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IMF STRUCTURAL ADJUSTMENT PROGRAMS
THE CASE OF HAITI

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INTRODUCTION

In developing countries, the problem of stabilization and adjustment has been the predominant feature of economic policy during the 1980's. Over the last decade, a combination of deteriorating international economic and financial environment, rising debt, depressed commodity prices and domestic mismanagement have unveiled critical imbalances prevailing in Third World economies and have forced these countries to undertake serious adjustment efforts. The need for adjustment has become even more pressing in the case of small low income countries, like Haiti, where the development process has been jeopardized by mismanagement and external shocks, but also negative per capita growth in the past 10 years were endangering the development process.

In recent years, the World Bank and the International Monetary Fund (IMF) have coordinated their efforts to assist developing countries in their structural adjustment efforts by designing policy reforms package and providing financial support. The ultimate aim of these programs is to attain sustainable growth in the medium term and restore the country's external position. Adjustment loans, by providing the liquidity necessary to smooth over temporary imbalances are crucial to the reform process. These loans which in the case of low income countries generally require the support of donor countries also act as a catalyst by mobilizing additional capital flows from private and official sources.

The main thrust of this paper is to review the design and implementation of structural adjustment programs (SAP) supported by the IMF and the World Bank for small low income countries. In so doing reference will be made to the structural adjustment program of Haiti implemented in 1986. This program was carried out within the context of an IMF structural Adjustment Facility (SAF), which provides concessional assistance to low income countries with protracted balance of payments problems. The Fund acted in coordination with the World Bank which also provided structural loans.

Chapter 1 provides an overview of the Haitian economy. This is followed in chapter 2 by a discussion of the factors behind the emergence of financial imbalances and the balance of payment crisis. Chapter 3 reviews the theoretical framework underpinning IMF structural adjustment programs. Chapter 4 examines the design and performance of the Haitian adjustment program. Finally, chapter 5 analyses the issue of structural adjustment programs and stresses the main areas where further action on the part of the IMF and the World Bank may be warranted.

CHAPTER 1

ECONOMIC BACKGROUND

Haiti, with a population of 6.2 million contained in an area of 28,000 square kilometres, is a relatively small and densely populated country. Three quarters of the country's population reside in rural areas where agriculture remains the predominant form of economic activity. While agricultural production employs the largest share of the labour force, this sector of the Haitian economy accounted for only 25% of GDP in 1986 compared to 50% in the 1950's. During the 1970's an increasing proportion of employment growth was generated by non-agricultural economic activity. Particularly significant in this respect was the development of a light manufacturing sector producing for export. The increase in output, as measured by the growth of 5.2% of GNP per year between 1975 and 1980, paved the way for improvement in the general level of social and economic well being. Unfortunately, in the early 1980's a series of internal and external shocks have jeopardized the progress achieved during the 1970's. Between 1980 and 1985, per capita income levels declined in real terms by 3% per year as average GDP growth of 0.5% trailed population growth by a full percentage point. With per capita income of less than US\$400, Haiti shares with Guyana and Nicaragua the distinction of being one the poorest nations in the Western Hemisphere¹.

¹See Table 1.1 for a statistical profile of Haiti.

1.1 Structure and Problems of the Economy

The misallocation of Haiti's inadequate supply of human, financial and natural resources have constituted the major constraints in the development of the different sectors of the economy. This has reinforced the country's dependence on foreign resources and thus increased its vulnerability to external developments.

1.1.1 The Agricultural Sector

The agricultural sector is extremely important. It employs the largest share of the workforce, and its output to a large degree determines the overall level of economic activity. Its long-term decline has resulted in a fall in agricultural production for both the domestic and export markets. This decline has led to a considerable rise in food imports over the last two decades (Table 1.2).

One of the most critical problems facing Haiti is the low level of productivity in agriculture², which can be viewed essentially as having four causes: (i) increasing population pressure on roughly one million hectares of cultivated land, consisting primarily of marginal hillside farms, on which an

² Value added per worker was estimated in 1987 at US\$ 364.

estimated two million peasants and agricultural workers apply archaic methods of cultivation; (ii) the perennial problem of deforestation and soil erosion created by the population pressure on the land and the demand for wood and charcoal for energy; (iii) government agricultural pricing policies such as heavy export taxes, food import quotas and trading monopolies, which distorted price incentives between export and food for domestic consumption, and resulted in the stagnation of production agricultural exports via lower prices received by producers; and (iv) insufficient public investment in agriculture³. Coffee production and coffee exports have been the most adversely affected, as coffee is the dominant agricultural export⁴ and the source of revenue for over a million smallholder (Chart 1.1).

1.1.2 The Manufacturing Sector

Despite the considerable expansion of its activities in the 1970's, the manufacturing sector accounts for only 20% of GDP and employs a mere 10% of the active labour force. For analytical purposes this sector can be divided into two sub-sectors:

³ For more detail see World Bank, "Haiti, examen des dépenses publiques", pp. 35-46 and "Le redressement de l'économie Haitienne: résultats, problèmes et perspectives", pp. 3-5.

⁴. Haiti's annual coffee export declined from a peak of nearly 450 thousand 60 kilo bags in the early 1960's to around 300 thousands bag of low quality in 1985.

(i) the non-competitive import-substitution industry, which is today suffering from the negative consequences of protection afforded by various trade barriers. These enabled a number of import substitution enterprises to prosper in the early 1970's. A large share of these activities consisted of the production of basic consumption goods (i.e. clothing, flour, cooking oil), plastic, steel and cement. However, the small domestic market was saturated by the mid 1970's, and since then these industries have been incurring high production costs due to underutilized capacity, poor management and outdated equipment. This in turn has generated high prices for many basic items; and

(ii) a dynamic labour-intensive light manufacturing assembly industry emerged in the 1970's. This export processing sub-sector experienced a rapid expansion in the mid 1970's and, until recently, was the fastest growing assembly industry in the Caribbean Basin. By the mid 1980's, light manufacturing exports were replacing agricultural exports as the main source of foreign exchange, and the sector was employing 50% of the manufacturing labour force. In terms of value added, the output from this sector grew at 17% per year between 1978 and 1986 whereas exports from this sector grew by 9% per annum during the same period.

This growth was stimulated by the cheap labour force⁵ and generous Industrial Incentives Law. Foreign capital, mainly

⁵. In the 1970's, the minimum wage was fixed at \$1.30 a day. In 1986, it is estimated at \$3 a day.

from the US , was instrumental in the establishment of these new activities, the primary functions of which is to assemble and process imported components for re-export to the US market (mainly electronics, clothing and sporting goods)⁶.

However, in recent years, the 1982 world recession, the difficulties of the US computer industry, the industrial countries' trade barriers to textile exports, and domestic political instability have all contributed to a slowdown in this sector. Furthermore, increased competition from Costa Rica, the Dominican Republic and Jamaica has put more pressure on some sub-sectors of the light assembly industry. With no backward or forward linkages with the rest of the economy, that is near total reliance on imported inputs and little capital investment, this sector is very mobile and remains vulnerable to the international economic environment and to foreign competition.

1.1.3 The Trade Sector

Haiti is a relatively open economy, with the total value of exports and imports of goods and services accounting for close to 40% of GDP in 1986. In 1986, 60% of merchandise exports

⁶For a description of this sector see Gladys Delva, "Haiti et la concurrence internationale dans l'industrie de l'assemblage", in Ministère de l'économie et des finances bulletin de conjoncture no. 3, pp. 111-125.

consisted of manufactured products, about 33% were coffee exports and 7% were other agricultural products (Table 1.3). Despite the expansion of the manufacturing sector for exports, the export base remains narrow leaving Haiti vulnerable to developments in the United States, and to fluctuations in the world coffee market. The vulnerability of the economy is exacerbated by the fact that trade is heavily concentrated with the US.

During the early 1970's, buoyant export performance enabled the country to more or less sustain the rising demand for imports. The current account deficit accounted for less than 5% of GDP. This trend was reversed in the early 1980's as the world recession affected manufacturing sector exports and the price and volume of coffee exports fell. The demand for imports continued to increase, however, as consumer demand for food and manufacturing products rose faster than domestic supplies and the public sector continued to import large quantities of capital goods (Table 1.4). The consequent larger resource gap was reflected in the increase of current account deficits between 1980-1985.

1.1.4 The Lack of Domestic Savings

The low level of per capita income and the consequent low saving capacity is one of the main structural problems

confronting the economy. Domestic saving represented less than 7 percent of GDP during the last decade. In recent years (1980-1985) it has fallen to less than 5 percent of GDP. This saving rate is insufficient to finance even one-third of the increase of the capital stock of the country. Meanwhile, gross domestic investment during this period stood at 16% of GDP. The large gap between gross national savings and gross domestic investment forced reliance on foreign savings which financed about 2/3 of gross domestic investment. The importance of these transfers is depicted in Table 1.5. Between 1980 and 1985 external savings accounted for more than 11 percent of GDP. During this same period, net inflow of private transfers, mostly in the form of remittances from Haitians working abroad, averaged more than 3.4% of GDP, whereas public transfers, mainly grants from multilateral agencies and foreign agencies, averaged 3.8% of GDP. In recent years, the increasing financing requirement of the public sector and the decline in private and public transfers have contributed to the worsening of the external accounts.

In summary, low productivity in agriculture, an inadequate infrastructure, a rudimentary non competitive industrial sector and a lack of financial resources and real savings, aggravated by political instability, have constrained higher growth prospects over the decades.

1.2. Recent Economic Development (1980-1985)

Spurred by the rapid expansion of the light assembly export sector and the rise in coffee prices, Haiti experienced an annual growth rate of 5.3% between 1975 and 1980. This reached a peak of 7% per annum between 1978-1979. Real income per capita grew at 1.5% during the same period. During this period exports and investment grew at 10.3% and 10.1% per annum, respectively, but by the end of the 1970's signs of underlying trouble appeared. Increasing population pressure led to decreasing agricultural productivity and declining rural incomes. This in turn resulted in a substantial rural-urban and international migrations. At the same time, the domestic manufacturing sector exhausted its expansion possibilities in the domestic market and was unable to compete internationally. And more importantly, consumption was growing more rapidly than output, and, as a result, import and the trade deficit increased. Meanwhile, public sector expenditures were rising while revenues were falling and the flow of foreign aid was slowing down.

At the beginning of the 1980's a series of shocks exacerbated the nation's underlying problems and initiated a severe economic recession between 1981 and 1982: (i) the two-and-a half fold increase in oil prices in 1979-1980 multiplied the country's oil bill by a factor of 3.4, (ii) the slow-down of the world economy, especially the US recession of 1981-82

adversely affected the demand for exports of the assembly sectors, and (iii) the 33% fall in coffee prices between 1980-1981. Moreover, the closure of the only bauxite mine in 1982, when its deposits were exhausted, further reduced export earnings. The economic situation was further aggravated by two hurricanes and droughts which seriously damaged coffee production and export volume. The fall in coffee prices coupled with the damages caused to coffee trees, resulted in a 64% reduction in value of coffee exports in 1982. Between 1980-1986 the real value of exports declined by approximately 15% and the terms of trade deteriorated by 10% (using 1976 as a base year).

Between 1980-1985 a serious deterioration in economic management (to be discussed in chapter 2) magnified the impact of the external shocks on the economy and caused a significant erosion of the country's income and living standards. Over the 1980-1985 period, real agricultural and industrial output declined by an average of 1.3% and 2.5% per year respectively. Open unemployment rose from 22% to 30%, inflation accelerated from 6% to 8%, and the current account deficit reached 8% of GDP (Table 1.6). In the same period, real private consumption per head declined by an average of 3% per year. As the economic situation deteriorated, the confidence of the private sector and the international aid donor community eroded. As a result, between 1980 and 1985 foreign aid declined from eight to six

percent of GDP, and some donors allocated their assistance away from the public sector towards non-governmental organizations.

Two adjustment efforts in 1981-82 and 1983-84, supported by the International Monetary Fund, sought to bring government fiscal and monetary accounts into balance. Each of these efforts was short-lived. In June 1984, unstable government finances led to the suspension of the second arrangement. During 1984 and 1985, the government deficit jumped, domestic inflation accelerated, the current account deficit expanded, and the balance of payments came under pressure inducing a net decline in foreign exchange reserves. In 1986, the new government⁷ recognized that the country faced serious structural adjustment problems and undertook to address them. Strong corrective measures were adopted to redress the domestic imbalances and restore the country's creditworthiness. In November 1986, the Government of Haiti negotiated a three-year program supported by the resources of the IMF and the World Bank reinforced by grants from donor countries. Details of this economic and financial program are presented in chapter 4.

⁷ End of the 30 years of the Duvalier's dictatorship.

CHAPTER II

FISCAL IMBALANCES AND MONEY CREATION IN THE EARLY 1980'S

Despite the role played by external factors, principally the recession in the US, the decline in coffee prices, and the rise in oil prices, unduly permissive fiscal and monetary policies were primarily responsible for the emergence of external and internal imbalances. This chapter will examine the recent fiscal, monetary and balance of payments developments in Haiti. The aim is to explore the relationship between fiscal policy and the current account balance and the ensuing interdependence between monetary and fiscal policy.

2.1. Fiscal Deficit and External Current Account Balances

The relationship between government fiscal operations and the current account is first expressed through the national account identities and the financial identities of the balance of payments. A number of empirical studies have tested this relationship for developing countries and have concluded that the fiscal deficit does in fact have a negative impact on the current account⁸. The method of financing the fiscal deficit and its

⁸ Gloria Bartolli, "Fiscal Expansion and External Current Account Imbalances", and Ashan H. Mansur, "Effect of Budget Deficit on the Current Account Balance: The Case of the Philippines" in *Fiscal Policy, Stabilization and Growth in Developing Countries*, edited by M. Blejer and K. Chu, pp. 171-207 and pp. 309-345.

subsequent effects on the external balance has important implications for the formulation of stabilization policies. It is in light of this consideration that the validity of the link between fiscal policy and the current account is examined.

2.1.1 Fiscal Developments

Public finances are typically the source of much instability in small underdeveloped countries because of the size of the government's operations relative to the economy as a whole. In the case of Haiti, the expansion of the public sector's role at the beginning of the 1980's marked the end of the fiscal discipline that had prevailed in the previous decade.

Table 2.1 illustrates the operations of the consolidated public sector for FY80-87⁹. In 1986, the Haitian consolidated public sector was comprised of the general government and six major public enterprises (cement company, the flour mill, the telecommunication company, the electricity company, the port authority, the water supply company). The operations of the general government cover the transactions of the Treasury, including those financed with transfers from public enterprises, and development expenditures financed either by grants received

⁹ FY refers to fiscal years which end September 30.

from abroad or by bilateral and multilateral concessional lending.

Government Revenues - Despite some substantive fiscal reforms in the 1980's Haiti's revenue system remains deficient in several aspects: excessive reliance on indirect on consumption goods and international taxes set at excessively high levels which render the system unproductive¹⁰ and inequitable; inefficient revenue collection; and finally, various government practices such as trade monopolies, outright closure of provincial ports and increasing tax exemptions as part of industrial investment and export promotion have reduced the government's potential tax base. The slackening of economic activity during the early 1980's also constrained the growth of government revenue. The persistence of important exemptions and loopholes in the collection system, however, remains the main cause of the low revenue yield from taxation. Between 1980-1985, current revenues of the general government have increased by only 3 percentage points. They were close to 12 per cent of GDP in 1985 which is 4 per cent percentage points below the standard for a country with an income per capita of \$400.

¹⁰ Indirect taxes on goods and services and on international trade are the most important source of government revenues accounting for more than 60% percent of total government receipts, income tax accounting for less than 20%. These taxes are inefficient as they affect the allocation of resources (see p.5).

Treasury revenues have been supplemented by transfers from public enterprises (which account for less than 1 per cent of GDP) and cash grants from bilateral donors in the order of 3.3 per cent of GDP. These latter receipts, which account for close to 20 per cent of the operating budget of the public sector, have fluctuated widely in recent years as the confidence of international lenders eroded (Chart 2.1). Foreign aid, in the form of cash grants and goods, is an important determinant of economic activity, and has an impact on the evolution and composition of aggregate demand.

Government Expenditures - Public expenditures in Haiti have been poorly allocated for a long time. Prior to 1986, in describing government current expenditures it suffices to mention the shares absorbed by different ministries: agriculture 5 per cent, education 14 per cent, health 13 per cent, defence 19 per cent, whereas extrabudgetary spending or the so-called political and "other ministries" expenditures claimed 52 per cent of total government outlays. Within most ministries 80 per cent to 90 per cent of expenditures were devoted to salaries, leaving little for supplies, materials, and equipment necessary for public employees and infrastructure to function effectively¹¹.

¹¹. For more detail see World Bank (1986), "Examen des Dépenses Publiques en Haiti", chapter 2.

However, total outlays were held in line with revenues until 1980. Thereafter, fiscal policy became largely expansionary as government extra budgetary spending, including the increase of public sector employment and capital expenditures, increased. Overall public sector spending jumped from 22 per cent of GDP in 1980 to more than 27 per cent in 1985 causing public sector savings to decline from an average of 1.8 percent of GDP between 1975-1980 to less than 0.5 percent between 1980-1985. Capital expenditures experienced the largest increase. They rose by 50 per cent between 1980-1981, falling slightly thereafter and rose again by 20 per cent between 1983-1984 (table 2.1). A large share of these outlays were used to undertake unprofitable and frequently unnecessary capital expenditures such as the establishment of the Darbonne sugar mill and the acquisition of two manufacturing enterprises (Ciment D'Haiti, and an Edible oil company ENAOL) rather than to efficiently expand the country's productive capacity. The capital outlays for these enterprises and the current transfer to those among them which incurred financial losses have entailed substantial loss of scarce financial resources. Moreover, state enterprises have been widely used for money laundering purposes by senior state officials and large traders with black marketing, overinvoicing tax evasion and corruption being widespread.

Between 1980-1985, the increase in government expenditures had an expansionary effect on aggregate demand, output, and the price level. These direct effects had a negative impact on the country's trade balance, as part of the increase in aggregate demand was translated into an increase in the demand for imports of consumer goods. Government expenditures were not the sole factor causing the expansion of aggregate demand, however, since foreign aid was also a stimulating factor.

Government Fiscal Deficit - The gap between revenue and expenditure growth resulted in a significant rise in the government deficit in both absolute terms and as a proportion of GDP. From an average of 7.7 per cent of GDP between 1975 and 1980 the deficit expanded to 9.4 per cent between 1980 and 1985. It fluctuated widely during this period, however, and reached an all time high of 12 per cent of GDP in 1981. It stabilized at 9 per cent and then rose again to 10.5 per cent in 1984 and then dropped to 7 per cent in 1985 (Table 2.1). These fluctuations mirror the effect of the 1981 recession, the short term stabilization measures imposed by the IMF in 1981-82 and in 1983-84, and their subsequent failure.

If the accumulated deficit, several billion gourdes, could give the impression that the wealth of the society did increase, however, the size of the deficit adjusted for inflation proved to be very disappointing, as the increase in prices during this

period lead to the erosion of the value of the deficit. The value of the deficit adjusted for inflation shows that the results of the fiscal policies of the time were largely illusory¹².

A critical element in the analysis of the effect of the budget deficit on the current account balance is the composition of government deficit financing. Traditionally, in the 1970's, the deficit of the public sector was financed almost exclusively by external saving in the form of grants and concessional loans. However, as illustrated in table 2.2, between 1980-1985 as the government deficit widened, the structure of financing of the deficit changed. The external nonconcessional loans and, more importantly, the domestic financing component expanded. On average over the period 1980-1985 the deficit was financed in the following proportion: external grants (67%), credit from Central Bank (28%) and external commercial loans (5%). Recourse to domestic financing from the Central Bank credit increased by 200 million gourdes per year. Following the record fiscal deficit in FY84, domestic financing by the Monetary authorities reached a peak 335 million gourdes. That is 50% of deficit excluding grants, or the equivalent of 3.5% of GDP.

¹². Vladimir Francois, "L'évolution récente du déficit réel du secteur public 1984-1987" in Ministère de l'économie et des finances bulletin de conjoncture no.4, pp. 95-104.

2.1.2 Monetary Developments

Capital markets are nonexistent in Haiti, and therefore the banking system carries the burden of financing both the private and public sectors. The banking system is comprised of the Monetary Authorities represented by the Central Bank, Banque de la République d'Haiti (BRH) and a state owned commercial bank, Banque Nationale de Crédit (BNC), five locally incorporated commercial banks; and four branches of foreign banks. In recent years the BRH and BNC together have accounted for over 70% of the total stock of domestic credit. The BNC is the largest bank within the commercial banking sector. It receives more than 20% of the banking system's deposits from the private sector and also accounts for a similar share of credit extended to the private sector.

Monetary policy was expansionary during most of the period under review. From 1980 until 1985, monetary developments in Haiti were dominated by a continuous expansion of credit in response to the increasing financial requirements of the public sector. This caused a steady fall in the banking system's net foreign assets. Table 2.3 illustrates the evolution of the consolidated accounts of the banking system and points to the rapid growth of its net domestic assets over the growth of its liabilities. Between 1981 and 1985 total domestic credit more than doubled in nominal terms. The situation reflected an

increase of net claims of the banking system on the public sector both in value terms and also as a percentage of total claims. Whereas, over the same period, the annual growth rate of the banking system's liabilities to the private sector only averaged 9%. Measured in relation to the stock of liabilities to the private sector at beginning of each year, the rate of domestic credit expansion averaged over 13 percent a year.

Domestic credit expansion to the public sector modeled the government fiscal operations. After soaring by 65% in 1981, it fell in 1982 and rose again between 1983-1985. The increase in domestic credit was provided almost entirely by the Central Bank. In 1985, 70% of domestic credit originating from monetary authorities was used to satisfy the financial needs of the central government and public enterprises. In contrast, credit to the private sector grew only marginally in current terms but decreased in constant terms. The low rate of credit expansion to the private sector reflected the slackness in economic activity.

The financing of the budgetary deficit by the Central Bank resulted in excessive money creation, which induced a substantial increase in the banking system's reserves. The weak demand for credit from the private sector, however, created a situation of excess liquidity in commercial banks. Consequently there was a shift in the composition of money plus quasi money as

the share of money in the total rose. This was mainly because of an increase in demand deposits, caused by the reluctance of commercial banks to offer other types of deposits due to the higher interest payments this would entail¹³.

The expansion of the money supply far in excess of the growth of output put increasing pressures on domestic prices. Inflation averaged more than 8 percent over the period, double that of Haiti's main trading partners¹⁴. However, there has never been a serious wage-price spiral, and in fact real wages in the metropolitan area declined during the 1980-1985 period.

A major indicator of the seriousness of the short-term problems was the decline in the level of net foreign assets of the banking system. Positive until 1980, the banking system's net foreign exchange position became negative in 1981 and deteriorated steadily thereafter as foreign liabilities of the Monetary Authorities increased substantially. The situation resulted in a decline of net foreign assets of the banking

¹³Legal reserve requirement of 50.0 percent on demand deposit and 30.0 percent on fixed-term saving deposits were imposed by Monetary Authorities.

¹⁴. In contrast, inflation measured by the consumer price index which in the US reached 13.3 in 1979 then 12.4 in 1980 had fallen to 2% in 1986. whereas in Haiti inflation which was running at 9.7% in 1979, and 18.1 in 1980 stabilized at only 8% in 1986.

system of 125 million gourdes per year (Table 2.3).¹⁵ The loss of foreign exchange combined with the rise of domestic prices above the level of country's main trading partners contributed to increased pressure on the value of the local currency. This led to the emergence of a parallel foreign exchange market, a phenomenon which had not occurred before.

So far, in the case of Haiti, the survey of fiscal and monetary developments has demonstrated the interdependence between fiscal and monetary policy. This link arises because of the nature of government deficit financing. Given the absence of domestic financial markets and the limited accessibility of the government and private domestic residents to international financial markets, the government is forced to rely on grants and domestic bank credit to finance its fiscal operations. Fiscal and monetary policy became two sides of the same coin, in that fiscal expansion could not occur without being financed by a parallel expansion in the domestic money supply.

¹⁵ In accordance with an agreement concluded with the Central Bank on June 19, 1984, commercial banks set aside up to 50% percent of foreign exchange proceeds from all exports, which is used to meet oil imports and certain debt service payments.

2.1.3 Balance of Payment Developments

Developments in the Haitian balance of payment have been characterized by steadily increasing non-externally financed current account deficits. These in turn, have resulted in a steady decline in net international reserves, the emergence of external payment arrears, and an increase in the country's external debt.

The difficulties with the current account resulted from the deterioration in the trade and service balances (Table 2.). After a record trade deficit in 1981, an outright ban on the importation of specific consumption items was introduced in 1981. This was replaced by an administered system of import licensing in 1982. The trade deficit did decline, but it is unclear how much of the improvement was due to the import restrictions and how much was due to the reduced ability to import which resulted from the decline in foreign aid. From 1982 to 1985 exports stagnated as foreign demand fell. At the same time declining harvests and the monetary and fiscal effects of an expansionary fiscal policy pushed up demand for food and capital imports. This problem was exacerbated by a real appreciation of the gourde brought on by a combination of rising inflation and a fixed nominal exchange rate. Care must be taken when interpreting such results, however. The bulk of the current account deficit that is explained by public expenditures results from an import of

capital goods, the financing of which is linked to externally funded development projects. In a sense this part of the current account deficit is self funding and raises no financial problem at all.

The deficit in the services account reflected an increase in insurance and freight payments, a decline in tourism earnings and was aggravated by the rise, in 1984, of the interest payments on the external debt. Net current transfers also declined in both 1983 and 1984. As a result, the current account deficit was equivalent to 7% of GDP over the 1980-1985 period.

The capital account illustrates the heavy reliance placed on external assistance. Capital inflows in the form of official grants and public sector borrowing from concessional sources are by far the largest items. However, capital inflows have been insufficient to balance the deficit on the current account. In FY85, the net inflow of capital from multilateral and bilateral sources decreased while the payment of short term debts increased, leading the balance of payment into a record deficit of US \$14 million. By 1985, short term debt increased by 73%, external payment arrears accumulated and net official reserves fell to the point where they were sufficient to cover only 3.1 weeks of imports.

For a country of this size and with such a high level of poverty, a deficit in the trade balance financed by grant-in-aid, private transfers from abroad and concessional loans is inevitable. A problem arises when the amount of foreign savings is below or less than the actual deficit. This case generally occurs when such a country is pursuing a credit policy without paying due consideration to the likely amount of financial support coming from abroad.

2.1.4 External Debt Development

The total external debt of Haiti in 1985 was estimated at US\$703.7 million. It increased steadily between 1975 and 1982 at an annual growth rate of 25% and then slowed to 10% per year between 1982 and 1986. The main feature of the country's debt is its highly concessional¹⁶ nature. The largest portion is owed to official creditors. In 1984, however, there was a hardening of interest rates and maturity terms and, as result, almost \$18 million in external credit from commercial sources was disbursed. Accordingly, the debt service, which was only 10.4% of the value of exports of goods and non factor services in 1982, rose to 14.7% in 1985. Simultaneously, the short term debt volume almost doubled from US\$46 million in 1983 to US\$108 million in 1984 and

¹⁶ This refers to the terms and conditions of the debt, which in this case was largely long term, at interest rate below 2%, and largely owed to international institutions.

US\$88 million in 1985. Seventy percent of the medium and long-term debt was issued to finance the requirements of the public sector.

2.1.5 Exchange Rate Development

Like most small economies that have a dominant trading partner, Haiti's currency, the gourde, is pegged to a dominant currency. The parity of the Haitian gourde is officially defined in terms of the SDR¹⁷ but in practice, a fixed relationship of G5 per US dollar is maintained. This relationship has existed since the initial establishment of the par value of the gourde in February 1918. The US dollar is generally accepted in Haiti as a means of payment. Prices are commonly quoted in U.S. currency, and local banks and large enterprises denominate their accounts in U.S. dollars, even though transactions are usually made in gourdes.

As indicated in Chart 2.2, Haiti's real effective exchange rate, as measured by a trade weighted index of the currencies of its major trading partners, appreciated by 36% between 1980 and 1985, reflecting the appreciation of the US dollar and the fixed parity of the gourde. The nominal effective exchange rate

¹⁷ The SDR serves as the unit of account for the IMF. It is the unit in which all Fund transactions and operations, and members' obligations to and claims on the Fund are denominated.

appreciated by 55% over the same period. To maintain a fixed rate requires careful management of the economy. The fiscal imbalances and excessive credit expansion in Haiti made this difficult. Under a fixed exchange rate, if demand for foreign currency exceeds supply, defending the parity requires either access to sufficient foreign exchange or the existence of a domestic capital market capable of attracting foreign portfolio investment. A lack of both of these implies a shrinking of reserve levels, usually ending in exchange controls or devaluation.

Between 1980 and 1985, prices in Haiti were rising, whereas they were relatively stable in the US.¹⁸ As a result the purchasing power of the gourde declined relative to the US dollar and a parallel foreign exchange market emerged in which the Gourde was traded at a discount. Between 1981-1984, the discount did not exceed 10% but soared to 20% and over by the end of 1985 and early 1986.

The expansion of domestic credit has an expansionary effect on the demand for imports of goods and services and, consequently, on the demand for foreign exchange. Consequently, for a small and poor underdeveloped economy, it is easy to reach

¹⁸. As already mentioned, inflation in the US measured by the consumer price index reach 13.3% in 1979 than 12.4% in 1980 and fell to 2% in 1986, whereas in Haiti inflation was running at 9.7% in 1979 and 18.1% in 1980 and than fell to 8% where it stabilizes until 1986.

the limit of credit that it can absorb periodically without impeding the stability of the domestic currency. Foreign aid to a certain extent can postpone these limits if it is used to reduce the gap between the demand and the supply in the foreign exchange market. It can do this by directly satisfying part of the foreign exchange needs or by reinforcing the net foreign asset position.

The examination of the fiscal, monetary and balance of payments developments over the 1980-1985 period indicates that as the fiscal deficit and the associated domestic credit creation increased sharply, the current account balance fell to record deficit levels (see Chart 2.3). These observations seem to support the contention that there is a relationship between government deficit and the current account deficit of the balance of payments and constitute the first step in establishing a relationship between the fiscal deficit and the current account. More testing in the form of causality test or structural model would be require to quantitatively assess this relationship¹⁹.

¹⁹ Bartolli, pp. 171-207, and Mansur, pp. 309-345.

2.2 Monetary and Fiscal Policy in a Small Open Economy without Developed Financial Markets.

2.2.1 The Mundell Flemming Model

Haiti is a small-open economy with "officially" a fixed exchange rate, a case for which the Mundell Flemming model has several interesting conclusions. The basic model considers a small open economy and makes the following assumptions:

- . World prices are given for the small country

- . A small country does not influence the world interest rate and the domestic interest rate (r) is equal to the world interest rate (r^*) such that:

$$r = r^*$$

- . The model also assumes perfect capital mobility, which implies that there is a perfect substitutability between foreign and domestic bonds and that portfolio adjustment would be instantaneous following a change in interest rate.

- . Static expectations about the exchange rate (e.g. people believe the government intends to defend the parity of the currency).

Given the following demand for money (M_d) function of interest rate (r) and income (Y):

$$(1) M_d = L(r, Y)$$

equilibrium in the money market requires that the money demand (M_d) equals the supply of money (M_s). The latter is equal to net foreign asset of the banking system (R) plus the net domestic assets (DC).

$$(2) M_s = R + DC$$

In other words

$$(3) L(r, Y) = R + DC$$

Using the IS-LM framework, the model considers the following two propositions:

a. Fiscal and Monetary Policy under Fixed Exchange Rate

The equilibrium output level is determined through the IS equation

$$(4) Y = E(r, Y) + T(Y, \dots)$$

The equation states that output is equal to aggregate demand (E) and the trade balance. The working of the model is illustrated graphically in chart 2.3. A lower interest rate, by increasing aggregate demand requires an expansion of output to maintain equilibrium in the goods market. While this effect is partially cancelled out by the impact of rising income on the trade

balance, the former effect is assumed to dominate, giving the IS curve a negative slope.

Starting from an equilibrium level of output, Y_0 , for a given level of interest rate, r , (equal to r^*), suppose that there is a fiscal expansion. This would shift the IS curve to the right, and at the same interest rate level output would rise by Y_1 equal to Y_0 times the keynesian multiplier $(1/s+m)$. At this point aggregate demand has increased and caused an increase in the demand for money relative to the supply, thus putting upward pressure on the interest rate. Subsequently, there will be a capital inflow which will force the Monetary Authorities to purchase foreign exchange to defend the parity of the currency and therefore increase the money supply. Money supply is, therefore, an endogenous variable.

Conversely, let us consider an expansion of money supply, generated by domestic credit expansion. This would tend to lower interest rates below the world level and lead to an outflow of capital. Reserves would decline as the Monetary Authority sells foreign currency with a corresponding decline in the money supply. This continues until the money supply is back at its previous level and the original interest rate is restored. The only result is a substitution of domestic for foreign assets within the Central Bank. This outcome leads to the proposition that under fixed exchange rate and perfect capital mobility, a

small country cannot conduct monetary policy. Thus, the famous proposition that under fixed exchange rates, perfect capital mobility, and small country conditions, fiscal policy is very effective and monetary policy is impotent.

Though instructive, the model does not fit perfectly the Haitian case. First, Haiti is a country without developed financial markets, so that local interest rates do not respond in the manner depicted in the model. Second, the public sector is responsible for printing money, since it borrows from the Monetary Authorities to finance its deficit. This means there is no clear-cut separation between fiscal (budget) policy and monetary (credit to the public sector) policy. Third, as a result of increasing pressures on the exchange rate, a parallel market developed very early in the 80's which effectively destroyed the assumption of fixed exchange rates. The government officially stuck to its commitment to defend the parity but, at the same time, by overspending it was doing just the reverse. Nevertheless, a critical review of the fixed exchange rate model has something useful to teach a small country like Haiti, and that is the interdependence of monetary and fiscal policies when the public sector resorts to the Central Bank for short and long term financing.



b. **Fiscal and Monetary Policy under Flexible Exchange Rate**

In view of what has just been said, we need to explore the case of fully flexible exchange rate. We now have to factor in the impact of the exchange rate movement on aggregate demand and output.

Again, starting from an initial equilibrium position A (Chart 2.5) let us consider an increase in money supply. The rise in money balances will lead to a fall in interest rates and expansion in income as the LM curve shifts out to the right and the economy moves to point A'. At point A', the interest rate is below the international rate. Therefore there is a tendency for capital outflow and a consequent depreciation of the currency. This depreciation, by favouring exports or lowering the relative price of domestic goods compared to imported goods, raises the demand for domestic output and results in a shift of the IS curve up to the right. As long the depreciation persists, income rise and so does the IS curve. This trend continues until income has expanded sufficiently to restore monetary equilibrium at the world rate of interest. This is the case at point A''. In summary, the initial monetary expansion had a double impact on income caused by the exchange rate depreciation and its effects on aggregate domestic demand. In other words monetary expansion raises output and employment through an improvement in the balance of trade.

Now let us consider a shift in the IS curve induced by rise in exports (Chart 2.6). From point A we go to point A' where income has increased and the interest rate is above the world interest rate. The latter will provoke a capital inflow causing an appreciation of the currency. This in turn will affect exports and lead to a progressive shift back of the IS curve to its initial position. The process of exchange appreciation will continue as long as the interest rate exceeds the world level. Given a constant stock of money, exchange appreciation will continue as long as output is above its initial level. The exchange appreciation leads to a trade balance deterioration that fully offsets the initial demand expansion. With full crowding out, demand expansion leaves output unaffected as long as there is no accommodating increase in real balances.

The model shows that under flexible exchange rates, monetary expansion lead to an increase in output while a fiscal or export expansion has no effect at all on the level of output. The divergence between the two conclusions is attributable to the fact that under fixed exchange rates the money stock is fully endogenous, while under flexible rates it is exogenous.

2.2.2 Applicability of the Mundell-Flemming Model
to the Case of Haiti

The model points to the difficulty of using either fiscal or monetary policy alone to address the problem of external balance disequilibrium. The main problem for the application of such a framework to a country such as a Haiti results from its assumption of the existence of financial capital markets. In our case the absence of domestic financial markets and the limited accessibility of the government and private domestic residents of these countries to international financial markets, force the government to rely on the Central Bank to finance its deficits. This feature reinforces the endogenous character of money. However, if the government abandoned the fixed exchange rate regime, it would have more room to use fiscal and monetary policies to address both internal and external disequilibrium. This is why donor countries and multilateral institutions such as the IMF or the World Bank show great reluctance to indulge in balance of payments support programs for countries such as Haiti which insist on maintaining an overvalued currency.

Fiscal policy is thus considered an important component of monetary policy, and monetary policy is an important component of fiscal policy. Monetary discipline requires fiscal discipline, because of the nature of the financing of the public sector's financial needs. A policy mix is what is needed and must also

encompass a different exchange rate policy. This point will be taken up later.

This chapter has highlighted the effect of the budget deficits and the composition of its financing on the current account of the balance of payment. As we will see in the next chapter, this relationship between the current account balance and the budget deficit is at the core of the analytical approach used by the International Monetary fund in formulating structural adjustment program.

CHAPTER 3**THEORETICAL ANALYSIS OF IMF STRUCTURAL ADJUSTMENT PROGRAMS**

Protracted balance of payments problems, rising inflation, and large external debt, combined with a refusal of international lenders to provide further funds, are the classical symptoms of external and internal disequilibrium which commonly force countries to seek IMF and World Bank assistance. This assistance usually comes in the form of an IMF stabilization program which releases funds gradually, subject to the successful implementation of prescribed policies and the achievement of specified economic targets. The purpose of this chapter is to describe the theoretical framework used by the Fund to analyze the immediate origins of disequilibrium, to develop models for financial programming, and ultimately, to design structural adjustment programs.

3.1. Objectives of the Fund Structural Adjustment Programs

The general objectives of Fund structural adjustment programs are prescribed by its Articles of Agreement. "These call for the expansion and balanced growth of world trade, as a means toward the promotion and maintenance of high employment and real income levels, as well as for the development of the productive resources of all members. The Fund seeks to fulfil

its purposes by fostering economic and financial cooperation among member countries in a setting of exchange stability and orderly exchange rate arrangements, and in the context of a liberal system of multilateral payments. To this end, it stands ready to make resources available to members in support of their efforts to correct maladjustments of their balance of payments. By putting financial resources at their disposal the Fund gives them an alternative to their adopting policies that would be detrimental to international trade in goods and services, thereby promoting world economic equilibrium²⁰".

"The Fund's mandate focuses mainly on external objectives, in particular on balance of payments viability. In its financial relationships with individual members, the Fund stresses the attainment of balance of payment objectives as a domain where the interest of each member and those of the membership as whole coincide. Out of respect for sovereignty in national policy decision making, the Fund observes a principle of political neutrality with regard to other domestic economic objectives (growth, price stability, social equity). However, in so far that these other economic objectives affect the balance of

²⁰ Manuel Guitian, "The Fund's Role in Adjustment" in *Adjustment with Growth: the Fund, the Bank and Country Experiences*, the IMF and the World Bank, p.18.

payments viability, the Fund argues forcefully for the adoption of policies to promote their achievement²¹".

3.2. Analysis of the Causes of Disequilibrium

The IMF analytical approach to the causes of external and internal disequilibrium integrate the traditional macroeconomic approach to aggregate demand management and the more recent microeconomic approach which stresses the importance of supply factors.

3.2.1. Macroeconomic Approach and Aggregate Demand Management

This approach stresses the link that exists between internal equilibrium, symbolized by the equality between saving and investment on the one hand, and the external equilibrium characterized by the equality between imports and exports of goods and services, on the other hand. According, to the IMF approach, internal equilibrium is the main determinant of external equilibrium.

The IMF theoretical analysis of internal and external disequilibrium stresses the monetary approach to the balance of

²¹ Ibid

payments but, it relies also on the absorption and the fiscal approach to the balance of payment. We will review each of these approaches to see how they complement one another with regard to policy design.

a. The Monetary approach of the Balance of Payments

The monetary approach to the balance of payments was developed by the University of Chicago at the end of the 1950's. It utilizes the principles embodied in the quantity theory of money and attributes the responsibility for a deficit in the balance of payments to an excess supply of money.

The IMF policy framework primarily builds on the monetary approach of the balance of payments. From the point of view of the IMF, the development of the monetary approach to the balance of payments with regard to the design of adjustment programs²² in less developed countries can be justified by three main factors²³:

1. the lack of reliable national income data in these countries, whereas financial data are more readily available;

²² With regard to the development of analytical framework, the pioneering work was done by J. Polack (1957). The first model was developed by Polack and L. Boissonneault. The model focuses on the relationship between credit expansion and change in foreign assets and considers net domestic credit as policy variable. The model is presented in "The Monetary Approach to the Balance of Payments" (1997), The IMF, pp. 15-64.

²³ Ibid., pp. 5-7

2. the simple financial structure of less developed countries. In the absence of well developed domestic asset markets and financial instruments, there are relatively few alternatives options open to domestic residents. Their choices are continued to either holding funds in monetary form or spending them on domestic or foreign goods and services or on foreign financial instruments. In these circumstances, the implications, for the external balance, of a difference between the amount of money newly supplied through domestic credit creation and the additional amount that residents wish to hold are more obvious than they would be in countries with a more complex financial structure; and
3. the monetary approach appears to be even more adequate in countries where the control over domestic credit is in fact a major instrument of demand management and balance of payments control.

The basic monetarist model considers a small open economy under a fixed exchange rate and at full employment. This implies that the country faces prices and interest rates determined at the world level. The model is based on two crucial assumptions, the first of which is that the money demand function is a stable function of income. As a consequence economic agents want to maintain a portion of their total assets in the form of money.

$$(1) \quad M_d = f(Y, P)$$

Where money demand balances is positively related to the change in real income (Y) and the change in the domestic price level (P).

The second assumption is that the monetary authorities can control money supply through domestic credit expansion, that is, domestic credit expansion is an exogenous variable and independent of the demand for money. The analysis is developed as follows:

Equilibrium in the money market requires that of money supply (M_s) is equal to the quantity of money demand:

$$(2) \quad M_s = M_d$$

From a balance sheet relationship for the banking system, we can express the change in net foreign asset of the banking system (R) as equal to the change in the money stock, i.e. liabilities of the banking system (M_s) and the change in net domestic assets of the banking system (DC).

$$(3) \quad \Delta R = \Delta M_s - \Delta DC$$

DC is the consolidated net domestic assets arising from net cumulative domestic credit expansion by the central Bank and by the commercial banks. M_s is the consolidated liabilities of the banking system, which in the present case means the total money supply. The consolidation means that bank's reserve deposits at the central Bank have been netted out, so that total liabilities of the banking system measure the money supply, that is, the

deposits belonging to the public and the public's holdings of currency.

The change in the country's net foreign assets (ΔR) is equal to the overall surplus or deficit of the balance of payments (B).

$$(4) \quad \Delta R = B$$

$$\text{thus, (5) } B = \Delta R = \Delta M_d(p, Y, i) - \Delta DC$$

According to equation 5, the monetary approach explains the overall balance of payments as the difference in the demand for money and the change in net domestic assets of the banking system (domestic credit creation). The adjustment between the money supply and the demand for money proceeds in the following manner: an increase in the demand for money bids up the price of money (interest rate) which initiates capital inflow. The subsequent build up of reserves at the central bank expands the domestic money supply ($M_s = R + DC$) until demand for money equates supply at a higher level. In the case of a domestic credit expansion money supply is increased (equation 3). The excess of supply over demand in the money market bids down the interest rate, initiating a capital outflow and loss of reserves. This continues until the loss of reserves equals the gain in domestic credit and equilibrium is restored to the money market.

b. The Absorption Approach to the Balance of Payments

This approach basically says that the deficit on the balance of payments results from an excess of absorption over national income. The demonstration relies on the national income identity and the balance of payments identity and goes as follows:

The national income identity in an open economy is specified as

$$(6) \quad Y = C + I + G + (X - M)$$

Where Y stands for gross domestic product (GDP) or gross national product (GNP)²⁴. C is private consumption, I private investment, G public sector expenditures, (X - M) exports minus imports of goods and services. The national income identity states that income is equal to aggregate spending by domestic residents, C, I, G, plus net exports. This implies that the excess of national product over aggregate spending is equal to net export.

$$(7) \quad (X - M) = Y - C - I - G$$

Considering total spending or absorption by domestic residents (A):

$$(8) \quad A = C + I + G$$

and the balance payment (B) is equal to net exports:

$$(9) \quad B = X - M$$

We can restate the national income identity as follows

$$(10) \quad Y = A + B$$

²⁴ GDP plus net factor income from abroad (NFI) equals GNP. NFI is usually negative for LDCs due to interest payment abroad.

The last identity states that income is equal to aggregate spending by domestic residents (A) plus net exports. Thus:

$$(11) \quad B = Y - A$$

This implies that the current account of the balance of payments is positive if revenue exceeds absorption and negative otherwise. Absorption (A) being the equivalent of domestic aggregate demand, it can be said that a deficit on the balance of payments has the same origin as inflation, an excess of aggregate demand except for that part of the deficit for which foreign credit is standing by²⁵.

c. The Fiscal Approach to the Balance of Payments

The fiscal approach is also derived out of the national income identity. It was developed in the mid 1970's by the Cambridge Economic Policy Group (CEPG). This approach focuses on public sector saving as the only relevant determinant of the current account of the balance of payments. Using equation (7), the fiscal approach models the current account of the balance of payments, (X-M), as determined by the fiscal balance, (T - G), and private balance, (S-I) as follows:

²⁵ One can argue that in the case of a country that is in great need of resources, a deficit on the current account that brings in goods and services tend to keep in check the inflationary forces. When the local currency depreciates on the exchange market, however, this lead to inflation. It is only partly true that the deficit on the current account has the same origin as inflation.

$$(7) \quad (X - M) = Y - C - I - G$$

If we modify equation (7) by subtracting net taxes (T) from both sides, then recalling the definition of private savings S,

$$(12) \quad S = Y - T - C$$

our initial identity can be written as:

$$(13) \quad X - M = (S - I) + (T - G)$$

$$\text{or, } (14) \quad X - M = (S + (T - G)) - I$$

This identity defines the current account in terms of sectoral balances. It implies that a current account deficit, (M greater than X), means that total savings are lower than private investment. This comes out clearly if one defines total savings as the sum of private savings S and public savings (T - G). Alternatively one could define G as including only non capital expenditures, and I as including both private and public investments, and conclude that a deficit on current account implies that investment in the economy is larger than domestic savings. We will stick to the former formulation, that is, investment means investment by the private sector. Conversely, a surplus on current account means that total savings exceeds investment. Third world countries certainly save less than they invest and they succeed in doing it by importing external savings. Put differently, third world countries have deficits on the current account.

d. Complementarity of the Approaches

In summary, the three approaches view demand factors as being the main cause of external deficits. As we will see, these approaches complement each other when it comes to designing policies for financial program. The monetarist approach, summarized by equation 5, underlines the crucial importance of global monetary variables in the determination of the external balance and the subsequent need to control the expansion of the monetary base.

The shortcoming of the monetarist approach is that it fails to explain which elements are the cause of uncontrolled monetary expansion and which elements should be treated to regulate it. It is the other two approaches to the balance of payments which have the task of identifying and analyzing the components of aggregate demand which give rise to monetary expansion. These approaches demonstrate that budgetary policy plays as important a role as monetary policy in explaining external deficits and designing adjustment program.

The demonstration can go as follows:

1. let us consider the three sources of increase in the money supply: a change in credit to the private sector, a change in credit to the public sector and a change in net foreign exchange reserves. Because of the primitive nature of the financial system in most LDCs, credit to the private sector is

rarely allocated by a market mechanism. More common is a quota-like system which stipulates a given quantity of credit to be made available each period. In this sense, the credit to the private sector can be considered an exogenous policy variable. Credit extended to the public sector is also a choice variable since the government controls both the supply and the demand. Credits extended to the public sector are associated with excessive public sector spending. Foreign exchange reserves, meanwhile are determined as the residual between money demand and domestic credit and are therefore endogenous.

As a consequence of the above, increases in domestic credit can be seen as the root cause of increases in the money supply and hence increase in the external imbalances. Credit to the private sector can be considered a choice variable and is easily controlled. Credit to the public sector is a more difficult problem. Since there is no limit to the amount the government can borrow, these amounts tend to increase to finance ever increasing fiscal deficit. The IMF attributes the ultimate cause of external disequilibrium to excessive government spending. This provides the link between the monetary and fiscal approaches to the balances payments in the design of IMF programs. Thus, the main performance clause in any adjustment program deals with restricting domestic credit to the public sector;

2. Starting from the public sector deficit, we can reestablish the link between fiscal policy and monetary policy because of the relationship between the financing of the public sector deficit and the granting of credits by the banking system. The deficit of the public sector (DPS) is financed by grants (FING), borrowing from outside (FINPU) and from inside, mainly from the banking system (OFIN)

$$(15) \quad \text{DPS} = G - T = \text{FING} + \text{OFIN} + \text{FINPU}$$

Underdeveloped countries having no developed capital markets rely mainly on the banking system as the source of domestic credit. We analyze the change in the banking system's net domestic assets as being made of two parts, the one in connection with credit to the private sector (FINPRI), the other in connection with credit to the public sector (FINPU)

$$(16) \quad \Delta R = \text{FINPRI} + \text{FINPU}$$

Given this definition of ΔR , one can write

$$(17) \quad \Delta R = (\Delta M_s - \text{FINPRI}) - \text{FINPU}$$

and after substituting from (15) above

$$(18) \quad \Delta R = (\Delta M_s - \text{FINPRI}) - (G - T - \text{FING} - \text{OFIN})$$

Changes in the banking system's net external asset position ΔR have as their counterpart either an increased net indebtedness of the private sector toward the banking system, that is an increase in credit in excess of the rise in the money supply, which is the difference $(\Delta M_s - \text{FINPRI})$, or a budget deficit in

excess of grants and outside financing and that is financed by the domestic banking system, which is given by the difference, $(G - T + FING + OFIN)$ what amounts to FINPU.

The IMF macroeconomic analysis of disequilibrium leads to major emphasis on demand management policy for stabilization purposes. The main aim is to bring domestic demand into line with available resources. In most cases the prescribed solution to disequilibrium is a restrictive budgetary policy carried out within the framework of stabilization of monetary variables. The complete set of stabilization policy is known as a financial program. Financial programming essentially deals with short term stabilization goals and is described below.

3.3. Financial Programming

3.3.1 Nature of Financial Programming

A financial program is a set of coordinated policy measures intended to achieve certain economic targets in a relatively short period of time. The task of setting economic targets, choosing policy instruments, and quantifying the appropriate magnitude of the instruments required to reach the targets is described as financial programming. As practised by the IMF, the underlying framework combines the three balance of payments approaches described above. The main assumptions are that there

is a relatively stable relationship between financial variables (such as money and domestic credit), on the one hand, and non financial variables (such as real national incomes and prices) on the other; and that the monetary authorities can control some of the financial variables so as to affect the real side of the economy. As we will see in the next chapter, although financial variables are emphasized, non financial policy measures, especially measures to promote economic growth are also included in financial programs.

3.3.2. Derivation of the basic Financial Programming Framework

The exercise is usually considered over a 12 month period. The design of the model of financial programming is based on the previously identified relationship between domestic credit expansion and the external balance. It proceeds by defining and estimating demand for money of the general form:

$$(5) \quad \&Md = F(\&Y, \&P)$$

Although the IMF demand function does not exclude the role of interest rate and other variables on the demand for money, their analysis focuses on the change in the domestic prices(&P) and the change in real income(&Y). This approach is realistically applicable to developing countries, such as Haiti, where financial markets do not play a significant role. Income and

domestic prices affect positively the demand for money.

Estimates of the real income²⁶ and the level of prices²⁷ over the next 12 months are needed in order to obtain an estimate for money demand.

The equilibrium condition of the money market states that:

$$(6) \quad \Delta M_d = \Delta M_s$$

Therefore, restating equation (5) with the new demand for money function yields:

$$(7) \quad \Delta R = \Delta M_s - \Delta DC = f(\Delta P, \Delta Y, \dots) - \Delta DC$$

This equation states that, for the small country case, given exogenously determined income and price an increase in domestic credit above the desired increase in money will be offset by a decrease in net foreign assets on a one for one basis.

In summary, if we assume that demand for money is stable and that change in demand for money is independent of any change in domestic credit, then imposing a ceiling for increases in domestic credit will also impose a limit in the loss of reserves.

²⁶The rate of growth of real national income is a policy objective that must be set realistically so as to be consistent with the other policy objectives. The rate of growth of real national income depends on a set of complex relationships that underline aggregate supply and demand. In particular it depends on the fiscal and monetary policies to be followed over the period of adjustment.

²⁷ The level of prices over the next 12 months is also a target variable and is set with reference to the purchasing parity theorem, so as to keep the domestic price level in line with the price level country's main trading partners.

This statement and equation (7) are used as the basis for the financial programming model. The policy design involves: first, setting the target for the balance of payments, i.e. change in international reserve for a given period; secondly, forecasting the demand for money for the same period; and finally, using equation (7) to determine the level of credit expansion compatible with the target balance of payment.

a. First extension of the model

The basic model outlined above can be extended to desegregate the balance of payments into its components²⁸. In order to do so the model first defines a second behavioural relationship, namely the demand for imports (IMV).

$$(8) \quad \text{IMV} = \theta Y$$

The parameter θ is a constant so, the volume of Imports (IMV) is an increasing function of real income Y . The value of imports (M) is obtained by multiplying the volume by import prices P_m . The change in net foreign assets ($\&R$), originally defined simply as $(X-M)$ is expanded to include capital flows. Thus where KA represents net capital flows.

$$(9) \quad \&R = X - M + KA$$

²⁸The second step consists in tentatively fixing the values of the target variables to be achieved in a specified period of time: targets include a current account balance, inflation rate and rate of economic growth and one contingent on the values of the previously identified exogenous variables. Subsequently, policy actions that may be required to achieve such targets may be envisaged.

Given a balance of payments target (&R), it is necessary that the model include projections of the exogenously determined variables of the balance of payment, namely, exports and capital inflows. For a primary export producer such as Haiti the small country assumption is that exports are essentially determined by supply and that export price are determined by the world market. Forecasting of export supply, in this case, is closely linked with the projection of domestic production of exportable, mainly coffee. This in turn is affected by the price received by the producer. The most important unknowns are the world prices for major export commodities receipts²⁹.

The capital account (KA) is usually fairly easy to estimate, especially for the poorer LDCs. In the absence of a developed capital market, and given Haiti's small capacity for commercial borrowing and foreign investment, the main source of capital flow funds considered here are projected capital inflows from official sources from which scheduled interest and amortization payments are deducted³⁰.

²⁹ Projections of exports receipts can also be made on the basis of forecasts of real income growth in the country's export markets, and possibly the export prices of competing countries in the world market.

³⁰ Another approach is to determine a "sustainable" level of foreign debt that is consistent with the country's current and future debt-service capacity, and then to ensure that the increase in net external indebtedness is consistent with this sustainable level.

Given the target level for change in reserves (ΔR) and the projection for the export level (X) and capital account (KA), the target value of imports (M) is derived from equation (9). Since the actual value of import (M) will depend on domestic income and on such variables as the ratio of the price of imports of domestic goods (as an indicator of possible substitution) it is also necessary to forecast. Real income is projected and targets for domestic prices are set. From there, using the previous framework, the demand for money is derived and using the second behavioural equation the demand for imports. Once all the variables have been estimated and the target value of net foreign assets has been fixed, the amount of domestic credit expansion of the banking system over the 12 months period can be calculated from equation (7). Finally, we solve for the credit ceiling using equation (7). The two values of imports obtained in each development should converge, if they do not some adjustments are made to the model until they do.

b. Second Extension: inclusion of the fiscal deficit.

The model can be extended to distinguish between credit allocated to public and private sectors. To this end, the variable total domestic credit expansion (ΔDC) is desegregated into credit expansion to the public sector ($FINPU$) and credit expansion to the private sector ($FINPRI$). (The policy variable to determine is the change in net domestic credit expansion to

the public sector as opposed to the change in total domestic credit expansion. The idea is to link the monetary and fiscal accounts.

$$(10) \quad \&DC = \&FINPU + \&FINPRI$$

By considering the government budgetary deficit after grants (G- T) to be financed by a combination of external borrowing (OFIN) and domestic borrower, borrowing from the banking system, (FINPU) we derive equation (11):

$$(11) \quad (G - T) = OFIN + FINPU$$

Because of the underdevelopment of financial markets in the LDCs, financing of the fiscal deficit by the public is negligible, and therefore is therefore omitted.

Finally by desegregating capital inflow (KA) into going to the private sector (CKp) and going to the public sector (CKg) we have:

$$(12) \quad KA = CKp + CKg$$

The distinctions between private and public sector become important when the total quantity of credit is restricted. Domestic credit to the public sector is often set as a policy variable. In the case of the private sector, it is generally an important secondary target in financial programs in order to ensure that the private sector exceeds a sufficient amount of credit for working capital and investment purposes.

The three equations above highlight the link between monetary expansion and the fiscal deficit. This provides the rationale for placing a ceiling on the amount of foreign borrowing to the public sector (OFIN) and the domestic credit expansion to the public sector (FINPU). The ceiling limits the possible expansion of the fiscal deficit. However, monitoring the public sector also involves some measures concerning revenues and expenditures.

Once we have established the total domestic credit ceiling using the basic framework and set a target to credit expansion to the private sector, using equation we derive the credit ceiling to the public sector (FINPU). And considering (OFIN) as an exogenously determined variable, using equation (11) we obtain an estimate of the government overall budget deficit.

c. Third Extension: inclusion of the central bank

To be complete, financial programming must involve the calculation of the expansion of central bank credit that is compatible with the expansion of banking system credit. That is credit ceiling imposed on commercial banks versus the Central Bank.

The policy variable to determine is the change in net domestic assets of the central bank as opposed to the change in net domestic assets of the banking system. To restrict our analysis to the central bank, it is necessary to first define the balance sheet identity of the central bank. The changes in the liabilities of the central bank, known as high-powered money (&H) are equal to the change in net foreign asset of the central bank (&R) and the change in its net domestic assets (net of deposits). This relationship is summarized by equation (13):

$$(13) \quad \Delta H = \Delta R + \Delta DC_{cb}$$

The total supply of money (M_s) is related to reserve money (H) through the money multiplier (m):

$$(14) \quad M_s = mH$$

Assuming a stable money multiplier, the model then replaces the banking system relationship of equation (5) with the following:

$$(15) \quad \Delta M_s = m(\Delta R + \Delta DC_{cb})$$

It is now easy to derive the credit expansion of the central bank. The choice of the form of domestic credit ceiling, i.e. between the banking system and the central bank, to use as a policy variable will depend on the structure of the financial system and the operating procedure for monetary policy in the particular country under consideration.

This basic model is part of a macroeconomic model, based on equations which describe the specific structure of the economy considered. After fixing the targets to be achieved and inserting the forecasted values of exogenous variable, the required value of policy instruments are calculated either by solving or by simulating the model. The result yielded by such a model are subject to all the errors commonly associated with econometric models, these include errors in the statistical data used, in the specification of the model, in the estimation procedure, and in forecasting of exogenous variables. Moreover, the use of stability of the behavioural relationships provide the link between variables in the model we supposes these relationships to be stable, in fact, this cannot be taken for granted outside the sample period³¹.

³¹ IMF Institute, "Financial Policy Workshops: The Case of Kenya", p. 263.

3.4 Microeconomic Approach

The IMF does not limit its approach to the search for a short term macroeconomic equilibrium of equating demand to the level of supply. It also has developed a microeconomic type of perspective based on supply growth conditions in the medium or long term. The new orientation corresponds to a shift in emphasis from stabilization to adjustment. This new direction has resulted in an increase in the type of lending instruments and financial assistance programs available to country facing balance of payment crisis and to an increase in the length of duration of the availability these resources. It has a double origin: the criticism of traditional policies of demand management as expressed by the structuralist in the 1950 and 1960's, and the external economic shocks of the 1970's.

The structuralists argue that inflation and the chronic balance of payment deficit cannot be explained exclusively by excessive aggregate demand. They believe that the causes of these disequilibrium are to be found in the economic and social structures specific to less developed countries. Accordingly, economic policy should focus on means to eliminate these bottlenecks and relax the rigidity on the supply side rather than try to curb domestic demand. In their view, restrictive demand management policy only depresses domestic production and investment, thus reducing the country's long-term capacity to earn foreign exchange and to make room for economic growth.

Fundamental changes in the world economy in the late 1970's and early 1980's including the deterioration of the terms of trade, stagnation of world markets, the rise in oil prices and rising debt service payments, and their impact on less developing countries have led to modifications in IMF analysis. The Fund came to the conclusion that external deficits in a number of LDCs were caused by an incapacity of the country to adapt to the new international environment. The rigidity in their economic and social structure prevented a reorientation of domestic production and consumption to the new international realities. To take these factors into account, the new approach incorporates micro-economic elements, dealing with the conditions of supply, to complement the excessive aggregate demand approach.

Both structuralists and monetarists stress the importance of supply factors in their analysis, however, the causes associated with these factors and, thus, their policy recommendations differ significantly. The structuralist impute these rigidities to the institutional structure specific to less developed countries, and more importantly to the unfavourable integration in the international division of labour. In this respect, the role of the state is essential in correcting these distortions. The IMF, relying on neo-classical resource allocation theory, alleges that, in the less developed countries significant distortions in relative prices, attributable to the excessive state

intervention, are one of the main causes of external and internal disequilibrium³².

The integration of the supply and the demand elements in the analysis of the causes of disequilibrium has resulted in the notion that growth and adjustment are mutually reinforcing. In effect, the IMF recognizes that: "macroeconomic balance, while a necessary condition for the additional objective of sustained growth, is not a sufficient condition. If a country's balance of payments position is unsustainable it will not be able to restore or maintain satisfactory growth unless adjustment takes place; conversely a viable balance of payment position can be sustained only in the context of adequate growth that enables production and trade to meet the demands of an increasing population³³".

Presently, most structural adjustment programs in addition to focusing on quantitative financial performance clauses have stressed the importance of pricing policies aimed at raising and changing the structure of aggregate output, increasing the rate of saving and improving the rate of return on investment. However, it remains to be seen how effectively the IMF integrates these two approaches.

³² Marie France L'Hériveau, "Le fond monétaire international et les pays du Tiers-Monde", pp. 139-153.

³³ Michael W. Bell and R.L. Sheeny, "Helping Structural Adjustment in Low Income Countries" in *Adjustment with Growth: the Fund, the Bank and Country Experiences, the IMF and the World Bank*, p.13.

CHAPTER 4**HAITI STRUCTURAL ADJUSTMENT PROGRAM**

The stabilization measures introduced in early 1986 had remarkable success in restoring fiscal balance. Haiti was able to regain the confidence of external donors and secure the necessary support for the implementation of a three year stabilization and adjustment program under the IMF Structural Adjustment Facility (SAF)³⁴. This was complemented by a structural adjustment loan from the World Bank. The structural adjustment program was described in a comprehensive policy framework paper outlining the medium term objectives and policies for achieving these objectives. This paper was developed by the national authorities in consultation with the International Monetary Fund and the World Bank.

The policy program was initially intended to last three years, from October 1st of 1986 to September 30 of 1989. This chapter reviews economic developments in Haiti during the period 1986-88 while focusing primarily on the content and the outcome of the structural adjustment program.

³⁴ The structural adjustment facility was established in March 1986, by the Fund's Executive Board . It is financed by about SDR 2.7 billion. This facility , which is financed by about SDR 2.7 billion, was more specifically designed to support adjustment process in low-income countries.

4.1 Program Design

4.1.1 Objectives

Haiti's structural adjustment program integrated restrictive demand management policies and structural adjustment policies in an effort to secure stabilization with growth. The program was designed to consolidated the gains secured in 1986³⁵, while creating conditions for sustainable growth in the medium term. The medium term objectives were as follows:

1. A sustained growth rate of real GDP of at least 4 1/2 per year;
2. a containment of Haiti's inflation rate to no more than that of its major trading partners (estimated at 4% a year); and
3. an achievement of an overall balance of payments surplus of about 1/12 of GDP in 1986/87 and close to 1% in each of the following years, so as to permit the strengthening of the official net international reserves and some replenishment of the central bank's gross foreign assets.

³⁵ As mentioned in chapter 1, in 1986 the new government took severe adjustment and stabilization measures in attempt to restore internal and external balance. These gains are briefly discussed later in this chapter.

4.1.2 Assumptions Concerning the External and Internal Environment

The success of the program was contingent on some critical assumptions:

1. The rate of inflation among Haiti's main trading partners was projected at 4% in 1986/1987;
2. Exports from the assembly sector were projected to rise by 4 1/2 percent in volume terms, and 8 1/2 percent in terms of US dollars. Much of this increase was expected to come from the textile sector, following the decision by the United States to raise annual quotas for various categories of textiles imported from Haiti;
3. The volume of coffee exports was expected to recover by one-sixth in 1986/87 to 320 thousand 60 kilogram bags. The average unit value of coffee exports would decline by 8 % to 183 cents per pound in 1986/87; and
4. A stable demand for money, independent of credit expansion to the public sector was assumed. The velocity of money, as measured by the ratio of nominal GDP to money, and quasi-money was projected to be unchanged in 1986/87 at 4.0.

4.1.3 Policy Instruments and Reforms

The program main policy changes have consisted of the reduction of the public sector size and scope, improvement in fiscal accountability, restricting the growth of credit, and trade liberalization.

a. Fiscal Policy.

The prime thrust of fiscal policy was to reduce the public sector deficit and its domestic and non-concessional external debt by improving the management of public finances. The objective was to limit the public sector deficit to 7% of GDP, to be financed only by external resources.

On the revenue side, efforts focused on administrative reforms of the tax and custom system. The objectives were to expand the revenue base and reduce the marginal tax rate while simplifying and improving the administration of the tax system. The reform also included a significant reduction in excise taxes on a number of consumer staples. In view of these reforms, revenues were expected to fall by 6% compared to 1985-1986 to 1130 million gourdes (10.2% of GDP, Table 4.1b). On the expenditure side, the program set a limit to Treasury outlays to 1290 million gourdes (11% of GDP). This target was to be achieved by strengthening administrative expenditure controls, limiting the expansion of public sector hiring and the wage bill and eliminating extrabudgetary spending and transfers to public enterprises. Current expenditures were to be reallocated toward health, education, agriculture and public works ministries.

For programming purposes grant disbursement had been set at G 140 million. This would permit running a budgetary surplus of G 40 million, to be used to reduce Government debt to the Central

Bank and government external financial obligations. As indicated by the quarterly benchmarks for net financing of the public sector, presented in Table 4.1a, the net repayment of outstanding credits was estimated at 60 million gourdes between October 86 and September 87.

b. Monetary and Credit Policies.

In line with the macroeconomic stabilization objectives of reestablishing both internal financial and monetary balances, a restrictive monetary policy was essential. In this respect, the main targets of the program were to restrict the net credit to the government, while allowing the expansion of credit to the private sector, and to cease deficit financing by the Central Bank.

As indicated in Table 4.1.c, the net domestic assets of the Central Bank and the state-owned National Credit Bank were to be reduced by 4.3% (1440 million gourdes) at the end of the fiscal year while commercial bank credit to the private sector was projected to increase by 8 percent. These objectives were set in order to allow financial resources to increase by 8.7%. This was necessary to improve the overall balance of payments by US\$32 million and to accommodate a moderate increase in money supply compatible with an inflation target of 4% and a real growth rate of GDP of 4.5% for FY86-87.

In order to improve the mobilization of domestic savings and increase the resources available for investment and growth, some measures featured in the program were to ease interest rate policy and improve the financial system's efficiency. The program recommended a greater flexibility in the reserve ratio of bank's to reduce the overhang of liquidity.

c. External Policies

External policies were designed to maintain an overall balance of payment surplus of US\$32 million a level which would allow some reconstitution of net international reserves and repayment of external arrears. External arrears, which stood at US\$14 million at the beginning of the fiscal year were to be rescheduled or settled with cash payments by the year end. The public sector commercial debt was to be reduced from US\$100 million as of September 1986 to \$96 million by September 1987 (Table 4.1d). A widening of the current account deficit to 7% of GDP was expected as the demand for imports and investment increased along with the implementation of the program.

d. Structural Adjustment Policies

The second facet of the program involved a number of measures to improve the allocation of resources in the economy and, thus, expand growth potential. These policies were designed and supported by a World Bank structural adjustment loan. They focused in particular on: (i) improvement in the performance of public sector management that included a) rationalization of public investment programs, b) improve public sector enterprise financial performance and c) rationalization of the size of public sector including divesture of public holdings; (ii) trade liberalization.

(i) the size and composition of the public investment program had to be reviewed annually with the World Bank as too many projects suffered from inadequate technical design, poor implementation and lack of sensitivity to national development needs. New investments were to focus on projects generating employment whereas existing projects which failed to meet this requirement were to be abandoned. Public investments were to continue to be financed by concessional aid and enhanced with technical assistance³⁶;

³⁶ See Annex I for more specific detail.

(ii) with regard to public enterprises, the objectives were to eliminate real resource losses and improve their efficiency and competitiveness. The reforms covered:

- 1) overall economic policy that affects enterprises performance such as pricing policy in order to eliminate any type of subsidies from either the consumer or the government through excessive pricing;
- (2) audit, organizational and managerial changes;
- and (3) closure of non profitable public enterprises; and

(iii) trade liberalization reforms included the progressive elimination of the export tax on coffee, abrogation of export taxes on agricultural products, the replacement of quotas and specific tariffs on a larger number of imported goods with ad valorem tariffs, the dismantlement of private and public trade monopolies and the opening of provincial ports. The administration of the tax, custom valuation, and enforcement procedures were also improved.

These reforms were intended to reduce nominal and effective protection and thus expose local enterprises to international competition and provide incentives to producers to allocate their resources toward those sectors where they had a comparative advantage, i.e agriculture and light assembly industry. This

would, in turn, result in lower consumer prices and increase relative profitability of exports.

Another key aspect of the IMF trade policy instrument is the exchange rate. In the case of Haiti, notwithstanding the fact that the real exchange rate had appreciated steadily over the period 1980-1985 and seriously affected export competitiveness, the program made no allowance for relative price adjustment through the exchange rate. The authorities chose to maintain the fixed parity of 5 Gourdes for one US dollar, as this was thought to create a stable environment conducive to export and investment growth.

These general supply side policies, designed to create a more competitive environment, were complemented by supportive sectoral policies. With regard to agricultural policy, in addition to pricing policy, the emphasis was on the improvement of public service and credit to private farmers. Industrial policy encompassed a review of the Industrial Investment Code (with the aim of stimulating investment). The policy also made provision for financial and technical assistance to firms wishing to adapt to the new competitive environment. Finally, social sectoral policies focused on the issue of improving human capital, taking into consideration education and health as well family planning. These policy changes and their timing are detailed in Appendix I.

4.1.4 Financial Support to the Program

One of the critical element to the success of any adjustment program is the availability of sufficient financial support. In this respect, the Haitian program was well supported. Overall, for the period of FY87-89 all donors together had indicated that net disbursement of concessional aid to Haiti would average about US\$ 185 million a year, implying an almost 25% increase in net disbursement over the period 1983-1985. Concessional loans and grants originated from three main lending programs:

(i) the Fund financial support under the structural adjustment facility (SAF)³⁷ was in the amount of SDR 20.7 million, equivalent to 47 percent of Haiti's quota of SDR 44.1 million. Over the three year period of the arrangement, three payments were scheduled: the first portion of \$10.7 million US, equivalent to 20% of Haiti's quota, was disbursed in December of 1986. A second tranche of 17 million US dollars representing 30% of Haiti's quota was programmed for 1987, with the balance due in the last year of the program;

(ii) as a complement to the SAF, the program was supported by a World Bank structural adjustment loan under the Economic Recovery Credit program (ERC). This loan, which constitutes a pillar of the program, reached US\$ 40 million. Two payments of US\$ 20 million were scheduled, the first one was received in April of 1987; and

(iii) The USAID granted \$18 million under the Economic Support Fund (ESF) in October 1986. This grant was to be followed by a second payment of \$20 million that was subsequently cancelled after the events of November 29, 1987.

³⁷ Loans under the SAF are made on concessional terms similar to those of the original Trust Fund loans. Interest is payable semi-annually at rate of 1\2 of 1 percent per annum and repayments are made in ten equal semi-annual instalments beginning five and one half years and finishing ten years after the date of disbursement.

In addition, the Caribbean Group for Economic Development had pledged substantial assistance in the form of commodity and project aid to support the country's adjustment and recovery program.

4.2. Performance Under Program

During 1986, remarkable progress were achieved on all fronts, and the domestic and external financial position improved substantially. In FY86 the overall public sector deficit before grants was reduced to 5.2% of GDP and the consumer price index fell by four percent from February to September. The current account deficit was narrowed to 4.8% of GDP, and the overall balance of payments registered its first surplus in over six years. During the first nine months of 1987, the gains of the previous fiscal year were consolidated. However, the momentum of the original economic reforms was lost by a series of political crises³⁸ beginning in the last quarter of FY87, which led to the cancellation of the arrangement with the IMF and the suspension of external assistance in November 1987.

³⁸ Increasing political instability was experienced during 1987. From July 1987, there has been intermittent civil disturbances associated with the electoral process, culminating in a cancellation of election at the end of November 1987, amidst violence on election day.

Tables 4.2 compares the achievements with the targets of the stabilization program for the fiscal year 1986/1987. Overall, these figures indicate that the economic performance fell short of expectations and point to the fragility of the country's economic and financial situation. In assessing the outcome of the adjustment program we will review its impact on the internal and external balance as well as on economic growth.

4.2.1. Internal Balance

a. **Fiscal Balance**

Although it was expected that the initial effect fiscal reform would reduce total government revenue, total government receipts for FY87 fell short of the targeted level by 170 million gourdes. Several factors account for this shortfall in revenue. Depressed economic activity, fiscal evasion, and the lack of familiarity of the tax collectors with the new tax system all played a role. Civil disturbance in the last quarter of 1987 and the upsurge of contraband activities with the opening of provincial ports also contributed to a reduction of revenues. The outcome was a disturbing erosion of total public sector receipts from the equivalent of 14% of GDP in FY85, to 10.5% in 1987. Official grants were below target levels by 48 million gourdes, which further depressed government revenues.