WHY DEFICITS GROW.

A CRITICAL DISCUSSION OF THE IMPACT OF STRUCTURAL ADJUSTMENT LENDING ON THE EXTERNAL ACCOUNT IN LOW-INCOME COUNTRIES

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Why Deficits Grow. A Critical Discussion of the Impact of Structural Adjustment Lending on the External Account in Low-Income Countries

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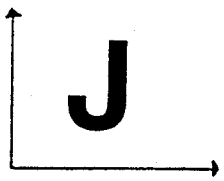
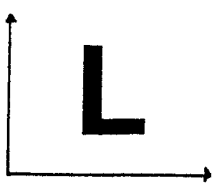
Introduction

To assess the effects of structural adjustment programmes is a tempting business for economists, as almost anything can be proved. With the help of some anecdotal evidence, an unfair selection of case studies and some statistical gangsterism, of which the present paper is a modest example, many different things can be "proved". There is no shortage of failures, and while "success stories" are relatively scarce, they are exploited to a maximum.

According to conventional wisdom, economies undergoing structural adjustment programmes sponsored by IMF and the World Bank tend to display a characteristic J-curve, popularly known as "short-term pain for long-term gain":

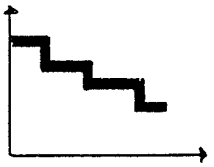


In actual practice, however, very few normal looking J-s - that is, countries experiencing a genuine transition according to the projected sequencing: crisis, stabilisation, structural adjustment, and sustained growth - have been observed. We have, on the other hand, a large number of curves which have more in common with other letters; the most typical one probably being L, symbolising short-term pain for long-term stagnation:



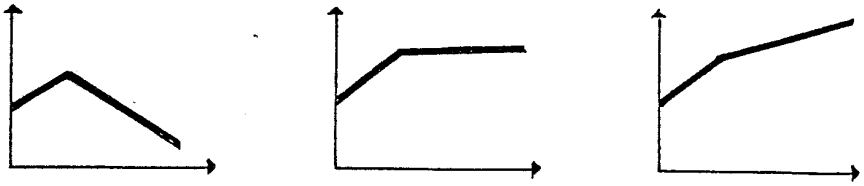
In some of the the former Soviet republics, the curve looks rather like the slash symbol:

Or, in cases such as Zambia or Nicaragua, where the road to disaster has been of the type "long-term stagnation interrupted by drastic declines", a staircase is most most appropriate symbol:



In recent years, a new pattern has become increasingly common in connection with structural adjustment programmes. In the name of providing "incentive goods", and to ease the social burden of adjustment, multilateral and bilateral agencies today often finance massive imports of both consumer goods and intermediate and capital goods with soft loans and balance of payments support. As a result of the substantial increase in aid, loans and debt relief in the wake of the signing of an agreement with the Bretton Woods Institutions, we sometimes get short-term gain for long-term pain (a) or, in milder cases, short-term gain for long-term stagnation (b). Occasional cases of immediate recovery followed by growth have, however, also been observed (c):

(a) (b) (c)



The differences in results observed from structural adjustment programmes may appear surprising, in view of the fact that the programmes have the same tutors, and have many elements in common. One explanation could be that political factors - which in the design of the programmes are treated as unfortunate, exogenous circumstances, almost like earthquakes - often make the programmes lack, or lose, credibility. Some governments and people genuinely want the programmes to be implemented, others do not; the problem of "ownership" of the programmes. "He who is convinced against his will is not convinced at all", as the saying goes.[1]

Another reason could be, as Douglass North has suggested[2], that "neoclassical theory is simply an inappropriate tool to analyze and prescribe policies that will induce development. It is concerned with the operation of markets, not with how markets develop."

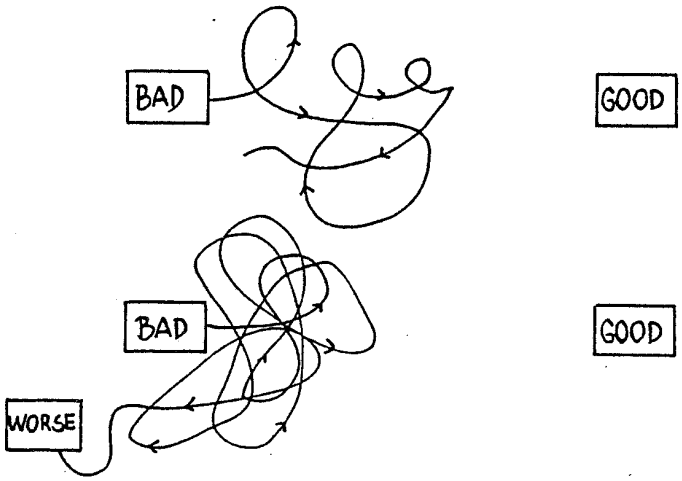
To modify North's statement somewhat, it could be argued that economic theory is good at making comparisons between two situations, or equilibria, but much worse at analysing processes of change. Any undergraduate student of economics can probably say that a particular situation ("good"), characterised by macroeconomic stability and non-distorted prices, is superior to another situation ("bad") with large macroeconomic disequilibria and severely distorted prices. "Good" is clearly better than "bad". However, the transition from "bad" to "good" is more difficult to analyse with neoclassical theory - involving, as it does, a large number of political, social, cultural and institutional factors which embarrass the models. Instead of a comfortable journey from "bad" to "good" (a), the transition may rather look like (b) below. As known from, among others, the former Soviet Republics, the transition can even look like a loop, where the expected journey from "bad" to "good" instead takes the country from "bad" to "worse" (c):

(a)

[1] Or, to quote Machiavelli: "Here is an infallible rule: a prince who is not himself wise cannot be well advised...Good advice, whomever it comes from, depends on the shrewdness of the prince who seeks it." Quoted by The Economist (January 15th 1994) - in a completely different context (the role of John Major's key advisers).

[2] Economic Performance through Time, Prize Lecture in Economic Science in Memory of Alfred Nobel, Stockholm, December 1993, mimeo, the Nobel Foundation, Stockholm 1993.

(b)



c)

Interesting as the analysis of these transitions may be, the purpose of this paper is more limited in scope, namely to discuss one particular aspect of structural adjustment programmes: their effects upon the external account. To judge from available data, an increase in external deficits - accompanied by an increase in the debt/exports ratio and an increase in the aid/GNP ratio - appears to be one of the few relatively robust observations that can be made about the impact of structural adjustment programmes. Also, data indicates that - contrary to the explicit objective of structural adjustment lending - there is a pronounced tendency to reward bad performance with increased flows of aid and loans, and to punish successful policies.

The paper begins with an introductory discussion about the macroeconomics of policy-related aid. I then turn to the main topics of the paper, which are related to the effects of structural adjustment programmes on the external account in low-income countries. This discussion is summarised under two separate, but closely interrelated, headings: aid and international competitiveness, and the soft budget constraint and perverse incentive structure of structural adjustment and debt relief negotiations.

It should be stressed that I do not attempt to discuss the impact of structural adjustment lending on variables not directly related to the

external sector (inflation, rate of growth, fiscal deficit, privatisation of state enterprises, etc.).

It may also be added that I will not question the need for external adjustment - or for appropriate foreign aid - in the vast majority of low-income countries. Indeed, the point of departure can be said to be a recognition of the alarming trend towards deteriorating external accounts and loss of international competitiveness in a large number of low-income countries, in particular in Sub-Saharan Africa. Something must be done, and aid has a role to play. What I do question is that the programmes implemented under the supervision of the IMF and the World Bank actually meet their own objective of reducing external imbalances.

1. The Macroeconomics of Policy-related Aid: A Brief Overview

Evaluation techniques at the micro level have been elaborated and applied extensively since the early years of development aid. Virtually all donors use, at least occasionally, some kind of cost benefit analysis in their feasibility studies and project evaluations, and from a methodological point of view, there exists a rather broad consensus among professional economists and aid officials as regards the issues involved, and the techniques to apply.

At the macro level, this is not the case. Although the analyses of the impact of development aid were originally developed in a macroeonomic framwork, it was not until the 1980s that macroeconomic analysis - and macroeconomic conditionality - came back to the forefront both in the theory and practice of development aid. But despite all the attention paid to macroeconomics among aid donors during the past twelve years, it must be recognised that our knowledge is still very limited.[3]

Another caveat should be made. Until recently, most analyses of the macroeconomic impact of aid were largely confined to the macroeconomic impact

[3] A useful and well-researched overview of the evolution of macroeconomic thinking about foreign aid, and of available empirical evidence on the macroeconomic impact of aid, is found in White (1992).

of aid, while disregarding the effects of the conditions to which the aid was linked. This may have been legitimate in the past, when macroeconomic conditionality played a subordinate role, but today, a large part of the discussion about the effects of aid deals with the broader issue, i.e. how policy-related assistance [4] can serve to influence domestic economic policies in a desired direction.

The practice of linking development assistance to policy changes in the recipient countries has intensified drastically since the early 1980s. Much of today's policy-related assistance is directed by the IMF and the World Bank (hereafter called IFIs - International Financial Institutions) in connection with structural adjustment programmes, and bilateral donors are, to an increasing extent, coordinating their non-project aid with such programmes. In Sweden, for example, an explicit objective of Swedish balance of payments support - including debt relief and import support - is currently to support structural adjustment in the recipient countries.[5]

Any serious attempt to analyse the impact of policy-related aid must therefore consider the impact of such aid on the recipient countries' economic policies, rather than merely the direct impact on a number of economic variables. The line of causation would, then, not be the traditional

aid => effects on investment, growth, balance of payments, income distribution, etc

but rather

aid plus conditionality => changes in economic policies => effects on investment, growth, exports, etc

or

aid plus conditionality => structural adjustment => effects on investment, growth, exports, etc.

No easy task, indeed. Still, an attempt will be made in subsequent chapters to address a few of these issues, with emphasis on effects of foreign aid and structural adjustment lending on the external account. But first, the

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[4] "Policy-related aid" is, in this paper, used synonymously with "programme aid", and denotes non-project aid, such as commodity support, balance of payments support, debt relief, and other forms of aid which today tend to be connected with macroeconomic conditionality, or at least have a macroeconomic rationale.

[5] Indeed, according to Sweden's new guidelines for import support, Swedish balance of payments support can only be extended to countries which have a structural adjustment programme approved by the IFIs.

conventional "gap approach" to the analysis of the macoeconomic impact of aid will be presented.

Foreign Aid and Gap Theories

The early discussions about development aid concentrated on its effects on economic growth. They were generally based on more or less sophisticated gap theories, largely developed on growth models of the Harrod-Domar kind, which mushroomed in the late 1950s and early 1960s.

In its simplest version, the rate of economic growth in such a model is determined by a fixed incremental capital-output ratio (ICOR) and a fixed domestic savings ratio, which together determine the rate of growth. Foreign aid in these textbook models enters as a simple addition to domestic savings. With a given ICOR, the effects of aid are identical to an increase in the domestic savings ratio, enabling higher investment and growth.

The "dual gap" theories, developed by Hollis Chenery and others in the early 1960s, concentrated on the existence of both a "savings gap" and a "foreign exchange gap". Domestic savings could be supplemented with foreign aid, as in the Harrod/Domar models, and by directing aid to new investment, the recipient country's investment ratio, and hence rate of economic growth, could be increased. If, however, the foreign exchange restriction was binding, the provision of foreign exchange through development aid could be expected to have an even larger positive impact in the recipient country, since aid in this case would allow domestic capital to be used more efficiently (the assumption being that some domestic capital would be redundant in the absence of imports of essential machinery, equipment, spare parts, etc.).

Ideally, foreign aid could both raise the nominator in the Harrod/Domar growth equations - the investment ratio - and lower the denominator, i.e. the capital-output ratio.

Dual gaps of the kind briefly described above still play an important role in current views on the effects of aid, in particular of balance of payments related aid when it is more or less explicitly assumed that the foreign exchange constraint is more binding than the domestic savings constraint.

Gap analyses of various kinds still play an important role. For example, in debt renegotiations in the Paris Club, or at meetings with the World Bank-chaired aid-coordinating Consultative Group in Paris or in connection with IMF-supported structural adjustment programmes, the dominant technique to assess how much balance of payments support and/or debt relief a particular

country "needs" is still largely based on the gap analysis developed in the 1950s. As will be discussed in Chapter 3 below, this technique entails a serious danger of creating a distorted incentive structure for the recipient country: a large and growing "financing gap" due to, for example, macroeconomic mismanagement, obviously requires larger amounts of foreign aid than more prudent behaviour.

The apparent lack of any firm empirical support for the gap theories, linking aid, investment and growth, has puzzled many observers. White (1992), for example, discusses what he labels the "micro-macro paradox": while a large number of studies, evaluations, etc. do indicate that aid performs reasonably well at the micro level, it is far more difficult to assess its macroeconomic impact.[6]

Causality is, of course, difficult in any attempt to measure the effects of aid. For example, a negative correlation between aid and growth need not imply that aid is bad for growth; the explanation could simply be that countries which are facing protracted economic difficulties receive more aid than countries that are doing fine, and that the situation in the former group of countries would be even worse in the absence of aid.

Another complication in an analysis of the macroeconomic impact of aid is that aid (outside Sub-Saharan Africa and a handful of other countries) constitutes such a marginal proportion of savings and investment that its effects on the recipient country's economy are lost in the general macroeconomic turmoil. For example, to make an econometric study of the impact of aid during the turbulent 1980s - characterised by, among other things, external shocks in the form of declining terms of trade for the majority of low-income countries, rising interest rates, loss of access to commercial borrowing, rampant inflation, etc. - by using time series data would probably, in most countries, capture the effects of a large number of external factors other than aid, as well as the effects of domestic policy reforms.

The large increase in aid dependency that has been observed in recent years in countries undergoing structural adjustment makes testing easier today, however. In Sub-Saharan Africa, the aid/exports ratio is today close to fifty per cent, and development aid accounts for well over ten per cent of GDP. Clearly, the impact of aid is far from marginal in these countries, and the fact that there appears to be a pronounced negative relationship in Sub-

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[6] [6] White's own conclusion is quite agnostic: "The answer (to the "micro-macro paradox") is we are not in position to say what aid does at the macro level, so there is no basis for saying that there is a paradox...We simply do not know how aid is affecting economies at the macro level." The reader who believes that White is right can stop reading here.

Saharan Africa between international competitiveness and aid dependence (see chapter 2 below), and between "good performance" and aid (see chapter 3 below), does indicate that there may be something fundamentally wrong with the incentive structure surrounding structural adjustment lending.

Gap Theories and Aid: Some Criticism

As for the theoretical foundations of various gap theories, it falls beyond the scope of this paper to make even a brief review of all the different issues involved. Still, a few critical aspects should be mentioned in this context.

One common form of criticism is the fact that gap theories tend to overestimate the role of capital formation in the development process. The link between investment and growth is far from mechanical, and the effects on economic growth of an increase by a few percentage points in the gross investment ratio should not be exaggerated. There is, today, a pronounced tendency among development economists to put more emphasis on "soft-ware" - human capital, institutions, accountability, credibility, "good governance", policy environment, legal framework and contract enforcement, property rights, transaction costs, "learning by doing", rate of technological adaptation, etc. - at the expense of "hard-ware" more easily captured in investment ratios.

If we return to the simple Harrod/Domar growth models, we could, somewhat simplistically, argue that modern development theory puts more emphasis on the factors affecting the efficiency of investment, i.e. the determinants of the capital-output ratio, than on the size of the investment ratio (although "good governance" etc. is also expected to exert a positive influence on the volume of savings and investment, of course). For example, a number of countries, such as Guinea-Bissau and Mozambique, have, for a number of years, had some of the highest investment ratios in the developing world, without achieving much growth. Since there are, on the other hand, few if any countries which have managed to combine a low rate of investment with a high rate of economic growth over a longer period of time, we may tentatively conclude that a high rate of investment is a necessary, albeit far from sufficient, condition for rapid economic growth.

Another criticism of gap theories, going back to the 1960s, is that gap theories tend to regard foreign aid as fully additional to domestic savings and investment. This, however, need not be the case. Foreign aid is highly fungible at the macro level, and can be used to increase either investment or consumption, or both. An inflow of aid may, for example, enable the recipient

country's government to lower taxes, reduce domestic borrowing, or increase current expenditures.

One corollary to this observation is that aid may replace, rather than supplement, some domestic savings, and weaken the country's own resource mobilisation effort.

Another weakness of dual gap theories is that they are based on an implicit notion of developing countries as being unable to increase the production of tradables sufficiently to overcome the external constraint. Indeed, one cornerstone of conventional Bretton Woods analysis in connection with structural adjustment programmes is that all countries undergoing such programmes have a binding foreign exchange constraint. Although seldom stated explicitly, imports always tend to be regarded as complementary, rather than competitive, vis-a-vis the domestic economy, and more imports are always better than less.

Theoretically, the argument that the foreign exchange constraint is binding is tantamount to saying that structural rigidities in the domestic economy make it impossible to substitute domestic for imported inputs into the production of investment goods.[7] While there is much truth in such a statement at the micro level - there are, for example, many capital goods that simply cannot be produced domestically in Guinea-Bissau today - it is also true that gap theories do imply a very pessimistic view about substitution mechanisms in developing countries. A foreign exchange gap can be said to reflect insufficient domestic production of tradables, not of a particular kind of commodity, and from the proposition that a poor country is unable to produce, say, certain sophisticated machinery does not follow that it cannot expand the production of tradables in general in order to ease the foreign exchange constraint.

With perfect substitution between tradables and non-tradables, the foreign exchange gap vanishes in the air. Or, rather: it is reduced to a trivial gap between domestic savings and investment or - which is the same thing - between domestic production and expenditure.

2. Aid, Structural Adjustment and the External Account

2.1 Aid and International Competitiveness[8]

[7] For an early and convincing critique against dual gap models, see Findlay (1973, Ch. 10).

[8] This section is largely based on de Vylder (1992).

Aid can, as discussed above, displace domestic savings. It can also displace foreign exchange earnings.

This may, in fact, be one of the most serious dangers of foreign aid. A number of theoretical and empirical observations seem to confirm the following blunt statements by Sweder van Wijnbergen: "From the export promotion point of view, aid has been a failure." (1985, p. 1) and "Aid, even when temporary, permanently worsens export performance, unless proper policy measures are taken." (1985, p. 10).

There are a number of different mechanisms to consider in this context. To begin with, there is a "policy effect": an inflow of foreign aid may allow a government to continue with erroneous policies, for example in the form of discrimination of exports. Since aid lessens the need for foreign exchange from other sources, it may reduce the government's export promotion incentives, and encourage a more inward-looking - and, presumably, less efficient - development strategy than would have been pursued in the absence of aid.

Further implications of this "soft budget constraint" on the external account will be discussed in a following chapter. Suffice it here to stress that from a policy point of view, a quite natural way to react to a large offer of foreign exchange - for example, in connection with a structural adjustment programme - is to import, rather than export, more than before.

In a similar way, it can be questioned whether the provision of additional foreign exchange is the most appropriate means of reducing the size of the external deficit. A reduction of the external deficit, usually interpreted as the current account deficit, is always a key objective of structural adjustment programmes; indeed, it is often mentioned as the single most important objective.[9] However, the mechanism behind current account deficits in many low-income countries can best be described as the tail wagging the dog. The current account deficit should not be regarded as endogenously

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[9] As an example of how the external objective is handled in policy documents, the following quotations may indicate the official IFI view: "These programs...aim at establishing a viable balance of payments position, to help meet external obligations in an orderly and timely manner...In all cases, programs were designed to achieve substantial progress towards external viability during the three-year period of the SAF arrangements." Michael W. Bell and Robert L. Sheehy, Helping Structural Adjustment in Low-Income Countries, in Finance & Development, December 1987. Or: "The explicit objectives of the ESAF are to promote external viability and higher output in a balanced manner by reducing domestic and external imbalances..." Schadler/Rozwadowski/Tiwari/Robinson, Economic Adjustment in Low-Income Countries. Experience Under the Enhanced Structural Adjustment Facility, IMF, Washington DC, September 1993.

determined; it is rather the amount of external finance available that allows a particular country to run a current account deficit, the size of which is decided abroad, after lengthy negotiations with the IFIs, bilateral donors and foreign creditors. The short-term effect of additional flows of aid and loans in the wake of the signing of a structural adjustment agreement is, almost by definition, to increase the current account deficit; only in a medium to long-term scenario, which is highly uncertain, can the additional flows of aid help to reduce the current account deficit through, hopefully, its positive effects on productivity and growth.

The paradox of the messages given by the IFIs and donor agencies - "If you promise to reduce your current account deficit, we will give you enough money to allow you to increase it" - has not been lost on low-income country governments. The question is: what counts most - the words ("conditionality"), or the money? The IFIs believe that it is the words, but facts tell a slightly different story.

We will return to the policy effects of large flows of aid and loans in a subsequent chapter, when the soft budget constraint and perverse incentive structure surrounding structural adjustment lending are discussed. Let us now turn to the price effect, i.e. the impact of aid on the recipient country's relative prices.

The disincentive effect of aid on export performance works, in this case, through the impact of aid on the recipient country's real rate of exchange. Ceteris paribus, it can be expected that an inflow of foreign aid will put upward pressure on the real rate of exchange, and this simple hypothesis, based on common sense, appears to be verified empirically.[10]

At root is the famous "Dutch disease" problem, originally used to describe the impact on the Dutch economy of the drastic increase in export revenues that followed upon the exploitation of natural gas in the North Sea. With strong export revenues from gas, the Dutch guilden appreciated against other currencies, exposing Dutch industries and agriculture to more intense competition from abroad.

In developing countries, similar effects have often been observed as a result of a sudden increase in the availability of foreign exchange due to, for example, a boom in export prices, or increased foreign borrowing. The inflow of "coca-dollars" in a country like Bolivia has given rise to an

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[10] van Wijnbergen concludes, on the basis of an econometric test of aid and real exchanges rates in a number of African countries, that "the results strongly support the theoretical prediction that increases in the real volume of aid cause real appreciation" (op.cit., p. 15). For a further discussion of empirical findings, see White (1992).

overvaluation of the currency to a level which has eroded the competitiveness of tradables other than coca.

In extreme cases, such as a number of oil-exporting countries in the late 1970s and early 1980s, favorable terms of trade coincided with easy access to foreign loans, causing a real appreciation of the domestic currencies, and loss of international competitiveness in the tradables sectors. Naturally, it can always be argued that wrong policies, rather than high export earnings and easy access to foreign borrowing, should be blamed; the point to be made, however, is that "good times" may greatly facilitate the implementation of very bad policies.[11]

There are, of course, cases when the "Dutch disease" does not need any particular remedies. If, for example, a "booming sector" is expected to continue to boom there is no need to prescribe any medicine.

Let us assume that a country develops a completely new industry with good long-term prospects on the world market. A gradual appreciation of the real rate of exchange can then be both reasonable and desirable. The fact that wages are pushed upwards in the booming sector is necessary in order to attract labour from the stagnating to the expanding sectors. Similarly, a gradual appreciation may be necessary if a a combination of productivity increases and a low rate of inflation makes unit costs of production fall, relative to major trading partners.

What may initially appear as a "Dutch disease" may not, in short, have to be a disease at all, but a desirable structural adjustment.

The serious "Dutch disease", however, refers to other situations, usually of a temporary character, i.e. a sudden improvement of export prices (which can be expected to drop again), unusually good access to foreign credit (which will eventually have to be paid back) or an increase in foreign aid and concessional loans in connection with a structural adjustment programme (which may end in strangulation of the external sector when the IMF and the "donor community" realise that things are going much worse than expected, and therefore refuse, for a while, to disburse the second tranche of an ESAF, and the expected balance of payments support from the otherwise nice and friendly bilaterals is postponed). In these cases, it is necessary to neutralise the effects on the exchange rate that the positive external shock would otherwise have induced.

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[11] Indeed, one lesson from the 1970s and 1980s should be that "good times" can be at least as dangerous as "bad times", and that it is difficult to neutralise the effects - on the exchange rate, on state expenditure, etc. - of a sudden increase in foreign exchange and government revenue.

To return to foreign aid, we may observe that aid - in particular aid of the kind usually accompanying structural adjustment programmes, i.e. highly fungible, more or less untied balance of payments support - can have similar, "Dutch disease" effects. In addition to the usual commodity cycles, developing countries may easily suffer from "credit cycles" or "aid cycles". As a result of the increased supply of foreign exchange thanks to aid, the domestic currency can either appreciate in nominal terms or, if there is inflation, depreciate less, in nominal terms, than is warranted by the difference between the domestic and international rate of inflation.

Aid can also, through its indirect effects, put an upward pressure on domestic costs, thereby making the real rate of exchange appreciate.

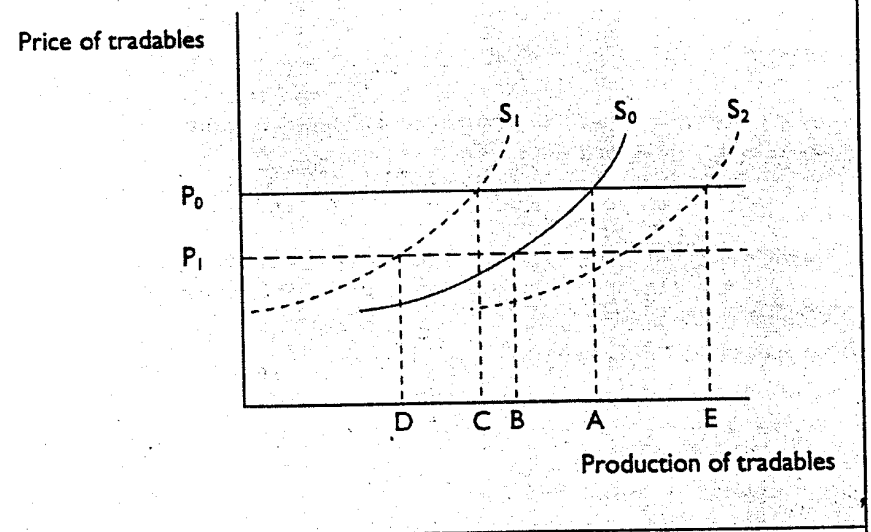
Project aid, which competes for scarce human and other resources, often contributes to the creation of inflationary bottlenecks. In particular, aid donors' fierce competition for skilled labour has, in many low-income countries, pushed up real wages for certain categories of professionals to such a level that activities which lack foreign financing often find it impossible to compete for skilled labour.

However, the inflationary effects of foreign aid may be mitigated by the inflow of foreign commodities purchased with foreign aid. Food aid, for example, and aid that increases the supply of commodities in general and/or eases supply bottlenecks in the economy, can be assumed to have a deflationary impact which may, or may not, exceed the upward pressure on the real rate of exchange which results from the aid.

Aid which increases overall productivity in the traded goods sector - for example, investments in physical infrastructure which decrease costs for producers of tradables, or technical assistance to key institutions which reduces transaction costs in the economy - serves to improve the international competitiveness, i.e. to increase the supply of traded goods at any given price (determined by world market prices, if the country is a price taker). Aid which raises the overall productivity can therefore be understood both in terms of a decrease of the ICOR in a Harrod/Domar growth model and in terms of a depreciation of the real rate of exchange, adjusted for productivity growth.

Figure 1 below is an attempt to capture these different effects of aid on the recipient country's international competitiveness:

Figure 1. The effect of foreign aid.



P = a given world market price (expressed in domestic currency) of tradables.
S = aggregate supply curves for tradables.

If an increase in aid leads to a nominal appreciation, domestic prices of tradables are shown by P 1, and production of tradables declines from A to B. If the impact of aid is to increase costs of production, output declines from A to C. If both effects are present, and reinforce each other, the combined effect of foreign aid is to reduce the production of tradables from A to D.

If, on the other hand, aid raises productivity in the traded goods sector - for example, by lowering transport costs, raising the educational level, improving the postal service, providing extension services to small farmers, etc. - the result will be a shift to the right of the supply curve, and production of tradables will increase from A to E.

The net effects of foreign aid on a recipient country's international competitiveness and production of tradables cannot be assessed without empirical studies, of which there are very few. Figure 1 above cannot be used to draw unequivocal conclusions - only to indicate some of the different, and often contradictory, mechanisms involved. Still, both common sense and a wealth of theoretical and empirical studies on "Dutch disease" problems in other contexts do suggest that there is good reason to be aware of the dangers of an aid-induced real appreciation of the rate of exchange in countries where foreign aid plays an important role - as it does in most of Sub-Saharan Africa, which today has reached an aid/GDP ratio of over ten per cent, on average.

Structural Adjustment and International Competitiveness: What does the Data Say?

As emphasised earlier, an important objective behind structural adjustment programmes is to reduce external deficits. Naturally, in the majority of low-income countries it is not a question of eliminating the deficits in the short-term; they should, however, be reduced and stabilised at manageable, or sustainable, levels.

There are few serious studies analysing the impact of aid on export performance; those referred to earlier by van Wijnbergen (1985) are somewhat old, but they do indicate a negative relationship. In what follows, I will use the standard IMF and World Bank methodology, based on "stylised facts" and simple comparisons.

But before proceeding to the presentation of the data, a few caveats should be made. To begin with, the data will basically be taken from Africa, and the vast majority of all African countries have, in the 1980s, had structural adjustment agreements with the IFIs. The few that have not are either relatively good performers (Tunisia, Botswana, Lesotho, Namibia and Swaziland, and possibly a few more) or the exact opposite (Liberia, Angola, Sudan and perhaps a few others). All other countries have had IFI agreements, although many of them have been discontinued, sometimes resumed after a few years. It is, for this and other reasons, difficult to make comparisons between "adjusting" and "non-adjusting" countries. Indeed, structural adjustment programmes have influenced African policy-making - even in countries without formal agreements - to such an extent that they have had a large impact on major macroeconomic trends on the entire continent. Since the sample of African countries without IFI agreements is so small and atypical it is, however, difficult to use it for comparative purposes in a meaningful way; there are no "normal" non-adjusting countries.

Another obvious problem is the well-known difficulty in distinguishing whether it is structural adjustment, or the additional flows of aid accompanying structural adjustment, that has produced a certain outcome. All that can be said about this problem is that it is about as old as economics; correlation does not say anything about causation. I have no good answer, and as indicated earlier, this paper will not apply any sophisticated methodology; I will simply try to follow the IFI's own footsteps.

In a recent evaluation of 19 low-income countries' experience with ESAF undertaken by the IMF, a number of indicators are provided to shed light on the development of the external account as a consequence of structural

adjustment.[12] Despite the ambition to underline the great success of the programmes, and the somewhat misleading heading of the chapter where the results are presented - "External and Domestic Performance: Progress Toward External Viability and Sustained Growth" - there is little in the data that supports an optimistic view of the impact of structural adjustment on external viability.[13]

Table 1 below summarises the data used in the IMF study to illustrate progress on the external account:

Table 1. Performance Indicators in 19 Low-income Countries with SAF/ESAF Programmes (annual averages in per cent)

	Pre-SAF or Pre-ESAF	Most Recent Year
Current Account/GDP	- 12.3 %	- 16.8 %
External Debt to Exports	451 %	482 %
Export Volume Growth	2.2 %	7.9 %
Official Grants as % of Exports	23 %	27 %

I fail to see how these figures could indicate progress on the external account, except in the trivial but misleading sense that foreign aid has increased after the SAF/ESAF agreements. While export growth - measured in one single year - is encouraging, the increase in current account deficits and in the debt to exports ratio may signal serious long-term problems; sustainability appears weak. To make things worse, a simple comparison between the average increase in export earnings in the fifteen sub-Saharan countries included in the above-mentioned study and the average for Africa as a whole actually reveals that the SAF/ESAF countries' performance between 1987 and 1991 was marginally worse than for the rest of the African countries, while net transfers from abroad were substantially higher:

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[12] Schadler/Rozwadowski/Tiwari/Robinson, op.cit., 1993

[13] As is often the case with IFI evaluations of adjustment programmes, there is a pronounced lack of consistency between the bright and optimistic phrasing of the findings and the actual figures.

Table 2. Africa. Percentage Change in Export Earnings between 1987 and 1991 and Net Transfers as Percentage of GDP, average 1987-91.

	% Increase in Exp. 1987-1991	Net Transfers % of GNP 1987-91
SAF/ESAF Countries Included in Above-mentioned IMF Study (15)	20.0 %	15.6 %
All other African Countries (32)	22.0 %	10.1 %

Source: All data based on World Bank, World Debt Tables 1992-93. For some countries, data from 1990 has been used. Unfortunately, I have not had access to data on export volumes.
Note: "Net transfers", as defined in World Debt Tables, are net flows of aid, loans and direct foreign investment minus total debt service payments.

If we make a few other comparisons, of the imports/exports ratio and a couple of debt indicators, the following picture emerges:

Table 3. Africa. Ratio of Imports (M) of Goods and Services to Exports (X) of Goods and Services, Debt/Export Ratio and Multilateral Debt (MD) as per cent of Total External Debt (TED) 1986 and 1991.

	M/X		Debt/X		MD/TED	
	1986	1991	1986	1991	1986	1991
15 SAF/ESAF Countries	158 %	186 %	422 %	521 %	31.2 %	42.4 %
32 other Countries	184 %	183 %	448 %	565 %	26.6 %	33.0 %

Source: Based on World Bank, World Debt Tables 1992-93. In a small number of countries, data from 1990 has been used.
Note: All SAF/ESAF countries did not sign the agreements in 1986; some did in 1987, 1988 or 1989. Still, I have maintained the comparison between 1986 and 1991, in order to make the global comparison easier.
Note: As is usually the case when official debt data is presented, debt to the IMF is excluded.

The table does indicate a deteriorating external account all over Africa. The M/X ratio - interpreted as a proxy for international competitiveness[14] - has deteriorated in the SAF/ESAF countries, but remained virtually constant in

[14] Or, if the tail (aid) is wagging at least one of the dogs (imports), the M/X ratio may, to a large extent, simply capture changes in import capacity as a result of fluctuations in foreign aid.

the rest of Africa. The debt/exports ratio has deteriorated everywhere, but slightly more in non-SAF/ESAF countries (mainly as a result of larger debt relief to the SAF/ESAF group of countries). It may also be observed that the share of multilateral debt - which has one great advantage: if is mainly given on concessional terms, in today's Africa, but one major disadvantage: it has to be paid back - of total external debt has increased everywhere, but, as could be expected, slightly more in the SAF/ESAF countries.

The story told by Tables 1-3 is straightforward: the external viability in Africa as a whole deteriorated between 1986 and 1991, and the erosion of international competitiveness appears to have been most pronounced in the 15 countries with SAF/ESAF agreements in these years.

It may be argued that the comparisons used by the IMF and in Tables 1-3 above cover a too short period to be meaningful. To take a longer-time perspective, we may compare Sub-saharan Africa in 1991 and in 1980, i.e. before structural adjustment had begun.

Table 4. Sub-Saharan Africa 1991 and 1980. Selected Indicators. Millions of current USD and percentages.

	1980	1991	% change
Gross National Product	192,796	162,451	- 15.7 %
Exports	57,895	52,432	- 9.5 %
Imports	61,814	67,576	+ 9.3 %
Current Account Deficit/Exports	5.6 %	14.6 %	
International Reserves	15,061	14,597	- 3.1 %
Total Debt Stock	56,246	178,005	+ 216.5 %
Multitaleral Debt	7,539	40,384	+ 435.7 %
Total Debt/Exports	97 %	339 %	
Multilateral Debt/Exports	13 %	77 %	

Source: Based on World Bank, World Debt Tables 1992-93.

The dramatic deterioration in Sub-Saharan Africa's external sector in the 1980s is, of course, due to a number of different factors. My simple point to stress in this context is that while structural adjustment programmes had a reduction of external deficits as a key objective, Sub-Saharan Africa's external account looks far worse in the early 1990s than before structural adjustment had started.

Towards the end of the 1980s, structural adjustment and IFI involvement in Africa escalated, and aid dependency increased. A very simple comparison between aid dependency and export performance in Africa may serve to

illustrate some new "stylised facts". In Table 5 below, 47 African countries have been divided into three broad groups - good, average, and bad - as to export performance between 1987 and 1991 (in some cases, because of lack of data, 1990). This performance is compared with a couple of indicators of aid dependency (as always below, unweighted averages are used).

Table 5. Export performance, Import/Export Ratios and Aid Dependency Indicators in 47 African Countries 1987-91.

	Exports % change 1987-91	Net Transfers as % of GNP 1987-91		Grants as % of X 1991
	Mean	Mean	Median	Mean
16 best performing countries:	54 %	10.0 %	4.8 %	26.3 %
16 average performing countries:	21 %	10.2 %	7.5 %	41.8 %
15 poorest performing countries:	- 13 %	15.7 %	10.3 %	80.9 %
Average all 47 countries:	21 %	11.9 %	8.4 %	48.6 %

Source: Based on World Bank, World Debt Tables 1992-93. As always when this source in used, there are a small number of countries from which data from 1991 is lacking. 1990, and average 1987-90, has then been used.

Note: "Grants" are total grants minus technical assistance (which I have assumed has little effect upon export performance and the real rate of exchange). The figures thus tend to underestimate aid dependence somewhat. M and X refer to imports and exports of goods and services, respectively. "Net transfers" include net flows of long-term debt (excl. IMF), direct foreign investment, and development aid ("grants", excl. technical assistance). In the large majority of African countries, grants account for the lion's share of net transfers.

To judge from Table 5, covering all African countries for which there is data available (excluding, however, South Africa), there is a pronounced negative relationship between export performance and aid. The relationship appears to be particularly strong for the "disastrous" cases; in the group of countries with stagnating or declining export earnings, aid dependency was markedly more pronounced than in "good" or "average" countries.

The M/X variable attempts, as indicated above, to be a proxy for the development of tradables, i.e. both exports and import-competing goods and services. If we divide all 47 countries into two major groups: those which improved, i.e. lowered, their M/X ratio between 1987 and 1991, and those

which did not, with a small group of countries with virtually unchanged M/X ratios in between, we get the following picture:

Table 6. Aid Dependency and Ratio between Imports and Exports. 47 African Countries.

	M/X 1987	M/X 1991	Grants/X 1991
15 countries with improving, i.e. declining, M/X ratio	228 %	174 %	35.1 %
7 countries with unchanged M/X ratio	143 %	143 %	48.9 %
25 countries with deteriorating, i.e. increasing, M/X ratio	153 %	201 %	56.6 %
Average all 47 countries:	175 %	184 %	48.6 %

The picture is far from encouraging: while IFI-supported structural adjustment accelerated, only one-third of all African countries managed to reduce their imports/exports ratio between 1987 and 1991 and, again, there is a clear negative correlation between aid dependency and international competitiveness.

Of the 15 countries receiving an Enhanced Structural Adjustment Facility between 1987 and 1990[15], only two belong to the group of countries which lowered their M/X ratios between 1987 and 1991; for the remaining 13 countries, the ratio was either constant or rising.

It thus appears as if there are two negative relationships present: between aid and exports, and between SAF/ESAF programmes and international competitiveness.

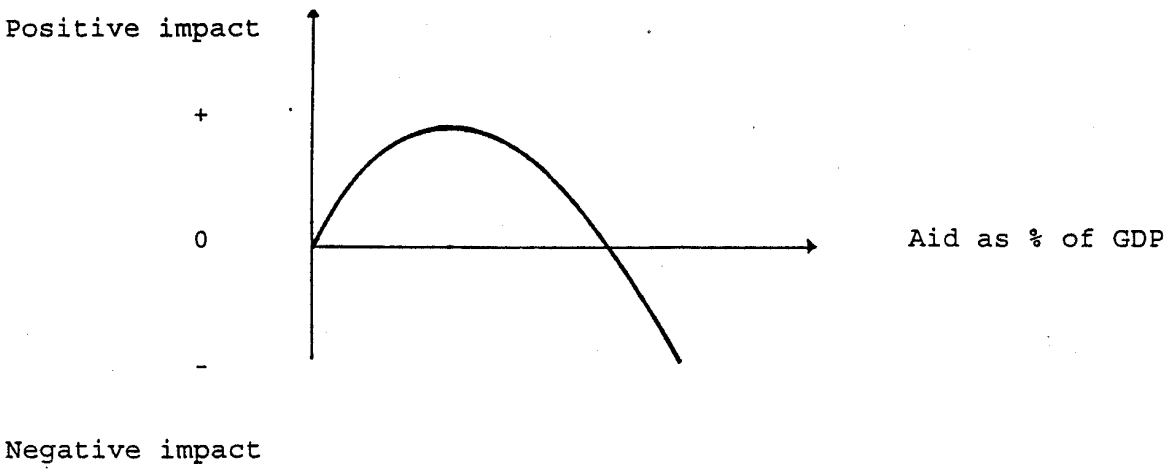
Now, how should these findings be interpreted? If we disregard statistical coincidence - the results appear to be quite significant - there are two possible reasons: either that a large volume of aid is bad for exports and for tradables in general, or that countries whose export performance is exceptionally poor receive a high and rising volume of foreign aid.

There are, in my view, good reasons to believe that both explanations are correct. Large volumes of aid - in particular the kind of balance of payments

[15] A much larger number of countries received SAF before 1987; this sample only includes the countries analysed in the IMF study on ESAF countries, referred to earlier.

support accompanying structural adjustment programmes - do hurt the international competitiveness of the economy, probably through the combined impact of "Dutch disease" effects and "policy effects" (but the aid can still be useful from a humanitarian point of view, of course). Although hard to tell from available data, a Laffer curve-looking relationship is likely to exist between aid and export growth (and, probably, economic development in general): while a certain minimum amount of aid may be highly useful, after a certain point, the impact on international competitiveness becomes destructive (see Figure 2). In the very poorly performing exporters in Table 5 above, the aid/export ratio was as high as almost 81 per cent (technical assistance excluded), and net transfers to GNP exceeded 15 per cent - it would be strange indeed if this enormous aid dependency did not create disincentives for exports.

Figure 2. Hypothetical Relationship between Aid and International Competitiveness



The tables presented above also indicate, however, that the second explanation might be true: poor export performance gives rise to high volumes of aid. Please observe that in Table 5 above, the strongest correlation of all is the one between miserable export performance in 1987-91 and volume of aid in 1991, rather than the average for 1987-91.

One reason could perhaps be that poor export performance was related to natural disasters, civil wars, etc. which caused the donor community to

increase their aid allocations to the most severely affected countries. While this would be a satisfactory explanation, from a humanitarian point of view, it does not appear to hold true; even if countries plagued by civil war (Angola, Sudan, Somalia, and others) are excluded, the above pattern is robust.

A more likely reason, to be discussed in the following section, is that the incentive structure surrounding structural adjustment lending benefits bad performers in the sense that external deficits are covered ex post by increasing volumes of aid. This is, however, contrary to the explicit objective of Bretton Woods conditionality and policy-related aid, which is to reward the best, not the worst, pupils.

This leads us over the a new set of "stylised facts" which may indicate why, many years after policy-related aid became the dominant type of aid in Africa, there appears to be an inverse relationship between "good performance" and foreign aid.

3. The Soft Budget Constraint and Perverse Incentive Structure of Structural Adjustment Lending

"They Always Come Back"

Between 1974 and 1987, Zambia had seven stand-by or structural adjustment agreements with the IMF, i.e. one every two years. All such programmes were discontinued by the Zambian government. The most comprehensive programme was the structural adjustment agreement signed with the IMF in 1985, and supported by the entire donor community. The thrust of the programme was to reduce the large macroimbalances charaterising the Zambian economy after two decades of gross mismanagement, and to deregulate the economy.

In May 1987, the Zambian government broke unilaterally with the IMF, revalued the domestic currency, reintroduced a number of price controls and replaced the auction system for foreign exchange, which had been supported by large amounts of balance of payments support from a number of donors, with a system of administrative allocation of foreign exchange. The reaction from the IFIs and the donor community was exceedingly strong; after seven frustrated attempts, the Zambian government had once again broken all agreements, and, in the meantime, accumulated sub-Saharan Africa's largest arrears to the preferred creditors (the IMF, the World Bank and the African Development Bank).

In 1988, I had the opportunity to visit Zambia in order to make an assessment of the (disastrous) macroeconomic policies which were pursued after the break with the IFIs. I then asked a minister about his government's reaction to the strong condemnation from the entire donor community: "-Was his government very concerned?" "-Concerned?" answered the minister, somewhat surprised, and added, smiling: "-Oh, no. They always come back."

The minister was right. Shortly afterwards, the IFIs were again knocking on the door, asking for a new agreement. Which they got. The bilateral donors promised to cover the remainder of the "financing gap" - which had widened alarmingly - and to clear the arrears to the preferred creditors.

Zambia has received more policy-related assistance than any other African country. In no other African country has IMF's involvement been so prolonged and expensive. But it is certainly not the best pupil in the class that has been rewarded.

Structural Adjustment and Macroeconomic Performance: Some Indicators

If macroeconomic conditionality worked according to the manuals, we would expect a positive relationship between "good performance" and foreign aid. Hopefully, the causality would be dual: large volumes of policy-related aid would lead to good performance, and good performance would lead to increasing flows of aid.

Data tells a different story, however. In a recent study by the World Bank[16], a classification of 28 African countries has been made according to their overall macroeconomic performance. Of the 28 countries, 14 fall into the category of "countries with improving macroeconomic policies", 11 are called "countries with deteriorating macroeconomic policies", and 3 are "unclassified". To facilitate comparisons, I have grouped the countries into two groups only: "good performers" and "others". Table 7 shows which group of countries has received most aid.

[16] Adjustment in Africa. Reforms, Results, and the Road Ahead, (1994). Because of lack of certain data, I have excluded The Gambia (classified as "good performer" in the World Bank study).

Table 7. Comparison of Aid Flows Between Group of Good Performers and Others in Africa 1991.

	Group of Countries (14) with Improving Macroeconomic Policies	Group of Countries with Deteriorating (11) or "Unclassified" (3) Policies
ODA as per cent of GDP in 1991	16.2 %	19.4 %
Net Transfers as per cent of exports of goods and services	65 %	87 %
Use of IMF Credit (accumulated debt to IMF as per cent of GNP)	5.0 %	6.0 %
IBRD and IDA disbursements 1991, per cent of exports	17.2 %	17.2 %

Source: ODA as per cent of GDP has been taken from World Bank, World Development Report 1993. All other figures from World Bank, World Debt Tables 1992-93.

Note: As before, certain data from 1990 has been used when more recent figures have been lacking from the above publications.
The indicator "accumulated debt to IMF" is intended as a - far from perfect - proxy for long-term IMF support to a particular country.

The pattern that emerges from Table 7 is not as robust as some of the former relationships, but the figures do confirm that macroeconomic conditionality is ineffective. The correlation between aid flows and macroeconomic performance is negative; not strongly negative, perhaps, but negative enough to refute simplistic notions about the positive impact on good behaviour of macroeconomic conditionality. There are a number of individual countries which can be said to have been "rewarded" for good performance; Ghana and Tanzania, which are both classified by the World Bank as countries with "large improvements in macroeconomic policies" and whose ODA/exports and IBRD/IDA disburements are among the highest in sub-Saharan Africa, are perhaps the most obvious cases. There are, on the other hand, also countries such as Zambia, Mozambique and Rwanda, classified as poor performers, to which aid disbursements, not least from the IFIs, have been huge.
The IFIs are smaller than the bilateral donors in terms of aid volumes, and the differences in their lending behaviour are perhaps too marginal to permit

a firm conclusion, but to judge from Table 7 above, even the tutors of structural adjustment lending have apparently failed to reward the good performers and punish the bad ones in a systematic way. Not surprisingly, the IMF registers a slightly negative correlation between performance and disbursements. Aid from other donors, i.e. the bilaterals, has increased substantially to the poor performers - despite the stated strategy adopted by the majority of donors to be tougher in their macroeconomic conditionality.

The paradox is only apparent, however. From the point of view of the recipient country, structural adjustment lending has tended to create a soft budget constraint on the external account; a country which mismanages its affairs can often expect to be bailed out by the donor community in order to avoid an acute or threatening balance of payments crisis. Sometimes there are good excuses - drought, floods, declining terms of trade, etc. - and sometimes the excuses are bad; this is largely a matter of negotiating skills. Quite often, the advisers get most of the blame; the golden rule of the highly successful Grameen Bank in Bangladesh has probably not been fully understood by the IFIs: "Never tell people what to do. Then you would be in serious trouble. People would say 'you gave me this terrible idea. It has failed, so now I will not repay you'."[17]

The bailing out of poor performers is particularly common for countries with large arrears to the IFIs. The "too big to fail" syndrome has, according to many observers, been very present in cases like Zambia, where the mere size of the arrears to the preferred creditors - eventually paid by the bilateral donors - appears to have contributed to making the IMF and the World Bank willing to sign a number of agreements without any domestic political credibility whatsoever. After each failure, the IFIs have involved the bilateral donors in massive rescue operations.

The anxiety on the part of the IFIs to make the bilaterals increase their contributions to structural adjustment programmes should be seen against this background. To encourage additional flows of bilateral support, the IFIs have tended to act as fund raisers among bilateral donors, and to become overly optimistic in both their overall assessments of programme performance and in their individual country analyses. This triumphalism, reminiscent of old-time socialist slogans - THE ROAD AHEAD, STABILITY AND GROWTH, TOWARDS ETERNAL VIABILITY, MANAGING THE TRANSITION FROM STABILIZATION TO SUSTAINED GROWTH etc. etc. - may also serve the purpose of trying to convince skeptical low-income countries of the merits of structural adjustment. Virtually all Policy Framework Papers and World Bank documents presented to donor coordination (Consultative Group) meetings in Paris thus tend to display an optimistic bias. As an illustrative example, the following comparison between actual

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[17] Muzammel Huq, General Manager of Grameen Bank, quoted in SID/IPS, Development Hotline, Vol. 4, No 20, 1993.

achievements of the structural adjustment programme in Nicaragua in 1992, and IMF and World Bank projections in late 1991 and early 1992 - i.e. the very same year - could be used:

Table 8. Comparison between IMF and World Bank Projections and Actual Economic Development in Nicaragua in 1992, selected indicators.

	IMF Proj. (Sept. 1991)	IBRD Proj. (March 1992)	Actual Development 1992
GDP/capita	+ 0.2 %	+ 1.2 %	- 2.7 %
Gross Domestic Investment/GDP	27.0 %	26.0 %	13.3 %
Current Account Deficit/GDP	49.1 %	30.4 %	58.0 %
Growth of Exports	+ 6.5 %	+ 7.1 %	- 21.0 %

Source: IMF, Nicaragua - Request for Stand-by Arrangement, September 12, 1991. World Bank, Nicaragua. Managing the Transition from Stabilization to Sustained Economic Growth, report prepared for Consultative Group Meeting for Nicaragua, Washington D.C., March 26, 1992. Actual development: various official Nicaraguan sources.

In 1993, the year after the attempted "Transition from Stabilization to Sustained Economic Growth" in Nicaragua, GDP/capita declined by around four per cent (the tenth consecutive year of declining GDP per capita in Nicaragua). Despite an aid/GDP ratio of almost fifty per cent, World Bank officials have stated, as an explanation of the poor performance, that the programme was "underfinanced"; a strange excuse in a country where a combination of drastic import liberalisation, massive foreign aid and an overvalued rate of exchange (a classical aid-induced "Dutch disease") has made the import/export ratio rise to over 3:1, the current account deficit to over fifty per cent of GDP and the debt/export ratio to 45:1.[18]

This leads us over to another question, briefly touched upon earlier:

Concluding Remarks: Who Pays for the Mistakes?

One obvious answer is the people in the countries plagued by poor macroeconomic policies. But while we should not forget the human suffering caused by bad policies, I will, in this context, disregard the social

[18] This line of reasoning provides, however, the IFIs with a convenient excuse when things go wrong: the design of the programme was excellent, but it failed because it was "underfinanced" by the bilateral donors, who are therefore to blame.

consequences, and concentrate on the role of the governments and foreign donors and creditors.

In debt renegotiations, the incentive structure and institutional set-up often tend to reward bad performance, and punish good policies. It is, for example, quite obvious that countries like Colombia, Chile, Botswana or Thailand, which have managed their foreign borrowing carefully and "put their house in order", will have to pay back a far higher share of their original debt than countries like Nicaragua, Peru, Ecuador, Zambia, Zaire or the Philippines.

The close links between stuctural adjustment agreements and debt negotiations - without an agreement with the IMF, no Paris Club rescheduling of the debt - reinforce this pattern, and force ordinary bilateral development aid, which could be used much better, to engage in bailing out operations in disastrously performing countries.

The bilateral donors' policy-related assistance, coordinated by the IFIs, has become one further step in this direction. Both debt relief and other forms of balance of payments support are normally granted on the basis of calculations of "financing gaps". The larger the expected deficits, the more debt relief and additional aid flows are "needed". A country which prudently manages its external sector will soon realise that the IFIs and the donor community breathe a sigh of relief - one problem country less! - and rush to mop up arrears from a disaster case instead. In a similar manner, the creditors normally insist on their share of any improvement in the external account. Many well-performing countries have today realised that the marginal tax on "good behaviour" can be very high, as concessional flows of aid are being reduced and the creditors adopt a tougher stand as the financing gaps diminish.[19] On the other hand, many a poor country with a responsible government has witnessed how neighbours who continue to run huge deficits are constantly being bailed out by the bilateral donors, who unintentionally polish the slippery slope.

The attempt to link balance of payments support to policy reform is undoubtedly a recognition, on the part of the donors, of this dilemma. A country in crisis should, in theory, put its house in order before receiving debt relief and additional balance of payments support. Also, the role of

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[19] The obvious way for a country to attempt to neutralise the effect on the real rate of exchange of a sudden increase in foreign exchange - thanks to high export prices, IMF agreements, coca exports, commercial loans, etc. - is to build up a foreign exchange reserve or, as tried by for example Colombia in the 1970s and Chile in the 1980s, a "a stabilisation fund" related to major export prices. Many donors, however, do not like their aid to be used for this purpose; if reserves become too large, the country in question apparently does not "need" as much aid as before.

conditionality can, as indicated earlier, be interpreted as an attempt to neutralise the fact that the additional flows of funds made available provide the financial means to continue with irresponsible policies. Governments are told to reduce the external deficit and the fiscal deficit, to enhance the international competitiveness of the economy, to harden the budget constraint and to stop bailing out inefficient state enterprises, etc., but they are, at the same time, given resources which enable them to do exactly the opposite.

Ten years ago, the "rules of the game" had not yet been learnt by the low-income countries. Today, they have.

One solution to this dilemma could be to base additional allocations of aid on past performance, rather than on expected future performance. The problem with the perverse incentive structure would then diminish, and the bilateral donors could be presented, at CG meetings in Paris and elsewhere, with facts, rather than with optimistic forecasts from the Bretton Woods institutions.

Another partial solution, aimed at facilitating a smooth rather than a crash landing in low-income countries with unsustainable external deficits, would be for the bilateral donors to act in a systematic countercyclical manner, i.e. to reduce aid flows to countries which have reached an agreement with the IFIs, and to increase their aid when negotiations with the IMF and the World Bank have collapsed (provided past performance justifies policy-related assistance, of course). It would then be possible to smoothen out the Bretton Woods-induced "aid and loan cycles" which have become a common pattern in many low-income countries, and which create enormous problems for the countries in both "good times" and "bad times".

The IFIs, as preferred creditors, are entitled to get all their money back, irrespective of circumstance. At present, the multilateral debt/exports ratio has risen alarmingly in low-income countries; in sub-Saharan Africa, the ratio is today around 200 per cent, while the overall debt/exports ratio is over 500 per cent (unweighted averages). Who will pay?

Under today's institutional set-up, neither the poorly performing countries, nor the IFIs, have to pay the full price for their own mistakes. The IFIs have been given the monopoly of handling structural adjustment negotiations and of presenting background information to the bilateral donors at CG meetings in Paris, and of coordinating the donor community's policy-related assistance. If they make mistakes, as is often the case, it does not cost them one single dollar.

Monopolies are (almost) always bad. Monopolies that never pay their bills should be every economist's nightmare.

"Preferred creditors" easily create distorted incentives, in particular if they are granted a dominant role as regards coordination of all other creditors. To improve the incentive structure, the concept of preferred creditors should be abolished, and each lender should assume its own responsibility, and risk. In order to facilitate a market-oriented solution to the problem of multilateral debt, and to enhance competition and accountability, the development of a secondary market for multilateral debt ought to be encouraged, and the IFIs should be free to decide whether to keep their non-perfoming debt, or to sell it on the secondary market.

The low-income country governments, whose responsibility it is to implement the agreed-upon programmes, know by now that "slippages" normally only signify short-term delays in the release of new funds. They also know that if accumulated arrears become too large, "they (the IFIs) always come back".

At present it is, then, the bilateral donors, not the major players themselves, who pay the price. The IFIs and the low-income country governments have come to share at least one common objective: to have someone else foot the bill. And they have, to an increasing extent, tended to end up on the same side of the negotiating table - with only the bilaterals, facing declining aid budgets and aid fatigue in their home countries, sitting on the other side, with a tremendous disadvantage vis-a-vis the IFIs in terms of macroeconomic preparations.

The rich countries can afford to pay, of course. But it is the quality of foreign aid, and thus people in poor countries, who pay the price, in the final analysis, if scarce aid resources are redirected away from countries and activities where the aid is used in a meaningful way to countries where the aid is wasted, or outright harmful.

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