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THE RATIONALE FOR STRUCTURAL ADJUSTMENT: A LAYMAN'S GUIDE

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Introduction and Conclusion

Ordinary people dread it. Politicians dodge it. Economists endlessly debate it. And nobody enjoys it. Such is the history of Structural Adjustment (SA), possibly one of the most talked-about and least-understood recipes in the economics' kitchen. Not that SA is always a failure. Argentinean, Chileans, Mexicans, Turks, and Poles, will tell you of the pecuniary beauties of shaking-up rusty, (hyper-)inflationary, public-sector-dominated economic systems. After all, it is not fun to live with 100 percent inflation per month, or being bossed around by an all-mighty bureaucrat at a public telephone company, or being a captive consumer to a you-buy-what-I-say local car-maker.

Few embrace SA with enthusiasm. In fact, quixotic foreign-trained pioneers, a major economic crisis (usually of monetary kind), and the push of powerful international organizations, are all usually needed to get SA going. Why the opposition? SA is supposed to make us happier. For the average citizen, it is just a question of giving up his secure job with the civil service, absorbing some jack-ups in utility prices, losing sundry subsidies, ignoring the devaluation-driven impact of his life savings, beginning to pay taxes seriously, and, above all, being supportive. That's all. In exchange for that pain, the economy will become more "**efficient**" (whatever that means), the telephone will work, glossy East-Asian plastic will be readily available, and well-paid jobs will pop up in the "**medium-term**" (meaning, not for now). No wonder SA defenders have a public relations problem!

There is little doubt that SA is a costly and rather painful undertaking. It is normally applied to economies whose basic structures have been forged against the market's wishes for decades. We are talking, for instance, about countries who engage in heavy subsidization and tariff protection in order to try to build capital-intensive sophisticated electronic industries despite the fact that most of their own people live in poverty, have no electricity, tap water, or sewerage connection, survive off agriculture, and are illiterate. In such structurally mis-formed set-ups the switch towards market-orientation is bound to be difficult.

This essay tries to explain the rationale of SA to those who have never entered (and do not want to enter) an economics course; that is, most people.

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In the same way as medical doctors ought to explain why hair-dropping, skin-burning chemotherapy is needed **before** they administer it, economists ought to spell out why normal human beings should be subjected to the strains of SA. (Not to mention the fact that SA, as is true of chemotherapy, may or may not work.) In that spirit, the arguments presented here seek to illustrate through examples. Mathematical models are eschewed.

The thrust of the following analysis is simple: **SA may not be perfect, but there is no alternative to it**. And the more you wait, the more complicated (and painful) SA becomes.

Opposing Structural Adjustment

People explain their opposition to SA in various ways. There follow the most common arguments and some counter-arguments that merit consideration.

Tight money. SA is usually preceded by an stabilization effort, a kind of bringing everybody back within his means, in particular the state's budget accounts. To stop inflation, the government is told to spend less (and/or collect more) and the Central Bank is told to stop printing money. Together, both things dampen economic growth (no money, no consumption). Recession means fewer jobs which means more poverty. But, wasn't SA about prosperity?

Well, let's examine this. Should the Central Bank (at the government's request) keep printing money? How much? For how long? Why not just keep printing as much as is needed to make everybody happy? Why not triple civil servants' salaries, brush up run-down public offices, build wider roads, bigger schools and fancier hospitals, and shore up troubled public companies by just using the good old money printer? The answer is a simple, rock-solid rule: **for a given amount of goods in the economy, more money means more inflation.** Of course, smart lab-economists can always build a battery of assumption-riddled mathematical models that prove otherwise but these are no consolation for, let us say, Yugoslavian pensioners in 1993. Moreover, inflation feeds on itself, as the government has to print more money to afford whatever it buys. Eventually, you find yourself in the midst of high or hyperinflation (anywhere from 30 percent to 300 per cent **a month**).

But what's so bad about high or hyper-inflation? As with putting one's finger in the burning candle, just live through it and you will see. Beyond the nuisance of having to alter price menus and business plans daily (something that is ultimately taken care of by setting prices in foreign currency) and spending much more time searching for the "best" price, high/hyper-inflation weakens the economy's pillars in a more fundamental way: **it rots its public institutions**. How do you think a red-blooded tax inspector makes ends meet when he sees his salary's purchasing power dilute by the day? Or, how do we expect a judge (usually a highly-regarded member of the society) to react when he has to take his children out of private school and moonlight as a

taxi-driver? And, how about policemen? Or public school teachers? Some may think that the so-called **indexation** (that is, adjusting salaries by inflation) provides a relief mechanism. Not really. When you adjust public salaries, you only push the government to print more money to pay them, you create more inflation, and eventually more need for salary adjustment. You basically chase your own shadow. How bad can that inflation-driven institutional mess be? Answer: bad enough to force governments from power as in Argentina (1989), Lebanon (1992), Bolivia (several times in the 1970s).

The point is clear: you do not want to play around with money creation. In fact, you want to keep money growth in line with growth in the economy's output. That **tight money** policy might hurt, especially when you are actually putting the brakes after a money printing spree. But the alternative is much worse.

Financial liberalization. Usually, economies that undertake (or should undertake) SA face the need to do so after years of strong "**financially repression**", that is, strict official setting of nominal interest rates (specially lending ones). Predictably, those rates are fixed well-below the levels free-working markets would turn out. More crucially, those officially set interest rates tend to be below the level of inflation. This last point means the following: if you get a loan and use the money to buy any good whose price keeps up with inflation (say, foreign currency, or gold), by the time you have to repay, you can sell the good, pay back the loan, and keep the difference for yourself. Put in other words, the bank gives you a free lunch. It is hardly surprising then that, whenever the government applies financial repression, long queues come up at the banks' lending windows. This does not scare policy-makers; by determining whom banks should serve, policy-makers have full control on where credit goes (and doesn't go). They can then pick economic sectors that meet their "**strategic priorities**".

But, if a big public-sector company, a large foreign joint-venture, and an old lady trying to buy a sewing machine, all show up at the credit queue, who do you think will get the loan? The problem with financial repression is that it allocates credit according to institutional weight, not project profitability. And those two characteristics are not necessarily correlated. Multiply this situation throughout the economy, and you are bound to end up with a depressing overall investment return performance. Put more simply, a misuse of the country's saving efforts. This highlights another negative aspect of financial repression: it destroys saving incentives.

Here is how this nasty consequence develops. To be able to give loans at interest rates below inflation, banks have to be able to get deposits at interest rates that are even more below inflation. That is, banks do not pay for the borrower's free-lunch; depositors do. But, why do they? Well, they usually have no choice. The best alternative placement for local currency when no bank offers deposit rates above inflation is to buy foreign currency. But, not surprisingly, administrative ceilings on interest rates are almost always accompanied by **foreign exchange controls** (which, as argued below,

produce distortions of their own). Those controls boil down to a couple of premises: your only legal partner to transact in foreign exchange is the government (which systematically only wants to buy foreign currency from you at the exchange rate it determines), and foreign currency cannot legally be taken abroad. Thus, since you cannot legally buy foreign currency, you are stuck with your local one; what else would you do if not putting it in low paying deposits? At least, you will lose less than by keeping it in cash at home and letting inflation dilute it. But that is hardly an incentive to save. You are better off ncreasing your consumption, if possible by borrowing to do so.

Of course, not everybody is actually bound by the foreign exchange controls and, ultimately, obliged to give a free-lunch to borrowers. In fact, it tends to be law-abiding middle-class individuals who pay the bill; the rich have means to keep their savings abroad, and the poor have no dealings with banks anyway. The distributional effect of financial repression does not stop there, though. The following chain is not uncommon in centrally-planned financially-repressed economies: policy-makers instruct banks to give preference in the cheap-credit queue to firms made out of joint-ventures with partial ownership by foreign private corporations (those that the central-planner struggled to attract into his country); everything else equal, that cheap credit means better dividends for the foreign corporation. Thus, the law-abiding local middle-classer mentioned above ends up effectively subsidizing rich shareholders in developed countries.

Thus, there is little doubt that the theoretical idea of using financial repression to direct credit towards the economy's "**priority areas**" becomes in practice a bureaucratic, economic, and distributional mess. Hardly the type of credit allocation that could foster sustainable growth.

Removing foreign exchange controls. Why should one let citizens spend the country's hard-earned foreign exchange in, for example, ordering vintage wine in a foreign country's capital? Why should resident savers be allowed to take their wealth abroad, instead of using it to support the country they live in? Or, why should we spend our foreign currency in importing items that are anyway produced locally with by and large comparable quality? All these genuine questions are answered with the same practical reason: however well-intentioned, foreign exchange controls leak.

SA normally calls for the removal of foreign exchange controls. Not that the countries undergoing SA do not need foreign exchange; on the contrary, most SA programs are actually carried out with "**balance of payments support**" (read foreign currency loans) from official international financial institutions (read IMF and World Bank). Removing foreign exchange controls is rather a recognition that they do not work. Invert the argument and you will see why: what do you think will happen in a country that has currently no foreign exchange controls, where people can take their savings in and out without problem, if tomorrow you were to announce that strict foreign exchange controls preventing capital outflows are to be imposed? Answer:

everybody would wire their money out today. Not because the projects they are currently putting their money in have suddenly become unprofitable, but because savers like freedom of choice. There is economic value in a flexible financial portfolio; people are willing to pay for the option of parking their money wherever they please. When you remove that freedom you are actually taxing them; hence, they run away from your economy. As simple as that. There is nothing sinister, or unpatriotic, about it. It is pure economics. Experience proves the point; the tougher the foreign exchange controls the larger seems the size (as percent of Gross Domestic Product) of a country's stock of flight capital stationed abroad (eg., Gabon, Syria, Sudan).

Discontinuing subsidies. To the layman, SA is also about subsidy-busting. True, government accounts have to be brought into balance, but why not at the same time boost growth by giving productive firms cheap inputs? In particular, why not deliver cheap electricity to factories? Why charge market prices for gasoline? Do we want to make life even harder for middle-class car owners? Wasn't SA about economic growth, job creation, and raising living standards?

There are two main practical problems with subsidization: it distorts decision making and it is difficult to target. On the first account, what do you think happens when electricity is 100 percent subsidized (i.e., sold at zero price, something not far from reality in energy rich countries)? You guessed it; nobody bothers switch off the light. Nor do firms care about producing at a low energy cost. The economy as a whole is "**misallocating**" its resources. That is, society could very well get much more output, and welfare, from the same amount of resources by simply using them less wastefully. Additionally, of course, there is the problem of the incremental negative environmental impact that arises from using more energy than necessary.

If global resource misallocation does not catch your attention, consider the targeting problems of subsidization. The following argument is always true: everything else equal, for each extra dollar a government spends subsidizing gasoline, it has one dollar less to distribute as food coupons to the poor. In plain English, street-begging children pay for the ride of rich people driving luxurious cars. In a country that provides a 25 percent subsidy to gasoline vis-a-vis international prices, the average luxury car costs the fiscal budget some US$ 200, roughly the beggar-child's yearly earning and less than one percent of the car-owner's. That is hardly a rational transfer if subsidization is about boosting living standards, as there is little doubt that the child would be much happier than the car-owner with an extra US$ 200. The issue is the difficulty of targeting the subsidy. That is why SA calls for the elimination of blanket subsidies, and their replacement by narrowly-focused ones, assuming that the latter are at all possible.

Privatization. This is the flagship of any serious SA program. Getting the state out of economic activities that could otherwise be performed by the private sector is very much the essence of SA. But, why? Why should we let

a private profit-driven individual (maybe a foreign one) have control of a naturally-monopolistic utility, like electricity or water? Why should he produce better and sell cheaper than fatherland-conscious civil servants? Why can't we create incentives for public-firm managers to be profit-oriented? What's wrong with keeping a nation's main wealth producers (like its national oil company) in public hands, pouring their huge profits into the fiscal budget and using this money to pursue national priorities like vaccinations, or basic education? Don't ordinary citizens feel better knowing that the telephone company belongs to them, and not to a group of rich shareholders? After all, most developed, industrialized, democratic, enlightened countries control big, market-dominant enterprises.

Well, up to a point. Look again, especially at developing countries. How many public companies do you know that make profits? How many times have you heard an "ordinary citizen" praise the quality of a public company's service? Isn't it true that many of those public companies are kept alive through direct or indirect subsidies from the fiscal budget (money that could otherwise be used to pay for vaccines or school books)? How many public companies do you know to be short of employees? And how many produce better quality products or deliver better services than their private competitors (when private competitors exist, of course)? More crucial, do you really feel "**owner**" of your country's national telephone company? In how many general assemblies (the meeting of a firm's shareholders where they grill the managers or increase their bonuses, as the case may be) of "**your**" public company have you participated? Do you know anybody that has ever taken part in such an assembly? When you show up to pay your electricity bill (let alone to ask for your service connection), are you indeed treated as a company "**owner**"? As owner-shareholder. how much cash dividend have you ever received from "**your**" national airline?

The problem with public ownership is that it does not work. It normally starts with well-meaning politicians (usually former "revolutionaries") **nationalizing** everything in sight with the laudable objective of putting the goods back into the hands of "the people". Soon, the politically-appointed managers of the newly-nationalized companies discover (but tell nobody) that they are not good at doing business. Why should staffers of the party in office be good at, say, leading a steel manufacturing firm? In fact, it is probably not coincidence that they are politicians and not businessmen in the first place. Moreover, they are normally saddled with political objectives: give a lot of employment, have no labor disputes, and sell cheap. Not surprisingly, the company fattens up quickly and starts losing money. To keep it afloat, a whole battery of blunt remedies are used: discontinuing or revoking licenses to potential or existing competitors, preventing competing imports from reaching the local market, granting under-priced credit, asking banks to continuously recapitalize the company's unpaid debts (destroying the banking system's solvency in the process), giving it cheap government-controlled inputs (like energy), and eventually providing outright cash transfers. Yet, the company rarely turns itself around. It becomes a parasite of the public purse.

In a way, the objective of nationalization is met: "the people" end up owning the company insofar as they have to pay for its corporate failure.

One other question regarding the state's role in the economy and the ensuing need for privatization. Where do you draw the line? What should be the principle by which economic activities are ear-marked as exclusively-public concerns? National security? Health? The environment? In fact, if you look at the sectoral composition of public enterprise portfolios (specially in developing countries), there seems to be no real limit to the public sector's business appetite. Everything seems fair game; from oil, steel, coal, railways, airlines, electricity, water, mass media and telecommunications, to banks, insurance, hotels, soft-drinks, mini-skirts, and movie productions. It is difficult to find an umbrella principle to justify public ownership of all that! You may as well close down the private sector.

Undoubtedly, the intrinsic lack of effective incentive within public sector firms to produce better and cheaper, and the need to put a sectoral boundary to public ownership (eg., stay away from activities that could otherwise be done by the private sector), makes privatization a must. In fact, the question is not whether privatization should be part of SA or not, but rather how deep and how fast should privatization proceed.

Trade liberalization. This is probably the most disputed component of any SA program. For a good reason: open up to foreign competition too fast, and the part of your local industry that has no international comparative advantage (that is, most of it, in developing countries) will go belly up overnight. It is not a coincidence that local companies, both public and private ones, go out of their way to prevent politicians from leaping into free trade. After all, why should we let our jobs vanish only to see them reappear in countries that do not even allow our products to enter their markets? Why should Argentina's automobile industry (and the fifty thousand jobs that go with it) be given away to, say, Japanese manufacturers if Japan, keen to protect its pampered farmers, does not allow cheap, superb Argentinean beef to reach Japanese tables? In fact, most of the countries currently on the frontier of material development hide behind tall trade barriers. The EEC's fortress protection and rampant subsidization of its world-class-costly farming is probably the best example of that. For lesser developed countries, there are also solid theoretical arguments in support of protecting "**infant**" industries, that is, those who might have a chance to compete internationally once they become "**big enough**".

All these points constitute serious charges against trade liberalization. The idea that we should allow foreign competition to push us into unemployment today in exchange for more efficiency tomorrow is, at least, difficult to swallow. Yet, before buying any protectionist argument, we should pass it through the **consumer saving test**, that is: Why should a decent, hard-working, middle-class Argentinean family pay three times as much for a given car as a similar Japanese family? Is it to protect the jobs of other fellow Argentineans? But, if Argentina were to allow duty free entry to Japanese

cars, couldn't all the cash savings made by Argentine car buyers pay for the whole wage bill of the local car industry? If the answer is yes (which it probably is), aren't trade barriers really protecting the shareholders, not necessarily the workers, of the Argentine car industry? Do those shareholders (many of which are foreigners, anyway) need our protection?

The general principle is simple: if the consumers' saving out of trade liberalization is bigger than the resulting loss of wages, the case for protection holds little water. In fact, the consumer saving test gives a good yardstick for judging the "**infant**" industry arguments: How long should we protect a certain industry before it can stand on its own two feet? Answer: if the sums consumers will have to fork out before the industry becomes an "**adult**" are unlikely to be compensated by the wages paid in its "**mature**" years, one should grant no protection.

Of course, there is a big practical problem with all this: How do we go about determining the business chances of infant industries in order to calculate consumer (dis)savings? For how long will the infant be an infant? Since the opinions of incumbent infant-industry owners are bound to be biased, can policy-makers make the judgement? Are those policy-makers good at picking "**winners**" (that is, fast-maturing industries)? And, even if they are, do you really think that after, say, ten years of "**infancy**", somebody will come up to the industry's owners to tell them that their protection time is up? How many "**infant**" industries have you seen maturing and how many have you seen dragging on in "**childhood**" (specially in the developing world)? Isn't it all bound to end up in a bureaucratic, lobby-riddled mess?

Put in that context, SA is the consumer's hero. At last a reform that, via trade liberalization, puts clothing, refrigerators, televisions, cars, and the other paraphernalia that most protectionist countries usually protect within the reach of ordinary citizens. If you can keep your job (most people do), you should praise SA pushers (most people do not).

The Timing of Structural Adjustment: Can't It Wait?

Let's face it, SA might be desirable but it is certainly not painless. Why should we go through it right now? Things are not great, but we all have jobs and nobody starves; we have lived with this system for decades and, in a way, we are used to our own inefficiency. Why go through a sudden change of structures that might (and probably will) cause major economic and social disruption? If we were to vote tonight, how many of us would be for having our industry shut down tomorrow (hoping for a more efficient one to come up later on)? Can't we do SA slowly, tenderly? Why jump? Look at Eastern Europe; isn't it enough proof that blunt, front-loaded SA is too much?

There is no simple answer to all this. Perhaps, some imagery may help. Think of a big jumbo jet high in the sky but rapidly losing altitude. Here are the economy class passengers (meaning the poor), lots of them, inexperienced air travellers that get cheap in-flight service and remain by and large unaware of the fact that their plane is in collision course; they are just happy that they

can fly at all. Further up, you have the business class (literally); these are frequent-fliers who can sense that something is not right with the aircraft's altitude (it's not time for landing yet) and who, eventually, know how to adopt damage-minimizing crash positions. Up at the front of the plane sits the first class, too rich and too dizzy from champagne to notice anything. In the cockpit, the pilot (usually a President or a Prime Minister) wonders nervously about the next move: should he pull up immediately and risk hurting and upsetting the passengers (especially business travellers who might then decide that they have had enough and change airlines next time around), or should he let it go down for a while longer to see if something less bold comes to mind? He certainly has instructed his crew (ministers) to keep everybody cool in the cabin; after all, that's what stewardesses are for (not that they are necessarily good at it). Finally, the control tower is filled with traffic controllers (read IMF and World Bank) desperately trying to convince the pilot to pull up. The convincing has to be smooth, though; at this point, you don't want the pilot to get too nervous. Yet, time is rapidly running out. The more you wait, the more painful the corrective maneuver will be. The pilot, the crew, the air controllers and, probably the business class, all know that there is a point beyond which the course can no longer be corrected. Still, the pilot usually waits. Why spill all those nice glasses of wine on the businessmen's expensive suits just now?

Well, the political economy of SA is somewhat less dramatic than this but it is equally unescapable. Sooner or later, the course will have to change, simply because changing course is better than crashing. Even if everybody on board complains about it. One may argue about how drastic and how sharp the pull-up needs to be, whether it can technically be done without major disruption to the passengers, and whether the difficulty of the maneuver is related to how far down the plane is allowed to go. But one overwhelming fact is clear: since SA must take place one way or the other, dithering makes little sense.

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