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The IMF Stabilization Package and Pakistan's Stabilization Experience

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I. INTRODUCTION

The application of IMF stabilization packages in the less developed countries (LDCs) has always been a controversial issue. The debate on IMF stabilization packages with their strong elements of conditionality and impact on the LDCs has intensified with the re-emergence of the payments imbalances in the Seventies and early Eighties. The objective of this paper is to evaluate, very briefly, Pakistan's three-year stabilization programme under the Extended Fund Facility (EFF) arrangement for the period 1980–83.

The plan of the paper is as follows. Section II describes the IMF stabilization package under the standby arrangements and developments leading to the EFF arrangements. Section III provides a brief evaluation of the stabilization programmes. In Section IV we attempt to evaluate Pakistan's programme in terms of quantifiable macro indicators as well as supply-side variables.

II. THE IMF STABILIZATION PACKAGE

The broad objectives sought of the standard IMF stabilization package include the alleviation of persistent balance of payments deficits, elimination of exchange controls and trade restrictions, and attainment of price stability without affecting economic growth. The policy instruments generally adopted by the IMF to achieve the objective of stabilization include fiscal and monetary restraint in conjunction with exchange rate adjustment and trade liberalization.[1] The access to credit from the Fund under standby and EFF arrangements is highly conditional.[2] Strict adherence to the performance criteria determines the continuous access to successive installments of an agreed credit.

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[1] For a comprehensive analysis of the contents of the programme, the degree of importance attached to different objectives and instruments in relation to standby arrangements see Bird (1981) and Killick (1981).

[2] For the evolution of the concept of conditionality and its justification in the context of the conditions in 1970s see Bird (1981).

After the international economic crisis in the mid and late Seventies, the IMF announced a number of special financing facilities including an extension in the duration of the one-year standby arrangements to a maximum of three years, the Extended Fund Facility (EFF) in 1974 (IMF Survey, Vol. 3, No. 6 and No. 18, 1974).

Although the duration had been extended, the conditionality remained strict until 1979. In 1979, after a detailed review of the Fund's conditionality and lending policies, a set of new 'guidelines' were announced (IMF Survey Vol. 8 No. 18, 1979). It was acknowledged by the Fund that the performance criteria were usually incompatible with the domestic, social, political, and economic priorities of the authorities. Therefore, the Fund decided that it would give due consideration to these factors in the formulation of the adjustment programmes of the LDCs. However, this flexibility over performance criteria was reversed in 1981-82 and the arrangement after 1982 involved more preconditions with strong insistence on exchange rate changes, stricter performance criteria, limited or no waivers, and stress on short-term programmes.

III. EVALUATION OF THE STABILIZATION PROGRAMMES

There exists no standard measure for the assessment of the IMF programmes. Connors (1979) and Killick (1984) evaluate the outcome of the programmes by comparing the performance of three major macro-economic indicators; balance of payments, the inflation rate, and the growth rate of GDP during the programme period with the behaviour of these variables in one and two years succeeding the programme period. Overall, the two studies show that the balance of payments improved, inflation rates increased and outcome of the GDP variable was mixed. A number of studies by the Fund Staff [Donovan (1981); Killick (1984); Reichman (1978); Reichman and Stillson (1978)] and the studies for Southern Cone countries [Diaz Alejandro (1981); Felix (1981); Wells (1981)] also showed similar results with respect to balance of payments and the GDP variable. However, inflation was considerably curtailed in Southern Cone countries.

With regard to the EFF arrangements, Killick (1984) evaluates the EFF programmes by comparing their outcome with that of the standbys. Overall, he found that the EFF performed better with respect to all the three macro indicators.

IV. EVALUATION OF PAKISTAN'S THREE-YEAR PROGRAMME

In the early 1980's, Pakistan adopted a three-year EFF programme of stabilization with the objective to follow appropriate policies to deal with underlying structural rigidities and to promote sustained economic growth in order to attain both financial and balance of payments stability. We first evaluate the performance of the programme in terms of some of the macro variables which are easily quantifiable and then discuss the implementation of supply-side policies.

Control of Inflation

Statistics on the rates of inflation with respect to all the indicators of inflation shows that, by and large, the inflation rate during the programme period was kept around the target, except for the sharp acceleration in the first year. However, contrary to the Fund's assertion that this was made possible due to efficient demand management, the provision of essential commodities through imports and extensive price controls by the government played an important role in the control of inflation in Pakistan. Price controls and rationing have been a regular feature throughout, and government publications over the programme years point out this fact quite strongly.[3]

The control over prices of essential commodities through imports in the face of domestic shortages is well established by the results obtained from the tests of the structuralist model of inflation for Pakistan (Firoze 1986). These results contradict the assertion that purely demand management policies can solve the problem of inflation in the LDCs.

Credit Ceilings

Credit ceilings have been the most important performance criteria in all the programmes. While credit ceilings were observed during the first two years of the programme, in the third year as a result of good harvests, excessive credit expansion in the form of commodity financing resulted in the breach of performance criteria and evoked strong reaction from the Fund.

This outcome is a very important factor as it highlights the contradictions involved in the application of demand-restraint policies as a measure of stabilization without due consideration to structural and socio-political factors and the priorities of the governments in the LDCs. Commodity operations are undertaken to acquire output at the time of harvest both for export as well as a buffer to be used in times of bad harvests or increased demand due to any other reason. Therefore, an increase in domestic bank financing due to commodity operations is an indirect method of keeping prices under control and, also, of ensuring adequate return to the farmer in times of bumper harvests to keep the incentive for future production. In the light of these structural limitations, characteristics of the less developed agrarian economies, credit ceilings cannot be justified as a strict performance criteria without due regard to their economic structures. The Fund, despite its declaration of the 1979 Review of Guidelines, ignored the basic structural factors underlying the economy which were beyond the control of the government.

[3] See Pakistan Economic Surveys 1980-81 page XVIII, 1981-82 page XVI, and 1982-83 page 31.

Balance of Payments

The balance of payments outcome of the programme is regarded as a major success in the Fund's appraisal due to the successful achievements of the targets in the first and the third years of the programme: the adverse outcome in the second year is attributed to the developments in the international economy. However, the annual review of the programme shows that over the entire period, and even in the post-programme period, the performance of the balance of payments has been closely linked with the trends in the inflow of workers remittances and the exports of two major primary products namely rice and cotton. Exports have been strongly affected by climatic conditions, inelastic demand, protectionist policies of the advanced economies and recession. Thus, the situation with regard to the balance of payments before, during and after the programme period remained unchanged.

Money Supply

In the discussion of monetary and fiscal performance an anomoly arises with respect to the role of non-bank domestic finance and the definition of money supply. Through the programme period increased non-bank finance, which to a considerable extent comprises of private savings in the form of various government saving schemes, is an important element in keeping deficit financing from the banking sector within the target. At the same time, the Pakistan Economic Survey for 1984-85 points out that, "in recent past M3 definition of money supply in Pakistan has been redefined to include M2 plus deposits with the cooperative banks, NDFC bearer certificates and various small savings schemes, and since the government in recent years has resorted heavily to financing its deficits by recourse to non-bank borrowing therefore it is useful to examine a broader definition of monetary assets (than M2) in order to get a broader impact of budgetary operations on domestic liquidity" (Pages 74-76). If this definition is adopted it is seen that while M2 and M3 moved very closely during the first two years of the programme; in the last year (1982-83) M3 showed an increase of 32 percent compared to 26 percent for M2. In the following two years the decline in money supply as measured by M3 is less than M2, which remained constant at 11.8 percent during 1983-84 and 1984-85 (Pakistan Economic Survey, 1984-85 p. 75). However, for the programme period and in the following two years, increases in the money supply on government account are represented by M2 which is an underestimation of monetary growth in the light of the argument of the Pakistan Economic Survey (1984-85) discussed above.

Supply-side Policies

On the supply side under the policy of cost-price rationalization price increases were administered regularly in the agriculture and energy sectors. It is maintained by the Fund that at the end of the programme period, prices of four major crops had been increased by about 17–52 percent. However, prices for wheat, rice and cotton remained significantly below world prices during and after the programme period, while prices for sugar were significantly above world prices over the period (see Pakistan Economic Survey 1984-85 Annex Table 3.17). This was so because these commodities represented the bulk of the budget for low-income groups and despite the Fund's insistence it was not possible, politically, to carry out this policy as outlined.

With regard to the elimination of subsidies, the total subsidy bill decreased rapidly by 23 and 19 percent in the first two years respectively but increased by 10 percent in the final year of the programme despite complete elimination of the subsidy on edible oil and on petroleum products since 1981-82. Furthermore, in 1983-84 the subsidy on edible oils was reintroduced and it amounted to Rs 1 million and 942 million in 1983-84 and 1984-85 respectively. The total subsidy bill over the two years increased by 56 and 25 percent. Again, this outcome reflects the fact that the socio-political costs of continuous price increases and withdrawal of subsidies, which had been ignored in the formulation of the performance criteria, could not be ignored for long by the government as the bulk of the subsidies were aimed at the lower income groups and elections were to be held in late 1984 and early 1985.

In the field of industrial development, emphasis on privatisation has been a basic policy focus of the IMF. However, during the programme period the response of the private sector, despite massive incentives, was below expectations. The Fund has claimed that the government has been slow in the implementation of structural reforms and other financial incentives to attract the private sector to invest in the large-scale manufacturing sector. However, this claim does not carry much conviction because private sector investment in the large-scale manufacturing sector since the early 1970's has been very strongly affected by political uncertainty. It has continued increasingly to shift to small-scale manufacturing which is highly profitable, yields quick returns and does not face a nationalization threat. Therefore, the large-scale manufacturing sector, especially with the banks still retained in the public sector, does not appear to hold much attraction for the private sector despite the introduction of various incentive schemes.

Finally, the main criteria for obtaining the Fund's credit are import liberalization and the lowering of tariff barriers. The underlying assumption behind import liberalization is that the increased availability of imports would provide crucial inputs-raw materials and capital goods-required by the local industry so that exports can be increased to ease the dependence on foreign capital for balance of payments purposes. The experience of Pakistan shows that the balance of payments performance has been more strongly linked with the inflow of remittances. After 1974-75 the value of imports increased at more than twice the rate of increase in export earnings, made possible mainly by increased availability of foreign exchange through remittances. Secondly, in general while the LDCs under the programme are pressurised to open their markets, reduce trade barriers and increase exports at any cost, the developed countries continue to impose greater restrictions on the exports from LDCs. The liberalization of trade cannot be possible without a change in the policies of the developed countries.

V. CONCLUSIONS AND POLICY IMPLICATIONS

The evaluation of the three-year programme shows that the application of short-term policies to the long-term adjustment problems resulted in a number of policy conflicts. The factors behind the sharp acceleration of credit and money supply show that the policy of credit restraint is in direct conflict with the objective of stabilization of prices in a less developed economy even when its output constraint is overcome in any period.

Similarly, the objective of improving the balance of payments by encouraging exports remained unfulfilled; firstly because exports continued to rely on two primary products subject to climatic conditions and the strong protectionist policies of the industrialized countries. Secondly, the inflow of remittances from workers abroad eased the flow of imports and at the same time the easy access to foreign exchange without repayment considerations led to the neglect of the development of manufactured exports as the reliable source of assured foreign exchange earnings in the long term.

Despite the experience of the 1960s that a policy of industrial development based on massive incentives when pursued too far becomes counter-productive, the repetition of this strategy of growth under the three year programme on a still more wider scale, especially in the light of an highly adverse international economic environment and the neglect of an unstable domestic political situation failed to achieve substantial results.

The most important element involves the control of domestic credit and money supply. The experience of Pakistan under the stabilization programme shows that a flexible policy of domestic credit control and money supply would be more appropriate as a measure of controlling inflation in the light of domestic output constraint which is highly dependent on climatic conditions. In extreme situations like that experienced during the third year of the stabilization programme, sharp and untimely vigorous controls would worsen the inflationary situation and accentuate the underlying constraint at a time when it should actually be controlled. This implies that the application of short-term stabilization policies to the control of inflation and correction of other inherent structural constraints tends to accentuate the key bottlenecks in the long run.

The problem of development in the LDCs is socio-political rather than purely economic and, therefore, requires political will to resist policies visibly in conflict with their economic structures. Socio-political factors should not be treated as "sensitive" in the field of economic research. Rather, socio-political and sociological perspectives to economic problems in the LDCs should be highlighted. This would help to clarify the true dimensions of the problem and the nature of policy implications which would facilitate the process of identification and elimination of bottlenecks.

Furthermore, the analysis suggests strongly the need to direct efforts towards the design of alternative stabilization programmes on the basis of given economic structures in which the conventional measures of the control of government credit and expenditures do not tend to offset the policies aimed at the control of inflation. The stabilization programmes based on the assumptions underlying the highly developed economic structures are generally not suitable for the less developed economic structures of the LDCs.

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