Structural Adjustment

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The Context

* The State *versus* Market debate: market failures and government failures

* Policy making after WWII emphasized need to correct market failures

  * How? Through development planning, public sector involvement, promotion of target industries, import-substituting industrialization

* Failures became increasingly clear during 1970s, crystallizing in the 1980s debt crisis
Winds of Change

* Oil price shocks: stagflation in industrialized countries, petrodollars fueled LDC lending (“loan pushing”)

* Rising interest rates in 1980 triggered the global Debt Crisis
New Paradigm

- Many LDCs approached the World Bank and IMF for assistance to weather recession/stagflation and debt problems

- New thinking outlined by McNamara in 1980: basic needs approach not enough, the Bank had to shape the economic foundations of LDCs

- Crisis seen not as temporary but the accumulation of government failures

  - Regulations had to be reduced, governments had to get out of managing the economy

- Bank, IMF stipulated conditions (‘conditionality’) for policy reforms
New Lending Instruments

✦ World Bank:

✦ Structural Adjustment Lending (SAL) = program (non-project) lending for general policy assistance

✦ IMF:

✦ Structural Adjustment Facility (SAF) = extended facility to advance 3-to-10 year loans, on condition of policy reforms to stabilize macroeconomic environment
SALs

- Between late 1970s and 1986: one out of every $3 of loans by the Bank was for structural adjustment

- Borrowing nations had some discretion on where and how to spend SAL funds, unlike project loans

- Once a SAL was arranged, fund disbursement was based on a sequence of policy changes
SAL Conditions

- 1980-1986: average SAL had conditions in 10 out of 19 policy areas the Bank emphasized

- Most frequent conditions:
  - ‘improve export incentives’ (76% of SALs)
  - ‘reform government’s budgets or taxes (70%)
  - ‘improve financial performance of public enterprises (73%)
  - ‘revise agricultural prices’ (73%)
  - ‘strengthen capacity to formulate and implement public investment programs’ (86%)
Evolution of SALs

- By 1987, the Bank was promoting ‘integration policy’

- Coordinate all Bank programs for a country under the umbrella concept of SA

- Even though SALs remained 1/3 of annual outlays, all loans (including project based) for such a country were intended for SA

- Cross conditionality: countries could get SALs if they had stand-by arrangements with the IMF, which they could if they accepted SALs from the Bank

- IMF entered into SAL later through its SAF (1986) and ESAF (1987)
Elements of Structural Adjustment

- Fiscal discipline
- Devaluation of currencies
- Trade liberalization (lifting import and export restrictions)
- Increasing investment through FDI and financial market liberalization
- Removing price controls and state subsidies
- Privatization, or divestiture of all or part of state-owned enterprises
- Improving governance and fighting corruption.
Reforms over Time

Figure 1. Structural Reforms Indices
(All countries)

Source: Prati, Onorato and Papageorgiou (2009)
Mexico’s Twin Crises

* 1952-72: “stabilizing development”, average growth of 3.2% per year

* 1970-76: “growth with redistribution”, coincided with the Bank’s basic needs approach

* Increased budget deficit from 2.2% to 8%, inflation shot up to 20% due to monetization

* Overvalued (fixed) exchange rate: export revenues stagnated but imports were cheaper, high external debt accumulation

* Currency attacked, devalued by 82%, growth fell to below 1%
Mexico’s Second Crisis

- **1978-81**: Oil reserves discovered in the Bay of Campeche, turned economy around, 6% growth

- Govt. again went on spending spree, deficit rose to 15% of GDP by 1982.

- Using oil revenues as collateral, govt. borrowed from abroad; foreign debt went up from $30b (1979) to $49b (1981).
Mexico Defaults

- Speculative attack on the currency in 1982. Move to float (lost 30% of its value). Currency devaluation meant Mexico’s $ debt had increased in Peso terms: more peso earnings needed to service debt.

- High world interest rates (*Volcker recession*).

- Unable to roll over existing debt, declared moratorium on debt payments (Aug 1982), triggered similar response in other LDCs.

  - Rise of SALs and SAPs as part of the debt resolution effort.

- Mexico’s per capita growth in 1982-94, -1% (“lost decade’’).
Have Reforms Worked?

Extensive research has a hard time reaching a consensus on this, on which reforms work and how they work.
Assessment

- Three main problems with SAPs:
  - Weak implementation
  - Ineffective at increasing growth
  - Negative side effects
Implementation

- Far from SAP/SALs restricting policy-making powers of sovereign nations, they were used by borrowing nations as bargaining chips

- Most recipient nations have not fully complied with intent of SALs

- Only a change from bad to good government can truly improve incentives

- For example, creative fiscal accounting to avoid real adjustment on budget deficits
Shifting Spending

- For example, govt can cut current spending on road maintenance, freeing extra money for patronage and corruption
- Although donors aware of this, hard to enforce such conditions
- 1979-1996: WB offered 19 SALs to Kenya and did several public expenditure reviews to preserve good spending and cut out waste
  - 1996 review: “abysmal record on maintaining equipment and facilities that is widely observed across ministries”
- Timely maintenance of $12b would have saved road reconstruction of $45b in Africa (WDR 1994)
Donors’ Incentives

- Donor agencies can face perverse incentives when their budgets depend on loan disbursement

- Kind-hearted donors/lenders create perverse incentives by making loans respond to changes in policies

- “Over the past few years Kenya has performed a curious mating ritual with its aid donors. The steps are: one, Kenya receives its yearly pledges of foreign aid. Two, the government begins to misbehave, backtracking on economic reform...Three, a new meeting of donor countries looms with exasperated foreign governments preparing their sharp rebukes. Four, Kenya pulls a placatory rabbit out of the hat. Five, the donors are mollified and the aid is pledged. The whole dance then starts again.” (The Economist, Aug 19, 1995)
Effect on Economic Growth

- Economic growth commonly used as a measure of success:
  - Summer and Pritchett (1993): SAP works with higher growth, exports and savings.
  - Prati, Onorato and Papageorgiou (2009): reforms (especially in agriculture and trade) increased growth in countries with middle-level of constraints to the executive
Effect on Growth

• In countries with low constraints (like dictatorships) the authorities undermine reforms

• In countries with high constraints (developed countries) reforms not effective because many market failures already eliminated

• Easterly (2002) : no positive or negative effect on growth

• 30 IMF & WB loans to Argentina over 1980-99, 26 to Cote d'Ivoire and Ghana

• Others: Criteria should include other economic indicators, social and cultural indicators
Unintended Consequences

- Emphasis on budgetary discipline led to social programs being axed or scaled back
- In many cases living standards for the poor declined under SALs as food subsidies, health care, education cut back
  - Women disproportionately hurt
- As formal sector employment dropped, women increased informal sector activity
  - Zambia’s informal sector workforce doubled during 1986-96 during SAPs, women over 2/3 of them in 1996
Women and ‘Invisible Adjustment’

- Removing subsidies meant prices of staples like maize (corn) in Africa, rice in Asia and oil and cooking fuel went up

- Women had to become more involved in production

  - But increase in income for Zambia’s women maize farmers (prices tripled) not enough to offset (seven-fold) increase in fertilizer prices

  - Many small maize farmers (mostly women) went out of business and maize output fell by 46%
Gender

- Introduction of user fees in education meant girl children dropped out of school.

- The Philippines: shift from maize for home consumption to sugar for export displaced women agricultural workers as men were hired to cut the sugarcane.

- Then again, young Filipino women gained employment and status from the boom in garment and electronics industries.
What we can Conclude

- SAPs contributed significantly in two cases:
  - Helping Latin American countries (Argentina, Mexico) escape from the *Debt Crisis*
  - Helping some South-East Asian nations (Indonesia, Thailand) become part of the *East Asian Miracle*
- But may have sown seeds of future crises in the 1990s due to emphasis on financial liberalization without insisting that the countries adopt appropriate regulatory structures