased concessional finance enabling increased imports which are necessary for higher investment, which in turn facilitates export growth, thus reinforcing the initial catalytic effect of increased concessional finance. The role of official finance in this process is spelt out in one of the background studies for the internal ESAF evaluation, which demonstrates that the countries which made progress towards external viability "maintained larger current account deficits than those that made no progress. These larger deficits were financed by higher levels of official transfers" (Tsikata, 1999: 154).

However, the sustainability of this process depends critically on continued access to concessional finance plus favourable global market developments. This

CHART 40: NET ODA AND NET FDI INFLOWS BEFORE AND AFTER THE INITIATION OF SAF/ESAF PROGRAMMES
(Changes in average annual inflows as percentage of GNP[a])



Source: UNCTAD secretariat calculations, based on World Bank, *World Development Indicators 2000.*
a 5 years before and 5 years after, in percentage points.

TABLE 25: TRADE PERFORMANCE AND DEBT–EXPORT RATIOS, 1994–1998

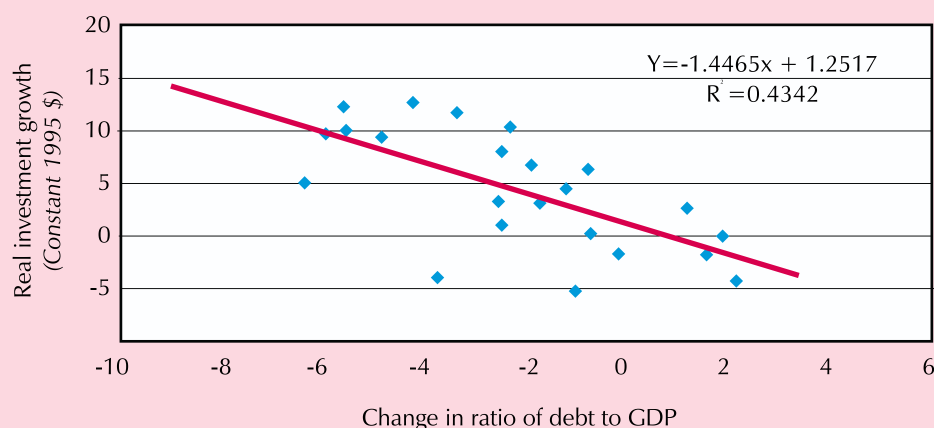
	EDT%XGS[a]	Growth rates (%) Exports of goods and services In value (A)	In volume (B)	(A) > (B)
LDCs with decreasing debt-export ratio		**17.2**	**14.3**	
Equatorial Guinea	-40.4	73.1	84.4	no
Haiti	-30.2	26.6	26.2	yes
Rwanda	-18.8	27.8	22.2	yes
Ethiopia	-13.7	19.1	14.9	yes
Bangladesh	-12.0	16.4	15.4	yes
Uganda	-11.3	17.1	18.3	no
Togo	-10.7	12.7	8.1	yes
Malawi	-7.6	12.1	9.3	yes
Mozambique	-6.7	9.6	4.8	yes
Angola	-5.4	6.3	-2.0	yes
Madagascar	-4.0	4.1	-3.7	yes
Gambia	-3.9	3.9	1.4	yes
United Republic of Tanzania	-3.0	13.6	2.1	yes
Nepal	-2.7	4.8	4.5	yes
Chad	-2.6	10.3	9.3	yes
LDCs with stable or increasing debt-export ratio		**4.9**	**6.4**	
Sao Tome and Principe	-1.4	1.7	2.5	no
Guinea	-0.9	4.0	10.0	no
Lesotho	-0.8	15.6	18.1	no
Niger	-0.7	4.5	3.3	yes
Guinea-Bissau	0.1	1.7	5.0	no
Yemen	1.6	35.4	-2.1	yes
Mali	2.2	11.8	14.1	no
Zambia	2.4	-3.9	3.2	no
Cape Verde	3.7	19.3	20.9	no
Central African Republic	5.9	-5.3	6.9	no
Mauritania	6.5	-3.0	-1.2	no
Benin	7.4	5.3	4.1	yes
Burkina Faso	7.5	6.4	8.1	no
Burundi	13.7	-8.3	5.0	no
Comoros	27.2	-6.7	5.8	no
Eritrea	50.9	-0.6	-1.4	yes

Source: UNCTAD secretariat estimates, based on World Bank, *Global Development Finance 2000* and *World Development Indicators 2000*.

a External debt stock as a percentage of exports of goods, services and remittances (annual average).

is particularly highlighted by the IMF's External Evaluation, which underlines that in those countries where faster growth has occurred following the adoption of ESAF programmes, the sustainability of that growth is questionable. The reason is that investment rates remain low and the scope for financing increased investment through domestic savings is limited because of low incomes.[9] To sustain initial gains, enhanced private and public capital inflows will be needed until domestic savings rise. But given the weak private flows response to reforms, this implies that there is a continued need for enhanced official capital inflows. To the extent that official credit-donors reduce concessional flows once the major policy reforms are in place and the economy is apparently "on track", the process can be quickly derailed.

CHART 41: REAL INVESTMENT GROWTH AND CHANGES IN EXTERNAL INDEBTEDNESS IN ESAF PROGRAMME LDCS, 1994–1998
(Annual percentage growth)



Source: UNCTAD secretariat calculations, based on World Bank, *World Development Indicators 2000* and *Global Development Finance 2000.*

2. CAUSES AND CONSEQUENCES OF PROGRAMME INTERRUPTIONS

An important background study for the IMF Internal Evaluation makes it clear that the outcomes of programmes depend on whether they are interrupted or not. For low-income countries as a whole, cumulative capital formation and per capita growth in interrupted programmes were significantly slower than during uninterrupted programmes (Mecagni, 1999: table 9.1). The recent World Bank Report on Africa also shows that on-track countries have been doing better than countries where reforms are interrupted.

These findings are important, but they reflect the consequences of interruptions for access to concessional finance as much as the effect of interruptions on the change in the policy environment. This is because interruptions entail a discontinuity in the disbursement of IMF funds. It is quite possible for such a delay to engender what has been called "a self-fulfilling collapse of fiscal resources" (Sachs et al., 1999: 7). This can happen if a fiscal target is not met, causing the IMF to delay payments. As Sachs et al. put it, "The IMF decision in turn blocks the disbursement of funds by other major creditors, including the World Bank and bilateral donors. The absence of such funds then dramatically worsens the budget situation, proving that the IMF was right to suspend the program. A long period of default, followed by difficult negotiations to restart lending, transpires"(p.7).

As interruptions are important for outcomes, an important issue for understanding the mechanism by which policy reforms work is to understand the causes of policy interruptions. Using the data set gathered for the

background studies for the internal evaluation, which covers SAF/ESAF arrangements approved during the period from 1986 to the end of 1994, it is possible to identify 34 interruptions, which occurred in 17 LDCs adopting these programmes. This is obviously not a complete sample, but it is the best available source for examining an issue discussion of which tends to be based on beliefs rather than facts. Interruptions in this data set are identified by discontinuities in the disbursement of IMF resources, and defined as "either an interval of more than six months between different annual or multiyear IMF arrangements or a delay of more than six months in completing a program review" (Mecagni, 1999: 217). This definition seeks to capture all potentially significant policy deviations, while avoiding mere procedural delays.

One might expect that the main cause of these interruptions was slippage in the fulfilment of agreed policy commitments. But in fact only 20 of the 34 interruption episodes were due to this (table 26). In six episodes, three of which were in Asian LDCs, there were no major deviations from the planned policies prior to implementation, but rather what are identified as "forward-looking disagreements". Such disagreements occurred "when either the IMF staff and authorities were unable to agree on the extent or pace of financial and structural programmes to be implemented in the period ahead, or the authorities needed more time to formulate a policy response to unexpected changes in the economic environment" (Mecagni, 1999: 220). A further eight interruption episodes were due to "political disruptions serious enough to call into question the continuing authority of the government and, therefore, to prevent meaningful negotiations" (p. 220).

An important question is the extent to which slippages are built into the programmes from the outset.

Of the 20 episodes in which there was slippage from agreed policy commitments, the main source of slippage was failure to meet fiscal targets (15 episodes). Slippage on structural reforms was only a source in 5 out of the 20 episodes. Moreover, where slippage occurred, a variety of exogenous influences also played a role in what happened. In 15 out of the 20 episodes, external shocks, natural disasters, or social unrest which could be related to the effects of adjustment programmes either strongly or weakly, played a role in the slippage. Of the remaining five cases, two had overambitious fiscal targets (out of a total of four cases identified as such in the sample), and of the remaining three, interruptions in two can be related to the democratic process, particularly by the pre-electoral climate (see table 26).

An important question is the extent to which slippages are built into the programmes from the outset. The internal evaluation background study examines this question in relation to five dimensions of policy design: (i) overly ambitious fiscal targets; (ii) insufficient prioritization of structural reforms; (iii) inadequate technical assistance; (iv) insufficient staff contact and monitoring; and (v) weak contingency planning. Of these aspects, the last emerges as the most problematic (although the evaluation study considers it hard to build contingency measures into programmes).

Focusing on a sub-sample of cases where slippage from policy commitments is due to external shocks, the study finds that terms-of-trade deterioration and shortfalls in external financing were often considered by IMF staff to be risks *ex ante*, but contingency measures and adjusters were not built into the programme. Thus, for example, for 10 LDC episodes in the sub-sample, uncertainty about external financing was perceived as an *ex ante* risk in six and materialized in four, and terms-of-trade deterioration was perceived as a risk in six and materialized in five of these. But in only one of these cases were contingent measures discussed to compensate for the potential effects on fiscal

TABLE 26: CLASSIFICATION OF CAUSES OF INTERRUPTIONS OF SAF/ESAF PROGRAMMES IN THE LDCS

Country		Starting date of interruption	Forward-looking disagreements Only (time needed to formulate a policy response to shocks; no major policy slippages)	Political disruptions (serious enough to prevent meaningful negotiations or call into question continuing authority of current government)	*Deviation from policy commitments* Type of deviation		Contributing factors				
							External shocks	Natural disasters	Social unrest		Democratization or pre-electoral climate
					Fiscal issues	*Structural reforms*			*Weakly related to adjustment effects*	*Strongly related to adjustment effects*	
Bangladesh	1	Dec.1989	X								
Benin	1	Jun.1990		X						X	
	2	Jun.1992	X								
Burkina Faso	1	Mar.1992			X		X	X			X
	2	Nov.1993			X						
Burundi	1	Aug.1987			X		X				
	2	Jul.1990			X						
	3	May.1993		X							
Eq. Guinea	1	Dec.1989				X	X				
	2	Sep.1993			X						X
	3	Oct.1994			X						
Guinea	1	Jul.1988			X		X				
	2	Mar.1990			X					X	
	3	Nov.1992			X		X				X
Lao PDR	1	Sep.1990	X								
	2	Jun.1994				X					
Madagascar	1	Jun.1991		X							
Malawi	1	Jun.1992			X		X	X		X	X
Mali	1	Jan.1991		X					X		
	2	Aug.1993			X					X	
Mauritania	1	Nov.1988				X					
	2	May.1990	X								
Mozambique	1	Dec.1993				X	X				
	2	Feb.1995			X		X				
Nepal	1	Nov.1990		X							
	2	Oct.1993	X								
	3	Sep.1994				X					X
Niger	1	Dec.1989			X		X	X			
	2	Mar.1991		X					X		
Sierra Leone	1	Nov.1987		X							
	2	Mar.1995	X								
Togo	1	Jun.1991			X			X	X		X
	2	Nov.1992		X							
UR of Tanzania	1	Mar.1993			X						
Total			**6**	**8**	**15**	**5**	**9**	**4**	**3**	**4**	**6**

Source: UNCTAD secretariat estimates based on Mecagni (1999), including from text table 9.10, table 9.11 and table 9.12.

accounts and balance of payments. In general, "these programmes implicitly assumed that any financing shortfall would have to be offset fully and immediately by a tightening of policies or a contraction of imports, or dealt with in a subsequent review. In no case were the modalities of the additional adjustment effort to address external financing shortfalls specified in advance, and hence agreed by authorities" (Mecagni, 1999: 236).

Related to the lack of contingency measures are problems of forecasting. The data from the background study for the internal evaluation on programme interruptions show that there is an important difference between LDCs in which programmes were uninterrupted and those in which programmes were interrupted and in which little or no progress was made towards external

TABLE 27: FORECASTS OF OFFICIAL LOANS AND MERCHANDISE EXPORTS: DEVIATION OF OUT-TURN FROM PROJECTIONS IN INTERRUPTED AND UNINTERRUPTED LDC SAF/ESAF PROGRAMMES

	Official loan targets versus out-turns[a]			Merchandise exports targets versus out-turns[a]		
	(O = overestimate; U = underestimate; E = on target)					
	t	t+1	t+2 [d]	t	t+1	t+2
Interrupted programmes in which limited or no progress was made to external viability						
Burundi (SAF, 1986)	O	E	O	O	O	O
Equatorial Guinea (ESAF 1993)	U	O	O	O	O	O
Guinea (ESAF 1991)	O	O	O	E	O	O
Madagascar (ESAF 1989)	O	O	O	U	O	O
Mali (ESAF 1992)	O	O	U	E	O	O
Mozambique (SAF 1987)	O	O	O	U	E	O
Mozambique (ESAF 1990)	O	O	O	E	U	O
Niger (ESAF 1989)	O	O	O	O	O	O
Sierra Leone (SAF 1986)	..	..	..	O	O	O
Togo (ESAF 1989)	O	O	U	U	E	O
Summary frequency distribution:						
Overestimates	8	8	7	4	7	10
On target	-	1	-	3	2	-
Underestimates	1	-	2	3	1	-
Uninterrupted programmes[b]						
Bangladesh (ESAF, 1990/1991)[c]	..	..	..	E	U	U
Benin (ESAF 1993)	O	O	O	O	O	O
Gambia (ESAF 1988/1989)	O	O	O	E	E	U
Lesotho (SAF 1988/1989)	U	U	U	U	U	O
Lesotho (ESAF 1991/1992)	U	U	U	E	U	U
Mozambique (SAF 1987)	O	O	O	U	E	O
Nepal (SAF 1987/1988)[b]	..	..	..	U	..	..
United Rep. of Tanzania (SAF 1987/1988)[b]	..	..	..	O	O	O
Uganda (ESAF 1989/1990)	U	U	O	O	O	O
Summary frequency distribution:						
Overestimates	3	3	4	3	3	5
On target	-	-	-	3	2	-
Underestimates	3	3	2	3	3	3

Source: Tsikata (1999), tables 7.19 and 7.20.

a "Targets" are the projections contained in the IMF staff report for the first annual arrangement. Out-turns that fall within 5% of the projection are classified as being "on target" (E); projections that exceed the out-turn by more than 5 per cent are classified as "overestimate" (O); and those below out-turns by more than 5 per cent are classified as "underestimate" (U).

b Coverage is for multiyear arrangements that ran their full course without major interruption.

c Gross official borrowing not reported in the IMF staff report.

d The initial annual arrangement is designated t, and the subsequent two years are t + 1 and t + 2.

viability. Forecasts were much more realistic in those programmes which were uninterrupted (table 27). Forecasts of merchandise exports were over-optimistic in two thirds of the interrupted programmes, but in under half of the uninterrupted programmes. More strikingly, projections of official lending were overestimated in eight out of nine programmes in the first and second years of the interrupted programmes, but in only three out of six of the uninterrupted programmes.

Given that the success of the programmes depends critically on whether they are adequately financed, an important policy issue is the extent to which programme slippage occurred because of underfinancing. This can occur owing to unforeseen shocks, or a general tendency to underestimate the financing requirements of adjustment efforts. These are calculated on the basis of estimates of financing gaps, and they may underestimate requirements either because of overoptimistic forecasts or because of adjustment of financing gaps in the light of the ability to mobilize donor support for programmes. This latter possibility arises because "supporting underfunded programmes is", as the evaluation of the Special Programme of Assistance for Africa explains, "not feasible for the Bank and the Fund, so if donor pledges fell short of financing requirements, the gap had to be adjusted in a somewhat ad hoc manner to meet donor allocations" (World Bank, 1998: 42). An inevitable consequence of such adjustment of financing gaps according to ability to mobilize funds rather than actual requirements is that a certain number of programmes are fated to break down from the outset because of underfunding and shortages of foreign exchange.[10]

A certain number of programmes are fated to break down from the outset because of underfunding and shortages of foreign exchange.

3. The role of macroeconomic policies and structural reforms

The positive benefits which follow if the foreign exchange constraint is loosened by increased concessional finance, if this is sustained, and if programmes are not interrupted and so there is low volatility in foreign financing, are enhanced by the domestic policy environment. It is extremely difficult to identify the elements of policy reform which contribute most to positive outcomes. However, many observers have concluded that the domestic policy changes which are likely to contribute most are the removal of gross macroeconomic distortions.[11]

The effectiveness of the structural reforms is more controversial. There is little hard evidence from the IMF evaluation studies that structural reforms have positive effects on growth. It is worth quoting here from the key background study for the internal evaluation for its measured language. The passage in question states that:

> A more detailed examination of structural policies in the ESAF countries, with the aid of score indices constructed for the purpose, does not provide findings that are sufficiently robust to support firm policy conclusions. This may well reflect the enormous difficulties in measuring differences in structural policies across countries and over time. Bivariate correlations suggest that reductions in structural distortions are associated with more rapid growth over time. But such effects are barely discernible when full account is taken of macroeconomic policies, human capital accumulation, initial conditions and exogenous shocks (Kochhar and Coorey, 1999: 87).

This result reflects the fact that in low-income countries, structural constraints and institutional weaknesses impede a positive response to private incentives which are intended to be at the centre of adjustment processes. The problem is that some key markets hardly exist, or they are so thin that they are characterized by monopolistic or oligopolistic pricing. The domestic entrepreneurial class, which hypothetically will act as the key agent of market-based growth, is weak. But foreign investors are not yet ready to step into the breach. As shown in the last chapter, although economic reforms can guarantee a more liberal and pro-business policy regime, there are more fundamental factors which deter investment decisions and which are not addressed by the structural reforms.

In low-income countries, structural constraints and institutional weaknesses impede a positive response to private incentives which are intended to be at the centre of adjustment processes.

The main deficiencies of the structural reforms in low-income contexts have been particularly highlighted in earlier UNCTAD work on structural adjustment in Africa (UNCTAD, 1998). Agricultural liberalization has often not been associated with a strengthening of output price incentives owing to falling world prices for export commodities, the removal of subsidies on food crops, and imperfect marketing systems. Input supply and credit provision have also dwindled, particularly in less accessible and low population-density regions and locations, since private agents have been unable to take up many of the functions previously discharged by market boards. Financial liberalization has led to high and unstable interest rates, widespread insolvencies, and a rapid accumulation of public domestic debt (Nissanke, 1998). Trade liberalization, where formal sector enterprises have weak technological and managerial capabilities, has often undermined domestic industry. There can be vigorous informal sector development where import compression ends, but this is not necessarily sustainable given the lack of export orientation of informal sector activities and constraints on their access to finance (Wuyts, 1998).

4. External indebtedness and ESAF outcomes

The outcomes of economic reform processes in developing countries also depend critically on the initial conditions in which efforts at structural adjustment are launched. It is now clear that supply responses are likely to be more muted in poor countries where physical and human infrastructure and market institutions are underdeveloped, and where there is only a small domestic entrepreneurial class. There is also growing evidence that economic liberalization does not deliver developmental integration into the world economy for countries which are more remote from the core growth areas of the world economy and with geographical constraints on access to international trade. Structural adjustment reacting to a situation of economic crisis is always likely to be more difficult and vulnerable than positive restructuring in line with a long-term developmental vision (ESCAP, 1990). Finally, an important factor which affects the working of economic reforms as well as their outcomes is the initial level of external indebtedness.

The effects of external debt on processes of adjustment are an underexplored issue. But it is quite vital. If it is the case that once external indebtedness passes a certain threshold, reform effectiveness is undermined, a necessary condition for economic reforms to work in severely indebted countries is prior debt reduction. The current policy of making successful adjustment a condition which must be met before debt relief is irrevocably provided puts the cart before the horse, condemning both the adjusting country and the official creditor-donors supporting the adjustment process to considerable frustration. Increased resource inflows in the form of aid and increased national policy effort towards

The current policy of making successful adjustment a condition which must be met before debt relief is irrevocably provided puts the cart before the horse, condemning both the adjusting country and the official creditor-donors supporting the adjustment process to considerable frustration.

structural adjustment simply cannot move the economy to external viability until the burden of external debt is reduced.

There is, surprisingly, little exploration of the effects of external debt on reform outcomes or the mechanisms through which external debt affects the working of adjustment programmes. However, simple comparisons between LDCs undertaking ESAF programmes classified according to initial levels of indebtedness suggest that this merits much more research. When countries with a debt-to-GNP ratio of less than 80 per cent are compared with those with a higher ratio, there appears to be a stronger investment and export response to reforms in the former group. The difference in performance between more indebted and less indebted ESAF programmes is particularly marked for the period when terms of trade movements were positive (table 28). As with all exercises of this sort, the results are sensitive to the country composition of the groups. Ideally, the effects of initial indebtedness should be examined in relation to the concessionality of the debt, and thus in present value (PV) terms . Account must also be taken of the levels of transfers, for these can offset the crowding-out effects of the debt. However, these simple results do provide some limited empirical support for the notion that initial indebtedness affects the efficacy of policy reforms.

High levels of external indebtedness are likely to reduce the efficacy of economic reforms in various ways. First, a large external debt greatly complicates stabilization efforts. This is highlighted in the only document that seeks to set out theoretical underpinnings of the ESAF reforms (IMF, 1987). This

TABLE 28: INITIAL INDEBTEDNESS AND ECONOMIC PERFORMANCE OF THE LDCS BEFORE AND AFTER THE INITIATION OF SAF/ESAF PROGRAMMES

	3 years before the initiation	1st 3 years after the initiation	2nd 3 years after the initiation	1996–1998
Average annual growth rates (%)				
Real GDP per capita				
Low initial indebtedness[a]	0.23	0.37	-0.33	2.56
High initial indebtedness[b]	-3.56	-0.54	-2.02	1.14
Exports of goods and services (volume)				
Low initial indebtedness	3.37	4.30	7.86	13.12
High initial indebtedness	-2.09	6.55	0.29	5.69
Gross domestic investment (volume)				
Low initial indebtedness	1.89	-0.44	0.49	11.24
High initial indebtedness	-0.56	3.46	1.03	0.77
Average annual ratio (as % of GDP)				
Gross domestic investment				
Low initial indebtedness	17.2	20.1	21.2	22.1
High initial indebtedness	15.3	18.4	16.9	16.7
Gross domestic savings				
Low initial indebtedness	-4.0	-2.2	-1.7	3.0
High initial indebtedness	3.0	4.8	1.8	2.6

Source: UNCTAD secretariat estimates, based on World Bank, *World Development Indicators 2000* and *Global Development Finance 2000*.

a LDCs with initial debt stock ratio to GNP < 80%: Bangladesh, Benin, Burkina Faso, Burundi, Central African Republic, Chad, Haiti, Lesotho, Mozambique, Nepal, Uganda.

b LDCs with initial debt stock ratio to GNP > 80%: Ethiopia, Gambia, Guinea, Madagascar, Malawi, Mali, Mauritania, Niger, Togo.

analysis shows that external indebtedness serves to bring into conflict the two main elements of the stabilization process – expenditure reduction through cutting the fiscal deficit, and expenditure switching through devaluation of the domestic currency. Devaluation increases the proportion of income going towards meeting interest payments on external debt (of both the public and private sector), thereby reducing aggregate demand and contracting domestic output. Devaluation is also likely to increase the fiscal deficit in countries with a large public-sector external debt. This occurs the "when interest payments have become such a large proportion of government expenditures that their rise following a devaluation, together with the increase in the domestic-currency equivalent of other foreign-exchange components of government expenditures, outweighs the normally dominant increase in revenues resulting from the rise in domestic-currency equivalents of foreign grants and foreign trade taxes" (IMF, 1987: 45). The results of these developments "may be increased capital flight, which puts further pressure on the domestic currency (to depreciate further) and on domestic interest rates (to be pushed higher to combat capital flight)", and these secondary effects "tend to lead to further deterioration of the fiscal situation" (p. 45). This problem may also be further exacerbated by a "big bang" approach to adjustment in which financial and trade liberalization is undertaken along with stabilization. The rising interest rates associated with financial liberalization increase expenditure requirements on domestic debt, whilst the falling revenues from trade taxes associated with trade liberalization cut government revenue (Toye, 2000).

If the effectiveness of reforms intended to promote economic growth and external viability is undermined by external indebtedness in these ways, a vicious circle is likely to ensue... Both international creditor-donors and debtor countries are then caught in an aid-cum-debt trap.

Secondly, high levels of external indebtedness reduce the probability that structural adjustment will be investment-led. High levels of external debt constrain domestic investment in various ways. Debt service payments absorb foreign exchange and thus reduce capacity to import capital goods. As much of the external debt is owed by government, debt service payments also adversely affect government budgets, reducing domestically driven public investment in physical and human infrastructure. The debt overhang creates uncertainty for domestic and foreign investors. It adversely affects country credit ratings and perceptions of country risk, limiting the access of potentially profitable firms within indebted countries to international capital markets.

Thirdly, high levels of external indebtedness can have perverse effects on aid flows. These arise when aid allocations start to be influenced by levels of external debt (see section F below). Diversion of aid, either directly or indirectly, to service debts reduces its developmental effectiveness, compounding the negative effects of the external debt on stabilization and investment during the reform process.

If the effectiveness of reforms intended to promote economic growth and external viability is undermined by external indebtedness in these ways, a vicious circle is likely to ensue. On the one hand, high levels of indebtedness undermine aid effectiveness, including in particular the investment and export response to economic reforms. On the other hand, the low level of aid effectiveness and the weak response to reforms mean that progress to sustained growth and external viability is slow and indebtedness remains severe. Both international creditor-donors and debtor countries are then caught in an aid-cum-debt trap.

F. The aid-debt service system

1. Evidence and motivations

Negative effects of the external debt on aid arise if allocations of aid by official creditors are dependent on the size of debt service payments. That this is so has only recently been realized. But now a number of experienced analysts of the aid and debt problems of poor countries have pointed out the fact.

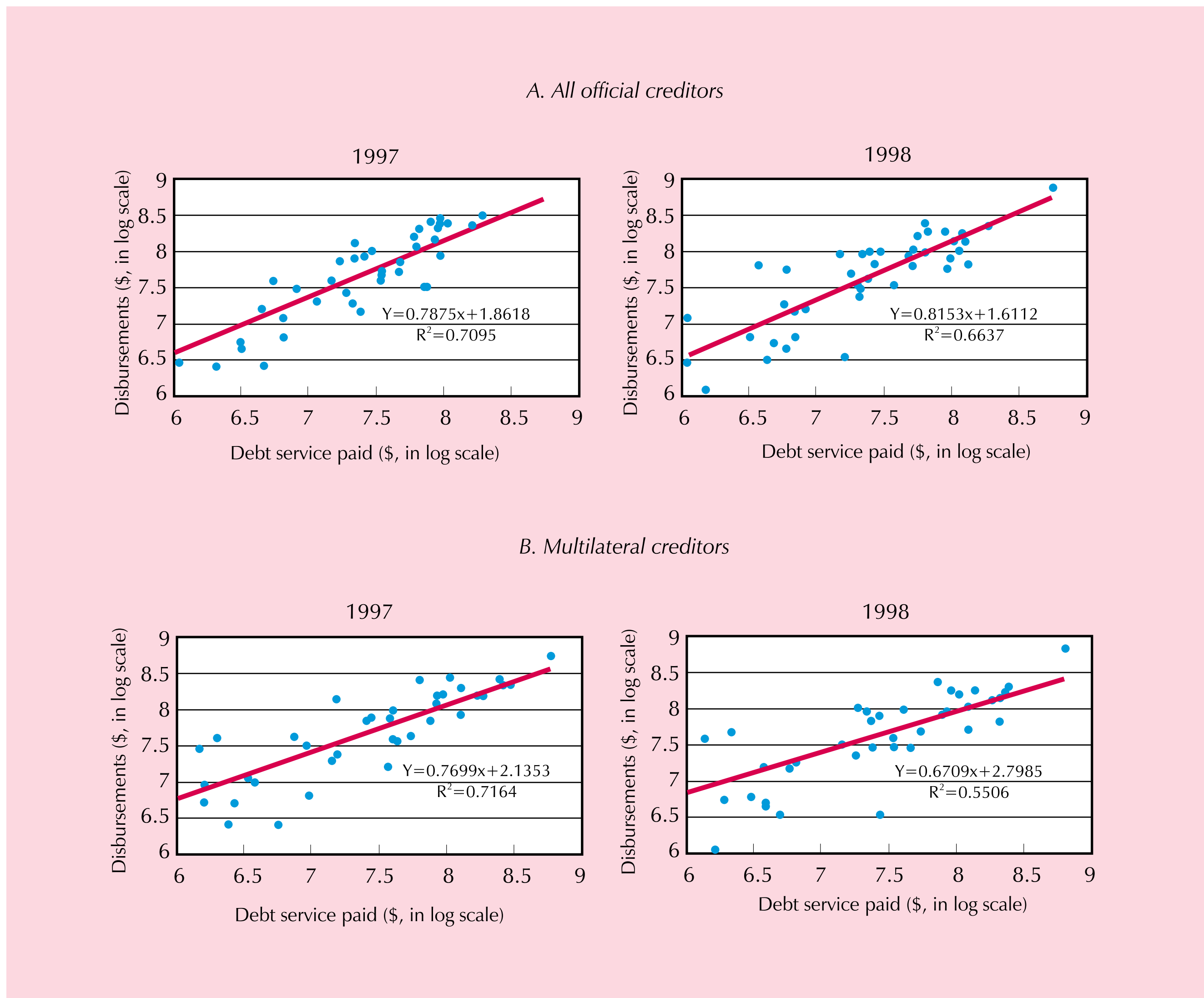
Thus, the former Director of the *World Development Report, 2000/2001* has recently written that "much of the aid inflows are motivated simply to ensure 'normal relations' with regular debt servicing… For their own reasons – to do with the institutional importance of avoiding certain types of balance sheet adjustments – the official donors, who are also the main creditors, are putting money in so that the debt can be serviced" (Kanbur, 2000: 688). Tony Killick, who was perhaps the first to highlight the system has written that: "Aid receipts are commonly treated by creditors as a government revenue item, permitting the servicing of more external debt than would otherwise be affordable. Creditor governments have been taking away with one hand what they have given with the other" (Killick and Stevens, 1997: 165). Moreover, Sachs, and his colleagues, speaking specifically of the HIPCs, describe the interrelated aid disbursements and debt service payments as "a complex shell game, in which large-scale debt servicing is very imperfectly offset by debt postponements, arrears, new loans and grants from donor governments" (Sachs et al., 1999: 5).

The more debt service payments a country has to make, the more official finance it receives.

Evidence for the extent to which the "debt-tail" has been wagging the "aid-dog" is apparent in the relationship between the geographical distribution of aid disbursements amongst LDCs and the geographical distribution of debt service payments. Both official and multilateral disbursements are highly correlated with total debt service, and multilateral disbursements are highly correlated with multilateral debt service (see Killick and Stevens, 1997; Birdsall, Claessens and Diwan, 2000). The more debt service payments a country has to make, the more official finance it receives (chart 42). This pattern has prevailed throughout the 1990s (table 29).

These patterns stem from a number of motivations. On the one hand, they reflect efforts to mobilize resources to support the economic reforms in countries facing debt problems. Until the HIPC Initiative also, the only way to respond to the growing multilateral debt-servicing difficulties of the clients of the World Bank and the IMF was to maintain a sufficient flow of new lending to debtor countries to ensure that they could continue to service past credits. This situation will continue until HIPC countries reach their decision point and start to receive interim assistance (see chapter V). The patterns also reflect "defensive disbursements" by creditors designed to ensure continued debt service of their own old loans, to avoid embarrassing arrears and to avert growing risks of documented development failure (Birdsall, Claessens and Diwan, 2000). Accounting reasons have also favoured the refinancing approach. Claessens et al. (1997a) note that "the upfront account loss resulting from a debt-reduction operation is likely to be much larger than the economic loss if the loan is still kept at face value or is otherwise overvalued on the creditors' books, and adequate or realistic loan-loss provisions have not been set aside" (p. 32). "In practice, some creditors", they note, "may be reluctant to grant debt forgiveness because they are unwilling or unable to take a large accounting loss. Also, explicit debt reduction may expose the extent of past imprudent lending decisions with adverse effects on the reputation of the creditor vis-à-vis borrowers and financial markets" (p. 32-33).

CHART 42: GROSS OFFICIAL DISBURSEMENTS TO, AND DEBT SERVICE OF, LDCS, 1997 AND 1998: ALL OFFICIAL CREDITORS[a] AND MULTILATERAL CREDITORS[a]



Source: UNCTAD secretariat calculations, based on World Bank, *Global Development Finance 2000*.
a Excluding IMF.

TABLE 29: STATISTICAL RELATIONSHIP BETWEEN OFFICIAL DISBURSEMENTS TO, AND DEBT SERVICE PAYMENTS OF, LDCS, 1990–1998

	All official creditors		Multilateral creditors	
	R-Square[a]	*T-statistic*[b]	*R-Square*[a]	*T-statistic*[b]
1990	0.77	11.70**	0.70	9.60**
1991	0.56	7.14**	0.58	7.42**
1992	0.82	13.35**	0.79	12.13**
1993	0.74	10.64**	0.69	9.30**
1994	0.71	9.67**	0.68	9.12**
1995	0.70	9.71**	0.45	5.74**
1996	0.73	10.45**	0.61	7.67**
1997	0.71	9.89**	0.72	9.93**
1998	0.66	8.77**	0.55	6.82**

Source: UNCTAD estimates, based on World Bank, *Global Development Finance 2000*.
a The R-square estimates the association between gross official (or multilateral) disbursements and official (or multilateral) debt service payments amongst LDCs (in log. scale). The sample is 40 to 42 LDCs depending on the year.
b ** Significant at 1% level.

2. Implications

The aid-debt service system reduces the developmental impact of aid for both highly and less severely indebted LDCs. For less indebted LDCs, the problem is that the geographical distribution of aid resources is skewed according to indebtedness rather than other criteria of potential and need. For the more heavily indebted LDCs, the problem is that the aid-debt service system acts to reduce the developmental impact of aid.[12]

The system reduces the developmental impact of aid because it subtracts from the level of aid resources available for developmental purposes, and it adversely affects the quality of aid. Subtractionality occurs directly through ODA grants being directly committed for debt relief. As indicated in chapter II, this was increasing in the 1990s. According to DAC information on ODA commitments, the proportion of grants going to debt relief rose from 2.7 per cent in 1992 to 14.1 per cent in 1998.[13] It also occurs through the direct contributions of bilateral donors to pay the arrears and current debt service of multilateral financial institutions. Taking a rather broad view of such diversion (which includes subventions to the Fifth Dimension Programme of the World Bank and IMF's Rights Accumulation Programme (RAP), contributions to balance-of-payments support for debt-related adjustment programmes, particularly through the Special Programme of Assistance for Africa, and subventions to ESAF and to IDA), the Commonwealth Secretariat has estimated that around $9 billion per year, which was nearly a quarter of bilateral aid to developing countries, was being diverted to debt relief through such channels in the early 1990s (Killick, 1995b). Finally, subtractionality occurs at the level of the debtor country as newly acquired external bilateral resources have to be employed for the service of external debt rather than for economic and social development purposes. A recent econometric analysis in 18 SSA countries over the period 1970-1995 found that 31 cents of every additional dollar of grants and concessional loans was used to finance principal repayments of foreign loans, and as much as 50 cents of every additional dollar of grants was used for the same purpose (Devarajan, Rajkumar and Swaroop, 1999).

The aid-debt service system reduces the developmental impact of aid because it subtracts from the level of aid resources available for developmental purposes, and it adversely affects the quality of aid.

The aid-debt service system not only reduces the resources available for developmental purposes but also adversely affects the developmental effectiveness of aid flows in various ways. The system may act as a disincentive to effective resolution to the debt problem because the better a country does in terms of reducing its debt service burden, the worse it is likely to do in terms of concessional flows of aid. Box 5 indicates with a simple numerical example how this can be part of the debt overhang effect, as all additional output benefits of

Box 5: A numerical example of the disincentives of the aid-debt service system

"A country owes official creditors $30 next period. Next period output will be $110, so in the absence of foreign aid, the resources available for consumption and investment would be $80. However, the country expects official creditors to provide foreign assistance (either in the form of grants or concessional loans) to prevent the country's resources from falling below the threshold value of $100. If creditors indeed behave as expected, foreign aid next period will be $20, and the country's net transfer of resources to official creditors will be $10 (the difference between the debt service payment and the aid inflow). The country has the opportunity to engage in an investment plan that will increase next period output by 10 per cent to $121. How would investment change the inflow of foreign aid? Output net of debt service payments would be $91, so foreign aid would fall to $100 - $91 = $9, instead of $20. The resources available for consumption and investment, on the other hand, would still be $100, so the indebted country would not benefit from investment. All the additional output obtained from investment goes to official creditors in the form of reduced assistance" (Claessens et al., 1997b: 242 – 243).

new investment go to official creditors in the form of reduced assistance. The system also creates uncertainty and undermines government capacity, a process which will be examined in much greater depth in chapter VI. Moreover, maintaining a given level of net transfers to a country involves high transaction costs associated with the continual negotiation of what proportion of scheduled debt payments will be serviced from the country's own resources.

Negotiations include: Paris Club and London Club agreements; accords with individual bilateral creditors, which are negotiated after an overall agreement with the Paris Club has been reached; discussion with IMF missions, which include annual consultation exercises, preparatory and negotiation missions for new programmes, and three-to-six-monthly review missions for programmes already in place; discussion with World Bank missions; negotiations with creditors outside the Paris and London Clubs, in particular the Governments of the former Eastern bloc countries and OPEC, and non-bank commercial creditors; Consultative Group preparations and meetings for ODA coordination (usually annual); and ODA negotiations with individual bilateral and other multilateral donors, such as regional development banks and UN agencies. There are unfortunately no estimates of all this activity in LDCs as a whole. But it has been estimated that the total number of negotiations of these types is 7,800 for 30 African Governments during the period 1980-1992, and updating this figure to 1997 would scarcely leave it below 10,000 (Killick and Stevens, 1997: 166). These negotiations make huge demands on senior staff and divert them from constructive analysis and implementation of policy options to servicing the informational and other requirements of the external creditors, thus effectively undermining efforts to increase ownership.

Maintaining a given level of net transfers to a country involves high transaction costs associated with the continual negotiation of what proportion of scheduled debt payments will be serviced from the country's own resources.

A further feature of the aid-debt service system is that for any given level of net transfers, countries are both "aid dependent", in the sense of the size of aid inflows in relation to economic activity, investment and imports, and highly indebted. The attempt to ensure that low-income countries receive a certain level of positive net transfers by increasing aid inflows to offset debt service payments, rather than by a straightforward upfront debt reduction, inevitably also increases the domination of capital formation processes in the debtor country by official creditor-donors.

Finally, "the ability to refinance nonperforming loans, thereby concealing the losses, may create a moral hazard problem on the creditor side" (Claessens et al., 1997a: 33). There is a marked contrast here with private commercial banking, where regulatory limits on banks' exposure to individual borrowers constrain the use of a refinancing strategy to deal with a debt problem. The effect of a refinancing strategy is to insulate official creditors from the full effect of their lending mistakes. This applies particularly to the international financial institutions, whose preferred creditor status has allowed them to make loans in the knowledge that if things do not work out and the sums invested do not yield positive returns they will get their money back anyway.

G.Conclusions and policy implications

This chapter has three main findings. First, in spite of problems of implementation, many LDCs have undertaken significant policy reforms during the 1990s, particularly trade liberalization, pricing and marketing reform, and the creation of a policy regime favourable to FDI. The national policy environment at the end of the 1990s in many LDCs is thus very different from

that at the end of the 1980s. It has moved decisively in the direction of economic liberalization.

Secondly, the key mechanism by which ESAF programmes work has been through the expansion of production and consumption possibilities, which occurs when foreign exchange constraints are lifted and import compression is eased as grants and concessional loans are increased, or relief on scheduled debt service payments is provided. Repairing gross macroeconomic distortions related to the real exchange rate and reducing inflation also creates a positive enabling environment for increased production, and this process has been greatly facilitated when the global market developments for key exports have been positive. But structural reforms have not taken sufficient account of structural constraints, the small indigenous entrepreneurial class and weaknesses of market institutions, which all impede a positive response to private incentives. Moreover, high levels of external indebtedness undermine the effectiveness of reforms through debt overhang effects on both debtor countries and the international creditor-donor community.

Thus – and this is the third main conclusion – although significant policy changes have been made in many LDCs, the new policy environment does not deliver sufficiently high growth rates to make significant inroads into poverty except where the external trade environment is favourable and reforms are adequately or stably financed. In those countries and periods where economic growth has accelerated, the sustainability of growth is questionable as it depends on the continuation of positive global developments and sustained high levels of concessional finance.

Although significant policy changes have been made in many LDCs, the new policy environment does not deliver sufficiently high growth rates to make significant inroads into poverty except where the external trade environment is favourable and reforms are adequately or stably financed.

The recent experience of African LDCs shows that some degree of adjustment can certainly take place without much new investment (UNCTAD, 1998: 166–171). As incentive structures change, small-scale producers, particularly in peasant agriculture, can switch resources between different activities, and there can also be a positive "vent-for-surplus" effect as land and labour resources which were previously underutilized are brought into production. But it is clear now that there is a limit to this process. Without the necessary finance, adjustment can be driven by intensified self-exploitation of all the family driven by pressing minimal consumption needs, as much as by improved incentives. Cheaper imports and less government regulation catalyse a flourishing informal sector. But businesses in this sector are not automatically going to become internationally competitive exporters, and the best domestic firms which might be able to do so fall far short of internationally realized productivity levels, and thus when exposed to sudden liberalization can face bankruptcy.

The disappointing results of economic reforms in low-income countries, and their questionable sustainability, have already prompted an international policy response to adjust the reform process. The principal elements of this response are: (i) tightening the links between aid flows and economic reform, and between debt relief and economic reform ("selectivity"); (ii) altering the design of economic reforms to ensure that they are more pro-poor; and (iii) shifting from a donor-driven to a country-owned reform process ("partnership and ownership"). The nature and potential effectiveness of these changes will be treated in more detail in the next two chapters. However, a major policy implication of this chapter is that making the existing reforms more pro-poor by changing the pattern of public expenditure and by ensuring that increased social spending is not inflationary will not get to the heart of the problem. The challenge is boldly to redesign adjustment programmes in such a way that they

will promote a sustained acceleration of economic growth to rates at which significant inroads can be made into poverty.

There are two basic policy requirements for this. First, a much more pragmatic approach needs to be adopted in the design of structural reforms. Second, adjustment programmes need to be adequately funded in ways which take account of the vulnerability of LDC economies to shocks and the social stresses which they entail.

Analysis of successful development experiences shows that sustained and accelerated economic growth is built on the development of productive capacities and international competitiveness, and on a structural transformation away from a narrowly specialized primary commodity economy. Success depends on establishing a virtuous circle between the growth of investment, exports and savings. In this process, exports support investment because they earn foreign exchange required for the import of goods and technology needed for capital accumulation and growth, while investment supports exports by providing the basis for technological change, productivity growth, increased competitiveness and structural change. As incomes and profits are raised through investment, they increasingly provide additional resources for capital accumulation (UNCTAD, 2000). Poverty reduction occurs as an integral part of the circle of cumulative causation if employment opportunities expand rapidly, although the poverty-reducing effects of growth are less in high-inequality countries than in low-inequality ones. Policy efforts are required in order to strengthen these effects by ensuring wide access to assets and by creating linkages which incorporate marginal sectors into the space of productivity growth.

The challenge is boldly to redesign adjustment programmes in such a way that they will promote a sustained acceleration of economic growth to rates at which significant inroads can be made into poverty.

It is well understood that such a sustained process of economic growth and poverty reduction is best realized by providing a greater role for market forces and private initiative. However, leaving growth to market forces without adequate attention to the shortcomings in markets, institutions and infrastructure in LDCs is not going to do the trick. A pragmatic approach to the design of structural reforms is thus required. Such an approach would seek a better balance between public action and private initiative than that mandated under ESAF reforms.

This certainly does not mean a rush back to public ownership and isolationism. However, beneficial and sustained integration into the world economy will be best achieved if growth-oriented macroeconomic policies are complemented by specific meso policies designed to increase productivity and competitiveness at the enterprise level and to improve the enabling environment for enterprise.[14] The design of these measures should take advantage of the policy leeway which countries at low levels of development have, by right, within international trade regimes (see *Least Developed Countries 1998 Report*).

The nature of these measures has been discussed in more detail elsewhere (see in particular, UNCTAD, 1998, and Griffin, 1996, for sub-Saharan Africa; and *Least Developed Countries 1999 Report*: part two, chapter 3). But it may be reiterated here that higher levels of public investment are necessary in order to rectify deficiencies in physical infrastructure, to promote educational attainment and human capital development, and to address pressing public health problems and the weaknesses of current health care service systems. Public investment is also required in order to strengthen administrative capacities so as to increase the effectiveness of the public sector. Policies which increase agricultural investment and productivity growth are particularly important in the

Box 6: Foreign aid and export promotion in Bangladesh

Two important aid projects have been launched in Bangladesh to promote and diversify exports: the Export Development Project, and the Bangladesh Export Diversification Project. These projects exemplify some of the types of special incentives which are required to promote export development in LDCs.

The Export Development Project

The Export Development Project, which lasted from 1989 to 1994, primarily consisted of a credit line of a $25 million equivalent financed by the International Development Association (IDA) to augment the Government of Bangladesh's (GOB) contribution of $5 million in an Export Development Fund (EDF) managed by the Central Bank of Bangladesh. The project also included a technical assistance component of around a $1.2 million equivalent financed by a grant from the United States Agency for International Development (USAID). The overall objectives of the project were to assist the Government's efforts to promote exports by: (i) providing a line of pre-shipment foreign exchange credit to private sector exporters, particularly to new non-traditional exporters; (ii) strengthening the export financing and guarantee elements of the credit delivery system; and (iii) addressing policy and procedural issues which constrain the active development of Bangladesh's export potential.

Overall, the project achieved many of its objectives. The first objective mentioned above was realized, to a great extent, by setting up a revolving Export Development Fund (EDF) at the Central Bank with $3 million contributed by the Government of Bangladesh and into which the entire credit proceeds of the project were added. The cumulative utilization of around $75 million from the EDF by the non-traditional exporters financed more than $150 million non-traditional exports during the four and a half year period (January 1991–June 1995). The export financing system was strengthened by the setting up of the EDF, which provided exporters in the early 1990s with the only local source of foreign currency pre-shipment financing at internationally competitive rates. The second objective was only partially achieved, as the export credit guarantee system did not work efficiently. The project's third objective has also been achieved up to a point since institutional reforms need to be expanded and deepened further. Financing from the EDF provided the exporters with import finance in foreign exchange at an international market rate (LIBOR+1%), thereby putting them on an equal footing with their foreign competitors insofar as the cost of financing imports is concerned. Procedural improvements in the Duty Drawback Scheme were also achieved since the exporters could expect to receive their drawback cheques within a week for flat rates and within a month for actual rates.

Bangladesh Export Diversification Project

On the basis of the experience of the Export Development Project, and in an attempt to promote trade-related capacity building, a three-year IDA-aided *Export Diversification Project* (BDXDP), amounting to $48 million, has been launched. The project will also receive parallel financing from the British Department for International Development (DFID). The agreement was signed between IDA and the GOB on 1 June, 1999 and the project started operation on 1 August, 1999.

The project activities of BDXDP are grouped under two broad categories: product and market development support (PMDS) activities; and trade management capacity-building (TMCB) activities. The former comprises: funding through the *Matching Grant Facility* (MGF) for exporting firms, groups of such firms, and service providers (this will involve a total of $12 million); administration and advisory services for the operation of the above MGF (this will involve a total of $3.10 million); and developing new sub-projects to strengthen selected public, private and public/private support service providers (this will involve a total of $4 million). The latter consists of: institutional capacity-building, for example, reforms in customs administration, in conjunction with the Government's proposed Revenue Administration Modernization Programme (RAMP) for providing better bonded warehousing and duty drawback and more rapid clearance.

Given the innovative features of the Matching Grant Facility, this particular component of the BDXDP project requires special attention. Under the MGF, grants are available (on a 50 per cent cost-sharing basis) to (i) exporters of goods and services to increase their international competitiveness, and (ii) local service providers to enhance their capabilities. These grants are intended to enable exporters to undertake the appropriate level of market and product development efforts needed for attaining competitiveness resulting in increased exports and profitability. The focus of this programme is to induce exporters to buy expert services for diversifying their products and markets.

The MGF is yet to complete its first year of operation. Projects approved are closer to targets for export development grants than for service development grants, and thus some improvements in the efficiency of the customer advisory team dealing with clients of the facility are warranted. However, this type of assistance programme has yielded high returns for exporters in other countries such as Argentina, India, Indonesia, Ireland, Uganda and the United Kingdom, and promising results are expected in Bangladesh as it seeks to diversify exports.

Source: Bhattacharya, 2000.

LDCs, and from the Asian experience, it is apparent that there can be a large pay-off in terms of both output growth and poverty reduction from promoting a Green Revolution in African LDCs (Mosley, 2000). But manufacturing or service sector development should not be neglected. In this regard, there is wide agreement that the spur of competition will have the desired results only if there are complementary measures which enable the improvement of technical and managerial capabilities, and special incentives and financing facilities may have to be created to develop new export activities (see box 6). In economies where markets are weakly developed, there is a strong case for targeted and time-limited fiscal and financial incentives to address specific market failures, and in particular to promote market development (Overseas Economic Cooperation Fund, 1990), as Japanese development policy analysts have been advocating for a long time. Recent work by the International Finance Corporation on a market-oriented strategy for small and medium-scale enterprises provides a theoretical case for, and limits to, subsidies for market development for the business services which form the support structure that helps build SME competitiveness (Hallberg, 2000).

It seems highly likely that the removal of the debt overhang from the official creditor-donor community is as important for successful structural adjustment and enhanced aid effectiveness as the removal of the debt overhang from the debtor countries themselves.

Pragmatic adjustment policies will not be successful unless they are adequately funded. This is a matter of the volume of external resources, how they are delivered (which will be discussed in chapter VI), and also the purposes to which resources are tied. From the evidence of this chapter, the bias towards underfinancing which results from the tension between projections of minimum resource requirements and creditor-donors' resource ceilings, together with the political impossibility of having an underfunded adjustment programme, creates misleading expectations for the public and private sectors and has worked against the effectiveness of adjustment programmes.

Finally, it is important that adequate funding of structural adjustment programmes takes account of the debt overhang and the net transfers associated with aid disbursements and debt service payments. The ways in which the interrelationship between aid disbursements and debt service payments affect aid effectiveness deserves much more research. But for now, it seems highly likely that the removal of the debt overhang from the official creditor-donor community is as important for successful structural adjustment and enhanced aid effectiveness as the removal of the debt overhang from the debtor countries themselves.

Notes

1. See UNCTAD (1989) for an overview of LDCs' experience with structural adjustment in the 1980s.
2. There is a much wider literature on structural adjustment. Particularly relevant for African LDCs are UNCTAD (1998), Griffin (1996), and Mkandawire and Soludo (1999), and for Asian LDCs, ESCAP (1990). There is also now a growing literature on ESAF reforms in academic journals; see, in particular, Green (1993); Killick (1995a); Schadler (1995); EURODAD (1998); Rivas and Morrison (1999); Collier and Gunning (1999); Comboni (1999); and Dicks-Mireaux, Decagni and Schadler (2000). Other IMF documents which evaluate the ESAF reforms are Abed et al. (1998) and Gupta et al. (2000).
3. The origins of the SAF and ESAF can be traced to the Baker Plan, announced in October 1985. This mainly dealt with the debt problems of middle-income countries, but it also included a short special section on dealing with the debt of low-income countries in SSA. Partly as a response to this, the IMF's SAF and ESAF were introduced.
4. The list of ESAF programme countries is set out in the "Status report on the follow-up to the reviews of the Enhanced Structural Adjustment Facility", 30 August, 1999 (http://www.imf.org/external/np/esaf/status/index.htm).
5. We are grateful to the IMF for furnishing this information.
6. For debt statistics in the 1990s, see chapter 2, tables 17 and 18.
7. The close relationship between ODA flows and ESAF reforms is also noted in IMF (1995). It is observed that "Within the group of low-income countries, in particular, bilateral ODA to countries pursuing IMF-supported adjustment programs grew more rapidly than to those countries without such programs. For example, the 41 ESAF-eligible countries with IMF arrangements completed between 1990 and 1993 experienced a 35 percent increase in bilateral net ODA on average from the period between 1987 and 1989 to that between 1990 and 1993 compared with an increase of 6.5 percent for ESAF-eligible countries without IMF arrangements. Some countries pursuing IMF-supported programs recorded remarkable increases in net ODA flows – for instance, Uganda completed three annual ESAF arrangements before the end of 1993 and received almost twice the level of ODA flows on average between 1990 and 1993 compared with the average for the period between 1987 and 1989" (IMF, 1995: box 14, p. 34).
8. This result also conforms to econometric analysis which shows that the presence of an ESAF programme has been found to have had no significant effect on private capital flows (Rodrik, 1995, quoted in IMF, 1998: 32).
9. For a useful discussion of growth sustainability in Africa, see ECA (1999).
10. For a case study of the juggling of the financing gap by adjusting projections to fit the available finance, see Martin (1991: 61–66). Killick (1993:10), writing specifically on IMF programmes in Africa, states that "a good many of the agreed programmes are unrealistic, fated to break down because of underfunding and shortages of foreign exchange. A former head of the key Exchange and Trade Relations Department of the IMF has stated privately that up to a third of programmes are inadequate and doomed from the start". Mistry (1996: 37) reports that "IMF/WB financing programming exercises underlying individual adjustment programmes were invariably recalibrated by making casual changes in elasticities when calculations of funding needs collided with the reality that these funds could not be mobilized", citing research in Martin and Mistry (1994; 1996).
11. UNCTAD (1998) and Helleiner (1992). One of the background studies for the IMF internal evaluation analyses, which seeks to isolate the sources for the narrowing of the growth differential between ESAF and non-ESAF countries for the period 1981–1995, finds that "over two-fifths of the narrowing in the actual growth differential over the past decade [to 1995] was attributable to improvements in macroeconomic policies" (Kochhar and Coorey, 1999: 84).
12. See Martin (1997) for a good discussion of these effects.
13. In theory, this type of aid should reduce debt service outflows and thus have equivalent effects on net transfers as aid inflows. However, grants committed to debt relief may apply to debt service payments which are not actually being made and are simply accumulating as arrears. If this occurs, grant commitments in the form of debt forgiveness do not necessarily free resources which can be used for more imports, and if these commitments substitute for forms of ODA which do increase import capacity, then the net effect can be smaller imports. Research for African countries in the early 1990s suggests that such a decline in imports did not actually occur in countries receiving this form of aid. But this was not because the mechanism described was not in operation. Rather, countries in which debt forgiveness accounts for a high proportion of grants were tending at the same time to obtain additional resources from multilateral

sources. They were thus able to finance a larger import bill "mainly because multilateral sources have made up for the decrease in new financing from bilateral sources, which in turn are partially substituting debt relief for new lending" (Hernandez and Katada, 1996: 20). Further research will be required in order to clarify whether such a mechanism continued in the late 1990s, and in non-African LDCs, but there is little reason to believe that any change occurred.

14. On the importance of meso policies, see Ocampo (1999).

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