CHAPTER I

INTRODUCTION

The 1980s was a decade of severe economic crises for most of the developing countries, especially in Africa and the Latin American region. These countries had been subjected to a series of historically unprecedented external shocks at the beginning of the decade. The major 'external shocks' were largely the consequences of the recessionary trends in global economic activity, especially in the early years of the decade. Different interpretations of the 1. The major 'external shocks' were largely the consequences of the slowdown in global economic activity, especially in the early 1980s, which affected economic and industrial development in the less developed countries through a number of channels: reduction in demand for LDC commodities and mineral exports; fall in commodity prices; increase in real interest rates and debt service payments; fall in the quantity of official development assistance/aid and other capital flows to LDCs, resulting in a negative net transfer of resources in 1984 and subsequent years. To this must be added the two oil price increases: quadrupling in 1974 and more than doubling again in 1979. The surge in petroleum producers' earnings together with changes in international financial markets produced dramatic increases in the flow of commercial bank credit to developing countries, especially those at intermediate stages of industrialization. Much of the lending carried maturities of five to ten years, and floating interest rates tied to the London Inter Bank Offer Rate (LIBOR), or the US prime rate. The tightening of macro economic policies, especially monetary policy by the US and other advanced countries following the second oil price rise increased the debt burden of the
causes have been put forward.

On the one hand, the neo-classical economists together with the international lending agencies, viz. the International Monetary Fund (IMF) and the International Bank for Reconstruction and Development (IBRD), commonly referred to as the World Bank, were of opinion that macroeconomic inefficiencies, misallocation of resources and supply-side deficiencies in the developing countries themselves are the basic causes of economic decline.2

On the other hand, some of the critics maintained that the crises was largely caused by global factors over which the developing countries have little control. The balance of payments constraint led to a compression of imports, directly affecting both agricultural and industrial production, indirectly affecting exports through shortages of intermediaries such as spare parts, fuels etc. Disequilibrium in the real economy in turn generated inflation and disequilibrium in government finances, and the balance of

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payments soon translated itself into an acute fiscal crisis, with serious consequences for economic, social and political stability, as well as for investment and future growth.\(^3\) It is within this context that the developing countries initiated policies of stabilization and structural adjustment.

The present chapter is divided into four sections: the Washington Consensus; evolution of adjustment lending; theoretical bases of structural adjustment; and a critique of structural adjustment programmes.

**The Washington Consensus**

The earlier policies of stabilization, especially in Latin America, associated with the stand-by arrangements of the IMF were based on the balance of payments difficulties and inflationary pressures of the countries concerned. Excessive government spending was considered to be the root cause of the problem. The prescriptions that were being offered included cuts in government spending, devaluation and positive real interest rates which would allow a suppression of the rational mechanism for foreign exchange and

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domestic credit allocation, while resolving the balance of payments and inflation difficulties.\textsuperscript{4} Structural problems such as foreign-exchange shortages, reduced domestic savings, and so on, were, according to the Fund, the consequences of the state-led industrialization through import substitution (ISI) model. Moreover, it was argued that the developing economies were small in relation to the rest of the world and hence faced an infinitely elastic external demand for their exports and an infinitely elastic supply of foreign capital: if they did not export more or attract more foreign investment, it was because domestic incentives were wrong.\textsuperscript{5}

However, experience with IMF programmes revealed the inadequacy of short-term monetary measures in tackling the economic crisis of the 1980s. It was in such a context that the World Bank stressed the need for a programme of structural adjustment, encompassing stabilization, and to be achieved by the adoption of liberal economic policies. Such a revised package became increasingly associated with the


lending programmes of the regional development banks. Thus
the focus was not only on demand management and potential
short-term gains in foreign exchange or savings but supply-
side changes as well, which normally take a longer period of
time. A wide consensus had by now emerged that short-term
stabilization measures have to be supplemented with those
oriented to introducing structural changes in the economy.
Such adjustment recommendations emanating from the IMF and
World Bank have been referred to as 'Washington Consensus'
(WC) approach to stabilization with growth for which the
roots of the crisis lie in the erstwhile ISI strategy of
economic development.6 According to the WC approach, the
ISI strategy entailed an inward oriented model of growth and

6. Such views are represented in the domain of economics by the
Austrian School (Hayek, von Mises), monetarists (Friedman), the
new classics (Lucas, Sargent), the free traders (Krueger, Balas-
sa), and the public choice school (Buchanan, Olson, Tullock,
Niskanen). Tempered by some degree of pragmatism, these views
are espoused by multilateral agencies in Washington, the Federal
Reserve, the US Treasury, the finance ministries of the G-7
countries and the chairmen of the twenty most important commer-
cial banks. For further details, refer Luiz Carlos Bessser
Pereira, "Economic reforms and economic growth: efficiency and
politics in Latin America" in Luiz Carlos Bessser Pereira, Jose
Maria Maravall and Adam Przeworski, Economic Reforms in New
Democracies A Social-Democratic Approach (Cambridge: Cambridge
University Press, 1993), pp.15-76. For further defense of out-
ward-orientation, see Jagdish Bhagwati, "Outward Orientation: Trade Issues" in Vittorio Corbo, Morris Goldstein and Mohsin
Khan, eds., Growth-Oriented Adjustment Programmes (Washington,
D.C.: International Monetary Fund and World Bank, 1987), pp.257-
90.
a serious mis-allocation of resources, especially because of the key role played by the public sector as an engine of growth. Such a consensus which was to become a firm part of the neo-classical thinking held that outward orientation -- trade and exchange rate policies that were not biased against exports -- was likely to ensure more successful adjustment to external shocks and a higher rate of economic growth. 7

The WC approach comprises ten measures:

(i) fiscal discipline be imposed to eliminate fiscal deficits;

(ii) priorities in state expenditures be changed to eliminate subsidies and to enhance education and

7. The terms 'neo-classical', 'neo-liberal' and 'orthodoxy' have been interchangeably used in the chapter. It refers to those who have a strong policy preference for economic liberalization, which "implies the roll-back of the state, both in terms of its ownership of industries, financial institutions and marketing agencies and of its regulatory activities in trade, industry, agriculture, credit and foreign investment. The economic arguments centre on the failure of the state to create the right system of incentives for an efficiently operating economy. This is sometimes expressed as the state's preference for macro economic policy instruments which are exercised at the expense of micro economic rationality. The corrective measures are then privatization and extensive deregulation, recommended in the belief that freely operating markets will conduct to the more efficient use of the scarce resources of poor countries". See for details, Paul Mosley, Jane Harrigan and John Toye, Aid and Power: The World Bank and Policy-based Lending, vol. I Analysis and policy proposals (London and New York: Routledge, 1991), pp.11-13.
health expenditures;
(iii) tax reform be implemented with a broadened tax base and moderate tax rates;
(iv) interest rates be market-determined and positive;
(v) exchange rate be market determined.
(vi) trade be liberalized and outward-oriented;
(vii) direct investment without any restrictions;
(viii) state-owned enterprises be privatized;
(ix) economic activities be deregulated; and
(x) property rights be made more scarce. 8

In short, while the first five measures pertain to stabilization by fiscal and monetary policies, the remaining significantly suggest different ways of reducing the size and role of the state.

To sum up, the economic crises of the 1980s had brought to fore the inadequacies of the erstwhile strategies of development. The short-term stabilization measures had to be supplemented with the adoption of adjustment measures that addressed structural factors as well. Such a new kind of thinking based on the principles of neo-classical economics began to find favour with the multilateral lending agencies; without denying the fact that such ideas of struc-

8. Luiz, n.6, p. 19.
tural adjustment had been put forward by the advanced industrial countries of the world, notably the United States. This new package of adjustment referred to as the 'Washington consensus' had at its centre, besides stabilization, principles such as budget balancing; relative prices correction; trade and foreign investment liberalization; privatization; and domestic market deregulation. The multilateral lending agencies were now on their part being imbued into a new kind of thought, which is being discussed in the following section.

Evolution of Adjustment Lending

Prior to the changes in the world economic situation in the 1970s, the IMF had two types of loan programmes - the compensatory loan and the stand by loans. While the former loans were meant to help countries cope with short-term balance of payments deficit caused by temporary conditions beyond their control, the latter were designed to help countries with balance of payments shortfall caused by long-term shifts in the world economy or fundamental errors of national economic policy. These loans were available only if countries agreed to adopt major economic policy reforms. The stringency of the reforms and the degree of IMF oversight increased as a country borrowed larger and larger amounts from the Fund.
Two new compensatory-type programmes to deal with the current economic crisis were established in the mid-1970s. The oil facility, established in 1974, attempted to recycle money from balance of payments surplus countries to hard-hit oil importing countries. In 1976 the IMF established the Trust Fund, financed with profit from the sale of IMF-owned gold, to make low-cost loans to the poor countries most affected by the new world situation.

Yet another loan programme created in the 1970s has been the extended fund facility (EFF) to make structural adjustment loans. It marked a departure from traditional IMF lending programmes in the sense the new loan programme, besides providing a longer period of Fund support and longer term of adjustment, included measures attacking structural

9. A country may borrow the amount in its 'reserve tranche' almost automatically, for the funds consist of the country's own money. To borrow from its first credit tranche, however, a country must show the IMF it is making a reasonable effort to deal with its balance of payments situation. To borrow from its second credit tranche, the country must show that it is honouring the programme it presented when applying for the first tranche and agree to further monitoring of its economic policies. To borrow from its third and fourth tranches, the country must agree to even closer IMF supervision and tighter performance standards regarding its economic policy. Money is disbursed in stages; countries must achieve their agreed upon goals to receive the later payments. IMF compensatory and adjustment loans carry near-market rates of interest (5% in 1974, 9.3% in 1991) and are repayable in five years. See Foreign Affairs and Defense Division, World Bank/IMF Adjustment Loans and the Poor in Developing Countries, CRS Report for Congress (Washington, D.C. : Library of Congress, 1991), p.13.
maladjustment and weak balance of payments that prevents pursuit of a development programme.\textsuperscript{10} The types of measures included trade liberalization, public sector pricing and subsidies, and policies affecting interest rates and the exchange rate. By the late 1970s the composition of Fund programmes tended to have a larger proportion of structural elements such as public enterprise rationalization and trade liberalization.\textsuperscript{11}

An additional loan programme was established in 1986 -- the structural adjustment facility (SAF) -- to provide the poorest countries with structural adjustment aid at concessional rates. The extended structural adjustment facility (ESAF) was established the next year, after the SAF's original resources -- loan repayments from the Trust Fund -- were fully committed.\textsuperscript{12} To be eligible for SAF and ESAF aid, countries have to submit a multi-year plan for economic reform together with appropriate benchmarks for measuring performance. They must also prepare annually, in cooperation

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\textsuperscript{12} The ESAF is financed with by special contributions by individual governments. These loans are repayable over 10 years at an interest rate of one-half of one per cent annually.
tion with IMF and World Bank staff, a policy framework paper (PFP) discussing the major economic and social implications of their structural reform programme.

The World Bank, on its part, while recognizing the need to provide quick disbursing aid to overcome the crisis of the 1980s which was structural in nature, responded by introducing its structural adjustment loan (SAL). Defined as a type of non-project lending, SAL has the specific objective of helping countries reduce their current account deficit to more manageable propositions over the medium term by supporting programmes of adjustment that encompass specific policy, industrial and other changes designed to strengthen their balance of payment while maintaining their growth and development momentum.\textsuperscript{13} Considerable additional momentum was added to this trend of lending by the introduction of sectoral adjustment loan (SECALS).\textsuperscript{14}

Prior to 1980, non-project operations were undertaken only in response to immediate and urgent needs. Such programme lending, however, has generally been designed to


meet the immediate consequences of a crisis. Rather than finding solution to a country's underlying long-term structural problems, it concentrated on immediate difficulties. Structural adjustment, on the other hand, envisages the possibility of multi-year programmes being worked out and supported by a succession of loans. As these are developed with long-term objectives, it is expected to have more enduring effects than the crisis-oriented operations that were characteristic of World Bank programme-lending in the past.

The historical roots of structural adjustment programme (SAP) can be traced to the proposals made by the then presi-

15. "...non-project operations were undertaken only in response to a few cases of immediate and urgent needs stemming from natural disasters or "man-made" ones (such as post-war reconstruction in Nigeria or Uganda); from serious declines in terms of trade due to export price declines (such as Zambia's experience with copper or Colombia's with coffee); from import price increase (most obviously in the price of oil in 1973-74, and again in 1979); or other acute needs such as India's need for help in financing imports of intermediate goods and spare parts for more fully utilizing its existing industrial capability rather than for financing new projects". See Stanley Please, "The World Bank: Lending for Structural Adjustment" in Richard Feinberg and Valeriana Kallab, eds., Adjustment Crisis in the Third World (Washington, D.C.: Overseas Development Council, 1984), p. 85.

dent of the World Bank, Robert S. McNamara, in 1979. With this the Bank took over a new role of policy-based lending, replacing project issues at centre-stage. McNamara thought that during the latter half of the 1970s, the less developed countries were not in a position to adopt policies which would enable them to have growth with equity and that the objectives of growth and better distribution of income were jeopardized by indiscriminate increases in external indebtedness of these countries. The World Bank was, however, unable through its project lending activities to induce the developing countries to undertake remedial action wherever warranted.

The oil price hike of the late 1970s together with increased interest rates and adverse terms of trade faced by non-oil exports left several oil importing countries reeling under the strain of external balance of payments deficits. It was further compounded by the outstanding external debts which in a way exposed the inappropriateness and ineffectiveness of their domestic policies to tackle problems of economic development they had in hand. It was thought that

in many developing countries inadequate agricultural producer prices and ineffective parastatal organizations were frequently preventing the successful conclusion and outcome of World Bank projects.

Since 1980, both SALs and SECALs have grown in importance accounting for around 20 per cent of all World Bank lending.\textsuperscript{18} It is about 20 per cent of official overseas development assistance to non-oil developing countries.\textsuperscript{19}

Thus, there has been a perceptible shift in the lending operations of the IMF and World Bank. In the 1970s, countries with balance of payments problems had recourse to the IMF stabilization programmes, with conditionalities requiring a short but sharp contraction of aggregate demand through currency devaluation and retrenchment of domestic credit and government expenditure. In contrast, the World Bank's lending operations were almost exclusively focused at the project level. With the deepening of the debt crisis in the 1980s, the growing perception that the crisis was structural and deeply rooted led to a shift in the roles of the IMF and World Bank. Expansion in SALs and SECALs, both in


\textsuperscript{19} Ibid.
size and geographic coverage, brought the Bank more and more into the area of macro economic management. Concurrently, IMF resources for supporting structural adjustment have sharply increased and delays of repayment progressively extended up to ten years, involving the Fund in structural and long-term development issues as is reflected in the establishment of new structural adjustment facilities.

An overview of structural adjustment programmes, together with its measures and components, is provided in the next section.

Structural Adjustment Programmes: An Overview

Structural adjustment, as has been noted, refer to a particular set of reforms undertaken by many governments in development countries in response to the crisis of the 1980s. These reforms are worked out and implemented in consultation with international lending institutions and donor countries, and the release of the loan is tied to progress in implementing them. The adjustment programmes aim to restore external and internal balances, and promote the efficient allocation of resources through reduction or elimination of distortions in product and factor markets. While the specific objectives vary from country to country, in general they seek to reduce public expenditure, enhance public revenue, stimulate an increase in foreign exchange
earnings, contain inflationary pressures and improve efficiency of public sector undertakings.

Quite often a distinction is drawn between structural adjustment and stabilization policies. The former involves policies "unleashing markets so that competition can help improve the allocation of resources... getting price signals right and creating a climate that allows business to respond to those signals in ways that increase the returns to investment." In short, these are reforms to free up market forces and so promote long-term policies designed to correct imbalances between domestic absorption and domestic supply. Macro-economic stabilization generally precedes or accompanies adjustment and many stabilization measures can also constitute important features of adjustment. In this

20. "The term stabilization is normally used for reducing demand and structural adjustment for stimulating supply. Stabilization measures mainly focus on financial disequilibrium (i.e., the fiscal and external accounts and rate of inflation). Structural adjustment policies seek to restructure production capacities in order to increase efficiency and help restore growth. While stabilization is concerned with the short term, structural adjustment extends over the medium to the long term... A reorientation of public expenditures and investment towards human capital and infrastructure, an expansion of exports and efficient import substitutes, efficient trade policies, and liberalization of prices and deregulation of controls to allow producers to increase output of goods and services are essential characteristics of structural adjustment programmes". For further details, see World Bank, Adjustment in Africa: Reforms, Results, and the Road Ahead (Washington, D.C.: World Bank, 1994), p.151.

chapter, structural adjustment is interpreted to include stabilization as well.

Under programmes of adjustment countries are encouraged to reduce macro-economic imbalances, shift resources from non-tradables to tradables, rely on prices and market mechanisms, liberalize internal and external trade, increase agricultural incentives, minimise the role of the state and encourage the private sector to take over functions which were previously within the purview of the public sector. Public sector reforms and reorganisation of important functions and processes, i.e. budget, plan and tax system features prominently in such programmes. The highest priority is attached to the reestablishment of external equilibrium, i.e., the reduction of the current account deficit to a level compatible with the real possibilities of access to external finance. A reduction in the rate of inflation, a stable and high rate of economic growth, and a manageable level of foreign debt are the remaining major objectives that characterize most macro-economic adjustment programmes.

The set of policies employed to achieve the above mentioned objectives may be classified into four groups, based on where their primary impact will be: on absorption-demand management policies; on the composition of absorption and production between the tradable and non-tradable goods -
exchange rate policies; on current and potential output - structural policies; and on capital flows - external financing policies. The mechanism through which these policies are expected to achieve the stated objectives are briefly described below:

(i) Monetary and fiscal policies are the primary instruments for restraining domestic absorption. The need for restraint is demonstrated on the basis of the following identity relating macroeconomic aggregates in real terms:

\[ M - X = (I - S) + (G - T) \]

Where, \( M \) = imports, \( X \) = exports, 
\( I \) = private investment, \( S \) = private savings, 
\( G \) = public expenditure, and 
\( T \) = public revenues (taxes).

This identity implies that an improvement in the external trade balance is contingent upon a reduction in the gap


between private savings and investment, which in turn implies a reduction in both private consumption and investment, and a lower public deficit. 24

A tighter monetary policy is expected to drive interest rates up and reduce the interest-sensitive components of aggregate demand (private investment and consumption). A tighter fiscal policy reduces aggregate demand directly through a reduction in government spending and, or, through higher taxes which have lower private consumption. The contraction of aggregate demand will dampen the demand for imports, but the resulting improvement in the external balance may be insufficient in the absence of complementary policies.

(ii) Demand management policies are usually accompanied by policies that shift expenditure away from tradable (imports) toward non-tradable and production from non-tradable to tradable (exports). 25 Devaluation of the exchange rate is the main policy instrument used to bring about these shifts. Devaluation is both an expenditure reducing and expenditure switching device. It reinforces the dampening effect of tighter monetary and fiscal policies on domestic


25. Ibid.
absorption by raising the general level of prices and hence reducing the real stock of money, as well as through its effect on the trade balance. Its expenditure switching effect operates through a rise in the price of tradable relative to non-tradables, which induces consumers to transfer expenditures towards the now cheaper non-tradables and encourages producers to move resources towards the production of tradables. These multiple effects make devaluation a policy instrument of considerable analytical and practical intent.

(iii) Demand restraint and devaluation are at the heart of stabilization programmes. Structural adjustment programmes (SAP) are designed to counter the unavoidably recessive effects of stabilization by promoting growth-inducing policies that permit the economy to recover its growth trajectory in the medium term.26 These policies focus on structural changes that, first improve efficiency and resources allocation, and second, expand the productive capacity of the economy. The former objective is pursued through policies designed to reduce price distortions, i.e., divergences between prices and marginal costs, and enhance the

26. Ibid.
role of commodity and factor markets. These consist of measures to remove or reduce price controls, trade restrictions, taxes and subsidies and other obstacles to the operation of more competitive markets. Liberalization may also extend to other areas such as domestic financial markets, international capital transactions, etc. The latter objective of capacity expansion calls for resource mobilization policies to permit higher levels of investment. Fiscal reforms, higher interest rates and measures to encourage and facilitate capital inflows are the major instruments of policy used to favour savings and increase inevitable funds.\(^\text{28}\)

(iv) A significant number of countries adopting adjustment programmes are burdened with a large external debt, and face severe problems in servicing it. Indeed, one of the motivations for reaching an agreement with the IMF on an adjustment programme is that it is often an indispensable step towards an arrangement with creditors to permit a temporary alleviation of debt servicing problems. Such arrangements may involve, \textit{inter alia} rescheduling the existing stock of external debt, increasing the flow of concess-
sional financing or limiting the amount of short and medium-term borrowing on non-concessional terms.\textsuperscript{29}

In short, any comprehensive macro-economic adjustment programme consists of expenditure reduction, expenditure switching and policies aimed at improving efficiency. Expenditure reducing policies, usually adopted as part of IMF stabilization programmes, are directed towards elimination of excess absorption, i.e., eliminating the imbalance between the total value of goods demanded and total national income generated from production. This is done over a short period of twelve to eighteen month period and is seen as key to reducing balance of payments deficit. The imbalance is tackled by means of controlling the credit by manipulating monetary policies. On the fiscal front, it is to reduce budgetary and fiscal deficits. Credit is controlled thereby to make the public sector function within their means and find non-borrowing ways to finance their operations.

To circumvent any deflationary impact which may arise out of such reduction measures, expenditure switching policies are introduced. These policies seek to change the relative prices of tradable and non-tradable goods. The relative price ratio can be determined by the terms of trade

\textsuperscript{29} Ibid.
formula:

\[ \left( \frac{Pt}{Pnt} \right) = \left( \frac{Pw}{Er} \right) / (Pnt), \]

where, Pt and Pnt are prices of tradable and non-tradable goods in the domestic market respectively; Pw is the international price of tradables; and Er is the exchange rate.

These policies which affect a change in the relative prices, lead to a switching of the pattern of production away from non-tradable goods that are no longer absorbable under the reduced domestic demand engineered by cut in expenditure, to goods which can be absorbed by sale in the foreign markets. Just as the expenditure reducing policies are administered via the stabilization programme of IMF, expenditure switching policies come under the purview of structural adjustment programmes.

Yet another element of a comprehensive macro-economic policy is the efficiency improvement measures. These include the removal of price distortion, reallocation of investment towards activities which have low domestic resource costs, liberalization and privatization of markets assuming higher efficiency of the private sector; liberalization of the foreign trade regime, and measures to improve the efficiency of the tax system.

These efficiency enhancing policies are to off set
recessionary and dampening effects of expenditure reducing and expenditure switching measures. It is, therefore, maintained that the macro-economic measures of adjustment programme, taken one with another, attempt at promoting medium-term growth which will help the SAP implementing countries in circumventing internal and external imbalances.

The measures used to bring about structural adjustment have been categorized into four:

(i) Demand conditionality, pioneered by the IMF through their monetary approach to balance of payments, which focuses on the cutting down of government expenditure, devaluation of currency and trade liberalization;

(ii) Supply conditionality, pronounced by the World Bank has the investment programme, system of incentives, financial liberalization and trade liberalization;

(iii) Growth conditionality has the development and operation of the private sector expanded, including denationalization of state-owned enterprises, promotion of foreign direct investment and trade liberalization at its core; and

(iv) Cross conditionality, enjoins by convention that a country seeking SAL must have had undertaken to abide by the strict conditionality of the IMF's upper credit tranche
Theoretical Underpinnings of Structural Adjustment Programmes

The principles underlying structural adjustment programmes are derived from neo-classical models. The World Bank's approach is that markets are essentially efficient and that government interventions in resource allocation are essentially distorting and inefficient. The only exceptions allowed are for market failures in the provision of infrastructure and education, where it recommends functional or "market friendly" interventions that do not discriminate between activities. Selective interventions, on the other hand, are considered to be "market unfriendly" and to distort efficient resource allocation. In the few instances that the case for selective intervention is admitted in theory, it is argued that in practice governments cannot

30. The move on behalf of the IMF and World Bank to have collaboration underscores the issue of leverage. While the Fund's views will prevail in matters pertaining to exchange rates, restrictive trade, stabilization programmes, temporary balance of payments disequilibria and the design of stabilization programmes, the World Bank's activities would include development planning, project evaluation and setting of priorities. These are areas where the two institutions have joint responsibilities. For instance, with regard to SAFs and ESAFs, the policy framework paper (PFP) is prepared by the concerned government in consultation with both the institutions.

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intervene efficiently, and that market failures are invariably less costly than government failures.

Adjustment is based on a number of assumptions which ensure that free markets are efficient, leading automatically to an optional or static allocation of resources. There is a further assumption that static optimization in turn leads to dynamic long-term growth. The standard neo-classical conditions include, among others, small firms, all price-takers, operating in competitive markets with no scale economies, perfect knowledge or information, no risk and uncertainty, and instantaneous adjustment in all markets.

As has been noted the purpose of SAPs is to simultaneously achieve balance of payments deficit reduction, resumption of economic growth and achievement of structural changes needed to prevent future payments and stabilization problems. The basis of a SAP can be considered in terms of certain themes.

SAPs already presume that the economy is under severe external strain following a shock. The foremost underlying basis for a SAP is that a part of the economic difficulty is due to structural rigidities in the economy which if they did not exist, would not have caused such hardship under the shock. Once they are removed, any further shock can be tackled and absorbed without undue hardship.
A second underlying theme is that domestic distortions cause static efficiency losses which can be remedied by removal of the distortions. This is presumed to lead to efficient resource allocation and maximisation of income in the medium and long run. Yet another underlying theme is that distortions limit growth prospects and hence faster growth can be achieved by removal of these bottlenecks. In short, the underlying theme is that "getting the prices right" will improve economic performance.

Strongly engrained in the neo-classical paradigm of economics, "getting the prices right" is based on the view that economic efficiency in the economy as a whole can be maximised by allowing prices and incomes to respond freely to market forces or setting them at the levels which would be reached in a free market. It is assumed that economic agents respond to price signals, and that they respond better to prices than to non-price incentives. This applies mainly to the key overall prices in the economy, particularly the exchange rate, interest rates, and real wage rates; other prices which are fixed by the government rather than being determined in the market, particularly agricultural producer prices and state-owned enterprises prices; and other structural adjustment policies affecting prices and incomes such as tax reform, the removal or reduction of
subsidies and/or price controls, and the introduction of or increase in user charges for health, education and other public services.31

On the question of efficient allocation of resources, it is maintained that private sector commercial operations are generally more efficient than those of the public sector. This calls for a reduction of the role of the state, which takes three main forms: reducing or limiting the size of the public expenditure relative to the GDP; reducing the role of the public sector in the production of goods and provision of services through privatization; and relaxing or removing regulations and state interventions in the operation of private markets.

Yet another important component of all SAPs is the opening up of the economy to foreign trade and investment or trade reform, which includes the relaxation of restrictions

31. Structural adjustment represents a deliberate shift away from the concept of the state as an economic agent and social provider, and towards a more minimalist view of its role; and this inevitably limits the range of economic and political models available. In the longer term it may also affect the political ethos of the country by lowering popular expectations of the state's role.

Yet another strand of reducing the role of the state is the privatization of state-owned enterprises. This impinges on macro economic policy in a constructive way: the proceeds of privatization represent a source of non-inflationary financing for the budget deficit; and if state-owned enterprises are sold to foreign buyers, privatization is supposed to be a useful source of foreign exchange.
and taxes on foreign trade. This can take place in two stages: first, replacing quantitative restrictions on import with tariffs, and making the level of tariffs more uniform between different goods; and second, reducing the overall level of tariffs. At the same time, if there are explicit taxes on exports, these are generally removed.

A second component of economic opening under structural adjustment is liberalization of the regulatory regime for increased flows of foreign direct investment. Essentially, this entails improving the terms available to foreign investors by easing the restrictions imposed on their initial investment or their subsequent production; relaxing or exempting them from labour regulations; increasing the amount of profit that can be repatriated from the investment to the parent company; offering tax incentives; providing priority access to foreign exchange and so on.

The objectives of these policies are to attract more foreign capital into the adjusting country, thus helping to provide additional foreign exchange; and to compensate for the reduction in domestic investment associated with adjustment. This in turn is intended to stimulate additional output, income and employment. Foreign direct investment is also widely seen as a useful channel for the transfer of technology from the developed to the developing countries.
Besides, structural adjustment also includes institutional strengthening and capacity building measures which allow the government and other agencies of the state to fulfil their functions both more effectively and efficiently.\textsuperscript{32} It may also help to improve the performance of the private sector, by reducing the bureaucratic obstacles to their productive and trading activities.

In short, structural adjustment policies aim at long term structural reform, including improvement in productivity of resources, improvement in allocation of resources, increase in economic efficiency and flexibility of the economy, increase in competition, and thereby expansion of the economy. A reduced role of the state and an expanded role of the private sector is also implied. It is often argued that but for the adjustment policies, distortions increase. The objectives of the policies has been thus to stabilize the economy and to improve allocation of resources, and thereby raise the level of output and income, and to achieve higher level of savings and a more efficient use of

\textsuperscript{32} This includes changes in institutional structures, for instance, the closure or merging of ministries, streamlining of administrative procedures, etc., reform of supervisory structures affecting the private sector, and increasing the state's ability to implement them effectively, where these are seen as necessary to the effective operation of the market, for e.g., banking supervision; staff training; and increased or more efficient use of office technology.
investment resources in order to raise the rate of economic growth. The policy has been described as "non-interventionist in spirit" and concentrates on increasing the efficiency of market signals as a guide to an improved allocation of resources.

The theory and concept of the policies of stabilization and structural adjustment have been elaborated and applied in the case of many developing countries. However, this practice has not remained without critics. A critical assessment of structural adjustment programmes is provided in the following section.

Structural Adjustment Programmes: A Critique

The neo-classical prescription of a simultaneous adjustment of the external sector via a real devaluation of the domestic currency and stabilization of the rate of inflation through across-the-board cuts in government spending, together with policies designed to structure and liberalize the economy have been criticised. Based on the monetary approach to balance of payment problems, the neo-classical economists did not pay sufficient attention to the cost or supply side factors in explaining inflation. To them the problem of inflation was primarily the result of money growth fueled by rapid increases in government expenditures and/or inflationary expectations. Essentially it is
treated as a problem of too much money chasing too few goods fueled by inflationary expectations and indexation mechanism that link wages and internal payments to the rate of inflation, thereby propelling the country's past inflation into the future. Such studies tend to confine their dimension to financial variables only, and therefore, the dynamic and political dimensions of the inflationary process, viz. its role as a social mechanism for defusing the distributional conflict that arise when no economic group or social class is sufficiently powerful to impose its stabilization plan over any extended period of time, is overlooked. As opined by Hirschman, inflation is "... a remarkable invention that permits a society to exist in a situation that is intermediate between the extremes of social harmony and civil war".33

The supply side factors that contribute to generating inflationary pressures are taken into account by the neo-structuralist economists.34 Distributional struggle is


34. The term 'neo-structuralist' is used to differentiate it from the original structuralist, who paid little attention to short-term fiscal and monetary measures to combat inflation. The structuralist position on inflation is best exemplified in the writings of Celso Furtado, Juan Noyola, Anibal Pinto, Raul Pre-
Again, in contrast to the economic policies of the neoclassical economists, those put forward by the neo-structuralists differ not only in terms of their nature and objectives, but also in terms of their timing and sequencing. Neo-structuralist point out that expenditure switching policies such as devaluation, designed to enhance the competitiveness of exports, and expenditure reducing policies such as indiscriminate cut in government spending, designed to bring inflation under control, should not be applied simultaneously. The outcome of such shock treatments would be an initial respite at the cost of a deep economic recession and of a steep fall in capital formation that eventually reignites inflation from the supply or cost-side.  

Further, they point out that devaluation can turn out to be stagflationary rather than expansionary in nature because of the negative impact on output from falling spending due to...

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35. Economic stagnation and inflationary pressures are generated by reductions in government spending on highways, bridges, dams, ports, airports, education and energy supplies because they increase the cost of doing business, thereby undermining private sector profitability and investment.

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the devaluation-induced reduction in the real income of the majority of the people and/or because of the steep rise in the domestic currency cost of dollar-denominated imports of essential capital inputs and intermediate goods, which forces producers to charge higher prices to recover cost. 36

If in addition to the expenditure switching policies, the domestic currency is sharply devalued simultaneously, domestic producers using imported capital inputs and intermediate goods will find that their costs have increased prohibitively. In order to produce the same level of output as before, they tend to charge a higher price to cover the rapidly rising domestic currency cost of their imports. The stagflationary effect may be compounded in the short run if the producers in oligopolistic or monopolistic industries promoting goods that directly compete with imports take advantage of their improved competitive position and increase profit margin by raising their mark up fraction on average costs of labour and material input. Such supply side shocks tend to be further intensified in the presence of reverse net transfer, massive capital flight, and demands by workers for higher nominal wages to effect the higher

price level.

As against the neo-classical approach, the neo-structuralists call for a sequential and gradualist approach in the short to medium term. They consider it better to first gradually devalue the currency and then implement a crawling-peg system to control the rate of domestic currency depreciation since a current account deficit that cannot be financed with a net inflow of funds becomes an immediate and pressing constraint on growth. Besides controlled prices for essentials should be increased gradually to counter inflationary surges in the short run, thereby preserving the long run benefit derived from increased competitiveness while minimizing the negative impact on real incomes. It is also pointed out that credit conditions during the transition period should not be so restrictive in order to prevent real interest rates from shooting up.

The composition of government spending should be altered toward investments in infrastructure, health and education for the long term success of trade reform and privatization programmes is the existence of adequate infrastructural support and non-inflationary environment. At the same time, there should be a gradual pruning of the rate of government expenditure and creation of money to reduce
inflationary pressures. If, on the other hand, inflation is not checked initially, then additional measures like incomes policies in the form of temporary wage and price controls via the establishment of a political pact between the organized labour, the business sector and the public sector, and gradually to de-index the economy while maintaining a degree of control over the rate of domestic currency depreciation in order to prevent inflationary surges and thus a rapid erosion in real wages and salaries, which otherwise could undermine the political pact.

The neo-structuralists advocate a set of consistent policies in the long run to change the prevailing pattern of economic growth and development. They analyze the importance of improving the productivity of the agricultural sector by introducing rational farming techniques and by funding unimodal development programmes that raise rural incomes and productivity, thereby increasing the supply of basic foodstuff and the size of the national market. Further it is argued that future growth ought to be based on a relatively greater use of labour-intensive methods in order to provide employment for those currently unemployed or underemployed, as well as for the millions who will enter the labour force annually. Exports have to be diversified away from primary products, toward export manufacturers and
non-traditional agricultural products that make relatively
greater use of the abundant factor. Investments by the
state should give preference to those projects that promote
the production of export and import substitutes. In the
initial phase of export substitution as cost competitiveness
and quality standards are higher in the international mar­
et, the state has to subsidize exports. It is also neces­
sary to undertake periodic unannounced mini-devaluations of
the domestic currency in order to both prevent speculation
against the currency and maintain the country's prices and
cost in line with those in the international market. Care
must be taken so that the export promotion policies do not
in the end lead to the setting up of enclaves with only a
marginal contribution to employment and income.

In addition to the above mentioned measures, the neo­
structuralists call for the creation of incentives to ensure
the efficient utilization of dwindling public resources.
Procedures have to be established for the allocation of
authorized public expenditure to high-priority operations
such as export promotion, education, health, and agricultur­
al development. The modernization and improvement of the
physical and human capital, and the gradual liberalization
of the national economy should not be viewed simply in terms
of the sale and liquidation of public enterprises. Privati-
zation efforts may be neither necessary nor politically desirable in the case of profitable state-owned enterprises. And even when they are not, it may be possible to improve their efficiency and profitability through programmes of internal reform. Finally, they stress the role of the state as a viable institution capable of making the necessary investment in infrastructure for the development of the economy. In short, restructuring should have less to do with ideology and more with the implementation of economically sound and politically responsible policies that lay the basis for a renewed collaborative relationship between the public and private sectors.

Last but not the least, the neo-structuralists stress the need to reform inefficient and highly regressive tax systems by introducing investment incentives and fiscal measures that generate the needed revenues in an efficient and equitable manner.

To sum up, neo-structuralism can be viewed as an 'updated structuralism' that seeks a long-term development strategy to tackle contemporary problems and at the same time to provide an alternative to short term neo-liberal
policies. It combines post-Second World War structuralist heritage with the short-term answers it provided in the 1980s.

Diverse international organizations have time and again criticised the IMF - World Bank adjustment policies. One such organization, the United Nations International Children's Emergency Fund (UNICEF) with its seminal work, Adjustment with a Human Face, put forward alternative policies for sustaining growth. It was argued that the adjustment policy, as then promoted by the multilateral lending agencies causes a contraction in the economy which raises the number of people living in poverty. Adjustment of some kind is a necessary response to the economic difficulties caused by the debt crisis. Though growth is necessary, growth-oriented approach to structural adjustment is not sufficient to protect the vulnerable groups in society.


38. Ibid.

39. These include organisations such as the United Nations Development Programme (UNDP) and World Institute for Development Economics Research (WIDER).

Only by the adoption of appropriately targeted programmes can these sections be protected and their condition improved. It is also contended that most programmes aimed at protecting the poor are relatively inexpensive in terms of total government expenditure and GDP; and that external financing is important in facilitating the smooth progress of adjustment. 41

The alternative approach offered by the group called for more expansionary macro-economic policies aimed at sustaining levels of output, investment and basic human need requirements over an adjustment period. It suggested the use of policies to address the needs of the vulnerable. Taxation, government expenditure, foreign exchange and credit policies would be used to restructure resources and activities in favour of the poor. Besides, sectoral policies would be designed to strengthen employment and income generating activities for low income people. It was further suggested that the public sector be structured to improve equity and efficiency. Compensatory programmes to protect health and nutrition of low income people would also be suggested. Finally, the group suggested that the human conditions be closely monitored during adjustment to ensure

identification and effectiveness of appropriate programmes. 42

A third set of critics propose ways of raising the cost-effectiveness of IMF programmes and of strengthening the balance of payments policies. 43 Referred to as the 'real economy approach', greater weight is placed on supply side measures and production variables, in contrast with approaches which stress the control of aggregate demand and monetary variables. 44 Such a strategy of 'adjustment with growth' is presented as often being more cost-efficient for less developed countries than present IMF programmes. An increase in the output of tradables -- equated with agriculture and industry -- to non-tradables, comprising essentially government services, utilizing a wide range of policy instruments. As the approach is growth-oriented, investment has to be protected; consumption to be restrained in the absence of international flows of concessionary finance.

42. Ibid, pp.290-91.

43. This group includes, among others, Tony Killick, Graham Bird, Jennifer Sharpley and Mary Sutton.

44. Adoption of a programme primarily aimed at re-orienting the productive system is referred to as the real economy approach. For a detailed account of the approach, see Tony Killick, ed., The Quest for Economic Stabilisation: The IMF and the Third World (London: Heinemann Educational Books, 1984).
At the centre of the real economy approach is the relative increases in the production of tradables through improved capacity utilization and more investment. Fiscal and monetary demand management measures are viewed as essential supporting measures. The approach to a large extent has been influenced by structural adjustment programmes.45

More to do with the policies of the IMF, it is argued that generalized solutions has little scope given the diversity of country situations. Instead, the real economy approach calls for the initiation of programmes that fit the specifics of any particular country instead of a standardized approach.46 And the Fund should adhere to the principles on which the EFF was initially introduced.47 Thus the approach favoured by Killick and others can be viewed as a re-design of the type of programmes that would be supported by an EFF-type credit. If IMF lending were to shift in such a direction, it would require more resources; the sources of increases could be further increases in quota; borrowing on

45. For details, see Tony Killick, Graham Bird, Jennifer Sharp-ley and Mary Sutton, "Towards a Real Economy Approach" in Killick, n.44, pp.278-80.


47. The EFF was the Fund's chief attempt to move towards long-term and more structurally oriented programmes, and it incorporated genuine changes.
private capital market; from member-countries; sale of gold, and an SDR link.48

Ways in which the less developing countries' balance of payments management could be strengthened are also addressed. It is suggested that some of the countries responded inadequately to the adverse external shocks --- deterioration in terms of trade resulting from the two oil price hikes and the world recession of the 1980s -- partly because of a reluctance to place adequate weight upon economic stabilization as a policy objective. The external causality of balance of payments difficulties does not remove the need for internal adjustment. Once shortages of foreign exchange are recognized as the binding constraint upon economic development then it follows that policies designed to deal with this constraint are part of the development effort. The significance of avoiding fiscal and monetary excesses is urged, as is the greater use of the price mechanism and the desirability of an active exchange rate policy.

In short, the real economy approach attempts to recast the role of the IMF within its historical terms of reference with assisting members governments to overcome balance of

payments difficulties. It is not intended to convert the Fund into another development aid agency, but rather an assertion that in contemporary circumstances it is impossible to draw any sharp distinction between balance of payments management and the design of development strategies.49

Yet another critique on structural adjustment has emanated from the United Nations Development Programme (UNDP) which call for a people oriented line of action. Such a human development approach considers the expansion of income and wealth as only a part of development and states that there is no automatic link between growth of income and human progress.50 Focusing on people and their role in the process of development, it stresses participative development to propel economic growth and progress. An important indicator is the human development index which shows the development situation of a particular country.51

As against the minimalist role of government, the UNDP recommends efficient government action in social policies especially in the fields of education, and health care;


51. The human development index (HDI) focuses on longevity, knowledge and command over resources as key elements.
shifts in public expenditure towards these areas needs to take place. Criticising the present adjustment process as creating unequal distribution of income, the human development approach attempt to promote the concept of growth with equity. The IMF and World Bank are criticised for their incapacity to provide resources to developing countries in time.

Responding to the criticism, the multilateral financial agencies have pointed to the failures of the neo-structuralist policies in the 1980s. While some of the policies put forward by institutions such as the UNICEF have been incorporated, these seem to be trivial in magnitude, insufficiently comprehensive and too short-lived.

To conclude, the economic difficulties of the late 1970s and 1980s led to a phenomenal increase in the number

52. UNDP, n.50.

53. For instance, the establishment of the SAF and ESAF for poor countries by the IMF. The Inter-American Development Bank (IDB) created in 1993 a Social Agenda Policy Group which incorporates elements beyond the Washington Consensus which stresses the need for innovation processes as a centre-piece of development policies as well as socio-economic reform. It calls for a balanced and integrated set of economic, financial and social policies. The IDB shares some common ground with neo-structuralists which is reflected by the membership of people like Nova Lustig, Frances Stewart and others in the Group.

of developing countries undertaking structural adjustment programmes. Short-term measures of stabilization policies had to be supplemented with medium term adjustment programmes. Referred to as the 'Washington Consensus', the new approach criticised the earlier development strategy of industrialization through import substitution and considered it to be the root cause of the economic crisis. Instead, a policy emphasizing outward orientation, as against the ISI's inward-looking approach with a key role assigned to the state, was thought of to ensure more successful adjustment to external shocks and a high rate of economic growth. Such a neo-classical approach to development became dominant in the decade of eighties. The WC approach consists, among others, macro-economic policy reforms, reform of the trade regime, and policies to encourage private sector development. Such thinking led to a shift in the roles of the multilateral financial agencies, viz. the IMF and World Bank. The IMF from providing short-term support to tide over balance of payments problems, and check inflationary processes, expanded its range of activities in the 1980s to include medium term policies as well. This has been reflected in the creation of the EFF in the mid-1970s and subsequently, the special facilities -- SAF and ESAF -- in the mid-eighties realizing the importance of providing more
finances. The World Bank, on its part, has shifted from its role of giving project loans to developing countries, to extending quick disbursement aid which are policy-based. The underlying intention has been to transform the structure of the economy. Measures are aimed at enhancing efficiency and raising the level of productivity, thereby ensuring economic growth.

But the above mentioned measures have been criticised for the lack of attention paid to the issues of redistribution of income. The neo-structuralists, while accepting the need for inclusion of demand management measures, advocate a gradualist approach and proper sequencing. Refuting the role of a minimalist state as advocated by the neo-classical economists, they accord a key role to the state in all economic matters. A second set of critique represented by the UNICEF while supporting the growth-oriented approach, call for the incorporation of safety measures to protect the vulnerable sections in society. The UNDP approach stresses the need for participative development to propel economic growth and progress. They, too, recommend efficient role of the government in diverse fields. Growth has to be promoted with equity.

The multilateral financial agencies, on their part have responded to the criticism by incorporating some of the
elements in their lending policies. But this has, however, been limited in its impact, which is being discussed in detail in the case of Jamaica, in the subsequent chapters.