

# Chapter 2

## Structural Adjustment: Causes, Content and Assessments

### 2.1 What is Structural Adjustment?

Structural adjustment can be defined as “an adjustment to some shock that requires not only compositional changes in production, resource allocation, demand, and relative prices, but also changes in macroeconomic aggregates such as income, investment, absorption, consumption, and government expenditure” [Robinson 1989]. While this definition would allow for a wide range of different “structural adjustment programs”, historically the term has come to refer to a specific policy package, for reasons described in this section.

During the past two and a half decades, the history of most economies in Asia, Africa and Latin America was characterized by recurring or ongoing economic crises that consisted of some combination of escalating domestic government debt, escalating foreign debt (government or private), and out-of-control inflation. While the debate on the underlying causes of these crises is far from settled, a frequent proximate cause was an acute shortage of foreign exchange, due to some combination of high interest rates, high indebtedness, adverse terms of trade, fluctuating foreign capital inflows, and lack of access to commercial lending. In most cases, countries experiencing such a crisis applied for a loan from the International Monetary Fund (IMF), whose institutional purpose is to assist countries in bridging transient balance of payments imbalances.

If the crisis facing the country was not judged by the IMF to be of a transient nature, an IMF loan was made contingent on the country undertaking a structural adjustment program approved by the IMF and the World Bank. These programs for different countries shared many common features, and are discussed in the next section.

### 2.2 A Typical Structural Adjustment Policy Package

The last two decades have seen widespread application of the so-called neoliberal policy package as a response to balance of payments difficulties. This package is a combination of fiscal austerity, tight monetary policies, devaluation, privatization, elimination of subsidies, trade and capital account liberalization.

One important reason for the widespread application of these policies is that neoclassical economics is the preferred paradigm of the World Bank and the International Monetary Fund (IMF), which through loans as well as their standing as experts in development and adjustment issues

are widely believed to have substantial influence on the policies chosen by the developing country governments. Between the two institutions, it was largely the IMF that determined the specifically macroeconomic content of the policies.

A structural adjustment policy package aims to achieve the two goals of balance of payments (BoP) stabilization and inflation reduction through the two levers of changes in exchange rate and control of the money supply<sup>1</sup>.

In practice, a typical stabilization program has the following components:

**Cut government spending and increase taxes** Firstly, the resulting decrease in total demand is supposed to improve the balance of payments both through decreasing the demand for imports and freeing up domestic productive capacity to supply more exports (as the IMF analytical approach, the Financial Programming Framework (FPF), implicitly assumes the total production is unaffected by the stabilization program).

Second, as typically the government in question is running a deficit, additional benefits are expected, depending on the previously dominant source of deficit financing: if the deficit was financed by borrowing from the central bank, i.e. by printing money, its reduction is expected to contribute towards inflation control; if the deficit was financed by foreign borrowing, its reduction will improve the balance of payments. The FPF does not really have a way to represent non-monetized borrowing from the domestic private sector (be it commercial banks or households), but the rhetoric is that a reduction in domestic borrowing should free up resources for private investment.

**Introduce floating exchange rates and depreciate the currency** The corresponding increase in domestic prices of exports and imports is supposed to make exports more competitive and to redirect demand away from imports. The overall reduction in domestic demand from reductions in government spending is supposed to make sure there is nonetheless no excess demand for domestic goods.

This is a common feature of programs that primarily aim at balance of payments stabilization, as common in Africa. The programs primarily aiming at inflation, such as seen in Latin America, often fix the nominal exchange rate instead, aiming to use it as a nominal price anchor through stabilizing the price of imports.

**Increase the interest rates and/or reduce the rate of expansion of the monetary base** Increasing the interest rates is supposed to stimulate savings, and thus provide more funds for investment. At the same time, high interest rates are supposed to prevent excessive depreciation of the currency by attracting foreign capital inflows. Reducing the rate of growth of monetary base is meant to decrease the rate of money supply growth and thus reduce inflation under the constant velocity of money assumption. (In the case of market-determined interest rates, these two policies coincide, as increased control of monetary base makes credit more scarce and thus more expensive).

---

<sup>1</sup>The causal connection between the targets and the levers is modeled by a simple model known as the Financial Programming Framework (FPF) that was first formulated by Polak [1957] and is discussed in detail by Khan et al. [1990]. FPF assumes constant price elasticities of export supply and import demand (connecting the exchange rate to the current account), and constant velocity of money, with the implication that ceteris paribus increases in the money supply translate in strict proportion into increases in the price level. FPF also assumes that the real output is unaffected by any of the variables in the model. We will discuss the FPF model in more detail alongside the other models in Chapter 4.

**Liberalize the current account** That measure is achieved by abolishing import quotas and reducing import tariffs and is expected to increase efficiency in some not clearly specified way. Sometimes it is also argued that lower prices for imports benefit consumers, but since at the same time higher import consumption means less income for domestic producers, that argument is not tenable without further refinement.

**Liberalize the capital account** Allowing a higher measure of capital mobility is expected to attract more funds for investment.

## 2.3 Assessments and Criticisms

It has been a subject of much controversy whether these policies achieved their declared objectives of macroeconomic stabilization (primarily stabilizing the balance of payments and lowering inflation) and sustainable GDP growth, or whether they had no effect at all or worsened the situation (at least in the medium to long term). An equally controversial issue is the impact of these policies on the income distribution.

Haque and Khan [1998] discuss a number of studies using a variety of approaches to analyze the impact of IMF programs on balance of payments, current account, inflation, and growth. The following results stand out:

Firstly, the number of statistically significant results in cross-country studies is quite low, which can be taken as an indicator of a large degree of variation between countries.

Secondly, the impact of IMF programs on the balance of payments and the current account, when significant, is generally found to be positive, while the impacts on inflation and growth rates vary in magnitude and in sign depending on the method chosen as well as between studies using a particular method.

Thirdly, the changes often take time to manifest themselves. Thus, Khan [1990] using the generalized evaluation estimator approach, found that both balance of payments and the current account deficit reductions are strengthened over time, and the initially adverse effects on growth are reversed in the subsequent years. Killick et al. [1995] in an extensive before-after study also find positive balance of payments and current account effects, and find that “[The programme effects] are at their smallest in the twelve months immediately following adoption of a program but larger in the following two years”.

Fourthly, the real exchange rate depreciates significantly right at the onset of a program and this depreciation is deepened in the following years. However, the reductions in the rate of credit expansion are small and non-significant, contrary to both expectations and Fund intentions.

Taylor [1988, 2001] discusses a series of case studies, and while finding a wide variety of individual experiences, points out the following similarities between them:

Firstly, when fiscal austerity did result in an improvement in the balance of payments it was not primarily because of relative price effects as postulated by neoclassical theory, but rather, because reduced government spending reduced domestic output and thus demand for imports, and also because the decrease in domestic absorption increased exports. Relative price effects did not appear important in the short run.

Secondly, fiscal austerity was not often successful in fighting inflation, while by reducing both private and public investment it undermined the prospects for long-term prosperity. If it was coupled with high interest rates, investment was undermined even further.

Killick et al. [1995] also find that the brunt of the reduction in domestic absorption, which is the keystone of IMF programs, seems to fall on investment, with overall consumption staying comparatively constant.

The stabilization and structural adjustment programs have also come under extensive criticism from civil society organizations both in developing and developed countries. Kanbur [2001] notes that many of their criticisms were not concerned with the specific research results that claimed to demonstrate positive impacts of structural adjustment, but were instead due to several persistent differences in focus between the civil society groups (referred to by Kanbur as “Group B”) and the majority of the development economics profession (“Group A”). Kanbur identifies three such differences in perspective:

The first difference is in the level of aggregation used to evaluate impacts, with academic studies often focusing on the aggregate poverty rates for the population as a whole and their critics highlighting the plight of specific groups. “Quite often a national fall in the poverty incidence can be composed of large movements in opposite directions”.

The second difference in perspective is the time horizon over which the consequences of policy are assessed. While development economists tend to think in terms of the “medium term”, used to refer to a time horizon of three to ten years, their critics are concerned with both the short term consequences of economic policies (“short run survival trumps medium run benefits every time, if the family is actually on the edge of survival”) and a time horizon much longer than a decade, in reference to issues of sustainable development.

The final systematic difference in perspective concerned the perspective of market structure and power. “The implicit framework of Group A in thinking through the consequences of economic policy on distribution and poverty is that of a competitive market structure of a large number of small agents interacting without market power over each other. The instinctive picture that Group B has of market structure is one riddled with market power wielded by agents in the large and in the small.”

These different assumptions lead to very different expected results of policies such as increased openness to trade, and a model that pre-judges any one of these issues will not be helpful for achieving agreement on optimal policy choice.

## Summary

When a country experiences balance of payments problem, the typical remedy mix proposed by the International Monetary Fund consists of fiscal austerity, tight monetary policies, devaluation, privatization, elimination of subsidies and trade liberalization, combined with low interest rate loans.

To the extent that these prescriptions are based on economic theory, the theory used is neo-classical, with an explicit or implicit assumption of full employment and thus blind to possible recessionary impacts of the programs. It is these recessionary impacts that are the source of most criticism of structural adjustment.